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General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-278608

160371

April 30, 1998

Ms. Nancy Killefer
Assistant Secretary for Management
and Chief Financial Officer
Department of the Treasury

Subject: SAS 70 Review: Treasury's Process for Distributing Net Tax Revenue to the Various Federal Government Trust Funds

Dear Ms. Killefer:

This letter presents the results of our attempt to review the Department of the Treasury's process for distributing to various federal government trust funds the net tax revenue collected by the Internal Revenue Service (IRS). Our work was anticipated to culminate in the preparation of a report in accordance with the American Institute of Certified Public Accountants' (AICPA) Statement on Auditing Standards (SAS) No. 70, Reports on the Processing of Transactions by Service Organizations (commonly called a "SAS 70 report").¹ This report, along with procedures that we performed at IRS, was determined by the Inspectors General (IG) of the Department of Transportation (DOT) and the Department of Labor (DOL) and us as necessary to provide a sufficient basis for these IGs to form an opinion on relevant trust fund (e.g., DOT's Highway Trust Fund) and departmental financial statements for fiscal year 1997. This letter (1) summarizes the reasons that we were unable to complete our review and prepare a SAS 70 report for fiscal year 1997 and (2) discusses actions that Treasury will need to take before such a review can be completed.

¹A SAS 70 report is issued by an independent auditor and discusses the effectiveness of internal controls over the processing of transactions by a service organization for use by other auditors. Treasury, because it collects federal tax revenue and then distributes it to government trust funds, would be considered a servicing organization by agencies administering the trust funds as well as by the auditors of these agencies.

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BACKGROUND

Administering agencies for federal government trust funds rely on Treasury to collect federal tax revenue and distribute this revenue to the applicable government trust funds. Consequently, the administering agencies and their auditors need to be satisfied that Treasury properly collects federal tax revenue and distributes this revenue to the appropriate trust funds. For this reason, we initiated a review of the processing of, and controls over, federal taxes from the point of deposit into the general fund at Treasury to the distribution to various trust funds and any subsequent adjustments. It was envisioned that this work, along with our audit of IRS' fiscal year 1997 Custodial Financial Statements² and other work at IRS, would culminate in the issuance of a SAS 70 report on the entire Treasury process for collection and distribution of net tax revenue to the trust funds.

Tax receipts are deposited into the general fund daily. However, the information directing how these receipts are to be applied (e.g., tax returns) is submitted periodically. As a result, Treasury uses a process to estimate the initial distribution of certain tax receipts (e.g., excise) to the trust funds. This process involves the use of economic models prepared by the Office of Tax Analysis (OTA) to estimate the initial distribution of tax receipts. Treasury's Financial Management Service (FMS) uses these estimates to process the initial distributions to the trust funds, which are recorded by the Bureau of Public Debt (BPD) in the books and records of the trust funds maintained by Treasury. Subsequent to this initial distribution, IRS certifies quarterly the amounts that should have been distributed to the excise tax-related trust funds based on the tax returns.³ FMS uses these certifications to prepare adjustments to the initial trust fund distributions, which are necessary to arrive at the certified distributions. These adjustments are recorded by BPD. There is typically a 6-month lag between the quarter end and the excise tax certification by IRS.⁴

²See Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

³For Federal Insurance Contributions Act (FICA) taxes (Social Security and Hospital Insurance) and Self-Employed Collection Act (SECA) taxes, the Social Security Administration Commissioner is responsible for certifying quarterly the amounts to be distributed.

⁴IRS policies and procedures for certification to Treasury of the distribution of the excise tax collections to the designated trust funds do not comply with the Internal Revenue Code. The Code requires IRS to certify the distribution of these excise tax collections to the recipient trust funds based on actual collections. However, IRS bases its certifications of excise tax amounts to be
(continued...)

It is important to note that our work was not intended to provide substantive assurance about the accuracy of the actual net amounts transferred to the trust funds. Rather, it was intended to result in a report which would describe the collection, distribution, and subsequent adjustment process, including key internal controls over this process, and conclude as to the effectiveness of the key identified controls. This work, our audit of the IRS' fiscal year 1997 Custodial Financial Statements, other procedures agreed to between us and the DOT and DOL IGs, and audit procedures performed by the IGs were envisioned as being sufficient to provide the information necessary for the IGs to draw conclusions on the reasonableness of the trust fund financial statements.

FINDINGS

For several reasons, we concluded that the SAS 70 review for fiscal year 1997 could not be completed. First, certain organizations within Treasury have never undergone a review of their internal controls and consequently were not prepared for some of the requirements for such a review to be successfully completed. Specifically, OTA maintained that, as a policy office whose involvement in the initial distribution of federal tax revenue to the trust funds is a small function of its overall operations, it did not have a full understanding of what would be required to facilitate the review. For example, OTA did not have documented in formal policies and procedures certain controls, such as controls to ensure that its models are updated for changes in tax laws. Because such controls were not observable via review of documentation, we were unable to determine whether certain key controls were actually in place and operating effectively during fiscal year 1997. Additionally, OTA did not retain all of the necessary documentation of the economic models it used to estimate the initial trust fund distributions. Also, during the period in which we attempted to perform the review, key OTA personnel from whom we needed information on the estimation process and related controls were heavily involved in the development of the Fiscal Year 1999 Budget of the United States Government. Consequently, they could not always be available to facilitate the review within the tight time frames established.

Another factor which led to our conclusion that the SAS 70 review could not be successfully completed for fiscal year 1997 was the degree of problems we identified in performing certain agreed-upon procedures related to IRS'

⁴(...continued)

distributed to specific trust funds on the assessed amount, or amount owed, as reflected on the tax returns filed by taxpayers.

certification of excise taxes to the various trust funds.⁵ As discussed above, while the initial distributions of tax receipts are based on estimates using OTA's economic models, these distributions are subsequently adjusted based on IRS' quarterly certifications.⁶ Our review of IRS' fiscal year 1997 excise tax certifications identified a number of errors that affected the amounts that were ultimately distributed to the trust funds. The existence of these errors raises questions as to the effectiveness of the controls over IRS' certification process. If controls over the certification process were considered effective, the process itself would be an effective compensating control for any deficiencies in the initial distributions.⁷

The combination of the factors discussed above led us to conclude that the SAS 70 review for fiscal year 1997 could not be successfully completed.

We also noted in our work that no central body within Treasury oversees the entire revenue collection and distribution process. Consequently, Treasury has no overall assurance that each bureau or office meets its responsibilities and thus is unable to provide assurances to the administering agencies that revenue is appropriately distributed to the trust funds.

TREASURY ACTIONS NEEDED

Although the results of the successful completion of a SAS 70 review of Treasury's process are uncertain, certain steps need to be taken before such a review can be completed. First, Treasury should act to ensure that controls over the deposit, distribution, and adjustment process are in place and documented. This includes ensuring that formal policies and procedures are written and that documentation that could serve as evidence of controls is maintained. For example, formal policies and procedures should clearly discuss how OTA monitors actual and proposed tax legislation and how such legislation is factored into revisions to its economic models. Policies and procedures should include a process for ensuring that such revisions are thoroughly

⁵See Agreed-Upon Procedures: Excise Taxes (GAO/AIMD-98-78R, February 26, 1998).

⁶Because of the delay in IRS' receipt of tax returns from the taxpayer, as discussed previously, IRS certified assessed amounts for the first two quarters of fiscal year 1997 excise tax receipts. The other two quarters of fiscal year 1997 were based on the OTA estimates.

⁷We will be reporting separately on internal control issues identified during our review of IRS' excise taxes certification process for fiscal year 1997.

reviewed and that evidence of such reviews is maintained. Also, OTA should retain documentation of its economic models for a specified period so as to be available for independent review. These actions are consistent with the Standards for Internal Controls in the Federal Government (1983), which require internal control systems and all transactions and other significant events to be clearly documented and the documentation readily available for examination.⁸

Additionally, Treasury, in conjunction with IRS, should review the findings from the agreed-upon procedures we performed on excise tax certifications and take steps to identify and correct the internal control deficiencies that led to the errors we identified in the certifications for fiscal year 1997. Such actions would allow a SAS 70 review to be completed and a report on the results of the review issued.

We provided a draft of this letter to Treasury for review and comment. The Treasury officials generally concurred with the contents of this letter. With respect to our observation that no central body within Treasury oversees the entire revenue collection and distribution process, Treasury officials noted that the department has established a task force to address the need for improved coordination and communication within the department on trust fund issues. Treasury officials noted that the task force has created a permanent body for trust fund coordination consisting of senior officials from IRS, FMS, BPD, OTA, and the Office of Cash and Debt Management within the Office of the Fiscal Assistant Secretary. The task force is currently preparing a letter to the Congress outlining planned improvements in the trust fund area, including (1) developing a systematic process for reconciling all Treasury trust fund operations and (2) formalizing controls to help prevent errors in future trust fund operations. Treasury officials stated that these actions should provide better assurances to trust fund administering agencies that revenue is appropriately distributed to the trust funds.

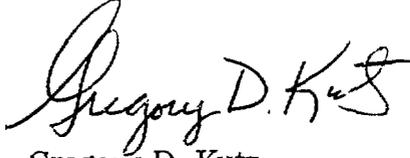
We are sending copies of this letter to the Director of the Office of Management and Budget, the Secretary of Transportation, the Secretary of Labor, and the Inspectors General of the Departments of Transportation and Labor. Copies of this letter will be made available to others upon request.

⁸This documentation requirement, along with proposed standards that will supersede the standards we issued in 1983, is included in our exposure draft, Standards for Internal Control in the Federal Government (GAO/AIMD-98-21.3.1), issued in December 1997.

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If you have any questions please contact me at (202) 512-9505, or Steven J. Sebastian, Assistant Director, at (202) 512-9521.

Sincerely yours,

A handwritten signature in black ink that reads "Gregory D. Kutz". The signature is written in a cursive style with a large initial 'G'.

Gregory D. Kutz
Associate Director
Governmentwide Accounting and Financial
Management Issues

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