United States General Accounting Office

GAO

Report to the Secretary of the Treasury

November 2002

FINANCIAL AUDIT

IRS's Fiscal Years 2002 and 2001 Financial Statements

G A O

Accountability ★ Integrity ★ Reliability

GAO-03-243

November 2002

FINANCIAL AUDIT

IRS'S FISCAL YEARS 2002 AND 2001 FINANCIAL STATEMENTS

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Highlights

Highlights of GAO-03-243, a report to the Secretary of the Treasury

Why GAO Did This Study

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

What GAO Recommends

In prior audits, GAO made numerous recommendations to IRS to address issues raised again in this audit. GAO will continue to monitor IRS's progress in implementing the more than 60 recommendations that remain open as of the date of this report. IRS agreed with the vast majority of GAO's recommendations and recognizes that only by implementing a new, integrated financial system can it overcome many of its weaknesses. IRS agreed with the report's findings and cited a number of planned improvements and initiatives to address some of the problems GAO identified.

www.gao.gov/cgi-bin/getrpt?GAO-03-243.

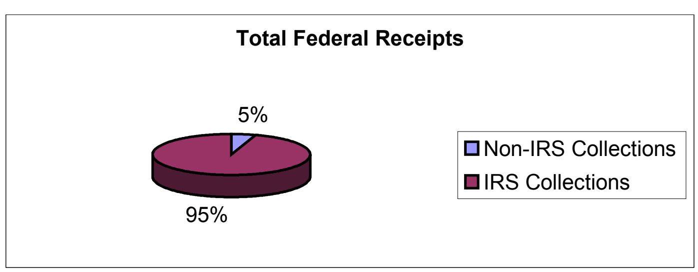
For a fuller understanding of GAO's opinion on IRS's 2002 financial statements, readers should refer to the complete audit report, available by clicking the link above, which includes information on audit objectives, scope, and methodology, as well as audit findings. For additional information, contact Steven J. Sebastian (202-512-3406).

What GAO Found

In GAO's opinion, IRS's fiscal year 2002 financial statements were fairly presented in all material respects. Because of serious financial systems and control weaknesses, however, IRS again had to rely extensively on various costly and resource-intensive processes to prepare its financial statements.

IRS made notable progress in a number of areas in fiscal year 2002, including addressing issues related to budgetary activity, accountability over property and equipment, and computer security. The agency also laid the groundwork for improvement in several other areas. Nevertheless, IRS continues to be challenged by many of the same issues reported each year since fiscal year 1992, when GAO began auditing IRS's financial statements. Serious problems continued to exist in the following five areas: (1) financial reporting, (2) unpaid tax assessments, (3) tax revenue and refunds, (4) property and equipment, and (5) computer security. Additionally, IRS was not always in compliance with laws concerning the structure of installment agreements IRS enters into with taxpayers and the timing of the release of federal tax liens.

One of the largest obstacles facing IRS management is the agency's lack of a financial management system capable of producing information needed for day-to-day decisions. Through compensating processes, extraordinary efforts, and some fundamental changes in how it processed transactions, maintained its records, and reported its financial results, IRS was able to issue its financial statements 6 weeks after the end of the fiscal year. Despite this, IRS's compensating processes and approaches cannot produce reliable, timely financial and cost-based performance information useful for ongoing decision making or fully address the financial management and operational issues that affect IRS's ability to fulfill its responsibilities as the nation's tax collector, largely because IRS's financial management systems do not comply with FFMIA.



Source: IRS.

IRS lacks an adequate, integrated financial system, although the agency is responsible for collecting nearly all federal receipts. IRS's fiscal year 2002 financial statements show that IRS programs collected more than $2 trillion in federal receipts; this constituted 95 percent of total federal receipts.

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Appendixes

Abbreviations

EITC	Earned Income Tax Credit
FFMIA	Federal Financial Management Improvement Act of 1996
FFMSR	Federal Financial Management Systems Requirements
FIA	Federal Managers' Financial Integrity Act of 1982
IRS	Internal Revenue Service
JFMIP	Joint Financial Management Improvement Program
OMB	Office of Management and Budget
P&E	property and equipment
SGL	*U.S. Government Standard General Ledger*
TIGTA	Treasury Inspector General for Tax Administration

Comptroller General
of the United States

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

November 15, 2002

The Honorable Paul H. O'Neill
The Secretary of the Treasury

Dear Mr. Secretary:

The accompanying report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) as of and for the fiscal years ending September 30, 2002 and 2001. We performed our audits in accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994. This report contains our (1) unqualified opinions on IRS's financial statements, (2) opinion that IRS's internal controls were not effective as of September 30, 2002, and (3) conclusion regarding IRS's noncompliance with two provisions of laws and regulations that we tested and IRS's financial management systems' lack of substantial compliance with the requirements of the Federal Financial Management Improvement Act of 1996.

Our unqualified opinions on IRS's fiscal years 2002 and 2001 financial statements were made possible by the continued extraordinary efforts of IRS senior management and staff to compensate for serious internal control and financial management systems deficiencies. Meeting a significantly accelerated reporting date for the issuance of the financial statements for fiscal year 2002 was also a major accomplishment. The Office of Management and Budget (OMB) required that agencies accelerate their timeline for issuing audited financial statements. For fiscal year 2002, OMB requires that agencies issue their audited financial statements by February 1, 2003, and for fiscal year 2004, OMB requires that agencies issue their audited financial statements by November 15, 2004, or 6 weeks after the end of the fiscal year. The Department of the Treasury went a step further and established a goal of completing its fiscal year 2002 audit, including those of its component entities such as IRS, and issuing its departmentwide accountability report by November 15, 2002.

In our report on the results of our audits of IRS's fiscal year 2001 and 2000 financial statements,[1] we discussed obstacles to IRS's ability to achieve the

[1]U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

department's goal. At that time, we noted that if IRS was to meet this deadline and sustain an unqualified opinion on its financial statements, the tremendous amount of hard work and commitment IRS demonstrated in recent years alone would not be sufficient unless accompanied by systemic changes in how IRS processed its transactions, maintained its financial records, and reported its financial results. IRS took this message seriously and made great strides in each of these areas. For example, IRS made a significant investment in improving its approach to analyzing, processing, and recording certain transactions throughout the year; previously, such analyses were not performed until the end of the fiscal year, an approach that limited our ability to test significant transactions and balances at interim periods. Other business process changes, such as better ongoing reviews of obligation levels and activity, enabled us to reduce the classification of control issues related to budgetary activity from a material weakness to a reportable condition. IRS's actions, coupled with the continued use of costly, resource-intensive processes to compensate for the continued serious weaknesses in systems and controls, enabled IRS to achieve Treasury's goal.

Nonetheless, it will remain a challenge for IRS management and staff to sustain the level of effort needed to produce reliable financial statements until the agency is able to fully address the underlying systems and internal control issues that have made this process so time consuming and resource intensive. Presently, IRS continues to lack timely, accurate, and useful financial information and sound controls with which to make fully informed decisions and to ensure ongoing accountability, which is the end goal of the CFO Act. IRS has made significant progress in addressing its serious control and systems deficiencies and improving financial management during the past 5 years under the strong leadership of former Commissioner Charles Rossotti and Acting Commissioner Robert Wenzel. It is important that these financial management initiatives continue to receive the needed support to achieve comprehensive and lasting financial management reform.

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

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

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

Sincerely yours,

David M. Walker
Comptroller General
of the United States

GAO Accountability * Integrity * Reliability

Comptroller General
of the United States

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

To the Acting Commissioner of Internal Revenue

In accordance with the Chief Financial Officers (CFO) Act of 1990, as expanded by the Government Management Reform Act of 1994, this report presents the results of our audits of the financial statements of the Internal Revenue Service (IRS) for fiscal years 2002 and 2001.[2] The financial statements report the assets, liabilities, net position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity related to IRS's administration of its responsibilities for implementing federal tax legislation. The financial statements do not include an estimate of the amount of taxes owed the federal government but which have not been identified by IRS, often referred to as the tax gap.

In its role as the nation's tax collector, IRS has a demanding responsibility in collecting taxes, processing tax returns, and enforcing the nation's tax laws. The size and complexity of IRS's operations present additional challenges to management. IRS is a large, complex organization with tens of thousands of people in 10 service center campuses, three computing centers, and numerous other field offices throughout the United States. In each of fiscal years 2002 and 2001, IRS collected more than $2 trillion in tax payments, processed more than 200 million tax returns, and paid about $281 billion and $251 billion, respectively, in refunds to taxpayers.

One of the largest obstacles facing IRS management today continues to be the agency's lack of a financial management system capable of producing the reliable and timely information its managers need to assist in making day-to-day decisions. Because of this systems issue and other factors, IRS continues to face many of the pervasive internal control weaknesses that we have reported each year since we began auditing its financial statements in fiscal year 1992.[3] Nevertheless, in fiscal year 2002, for the third consecutive year, IRS was able to produce financial statements covering its tax custodial and administrative activities that are fairly stated

[2]In accordance with OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, IRS prepared comparative Balance Sheets, Statements of Net Cost, and Statements of Custodial Activity as of and for the fiscal years ended September 30, 2002 and 2001. IRS prepared the Statements of Changes in Net Position, Budgetary Resources, and Financing for the fiscal year ended September 30, 2002, only.

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

in all material respects. Moreover, IRS was able to produce these statements by November 15, 2002, only a month and a half after the end of the fiscal year.[4]

The significant acceleration of IRS's reporting date was a major accomplishment and represents a significant improvement over previous years. In our report on the results of our audit of IRS's fiscal years 2001 and 2000 financial statements, we noted that for IRS to be able to achieve this ambitious goal for fiscal year 2002, it would need to make fundamental changes in the way it processed transactions, maintained its records, and reported financial information. IRS made great strides in each of these areas in fiscal year 2002. However, these improvements alone were not enough to make this outcome possible. Many of IRS's longstanding systems and internal control weaknesses continued to exist, necessitating continued reliance on costly compensating processes, statistical projections, external contractors, substantial adjustments, and monumental human efforts to prepare a set of reliable financial statements. These costly efforts would not have been necessary if IRS's systems and controls had operated effectively.

Strong commitment, hard work, and a reassessment of certain basic business processes by both IRS senior leadership and staff were the key to IRS's ability to meet Treasury's goal of both receiving an unqualified audit opinion on its financial statements and issuing the statements by November 15, 2002. Part of the reason IRS was able to meet this accelerated reporting goal was that it made further refinements to its compensating procedures. Another essential element was IRS's significant investment in improving its approach to processing and recording certain types of transactions throughout the year, rather than undertaking end-of-year analyses of transactions and activity to produce financial statement balances—a process that in prior years took several months to complete. During the latter half of fiscal year 2002, for example, IRS was able to produce quarterly financial information on property and equipment acquisitions within a few weeks after the end of each quarter. Previously, such information for the entire fiscal year was not available until several months

[4] In 2001, the Office of Management and Budget announced the executive branch's intention to significantly accelerate agencies' financial reporting timeline, requiring that by fiscal year 2004 they issue their financial statements by November 15. The Department of the Treasury established its own goal of issuing its fiscal year 2002 audited financial statements by November 15, 2002. As a component entity of Treasury, IRS is subject to Treasury's financial-reporting timeline.

after the fiscal year end. IRS also significantly enhanced its accountability over budgetary activity by increasing the frequency of its analyses of outstanding obligations and other budgetary accounts. As a result of these and other improvements, IRS management had earlier access to information and we were able to test financial data on an interim basis during the year rather than almost exclusively at year end.

IRS made notable progress in a number of areas in fiscal year 2002 and has laid the groundwork for sustainable improvements in several others. IRS's continued progress in addressing deficiencies in its controls over budgetary activity, for example, allowed us to conclude that the remaining issues related to budgetary activity no longer constitute a material weakness. At the same time, despite improvements in controls over property and equipment, financial reporting, and computer security, further actions are needed, and we continue to consider these issues as well as management of unpaid assessments and collection of revenue and issuance of tax refunds to be material weaknesses.[5]

Producing financial statements within a month and a half after the end of the fiscal year while sustaining an unqualified opinion was a significant accomplishment for IRS. At the same time, however, the effort it took placed a considerable strain on IRS resources and required substantial contractor support. IRS has clearly made progress in improving its financial management, and several of the process changes IRS made in fiscal year 2002 represent good financial management practices. Nevertheless, it will be difficult for IRS personnel to sustain the level of effort needed to produce reliable financial statements timely without addressing the underlying systems and internal control problems that cause this process to be so unnecessarily time consuming and expensive. Additionally, this process does not produce the reliable, useful, and timely financial and performance information IRS needs for decision making on an ongoing basis, which is a goal of the CFO Act, nor can it fully address the underlying financial management and operational issues that adversely affect IRS's ability to effectively fulfill its responsibilities as the nation's tax collector.

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

The challenge for IRS will be to continue the improvements made in recent years and to develop and implement the fundamental long-term solutions that are needed to address the internal control weaknesses we have identified. As we have seen, some of these solutions can be addressed in the near term through the continued efforts and commitment of IRS senior management and staff. Others, which involve modernizing IRS's financial and operational systems, will take years to fully achieve.

Opinion on IRS's Financial Statements

IRS's financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, IRS's assets, liabilities, net position, net costs, and custodial activity, as of and for the fiscal years ended September 30, 2002, and September 30, 2001, and IRS's changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the fiscal year ended September 30, 2002.

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

IRS's financial statements include tax revenues collected during the fiscal year as well as the total unpaid taxes for which IRS, the taxpayer, or courts agree on the amounts owed. Cumulative unpaid tax assessments for which there is no future collection potential or for which there is no agreement on the amounts owed are not reported in the financial statements. Rather, they are reported as write-offs and compliance assessments, respectively, in supplemental information to IRS's financial statements. Also, in accordance with U.S. generally accepted accounting principles, to the extent that taxes owed in accordance with the nation's tax laws are not reported by taxpayers and are not identified through IRS's various enforcement programs, they are not reported in the financial statements nor in supplemental information to the financial statements. As IRS discusses in the accompanying information to the financial statements, its current estimate of the magnitude of these unidentified and unpaid taxes—referred to as the tax gap—is between $250 billion and $300 billion.

Opinion on Internal Controls

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

Despite its material weaknesses in internal controls and its system deficiencies, IRS was able to prepare, primarily through compensating processes and approaches, financial statements that were fairly stated in all material respects for fiscal years 2002 and 2001. Nonetheless, IRS continues to face the following key issues that represent material weaknesses in internal controls:

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

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

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

- weaknesses in controls over property and equipment, resulting in IRS's inability to have reliable and timely information on its balance of property and equipment throughout the year and to reasonably ensure that its property and equipment are safeguarded and used only in accordance with management policy; and

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

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

In addition to the material weaknesses discussed above, we identified two reportable conditions which, although not material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect IRS's ability to meet the internal control objectives described in this report. These conditions concern deficiencies in (1) controls over budgetary activity, which affect IRS's ability to routinely ensure that its budgetary resources are being properly accounted for, reported, and controlled and (2) controls over hard-copy tax receipts and taxpayer data, which increase the government's and taxpayers' risk of loss or inappropriate disclosure of taxpayer data. We reported controls over budgetary activity as a material weakness in our prior audits, but based on improvements we found during our fiscal year 2002 audit, we have reassessed it as a reportable condition.

We have reported on these material weaknesses and reportable conditions in prior audits and have provided IRS numerous recommendations to address these issues. More than 60 of these recommendations were still open as of the date of this report. IRS has made marked strides in resolving these matters. We will follow up in future audits to monitor IRS's progress in implementing these recommendations. For more details on these issues, see appendix I.

Compliance with Laws and Regulations and FFMIA Requirements

Our tests of compliance with selected provisions of laws and regulations disclosed two instances of noncompliance with laws and regulations that were reportable under U.S. generally accepted government auditing standards. These related to IRS's (1) lack of timely release of tax liens on taxpayers' property and (2) failure to ensure that installment agreements were structured to require that taxpayers fully satisfy their tax liability within the statutory collection period.[6] Also, IRS's financial management

[6]Prior to fiscal year 2001, we reported that IRS was not in compliance with section 6159 of the Internal Revenue Code, which authorizes IRS to enter into installment agreements with taxpayers to fully satisfy the taxpayer's liability (see GAO-01-394). We did not identify any instances of material noncompliance with section 6159 during fiscal year 2001 and therefore did not report it as an area of noncompliance, but we found instances of noncompliance with the section again in fiscal year 2002.

systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA): (1) Federal Financial Management Systems Requirements, (2) applicable federal accounting standards (U.S. generally accepted accounting principles), and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. IRS has readily acknowledged that its financial management systems do not comply with FFMIA and that it needs to overhaul these systems as part of its broader systems modernization efforts. For more details on these issues, see appendix I.

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

Consistency of Other Information

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

Objectives, Scope, and Methodology

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

We are responsible for obtaining reasonable assurance about whether (1) the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal controls, the objectives of which are the following:

- Financial reporting—transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles and assets are safeguarded against loss from unauthorized acquisition, use, and disposition.

- Compliance with laws and regulations—transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and governmentwide policies identified by OMB audit guidance.

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

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

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

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

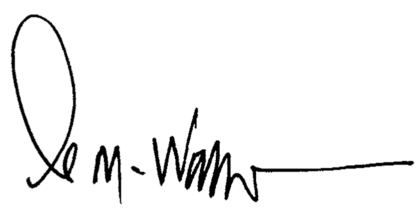
Agency Comments and Our Evaluation

In responding to this report, IRS noted that the report fairly presented IRS's progress and its remaining challenges. IRS noted that, in addition to maintaining its unqualified audit opinion, it also met the significant challenge set by the Secretary of the Treasury of completing the fiscal year 2002 audit by November 15, 2002, 6 weeks after the end of the fiscal year and 3 and a half months earlier than last year. IRS noted that this was accomplished by making significant improvements in its financial management by reassessing and systematically changing how it processes transactions, maintains financial records, and reports financial results. IRS cited a number of financial management reforms and improvements, which contributed to its ability to retain the clean opinion and to meet the accelerated reporting date. For example, IRS noted that it implemented procedures to improve the timeliness and accuracy of recording property and equipment transactions in its accounting records, enhanced its accountability over budgetary activity by increasing the frequency of its analyses of outstanding obligations and other budgetary accounts, conducted a comprehensive assessment of its strategic initiatives to prioritize the programs relative to its mission and available resources, revised its information technology security policy and guidance, and began conducting periodic security reviews of receipt processing areas. In addition, IRS noted that it took specific actions in fiscal year 2002 to expedite the resolution of material weaknesses identified under its annual FIA assessment process, revised its remediation plans for custodial and administrative financial management systems to align the remediation plans with its material weakness plans and business system modernization plans, and included more intermediate target dates to help ensure that it stays on schedule for bringing its systems into FFMIA compliance.

In its response, IRS recognized that it is only through implementation of the new integrated financial management system that IRS will be able to overcome many of the material weaknesses cited in the report. IRS noted that it would focus on ensuring that its financial management practices are institutionalized and that its new integrated financial system is implemented. IRS added that it would continue the improvements made in the last few years as it develops and implements the fundamental long-term solutions needed to address the internal control weaknesses cited in the report.

In its response, IRS agreed with the issues presented in the report. However, in commenting on the report's discussion of IRS's controls over budgetary activity, IRS disagreed with the report's statement that IRS management and staff might enter into obligations that exceed the budgetary authority made available by Congress. IRS indicated that it clearly does have the capability to prevent this from happening, and, according to IRS, its obligations have never exceeded its budget authority. However, the weaknesses we identified in IRS's controls over its budgetary activity, particularly with respect to delays in recording obligations, increase the risk that IRS could incur obligations in excess of its budget authority and not timely detect this occurrence. As discussed in our report, until the obligation of funds is recorded in IRS’s accounting system, obligations reflected in the system will understated. This understatement could lead IRS management to believe the agency has more funding than is actually available. Our intent is to point out a potential impact of the internal control weakness we identified.

IRS provided a number of technical comments, not included in its written response, which we considered in finalizing the report. The complete text of IRS's response is included in appendix III.



David M. Walker
Comptroller General
of the United States

November 1, 2002

Department of the Treasury
Internal Revenue Service

Management Discussion and Analysis

Fiscal Year 2002

1

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

I. Introduction

The mission of the Internal Revenue Service (IRS) is to provide America's taxpayers top quality service by helping them understand and meet their responsibilities and by applying the tax law with integrity and fairness to all. The IRS is responsible for the collection of about $2 trillion in Federal tax payments. At the IRS, the mission statement serves as the central theme and guiding business philosophy for management actions and organizational decision making.

The IRS is executing its mission with increasing effectiveness and efficiency. We have identified three strategic goals and critical performance measures to track our progress against those goals. We use a balanced measures approach for each performance measure addressing business results, customer satisfaction, and employee satisfaction. Over the past year, our measures show we made great progress in a number of high priority areas, such as e-filing, telephone and in-person taxpayer service, protection of taxpayer rights and burden reduction. We stabilized and refocused our key compliance activities and are identifying and attacking systematic areas of non-compliance, such as the promotion and use of abusive tax devices. Internal morale has improved, and perhaps most importantly, we are regaining the confidence of the public and other stakeholders.

Mission, Strategic Goals, and Guiding Principles

The IRS mission statement accurately describes our role, as well as the public's expectation as to how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply with them. The taxpayer's role is to understand and meet their tax obligations - and most do, since roughly 98% of the taxes collected are paid without active intervention by the IRS. The IRS' role is to help the majority of taxpayers who are willing to comply with the tax law, while seeing to it that the minority who are unwilling to comply are not allowed to burden their fellow taxpayers. The IRS recognizes that it must meet the highest standards in performing this role.

The IRS has formulated three strategic goals needed to achieve our mission. If progress is made on all three of these goals, we can be confident that we are moving toward achieving our mission and meeting the public's expectations. The strategic goals and a brief description of each follows:

- *Top-quality service to each taxpayer in every interaction* – Whenever the IRS deals with a taxpayer, we should give first-quality service and treatment that is helpful. We should provide better guidance to taxpayers, reducing the chances of error and the time and effort required. We should give accurate, timely and convenient assistance to taxpayers, and should inform them promptly and treat them professionally if we intervene in the form of an examination, a collection action, or a notification.

- *Top-quality service to all taxpayers through fair and uniform application of the law* – Our tax system depends on each person who is voluntarily meeting his or her tax obligations having confidence that his or her neighbor or competitor is also complying. Therefore, when taxpayers do not voluntarily meet their tax obligations, the IRS must use its enforcement powers to collect the taxes that are due.

- *Productivity through a quality work environment* – By ensuring our employees are satisfied, we are able to provide services more efficiently, getting the greatest value for every dollar we

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INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

spend. Good productivity requires employee satisfaction. This means our employees must have the management support, tools and equipment they need to provide good service to our customers, and there must be effective communication vertically and laterally throughout the organization.

Guiding principles are a link between our strategic goals and the actions we take to achieve them. All IRS executives, managers and employees are expected to manage and operate through these guiding principles.

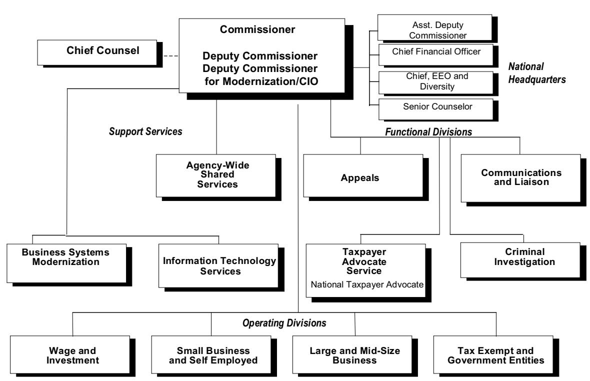
The following guiding principles describe how we will operate in achieving our strategic goals.

- *Understand and solve problems from the customer's point of view.*
- *Enable managers to be accountable, with the requisite knowledge, responsibility, and authority to take action.*
- *Align measures of performance at all organizational levels.*
- *Foster open, honest communication.*
- *Insist on total integrity.*
- *Demonstrate effective stewardship of assets and information entrusted to the IRS.*

Organization

IRS' structure closely resembles the private sector model of organizing around customers with similar needs. The IRS created four customer-focused operating divisions to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, and Criminal Investigation.

Internally, the Modernization and Information Technology Services organization, which includes the Business Systems Modernization Office, and the Agency-Wide Shared Services unit provide information technology and administrative support, respectively, to all divisions.



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Within the four divisions, operations are structured principally along three program areas: pre-filing, filing, and compliance. Pre-filing services are provided before returns are filed to assist taxpayers in preparing correct returns. Filing and account services are those provided to a taxpayer in the process of filing a return and paying taxes, including electronic filing and payment. Compliance services are provided to a taxpayer after a return is filed to identify under-reporting, non-filing and nonpayment.

The **Wage and Investment Division** (W&I) serves individual and joint filers with wage and investment income only, almost all of which is reported by third parties. Most of these taxpayers deal with the IRS only once a year, when filing their returns, and most receive refunds. Compliance issues are limited, concentrated on dependent exemptions, credits, filing status, and deductions. Through its field organization, W&I provides information, support and assistance taxpayers need to fulfill their tax obligations. It also conducts processing, account management, and compliance services through eight campus locations.

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

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

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

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

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

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

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

National Headquarters (NHQ) includes the Office of the Commissioner, Deputy Commissioner, Assistant Deputy Commissioner, Chief Financial Officer, Senior Counselor to the Commissioner, Competitive Sourcing Program, National Headquarters Management and Finance, Servicewide EEO/Diversity, Office of Tax Administration Coordination, Commissioner's Complaint Processing & Analysis Group, Strategic Human Resources, and Research, Analysis and Statistics of Income. NHQ focuses on strategic direction, capital allocations, and building partnerships with key stakeholders, e.g., Congress, Office of Management and Budget.

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

The **Modernization, Information Technology and Security Services** (MITS) organization provides information technology solutions that anticipate and meet enterprise-wide needs.

The **Agency-Wide Shared Services** organization (AWSS) provides efficient and standardized common services to all organizational components of the IRS, such as, personnel, security, and facilities management.

II. Performance Goals and Results

When all things are considered, the IRS performed well in 2002. This was in the face of unanticipated funding dilemmas (e.g., unfunded increased pay raise and postage), changing program priorities (e.g., greater focus on more complicated and time consuming high-risk cases) and the impact of 9/11 (e.g., suspension of notices in targeted geographic areas). In addition, any discussion or review of IRS performance must consider the context in which performance goals are set. FY 2002 marks the second year in which the IRS has set corporate goals for its balanced measures under the agency's new program and organizational structure. Thus, FY 2002 goals were set with one year's experience in the new IRS. The learning process for goal development continues. To drive the agency to high levels of performance, the IRS set aggressive goals with the knowledge that it is best to push for greater performance than settle for marginal progress.

The IRS uses performance measures to determine its effectiveness in meeting the three IRS strategic goals. The FY 2002 performance information that follows is organized by the main objectives within each strategic goal.

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

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

Whenever the IRS deals with a taxpayer, we strive to give quality service. The measures of our success in this goal are whether or not taxpayers believe we are meeting their expectations and how well we help them understand and meet their tax obligations.

Major Results and Accomplishments

Make Filing Easier

a. Results Summary

- Increased the number of e-filed individual returns by 17% over FY 2001 resulting in 36% of all returns being filed electronically.
- Increased number of Federal Tax Payment Transactions Paid Electronically by 3% over FY 2001.
- Introduced a newly designed and more accessible web site. Increased the number of web site hits to 3.4 billion and downloaded files to 436 million projected through the end of FY 2002. This represents increases of 31% and 38% respectively over FY 2001.
- The number of taxpayers e-filing from their home computers is up 38% over last year.
- Increased the number of private letter rulings completed by 19% over FY 2001.

b. Improved Electronic Filing

- Added 29 electronic forms and schedules for individual and business filers.

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- Opened up e-file eligibility to over 99% of all individual taxpayers, adding 38 million potential new e-filers.
- Virtually all 1040 forms and schedules could be filed electronically this year and no paper signature document was required.

c. Reducing Burden

- Expanded the check-the-box initiative to allow taxpayers to designate a friend, family member or tax professional to talk to the IRS to correct errors during processing of returns.
- For tax years beginning with 2002, will exempt 2.6 million corporations from filing Schedules L, M1 and M2 at a burden reduction of 61 million hours.
- Allowing more businesses to use the cash method of accounting.
- Indefinitely suspended the requirement for taxpayers filing Schedule F of Form 5500.
- Simplified forms, such as the Schedule D for reporting capital gains.
- Rewrote and simplified procedures, such as those for distributions from qualified retirement plans.
- Created the Office of Taxpayer Burden Reduction.
- Working to develop a methodology for calculating the number of taxpayer hours that will be saved through burden reduction efforts.

d. Simplifying Forms and Notices

- Reduced lines on forms, such as the Schedule D to report capital gains.
- Eliminated 11 lines on Form 6251 for the Alternative Minimum Tax and working with a contractor to redesign Form 941, Employers Quarterly Federal Tax Return.
- Simplified determination letters for the nearly one million employee plans.
- Began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets.
- Redesigning 24 additional notices; released eleven and remaining 13 will be released in January 2003.

<u>Provide top-quality service to taxpayers needing help with their returns or accounts.</u>

a. Results Summary

- On the American Customer Satisfaction Index (ACSI) Survey, taxpayers gave the IRS an overall score of 62, an 11% increase in satisfaction among individual tax filers over 2000, and a 22% increase over 1999. This was the largest favorable gain of the 30 federal agencies surveyed by the ACSI.
- The 2002 annual rating for IRS in the Roper Starch customer satisfaction survey was 44% - a 12 point increase over our result of 32% in 1998. It does, however, reflect a small decrease from the 2001 score of 46%.
- By the end of the 2002 filing season, taxpayers were receiving correct responses to 84% of their telephone tax law questions and 90% of their telephone account questions compared to the overall rates for FY 2001 of 79% and 88% respectively.
- Access to telephone service and time spent waiting, while still below private sector standards, improved substantially. Average wait time is down 26% from last year. Assistor access rose from 56% only two years ago to nearly 70% this year.

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b. Improvements in Telephone Service

- Increased toll-free phone assistance with regard to: level of service, quality of tax law responses, and quality of responses to account inquiries.
- Organized telephone Customer Service Representatives by specialization on a division-wide basis to utilize call routing more effectively. Trained assistors in one or more technical and account topics, enabling them to be more proficient in assisting customers quickly and accurately.
- Implemented toll-free script changes to better address the needs of Business Master File (BMF) callers and to address the significant number of inquiries regarding the tax rebate.
- Implemented an automated voice recognition service to provide taxpayers the amount of the advanced credit, reducing burden on the telephone system.
- Increased staffing for Spanish language Customer Service Representatives.

c. Expanded Face-to-Face Services

- Offered walk-in service during the filing season at more than 400 locations nationwide for face-to-face meetings to resolve account or case problems.
- At many sites, walk-in service was offered on 12 Saturdays between January 27 and April 14.

d. Special Assistance in Response to 9/11

- Issued guidance to resolve tax-related issues, including setting up appropriate tax relief and postponement of certain filing deadlines.
- Established a dedicated toll-free line for impacted victims and families in response to the September 11 tragedy.

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

a. Results Summary

- Field Collection customer satisfaction and quality stayed at FY 2001 levels.
- Field Exam customer satisfaction and quality increased slightly above FY 2001.
- Service Center Exam customer satisfaction declined slightly and quality stayed the same.
- Automated Collection System level of service and customer satisfaction declined below FY 2001 as volume was greater than expected from new levy programs.

b. Enhanced Customer Service

- Throughout the year, and at a variety of locations, held Problem Solving Days at 46 Taxpayer Assistance Centers to resolve long-standing taxpayer issues for those who cannot take advantage of weekday problem solving services.
- Created the Tax Resolution Representative position. These IRS employees will receive the training and authority to provide “one-stop-service” for a broad range of issues.

c. Special Assistance in Response to 9/11

- Developed computer programs to suppress assessments of penalties and interest, allowing individuals impacted by the September 11 tragedy additional time to meet their federal tax obligations.
- Froze the accounts of taxpayers who lived in the Federal Disaster and Emergency Areas of New York, New Jersey, Virginia, and 11 other counties in Connecticut and New York. The freeze indicator alerted IRS employees of a taxpayer's disaster status.
- Advised affected taxpayers who lived outside of the federal disaster and emergency areas to contact the IRS to obtain tax relief.

Balanced Measures

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

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

FY 2002 Performance: Exempt Organizations (EO) closures were at the planned level, but Employee Plans (EP) determinations were substantially below plan. With the closure of the remedial plan amendment period scheduled for December 2001, EP expected to receive 120,000 determination requests in FY2002. However, due to a two-month extension of the deadline (granted in response to 9/11) and overall consolidation in the pension plan market, IRS received slightly more than half that number of applications. As a result, EP issued fewer than half of the planned 106,000 determination letters. There was a positive trend among the receipts toward more pre-approved plans. Reduced determination workload freed up resources to support other critical program goals such as the examination program.

EP/EO Determination Letters

FY2000	FY2001	FY2002	
		Plan	Actual
109,461	109,326	190,800	129,680

Future Plans: IRS plans to stabilize resources and improve performance in Exempt Organization determinations. Dedicated groups reporting to Determination Management will improve consistency and efficiency to keep up with steadily increasing customer demand. To further improve productivity, IRS began a pilot of a new method of reviewing applications in FY2002 and is designing a new form for determination applicants to use beginning in FY2004. Not only should customers find this new form easier to use, but it should also reduce the resources necessary to review each application.

The existing system for processing determination letter requests has severe shortcomings. The redesign and replacement of this system with the new Tax Exempt Determination System (TEDS) will provide critical business capabilities required by customers, while improving overall system performance and reliability. Release 1 will be piloted in FY 2003.

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B. Private Letter Rulings Completed

Description: Total number of Private Letter Rulings (PLRs) completed by the Office of the Chief Counsel. PLRs are written statements that address specific, tax-related issues pertaining to the taxpayer and the IRS about the tax treatment of particular matters before a taxpayer's return is filed. These techniques reduce taxpayer burden, eliminate controversy, and enhance voluntary compliance, even before the taxpayer is involved.

FY 2002 Performance: Private Letter Rulings have been a very popular and high growth program for Chief Counsel because of their positive impact on the taxpayer of reducing burden and resolving questions about tax code interpretation up front.

Private Letter Rulings Completed

FY2000	FY2001	FY2002	
		Plan	Actual
1,913	2,428	2,000	2,896

Future Plans: IRS' Chief Counsel Division will move toward greater use of Revenue Rulings, a key Published Guidance product, and reduce use of Private Letter Rulings, an Advance Case Resolution product, as a means of providing guidance to taxpayers. Consistent with its major strategy and operational plans, Chief Counsel Division will work with IRS Operating Divisions and Treasury to identify and address emerging issues through Published Guidance, and integrate efforts directed to the Published Guidance program with the IRS Operating Divisions.

C. Taxpayer Advocacy Projects

Description: An Advocacy Project is an Operating Division Taxpayer Advocate project to address an identified operational issue that adversely affects a group of taxpayers.

FY 2002 Performance: Taxpayer Advocate Services (TAS) originally planned to open 88 projects in FY 2002. However, TAS only opened 67 because they focused on the quality and impact of their projects instead of the raw number opened.

Taxpayer Advocacy Projects

FY2000	FY2001	FY2002	
		Plan	Actual
88	92	88	63

Future Plans: This measure is slated for deletion from the Critical Measures list for FY 2003.

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D. Percent Individual Returns Filed Electronically

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

FY 2002 Performance: The IRS can provide the customer service taxpayers deserve only with the efficiencies of modernization, especially electronic filing and processing. Each year, Electronic Tax Administration (ETA) works with Modernization, Information Technology and Security Services (MITS) to allow more submissions to be filed electronically. As a result, in FY 2002 over 46 million individual returns were filed electronically. Focused advertising and marketing as well as expansion of electronic signature and payment options contributed to success in this area in FY 2002. Continued growth is expected as we increase the number of forms and schedules available for use in electronic filing.

Percent Individual Returns Filed Electronically

FY2000	FY2001	FY2002	
		Plan	Actual
28%	31%	35%	36%

Future Plans: To continue a solid e-file marketing campaign, IRS will use its research strategies to identify and educate targeted EROs (Electronic Return Originators), self-preparers and filers who use paper instead of electronic media. IRS will focus on those non-EROs who currently file a significant volume of paper returns and current EROs who file high volumes of computer prepared returns as paper tax returns.

In addition, IRS will continue to develop key messages to display on the IRS Digital Daily web site, the Servicewide Electronic Research Program web site, and QuickAlerts to encourage e-filing by tax professionals and taxpayers. IRS territory offices will expand distribution of the e-file marketing toolkit and related publications through local outreach efforts and promote e-filing through partnering opportunities which may include seminars, training, presentations at Nationwide Tax Forums, advertising, public service announcements and coordination with Stakeholder Partnership, Education and Communications (SPEC). If we are successful in this marketing, IRS may more rapidly approach the 80% Congressional mandate for e-filing and concurrently reduce return error rates.

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E. Electronic Federal Tax Payments System

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

FY 2002 Performance: Fiscal years 2000 and 2001 saw a 2% increase over the prior year. Based on the IRS' marketing and anticipated growth, an expected 5% increase established the original planned target of 67.4 million. The actual performance, however, stayed at the 2% growth level in line with historical growth rates.

Offering convenient, easy to use electronic payment options, such as credit card payments, encourages taxpayer compliance, reduces internal paper processing burdens, and promotes the use of electronic commerce when transacting with the Service. Taxpayers may now use any of the four major credit cards – VISA, Mastercard, American Express or Discover – for federal tax payments. The current year Form 1040 balance due, Form 1040-ES and Form 4868 payments can be made with a credit card. Taxpayers can also charge installment agreement payments for tax year 1998 or later. The acceptance of installment agreement payments by way of credit card furthers the Service's goals of expanding electronic payment options. The acceptance of credit cards reduces the number of misapplied payments, minimizes insufficient funds conditions, and reduces lockbox volumes and related fees.

In 2002, the IRS extended PIN authority to selected tax practitioners. As a result, nearly 15 million PIN's were used, saving the IRS about $4 million in direct labor costs alone.

Electronic Federal Tax Payments (000)

FY2000	FY2001	FY2002	
		Plan	Actual
63,380	64,366	67,438	66,029

Future Plans: IRS continues to improve and expand the use of Personal Identification Number (PIN) programs to allow taxpayers nationwide to file electronically using a self-selected PIN and a "shared secret" known only to the taxpayer and the IRS. This will reduce the need for the paper signature jurat and produce savings.

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F. Toll-Free Customer Satisfaction

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

FY 2002 Performance: The IRS barely missed meeting the plan because of customer dissatisfaction with getting connected to the appropriate live assistor or automated application to address their issue. While we missed the plan, 55% of customers did rate service as a 4 out of 4 and only 2% rated service as a 1.

Toll-Free Customer Satisfaction
(4 point scale)

FY2000	FY2001	FY2002	
		Plan	Actual
3.46	3.45	3.54	3.44

Future Plans: The two areas for top-priority improvement efforts are the automated answering system and ease of getting through by phone. To reduce the demand for phone access, IRS implemented Internet Refund/Fact of Filing to provide on-line ability to check refund status through the IRS.gov web site.

To increase accessibility to assistors, IRS is making changes in the routing of calls and scripting of telephone systems. IRS will implement recommendations from the Customer Contact Engineering Study group's plan to optimize the use of outward facing Toll-Free numbers by configuring these numbers to relate directly to taxpayers' inquiries. Rather than using one or two general numbers for all inquiries, customers will call a telephone number relative to the inquiry at hand. This plan will enable taxpayers to reach assistors with fewer levels of prompting and will decrease the number of customers who hang up due to the complexity of the menu system.

Telephone numbers on notices, letters, and bills will direct customers to prompts related to their circumstance, and not to tax law-related prompts. A team is being formed to identify and implement the technical aspects of the changes. IRS expects these changes to have a positive impact on customer satisfaction, which should be reflected in survey data available in 2003.

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

Description: Reported as the percentage of taxpayers that call IRS toll-free services and want to talk to an assistor, and get to speak to one. Factors used to arrive at the level of service provided by assistors and taken into consideration in the calculation are callers selecting an automated application, receiving a busy signal or abandoning while in queue waiting for an assistor.

FY 2002 Performance: Assistor level of service shows the percentage of taxpayers who want to talk to an assistor who actually reach an assistor. Level of service was negatively impacted by problems with the call routing system and several weeks with higher than anticipated call demand made up of residual rebate issues.

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

FY2000	FY2001	FY2002	
		Plan	Actual
59.0%	56.4%	71.5%	68.0%

Future Plans: IRS will implement recommendations from the Customer Contact Center Optimization study, including a call router to build a pyramid of specialization that will enable us to route each customer to an employee having the appropriate skill level to successfully address the customer's issue. Once implemented, we will also utilize CSR call recording technology for purposes of quality review, training and evaluation. This will optimize employee commitment to quality customer service, enhance performance feedback systems and improve the value of training modules.

IRS will make modifications to the scripting, routing and handling of taxpayer calls in order to improve access levels and customer satisfaction. We plan to test a skill-based routing concept, which involves rules-based routing to agent groups of similarly skilled employees, as opposed to the current system of routing to applications, based upon menu selection chosen. This will allow us to more easily use one group of employees to staff 2 or 3 similar applications. This concept will be tested early FY 2003, and if successful, we will fully deploy skill-based routing at the end of the FY 2003 filing season.

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H. Toll-Free Tax Law Quality

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

FY 2002 Performance: The FY2002 goal was met because of a strong accuracy score for responses to taxpayer questions. Continued focus on the individual factors that contribute to the overall score including the standards associated with case documentation was also a contributor to improvement.

Toll-Free Tax Law Quality

FY2000	FY2001	FY2002	
		Plan	Actual
73%	75%	78%	81%

Future Plans: IRS plans to implement the Embedded Quality Review System. The new quality attributes place more focus on the customer experience and will provide us with a better indication of our accuracy, professionalism and timeliness. Evaluating quality within our product lines focusing on the customer's experience will build commitment and capability among employees and managers, thus providing opportunities to improve our performance in all areas of our balanced measures. Improved accuracy will increase customer satisfaction and reduce repeat calls, aiding achievement of the level of service plan.

I. Toll-Free Account Quality

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

FY 2002 Performance: The FY2002 goal was met because of a very high accuracy score for responses to taxpayer inquiries about their accounts. Increased management attention and focused training to improve knowledge of the Customer Service Representatives contributed to the increase in this area. The significant improvement in the scores in FY 2001 continued into FY 2002 with additional progress made in focusing on both quality and quantity on account cases.

Toll-Free Account Quality

FY2000	FY2001	FY2002	
		Plan	Actual
60%	69%	72%	74%

Future Plans: The IRS will continue to align toll-free sites according to specialty areas. We will enable front-line employees to access accurate, up-to-date information about taxpayers' accounts and to adjust accounts immediately. We will continue to increase taxpayer access and customer satisfaction through the intelligent call routing system by routing calls to sites dedicated to specific types of work. Intelligent call routing will also be used to route calls to Customer Service Representatives (CSRs) who will specialize in specific areas of expertise.

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J. Customer Satisfaction Walk-In

Description: Represents the customers' overall level of satisfaction with the services provided by the IRS at its Taxpayer Assistance Centers. The scores represent the average overall level of customer satisfaction ("Keystone" question) from the Customer Satisfaction transactional surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. A Limitation that may affect the validity of the data is the method in which the survey is conducted. This is a "comment card" hand out survey. The taxpayer receives a survey card after being served. A very small number of cards are returned. This "non-response" bias leads to a small sample size that may not represent the whole population.

FY 2002 Performance: Based on our analysis of the data, IRS did not meet the plan because even those customers who were satisfied overall were still not completely satisfied with our promptness of service, and dissatisfied customers were not satisfied with our resolution of their question or issue. While the target was missed, 86% of customers rated service performance as a 4 or 5 on a five-point scale, and only 8% of customers rated service performance at a 1 or 2.

Customer Satisfaction Walk-In (7 pt. Scale 2000/2001, 5 pt. Scale after January 2002)

FY2000	FY2001	FY2002	
		Plan	Actual
6.48	6.40	4.68	4.41

Future Plans: Field Assistance will continue to concentrate on identifying ways to address customer expectations and perceptions of the "promptness of service" including explaining the automated numbering system at sites and advising taxpayers of the approximate wait time.

K. EP/EO Customer Satisfaction

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

FY 2002 Performance: Customer satisfaction has improved as Area managers promote effective case management practices to reduce cycle time and address the highest improvement opportunity, Time Spent on Audit. In addition, employee and stakeholder input has been solicited to identify actions to further improve service to the EP/EO customers.

EP/EO Customer Satisfaction (7 pt. Scale)

FY2000	FY2001	FY2002	
		Plan	Actual
5.71	5.70	5.70	5.78

Future Plans: The IRS Tax-Exempt and Government Entities Division (TE/GE) is expanding customer satisfaction measurement efforts.

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

Description: Level of quality in the EP & EO examination program is measured by the Tax Exempt Quality Measurement System.

FY 2002 Performance: IRS established aggressive goals to improve the quality of examinations over FY2001 results. Though still short of its goal, EP made significant improvements in quality through site visits by Quality Review staff to address quality concerns and distribution of Frequently Asked Questions to all employees. EO, on the other hand, continued to have problems with targeted elements of Examination Planning, Examination Scope and Workpapers, despite actions to share best practices and incorporate quality goals into Area managers' performance plans.

EP/EO Examination Quality

FY2000	FY2001	FY2002	
		Plan	Estimate
83%	73%	81%	75%

Future Plans: For FY2003, IRS has formed a task team to review the quality standards to ensure that measurement reflects actual technical and procedural quality. Removing determination work from the responsibilities of both Examination agents and managers will promote efficiency, consistency and quality in Examination.

M. Telephone Customer Satisfaction – Automated Collection System (ACS)

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

FY 2002 Performance: Telephone Customer Satisfaction was impacted significantly in the factor, "difficulty in getting through to representatives by phone" because of higher than planned incoming call demand, which also negatively affected ACS Level of Service (LOS). Customers report high degrees of satisfaction in the areas of courtesy, attitude and professionalism.

Telephone Customer Satisfaction – ACS (4 pt. Scale)

FY2000	FY2001	FY2002	
		Plan	Actual
3.41	3.46	3.53	3.38

Future Plans: In FY2003, IRS will better align workload to staffing to improve the ease of reaching a representative. IRS will identify and implement process and infrastructure requirements to move the Automated Collection System (ACS) from 9 stand-alone sites to an enterprise-operating environment that better balances telephone operations with management of notice issuances and case closures. By the end of FY 2003, ACS will complete consolidation of inventory.

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N. Automated Collection System – Telephone Level of Service

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

FY 2002 Performance: The start-up of the State Income Tax Levy Program and the Federal Payment Levy Program increased call demand, significantly affecting the workplan. Although resources were redirected, IRS was unable to meet the incoming volume. IRS is assessing the increased volume of calls and evaluating the methods used to forecast calls to better align workload to staffing. The reduced level of service also negatively impacted Customer Satisfaction.

ACS – Telephone Level of Service

FY2000	FY2001	FY2002	
		Plan	Actual
79.0%	77.5%	80.0%	69.0%

Future Plans: In addition to consolidating ACS inventory, IRS has developed call recording capability for use in training ACS assistors. Implementation is contingent upon funding.

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O. Customer Satisfaction – Collection Field

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

FY 2002 Performance: Field Collection's FY2002 actual was only 3 hundredths below their FY2002 plan. While they missed the goal, this difference is not statistically significant. They are in the process of analyzing their results to continue the drive for improvement in FY2003. In FY2002, satisfaction was highest among taxpayers who had a case time of 120 days or less, were self represented, or were in a delinquency investigation. Targeted training, procedural improvements, a re-examination of the documentation standards were all factors examined by the re-engineering team put in place as a result of the FY 2001 results.

Customer Satisfaction – Collection Field (7 pt. Scale)

FY2000	FY2001	FY2002	
		Plan	Actual
4.60	5.01	5.00	4.97

Future Plans: IRS will continue re-engineering initiatives in Collection operations. The Collection Quality Measurement System will also be re-engineered, as we incorporate features from the joint Small Business and Self-Employed and Wage and Investment Divisions embedded quality effort. IRS will examine and refine data gathering and reporting systems, making available quality review information to improve training and training management for front-line employees.

P. Field Collection Quality

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

FY 2002 Performance: The score was slightly below the plan target of 85%. Defects occurred primarily in Clear Action Dates and Case Documentation.

Field Collection Quality

FY2000	FY2001	FY2002	
		Plan	Actual
84%	84%	85%	84%

Future Plans: IRS will continue to incorporate features of the embedded quality effort to Collection operations. Among these features will be an assessment indicating whether or not we are measuring the right program aspects as well as where we stand in assigning top to bottom accountability for case quality.

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Q. **Automated Underreporter Quality**

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

FY 2002 Performance: While still 94%, quality defects have increased in comparison to the prior year. Defects are primarily attributable to Inventory Management/Case Controls, Transaction Code (Account Action), and Correspondence (IRS Procedure). The AUR sites have implemented various steps to decrease errors associated with the defects. Flyers/alerts and Job Aids addressing the errors were issued, and weekly meetings at which top errors were discussed were held with managers.

Automated Underreporter Quality

FY2000	FY2001	FY2002	
		Plan	Actual
93%	95%	97%	94%

Future Plans: IRS expects the AUR paper quality score to drop slightly from FY 2002 levels due to the increase in complexity of work resulting from more Schedule K-1s. Using analyses of error trends arising from this more complex work, IRS will ensure training efforts and new job aides target problem areas. IRS will also develop business requirements to record phone calls to improve case quality, managerial oversight, and employee accountability.

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

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

FY 2002 Performance: The target was missed because of low scores on discussing length of process, explanation of adjustments, perception of fairness of treatment and listening to concerns. Aspects of attitude, professionalism and staff courtesy rank the highest. Significant increases have been noted in aspects of explanation of rights, explanation of process and records required.

Service Center Exam – Customer Satisfaction (7 pt. Scale)

FY2000	FY2001	FY2002	
		Plan	Actual
4.04	4.18	4.45	4.03

Future Plans:
IRS will embed quality into our Service Center Compliance programs, providing a higher-quality experience for taxpayers and engaging managers in the delivery of our services. Identifying customer service trends and issues earlier will allow us to react to our customer needs more rapidly, increasing customer satisfaction.

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S. Service Center Examination Quality

Description: Quality of actions taken while working service center examination cases. Each site's quality reviewer reviews a sample of cases and writes a review record for each case.

FY 2002 Performance: The target was missed in FY2002 because of the large number of overage cases that were closed. Long cycle times negatively impacted the quality score. Since the overage cases were closed in FY2002, average cycle time should drop in FY2003 and the quality score rise accordingly.

Service Center Examination Quality

FY2000	FY2001	FY2002	
		Plan	Actual
70%	71%	74%	71%

Future Plans: IRS will continue efforts to embed quality into Service Center Compliance operations. Compliance will process cases more efficiently with less systemic work disruptions by implementing the Correspondence Examination Automation Support system as a replacement to Report Generation System Batch Processing. The Inventory Management Tool, which predicts the receipt of taxpayer correspondence and phone calls, will be used to ensure started cases can be handled timely. Audit issues initiated through improved system processes will produce resource savings.

T. Examination – Customer Satisfaction

Description: Represents the level of satisfaction customers receive from interactions with IRS Field Examination employees. Scores represent the average overall level of customer satisfaction ("Keystone" Question) from the Customer Satisfaction Transactional Surveys. Survey recipients are asked to rate IRS performance on a seven-point scale, where 1 indicates *Very Dissatisfied* and 7 indicates *Very Satisfied*. A limitation on survey data not affecting the statistical validity in the survey population is based solely on the audit closures of individual taxpayers. Audit closures involving estate, corporate, excise and gift tax returns are not included in the survey population. The results also do not include contacts the Examination division had with individuals that did not result in an audit closure.

FY 2002 Performance: The highest satisfaction was by taxpayers whose cases were handled by a tax professional and/or whose examinations had a relatively short cycle time. Further reducing cycle time offers the largest improvement opportunity. The hiring of additional resources in FY 2001 and resultant productivity gains, particularly in working through the case backlog (reducing overall cycle time), was a significant contribution to the improvement in the score over the FY 2001 level and achievement of the FY 2002 target.

Field Exam Customer Satisfaction (7 pt. Scale)

FY2000	FY2001	FY2002	
		Plan	Actual
4.41	4.65	4.70	4.73

Future Plans: IRS will continue to fulfill the vision of the Examination Re-engineering project, to make the Examination process easier and faster for taxpayers, minimizing the accrual of interest on additional assessments, while ensuring consistency and fairness.

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U. Examination – Case Quality Score

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

FY 2002 Performance: Continued focus on targeted improvement areas coupled with the reduction in cycle time (a quality standard) were major contributions to continued achievement of the target.

Field Exam Case Quality Score

FY2000	FY2001	FY2002	
		Plan	Actual
58%	70%	72%	73%

Future Plans: We will improve the Examination process by combining database systems to provide faster results. We will enhance our examination inventory selection processes by incorporating more data from additional sources. We will also improve our ability to identify non-compliance electronically and automate routine examination processes to optimize our resources.

V. Taxpayer Advocate Casework Quality Index

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

FY 2002 Performance: Taxpayer Advocate Service met this goal and greatly exceeded FY2001 performance by having each office set a goal and make an improvement plan around the three standards listed above to achieve that goal.

Taxpayer Advocate Casework Quality Index

FY2000	FY2001	FY2002	
		Plan	Estimate
65%	72%	80%	80%

Future Plans: Taxpayer Advocate Service field offices will continue to focus on improving case quality through locally developed action plans. IRS will study those offices making the greatest improvement to see what “best practices” may be applicable elsewhere.

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

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

Our tax system depends on each person who is voluntarily meeting his or her tax obligations having confidence that his or her neighbor or competitor is also complying. We cannot allow those taxpayers who do not comply to place a burden on those who do.

Major Results and Accomplishments

Increase overall compliance

a. Results Summary

- Field Collection Taxpayer Delinquent Account closures decreased 4% and Taxpayer Delinquent Investigation closures increased 18% over FY 2001.
- Automated Underreporter case closures are up 16% over FY 2001.
- Increased the number of examinations for Coordinated Industry Cases by 27% over FY 2001.
- Automated Collection System Closures declined noticeably below FY 2001 levels because of the suppression of notices as a result of the 9/11 crisis, which delayed the issuance of liens and levies on ACS inventories. Also, the need to address increased incoming call volume pulled resources from the time available to close assigned cases.

b. Improved Communications and Service

- Placed significant media attention on Abusive Tax Schemes in order to alert Taxpayers to the schemes and prevent potential tax problems.
- Piloted an accelerated determination processing program to ascertain types of applications suitable for accelerated processing and to track time savings and trends in issues developed.
- As part of a national strategy to combat abusive schemes, placed emphasis on cross-functional training and multi-function coordination in the identification of fraudulent trust promotions and the use of civil and criminal enforcement actions. Engaged in outreach activities to educate people to recognize and avoid fraudulent trust promotions.

c. New Initiatives and Program Improvements

- Identified five serious compliance problem areas: promoters of tax schemes; misuse of devices such as trusts and passthroughs to hide or improperly reduce income; use of complex and abusive corporate tax shelters to reduce taxes improperly; failure to file and pay large accumulations of employment taxes; and erroneous refund claims.
- Revamped compliance programs to refocus resources and to use a full scope of tools and techniques ranging from educating the public to systematically identifying promoters and participants, to reinvigorating enforcement actions such as summons enforcement, injunctions and criminal investigation of promoters.

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- Began matching information reported on Schedule K-1 with income and losses reported on Form 1040 and other schedules.
- Reinvigorated the use of long dormant enforcement tools that deal with serious cases of non-compliance and tax schemes, e.g., aggressively identifying promoters and schemes through summonses of records, including John Doe summonses on credit card accounts in offshore tax havens and vendor summonses to refine that data.
- Initiated 43 contacts of promoters to uncover lists of taxpayers participating in shelters.
- Launched a tax shelter disclosure initiative. As of August 2002, processed 1,664 disclosures from 1,206 taxpayers who came forward. These disclosures cover 2,264 tax returns and involved more than $30 billion in claimed losses or deductions.
- Commenced a test to gauge the effectiveness of the Automated Substitute for Return Program (ASFR).
- Initiated summons procedures on all major credit card companies and commenced initial examinations from credit card leads (off shore credit card data & charges).
- Intercepted Slavery Reparation scheme credit cases and stopped erroneous payments from approximately 17,000 erroneous claims this fiscal year.
- Published the Tax Shelter Disclosure Initiative, providing taxpayers with a 120-day opportunity period to voluntarily disclose their participation in tax shelters and other questionable items that may have resulted in an underpayment of tax. For taxpayers who voluntarily disclosed, the IRS promised to waive certain accuracy-related penalties.
- Announced a voluntary compliance program to help Section 527 political organizations comply with their new reporting requirements. Sent letters to organizations that appeared to have some confusion with their reporting requirements.

d. Special Assistance in Response to 9/11

- Established a special program to expedite processing of applications from organizations created to assist in relief efforts.
- Provided compliance guidance and a single point of contact to new disaster relief organizations.
- Posted a draft publication, Disaster Relief: Providing Assistance through Charitable Organizations, to the IRS website within days of the September 11 attacks (subsequently revised and published as Publication 3833).
- Provided extensions and other relief in response to the attacks.

Increase fairness of compliance

a. Results Summary

- Increased number of examinations for individual returns greater than $100,000 by 20% over FY 2001. Decreased number of examinations for individual returns less than $100,000 by 4% over FY 2001. These data reflect success in shifting focus to high-income taxpayers.

b. Reengineering

- Revisiting the examination workload model and planning processes to include more data on other return types and to incorporate non-filer and non-payment data.
- Placed all innocent spouse claim processing at the Cincinnati Centralized Innocent Spouse Operation and provided increased and specialized skills for examiners working claims.

- Implemented an automated decision-making tool to lead examiners through the complex decision-making process and to assist them in making timely and accurate decisions.

c. Focus on Higher Risk Areas

- Improving the methodology of examination workload planning for higher income individuals.
- Implementing new systematic way to identify returns with a high probability of omitting income. Previously, these returns were only identified by indirect examination techniques.
- Shifting audit and enforcement forces to focus more resources on tracking down high-income taxpayers who fail to report income or hide it offshore.
- Reorienting agents so that most of their activities are focused toward the highest-risk areas.
- Increased focus on promoters of abusive tax schemes by: identifying flow-through entities used to mask questionable structured transactions; addressing abusive schemes through enforcement; implementing the Schedule K-1 matching program; directing research efforts to profile promoters and build our understanding of trust filing reporting issues; developing skilled employees; and targeting educational products and outreach to influence tax compliance behaviors.

d. Improved Communications

- Improved service to taxpayers by reducing the time it takes to notify them of innocent spouse claim decisions.
- Provided innocent spouse literature to Low Income Tax Clinics and Volunteer Income Tax Assistance tax return preparation sites.

Balanced Measures

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

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

FY 2002 Performance: TDA closures were impacted by 1) the suppression of notices as a result of the 9/11 crisis which delayed the issuance of liens and levies on ACS inventories, 2) holiday moratorium on notices was instituted a week earlier this year compared to last year, and 3) increase in incoming calls and time spent on calls detracted from the time available to close assigned cases.

ACS – Taxpayer Delinquent Accounts

FY2000	FY2001	FY2002	
		Plan	Actual
1,052,221	1,006,600	1,012,628	950,696

Future Plans: IRS will shift the mix of cases for Automated Collection System work in FY 2003. TDA entities are traditionally high priority inventory and the emphasis on high priority cases will increase the number of TDA closures. Additional factors that will contribute to increased TDA dispositions include: an overall refocus on ACS mission of collecting delinquent accounts and securing delinquent returns, ACS employees hired in FY 2002 should become more productive in FY 2003 as they continue to gain experience, and the percent of direct time to total time should increase due to reduced training.

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

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

FY 2002 Performance: The number of TDI closures did not meet the FY 2002 plan because of a management decision in February 2002 to shift inventory priorities that resulted in a change in the mix of closures of TDAs and TDIs.

ACS – Taxpayer Delinquent Investigations

FY2000	FY2001	FY2002	
		Plan	Actual
412,150	297,791	317,906	190,411

Future Plans: To better identify TDI cases, certain TDI select codes will be worked thoroughly, and the results used to improve TDI case creation. Additionally, productivity is planned to recover to FY 2001 levels.

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

Description: A count of the number of actual TDA dispositions completed by Revenue Officers. A TDA disposition occurs on the Integrated Data Retrieval System (IDRS) when the status of an account changes from an open status to any closed status as defined in Section 8 (Document 6209 - Automated Data Processing (ADP)/IDRS Information.) Data is reported as modules.

FY 2002 Performance: TDA closures were adversely impacted by a variety of factors including the suppression of notices and enforcement actions due to September 11th attacks; concentration on working higher risk cases; computer reprogramming to segment cases between Area and Territory Offices; and Service Center Workload Realignment.

Field Collection # Cases Closed TDA

FY2000	FY2001	FY2002	
		Plan	Actual
771,455	757,392	804,085	724,430

Future Plans: The shift toward higher-priority TDA entities will increase the number of cases closed. IRS will continue re-engineering initiatives to increase productivity.

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

Description: Count of the number of actual TDI dispositions completed by Revenue Officers. A TDI disposition occurs on Integrated Data Retrieval System (IDRS) when the status of an investigation changes from an open status to a closed status as defined in Section 8 of Document 6209 (Automated Data Processing (ADP)/IDRS Information.) Data is reported as entities.

FY 2002 Performance: The target was exceeded as a result of efforts to re-balance inventories and increasing the percentage of time applied to TDI cases.

Field Collection # Cases Closed TDI

FY2000	FY2001	FY2002	
		Plan	Actual
144,764	119,451	107,119	140,737

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

E. Automated Underreporter Closures

Description: Total number of closures of Automated Underreporter Cases.

FY 2002 Performance: We surpassed our plan through the implementation of improved workload selection systems and management practices resulting from partnering efforts between Headquarters and Field Management on the use of Management Information Systems data.

Automated Underreporter Closures

FY2000	FY2001	FY2002	
		Plan	Actual
2,888,900	2,511,424	2,919,980	2,922,182

Future Plans: IRS will refine selection criteria in our Automated Underreporter (AUR) unit to coincide with our strategic priorities. As a result, we anticipate closing more leads in the AUR unit. IRS will develop, test and implement a centralized AUR workload selection model. IRS will implement a research study of each AUR income category to gather data for analysis of screen-outs, seldom worked categories, minimally productive categories, and categories with potential for productive Correspondence Examination cases. Differences across categories and sub-categories, operating divisions, and campuses will also be analyzed in order to maximize workload selection.

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F. **Individual Return Examinations Greater Than $100K**

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

FY 2002 Performance: The goal was exceeded because productivity was higher than planned in some case categories, and there were improvements in direct examination time (DET) applied. The hiring of additional resources in FY 2001 (565 Revenue Agents and 108 Tax Compliance Officers) and completion of their initial training significantly improved the productivity, closing the gap created in past years. More management attention paid to case management and maintaining optimal inventory levels were also primary contributors to improvement in this area.

Individual Return Examinations > $100K

FY2000	FY2001	FY2002	
		Plan	Actual
63,217	50,827	54,468	60,894

Future Plans: IRS will develop and implement a strategy for high income taxpayers. Research of higher income taxpayers has revealed potential pockets of non-compliance in income strata of $1 million Total Positive Income (TPI) and above. We will use new national Unreported Income Discriminate Index Function (UI DIF) formulas in conjunction with the new TPI strata to surface potential non-compliant returns for audit. Our most experienced field revenue agents will work these cases. We will redirect our traditional audit program to include taxpayers with incomes over $100,000. Since many higher income taxpayers invest in various flow-through entities to defer or hide potential taxable income, we will continue to build our understanding of the filing, reporting and payment attributes of Partnerships and Trusts.

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

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

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

FY 2002 Performance: See measure F. above.

Individual Return Examinations < $100K

FY2000	FY2001	FY2002	
		Plan	Actual
187,891	145,144	122,313	139,576

Future Plans: See measure F. above.

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H. **Total Returns Examined**

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

FY 2002 Performance: See measure F. above.

Total Returns Examined

FY2000	FY2001	FY2002	
		Plan	Actual
251,108	195,971	176,781	200,470

Future Plans: See measure F. above.

I. **Number of Business Returns Examined**

Description: Includes all Large and Mid-Sized Business returns closed outside of coordinated industry, and Small Business/Self Employed corporation and schedule C and F examinations.

FY 2002 Performance: Fiscal year to date closures are somewhat under plan, but starts and inventories are in line to accomplish full year targets. Accomplishments are also expected to increase with the realignment of $5 million to $10 million cases from the Large and Mid Size Business Division to Small Business/Self Employed.

Number of Business Returns Examined

FY2000	FY2001	FY2002	
		Plan	Actual
103,112	84,748	81,369	85,190

Future Plans: IRS will increase emphasis on shelters, establish a strategy to address high-risk passthrough entities related to high wealth individuals, continue the Compliance Initiative Project on passthrough entities, and continue reduction in staff years applied to Coordinated Industry Cases through the use of issue management strategies.

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J. **Number of Cases Examined – Large Case**

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

FY 2002 Performance: The FY 2002 Performance was 528 Cases or 93% of the 566 planned. There is no single barrier to explain this performance, although the increased focus upon abusive shelters frequently increases cycle time. While short of the target, this level of performance demonstrates a significant improvement from the Large & Mid-Size Business Division Stand-up year (FY 2000) when 328 were closed, and FY 2001 when 417 were closed. In fact, FY 2002 performance for CIC closures reflects a 43% increase from FY 2000 and the number of CIC closures for FY 2002 exceeds the performance in each of the last 5 years.

Cases Examined – Large Case

FY2000	FY2001	FY2002	
		Plan	Actual
369	417	566	528

Future Plans: IRS' highest priority for resources will be to address abusive shelters, especially at the promoter level. For non-shelter coordinated industry workload, we will use an issue driven approach, based on risk analysis results, and smartly employ issue management strategies to reduce examination time and to determine scope. We will apply resources to pre-filing activities with the goal of reducing the issues that are resolved in a post-filing, contentious environment. We will develop procedures and policies to engage all employees in the use of productivity improvement tools such as pre-filing products, risk analysis, improved planning, and other issue management strategies. These activities should directly improve cycle time, currency, and quality.

K. **Number of Returns Closed – Large Case**

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

FY 2002 Performance: IRS surpassed the plan because of a greater than expected number of Employment Tax Returns associated with Coordinated Industry Cases.

Number of Returns Closed – Large Case

FY2000	FY2001	FY2002	
		Plan	Actual
3,578	3,734	3,453	4,851

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

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L. Employee Plans / Exempt Organizations Examinations Closed

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

FY 2002 Performance: The FY 2002 goal was based on an assumption about the number of determination letter receipts that would come in and how many Full-Time Equivalents (FTEs) would need to be diverted from examination casework to cover that workload. Since determinations were lower than forecast, Examination FTEs were moved back to doing examinations and the additional FTEs enabled surpassing the goal.

EP/EO Examinations Closed

FY2000	FY2001	FY2002	
		Plan	Actual
19,080	15,988	11,900	13,549

Future Plans: By removing determination work from the responsibilities of both Examination agents and managers, realignment of resources will promote efficiency, consistency and quality in Examination. To improve productivity in the face of declining resources in FY2003, IRS is aggressively pursuing the use of limited-scope and correspondence audits. Limited-scope audits were initiated in FY2002, and more are planned in FY2003 and FY2004. Beginning in FY2003, IRS will also implement recommendations from a study of time-per-case and related returns now underway, as well as any findings regarding the effectiveness of the limited-scope approach.

M. Criminal Investigations Completed

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

FY 2002 Performance: IRS achieved approximately 98 percent of its year-end plan for total investigations completed, a significant accomplishment in light of redirection of resources to the war on terrorism. IRS also shifted criminal investigation inventory mix, reducing the time spent on narcotics related investigations, and increasing the resources dedicated to income tax related investigations.

Criminal Investigations Completed

FY2000	FY2001	FY2002	
		Plan	Actual
3,499	3,340	3,280	3,201

Future Plans: IRS will increase emphasis on promoters of abusive foreign and domestic trusts, and schemes based on frivolous legal arguments. The Criminal Investigation Division will partner with the Small Business and Self-Employed and Large and Mid-Size Business Divisions in their efforts to identify abusive tax schemes, promoters, and abusive tax shelter activities.

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N. Appeals Cases Closed

Description: Total Cases Closed equals the total number of cases closed in Appeals, including both non-docketed and docketed cases. (A docketed case is one in which a taxpayer has filed a petition in the Tax Court.) This measure is currently reported in workunits. A workunit represents a single case or group of related cases, which are being considered by Appeals as one unit for settlement of decision purposes.

FY 2002 Performance: Appeals exceeded its FY2002 plan by closing 68,015 cases. Improved resource allocations, case development practices, better management and communications resulted in more efficiency and greater productivity during FY 2002 making it possible for Appeals to achieve its target.

Appeals Cases Closed

FY2000	FY2001	FY2002	
		Plan	Actual
54,986	54,748	67,560	68,015

Future Plans: One of our top priorities is to reduce the length of time it takes for a case to go through Appeals (cycle time). We are taking a multifaceted approach to achieve this goal. IRS plans to balance inventory among teams, within areas, across Appeals Operating Units and nationally. IRS will pursue workload prioritization to ensure appropriate resources are spent on the right cases, and process cases more efficiently based on particular characteristics of certain case segments. IRS also plans to test the use of Fast Track Mediation for new types of casework and permanently implement and actively promote the Fast Track Settlement program.

O. Taxpayer Advocate Service (TAS) Closed Cases

Description: Number of cases worked in TAS and closed on the Taxpayer Advocate Management Information System.

FY 2002 Performance: The closure target was missed because receipts were significantly lower than forecast. The original plan number was based on the assumption that case receipts would decrease approximately 1.5% from the prior year, however, TAS receipts decreased at a much higher rate.

TAS Closed Cases

FY2000	FY2001	FY2002	
		Plan	Actual
237,885	248,011	252,289	234,327

Future Plans: Additional training, cross-training and experience by Taxpayer Advocate Service case advocates, along with National Customer Service Agreements with IRS Operating Divisions, should continue the Advocate's efficiency in closing cases. Since receipts, and consequently closures, are decreasing, TAS is changing this measure to focus on the efficiency of processing cases instead of just the raw number. In FY2003, TAS is replacing this critical measure with the Case Closure to Receipt Ratio.

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Strategic Goal 3: Productivity Through a Quality Work Environment

Main Objectives:
- Increase employee job satisfaction
- Increase productivity and staffing to levels necessary to adequately close the tax gap and manage workload growth and expansion in scope

Employee satisfaction is one measure of management effectiveness and, as such, is viewed as an early indicator of the ability to succeed in meeting the mission and providing quality products and services to the public. By ensuring our employees are satisfied, we are able to provide services more efficiently, getting the greatest value for every dollar we spend. Good productivity requires employee satisfaction. This means our employees must have the management support, tools and equipment they need to provide good service to our customers, and there must be effective communication vertically and laterally throughout the organization.

Major Results and Accomplishments

a. Major Results

- The overall level of IRS employee satisfaction reached 55% in FY 2002, exceeding FY 2001 by 4% and the FY 2002 target by 1%.
- This year a record 82,027 (69%) employees responded to our annual census survey.
- In an effort to reduce errors inherent in a paper survey and to provide workgroup reports much quicker, IRS piloted a totally paperless survey in two of its campus locations. Moving to a paperless process in the campuses will provide employees with the same flexible survey application available in locations other than the campuses.
- Improvement in the area of training and career development continued to increase as evidenced by higher employee satisfaction scores in these areas.
- Began greater focus on Employee Health and Safety and established related measures.
- The addition of the employee scholarship program targeted at key staffing needs reinforced our commitment to employee development.
- The Human Resources Investment Fund, established in response to earlier employee feedback about training needs, continued as a complement to the scholarship program.
- An electronic data base of Employee Satisfaction meetings, issues arising from these meetings and actions taken as a result of the meetings will expand our ability to identify cross-cutting issues and best practices. The database will also facilitate our ability to hold managers accountable for actions taken in response to Employee Satisfaction data.
- IRS has addressed employee health and safety by replacing old desks and chairs with ergonomically correct models.

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Balanced Measures

A. **Agency Wide Employee Satisfaction**

Description: Measure of employee's satisfaction with their job at the IRS. At the Service-wide level the results of Survey Item CO 1 (Considering everything, how satisfied are you with your job?) are used as the sole determining factor in the externally reported results. Additionally, survey questions regarding the employees perception of management practices, organizational barriers, and overall work environment that impacts an employees' efforts to do a good job are used in the internally reported results.

FY 2002 Performance: Improvement was most notable in the areas of overall job satisfaction, recent recognition or praise for doing a good job, and increased feelings of job importance. IRS' strongest performance was in the areas of ensuring employees know what is expected of them, creating a caring environment, and engendering a commitment to quality work. IRS provided results of SURVEY2002 to employees for discussions in workgroups this summer, with subsequent action plans developed to ensure continued improved working conditions.

In an effort to reduce errors inherent in a paper survey and provide workgroup reports much quicker, IRS piloted a totally paperless survey in two campus locations. Moving to a paperless process in the campuses will provide employees with the same flexible survey application available in locations other than the campuses.

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

Agency Wide Employee Satisfaction

FY2000	FY2001	FY2002	
		Plan	Actual
59%	51%	54%	55%

Future Plans: IRS has conducted an analysis of the top and bottom 10% of workgroups to determine what drives scores. Survey questions that deal with employee recognition, development, opinions and progress have the greatest impact for groups falling in this category. In FY 2003, IRS will more actively involve the second line manager in evaluation of those work groups most in need of improvement and development of plans to improve both manager skills and workgroup scores.

IRS also plans to improve readability of the survey and will expand the use of electronic (telephone and web-based) survey tools to make it easier for employees to participate.

Several current activities will be continued in the future to sustain progress in this area. An electronic database of Employee Satisfaction meetings, issues arising from these meetings, and actions taken as a result of the meetings, will expand our ability to identify cross-cutting issues and best practices, and will facilitate our ability to hold managers accountable for actions taken in response to Employee Satisfaction data. Operating Divisions are providing managers with new tools to improve their ability to take action in response to survey results and workgroup meetings. For example, SBSE has a managers guide to employee satisfaction on-line and W & I has a "Managers' Tool for Engaging the Workforce," on-line and has developed a training course for managers on Employee Engagement.

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B. **Lost Work Day Case Rate**

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

FY 2002 Performance: IRS formed a new team this year to define the national strategy for the Safety and Health Program. The team began work toward developing the Concept of Operations that will result in a Strategic Plan for the Safety and Health Program.

Lost Work Day Case Rate

FY2000	FY2001	FY2002	
		Plan	Actual
N/A	N/A	N/A	1.01

Future Plans: IRS will integrate the Safety and Health Program into our Strategic Planning Process for the next cycle (FY 2005).

III. System Controls and Legal Compliance

Federal Managers' Financial Integrity Act (FMFIA)

In accordance with the requirements of the Federal Managers' Financial Integrity Act, the Service evaluated its systems of internal controls for the fiscal year ending September 30, 2002. The Service provides qualified assurance that the objectives of the FMFIA are being achieved with regard to Section 2 (procedures and records of the organization) and Section 4 (systems that carry out financial management functions and accounting systems that carry out unique programs). This qualified assurance is based on our identification of material weaknesses and reportable conditions, all of which are being addressed by corrective action plans.

This summer we thoroughly reassessed our material weaknesses. As discussed below, we are proposing to close, downgrade or consolidate several, reducing the number remaining open from 14 to 9. Top executives reviewed each remaining material weakness to identify the key issues and determine what types of actions could be taken to more expeditiously resolve them. We identified procedural modifications that could be implemented quickly wherever possible, instead of waiting for the longer-term systemic solutions. All of these actions enabled us to move up the planned closing dates of the following material weaknesses:

- "Demonstrate Capability to Manage Replacement of Tax Processing and Business Systems" (from FY 2010 to several years earlier, specific date to be determined)
- "Financial Accounting of Revenue – Custodial" (from FY 2009 to FY 2006)
- "Financial Statements – Administrative" (from FY 2005 to FY 2003)

Three other material weaknesses will close in the same fiscal years as previously planned and one other had its planned closing date extended by one year.

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Federal Financial Management Improvement Act (FFMIA)

As of September 30, 2002, the Service's financial management systems did not substantially comply with the FFMIA. Plans are in place to resolve the material weaknesses causing this condition. The estimated dates for bringing our financial management systems into substantial compliance are 2006 for the custodial and 2004 for the administration functions. The initiatives associated with these plans are in the IRS Modernization Blueprint. Due to changes in the Business Systems Modernization plan, the 2006 date for custodial accounting is under evaluation.

Laws and Regulations

As of September 30, 2002, the IRS did not always comply with section 6325 of the Internal Revenue Code regarding the release of federal tax liens nor with section 6159 of the code regarding the structuring of installment agreements.

Performance Measures

The Service provides assurance that the IRS Critical Performance Measures are reliable. During the year, IRS has enhanced the level of detail required for its critical measures to ensure reliability and validation and verification of data. Data owners are now required to provide information on management controls in place for data submitted and used in reports.

Continuity of Operations

IRS is addressing continuity of operations planning in critical areas and the planning is sufficient to reduce risk to reasonable levels.

Improper Payments

Within current law and resources available, IRS will continue to focus on assuring that controls are adequate to minimize erroneous EITC payments. The most significant actions for program improvement include implementation of the joint IRS-Treasury Task Force recommendations.

Reports Consolidation Act of 2000

The IRS FY 2002 Performance and Accountability Report was prepared to comply with the Reports Consolidation Act of 2000. This act authorizes the consolidation of Federal financial and performance management reports while also satisfying the requirements of the Government Performance and Results Act.

Limitations of the Financial Statements

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

IV. Future Challenges

This report discusses many of the IRS' major accomplishments in FY 2002. The improvements in service and widespread redirection of compliance programs toward higher priorities reflect the benefits of a more customer-focused and accountable organization. We remain committed to reach even higher levels of performance in the coming years, but we also must acknowledge the many challenges ahead.

Our strategic planning process is the major vehicle through which we identify and assess challenges to our continuing success. We use this systematic approach to inform our decision making as we allocate resources and direct our management focus to achieve IRS goals. We are also guided by the General Accounting Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA) who have identified Management Challenges and High-Risk Areas facing the IRS over the last several years (discussed in the next sub-section). Together, these sources of information reveal four key areas upon which we must focus in the next few years – *Modernizing Systems and Business Processes; Compliance and Enforcement; Customer Service; and Employee Satisfaction*.

Modernizing Systems and Business Processes – The modernization of the IRS' tax administration and internal management systems and processes is the greatest long-term challenge we face. Successful implementation of new systems and processes will increase: (1) customer satisfaction through more timely and accurate handling of taxpayer returns, refunds and accounts management; (2) employee satisfaction through a more productive workforce that will, for example, reduce rework caused by errors inherent in the current manual processes; and (3) business results as greater accuracy will increase quality and greater efficiencies will increase quantity. Systems modernization will take approximately ten years to accomplish. In FY 2003, our plans project the following accomplishments: (1) implementation of a new Integrated Financial System, (2) an Enterprise Systems Management strategy to provide network and systems management to improve information technology infrastructure availability and performance, (3) the deployment of Customer Account Data Engine Release 1, authoritative computations and data stores for individual taxpayer account and return data, (4) the deployment of Enterprise Data Warehouse / Custodial Accounting Project Release 1, integrated, reliable tax operations and internal management information, (5) the implementation of Security and Technology Infrastructure Release, a technical infrastructure for secure phone and electronic communication, and (6) the deployment of HR Connect, which allows employees to manage their human resources information online.

Compliance and Enforcement – The most current projection of our nation's gross tax gap (i.e., Federal taxes owed but not paid voluntarily and timely) is somewhere between $250 billion and $300 billion. Some of the most serious and current compliance problem areas include: promoters of tax schemes of all varieties; the misuse of devices such as trusts and offshore accounts to hide or improperly reduce income; abusive corporate tax shelters; underreporting of tax by higher-income individuals; and the failure to file and pay large amounts of employment taxes by some employers. Efforts in FY 2003 and beyond will address these compliance areas through better education of the public; systematically identifying promoters and participants; improving the efficiency of exam and collection efforts through reengineering; and reinvigorating enforcement actions such as summons enforcement, injunctions and criminal investigation of promoters. We must continue to make significant progress in collecting better compliance and noncompliance data, as well as in quantifying our corporate level strategic compliance measures. These two goals will be achieved in large part through our new National Research Program (NRP). The first available data on payment compliance and return filing compliance recently became available. Initial data on reporting compliance will be available in October 2003.

Customer Service – Over the past several years, the IRS has achieved an increase in public perception scores on both American Customer Satisfaction Index and the Roper Starch surveys. The most recent data from Roper Starch, however, shows a slight decrease in 2002 below 2001. Although the Roper Starch score remains above the levels recorded in 1998 through 1999, the drop must be taken seriously.

Employee Satisfaction – Results from our 2002 survey of all employees showed an increase in employee satisfaction. This followed a drop in 2001 that we believe was attributable to the uncertainty and change that naturally comes from a reorganization of significant magnitude. Even though overall scores increased in 2002, the survey indicated areas for improvement. For 2003 we must continue to increase engagement of front-line managers so that they are full partners in the new IRS. Our management team must also work to more actively engage our front-line employees, so those employees know they are valued and appreciated.

Management Challenges and High Risk Areas

IRS has undertaken specific actions to address each of the Management Challenges and High-Risk Areas identified by GAO and TIGTA. Measures within our program activities show progress in addressing them. The first twelve Management Challenges and High Risk Areas listed below are those identified and prioritized by TIGTA in January 2002. The last two areas discussed, *Collect Unpaid Taxes* and *Revamp Business Practices to Meet Taxpayer Needs* are additional carry over items from GAO's list published in January 2001.

Security of the IRS – Employees and Facilities

Recent terrorist activity in the United States demonstrated very graphically that the physical security of IRS employees, equipment, and structures should be of utmost concern to IRS management. Immediately after the terrorist attacks, Facilities Management Officers were directed to assess all IRS offices and take actions necessary to safeguard personnel and assets in concert with the General Services Administration (GSA) and local law enforcement.

In FY 2002, IRS addressed this challenge through the following accomplishments:

- Developed National Physical Standards that establish security enhancements for areas such as guard services, blast mitigation, and IRS infrastructure.
- Conducted an assessment of all IRS buildings and facilities based upon current and proposed security standards.
- Developed contingency plans for all ten IRS campuses to address hazardous materials threats for the upcoming filing season.
- Purchased and distributed protective equipment, such as gloves, masks, and lab coats, as a result of the anthrax threats.
- Consolidated all mail-opening activities throughout IRS.
- Participated in government-wide programs that plan for and minimize the risk of catastrophic events on mission achievement.

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- Developed posters, tri-fold brochures, and a Director's briefing package to provide information and instruction to managers and employees regarding anthrax and other hazardous materials threats.
- Developed a plan to upgrade communications systems such as public address and closed circuit television for all ten IRS campuses.
- Developed an action plan to address deficiencies in offices that do not meet the National Physical Security Standards.
- Completed Phase 1 and 2 initiatives to contain Service Center Automated Mail Processing System and mail extraction units in all campuses to isolate these areas from other units.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Continue to work with GSA and law enforcement agencies to safeguard personnel and assets.
- Closely monitor procedures regarding the inspection of incoming mail and packages.
- Continue implementation of security enhancements.
- Continue to participate in government-wide programs that plan for disaster response.
- Take actions to improve and institutionalize changes for campus mail operations.
- Complete security risk assessments of all level 1, 2, and 3 buildings and implement all necessary corrective measures and/or upgrades identified.

Security of the IRS – Information Systems

Although computer security has measurably improved, computer security control weaknesses continue to place automated systems and taxpayer data at serious risks to both internal and external threats. As the primary revenue collector for the United States, IRS is a target for both terrorists and hackers. This threat has increased over the last few years with more interconnectivity of systems. Until stronger security controls are in place over its information systems, tax-processing operations remain vulnerable to disruption. Furthermore, the sensitive taxpayer data maintained by IRS is at risk of being disclosed to unauthorized individuals, modified and improperly used, or destroyed, thereby unnecessarily exposing taxpayers to financial crimes such as identity fraud.

In FY 2002, IRS addressed this challenge through the following accomplishments:

- Established Security Services organization to create corporate security solutions.
- Focused on evaluating and improving IRS security programs and processes, and identifying how to implement security capabilities that are balanced with operational requirements.
- Conducted reviews of IRS facilities and programs to evaluate and test security controls, and assisted IRS organizations to set up internal security review processes.
- Monitored IRS networks to prevent cyber attacks.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Conduct reviews to evaluate security performance in key business areas, such as remittance processing, and work with IRS business units to mitigate these weaknesses.
- Improve the adequacy of physical, logical, communications, and personnel security, operating practices, software quality assurance activities and business resumption plans to mitigate the IRS' computer security material weaknesses.

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- Use a model facilities approach to improve the consistency of security controls across IRS facilities.
- Continue to improve the ability to prevent, identify and resolve cyber attacks by completing build-out and improving operational readiness of the Computer Security Incident Response Center.
- Conduct regular assessments of the overall state of security in IRS; use the security assessment framework as a guide to improve and better measure IRS security capabilities.

Systems Modernization of the IRS

The ability to balance the goals of helping taxpayers meet their tax responsibility and improving overall compliance with tax laws depends on the successful completion of the modernization effort. Modernization of technology is crucial to implementing the new business vision of providing world-class service to taxpayers. While the development of new technology evolves, existing operations must continue, and improvements must be made to meet the needs of tax administration and demonstrate IRS' commitment to improved service to taxpayers.

In FY 2002, IRS addressed this challenge through the following accomplishments:

- Implemented repeatable management processes.
- Ensured ongoing projects are aligned with the Enterprise Architecture (EA) in accordance with the compliance certification process.
- Fully implemented a risk management program.
- Established a centralized Configuration Management repository.
- Fully defined and institutionalized standard configuration management procedures.
- Identified configuration items for current production environment impacted by near-term modernization project releases.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Identify and implement efforts to slow projects to match management capacity.
- Focus on better cost and schedule estimating and on building reserves in plans.
- Continue strong governance and rigid adherence to Enterprise Life Cycle.
- Identify and address all potential funding problems by scaling back or deferring some projects, improving estimates and releasing funds annually to reduce administrative burden.
- Identify and correct inconsistencies in implementing key systems, focusing on 14 key management processes.
- Provide special executive focus in acquisition and contracting areas.
- Develop a detailed plan for maturing all management processes presented to GAO/TIGTA and implement a monthly progress reporting process.

Integrating Performance and Financial Management - Performance Management / GPRA

Balanced measures are being aligned with the employee performance evaluation system to clearly link the work of individual managers and employees to the mission and goals. Additionally, the effectiveness of compliance improvement initiatives and current compliance levels can not be accurately determined until a measure of taxpayers voluntary compliance is developed.

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In FY2002, IRS completed the following actions:

- Almost all functions have approved balanced measures composed of business results quantity and quality, customer satisfaction and employee satisfaction.
- Divisions used balanced measures to report to the Commissioner on executing their workplans, and also as the cornerstones for building their strategic plans.
- Divisions are in the process of deploying and setting targets for their balanced measures down to the Area office (or equivalent) level.
- Began implementing Embedded Quality (EQ), which revamps the way quality is measured, calculated, and reported in the sites. EQ will create accountability by connecting employee evaluations directly to the corporate balanced measures in a fair and meaningful way.
- IRS replaced the manual process to collect, collate and report performance data by automating these steps through the Data Mart and Business Performance Management System (BPMS) for most of the IRS critical measures.
- IRS continues to develop its strategic measures, and included seven strategic measures in the FY2004 OMB Budget Submission - four related to tax administration and three on worker safety. Three of the tax administration strategic measures in the budget had historical data: Payment Compliance, Filing Compliance and Potentially Collectible Inventory (PCI). Data for the fourth, Reporting Compliance, will be available by December 31,2002.
- Expanded participation in American Customer Satisfaction Index.

In FY2003, IRS will continue to respond to this challenge through the following actions:

- Continue to automate data collection and reporting through Data Mart and BPMS.
- Beginning with linking collection workplans to reducing PCI, divisions are in the process of linking their operational critical measures to relevant strategic measures to better align resource decisions to achieving strategic outcomes.
- Major operating divisions are developing their own strategic measures.

Integrating Performance and Financial Management - Financial Management

IRS' current financial systems alone cannot produce reliable information necessary to prepare financial statements in accordance with federal accounting standards. The data produced from the current financial system has to be reconciled with other subsidiary systems to produce reliable financial statements. Further, IRS does not fully comply with the requirements of the Federal Financial Management Improvement Act (FFMIA). IRS' remediation plans do not identify resource commitments for all remedial actions, independent verifications were not performed for all implemented remedial actions, and sufficient explanations were not provided for the necessity of revised remedial action intermediate target dates. In addition, the current financial systems cannot provide reliable cost accounting information.

To improve overall financial management, IRS is implementing two major systems: the Custodial Accounting Project (CAP) and the Integrated Financial System (IFS).

In FY2002, IRS completed the following actions:

- IRS has completed the Architecture Phase of the CAP.

In FY2003, IRS will continue to respond to this challenge through the following actions:

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- The Systems Development Phase of the CAP is scheduled for completion in December 2002.
- Deployment of Build 1 of Taxpayer Accounts Sub Ledger (TASL) is scheduled for March 2003.
- The first release of IFS is scheduled for deployment on October 1, 2003 and will include the Core Financial System as defined by the Joint Financial Management Improvement Program (General Ledger, Accounts Payable, Accounts Receivable, Funds and Cost Management, and Financial Reporting), as well as Budget Formulation.

Processing Returns & Implementing Tax Law Changes during the Filing Season

The filing season impacts every American taxpayer and is therefore always a highly critical concern. Many programs, activities and resources have to be planned and managed effectively for the filing season to be successful. Critical programming changes for the filing season must receive priority over other programming requests. This is further complicated by the modernization efforts that are updating and replacing the very core tax processing systems needed to deliver a successful filing season. In addition, IRS must ensure systems capacity and telecommunications will accommodate the new electronic filing requirements and the accuracy and utility of information received and processed.

In FY 2002, IRS completed the following actions:

- Implemented a secure transaction-based web site.
- Incorporated new procedures required by the Economic Growth and Tax Relief Reconciliation Act of 2001.
- Completed centralization of all employment tax processing, including information returns, by consolidating operations in two Submission Processing sites.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Continue to use workload forecasting to ensure the required number of employees is available for each telephone product line and ensure tools are updated and available timely.
- Continue to identify training needs and develop training plans to improve performance.
- Conduct CPE training to ensure assistors are knowledgeable of tax law changes.
- Ensure the Corporate Filing Season Readiness Process is operational and covers all aspects of the filing season, including the Annual Readiness Certification.
- Conduct pilot and roll out the Remittance Transaction Research (RTR) system.
- Implement registered user access to enable authorized third parties and practitioners to request and receive transcripts electronically, submit account inquiries, powers of attorney and disclosure authorizations electronically.
- Implement taxpayer identification number (TIN) matching with payers.
- Expand e-filing options by adding and converting additional forms.

Complexity of the Tax Law

According to the FY 2000 Taxpayer Advocate's Annual Report to the Congress, the highest-ranked problem individual and business taxpayers had with IRS was tax law complexity. The problems that exist because of this complexity range from individual to corporate and international tax issues. Stakeholders from divergent constituencies have informed decisionmakers about the problems and recommended solutions. It is unlikely that the Internal Revenue Code will be simplified at one time. Therefore, IRS has the challenge to remove as much complexity as possible as a service to taxpayers. The effect of tax law complexity is compounded as IRS modernizes. Since complexity can be a major factor in the cost of operations, IRS must devote resources to simplifying taxes while at the same time modernizing its systems and processes.

In FY 2002, IRS completed the following actions:

- Integrated Probe and Response methodology into IRS publications and made their use the standard tool for Field Assistance technical employees.
- Trained Customer Service Representatives in one or more technical and account topics, enabling them to be more proficient in assisting customers quickly and accurately.

In FY 2003, IRS will continue to respond to this challenge through the following actions:

- The National Taxpayer Advocate's FY2001 Annual Report contains 28 legislative proposals, 19 of which are described in detail as key recommendations. The legislative recommendations taken as a whole represent proposals the NTA believes will reduce complexity of the Code, reduce taxpayer burden in complying with requirements, and reduce IRS' burden in administering the tax system.
- The NTA has also identified potential legislative issues to be developed for the 2002 Annual Report to Congress and continues to work with members of Congress and their staffs to increase understanding and support of the key legislative recommendations contained in the 2001 report. The NTA has addressed complex issues such as family status, alternative minimum tax, installment agreements for less than full payment, joint and several liability, penalty and interest, and collection procedures.

Tax Compliance Initiatives

The most current analysis estimates that our nation's gross tax gap (i.e., Federal taxes and related payments owed but not paid) is somewhere between $250 billion and $300 billion. Some of the most serious and current compliance problem areas include: promoters of tax schemes of all varieties; the misuse of devices such as trusts and offshore accounts to hide or improperly reduce income; abusive corporate tax shelters; underreporting of tax by higher-income individuals; and the failure to file and pay large amounts of employment taxes by some employers. Efforts in FY 2003 and beyond will address these compliance areas through better education of the public; systematically identifying promoters and participants; improving the efficiency of exam and collection efforts through reengineering; and reinvigorating enforcement actions such as summons enforcement, injunctions and criminal investigation of promoters. We must continue to make significant progress in collecting better compliance and non-compliance data as well as quantifying our corporate level strategic compliance measures. These two goals will be achieved in large part through our new National Research Program (NRP). The first available NRP data on payment compliance recently became available. Initial data on reporting compliance will be available in October 2003.

In FY 2002, IRS completed the following actions:

- Analyzed Correspondence Examination programs to determine areas of non-compliance that can be addressed through the use of soft notice and math error treatments.

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- Developed improvement strategies to address escalating and aged Offers in Compromise (OIC) inventory and to reduce open OIC inventory within six to twelve months.
- Enhanced and realigned the current Examination legacy systems to help identify the most productive returns to examine. Information will be made available to examiners to conduct more effective examinations.
- Expanded the range of information documents and returns that may be filed electronically for Corporate Taxpayers.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Deploy a range of initiatives using education and outreach to improve the overall rate of voluntary compliance.
- Increase efficiency and effectiveness by updating and re-engineering work processes to make better use of resources.
- Advance the use of Voluntary Compliance Agreements, reducing the need for traditional enforcement actions.
- Fully implement K-1 matching program and target enforcement efforts towards promoters and participants of abusive tax schemes.
- Implement improved processes to move to an issue-driven compliance process that will result in productivity savings and redirect these savings to the highest compliance work.
- Compliance, with the assistance of SB/SE Research, is in the process of analyzing the Potentially Collectible Inventory reports to identify the causes of growth and develop a course of action to impact continued growth.
- Explore the use of limited scope examination processes to improve case resolution.
- Apply alternative dispute resolution procedures and other issue resolution programs to resolve tax shelter issues in timely and consistent manner.

Providing Quality Customer Service Operations

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

In FY 2002, IRS completed the following actions:

- Created a bar-coding system for adjustment notices and refund checks so they can be mailed in the same envelope.
- Developed a formal training plan and schedule to improve employee knowledge of tax law, marketing, communication, and relationship management skills.
- Targeted and built quality relationships with internal and external partners and intermediaries to educate and support taxpayer and practitioner programs.
- Provided employers with access to on-line employment tax and wage information through the Simplified Tax and Wage Reporting System.
- Reconfigured the Practitioner Hotline into a centralized system.
- Trained Customer Service Representatives in one or more technical and account topics, enabling them to be more proficient in assisting customers quickly and accurately.

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- Analyzed and trained the volunteer workforce to create subject matter experts both internally and externally.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Add 7 new forms that can be electronically filed in 2003.
- Implement and improve availability of on-line services such as Internet Employer Identification Number (EIN), Centralized Authorization File and Practitioner Priority Services.
- Improve e-services for practitioners.
- Enhance electronic interactions (such as e-filing and e-paying), augment communication with taxpayers through the development of e-government operations, and provide employers with access to on-line employment tax and wage information.
- Implement recommendations developed as part of the Service's Multilingual Initiative.
- Review computer-generated notices and correspondence to improve quality and clarity.
- Configure outward facing Toll-Free numbers to relate directly to taxpayers' inquiries.
- Provide new and expanded services through Internet Refund/Fact of Filing (IRFOF) to reduce toll-free demand and offer customers alternative methods of service.
- Provide taxpayers a way to resolve tax problems every day at Taxpayer Assistance Centers.
- Address issues associated with Globalization by using Tax Attachés stationed overseas.

Erroneous Payments; Noncompliance with EITC

The President and the Congress have expressed concerns with the large amount of erroneous payments made by Federal agencies each year. The risk of improper payments increases in programs with complex criteria for computing payments, a significant volume of transactions, or emphasis on expediting payments. Although many IRS programs are susceptible to erroneous payments, the Earned Income Tax Credit (EITC) Program is particularly vulnerable. Subsequent to studies showing billions of dollars of EITC noncompliance, Congress provided additional funding and enforcement tools to improve compliance. In 1998, a five-year compliance initiative directed at major sources of EITC noncompliance was initiated. In addition, IRS received from Congress and implemented additional statutory authority to deny questionable claims during initial processing (math error processing).

Despite its compliance initiative, which has saved the Government over $5 billion, the most recent compliance study, *Compliance Estimates For Earned Income Tax Credit Claimed on 1999 Returns,* released in February 2002, estimates a 31-36% error rate and a 27-32% unrecovered overclaim rate. EITC non-compliance results from three major error sources: (1) taxpayers claiming EITC amounts based on children with whom they do not have the required relationship and/or with whom they did not reside for at least six months of the tax year; (2) taxpayers claiming EITC amounts based on erroneously reporting their filing status and (3) income misreporting. To address the systemic flaws in the current EITC program, and to address the complexity of the EITC law, which was highlighted in a then-recent Taxpayer Advocate Report to Congress, Secretary O'Neill convened an EITC task force. This mission of this joint Treasury-IRS task force was to achieve the objectives of the EITC program while reducing taxpayer confusion and increasing the accuracy of the administration of benefits. The task force was convened in March 2002 and presented final recommendations in July 2002. In August 2002, Secretary O'Neill approved the recommendations and also approved the formation of an IRS implementation team charged with development of an implementation plan. This team began a study of the cost and business process changes necessary for implementation, and is on-going at this time.

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In FY 2002, IRS completed the following actions:

- Convened a Task Force to thoroughly examine complexity and compliance issues of EITC and recommend fundamental program changes to reduce complexity and improve compliance.
- Expanded use of the Dependent Database (DDb) as an external data source to identify non-compliant taxpayers.
- Expanded examinations of the Duplicate TIN repeater population.
- Began study of data supplied to DDb by the Federal Case Registry of Child Support Orders.
- Created the EITC Executive Advisory Council.
- Realigned EITC Project Office to enhance strategic program development and execution.
- Participated in a government-wide task force on erroneous payments.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Assess overall EITC compliance, identify knowledge gaps and plan additional research.
- Assess marketing/awareness campaigns that target eligible EITC non-claimant population.
- Analyze processing year 2002 audit results to refine existing DDb business rules.
- Identify, investigate, and prosecute promoters of EITC-related refund schemes.
- Finalize EITC preparer cases being actively investigated and prepared for prosecution.
- Assess Federal Case Registry of Child Support Orders study data to determine if using expanded math error authority to deny EITC will improve compliance efforts.
- Continue to address the EITC Task Force recommendations.
- Continue our participation in a government-wide task force on erroneous payments.
- Better integrate EITC Program Office into the IRS' established strategic planning process.
- Continue to expand and refine tools used by campus examiners in EITC examinations.

Taxpayer Protection and Rights

The legislative changes required by the Restructuring and Reform Act of 1998 (RRA 98) continue to have a profound impact. RRA 98 included fundamental changes to tax law procedures, and required IRS to change its organizational structure from one that was geographically structured to one that was set up to serve particular groups of taxpayers with similar needs. Most RRA 98 provisions, including massive training programs for thousands of employees, have been modified or implemented. Significant management attention will be required to evaluate the effectiveness of the reforms. Additionally, IRS' reorganization focus on taxpayer groups presents both a risk of treating groups of taxpayers differently and an opportunity to use specialized knowledge to promote compliance among all taxpayers equitably. IRS is committed to treat all taxpayers equitably, and strategic plans indicate equitable treatment of taxpayers is included in efforts to promote compliance among business taxpayers.

In FY 2002, IRS completed the following actions:

- Implemented a secure transaction-based web site.
- Ensured alternative signature initiatives comply with IRS authentication policy.
- Implemented the next phase of the Checkbox initiative to allow taxpayers to designate an individual preparer to serve as their designee to discuss tax matters and notices with IRS.

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- Combined the Centralized Authorization Files into a central repository to eliminate the need for taxpayers to submit multiple third party authorization requests for numerous issues.
- Evaluated performance by deploying balanced measures to the appropriate levels.
- Linked Critical Job Elements and performance expectations to organizational quality goals.
- Redesigned examination work processes and assessed legal requirements.
- Redesigned internal Collection processes, policies and procedures, and updated workload selection and inventory delivery systems.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Continue to administer the credit card contract to ensure protection of taxpayer data and credit card numbers.
- Reduce the volume of paper jurats, expand alternative methods of signature.
- Evaluate computer security to ensure protection of taxpayer information.
- Review and assess implementation of Title VI of the Civil Rights Act of 1964 to certify that all tax preparation sites provide equal access and non-discriminatory services.
- Ensure documentation does not include specific labeling of taxpayers raising frivolous tax arguments.
- Reinforce the requirements to provide a statement to taxpayers at initial meetings that advises them of the Taxpayer Advocate's independence.
- Develop a standard practice for IRC Section 7803 (c)(4)(iv), which states that local taxpayer advocates may choose not to disclose contact with or information provided by a taxpayer.

Human Capital

GAO considers strategic human capital management as a high-risk area for the government, and the President's FY 2001 budget has added human capital to its list of Priority Management Objectives. Inadequate attention to strategic human capital management has created a government-wide risk of eroding the capacity of some agencies to perform their missions. Like many other government agencies, IRS faces a range of serious personnel management issues, ranging from recruiting, training, and retaining employees to problems associated with IRS' recent reorganization and modernization efforts. During FY 2001, IRS struggled with a continuing need to properly staff, train, and provide adequate tools for employees.

In FY 2002, IRS completed the following actions:

- Used the Senior Manager Pay Band system to more effectively allocate salary resources to promote and encourage individual and organizational excellence.
- Expanded the pay band system to all front-line and mid-level managers.
- Continued to offer an extensive array of web- and computer-based training for employees via the Internet, Intranet, and by CD-ROM covering subjects such as communications, customer service, project management, finance, accounting, and leadership.
- Continued to provide an extensive array of executive development training activities that prepare our participants for top-level leadership positions.
- Continued to encourage executives to establish relationships with their alma mater or with schools in their local areas.
- Continued partnerships with employee organizations to help recruiters establish relationships with community-based organizations.

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- Continued the state-of-the-art advertising campaign that was established to promote IRS as an employer of choice.
- IRS has established a strategic human capital strategy that consists of four principal elements: Renewal, Training and Development, Performance, and Transition.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Sustain recruitment efforts over the long term with continued entry-level intake in key front-line occupations remaining a high priority.
- Maintain a continued labor market presence through electronic and print advertising.
- Continue to streamline and automate the hiring process.
- Emphasize a management development pipeline.
- Implement a mid-career recruiting strategy.
- Implement an IRS-wide learning strategy, including additional investment in e-learning.
- Continue expansion of pay-for-performance system to all remaining front-line managers.
- Increase bonus and staffing flexibility to strengthen the linkage between executive performance and compensation.
- Capitalize future transition efforts on past experience; coordinate efforts such as workload realignment to maximize placement of employees while addressing business needs.

Collect Unpaid Taxes

Reliable and timely financial, operational, and compliance data is not available to help target efforts to collect billions of dollars in unpaid taxes. As a result, the Federal government is exposed to significant losses of tax revenue while compliant taxpayers bear an undue burden of financing the government's activities. Certain key collection actions, such as levies and seizures, have declined since 1997 during IRS modernization efforts and because of the IRS Restructuring and Reform Act of 1998 (RRA98) impacts. These declines may increase the incentives for taxpayers to either not report or underreport their tax obligations. Attempts to identify taxpayers that have not paid the taxes they owe are made through various enforcement programs. IRS inability to fully pursue such cases is attributable to a decrease in staff, reassignment of collection employees to support customer service activities, and additional staff time needed to implement certain taxpayer protections that were included in RRA98. Additionally, inadequate financial and operational information has hindered development of cost-based performance information for tax collection and enforcement programs.

In FY 2002, IRS completed the following actions:

- Developed a risk-based compliance strategy to use knowledge regarding taxpayer behavior, history, and needs in the collection decision process to ensure that the highest priority cases get worked first and reduce the number of accounts closed as currently not collectible.
- Centralized the processing of Offers in Compromise.
- Used non-Compliance resources during the filing season to minimize impact on Compliance casework.
- Redesigned internal processes, policies, and procedures, and updated the antiquated system of workload selection and inventory delivery.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

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- Provide credit card payment option for delinquent taxes (individuals), installment agreement payments and extension-related payments and expand credit card options to BMF returns.
- Develop and implement a comprehensive nonfiler strategy.
- Identify and target noncompliance with employment tax deposit and payment requirements.
- Continue efforts to gain full participation in the State Income Tax Levy Program.
- Align Collection legacy systems.
- Implement a modernized collection system.
- Tailor treatment streams and route cases to appropriate functions and employees.
- Develop educational products and a marketing plan to address abusive flow-throughs, tax shelters, trust filers and their practitioners.
- Develop and implement a strategy for High-Income Taxpayers.
- Fully implement the K-1 matching program, reconciling partnership income reporting documents to the beneficiaries of this income on federal income tax returns.

Revamp Business Practices to Meet Taxpayer Needs

The ability to balance the goals of improving customer service and improving overall compliance depends in part on successful modernization of business practices.

In FY 2002, IRS completed the following actions:

- Completed centralization of all employment tax processing to two Submission Processing sites.
- Tested feasibility of correspondence imaging to allow Customer Service Representatives immediate on-line access to customer correspondence.
- Improved and enhanced employee manuals and tools.
- Provided new tools and information such as the Remittance Transaction System (RTR), Notice Viewing, and Correspondence Imaging to employees.
- Improved training to Toll-free/Adjustments workforce by determining skill gaps.
- Integrated business systems such as Automated Offer in Compromise, Automated Lien System, Inventory Delivery System and Automated Trust Fund Recovery System onto a single platform.
- Provided a single-point for electronic filing and test prototype solutions for the combined electronic transmission of federal and state employer quarterly tax and wage reports.
- Prototyped an application to provide employers a quicker method to securely access, apply for, and receive a Federal EIN on-line.
- Reconfigured the Practitioner Hotline to a centralized system.
- Centralized the processing of Offers in Compromise (OIC).
- Continued efforts to ensure that work is allocated to the proper operating division by implementing standardized criteria to reassign compliance cases.
- Responded to taxpayer demand and implemented pre-filing agreement program.

In FY 2003, IRS will continue to respond to this challenge through the following planned actions:

- Establish customer liaisons for media and publications.
- Continue to work with industry to enable online tax return entry and submission at no cost.
- Expand electronic tax products for business.
- Enhance customer experience by routing calls to appropriate assistors.
- Improve and enhance employee manuals and tools.

- Continue to deploy the Integrated Case Processing system.
- Redesign business processes to provide service around an industry rather than geographically to provide better service for each taxpayer.
- Move to an issue-driven examination process for large and midsize businesses.
- Re-engineer the Published Guidance process.

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V. Financial Highlights

Stewardship Information Analysis

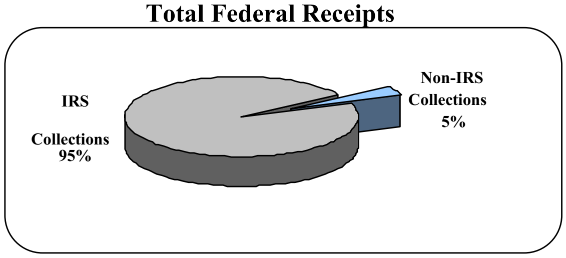
a. Overview of Revenue and Administrative Accounts

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

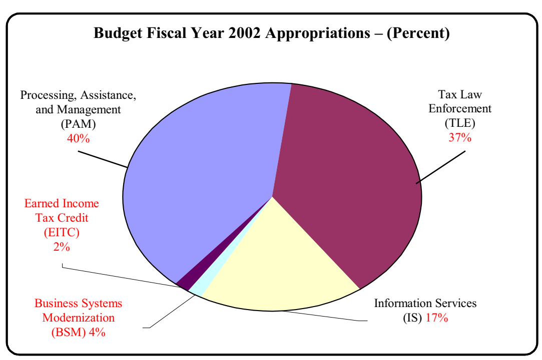
The Balance Sheet reflects total assets of $24.71 billion. Of these assets, almost 81 percent are Federal Taxes Receivable. These receivables are the amounts expected to be collected from past due accounts. The decrease in assets of $0.53 billion is mainly attributable to a decrease in the IRS' fund balance with Treasury. The majority of the liabilities, a little over 86 percent, consist of Federal Taxes Receivable due to Treasury.

The Statement of Custodial Activity shows that IRS programs resulted in $2.016 trillion in Federal receipts. IRS collections constitute 95 percent of the Federal Government receipts, as shown in the following chart.

Total Federal Receipts



b. Financing Sources



The IRS receives the majority of its funding through annual, multi-year, no-year and trust fund appropriations which are available for use within certain specified statutory limits. There are three major and several minor operating appropriations. The Processing, Assistance and Management appropriation funds the processing of tax returns and related documents, assistance for taxpayers in the filing of their returns and paying taxes due,

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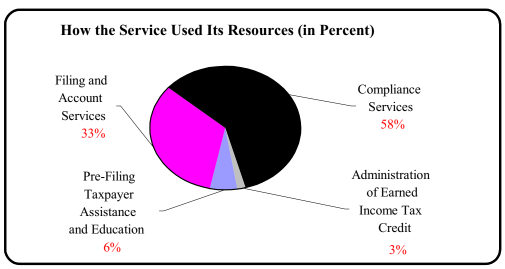
matching information with returns, conducting internal audit reviews and security investigations, and managing financial resources. The Tax Law Enforcement appropriation provides funds for the examination of tax returns and the administrative and judicial settlement of taxpayer appeals of examination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

Besides appropriations, the Service utilizes other financing sources. These include net transfers from other federal agencies, and imputed financing (subsidies from other federal funds that cover specific expenses such as retirement benefits).

c. Use of Resources

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



Revenue and Refund Trend Information

Federal tax revenues are collected through six major classifications: individual income, corporate income, excise taxes, estate and gift taxes, railroad retirement, and Federal unemployment taxes. Overall revenue receipts (approximately $2.016 trillion) for FY 2002 decreased by approximately 5 percent. Individual income taxes, which include both FICA and SECA taxes, decreased by 7 percent. Corporate income taxes increased by 13 percent. Collections from all other tax sources were relatively stable from 2001 to 2002.

The decline in receipts is predominately due to the 2001 recession, the decline in the stock market, and the September 11, 2001 terrorist attacks. These occurrences resulted in reductions in relatively highly-taxed forms of income, especially wages and salaries, and indicates that much of the decline in these forms of income is attributable to the recession. At the same time, the decline in the stock market reduced capital gain receipts and further reduced taxes on wage and salary income. The entire amount of Federal revenue received in 2002 was distributed to Treasury.

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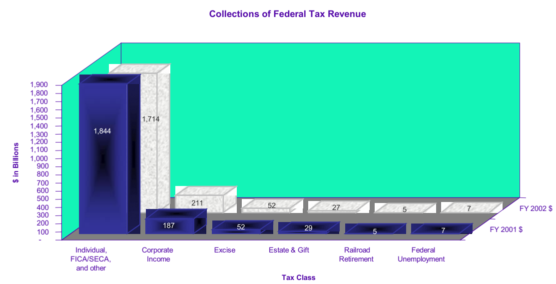
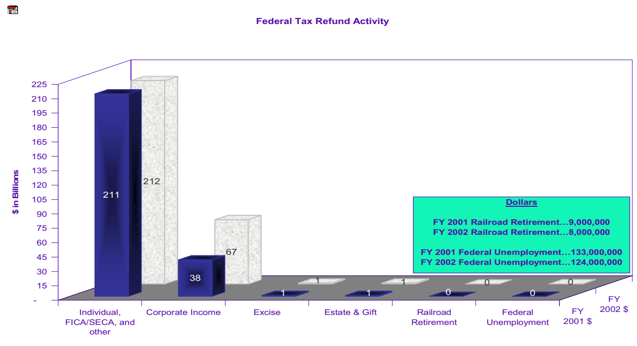
For the Fiscal Year Ended September 30, 2002



Federal tax refund activity, which includes tax, interest, the special tax rebate authorization, payments for Earned Income Tax Credits, and Child Tax Credits in excess of the tax liability was $281 billion. This increase from FY 2001 activity is attributable to the Job Creation and Worker Assistance Act (the Economic Stimulus Bill) that affects both individuals and corporations by reducing the tax rate for individuals, extending the corporation carry-back period for net operating losses from two to five years, and temporarily extending a number of tax reductions that had expired December 31, 2001.

Overall refund disbursements increased by 12 percent. The table below shows that the largest dollar volume tax classes, Individual, FICA/SECA, and the other refunds appear to remain relatively consistent; however, in FY 2001 approximately $36 billion was disbursed for the special tax rebate, which means the remaining disbursements were approximately $175 billion. When FY 2001 and 2002 are normalized to exclude the special tax rebate refunds for these same tax classes in FY 2002 ($212 billion) increased by approximately 21 percent. Corporate Income refunds increased by 76 percent, which offset increased corporate tax receipts. Other tax class refunds remained relatively consistent.



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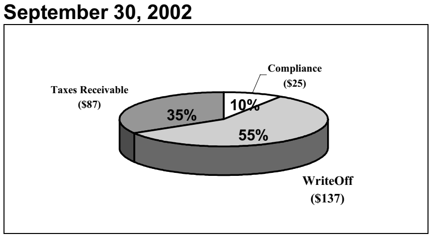
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

Analysis of Unpaid Assessments

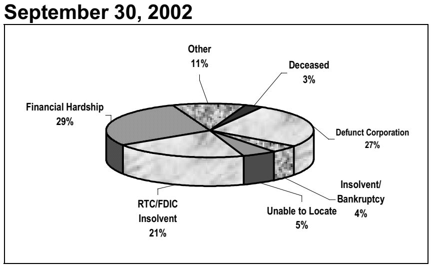
Figure 1: Components of IRS' $249 Billion of Unpaid Assessments as of September 30, 2002



As reflected in the supplemental information to IRS' fiscal year 2002 Financial Statements, the unpaid assessment balance was about $249 billion as of September 30, 2002. This unpaid assessment balance represents assessments resulting from taxpayers filing returns without sufficient payment; as well as from the Service's enforcement programs such as Examination, Underreporter, Substitute for Return, and Combined Annual Wage Reporting. The majority of this balance is not considered a receivable. In addition, a substantial portion of the amounts considered receivables is largely uncollectible.

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

Figure 2: Components of IRS' $137 Billion of Write offs as of September 30, 2002



Of the $249 billion balance of unpaid assessments, $137 billion represents write-offs. Write-offs principally consist of amounts owed by defunct corporations and include many failed financial institutions resolved by the Federal Deposit Insurance Corporation (FDIC) and the former Resolution Trust Corporation (RTC). Taxpayers with extreme economic and/or financial hardships, deceased taxpayers, and taxpayers who are insolvent due to bankruptcy owe the remaining amounts.

In addition, $25 billion of unpaid assessments represent amounts that have not been agreed to by either the taxpayer or a court. These assessments result primarily from various Service enforcement programs to promote voluntary compliance. Due to the lack of agreement, these compliance assessments have less potential for future collection than the unpaid assessments that are considered federal taxes receivable.

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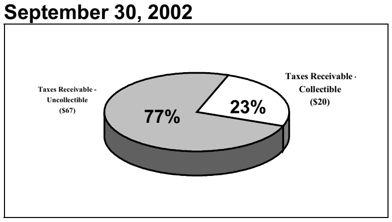
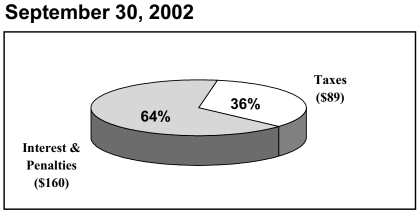
Figure 3: Components of IRS' $87 Billion of Taxes Receivable as of September 30, 2002



The remaining $87 billion of unpaid assessments represent federal taxes receivable. About $67 billion (77%) of this balance is estimated to be uncollectible due primarily to the taxpayer's economic situation, including individual taxpayers who are unemployed, are currently in bankruptcy, or have other financial problems. However, under certain conditions, IRS may continue collection action for 10 years after the assessment. Thus, these accounts may still ultimately have some collection potential if the taxpayer's economic condition improves.

About $20 billion, or about 23%, of federal taxes receivable is estimated to be collectible. Components of the collectible balance include installment agreements with estates and individuals; confirmed payment plans through bankruptcy; and some newer amounts due from individuals and businesses with a history of compliance. The taxes receivable amount from September 30, 2001, to September 30, 2002, increased $7 billion from $80 billion to $87 billion. The percent estimated to be collectible at September 30, 2002 (23%), decreased from September 30, 2001 (25%).

Figure 4: Unpaid Taxes and Interest and Penalty Components of $249 Billion in Unpaid Assessments as of September 30, 2002



It is also important to note that the unpaid assessment balance contains unpaid assessed tax, penalty, and interest; and accrued penalty and interest computed through September 30, 2002. About $160 billion (64%) of the unpaid assessment balance as of September 30, 2002, contains interest and penalties, as depicted in Figure 4, and are largely uncollectible.

Interest and penalties are such a high percentage of the balance because IRS must continue to accrue them through the 10-year statutory collection date, regardless of whether an account meets the criteria for financial statement recognition or has any collection potential. For example, interest and penalties continue to accrue on write-offs, such as FDIC and RTC cases, and on exam assessments where taxpayers have not agreed to the amount assessed. The overall growth in unpaid assessments during fiscal year 2002 was mostly attributable to the accrual of interest and penalties.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

ADDENDUM: President's Management Agenda

The IRS made steady progress on the President's Management Agenda this year and we still have room for improvement. The table below summarizes the status and progress ratings for IRS in the second, third and fourth quarters of FY 2002. In "Progress" ratings, the area where we can have the most short-term impact, we received two greens and three yellows. In "Status" ratings, we received one green, two yellows and two reds. The IRS was not rated in the first quarter for any agenda item, and received ratings in the area of Budget & Performance Integration in the third and fourth quarters only.

IRS Overall Ratings as of September 30, 2002

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

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

Major Accomplishments and Future Plans

Human Capital

- IRS has developed a rigorous, quantitatively-driven succession planning and management system that assesses current and projected candidate supply/demand at each management level of the organization.
- IRS implemented a pay-for-performance system for its executives and managers that links salary adjustments directly to performance evaluations.
- IRS was awarded two prestigious Creative Excellence Awards, sponsored by the Society for Human Resources Management, for its interactive professional recruitment efforts.

Competitive Sourcing

- Established a program for FY 2002 and FY 2003 to review approximately 4500 FTE for competitive sourcing.
- Completed feasibility studies in five functional areas, and studies are ongoing in seven additional functional areas.
- A-76 Project Development – Began Performance Work Statements (PWS) for 500 FTE; began streamlined competition for 30 FTE; convened most efficient organization team for 500 FTE; and convened PWS teams for 560 FTE.
- Completed direct conversion of 93 FTE.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

Budget & Performance Integration

- Developed and used for first time ever, data on program performance gaps to develop strategic plans and prioritize budget initiatives.
- Developed integrated financial and performance plans that tie budget to performance for each program. Plans were certified by Division Commissioners to assure accountability.
- Enhanced the use of performance data and program evaluations in the budget decision-making process to create stronger linkage between current performance and future-year performance goals.
- Will continue development and reporting of corporate strategic measures and will use data to begin discussion and development of servicewide outcome goals.
- Will realign IRS budget structure to help link costs to program results.
- Will develop the Integrated Financial System and deploy a cost module that is interfaced with program area data systems to provide both direct and indirect cost data to support budget requests and execution.

E-Government

- Increased the number of e-filed individual returns by 17% over FY 2001 resulting in 36% of all returns being filed electronically.
- The number of taxpayers e-filing from their home computers is up 38% over last year.
- Implemented electronic payment via the internet for the 2002 filing season.
- Increased the number of Federal Tax Payment Transactions Paid Electronically by 3% over FY 2001.
- Implemented internet based taxpayer access to answers for their inquiries regarding refunds and fact of filing.
- Introduced a newly designed and more accessible web site. Increased the number of web site hits to 3.4 billion and downloaded files to 436 million projected through the end of FY 2002. This represents increases of 31% and 38% respectively over FY 2001.
- Will continue efforts with industry partners to develop the free internet filing web page, to be hosted on IRS.gov.
- Will continue initiatives on EZ Tax Filing and Expanding Electronic Tax Products for Businesses.

Financial Performance

- Achieved clean audit opinion by November 15 through significant improvements in the timing and accuracy of financial data throughout the fiscal year.
- Administrative and Revenue Accounting Divisions achieved the Treasury June target for 3-day close for both timeliness and quality.
- Revising the Remediation Plan to reflect a comprehensive set of actions to improve IRS' financial management systems and ensure they meet federal requirements and standards.
- Addressed components of material weaknesses in internal controls, e.g., controls over material balances in the general ledger and recording of transactions; quarterly reporting of capital items; timely recording of adjustments; and consistent implementation of existing computer security policies and procedures.
- Formed an implementation team to develop procedures, processes, and costs associated with recommendations of joint Treasury and IRS task force to address erroneous payments.

INTERNAL REVENUE SERVICE
Management Discussion and Analysis
For the Fiscal Year Ended September 30, 2002

- Actions are on schedule for long-term solutions to address six material weaknesses in internal controls.
- Integrated Financial System is on schedule for implementation on 10/1/03.
- Custodial Accounting Project (CAP) Build 1 will be deployed November 2003. All future dates and builds of CAP/EDW (Enterprise Data Warehouse) are under review due to changes in the Business Systems Modernization Plans (dependent on Modernized Data Access Projects).

Financial Statements

Balance Sheets

Department of the Treasury
Internal Revenue Service
Balance Sheet
As of September 30, 2002 and 2001

(In Millions)

	2002	2001
Assets		
Intragovernmental:		
Fund balance with Treasury and cash (Note 2)	$ 1,652	$ 2,070
Due from Treasury (Note 13)	1,287	1,419
Accounts receivable, net (Note 3)	7	33
Advances to government agencies	126	128
Total Intragovernmental	3,072	3,650
With the Public:		
Federal Taxes receivable, net of allowance for doubtful accounts (Notes 5, 13)	20,000	20,000
Accounts receivable, Net (Note 3)	1	3
Advances to the public	15	15
Other assets (Notes 4, 13)	78	195
Total with the Public	20,094	20,213
Property and equipment, Net (Note 6)	1,546	1,381
Total Assets	**$ 24,712**	**$ 25,244**
Liabilities		
Intragovernmental:		
Due to Treasury (Notes 5, 13)	20,000	20,000
Accrued expenses (Note 7)	142	89
Other liabilities (Note 8)	90	81
Total Intragovernmental	20,232	20,170
Federal tax refunds payable (Note 13)	1,287	1,419
Accounts payable (Note 7)	51	27
Accrued expenses (Note 7)	424	608
Other liabilities (Note 8)	962	1,071
Capital lease liability (Note 9)	158	125
Contingencies (Note 10)	9	6
Total Liabilities	**$ 23,123**	**$ 23,426**
Net Position		
Unexpended Appropriations	1,039	1,380
Cumulative Results of Operations	550	438
Total Net Position	**$ 1,589**	**$ 1,818**
Total Liabilities and Net Position	**$ 24,712**	**$ 25,244**

The accompanying notes are an integral part of these statements

- 1 -

Statement of Net Cost

Department of the Treasury
Internal Revenue Service
Statement of Net Cost
For the Years Ended September 30, 2002 and 2001

(In Millions)

Program	2002	2001
Pre-Filing Taxpayer Assistance and Education		
Full cost	$ 711	$ 579
Exchange revenue	(69)	(48)
Net cost of program	642	531
Filing and Account Services		
Full cost	$ 3,382	$ 3,099
Exchange revenue	(31)	(18)
Net cost of program	3,351	3,081
Compliance Services		
Full cost	$ 5,937	$ 5,601
Exchange revenue	(163)	(170)
Net cost of program	5,774	5,431
Administration of Earned Income Tax Credit		
Full cost	$ 270	$ 255
Exchange revenue	-	-
Net cost of program	270	255
Net Cost of Operations (Note 18)	**$ 10,037**	**$ 9,298**

The accompanying notes are an integral part of these statements

- 2 -

Statement of Changes in Net Position

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

(In Millions)

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

The accompanying notes are an integral part of these statements

- 3 -

Statement of Budgetary Resources

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

(In Millions)

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

The accompanying notes are an integral part of these statements

- 4 -

Statement of Financing

Department of the Treasury
Internal Revenue Service
Statement of Financing
For the Year Ended September 30, 2002

(In Millions)

Resources Used to Finance Activities:	
Budgetary Resources Obligated:	
Obligations incurred (Note 20)	$ 9,751
Less: spending authority from offsetting collections and recoveries	(273)
Net Obligations	$ 9,478
Imputed financing from costs absorbed by others	455
Transfers in/out without reimbursement	10
Exchange revenue not in the budget (Note 11)	(136)
Total Resources Used to Finance Activities	**$ 9,807**
Resources Used to Finance Items Not Part of the Net Cost of Operations:	
Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided	329
Resources that finance the acquisition of assets	(515)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	(186)
Total Resources Used to Finance the Net Cost of Operations	**$ 9,621**
Components of the Net Cost of Operations That Will Not Require or Generate Resources in the Current Period:	
Components Requiring or Generating Resources in Future Periods:	
Increase in annual leave liability	15
Other	8
Total Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods	**23**
Components Not Requiring or Generating Resources:	
Depreciation and amortization	393
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**416**
Net Cost of Operations	**$ 10,037**

The accompanying notes are an integral part of these statements

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Statement of Custodial Activity

Department of the Treasury
Internal Revenue Service
Statement of Custodial Activity
For the Years Ended September 30, 2002 and 2001

(In Billions)

	2002	2001
REVENUE ACTIVITY		
Collections of Federal Tax Revenue (Note 16)		
Individual income, FICA/SECA, and other	$ 1,714	$ 1,844
Corporate income	211	187
Excise	52	52
Estate and gift	27	29
Railroad retirement	5	5
Federal unemployment	7	7
Total Collections of Federal Tax Revenue	**2,016**	**2,124**
Increase/(Decrease) in federal taxes receivable, net	-	(2)
Total Federal Tax Revenue	**2,016**	**2,122**
Distribution of federal tax revenue to Treasury	2,016	2,124
Increase/(Decrease) in amount due to Treasury	-	(2)
Total Disposition of Federal Tax Revenue	**2,016**	**2,122**
NET FEDERAL REVENUE ACTIVITY	**$ -**	**$ -**
FEDERAL TAX REFUND ACTIVITY (Note 17)		
Total Refunds of Federal Taxes	**$ 281**	**$ 251**
Appropriations Used for Refund of Federal Taxes	**(281)**	**(251)**
NET FEDERAL TAX REFUND ACTIVITY	**$ -**	**$ -**

The accompanying notes are an integral part of these statements

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Notes to the Financial Statements

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 1. Summary of Significant Accounting Policies

A. Reporting Entity

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

In fiscal year (FY) 2001, the Service completed the implementation of a plan to reorganize its structure and management in accordance with the IRS Restructuring and Reform Act enacted by Congress in 1998. The Service implemented a modernized structure built around taxpayer needs. Currently, the organization consists of :

Four operating divisions – Wage and Investment addresses the needs of taxpayers with wage and investment income only. Small Business and Self-Employed serves self-employed individuals and small businesses. Tax-Exempt and Government Entities supports employee plans, tax exempt organizations, and government entities. Large and Mid-Size Business serves corporations, sub-chapter S corporations, and partnerships with assets greater than $5 million. Each of these divisions performs the functions of processing and examination of tax returns for its constituent taxpayers. Wage and Investment performs collection activities related to its own customers. Small Business and Self-Employed performs collection activities on its customer accounts as well as those of Tax Exempt and Government Entities and Large and Mid-Size Business.

Two service organizations – Modernization and Information Technology Services and Agency Wide Shared Services provide central support to all areas of the Service;

Separate specialized independent channels for taxpayers – Appeals and Taxpayer Advocate Service divisions are independent of the operating divisions and other units of the Service. The Taxpayer Advocate Service reports directly to Congress.

A line unit, Criminal Investigation, has sole responsibility for investigation of criminal violations of the tax law and is independent of the operating divisions;

Chief Counsel provides tax advice, guidance, and legislative services to all components of the Service; and

National Headquarters fills the role of setting broad policy, providing executive oversight, reviewing plans and goals of the operating units, and developing major improvement initiatives.

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

B. Basis of Presentation

The balance sheet reports the Service's financial position as of September 30, 2002 and 2001. Net cost and custodial activity are reported for the years ended September 30, 2002 and 2001. Changes in net position, budgetary resources, and financing are reported for the year ended September 30, 2002.

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

C. Basis of Accounting

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

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

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

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

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

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

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

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

Administration of Earned Income Tax Credit (EITC)
Administers the EITC program. It includes expanded customer service, public outreach, enforcement, and research efforts to reduce claims and erroneous filings associated with EITC. It comprises pre-filing, filing and account services, and compliance activities. EITC payments actually refunded to individuals or credited against other tax liabilities are not included in program costs.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

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

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

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

D. Financing Sources and Exchange Revenue

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

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

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

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Other
These budgetary accounts consist of an aggregate of smaller multi-functional funds that support the Service's mission to collect the proper amount of tax and provide improved customer service to the taxpayer. The Business Systems Modernization (BSM) appropriation is the largest of these funds and may be obligated as Congress approves expenditure plans. Also included is the Earned Income Tax Credit appropriation that funds the administration of the EITC program.

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

E. Fund Balance with Treasury and Cash

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

F. Accounts Receivable, Net

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

G. Advances

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

In FY 1999 the Service recorded a one-time accounting adjustment to capitalize telecommunications equipment owned by the WCF. These costs are included in advances to government agencies as of September 30, 2002 and September 30, 2001, and are amortized over the seven-year life of the equipment. After FY 1999, further capitalization of WCF equipment was discontinued. Subsequently, all WCF costs--including depreciation of equipment--are reported as current year expenses.

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

H. Property and Equipment

The net book values of Property and Equipment as of September 30, 2002 and 2001, consist of the following components:

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

ADP and Telecommunication Equipment acquired after September 30, 1999
The method used by the Service to report the capitalized ADP and telecommunication assets acquired after September 30, 1999 is described as "pooling." Under pooling, all ADP and telecommunication equipment is recorded at cost. Each fiscal year separate pools are established for each class of ADP and telecommunication assets, as distinguished by the useful lives of the assets. In FY 2002 and FY 2001, there are two pools--one for equipment with a useful life of three years, consisting of microcomputers, related equipment, and software; the other for assets with a useful life of seven years, consisting of supercomputers, mainframes, minicomputers, telecommunications equipment and all related equipment and software. ADP and telecommunications equipment includes all related software, including commercial off-the-shelf software, except as separately stated under Internal Use Software, discussed below. Small computer peripherals are excluded from the pools. With these exceptions, all other costs of ADP and telecommunication equipment acquired after September 30, 1999 are accumulated regardless of the dollar value of individual assets.

Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half-year of depreciation taken in the first and final years. Under the pooling concept, only disposals that are material to the financial statements are recognized. The Service performed an analysis of the FY 2002 and 2001 pools and determined that disposals were not material to the financial statements.

Office Equipment and Furniture, Investigative Equipment, and Vehicles acquired after September 30, 1999
The Service capitalizes office equipment and furniture, investigative equipment, and vehicles acquired after September 30, 1999, with an individual-asset acquisition cost of $5,000 or more. Depreciation on these assets is calculated using the straight-line method over the estimated useful lives with a half- year of depreciation taken in the first and final years. Useful lives are established as ten years for office equipment and investigative equipment, eight years for furniture, and five years for vehicles. Only disposals that are material to the financial statements are recognized. The Service performed an analysis of the FY 2002 and 2001 property and determined that disposals were not material to the financial statements.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

The Service has ten systems it considers major systems as of September 30, 2002 and September 30, 2001. As of September 30, 2002 major systems consisted largely of costs associated with re-engineering the Martinsburg and Tennessee Computing Centers, known as the Mainframe Consolidation project, and a system to convert paper tax documents and remittances into electronic records, known as the Integrated Submission and Remittance Processing System.

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

Major systems are depreciated using the straight-line method over an estimated useful life of seven years with a half-year of depreciation taken in the first and final years. Major systems are disposed—or net book value is reduced—to the extent they are considered impaired. During the years ended September 30, 2002 and September 30, 2001 there were no disposals of assets included in major systems.

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

As of September 30, 2002, the Service has 13 internal use software projects, including deployed and work in process. Major deployed projects include Customer Communications, a project to improve the customer service telephone system. Major systems in process include Customer Account Data Engine (CADE), a project to replace the IRS's master file for taxpayer accounts, and Security and Technology Infrastructure Release (STIR), a project to modernize and standardize the technical infrastructure throughout the Service.

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

IRS applies overhead to internal use software projects using a three-year average rate of overhead costs. In FY 2002 and prospectively, the overhead rate is applied only to salaries and benefits of IRS employees directly assigned to the internal use software projects.

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

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

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

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

I. Capital Lease Liability

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

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

In accordance with *SFFAS No. 10*, capital lease liability also includes amounts for computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments. The capital lease liability for software licenses is generally included in Liabilities Not Covered by Budgetary Resources. There is an exception for lease agreements subject to a cancellation clause in the lease. The liability is treated as fully funded up to the amount of the cancellation penalty. As of September 30, 2002 and 2001, there were no capital leases with cancellation clauses.

J. Permanent and Indefinite Funds

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

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

K. Tax Assessments and Abatements

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

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

L. Federal Taxes Receivable

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

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

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

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

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

Fund balance with Treasury and cash as of September 30, 2002 and 2001, consist of the following:

Fund Balance and Cash	2002	2001
Appropriated and other funds	$ 1,648	$ 2,067
Imprest funds	4	3
Fund Balance with Treasury and Cash	$ 1,652	$ 2,070

Status of Fund Balance with Treasury	2002	2001
Unobligated balances		
- Available	$ 217	$ 196
- Unavailable	225	245
Obligated balances not yet disbursed	1,225	1,635
Other funds	(19)	(9)
Fund Balance with Treasury	$ 1,648	$ 2,067

Available unobligated balances represent no-year and multi-year appropriations that can be obligated after September 30, 2002 and September 30, 2001. Unavailable unobligated balances are expired appropriations no longer available to incur new obligations. Obligated balances not yet disbursed include undelivered orders – unpaid of $594 million and $921 million as of September 30, 2002 and 2001, respectively, as shown in note 12, Obligated balances. Other funds primarily consist of suspense, deposit, and clearing funds.

In FY 2002 and FY 2001, the $1,036 million and $1,362 million totals of unobligated balances and undelivered orders are different than the $1,039 million and $1,380 million balances of unexpended appropriations, respectively, as shown on the balance sheet. These differences result from user fees, undelivered orders – paid, and receivables with the public. User fees that have not yet been transferred to appropriations are included in fund balance but do not represent unexpended appropriations. Undelivered orders – paid and receivables from the public are included in unexpended appropriations but not in fund balance.

The Business Systems Modernization (BSM) fund represents $354 million and $270 million of the appropriated fund balance as of September 30, 2002 and 2001, respectively. BSM funds can only be obligated pursuant to an expenditure plan approved by Congress. As of September 30, 2002, Congress has approved a cumulative amount of $968 million in BSM appropriations received, of which $811 million has been obligated. Unobligated balances include $171 million and $78 million of the BSM fund as of September 30, 2002 and 2001, respectively. As of September 30, 2002, $157 million was approved for expenditure. As of September 30, 2001, the entire $78 million was approved for expenditure.

Note 3. Accounts Receivable, Net
(In Millions)

Accounts receivable and allowances for uncollectible accounts as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	With the Public	Intra – Governmental	With the Public
Accounts receivable	$ 7	$ 2	$ 35	$ 5
Allowance for uncollectible accounts	-	(1)	(2)	(2)
Accounts Receivable, Net	$ 7	$ 1	$ 33	$ 3

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 4.
Other Assets
(In Millions)

Other assets, as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Other custodial assets	$ -	$ 74	$ -	$ 191
Federal tax lien revolving fund	-	4	-	4
Total Other Assets	$ -	$ 78	$ -	$ 195

Other custodial assets primarily represent voluntary deposits received from taxpayers, pending application of the funds to unpaid tax assessments. This category also includes seized monies of $1 million and $2 million as of September 30, 2002 and 2001, respectively, which are held pending the results of criminal investigations. As described in Note 13, other custodial assets are classified as "Non-Entity Assets" and are offset by an equal liability in other custodial liabilities.

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

Note 5.
Federal Taxes Receivable, Net

Federal taxes receivable (gross) was $87 billion and $80 billion as of September 30, 2002 and 2001, respectively, and consisted of tax assessments, penalties, and interest that were not paid or abated, and which were agreed to by the taxpayer and the Service, or upheld by the courts.

Federal taxes receivable (net) equaled $20 billion and $20 billion as of September 30, 2002 and 2001, respectively, and is the portion of federal taxes receivable (gross) estimated to be collectible. It is based on projections of collectibility from a statistical sample of taxes receivable. An allowance for doubtful accounts of $67 billion and $60 billion was established in FY 2002 and FY 2001, respectively, for the difference between the gross federal taxes receivable and the portion estimated to be collectible. Due to Treasury is the offsetting liability to federal taxes receivable, representing amounts to be transferred to Treasury when collected.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 6. Property and Equipment *(In Millions)*

Property and equipment as of September 30, 2002 and 2001 is shown in the schedule below. Net Book Value is stated net of accumulated depreciation. The cost basis for fiscal years 2002 and 2001 is $2,648 and $2,095, respectively. Accumulated depreciation for fiscal years 2002 and 2001 is $1,102 and $714, respectively.

Category	Useful Life	Net Book Value/ Cost	Accumulated Depreciation	Net Book Value 9/30/2002	Net Book Value 9/30/2001
ADP assets	3 to 7 Years	$ 1,521	$ (759)	$ 762	$ 681
Furniture and non-ADP equipment	8 to 10 Years	55	(21)	34	42
Investigative equipment	10 Years	11	(6)	5	7
Vehicles	5 Years	81	(53)	28	31
		1,668	(839)	829	761
Major systems	7 Years	422	(152)	270	331
Internal use software	7 Years	36	(6)	30	24
Internal use software – work in process		181	-	181	52
Leasehold improvements	10 Years	341	(105)	236	213
Total Property and Equipment		**$ 2,648**	**$ (1,102)**	**$ 1,546**	**$ 1,381**

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

Beginning in Fiscal Year 2001, the costs of major software projects are captured in "Internal Use Software" and "Internal use software – work in process". As of September 30, 2002, major projects in Internal use software included Customer Communications, a project to improve the customer service telephone system. As of September 30, 2002, Internal use software – work in process, includes Customer Account Data Engine (CADE) and Security and Technology Infrastructure Release (STIR). CADE is a project to replace the Service's master file for taxpayer accounts. STIR is a project to modernize and standardize the technical infrastructure throughout the Service.

In FY 2002, internal use software - work in process has been reduced for impairment in the amount of $6 million. This represents 100% of the costs of the Customer Relationship Management Exam project due to discontinuation of the project.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 6.
Property and Equipment
(In Millions)

(Continued)

The Net Book Value/Cost column for property and equipment represents the combination of (1) net book value of certain property and equipment acquired before October 1, 1999, derived from estimates, as discussed in Note 1; and (2) the actual cost of other property and equipment. The net book value of property and equipment derived from estimates--item (1) above-- consists of the following:

Category	Useful Life	Net Book Value	Accumulated Depreciation	Net Book Value 9/30/2002	Net Book Value 9/30/2001
ADP assets	3 to 7 Years	$ 668	$ (502)	$ 166	$ 263
Furniture and non-ADP Equipment	8 to 10 Years	16	(7)	9	11
Investigative equipment	10 Years	11	(6)	5	7
Vehicles	5 Years	48	(44)	4	15
Total Property and Equipment		**$ 743**	**$ (559)**	**$ 184**	**$ 296**

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 6. Property and Equipment *(In Millions)*

(Continued)

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

Category	Useful Life	Cost	Accumulated Depreciation	Net Book Value 9/30/2002	Net Book Value 9/30/2001
ADP assets					
Mainframe Consolidation	7 years	-	-	-	52
ADP Equipment	7 years	-	-	-	7
Software licenses	3 to 7 Years	215	(59)	156	108
		$ 215	$ (59)	$ 156	$ 167
Equipment					
Mail sorters	10 Years	14	(5)	9	14
Photocopiers	10 Years	6	(1)	5	3
		20	(6)	14	17
Totals		**$ 235**	**$ (65)**	**$ 170**	**$ 184**

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

Accounts payable and accrued expenses as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Accounts payable	$ -	$ 51	$ -	$ 27
Accrued expenses	120	295	43	301
Accrued payroll and benefits	22	129	46	307
Total Accounts Payable and Accrued Expenses	$ 142	$ 475	$ 89	$ 635

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 8.
Other
Liabilities
(In Millions)

Other liabilities as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	**With the Public**	**Intra-Governmental**	**With the Public**
Workers' compensation	$ 89	$ 506	$ 85	$ 513
Accrued annual leave	-	382	-	367
Suspense	1	-	(4)	-
Other custodial liabilities	-	74	-	191
Total Other Liabilities	$ 90	$ 962	$ 81	$ 1,071

Workers' compensation is paid to employees injured on the job or incurring work-related illnesses, as required by the Federal Employees Compensation Act (Act). The Act provides income, medical cost protection, and death benefits to covered federal civilian employees and their beneficiaries. The program is administered by the U.S. Department of Labor, which initially pays valid claims and subsequently seeks reimbursement from federal agencies. The liability of $595 million at September 30, 2002 includes a current portion of $89 million and estimated future costs of $506 million. As of September 30, 2001, the liability of $598 million includes a current portion of $85 million and estimated future costs of $513 million. Estimated future costs have been actuarially determined, and are regarded as a liability to the public because neither the costs nor reimbursement have been recognized by the Department of Labor. Workers' Compensation is included in Liabilities Not Covered by Budgetary Resources, as described in Note 14.

Accrued annual leave consists of employees' unpaid leave balances at September 30, 2002 and 2001, and reflects wage rates in effect at fiscal year end. Accrued annual leave is included in Liabilities Not Covered by Budgetary Resources, as described in Note 14.

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 9.
Leases
(In Millions)

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

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

The capital lease liability as of September 30, 2001, is as follows:

	Total	2002	2003	2004	2005 and Beyond
Mail sorters	11	6	5	-	-
Copiers and other	10	4	3	3	-
Software licenses	124	39	40	33	12
Total Lease Obligations	$ 145	$ 49	$ 48	$ 36	$ 12
Less: Interest	(20)				
Present Value of Lease Payments	$ 125				

In fiscal years 2002 and 2001, certain computer equipment, mail sorters, copiers and other equipment are leased under Lease-To-Ownership-Plans (LTOPs). The original terms of these LTOPs provide for 36 monthly payments for computers, and from 36 to 60 monthly payments for other equipment. Under each LTOP, the equipment is owned as of the last monthly payment. Interest rates range from 3 to 10 percent. In fiscal year 2002, the Service exercised its option to purchase computer servers in the amount of $5 million and retire all remaining capital lease liabilities on this equipment.

Capital lease liabilities for equipment is included in funded liabilities. Prior to fiscal year 2001, capital lease liabilities for equipment was included in Liabilities Not Covered by Budgetary Resources. As of September 30, 2002, the Service had $2 million in funded capital lease liabilities and $156 million in Liabilities Not Covered by Budgetary Resources. As of September 30, 2001, the Service had $10 million in funded capital lease liabilities and $115 million in Liabilities Not Covered by Budgetary Resources.

Capital lease treatment is accorded to computer software leased under software licensing agreements. These licensing agreements provide for payments over periods ranging from three to six years. The liability reported represents the net present value of future lease payments, and is generally included in Liabilities Not Covered by Budgetary Resources, with the exception of software lease agreements subject to a cancellation clause in the lease. Cancellation clauses are treated as fully funded liabilities. As of September 30, 2002, the Service had no funded cancellation clauses on software licenses.

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

Note 10. Contingencies

As of September 30, 2002 and 2001, the Service provided an accrual for contingent losses of $9 million and $6 million, respectively, for pending and threatened legal matters, that, in the opinion of Chief Counsel, are considered probable. No additional losses are considered probable by Chief Counsel. Of these amounts, certain settlements and awards may be payable from the Treasury Judgment Fund in accordance with 31 U.S.C. 1304. For fiscal years 2002 and 2001, of the $9 million and $6 million, respectively, accrued by the Service, all is estimated to be payable from the Treasury Judgment Fund for settlements and awards relating to these claims.

The Service does not have contractual commitments for payments on obligations related to canceled appropriations.

Note 11. Appropriations Received

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

Note 12. Obligated Balances
(In Millions)

Obligated balances as of September 30, 2002 and 2001 in the Statements of Budgetary Resources and Financing are as follows:

	2002	2001
Budgetary accounts receivable	6	31
Budgetary accounts payable	(637)	(745)
Undelivered orders – unpaid	(594)	(921)
	$ (1,225)	$ (1,635)

Note 13. Non-entity Assets
(In Millions)

Non-entity assets arise from the Service's custodial duty to collect taxes, disburse tax refunds and maintain proper accounting for these activities in the books and records of the Service. Non-entity assets as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Due from Treasury	$ 1,287	$ -	$ 1,419	$ -
Federal taxes receivable, net of allowance for doubtful accounts	-	20,000	-	20,000
Other custodial assets	-	74	-	191

Due from Treasury represents tax refunds due to taxpayers but not disbursed as of September 30, 2002 and 2001.

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

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

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

Liabilities not covered by budgetary resources as of September 30, 2002 and 2001, consist of the following:

	2002		2001	
	Intra-Governmental	With the Public	Intra-Governmental	With the Public
Workers' compensation	$ 89	$ 506	$ 85	$ 513
Accrued annual leave	-	382	-	367
Contingencies	-	9	-	6
Capital lease liability	-	156	-	115

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

Note 15. Comparison of Statement of Budgetary Resources and the President's Budget

Statement of Federal Financial Accounting Standards No. 7 (*SFFAS No. 10*), *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting,* calls for explanations of material differences between budgetary resources available, status of those resources and outlays as presented in the statement of budgetary resources to the related actual balances published in the *Budget of the United States Government*. However, the *Budget of the United States Government* has not yet been published. The *Budget of the United States Government* is scheduled for publication in January 2003 and will be available through OMB. Accordingly, information required for such disclosure is not available at the time of publication of these financial statements.

Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

The Service transfers total tax collections to the U.S. Treasury. Collection activity, by financial statement line item for the fiscal year ended September 30, 2002 and 2001, and by tax year for fiscal year ended September 30, 2002:

	Tax Year				Collections Received	Collections Received
	2002	2001	2000	Prior Years	FY 2002	FY 2001
Individual income, FICA/SECA, and other	$ 1,105*	$ 584	$ 15	$ 10	$ 1,714	$ 1,844
Corporate income	113**	89	1	8	211	187
Excise	38	14	-	-	52	52
Estate and gift	-	24	1	2	27	29
Railroad retirement	4	1	-	-	5	5
Federal unemployment	5	2	-	-	7	7
Total	**$ 1,265**	**$ 714**	**$ 17**	**$ 20**	**$ 2,016**	**$ 2,124**
	63%	35%	1%	1%	100%	

* Includes other collections of $538 million.
** Includes tax year 2003 corporate income tax receipts of $5 billion.

In FY 2002, Individual income, FICA/SECA, and other taxes include $55 billion in payroll taxes collected from other federal agencies. Of this amount, $11 billion represents the portion paid by the employers.

Note 17. Federal Tax Refund Activity *(In Billions)*

Refund activity, broken out similarly to collection activity by financial statement line item for the fiscal years ended September 30, 2002 and 2001, and by tax year for fiscal year ended September 20, 2002:

	Tax Year				Refunds Disbursed	Refunds Disbursed
	2002	2001	2000	Prior Years	FY 2002	FY 2001
Individual income, FICA/SECA, and other	$ 1	$ 194	$ 12	$ 5	$ 212	$ 211
Corporate income	2	16	14	35	67	38
Excise	-	1	-	-	1	1
Estate and gift	-	-	1	-	1	1
Railroad retirement	-	-	-	-	-	-
Federal unemployment	-	-	-	-	-	-
Total	**$ 3**	**$ 211**	**$ 27**	**$ 40**	**$ 281**	**$ 251**
	1%	75%	10%	14%	100%	

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

In FY 2001, Refunds Disbursed included $36 billion in special tax rebates as required by the Economic Growth and Tax Relief Reconciliation Act (Public Law 107-16).

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Internal Revenue Service
Notes to the Financial Statements
For the Years Ended September 30, 2002 and 2001

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

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

	Intragovernmental		With the Public		Total	
	2002	2001	2002	2001	2002	2001
Gross Cost	$ 2,995	$2,161	$7,305	$7,373	$10,300	$9,534
Earned Revenue	(103)	(109)	(160)	(127)	(263)	(236)
Net Cost	$2,892	$2,052	$7,145	$7,246	$10,037	$9,298

Note 19. Budgetary Rescissions

Permanently not available in the Budgetary Resources section of the Statement of Budgetary Resources comprises rescissions of budget authority of $42 million and canceled appropriations of $61 million. Rescissions and canceled appropriations are also reported in the statement of changes in net position. Rescissions include $17 million under Public Law 107-206, $22 million under Public Law 106-554, and $3 million under Public Law 103-329. Public Law 106-554 and Public Law 103-329 reappropriated $24 million to current multi-year and no-year appropriations.

Note 20. Obligations Incurred

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

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

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

Reimbursable revenue	$ 126
Receipts for Tax Lien Revolving Fund	5
Refunds from vendors	22
Treasury Asset Forfeiture Fund	11
	$ 164

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Supplemental and Other Accompanying Information

Internal Revenue Service
Supplemental Information - Unaudited
For the Years Ended September 30, 2002 and 2001

Other Claims for Refund

Management has estimated amounts that may be paid out as other claims for tax refunds. This estimate represents an amount (principal and interest) that may be paid for claims pending judicial review by the Federal courts or, internally, by Appeals. In FY 2002, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $4.7 billion and by Appeals is $8.4 billion. In FY 2001, the total estimated payout (including principal and interest) for claims pending judicial review by the Federal courts is $7.7 billion and by Appeals is $13.6 billion. Although these refund claims have been deemed to be probable, they do not meet the criteria in SFFAS No. 5 for reporting the amounts in the balance sheet or for disclosure in the notes to the financial statements. However, they meet the criteria in SFFAS No. 7 for inclusion as supplemental information. To the extent judgments against the government in these cases prompt other similarly situated taxpayers to file similar refund claims, these amounts could become significantly greater.

Federal Taxes Receivable, Net
(In Billions)

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

The components of the total unpaid assessments and derivation of net federal taxes receivable at September 30, 2002 and 2001 were as follows:

	2002	2001
Total unpaid assessments	$ 249	$ 239
Less: Compliance assessments	(25)	(22)
Write-offs	(137)	(137)
Gross Federal Taxes Receivable	87	80
Less: Allowance for doubtful accounts	(67)	(60)
Federal Taxes Receivable, Net	$ 20	$ 20

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

To eliminate double-counting, the compliance assessments reported above exclude trust fund recovery penalties, totaling $13 billion and $14 billion as of September 30, 2002 and 2001, respectively, assessed against officers and directors of businesses who were involved in the non remittance of federal taxes withheld from their employees. The related unpaid assessments of those businesses are reported as taxes receivable or write-offs, but the Service may also recover portions of those businesses' unpaid assessments from any and all individual officers and directors against whom a trust fund recovery penalty is assessed.

Earned Income Tax Credit

The EITC was originally authorized by the Tax Reduction Act of 1975 (Public Law 94-12) and made permanent by the Revenue Act of 1978 (Public Law 95-600). The EITC is a special credit for taxpayers who work and whose earnings fall below the established allowance ceiling. Qualified taxpayers can receive partial credit in advance in each paycheck. In fiscal year 2002, the Service issued $27.8 billion in EITC refunds, of which $66 million was applied to advance EITC. In fiscal year 2001, the Service issued $26.1 billion in EITC refunds, of which $72.0 million was applied to advance EITC. An additional $4.7 billion and $5.1 billion of the EITC was applied to reduce taxpayer liability for fiscal years 2002 and 2001, respectively.

Internal Revenue Service
Supplemental Information - Unaudited
For the Years Ended September 30, 2002 and 2001

Intra-Governmental Assets
(In Millions)

Fiscal Year 2002

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

Fiscal Year 2001

Agency	Fund Balance with Treasury	Due from Treasury	Accounts Receivable, Net	Advances to Government Agencies
Treasury	$ 2,067	$ 1,419	$ 27	$ 128
Other	-	-	6	-
Total	$ 2,067	$ 1,419	$ 33	$ 128

Intra-Governmental Liabilities
(In Millions)

Fiscal Year 2002

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

Fiscal Year 2001

Agency	Due to Treasury	Accrued Expenses	Accrued Payroll and Benefits	Other Liabilities
Treasury	$ 20,000	$ 6	$ -	$ -
U.S. Postal Service.	-	20	-	-
Department of Labor	-	8	-	85
Office of Pers. Mgmt	-	1	46	-
Other	-	8	-	(4)
Total	$ 20,000	$ 43	$ 46	$ 81

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Internal Revenue Service
Supplemental Information - Unaudited
For the Year Ended September 30, 2002

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

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

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Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2002 and 2001

Child Tax Credit

The child tax credit was originally authorized by the Taxpayer Relief Act of 1997 (Public Law 105-34). The child tax credit is a special credit for taxpayers who work, whose earnings fall below the established allowance ceiling, and who have a qualifying child. In fiscal year 2002, the Service issued $5 billion in child tax credit refunds. An additional $22 billion of child tax credits were applied to reduce taxpayer liability. In fiscal year 2001, the Service issued $972 million in child tax credit refunds. An additional $19.6 billion of child tax credits were applied to reduce taxpayer liability.

Tax Gap

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

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

Tax Burden and Tax Expenditures

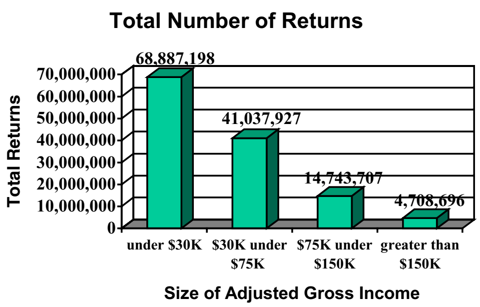
The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The bar charts and pie graphs below present the latest available information on income tax and on related income, deductions, and credits for individuals by income level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

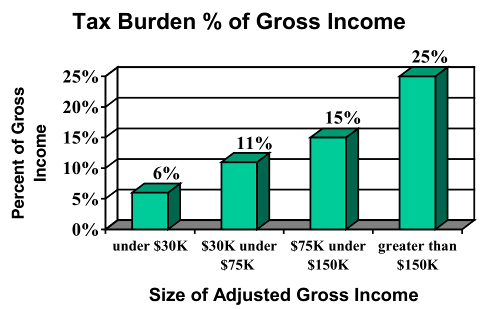
Total tax expenditures are the foregone federal revenue resulting from deductions and credits provided in the Internal Revenue Code. Since tax expenditures directly affect funds available from government operations, decisions to forego federal revenue are as important as decisions to spend federal revenue.

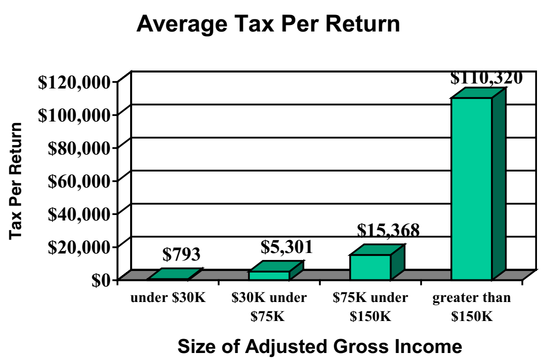
Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2002 and 2001

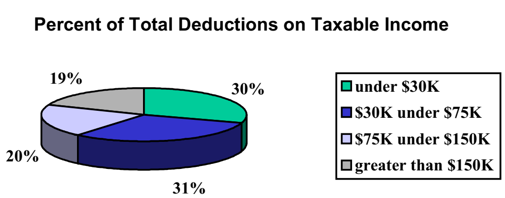
(All figures are estimates based on samples provided by the Statistics of Income office)

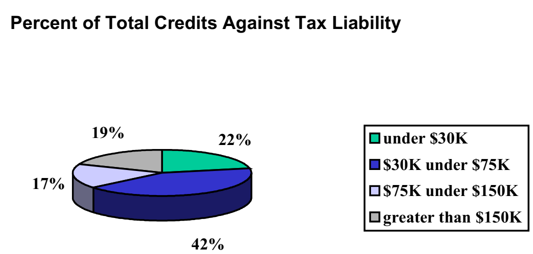
Individual Income Tax Returns (Tax Year 2000 Data)











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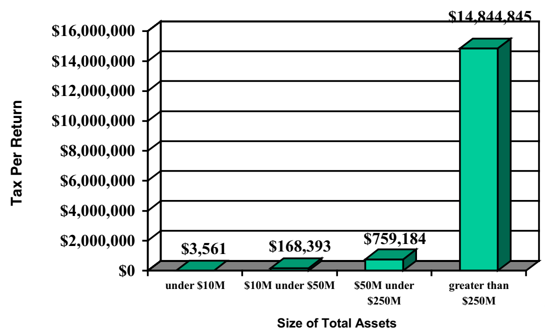
Internal Revenue Service
Other Accompanying Information - Unaudited
For the Years Ended September 30, 2002 and 2001

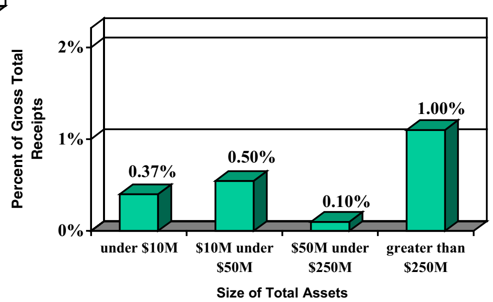
(All figures are estimates based on samples provided by the Statistics of Income office)

Corporation Income Tax Returns (Tax Year 1999 Data)

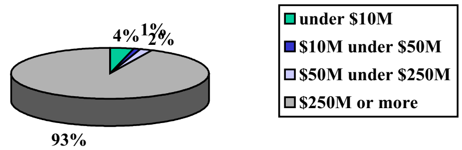
Average Tax Per Return



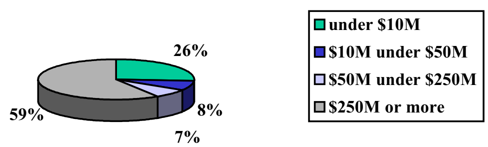
Tax Burden % of Gross Income



Percent of Total Credits Against Tax Liability



Percent of Total Deductions on Taxable Income



Material Weaknesses, Reportable Conditions, and Compliance Issues

Material Weaknesses

During our audits of the Internal Revenue Service's (IRS) fiscal year 2002 and 2001 financial statements, we identified five material weaknesses in internal controls. These material weaknesses have given rise to significant management challenges that have (1) impaired management's ability to prepare financial statements and other financial information without extensive compensating procedures, (2) limited the availability of reliable information to assist management in effectively managing operations on an ongoing basis, (3) reduced IRS's effectiveness in enforcing the Internal Revenue Code, (4) resulted in errors in taxpayer accounts, and (5) increased taxpayer burden. The issues that we have identified and discuss in this report relate to IRS's controls over (1) financial reporting, (2) unpaid assessments, (3) federal tax revenue and refunds, (4) property and equipment, and (5) computer security. We reported on each of these issues last year.[7] We also reported a material weakness in controls over IRS's budgetary activity in prior years. However, as a result of improvements in IRS's controls over its budgetary transactions, we have reassessed this as a reportable condition. We highlight these issues in the following sections. Less significant matters involving IRS's system of internal controls and its operations will be reported to IRS separately.

Financial Reporting

In fiscal year 2002, as in prior years, IRS did not have financial management systems adequate to enable it to timely, routinely, and reliably generate and report the information needed to prepare financial statements and manage operations on an ongoing basis. To overcome these systemic deficiencies, IRS was compelled to rely on extensive compensating procedures that were costly, labor intensive, and not always effective. During fiscal year 2002, IRS (1) did not have an adequate general ledger system for financial reporting and management purposes, (2) did not always timely recognize material transactions in its general ledger system, (3) could not determine and report on the specific amount of revenue collected for each of several of the federal government's largest revenue sources, and (4) did not have a cost accounting system capable of providing timely and reliable cost information related to IRS's activities and programs. In fiscal year 2002, IRS enhanced its procedures to more timely record certain types of transactions and thereby improved the ongoing reliability of its financial information. However, primarily because it continues to rely on the same

[7] U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Year 2001 and 2000 Financial Statements*, GAO-02-414 (Washington, D.C.: Feb. 27, 2002).

inadequate financial management systems as in prior years, material financial reporting control weaknesses remain. To compensate for these weaknesses, IRS continued to depend extensively on labor-intensive compensating procedures to enable it to generate reliable information for the annual financial statements. Although this approach culminated in financial statements that were fairly stated as of September 30, 2002 and 2001, it has not produced the current data needed to assist in managing operations on an ongoing basis, such as cost-based performance information to assist in making resource allocation decisions.

As in previous years,[8] during fiscal year 2002, IRS's general ledger system (1) comprised two independent general ledgers that were not integrated with each other or with their supporting records for material balances, and (2) was not supported by adequate audit trails for federal tax revenue, federal tax refunds, taxes receivable, or property and equipment. IRS's use of two separate general ledgers to account for its tax collection activities and the costs of conducting those activities, respectively, greatly complicates efforts to measure the cost of IRS's tax collection efforts. In addition, IRS's general ledger for its custodial activities does not use the standard federal accounting classification structure. Because of these deficiencies, IRS's general ledger system does not conform to the *U.S. Government Standard General Ledger* (SGL) as required by the *Core Financial System Requirements* of the Joint Financial Management Improvement Program (JFMIP)[9] or the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA). In its Management Discussion and Analysis, IRS discusses its plans to implement a single, integrated general ledger that will be fully compliant with FFMIA.[10] However, it is unclear when this will be accomplished, and thus when IRS will have a functional general ledger that is fully compliant with FFMIA, including being supported by detailed subsidiary records for its administrative and custodial accounts.

[8]GAO-02-414.

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

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

Also, during fiscal year 2002, IRS did not always timely record material transactions in its general ledger. As a result, affected balances were not always current and accurate on an ongoing basis. In fiscal year 2002, IRS implemented procedures to more timely record material activity, such as quarterly recording of property and equipment acquisitions and related depreciation and monthly recognition of imputed financing costs, which have significantly improved the reliability of related balances during the year. However, IRS did not record accruals to recognize nonpayroll-related expenses, such as rent and utilities, during the year. As a result, transactions totaling more than \$156 million and more than \$95 million remained in IRS's suspense account as of March 31 and June 30, respectively.[11] Thus, affected accounts in IRS's general ledger continued to be materially misstated during the year. At interim periods, these problems also resulted in the understatement of the cost of IRS's operations and outlays in the Statements of Net Cost and Budgetary Resources, respectively. Additionally, as discussed in the material weakness over unpaid assessments, IRS requires months of effort and compensating procedures to produce a balance for taxes receivable, the single largest item on its balance sheet. This number is only derived on an annual basis.

During fiscal year 2002, IRS continued to be unable to determine the specific amount of revenue it actually collects for three of the federal government's four largest revenue sources—Social Security, hospital insurance, and individual income taxes. In addition, IRS continued to be unable to determine, at the time payments are received, collections for the Highway Trust Fund or other trust funds that receive excise tax receipts. This is primarily because the accounting information needed to validate the taxpayer's liability and record the payment to the proper trust fund is provided on the tax return, which is received months after the payment is submitted. Further, the information on the tax return pertains only to the amount of the tax liability, not to how to distribute the amount previously collected among the appropriate trust funds. IRS does not require taxpayers to submit information identifying the type of tax at the time of payment because it believes that imposing such a requirement would create an additional burden to taxpayers. In addition, IRS's systems cannot

[11]Suspense accounts are used to temporarily recognize certain transactions until sufficient information is available to determine their appropriate permanent account classification. As of September 30, 2002, IRS recorded estimated nonpayroll expenses and in the process, reduced the suspense balance to an immaterial amount by analyzing its content and reclassifying most of it to the appropriate permanent accounts. However, IRS did not perform this process during the year.

presently capture and report such information routinely. IRS is working on systems improvements to accommodate this type of information. IRS will continue to be unable to timely report the specific amount of revenue it actually collects for these large revenue sources until it has the systems capability to record, and requires taxpayers to provide, this information. This condition also makes the federal government rely on a complex, multistep process to distribute excise taxes to the recipient trust funds that continues to be susceptible to error.

During fiscal year 2002, IRS continued to lack a cost accounting system (1) capable of accurately and timely tracking and reporting the costs of IRS's programs and projects to assist it in managing its costs and (2) meeting the JFMIP *Systems Requirements for Managerial Cost Accounting*.[12] This condition also renders IRS unable to produce reliable cost-based performance information. IRS officials have indicated that IRS's records contain information necessary to enable them to determine the cost of various activities, such as conducting investigations. However, this information is widely distributed among a variety of information systems, which are not linked and therefore cannot share data. This makes the accumulation of cost information time consuming, labor intensive, and not readily available as a tool to manage costs. For example, IRS has a variety of workload management systems that staff in different units use to track how their time is spent on specific tasks. However, these systems are not integrated with IRS's general ledger or each other to allow IRS to readily identify and accumulate the total costs for time spent by all units involved in any specific activity. In addition, IRS's workload management systems are not designed to track certain material forms of nonpersonnel costs by project and subproject, such as equipment depreciation, rent, and utilities.

Without a cost accounting system to centrally accumulate, organize, and timely report cost data in a format that meets management's current needs, such information is not readily available for use by managers to aid in routinely managing costs and in decision making. Instead, IRS often finds it necessary to conduct special research efforts tailored to determine the cost of a specific task or project. In its Management Discussion and Analysis, IRS stated that the new cost management system, which includes a cost accounting module, is scheduled for deployment on October 1, 2003. IRS

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

expects this system to provide and reliably report cost information that it can use to manage its operations.

As a result of these pervasive financial reporting weaknesses, IRS was compelled to expend far more time and effort to maintain its accounting records and generate financial management information than would otherwise have been necessary, and despite these monumental efforts, continued to lack current, reliable financial information available to assist in managing operations throughout fiscal year 2002. During fiscal year 2002, as part of its strategic planning process, IRS conducted a comprehensive assessment of its strategic priorities. A major goal of this exercise was to prioritize IRS's programs relative to its mission in light of its available resources. IRS is using the outcome of this process as a basis for resource allocation decisions intended to reduce the difference between the aggregate amount of taxes assessed by federal tax laws in any given year and the amount that is paid voluntarily and timely (known as the tax gap). This initiative represents a major step forward in IRS's efforts to ensure that it is utilizing its resources as efficiently and effectively as possible. Addressing the financial reporting deficiencies discussed above would enhance this process by providing sound, reliable, and timely information to assist in evaluating the impact of these decisions in terms of both the costs incurred and the benefits derived.

Unpaid Tax Assessments

During fiscal year 2002, we continued to find serious internal control issues that affected IRS's management of unpaid assessments. Specifically, we found (1) IRS continued to lack a subsidiary ledger for unpaid assessments that would allow it to produce timely and useful information with which to manage and report externally and (2) errors and delays in recording taxpayer information, payments, and other activities that continued to hinder IRS's ability to effectively manage its unpaid assessments.[13]

[13]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, 2002, IRS reported $20 billion (net of an allowance for doubtful accounts of $67 billion), $25 billion, and $137 billion in these three categories, respectively.

IRS's management of unpaid assessments is hindered by a lack of effective supporting systems. IRS lacks a detailed listing, or subsidiary ledger, that tracks and accumulates unpaid assessments and their status on an ongoing basis. As a result, IRS must rely on a costly, labor-intensive manual compensating process for external reporting. Specifically, to report balances for taxes receivable and other unpaid assessments in its financial statements and supplemental information, IRS must apply statistical sampling and projection techniques to data in its master files[14] to estimate the balances at year end. While refinements were made to this process during fiscal year 2002, it continued to take several months to complete, required adjustments totaling tens of billions of dollars, and produced amounts that were only reliable as of the last day of the fiscal year. Consequently, this information is not useful for ongoing management decisions. In addition, the lack of a subsidiary ledger renders IRS unable to timely develop reliable financial and management reports and promptly identify and focus collection efforts on accounts most likely to prove collectible.

IRS's management of unpaid assessments also continued to be hindered by inaccurate tax records. We continued to find errors and omissions in taxpayer records resulting from IRS's failure to accurately and timely record information. As in prior years, the most prevalent errors we found involved IRS's failure to record payments to all related taxpayers associated with unpaid payroll taxes.[15] IRS's current systems continued to be unable to automatically link each of the multiple assessments made for the one tax liability. Consequently, if the business or an officer pays some or all of the outstanding taxes, IRS's systems are unable to automatically reflect the payment as a reduction in the related account or accounts. In reviewing unpaid payroll tax cases where one or more individuals were assessed a trust fund recovery penalty, we found 23 cases in which

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

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

payments were not recorded in all related taxpayer accounts. We are 95 percent confident that the error rate in the population could be as high as 20 percent. IRS has recognized the seriousness of this issue and has attempted to compensate for the lack of an automated link between related accounts by manually inputting a code in each account that cross-references it to other related accounts. However, our work in fiscal year 2002 indicates that this compensating control has not been fully effective: of the 23 cases with unrecorded payments, 21 had the manual cross-references and in 9 of those cases, the unposted payments were made after the cross-references had been added to the accounts.

We found other errors in taxpayer accounts that were caused by IRS input errors. For example, in two different cases involving the estates of deceased taxpayers, IRS erroneously input the deceased taxpayer's date of birth as the date of death. This input error caused the IRS system to automatically generate interest and penalties of almost $50 million in one case and $1.8 million in another. IRS sent out tax notifications to both estates and, at the time of our testing, these amounts were recorded as valid unpaid tax assessments. Delays and errors in recording activity in taxpayer accounts complicate IRS's efforts to derive a reliable balance for taxes receivable and other unpaid assessments for its financial statements and other accompanying information. Additionally, failure to record payments and other activity timely could result in a burden on taxpayers, including having enforcement actions taken against them for taxes they do not owe or that have already been paid.

We have reported on these issues in previous audits.[16] IRS has acknowledged the seriousness of these issues and continues to take remedial steps to address their impact. For example, IRS has convened a task group to design an automated trust fund recovery penalty system that can properly cross-reference payments received and thus eliminate the opportunity for errors that plague the current manual process. However, the ultimate solution to many of these issues continues to be the successful modernization of IRS's systems, which IRS acknowledges will take several years to complete.

[16]GAO-02-414.

Tax Revenue and Refunds

During fiscal year 2002, we continued to find that IRS's controls were not fully effective in maximizing the government's ability to collect what is owed and in minimizing the risk of payment of improper refunds. IRS recognized this in its fiscal year 2002 Federal Managers' Financial Integrity Act (FIA) assurance statement to the Treasury, in which it reported a material weakness in Earned Income Tax Credit (EITC) noncompliance. IRS's taxpayer compliance programs identify billions of dollars of potentially underreported taxes and invalid EITCs each year. However, due in large part to perceived resource constraints, IRS selects only a portion of the questionable cases it identifies for follow-up investigation and action. In addition, IRS often does not initiate follow-up on the cases it selects until months after the related tax returns have been filed and any related refunds disbursed, affecting its chances of collecting amounts due on these cases. Consequently, the federal government is exposed to potentially significant losses from reduced revenue and disbursements of improper refunds.

The options available to IRS in its efforts to identify and pursue the correct amount of taxes owed and to ensure that only valid refunds are disbursed continue to be limited. For example, third-party information such as form 1099s[17] that can corroborate the amount of income reported by taxpayers are not required to be filed until after the start of the tax filing season.[18] Consequently, comparison of such information with tax return data is problematic because IRS does not have time to prepare the third-party data for matching prior to the receipt of individual tax returns. Additionally, while it processes hundreds of millions of tax returns each filing season, IRS must issue refunds within statutory time constraints or be subject to interest charges.[19]

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

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

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

IRS has some preventive controls that help to reduce the magnitude of underreported taxes owed and improper refunds issued. For example, IRS's Examination Branch is responsible for performing examinations on tax returns with potentially invalid EITC claims[20] to determine the validity of the claim. When performed before refunds are disbursed, these examinations are an important control to prevent disbursement of improper refunds. However, these examinations are often performed after any related refunds are disbursed, which reduces their effectiveness as a preventive control. In February 2002, IRS estimated that of about $31.3 billion in EITC claims filed by taxpayers for tax year 1999, at least $8.5 billion (27 percent) should not have been paid.[21] Of this amount, only $1.2 billion (14 percent) was either recovered or expected to be recovered through compliance efforts. The dollar amount of improper refunds disbursed related to these invalid EITCs is unknown. However, based on the fiscal year 2000 refund rate, which was about 84 percent,[22] IRS may have disbursed about $7.1 billion in EITC-related improper refunds in tax year 1999, of which about $6.1 billion (86 percent) may never be recovered. The full magnitude of improper refunds disbursed annually due to invalid EITCs is unknown.

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

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

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

Due to time and other constraints, IRS relies extensively on detective controls, such as automated matching of returns with third-party data such as W-2s (wage and tax statements) to identify for collection underreported taxes and improper refunds. However, these programs are not run until months after the returns have been filed. As a result, they are used too late to prevent improper refunds from being disbursed. In addition, although IRS's matching program for individual tax returns identifies billions of dollars of potentially underreported taxes each year, IRS only follows up on a portion of these cases to determine how much tax is actually due and to pursue collection of those amounts. For example, for tax year 2000,[23] IRS's matching program for individuals identified 16.2 million individual tax returns with potential underreported taxes totaling $19.2 billion. IRS investigated 3 million (18.5 percent) of these returns accounting for about $9 billion (47 percent) of the total potential underreported taxes. There are factors that affect IRS's ability to accelerate the timing of its automated matches, such as the limitations of its current automated systems and the timing of filing requirements for preparers of third-party documents, which are beyond IRS's control. Nonetheless, the information from IRS's automated matching program suggests that a substantial amount of additional revenue might be realized if additional resources were devoted to follow-up efforts. At present, billions of dollars in underreported taxes could remain uncollected and improper refunds could be disbursed. This, in turn, could further erode taxpayer confidence in the equity of the tax system and reduce compliance with the tax laws.

Property and Equipment

In fiscal year 2001, we reported that material weaknesses in IRS's property and equipment (P&E) systems and controls prevented it from having (1) current, reliable P&E information available on an ongoing basis and (2) reasonable assurance that its assets were properly safeguarded and used only in accordance with management policy.[24] During fiscal year 2002, IRS continued efforts to compensate for these longstanding deficiencies in systems and controls over its P&E. Specifically, IRS implemented procedures to improve the (1) timeliness of recording P&E transactions in accounting records and (2) accuracy and reliability of its P&E inventory

[23]Individual tax returns are not due until April 15 of the following year (up to October 15 if extensions are filed), and the underreporter screening programs cannot be run until after the returns are filed. Consequently, tax year 2000 is the most recently completed tax year for which the cited data are available.

[24]GAO-02-414.

records. Nonetheless, fundamental deficiencies in IRS's financial management system continued to exist, which precluded IRS from having ongoing information on its balance of P&E and assurance that its assets were properly safeguarded. However, through the use of compensating procedures, IRS was able to report a balance for P&E on its financial statements at September 30, 2002, that was fairly stated in all material respects. IRS has reported a material weakness in its controls over P&E in its FIA assurance statement to Treasury every year since 1983.

As we previously reported, IRS does not have an integrated property management system that appropriately records P&E additions and disposals as they occur and links costs on the accounting records to property records. Instead, IRS expenses property purchases as they occur, and then later extracts the costs of property acquisitions from operating expenses and records adjustments to remove property purchases from expenses and capitalize them as P&E. Consequently, IRS does not have reliable P&E data available on an ongoing basis that it can use to make operational decisions related to the acquisition and use of P&E, and its property management system does not provide timely and reliable information to facilitate the preparation of financial statements.

In fiscal year 2002, IRS improved the timeliness of extracting and recording P&E financial information. Beginning in mid-fiscal year 2002, IRS was able to produce, with contractor assistance, P&E information within a few weeks after the end of the quarter. This is a significant improvement over fiscal year 2001, when reliable P&E information was not available until 3 months after the end of the fiscal year. Although IRS was able to produce P&E financial information on a more timely basis in fiscal year 2002, the fundamental deficiencies in its property management system remain. IRS did not properly record P&E transactions in P&E accounts as they occurred, and it was necessary for IRS to hire a contractor to extract, analyze, and compile the data needed to report a reliable P&E balance. In addition, IRS could not always link the property acquisitions eventually recorded on IRS's accounting records to assets recorded on IRS's property records. In transactions selected from IRS's accounting records that we tested, some or all of the assets acquired could not be linked to inventory records.[25] For example, one of the transactions we tested was for the purchase of 39 desktop computers. IRS had recorded this transaction in the

[25]Each transaction can involve multiple assets.

accounting records in November 2001 but had not recorded 38 of the 39 computers on the inventory records as of September 2002.

Accurate records are essential for maintaining control over P&E to ensure that assets are properly accounted for and safeguarded. In prior years, we reported that IRS's procedures for recording P&E transactions in its inventory records were not effective in ensuring that acquisitions, disposals, and transfers were promptly and accurately recorded in its P&E inventory records. In fiscal year 2002, IRS made a concerted effort to improve procedures and practices used to account for its assets. Our testing indicates that IRS continued to make significant progress on this issue, but that nonetheless, transactions were not always promptly and accurately recorded. Specifically, we found that 22 of 220 P&E items, including computers and printers, selected at 22 sites could not be located at the time of our review.[26] Based on our work, we estimate that 10 percent of the items in IRS's P&E inventory records were erroneously included as assets.[27] This year, however, we found that the majority of the errors we identified in our sample were attributable to a system limitation. Specifically, 16 of the 22 assets we could not locate had been disposed of, but the inventory records had not been updated to reflect these disposals due to a system problem that prevented personnel responsible for updating the inventory records for disposals from having access to the records. At the time of our testing, IRS was aware of the system problem and had identified 13 of the 16 disposed item records for review but had not yet corrected its inventory records. Despite these findings, we believe IRS is making clear progress in improving accountability over P&E. For example, in our fiscal year 2001 audit, we estimated that 12 percent of the items in IRS's P&E inventory records were erroneously included as assets,[28] and the reasons for the errors we identified last year were not primarily attributable to a single cause. Additionally, individual sites we tested showed significant improvement over previous years: at one location where we found that 5 of 10 assets we tested in fiscal year 2001 could not be located, all 10 assets we tested were accounted for in fiscal year 2002.

[26]For our book-to-floor sample, we obtained a sample of P&E items with a two-stage cluster sample. In the first stage, we selected a sample of 22 buildings. In the second stage, we selected a sample of 10 assets located at each of the 22 buildings from IRS's asset records.

[27]We are 95 percent confident that the error rate does not exceed 18 percent.

[28]In our fiscal year 2001 audit, we were 95 percent confident that the error rate did not exceed 20 percent.

While further improvements are needed, there has been notable progress made on this issue.

During our fiscal year 2001 audit, we found that IRS's property management system did not capture information, such as licenser, contract period, and number of authorized users, essential to ensure that software and software licenses were controlled and utilized only in accordance with software license contracts. In fiscal year 2002, IRS initiated a process to identify and record software licenses and began developing an action plan that will set policies and procedures for review of and compliance with the terms of the licenses. However, as of the completion of our fieldwork, IRS had not completed this effort, and as a result continued to lack an inventory record system that captured information essential to ensure that software and software licenses were properly controlled and used only in accordance with license agreements.

Although we determined through detailed tests of transactions and analyses that IRS's reported September 30, 2002, P&E balance was fairly stated, longstanding weaknesses in IRS's property and accounting systems continue to affect IRS's ability to account for its property and report a reliable P&E balance on an ongoing basis. These weaknesses will continue to exist until IRS has an integrated accounting and property system. In March 2005, IRS plans to acquire and install an asset management module to the integrated financial system. According to IRS, the system will be capable of recording P&E as assets when purchased and generating detailed records for P&E that reconcile to the financial records.

Computer Security

IRS relies extensively on computer information systems to perform basic functions, such as processing tax returns and payments, maintaining sensitive taxpayer data, calculating interest and penalties, and generating refunds. Although IRS has corrected or mitigated many of the computer security weaknesses identified in our previous reports, much remains to be done to resolve the significant control weaknesses that continue to exist within IRS's computing environment and to be able to promptly address new security threats and risks as they emerge. Such weaknesses can impair the agency's ability to perform vital functions, and can increase the risk of unauthorized disclosure, modification, or destruction of taxpayer data.

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

However, IRS continued to have serious weaknesses in fiscal year 2002 with computer controls designed to protect computing resources such as networks, computer equipment, software programs, data, and facilities from unauthorized use, modification, loss, and disclosure. For example, IRS did not always effectively configure and implement computer systems in accordance with its computer security policies, monitor system configuration and implementation, and provide sufficient technical security-related training to key personnel. In addition, IRS has not taken sufficient steps to ensure that internal control deficiencies identified at one facility are considered and addressed at other facilities. The following examples illustrate the types of computer control weaknesses that affect IRS's financial and tax processing systems.

- IRS did not adequately restrict electronic access rights and permissions on its servers, network devices, and mainframe computers. Inappropriate access to sensitive files and directories can enable an intruder or user to gain unauthorized access to computing resources.

- IRS did not sufficiently segregate system administration functions on its servers from those related to security administration and system backup operations, thereby increasing the risk that system administrators could perform unauthorized system activities without detection.

- IRS did not securely control network services or configure system software to minimize the risk of unauthorized access to and ensure the integrity of system programs, files, and data. At one location, for example, IRS did not secure its network against known vulnerabilities or minimize the operational impact of a potential failure in a critical network device.

- IRS did not sufficiently plan or test the activities required to restore certain critical business systems when unexpected events occur. Disaster recovery plans for some systems lacked essential information to facilitate recovery operations and were not fully tested.

- IRS did not effectively monitor key systems and network devices to identify unauthorized activities. Computer logs often did not record key security-related events and pertinent data. Security specialists also did not routinely or fully examine logs for unauthorized activity or usage trends.

Collectively, these problems indicate material weaknesses in IRS's internal controls over information systems and data. These weaknesses decreased the reliability and increased the vulnerability of data processed by the systems. Until IRS can adequately mitigate these weaknesses, unauthorized individuals could gain access to critical hardware and software, and intentionally or inadvertently access, alter, or delete sensitive data or computer programs. Such individuals could also obtain personal taxpayer information and use it to commit financial crimes in the taxpayers' names (identity fraud), such as establishing credit and incurring debt.

Reportable Conditions

In addition to the material weaknesses discussed above, we identified two reportable conditions. These concern weaknesses in IRS's internal controls over budgetary activity, which we have reported as a material weakness in prior years, and weaknesses in internal controls over tax receipts and taxpayer information, which we have reported as a reportable condition in prior years.[29]

[29]GAO-02-414.

Budgetary Activity

In prior years, we identified serious internal control deficiencies that prevented IRS from ensuring that its budgetary authority[30] was routinely accounted for, reported, and controlled. Over the past several years, IRS has made considerable progress in addressing internal control deficiencies related to budgetary activity. In fiscal year 2002, we noted further improvements in IRS's controls and procedures that enhanced its ability to account for and report on the status of its budgetary resources. Specifically, IRS (1) improved its reviews of outstanding obligations and (2) performed more frequent analyses of certain general ledger accounts containing transactions incorrectly recorded as adjustments to prior years' obligations.[31] These further improvements allowed us to conclude that the remaining issues related to budgetary activity no longer constitute a material internal control weakness. However, IRS did not implement these improvements until after the first quarter of fiscal year 2002. Additionally, we continued to find that IRS recorded invalid transactions in its general ledger and instances in which IRS did not timely record obligations and expenditures.

Over the past several years, IRS has issued numerous policy memorandums and implemented procedures to deobligate funds[32] no longer required for a specific purpose. IRS's business units were required to review outstanding obligation reports on a quarterly basis and identify all obligations that were no longer active and thus would need to be deobligated. Beginning in the second quarter of fiscal year 2002, IRS improved its reviews of outstanding obligations by (1) providing specific guidelines to the business units that performed the reviews, (2) requiring the business units to perform monthly reviews, and (3) providing more relevant and timely information on the outstanding obligation reports to assist the business units in their reviews. IRS's improvements to its reviews of outstanding obligations enabled it to identify on a more timely basis obligated funds that could be deobligated

[30]Budgetary authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds.

[31]An adjustment to a prior year's obligation is recorded when the dollar amount previously recorded is affected by a subsequent event, such as a change in the price of goods or services.

[32]Deobligations are downward adjustments of previously recorded obligations. Deobligations can occur for a variety of reasons, such as if the actual expense was less than the amount obligated, a project or contract was cancelled, an initial obligation was determined to be invalid, or previously recorded estimates were reduced.

and made available for future or existing obligations, thus improving its management of budgetary resources.

IRS's accounting system records all adjustments that affect a prior year's appropriation, including those that do not affect the obligated amount, as adjustments to prior years' obligations. Many of the activities recorded as adjustments to prior years' obligations are related to changes in accounting codes, travel, and adjustments to doubtful accounts and are thus not valid adjustments to prior years' obligations. For example, IRS records a change in an internal accounting code as a new obligation and erroneously adjusts the original obligation downward, thereby misstating its reported level of adjustments to obligations.

To identify valid adjustments to prior years' obligations, IRS manually analyzes the adjustment activity recorded in its accounting system. IRS then uses the results of this analysis to record adjusting entries to the applicable general ledger accounts. For fiscal year 2002, this analysis resulted in IRS making correcting entries to remove $1.2 billion of invalid transactions from the $1.4 billion balance of adjustments to prior year obligations in its general ledger. In prior years, IRS only performed this analysis at fiscal year end to prevent its financial statements from being misstated. This enabled the year-end financial statements to be correct, but did not address the impact of these errors on interim internal and external reporting. Beginning in mid-fiscal year 2002, however, IRS began performing these procedures on a quarterly basis.

By increasing the frequency of its analysis of adjustment activity, IRS improved the reliability of budgetary information it submits to OMB on a quarterly basis through its SF133 *Report on Budget Execution and Budgetary Resources*.[33] However, IRS's compensating procedures only produce reliable adjustment balances for the specific date covered by the analysis. Thus, the existing deficiency in IRS's accounting system with respect to recording adjustments to prior years' obligations prevents IRS from having accurate and reliable information on budgetary resources and obligations on an ongoing basis. IRS plans to acquire and install, in fiscal year 2004, an integrated financial system with the capability to differentiate between activities that are and are not valid adjustments to prior years' obligations.

[33]OMB requires that each agency submit SF133s on a quarterly basis to report on each agency's budget execution as well as the status of its budgetary resources.

In prior audits, we found instances in which IRS received goods and services during one fiscal year but did not record the applicable expenditure to reduce the undelivered orders balance in its accounting system until the following fiscal year. This resulted in IRS overstating its balance of undelivered orders and understating its accrued expenses. During fiscal year 2001, IRS developed a methodology to more reasonably accrue expenditures at year end and thus recognize the associated reduction in the balance of undelivered orders. By applying this methodology, IRS was able to report reliable amounts for undelivered orders and accrued expenses on its fiscal-year-end financial statements. However, IRS's balances of undelivered orders, expenses, and capital expenditures were not accurate throughout fiscal year 2002 because of delays in recording expenditures. Specifically, in our testing of undelivered orders, we identified instances in which IRS took more than 30 days from the date it accepted the goods or services to record the applicable expenditure in its accounting system. For example, in one instance, IRS received telecommunication services that covered the month of November 2001, at a cost of $1.4 million. However, IRS did not record the associated expenditure in its accounting system until June 7, 2002—more than 6 months after the services were provided. Untimely recording of expenditures affects IRS's ability to efficiently manage its budgetary resources by delaying the identification of obligated funds that (1) are insufficient to cover the expenditure or (2) exceed amounts owed and thus can be deobligated and made available for future or other existing obligations.

We also found that IRS continued to experience delays in recording obligations in its accounting system during fiscal year 2002. In our testing of undelivered orders, we found instances in which IRS took more than 30 days from the date the obligation document was established to record the obligated amount in its accounting system and instances in which IRS incurred costs prior to recording the obligation in its accounting system. For example, in one instance, IRS established an obligation on October 1, 2001, for armed security guard services totaling $366,000. However, IRS did not record the obligation in its accounting system until April 22, 2002—more than 6 months after the obligation was established. In another instance, IRS received office equipment on October 9, 2001, at a cost of $154,000. However, IRS did not generate the initial obligating document to establish the obligation of funds until March 18, 2002, and recorded the obligation in its accounting system on March 28, 2002—more than 5 months after the equipment was received.

Delays in recording obligations affect the reliability of IRS's financial records used to track the status of its budgetary resources for day-to-day decision making. Until the obligation of funds is recorded, obligations reflected in IRS's accounting system will be understated. Understatement of obligations could lead IRS management to believe that the agency has more funding than is actually available. Consequently, IRS management and staff might enter into obligations that exceed the budgetary authority made available by Congress.

Hard-Copy Tax Receipts and Taxpayer Information

IRS manually processes tax receipts and taxpayer information at its service center campuses and field offices. In addition, commercial lockbox banks, operating under contract with Treasury's Financial Management Service, process tax receipts and taxpayer information on behalf of IRS. During fiscal year 2002, IRS's controls over cash, checks, and related hard-copy taxpayer data it received from taxpayers continued to be inadequate to sufficiently limit the risk of theft, loss, or misuse of such funds and data. Recognizing its responsibility to protect taxpayer information and receipts, IRS has taken action in the past several years to address a number of its internal control deficiencies. For example, to improve the safeguarding of taxpayer receipts and data, IRS began conducting periodic security reviews of receipt processing areas, implemented many of its new hiring and courier standards, and updated policies and procedures. In fiscal year 2002, IRS issued the Lockbox Processing Guidelines to improve the safeguarding of taxpayer receipts and data at lockbox facilities. Nonetheless, internal control deficiencies remain, primarily because of inconsistencies in the establishment and implementation of, and compliance with, these policies at IRS service center campuses, field offices, and commercial lockbox banks.

We previously reported that IRS was hiring individuals and allowing them access to cash, checks, and other taxpayer data before it had received satisfactory results of their fingerprint checks.[34] Since establishing a policy prohibiting new hires from entering on duty in any IRS offices until their fingerprint checks are completed, IRS has worked aggressively to enforce this policy and continued to make substantial progress in this area in fiscal year 2002. As a result, IRS has significantly reduced its exposure related to this issue.

[34] GAO-02-414.

We previously reported on weaknesses in internal controls to deter unauthorized access to receipt processing areas.[35] In fiscal year 2002, we continued to find significant security access issues at field offices and lockbox banks, as well as at one of the two service center campuses we visited. For example, IRS policy requires that all perimeter doors be equipped with locks and alarms and that the doors must be locked and alarms set. At lockbox sites, we found one perimeter door unlocked, one without an alarm, and one where the alarm was not sufficiently audible. Guards also failed to respond when we activated the perimeter door alarms in two instances at a lockbox site and in one instance each at a field office and a service center campus. The building perimeter is the first line of defense in the effort to prevent unauthorized access to receipt processing areas. We also found other weaknesses in physical security at the service center campus, such as a door to a receipts-processing area with a broken lock that could be opened by an unauthorized individual, and a door with a cipher lock that we were able to open because it had not been properly closed. At field offices, we found that taxpayers visiting the taxpayer assistance centers to make tax payments or obtain assistance with tax questions could gain access to areas of the centers that are restricted to authorized IRS personnel handling tax receipts and taxpayer information. We further found that employees at IRS field offices had, or could have, access to certain areas where tax receipts and taxpayer information are handled, regardless of their need for access.

We continued to find other weaknesses and inconsistencies in controls over taxpayer receipts and taxpayer data at service center campuses, field offices, and lockboxes that have not been adequately addressed. For example, we continued to find receipts stored in open, unlocked containers, contrary to IRS policy. Another IRS policy limits personal belongings that each worker can bring into receipt processing areas to small items that can fit into a clear plastic bag, and specifically prohibits large items such as purses and backpacks in which taxpayer receipts could be concealed. However, we found that at one service center campus personal items were allowed in clear plastic bags of various sizes, with many of the bags containing so many items that not all of the items could be identified through the bag. In addition, at the same service center campus, we found that employees carried CD cases, newspapers, and

[35]U.S. General Accounting Office, *Internal Revenue Service: Progress Made, but Further Actions Needed to Improve Financial Management*, GAO-02-35 (Washington, D.C.: Oct. 19, 2001).

magazines in the clear plastic bags—all objects in which taxpayer receipts could be easily concealed. At another service center campus, we noticed an employee leaving the processing area with a plastic bag that was not clear. At a field office, we found that employees were allowed to store personal belongings with taxpayer receipts and official receipt certificate vouchers in desk drawers or cabinets. Additionally, at four lockbox sites we visited, we were able to bring purses and fanny packs into processing areas, and at several lockbox sites we saw employees wearing bulky clothing or bring in personal belongings, such as gift bags and purses.

We previously reported that checks made payable to "IRS" could easily be altered and cashed and that returned refund checks were highly susceptible to theft.[36] At field offices we visited during fiscal year 2002, we continued to find that checks were not overstamped with "United States Treasury," and we continued to find instances at service center campuses, field offices, and lockbox sites where returned refund checks were not restrictively endorsed at the point of extraction.

We previously recommended that IRS develop policies and procedures to reconcile logs of payments found during final candling to the related receipts and documents.[37] During fiscal year 2002, we continued to find that discovered items were not reconciled at both of the service center campuses we visited and at two lockbox sites. At service center campuses, we also found that discovered items were not immediately recorded and that personnel who had overlooked items during candling were not always identified.

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

[37]U.S. General Accounting Office, *Internal Revenue Service: Status of Recommendations from Financial Audits and Related Financial Management Reports*, GAO-02-848 (Washington, D.C.: July 30, 2002). Candling is a process that uses a light source to determine if any contents remain in the open envelopes before their destruction.

IRS procedures require that emptied envelopes be candled twice, and the lockbox processing guidelines have this same requirement. Yet during fiscal year 2002, we found instances at both service center campuses and at lockbox sites where candling that should have been performed twice was performed only once. Furthermore, at one service center campus, we found that a single employee was performing final candling in a closed room, thereby increasing the possibility of theft or destruction of discovered remittances.[38] *Standards for Internal Control in the Federal Government* requires agencies to establish physical controls to secure and safeguard vulnerable assets.[39]

IRS has made an effort to address courier security weaknesses by adopting more stringent security standards for couriers who transport IRS's daily deposits to depository institutions. However, IRS did not have effective controls in place to ensure that the contract requirements were enforced. In fiscal year 2002, we found that at one of the two IRS service center campuses we visited, IRS failed to assure itself that the courier service had met the insurance coverage requirements or that the courier service employees had passed the required limited background investigation. In fact, the courier service had failed to meet the insurance coverage requirements, and IRS had performed no limited background investigation of courier service employees. At a lockbox site, management of the site had authorized three couriers to start transporting daily deposits prior to receipt of their fingerprint check results.

Furthermore, we noted differing requirements for couriers depending on whether the couriers are operating at IRS's own service center campuses or at contractor-operated lockbox banks, even though all couriers are entrusted with daily deposits. For example, at lockbox banks, pursuant to the Lockbox Processing Guidelines, couriers are only required to have a fingerprint check. Requirements also differed among the service center campuses: at the five service center campuses where couriers are under IRS-negotiated contracts, they are required to have a background investigation and a fingerprint check; at the other five service center campuses, the couriers operate under FMS-negotiated contracts and are

[38]Discovered remittances are cash or checks that were erroneously overlooked during the extraction process.

[39]U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: Nov. 1999).

not required to have either a background investigation or a fingerprint check.

These weaknesses increase IRS's vulnerability to theft or loss and expose taxpayers to increased risk of losses from financial crimes committed by individuals who inappropriately gain access to confidential information entrusted to IRS. Thus, it is important that IRS continue to work to effectively address these matters because they are critical to IRS successfully meeting its customer service goals.

Compliance Issues

Our tests of compliance with selected provisions of laws and regulations disclosed two areas of noncompliance that are reportable under U.S. generally accepted government auditing standards and OMB guidance. These relate to the release of federal tax liens against taxpayers' property and the structure of installment agreements IRS enters into with taxpayers to satisfy the taxpayer's outstanding tax liability. We also found that IRS's financial management systems do not substantially comply with the requirements of FFMIA.

Release of Federal Tax Liens

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

In previous audits, we found that IRS did not always release the applicable federal tax lien within 30 days of the tax liability being either paid off or abated as required by the Internal Revenue Code.[40] We found that this condition continued to exist in fiscal year 2002. Specifically, in our testing of 59 tax cases with liens in which the taxpayers' total outstanding tax liabilities were either paid off or abated during fiscal year 2002, we found 20 instances in which IRS did not release the applicable federal tax lien within the 30-day statutory requirement. The time between satisfaction of the liability and release of the lien ranged from 46 to 1,263 days. For example, in one case we found that although the taxpayer satisfied the outstanding tax liability in April 2000, IRS did not formally release the lien against the taxpayer's property until November of the following year—578 days later. Based on the results of our work, we estimate that for 34 percent of unpaid tax assessment cases where IRS had filed a tax lien that were resolved in fiscal year 2002, IRS did not release the lien within the 30-day requirement.[41] The failure to promptly release tax liens could cause undue hardship and burden to taxpayers who are attempting to sell property or apply for commercial credit.

[40]GAO-02-414.

[41]We are 95 percent confident that the error rate could be as high as 44 percent. In our fiscal year 2001 audit, we found five instances of noncompliance. At that time, we estimated that for 8 percent of unpaid tax assessment cases where IRS had filed a tax lien that were resolved in that fiscal year, IRS did not release the lien within the 30-day requirement. We were 95 percent confident that the error rate could be as high as 19 percent.

Structuring of Installment Agreements

Section 6159 of the Internal Revenue Code authorizes IRS to enter into installment agreements with taxpayers to fully satisfy the taxpayer's tax liability. While our fiscal year 2001 audit did not identify instances of material noncompliance in a statistical sample of installment agreements,[42] audits for prior years showed that IRS had not always structured installment agreements to ensure that they would satisfy the taxpayer's outstanding tax liability, including future interest accruals, before the statutory collection period for the tax liability expired.[43]

During our fiscal year 2002 financial audit, we again found that installment agreements were not always structured to provide for full payment of the tax liability. Specifically, in our testing of 59 installment agreements, we found 4 instances in which the terms of the installment agreements did not require full satisfaction of the tax liability. Based on the results of our work, we estimate that nearly 7 percent of new installment agreements entered into during fiscal year 2002 had payment terms that would not fully satisfy the tax liability within the statutory collection period.[44] The presence of such cases in fiscal year 2002 indicates that IRS was not in compliance with section 6159 of the Internal Revenue Code.

Financial Management Systems' Noncompliance with FFMIA

In fiscal year 2002, we continued to find that IRS's financial management systems did not substantially comply with the requirements of FFMIA. Specifically, IRS's systems did not comply with Federal Financial Management Systems Requirements (FFMSR), federal accounting standards (U.S. generally accepted accounting principles), and the *U.S. Government Standard General Ledger* (SGL) at the transaction level. We found that IRS (1) cannot rely on information from its general ledger to prepare its financial statements, (2) does not have a general ledger that

[42]In last year's audit, we found that based on a statistical sample of 59 installment agreements IRS entered into with taxpayers during fiscal year 2001, we were 95 percent confident that the rate of occurrence of installment agreements entered into during fiscal year 2001 whose terms did not require full satisfaction of the tax liability did not exceed 5 percent. However, we also pointed out that this did not mean that all installment agreements IRS had entered into with taxpayers were structured to provide for full satisfaction of the tax liability.

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

[44] We are 95 percent confident that the error rate could be as high as 15 percent.

conforms to the SGL, (3) lacks a subsidiary ledger for its unpaid assessments, (4) lacks a reliable subsidiary ledger for its P&E, and (5) lacks an effective audit trail from its general ledger back to subsidiary detailed records and transaction source documents for material balances. Other material weaknesses we discussed earlier—controls over unpaid assessments, federal tax revenue and refunds, P&E, and computer security—are also conditions indicating that IRS's systems do not substantially comply with the requirements of FFMIA.

As a result, IRS's financial management systems cannot produce auditable financial statements and related disclosures that conform with U.S. generally accepted accounting principles without substantial compensating processes and significant adjustments. These weaknesses also indicate that IRS's systems cannot routinely accumulate and report the full cost of its activities. Since IRS's systems do not comply with FFMSR, U.S. generally accepted accounting principles, and the SGL, they also do not comply with OMB Circular A-127, *Financial Management Systems*. In its FIA assurance statement to Treasury, IRS reported that its financial management systems did not substantially comply with the requirements of FFMIA in fiscal year 2002.

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

Details on Audit Methodology

To fulfill our responsibilities as the auditor of IRS's financial statements, we did the following:

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

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

- Evaluated the overall presentation of the financial statements.

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

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

- Considered the process for evaluating and reporting on internal controls and financial management systems under FIA.

- Tested compliance with selected provisions of the following laws and regulations: Anti-Deficiency Act, as amended (31 U.S.C. §1341(a)(1) and 31 U.S.C. §1517(a)); Agreements for payment of tax liability in installments (26 U.S.C. §6159); Purpose Statute (31 U.S.C. §1301); Release of lien or discharge of property (26 U.S.C. §6325); Interest on underpayment, nonpayment, or extensions of time for payment of tax (26 U.S.C. §6601); Interest on overpayments (26 U.S.C. §6611);

Determination of rate of interest (26 U.S.C. §6621); Failure to file tax return or to pay tax (26 U.S.C. §6651); Failure by individual to pay estimated income tax (26 U.S.C. §6654); Failure by corporation to pay estimated income tax (26 U.S.C. §6655); Prompt Payment Act (31 U.S.C. §3902 (a), (b), and (f), and 31 U.S.C. §3904); Fair Labor Standards Act of 1938, as amended (29 U.S.C. §206); Civil Service Retirement Act of 1930, as amended (5 U.S.C. §§5332, 5343); Federal Employees' Retirement System Act of 1986, as amended (5 U.S.C. §§8422 and 8423); Social Security Act, as amended (26 U.S.C. §§3101 and 3121, and 42 U.S.C. §430); and Federal Employees Health Benefits Act of 1959, as amended (5 U.S.C. §§8905, 8906, and 8909).

- Tested whether IRS's financial management systems substantially comply with the three FFMIA requirements.

Comments from the Internal Revenue Service

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

COMMISSIONER

November 7, 2002

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

Dear Mr. Walker:

Fiscal Year 2002 was a landmark year for Federal financial management at the IRS. We are pleased that your draft report titled, *Financial Audit: IRS' Fiscal Years 2002 and 2001 Financial Statements*, so fairly presents both our progress and our remaining challenges. For the third consecutive year, we achieved an unqualified audit opinion for the annual financial statements. Doing so demonstrates to the public that we can properly and consistently account for approximately $2 trillion in revenue receipts, $281 billion in refunds, and $10 billion in appropriated funds.

We wish to recognize the GAO's dedication and cooperation throughout this audit process. We appreciate the excellent counsel and support the auditors provided to us. As you noted in your report, in addition to maintaining our unqualified audit opinion, we met the significant challenge set by the Secretary of the Treasury of completing the FY 2002 audit by November 15, 2002, six weeks after the end of the fiscal year and three and one half months earlier than last year. This was accomplished by making significant improvements in our financial management by reassessing and systematically changing how we process transactions, maintain financial records, and report financial results. Our success was also dependent upon the GAO's agreement to test transactions and balances at interim periods rather than conducting all testing at year-end. We appreciate your acknowledgement of the great strides we made in FY 2002 and your willingness to work with us to adapt the audit process to the accelerated schedule.

During the fiscal year, we instituted a number of financial management reforms and improvements, which contributed to our ability to retain the clean opinion and meet the accelerated reporting dates. Specifically, we:

- Implemented procedures to improve the timeliness and accuracy of recording Property and Equipment (P&E) transactions in our accounting records
- Capitalized property and equipment acquisitions at the end of each quarter
- Recorded imputed financing costs regularly

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- Enhanced our accountability over budgetary activity by increasing the frequency of our analyses of outstanding obligations and other budgetary accounts
- Improved our review of outstanding obligations and performed more frequent analyses of certain general ledger accounts
- Established formal organizations within the revenue and administrative activities to develop and update financial management policies and procedures
- Conducted a comprehensive assessment of our strategic initiatives to prioritize the programs relative to our mission and available resources
- Began the design of an automated Trust Fund Recovery Penalty system that can properly cross-reference payments and eliminate the opportunity for errors
- Revised our information technology security policy and guidance, updated security standards for several of our computing systems and devices, and improved certain physical security controls at our data processing facilities
- Began conducting periodic security reviews of receipt processing areas, implemented many of our new hiring and courier standards, and updated relevant policies and procedures to safeguard taxpayer receipts and data
- Issued Lockbox Processing Guidelines to improve the safeguarding of taxpayer receipts and data at lockbox facilities
- Established a Peer Review Program to ensure adequacy and compliance with internal access control guidelines
- Published guidance to all field offices to assure that a "controlled access environment" is implemented in every Taxpayer Assistance Center to the maximum extent possible within space and funding constraints

To further improve financial management, we took specific actions in FY 2002 to expedite the resolution of all IRS material weaknesses. The existing material weaknesses were reviewed by senior executives to identify the key issues requiring resolution. We determined and documented the actions necessary to resolve the issues. Where initial review indicated that long-term systems improvements were required, we reassessed to identify possible interim process solutions that would allow us to alleviate the materiality of the weakness while we waited for the long-term system fix. Expedited action plans were developed to resolve key issues for some material weaknesses and are being developed for three others. As a result, we reduced the number of material weaknesses from 14 to 9 and we plan to close at least three significantly earlier than previously planned. Work continues to expedite resolution of the others.

We also revised our Remediation Plans for Custodial and Administrative Financial Management Systems. We changed the format and content of the plans to better meet the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. The Remediation Plans are now aligned with our Material Weakness Plans and our Business System Modernization Plans. We included more intermediate target dates to help ensure we stay on schedule for bringing our systems into FFMIA compliance.

As a result, these Remediation Plans are a better tool for effectively managing the remedial action process.

We must now focus on ensuring financial management practices are institutionalized and our new Integrated Financial System (IFS) is implemented. As we pursue these two primary initiatives, it is worth noting that system modernization efforts will address almost one-third of the currently open audit recommendations. We are also aggressively planning other short-term actions that will further improve the accuracy and timeliness of our financial management information. As examples, we plan to:

- Evaluate and determine ways to provide more precise revenue data and streamline the audit approach for unpaid assessments
- Improve the timeliness of obligation transactions
- Develop and implement a methodology to accrue non-payroll expenditures at least quarterly
- Conduct reviews to assist offices in correctly implementing policies and procedures
- Participate in each Treasury Financial Management Service review of commercial lockbox banks to assess compliance with Lockbox Processing Guidelines
- Improve accountability over software licenses
- Continue the automation of the Trust Fund Recovery Penalty process

Though we are pleased with the balanced presentation of the progress, we continue to disagree with the GAO's assertion that "IRS management and staff might enter into obligations that exceed the budgetary authority made available by Congress." As we stated in our response to last year's report, we clearly have the capability to prevent this from happening and have never exceeded our budget authority. Once again, we ask the GAO to consider modifying this specific conclusion.

We concur with GAO's statement that fundamental deficiencies continue to exist in our property management system. We will reiterate our policy that all purchases of computer equipment must go through the Single Point Inventory Function first to be entered into the inventory database. During FY 2003, an interim process is being established to implement an electronic means of detecting computer equipment not in the inventory database. This should preclude the occurrence of situations similar to the one noted in your report concerning the 38 desktop computers not recorded in IRS' inventory records. Additionally, the GAO correctly identified disposal problems in this audit. We corrected the system problem identified in the report prior to the audit. However, there was not sufficient time after the certification activity ended and before the audit samples were extracted to correct the data. We provided the GAO with an exception report that listed the specific items. We will continue to refine the disposal process by providing Servicewide guidance on proper disposal procedures, ensuring that the property disposal database is properly updated, establishing a link to the procurement and financial systems, and tracking the deployment and usage of the site

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license via our automated processes. Full implementation and deployment of IFS will enable us to remedy all property-related issues.

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

Sincerely,

Bob Wenzel

Bob Wenzel
Acting Commissioner

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