



Testimony

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IRS OPERATIONS

Critical Need to Continue Improving Core Business Practices

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to provide an overall perspective on opportunities to improve the Internal Revenue Service's (IRS) business operations. Our reports and recent testimonies before this Committee extensively describe the substantial problems IRS has experienced in (1) fulfilling its business vision—reducing the volume of paper returns, better serving customers, and improving compliance, (2) overcoming management and technical weaknesses in its tax systems modernization (TSM) efforts, and (3) improving the reliability of its financial management and systems used to account for hundreds of billions of dollars and to measure IRS' performance.¹

Today, we will focus on pivotal actions that IRS should take to fully implement our recommendations and improve its management practices. These steps include:

- limiting funding for TSM to critical priorities;
- developing an effective implementation strategy for achieving IRS' business vision that includes an agreed upon set of performance measures, which is imperative to changing the way IRS operates and serves customers;
- developing the capacity to make sound investments in information technology, which will be heavily relied upon to achieve IRS' business strategy and measure performance;
- building the necessary technical foundation for TSM information systems projects, which will provide the overall blueprints for developing systems, and the disciplined processes needed for completing information systems projects timely and economically, and ensuring that information systems concepts are transformed into practical tools that perform as intended; and
- addressing serious and persistent financial management problems, which affect the credibility of financial information, such as over \$1 trillion in monies collected from American taxpayers and billions of dollars in delinquent taxes owed to the government.

¹Tax Systems Modernization: Management and Technical Weaknesses Must Be Overcome To Achieve Success (GAO/T-AIMD-96-75, March 26, 1996); Tax Systems Modernization: Progress in Achieving IRS' Business Vision (GAO/T-GGD-96-123, May 9, 1996); Letter to the Chairman, Committee on Governmental Affairs, U.S. Senate, on security weaknesses at IRS' Cyberfile Data Center (AIMD-96-85R, May 9, 1996); Financial Audit: Actions Needed to Improve IRS Financial Management (GAO/T-AIMD-96-96, June 6, 1996); Tax Systems Modernization: Actions Underway But IRS Has Not Yet Corrected Management and Technical Weaknesses (GAO/AIMD-96-106, June 7, 1996); Tax Systems Modernization: Cyberfile Project Was Poorly Planned and Managed (GAO/AIMD-96-140, August 26, 1996); and Internal Revenue Service: Business Operations Need Continued Improvement (GAO/AIMD/GGD-96-152, September 9, 1996).

We also will underscore the critical importance of follow-through by IRS, the Department of the Treasury, the Office of Management and Budget (OMB), and the Congress. Historically, IRS has not been highly responsive in fixing business operation problems and implementing our recommendations. Treasury, in particular, has become more active in oversight and, while that is a positive development, the department's continued focus on monitoring IRS' corrective actions will be a key factor in ensuring progress. OMB needs to emphasize its leadership and oversight roles in resolving these matters as well.

The Congress has legislatively established management tools it can use to closely monitor IRS' progress and hold IRS accountable for improving its business operations. These laws include the Chief Financial Officers Act of 1990; the Government Performance and Results Act of 1993; the Paperwork Reduction Act of 1995, as amended; and the Information Technology Management Reform Act of 1996.

Through this legislation, the Congress has provided an excellent framework for (1) overseeing IRS' efforts to improve its management operations and modernize tax processing with more effective technology and (2) measuring IRS' performance in meeting its business vision. In addition, the National Commission on Restructuring IRS, recently established by the Congress, will have a principal role over the next year in conducting a broad-based evaluation of IRS' operations and recommending changes to IRS' organizational structure, management practices, and operating procedures.

Limiting Funding for TSM to Critical Areas

In its May 6, 1996, status report on TSM to the Senate and House Appropriations Committees, Treasury candidly assessed TSM progress and future redirection. It described ongoing and planned actions intended to respond to our July 1995 recommendations to correct management and technical weaknesses.² It concluded that despite some qualified success, IRS had not made progress on TSM as planned because systems development efforts had taken longer than expected, cost more than originally estimated, and delivered less functionality than originally envisioned. It further stated that significant changes were needed in IRS' management approach and that IRS did not currently have the capability to develop and integrate TSM without expanded use of external expertise.

²Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995).

As detailed in our recent studies, IRS has initiated actions that begin to implement the dozens of recommendations we have previously made to correct its management and technical problems. However, as we reported in June 1996 and our Chief Scientist for Computers and Telecommunications will discuss in her testimony today, many of these actions are still incomplete and do not respond fully to any of our recommendations.³ As a result, IRS has not made adequate progress in correcting its management and technical weaknesses. Consequently, we reported that, until IRS' weaknesses are corrected and our recommendations are fully implemented, the Congress should consider limiting TSM spending to only cost-effective modernization efforts that

- support ongoing operations and maintenance;
- correct IRS' pervasive management and technical weaknesses;
- are small, represent low technical risk, and can be delivered in a relatively short time frame; and
- involve deploying already developed systems that have been fully tested, are not premature given the lack of a completed architecture, and produce a proven, verifiable business value.

The Senate and House Appropriations Committees are moving in a direction that is consistent with our suggestion. In debating IRS' appropriations for fiscal year 1997, these Committees have proposed, and the House has passed, significant limitations on TSM funding and restrictions on the use of TSM funds when they are ultimately appropriated by the Congress. Funding limitations and restrictions would reduce the size of the TSM program and control project development until IRS strengthens its technical and management capabilities. Only then will IRS be able to undertake larger, more complex, and more expensive system development projects.

Effective Strategy to Implement Business Vision Is Essential

In 1986, IRS initiated TSM primarily to replace the computers that it was using to process and store the information on tax returns. IRS planned to introduce the new technology without changing its existing organizational and operating structure. In 1992, in response to recommendations by GAO and others, IRS began to analyze how it might use new technology to change its business operations. As a result, IRS developed a vision for 2001 that called for organizational, technological, and operational changes

³Tax Systems Modernization: Actions Underway But IRS Has Not Yet Corrected Management and Technical Weaknesses (GAO/AIMD-96-106, June 7, 1996) and Tax Systems Modernization: Actions Underway But Management and Technical Weaknesses Not Yet Corrected (GAO/T-AIMD-96-165, September 10, 1996).

affecting the way it processes tax returns, provides customer service, and ensures compliance.

Since 1992, IRS has made some progress in modernizing its operations, but the differences between IRS' current operations and those proposed in its vision are great. Part of the reason IRS has not been more successful in significantly changing its business operations is that it does not have a well-defined business strategy for achieving its vision.

For example, one of the most important business changes was IRS' decision to significantly increase, by the year 2001, the number of tax returns received electronically. Although IRS has implemented some initiatives that have increased the number of electronic returns since 1993, IRS does not have a comprehensive business strategy to reach or exceed its electronic filing goal.

We have reported that IRS' business strategy would not maximize electronic filings because it primarily targeted taxpayers who use a third party to prepare and/or transmit simple returns, are willing to pay a fee to file their returns electronically, and are expecting refunds. Focusing on this limited taxpaying population overlooked most taxpayers, including those who prepare their own tax returns using personal computers, have more complicated returns and/or owe tax balances. Also, IRS has not yet successfully addressed one of the major impediments to the expansion of electronic filing—its cost to taxpayers.

Accordingly, we recommended that IRS refocus its electronic filing business strategy to target, through aggressive marketing and education, those sectors of the taxpaying population that can file electronically most cost-beneficially. Also, in October 1995, we recommended that IRS identify those groups of taxpayers that offer the greatest opportunity to reduce IRS' paper processing workload and operating costs if they filed electronically and develop strategies that focus on eliminating or alleviating impediments that inhibit those groups from participating in the program.⁴

To respond to our recommendations, to date, IRS has initiated some actions, such as performing an electronic filing marketing analysis at local levels and developing a marketing plan to promote electronic filing, which could result in future progress toward increasing electronic filing. IRS plans to complete an electronic filing strategy by October 31, 1996. The

⁴Tax Administration: Electronic Filing Falling Short of Expectations (GAO/GGD-96-12, October 31, 1995).

development of this strategy, which was initially scheduled for completion in August 1996, is consistent with our recommendation, and we are encouraged that this initiative could result in future progress toward increasing electronic filings. It will, however, be important for IRS to ensure that the strategy is focused on achieving its electronic filing goals and to develop and then carry out effective implementation plans.

In addition, IRS faces several challenges in implementing its customer service vision. For service to improve, taxpayers must be able to reach IRS by telephone when they have questions or problems, and IRS employees must have easy access to the information needed to help taxpayers. IRS' strategy for improving customer service includes consolidating work units, changing work processes, and increasing the use of information systems.

While this strategy offers promise, IRS must address several important challenges. Specifically, IRS has to

- manage the transition to the customer service vision while continuing to answer taxpayer inquiries, manage taxpayer accounts, and collect unpaid taxes and
- determine the scope of responsibilities for those staff employed at customer service centers and provide the necessary training.

Further, achieving customer service and compliance goals also depends in large measure on increasing the use of information systems. Making it easier for taxpayers to reach IRS by telephone is of limited value if IRS employees on the other end of the line do not have access to the data needed to help the taxpayers, which has been a long-standing problem in IRS. Also, achieving IRS' goal to increase compliance hinges on the ability of enforcement staff to readily access good data.

IRS eventually intends to provide its employees with access to greater amounts of on-line taxpayer data in shorter time frames than current systems can provide. However, IRS has not fully defined its business requirements for those systems and lacks a cost-effective strategy for accessing taxpayer data that may be needed for customer service and compliance. Also, IRS has not yet identified all of the data that enforcement staff need to do their job, which is key in helping an organization collect good data and make it readily accessible to employees.

Finally, TSM projects and reengineering efforts must be integrated. One of the managerial weaknesses discussed in our July 1995 report on TSM that

has significant programmatic implications was a lack of integration of IRS' reengineering efforts and TSM projects. Specifically, we said that IRS' business reengineering efforts were not tied to its TSM projects and that IRS lacked a comprehensive plan and schedule defining how and when to integrate these business reengineering efforts with ongoing TSM projects.

We continue to question IRS' ability to make sound investment decisions on TSM until the reengineering of important processes is sufficiently complete. Reengineering could result in new business requirements that are not addressed by planned TSM projects or that make those projects obsolete.

Developing the Capacity to Make Sound Technology Investments

IRS information systems need to be better managed as investments, and strategic information management practices are not yet fully in place. To overcome this, and provide the Congress with insight needed to assess IRS' priorities and rationalization for TSM projects, we recommended that the IRS Commissioner take immediate action to implement a complete process for selecting, prioritizing, controlling, and evaluating the progress and performance of all major information systems investments, both new and ongoing. This process should include explicit decision criteria, and we recommended that, using these criteria, IRS review all planned and ongoing systems investments.

IRS has taken positive steps that indicate a willingness to address the strategic information management problems we have raised. For example:

- IRS has created the executive-level Investment Review Board for selecting, controlling, and evaluating all of its information technology investments.
- IRS has postponed planned software development and deployment of personal computers for its Integrated Case Processing (ICP) system, which is intended to be a key information system to help provide the capability to quickly obtain the data to answer taxpayer questions and resolve problems. According to the Associate Commissioner for Modernization, ICP efforts will focus on establishing reasonable requirements and initially preparing for a smaller systems development effort that represents low technical risk and can be delivered in a relatively short time frame using outside contractors.
- IRS is reevaluating its need for a Document Processing System (DPS), which it began to develop in 1988 in an effort to use imaging and optical character recognition technologies to process paper tax returns and capture 100 percent of the data on those returns. In April 1992, we said that IRS had not adequately assessed the cost-benefit trade-offs associated

with its strategy for receiving and capturing tax return data using DPS.⁵ IRS proceeded with the development of DPS without this analysis and estimates that it spent about \$270 million on DPS through fiscal year 1995.

While IRS has recognized the need to match the scope of TSM projects with its capabilities and is beginning to scale back its TSM investment to projects it is more capable of managing, IRS' investment process is not yet complete. According to Treasury, it is missing (1) specific operating procedures, (2) defined reporting relationships between different management boards and committees, and (3) updated business cases for major TSM technology investments. Our own analysis shows serious weaknesses, such as inadequate data, an incomplete portfolio, and the lack of an effective investment evaluation review process.

Because of the sheer size, scope, and complexity of TSM, it is imperative that IRS institutionalize a repeatable process for selecting, controlling, and evaluating its technology investments, and that it make informed investment decisions based on reliable qualitative and quantitative assessments of costs, benefits, and risks. Although IRS is in the initial stages of implementing parts of such a process, a complete, fully-integrated process does not yet exist.

Building a Technical Foundation for TSM

Once investment decisions are made, the activities of transforming these ideas into successfully developed and operated systems requires following good business practices. IRS' serious technical weaknesses continue to impede successful systems modernization. We have reported the following.

- IRS' software development activities are inconsistent and poorly controlled. Unless IRS improves its software development capability, it is unlikely to build TSM timely or economically, and systems are unlikely to perform as intended. IRS has begun to improve its software development capability, but IRS' actions are not yet complete or institutionalized, and, as a result, systems are still being developed without the disciplined practices and metrics needed to give management assurance that they will perform as intended.

⁵Tax Systems Modernization: Input Processing Strategy is Risky and Lacks a Sound Analytical Basis (GAO/T-IMTEC-92-15, April 29, 1992).

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- IRS' systems architectures,⁶ integration planning, and system testing and test planning are incomplete. IRS said that it was identifying the necessary actions to define and enforce systems development standards and architectures agencywide. Although IRS has taken actions to prepare a systems architecture and improve its integration and system testing and test planning, these efforts are not yet complete or institutionalized. As a result, TSM systems continue to be developed without the detailed architectures and discipline needed to ensure success.
 - IRS has not yet established an effective organizational structure to consistently manage and control systems modernization organizationwide. IRS has made improvements in consolidating management control over systems development, but the Associate Commissioner for Modernization still does not have control over all IRS systems development activities. Specifically, systems development conducted by the research and development division has now been redefined as technology research, keeping it from the control of the Associate Commissioner.

IRS has initiated a number of actions to address these weaknesses but additional measures are necessary to correct them and, in the interim, to mitigate the risks associated with ongoing TSM spending. Key to monitoring and completing these actions will be the establishment of realistic and achievable target dates, which IRS has said it plans to do. However, IRS has not yet set the time frames for several measures necessary to build a technical foundation for TSM.

Also, IRS expects to improve the accountability for and probability of TSM success by increasing its reliance on contractors. IRS has outlined a three-track approach for transitioning over a period of 2 years to the use of a "prime" contractor that would have, according to IRS, overall authority and responsibility for the development, delivery, and deployment of modernized information systems. IRS' approach to expanding the use of contractors to build TSM is still in the early planning stages. Because of this, IRS was unable to provide us with formal plans, charters, schedules or the definitions of shared responsibilities between the Government Program Management Office and the existing program and project management staff.

Consequently, at this point, it is unclear what these IRS plans entail, or how they will work. Further, plans to use additional contractors will succeed if,

⁶A system architecture is an evolving description of an approach to achieving a desired mission. It describes (1) all functional activities to be performed to achieve the desired mission, (2) the system elements needed to perform the functions, (3) the designation of performance levels of those system elements, and (4) the technologies, interfaces, and location of functions.

and only if, IRS has the in-house capabilities to manage these contractors effectively. As discussed in our recent report on the IRS' Cyberfile project, IRS has serious problems planning and managing TSM projects using contractors.⁷

We found that IRS' selection of the Department of Commerce's National Technical Information Service (NTIS) to develop Cyberfile was not based on sound analysis. IRS did not adequately analyze requirements, consider alternatives, or assess NTIS' capabilities to develop and operate an electronic filing system. IRS selected NTIS because it was expedient and because NTIS promised IRS, without any objective support, that it could develop Cyberfile quickly. Development and acquisition were undisciplined, and Cyberfile was poorly managed and overseen.

As a result, it was not delivered on time, and after advancing \$17.1 million to NTIS, IRS has suspended Cyberfile's development and is reevaluating the project. The Cyberfile experience has heightened IRS' awareness that, unless it has mature, disciplined processes for acquiring software systems through contractors, it will be no more successful in buying software than it has been in building software.

Addressing Serious Financial Management Problems

As part of a pilot program under the Chief Financial Officers (CFO) Act of 1990, IRS began preparing annual financial statements showing the results of its operations starting with those for fiscal year 1992. CFO implementation has (1) led to IRS top managers having a much better understanding than ever before of IRS' serious accounting and reporting problems, (2) provided information on the magnitude of IRS' tax receivables collection problems, and (3) identified the need for stronger controls over such areas as payroll operations. The CFO Act's requirements also have provided the impetus for efforts to improve IRS operations and address the substantial problems identified by our financial audits.

However, we have been unable to express an opinion on the reliability of IRS' financial statements for any of the 4 fiscal years from 1992 through 1995.⁸ We identified fundamental, persistent problems that remained

⁷Tax Systems Modernization: Cyberfile Project Was Poorly Planned and Managed (GAO/AIMD-96-140, August 26, 1996).

⁸Financial Audit: Examination of IRS' Fiscal Year 1995 Financial Statements (GAO/AIMD-96-101, July 11, 1996); Financial Audit: Examination of IRS' Fiscal Year 1994 Financial Statements (GAO/AIMD-95-141, August 4, 1995); Financial Audit: Examination of IRS' Fiscal Year 1993 Financial Statements (GAO/AIMD-94-120, June 15, 1994); and Financial Audit: Examination of IRS' Fiscal Year 1992 Financial Statements (GAO/AIMD-93-2, June 30, 1993).

uncorrected and, until they are resolved, will continue to prevent us from expressing an opinion on IRS' financial statements in the future.

IRS worked to resolve these issues during our fiscal year 1995 financial statement audit and progress was made, but many of IRS' efforts were incomplete at the conclusion of the audit. IRS is continuing these efforts. Since we testified before the Committee on June 6, 1996, IRS and GAO have worked to further develop a plan and strategies for addressing the major weaknesses preventing IRS from receiving an opinion on its financial statements. The following paragraphs discuss IRS' five major uncorrected financial management problems and short-term plans for resolving them.

First, the amounts of total revenue (reported to be \$1.4 trillion for fiscal year 1995) and tax refunds (reported to be \$122 billion for fiscal year 1995) cannot be verified or reconciled to accounting records maintained for individual taxpayers in the aggregate. Second, the amounts reported for various types of taxes collected (social security, income, and excise taxes, for example) cannot be substantiated. As a short-term resolution for these two issues, IRS has developed software programs that it believes will capture, from its revenue financial management system, the detailed revenue and refund transactions that would support reported amounts in its future financial statements until longer term system fixes can be made to achieve more reliable reporting of these amounts. In addition, IRS plans call for completing documentation of its revenue financial management system, which is critical to aid in identifying better interim solutions for reporting revenues and refunds and provide better insights on the longer term system fixes needed to enable IRS to readily and reliably provide the underlying support for its reported revenue and refund amounts.

Third, the reliability of reported estimates for fiscal year 1995 of \$113 billion for valid accounts receivable and of \$46 billion for collectible accounts receivable cannot be determined. IRS initially plans to continue efforts to determine a means of using its current revenue financial management system's coding to identify its accounts receivables. IRS' efforts are focused on correcting known current coding errors through reviewing 100 percent of all receivables over \$10 million. In addition, IRS plans to ensure more accurate input and processing of transactions that underpin accounts receivables by intensifying training efforts and improving internal control policies and procedures.

Fourth, a significant portion of IRS' reported \$3 billion in nonpayroll operating expenses cannot be verified. IRS believes the core issue for

correcting its receipt and acceptance problems relate to properly accounting for transactions with other federal agencies. IRS, GAO, and a contractor are working together to determine the root causes of and develop solutions to the issue.

Fifth, the amounts IRS reported as appropriations available for expenditure for operations cannot be reconciled fully with Treasury's central accounting records showing these amounts, and hundreds of millions of dollars in differences have been identified. IRS believes that it has completed the reconciliation of its Fund Balance with Treasury accounts except for IRS' suspense accounts that contained reconciling items that were more than 6 months old. However, IRS is still in the process of making the necessary adjustments required to its general ledger and the related Treasury records to complete this effort. We plan to review IRS' reconciliation of outstanding differences and verify the accuracy of adjustments as they are made.

It will be essential for IRS to now follow through and ensure that its planned short-term, interim actions are completed on schedule to improve the reliability of IRS' financial statements. We will continue to work with IRS in doing so. Additionally, some of IRS corrective actions are longer term and involve reprogramming software for IRS' antiquated systems and developing new systems.

Providing Effective Oversight

The recommendations we have outlined provide a road map for bringing greatly strengthened management to IRS' operations. IRS needs to fully implement these actions in order to fulfill any business strategy it and the Congress decide upon to provide efficient and effective taxpayer services into the next century. But, bringing these actions to fruition and making needed management improvements a reality, will require intense follow through and sustained oversight by IRS top management, Treasury, OMB, and the Congress. This will be especially important, as we have not always observed the close oversight and strong follow through within the Executive Branch that it will take to overcome the substantial problems IRS has experienced in effectively carrying out its business vision, successfully developing TSM, and obtaining an opinion on its financial statements.

Foremost, IRS and Treasury must concentrate on the specific actions we have outlined. We are encouraged that Treasury is taking a more active role in overseeing IRS' efforts to improve its business operations. A joint

Treasury-IRS Modernization Management Board, chaired by the Deputy Secretary of the Treasury, has been established as the primary review and decision body for modernization and TSM policy and strategic direction. For the Board to succeed, however, it will be essential for it to have independent sources of information on IRS' efforts and progress to effectively oversee and track the cost and schedule of all TSM projects.

For its part, OMB should emphasize reviewing the government's investment in developing TSM, the use of technology in IRS' changing business environment, and the steps IRS plans to take to improve its financial management. The CFO Act and the Information Technology Management Reform Act give OMB important leadership responsibilities in these areas. In this regard, for example, the Director of OMB is responsible for (1) promoting and directing that federal agencies establish capital planning processes for information technology investment decisions, (2) evaluating the results of those investments, and (3) enforcing accountability for them through the budget process.

The Congress has established a comprehensive legislative framework that provides the structure necessary to help IRS achieve better financial and information management and measure the results of implementing its business vision. This framework includes:

- the CFO Act's focus for correcting financial management weaknesses and reliably reporting on the results of IRS' financial operations,
- the Government Performance and Results Act's emphasis on managing for results and pinpointing opportunities for improved performance and increased accountability, and
- the amended Paperwork Reduction Act's and the Information Technology Management Reform Act's (1) focus on the application of information resources to support agency missions and improve agency performance and (2) requirements for improving the efficiency and effectiveness of operations and the delivery of services to the public through an effective use of information technology.

These laws also provide a basis for the Congress to hold IRS accountable for resolving the weaknesses and taking the actions we have discussed. In this regard, the Committee's recent hearings on these matters have brought greater attention to the consequence of continued delays in solving IRS' management problems. We encourage this Committee, and other congressional oversight and appropriations committees, to use these

management statutes to help focus on the progress IRS is making to correct these important issues.

The New Commission's Role

In IRS' appropriations act for fiscal year 1996, the Congress established the National Commission on Restructuring the IRS. It gave the Commission a broad, sweeping charter for reviewing:

- present IRS practices, especially its organizational structure, paper and return processing activities, infrastructure, and collection process;
- what is required for (1) making returns processing "paperless," (2) modernizing IRS operations, (3) improving the collections process without major increases in personnel or funding, (4) improving taxpayer accounts management, (5) improving accuracy of information requested by taxpayers in order to file returns, and (6) changing the culture of IRS to make it more efficient, productive, and customer oriented;
- whether IRS could be replaced with a quasi-governmental organization with tangible incentives for managing programs and activities, and for modernizing its activities; and
- whether IRS could perform other collection, information, and financial service functions of the federal government.

The Commission's 17 members were appointed by congressional leaders and the President in May 1996. Cochairing the Commission are Senator Bob Kerrey and Representative Rob Portman. The Congress provided \$1 million in direct funding for the Commission to examine IRS' organization and recommend actions to expedite implementation of TSM and improve service to taxpayers. The Commission's report, which is to be completed 1 year after its first meeting, should provide the Congress an in-depth look at operations and management structures across IRS and insights for resolving IRS' persistent uncorrected management problems.

Mr. Chairman, this concludes my statement. We will be glad to answer any questions.

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