



*Internal Accounting Errors Reduced the  
Federal Funding Available for  
Unemployment Benefits by \$63 Million  
During Fiscal Years 2005 Through 2009*

**March 26, 2010**

**Reference Number: 2010-10-039**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

March 26, 2010

**MEMORANDUM FOR CHIEF FINANCIAL OFFICER**

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Internal Accounting Errors Reduced the Federal Funding Available for Unemployment Benefits by \$63 Million During Fiscal Years 2005 Through 2009 (Audit # 200910020)

This report presents the results of our review to determine whether the Internal Revenue Service (IRS) has developed and implemented a methodology to reasonably and accurately calculate the cost of Unemployment Trust Fund (UTF) administrative expenses using data from appropriate business unit sources. This review was part of our Fiscal Year (FY) 2009 Annual Audit Plan under the major management challenge of Leveraging Data to Improve Program Effectiveness and Reduce Costs. It is a followup review to a FY 2003 Treasury Inspector General for Tax Administration report<sup>1</sup> which found that UTF administrative expenses could not be supported or replicated and that required reports were not always timely submitted or properly prepared.

*Impact on the Taxpayer*

Our review identified that while additional procedures and controls have been implemented, there are still insufficient controls to ensure that expenses associated with the administration of the UTF are accurately calculated. For example, the IRS overestimated its UTF-related expenses by \$63 million during FYs 2005 through 2009. As a result, these funds were not available during this period to fund the Federal Government's share of unemployment benefit payments to eligible taxpayers.

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<sup>1</sup> *The Internal Revenue Service Needs to Establish an Effective Process to Accurately Identify, Record, and Report Unemployment Trust Fund Administrative Expenses* (Reference Number 2003-10-054, dated March 27, 2003).



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## Synopsis

Since our last audit, the IRS Chief Financial Officer (CFO) has taken several actions in an effort to improve the reporting of expenses associated with the administration of the UTF.

Specifically, we determined the CFO developed detailed procedures in Calendar Year 2004 to support the process used to calculate the UTF expenses submitted for reimbursement. These procedures detail the process that the IRS business units should follow when calculating the cost associated with administering the UTF. In addition, the IRS business units are now required to maintain an audit file to support the costs submitted to the Bureau of the Public Debt for reimbursement.

While the CFO can now better support the UTF expenses submitted for reimbursement, the IRS needs to update its current procedures to ensure more accurate costs are calculated and requested for reimbursement. Specifically, we found that incorrect program codes used by the IRS to track the volume and costs of forms submitted by taxpayers were used to calculate Employer's Annual Federal Unemployment Tax Return (Form 940) processing costs. In addition, salary estimates for personnel assigned to Form 940-related work were not always properly calculated. When we brought these errors to CFO management's attention, the IRS immediately reviewed its calculations. Based on this review, the IRS recalculated its administrative expenses for the period and submitted revised reports in October 2009 to the Bureau of the Public Debt. These errors in the calculation of IRS administrative expenses resulted in both yearly overcharges and undercharges for the period FY 2005 through the second quarter of FY 2009, totaling \$100,813,988.

We also identified approximately \$7 million in additional erroneous administrative expense overcharges occurring during the third quarter of FY 2009. These calculations had been submitted to the CFO from the business units but had not yet been formally submitted by the CFO to the Bureau of the Public Debt. We informed the IRS of these erroneous administrative expense calculations, and the IRS was able to correct its calculations prior to submitting its administrative expenses to the Bureau of the Public Debt and, as such, no formal revisions were required.

Further, we believe the IRS should closely monitor the development of future financial accounting system requirements to ensure the capability to track and record UTF expenses is considered. By taking these actions, the IRS will be able to more readily and precisely calculate all costs associated with administering the UTF.

## Recommendations

We recommended that the IRS CFO update the procedures used by the IRS business units to calculate their UTF administrative expenses; instruct that the audit file and supporting



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documentation be maintained in a central location, such as the Business Unit Financial office, for a minimum time period; implement a policy to routinely review documentation supporting the summary cost reports submitted to the CFO by the IRS business units; and determine on an annual basis, in coordination with the Commissioner, Wage and Investment Division, if new versions of the Form 940 are developed and incorporated into its procedures. Finally, we recommended that the IRS CFO ensure the development of a cost accounting capability is considered during the development of future financial accounting system requirements that supports the ability to readily track, record, and report UTF expenses.

### Response

IRS management agreed with all of the recommendations in our report. IRS management agreed to update procedures used by the business units to calculate their UTF administrative expenses by including in the procedures all types of Forms 940 in use, recognize current business unit responsibilities, and specify the documentation necessary to be maintained in the audit file. In addition, IRS management stated that the new procedures will require the audit file be maintained in the business unit finance office for a minimum of 3 years. Further, management agreed to institute quarterly reviews of business unit trust fund expense submissions on a rotating schedule. IRS management will also determine on an annual basis the completeness of the Wage and Investment Division list of all versions of Form 940 and ensure those versions are included in the calculation of the UTF administrative expenses. Finally, IRS management will determine the feasibility of identifying workload management data and integrating it with the IRS financial accounting system to support the tracking, recording, and reporting of UTF expenses in future financial accounting system requirements. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



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*Abbreviations*

CFO	Chief Financial Officer
FY	Fiscal Year
IRS	Internal Revenue Service
UTF	Unemployment Trust Fund



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## *Background*

The Federal-State unemployment compensation program is a system that provides benefits to eligible, unemployed workers to help provide for necessities such as food, clothing, and shelter. A Federal tax is levied on employers based on wages paid to employees, which is used to fund Federal responsibilities under the program. The Internal Revenue Service (IRS) is responsible for

***The Unemployment Trust Fund was established to provide a portion of extended unemployment benefits during periods of high unemployment.***

collecting and processing this tax through the filing of the Employer's Annual Federal Unemployment Tax Return (Form 940). Funds received by the IRS are deposited into the Unemployment Trust Fund (UTF), for which the Department of the Treasury is designated to act as the managing trustee. The IRS advised us that it received approximately \$6.8 billion in UTF deposits in Fiscal Year (FY) 2009. The Department of Labor shares responsibility for administering the UTF.

The UTF was established by the Social Security Act<sup>1</sup> to provide a portion of extended unemployment benefits during periods of high unemployment and provide a loan fund for States when State unemployment funds are insufficient to pay State unemployment benefits. The Social Security Act directs the Secretary of the Treasury to pay from the UTF the estimated costs incurred by the Department of the Treasury, including activities of the IRS, in connection with the administration of the fund. As a result, the IRS determines and reports its administrative expenses associated with collecting and processing the Forms 940 in accordance with established Department of the Treasury policies. The IRS reported approximately \$96.4 million in UTF administrative expenses for FY 2009.<sup>2</sup>

Specifically, Treasury Directive 32-06, Administrative Expenses for Trust Funds, guides the IRS' reporting of UTF administrative expenses and requires the IRS to compile and report these expenses to the Bureau of the Public Debt. This directive requires the IRS to submit the following reports to the Bureau of the Public Debt's Office of Public Debt Accounting:

- A quarterly report estimating trust fund administrative expenses.
- A fiscal year-end report summarizing and adjusting estimated expenses to actual expenses.

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<sup>1</sup> 42 U.S.C. Section 1104 (a) (Supp. V 1999).

<sup>2</sup> After the IRS determines its costs associated with collecting unemployment taxes, it requests reimbursement from the Bureau of the Public Debt, which transfers the requested reimbursement from the UTF to the Department of the Treasury General Fund for overall Federal Government operations. The funds are not returned to the IRS' budget.



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- A report of expected annual expenses for budget purposes covering the current and the next 10 budget years.

The IRS calculates the full cost of administering the UTF for the Department of Labor in two steps: 1) by calculating the direct costs of labor resources used on UTF-related work and 2) by applying an overhead rate to those direct labor resource costs. To determine the direct costs of labor resources, the IRS relies on cost calculations performed by the individual IRS business units directly responsible for performing unemployment tax work, such as processing and/or performing enforcement duties related to the Form 940. Five IRS business units incur direct labor costs in the administration of Form 940-related duties, and these business units report their direct labor costs to the IRS Chief Financial Officer (CFO) in the form of summary reports. The CFO is responsible for compiling these summary reports and submitting the composite UTF administrative costs to the Bureau of the Public Debt.

In FY 2003, a Treasury Inspector General for Tax Administration report<sup>3</sup> found that the IRS did not have an effective process to accurately identify, record, or report UTF administrative expenses. Specifically, we found that administrative expenses reported to the Bureau of the Public Debt could not be supported or replicated and that required reports were not always timely submitted or properly prepared. We also found that the IRS did not have sufficient, comprehensive cost information on which to base estimated expenses of administering the UTF. As a result, we were unable to substantiate the reported expenses or make any assurances that reported expenses were accurate, complete, or consistent. We recommended that the CFO:

- Develop written procedures documenting a methodology identifying all systems and sources of information associated with the UTF administrative expenses to ensure the most reasonable and timely means of identifying and reporting all expenses.
- Establish controls to ensure that any amounts reported to the Bureau of the Public Debt are reviewed and approved by a senior level IRS executive.
- Ensure that the ability to record and report trust fund administrative expenses be incorporated into the Integrated Financial System.<sup>4</sup>

Our review was performed at the Washington, D.C., offices of the CFO, Tax Exempt and Government Entities Division, and Department of Labor; the Small Business/Self-Employed Division in San Francisco, California; and the Wage and Investment Division in Atlanta, Georgia, during the period May through November 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We

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<sup>3</sup> *The Internal Revenue Service Needs to Establish an Effective Process to Accurately Identify, Record, and Report Unemployment Trust Fund Administrative Expenses* (Reference Number 2003-10-054, dated March 27, 2003).

<sup>4</sup> The IRS accounting system.



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believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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## *Results of Review*

Our review identified that while additional procedures and controls have been implemented since our last audit, there are still insufficient controls to ensure that expenses associated with the administration of the UTF are accurately calculated. For example, the IRS materially overestimated its UTF-related expenses by \$63 million during the period FY 2005 through FY 2009. As a result, these funds were not available during this period to fund the Federal Government's share of unemployment benefit payments to eligible taxpayers.

Since our last audit, the CFO has taken several actions in an effort to improve the reporting of expenses associated with the administration of the UTF. Specifically, we determined the CFO developed detailed procedures in Calendar Year 2004 to support the process used to calculate the UTF expenses submitted for reimbursement. These procedures detail the process that the IRS business units should follow when calculating the cost associated with administering the UTF. In addition, the IRS business units are now required to maintain an audit file to support the costs submitted to the Bureau of the Public Debt for reimbursement.

While the development of detailed procedures and the requirement to maintain an audit file allow the CFO to better support the UTF expenses submitted for reimbursement, we determined the IRS needs to update its current procedures to ensure more accurate costs are calculated and requested for reimbursement. In addition, we believe the IRS should plan to integrate the capability to record and calculate UTF expenses into the future financial accounting system requirements currently being developed to more precisely calculate all costs associated with administering the UTF in the future. By taking these actions, the IRS will more readily and accurately estimate the costs associated with administering the UTF and ensure the proper amount of funds is paid from the UTF to cover the IRS' costs.

### ***Unemployment Trust Fund Expenses Are Not Being Calculated Accurately***

The IRS can take additional actions to more accurately calculate the costs associated with administering the UTF. Specifically, we determined that incorrect program codes were used to calculate the costs associated with processing the Form 940. In addition, the procedures used by the IRS to calculate its UTF costs have not been updated to reflect changes in IRS work processes and new policies.

#### ***Incorrect program codes were used to calculate Form 940 processing costs***

During our review of the audit files and supporting documentation maintained by the IRS offices responsible for determining UTF administrative expenses for reimbursement, we found that



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errors occurred in the calculation of expenses incurred in the administration of the UTF. The IRS assigns code numbers to forms submitted by taxpayers (such as the Form 940) which allow it to track the volume of forms processed and estimate costs associated with processing these forms. However, we determined that codes used by the IRS to track the volume and cost of processing Employer's Quarterly Federal Tax Returns (Form 941) were incorrectly applied to the cost of administering the UTF. In addition, salary estimates for personnel assigned to Form 940-related work were not always properly calculated. These errors in the calculation of UTF administrative expenses occurred during the period FY 2005 through FY 2009. Specifically, we determined:

- Not all codes associated with Form 940 were included in the calculation of IRS administrative costs. These codes relate to electronic processing of the Form 940. As a result, the IRS underestimated some of its costs for administering the UTF by not including all electronic processing costs associated with the filing of Form 940.
- The IRS included the costs of processing Forms 941 when calculating its UTF expenses. However, the Form 941 is used by employers to report their quarterly employment tax obligations and is not related to the Form 940. As a result, these costs should not be included in the UTF administration costs. The IRS overestimated its costs for administering the UTF by including costs associated with Forms 941.
- The salary allocation for certain personnel assigned to UTF-related work was not always properly calculated. As a result, the IRS underestimated its costs for administering the UTF.

When we brought these errors to CFO management's attention, the IRS immediately reviewed its calculations. Based on this review, the IRS recalculated its administrative expenses for the period and submitted revised reports in October 2009 to the Bureau of the Public Debt. These errors in the calculation of IRS administrative expenses resulted in both yearly overcharges and undercharges for the period FY 2005 through the second quarter of FY 2009, totaling \$100,813,988. Due to the offsetting nature of the 2 types of errors, the IRS' revised submission to the Bureau of the Public Debt represented a net overstatement of administrative expenses of \$63,368,413. This \$63,368,413 overstatement represents the amount the UTF was underfunded during the period FY 2005 through the second quarter of FY 2009.

The lengthy duration of these errors is attributable to both a lack of routine reviews of administrative expense cost calculation documentation submitted by the IRS business units to the CFO and the use of outdated procedures, which did not include all necessary variations of the Form 940 in its administrative expenses calculation instructions. Routine reviews of business unit submissions for conformity to updated procedures by the CFO's office could have limited the extent of the occurrence of these errors.

Figure 1 provides a yearly breakdown of the IRS calculation errors requiring the submission of revised billing reports to the Bureau of the Public Debt, including the total net effect and the



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absolute value of both erroneous overcharges and undercharges (amounts undercharged to the UTF shown in parentheses).

**Figure 1: Erroneous UTF Expenses for FY 2005 – FY 2009 (Second Quarter)<sup>5</sup>**

<b>FY</b>	<b>Undercharge</b>	<b>Overcharge</b>	<b>Net Value</b>
2005	(\$471,671)	\$6,154,567	\$5,682,896
2006	(\$7,368,203)	\$72,208	(\$7,295,995)
2007	(\$4,943,232)	\$21,631,521	\$16,688,288
2008	(\$5,798,546)	\$34,965,584	\$29,167,039
2009 (through the Second Quarter)	(\$141,134)	\$19,267,321	\$19,126,187
<b>Totals</b>	<b>(\$18,722,787)</b>	<b>\$82,091,201</b>	<b>\$63,368,413</b>

*Source: IRS UTF administrative expense reimbursement submissions to the Bureau of the Public Debt (October 2009).*

We also identified approximately \$7 million in additional erroneous administrative expense overcharges occurring during the third quarter of FY 2009. These calculations had been submitted to the CFO from the business units but had not yet been formally submitted by the CFO to the Bureau of the Public Debt. We informed the IRS of these erroneous administrative expense calculations, and the IRS was able to correct its calculations prior to submitting its administrative expenses to the Bureau of the Public Debt and, as such, no formal revisions were required.

**Written procedures have been developed but need to be updated, and routine reviews of reimbursement claims should be performed**

While the development of procedures in response to our prior report was an important step in improving the way the IRS determines its cost for UTF administrative expenses, the procedures have not been updated since their development in Calendar Year 2004 to reflect changes in IRS organizational responsibilities due to realignment and new policies. In addition, we determined detailed documentation supporting UTF expense calculations is not maintained or reviewed to ensure the accuracy of reported costs.

Specifically, we determined the current procedures do not include all types of the Form 940 which are currently in use. In addition, the IRS has undergone changes to its work processes in

<sup>5</sup> Due to rounding, minor variations in totaling the stated figures may occur. The actual amount of total IRS revised reimbursement submissions was \$63,368,413.



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the 5 years following the initial development of these procedures. Most notably, work processes accounted for in the procedures by the Small Business/Self-Employed Division are now performed by the Wage and Investment Division. However, the procedures have not been updated to reflect these changes. By not updating the procedures with this information, there is an increased risk that the IRS will calculate inaccurate UTF expenses.

Further, the procedures currently require the IRS business units to calculate the amount of certain nonlabor costs, such as storage of returns filed, and include these costs in the UTF expenses. However, beginning in FY 2009, the CFO implemented a policy which excludes actual nonlabor costs from its calculation of administrative expenses. Although we did not identify any instances of actual nonlabor costs included in the calculation of administrative expenses, the potential exists that these costs could be incorrectly included in UTF expense estimates if IRS procedures are not updated to reflect this recent policy decision.

In addition, the procedures should be expanded to require responsible IRS business units to maintain additional documentation which can be used to support their calculations of administrative expenses. The procedures require that an audit file must be maintained; however, they do not specifically require the maintenance of detailed documentation supporting the calculations used by the business units to report quarterly administrative expenses to the CFO's office. Further, the procedures do not specify a minimum amount of time for documents in the audit file to be maintained. An expanded audit file, along with a requirement to maintain the documentation located in the audit file for a minimum time period, would allow for the increased ability to review future administrative expense calculations for accuracy.

Our review of FY 2009 administrative expenses submitted to the Bureau of the Public Debt showed that the final amounts reported were approved by a senior level IRS executive, as recommended in our prior report. However, the IRS did not perform documented reviews of detailed supporting documentation for the figures in the summary reports submitted from the individual IRS business units. As a result, the IRS executive approver within the CFO's office did not identify that errors in the calculation of administrative expenses occurred. Periodic reviews by management of detailed expense documentation are a critical control in ensuring the accuracy of reported program costs.

## ***Recommendations***

The IRS CFO should:

***Recommendation 1:*** Update the procedures used by the IRS business units to calculate their UTF administrative expenses. At a minimum, the procedures should be updated to include, by name, all types of Form 940 in use; recognize current business unit alignments and responsibilities; and specify the documentation necessary to be maintained in the audit file.



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**Management's Response:** IRS management agreed and will issue new procedures to the business units. The updated procedures will address all types of Forms 940 in use, recognize current business unit alignments and responsibilities, and specify documentation necessary to be maintained in the audit file.

**Recommendation 2:** Instruct that the audit file and the supporting documentation be maintained in a central location, such as the Business Unit Financial office, to facilitate the effective location and retrieval of the files when performing a review. The supporting documentation in the audit file should be maintained for a minimum time period, such as 3 years.

**Management's Response:** IRS management agreed and will include in the new procedures the requirement to maintain the audit file in the Business Unit Financial office for a minimum of 3 years.

**Recommendation 3:** Implement a policy to routinely review documentation supporting the summary cost reports submitted to the CFO by the IRS business units to ensure the accuracy of the information submitted in the summary reports.

**Management's Response:** IRS management agreed and will institute quarterly reviews of business unit trust fund expense submissions and the underlying supporting data for those submissions.

**Recommendation 4:** Determine, on an annual basis in coordination with the Wage and Investment Division, if new versions of the Form 940 are developed; incorporate any new versions of the Form 940 into its procedures; and review summary cost reports submitted by the Wage and Investment Division to ensure new versions of the Form 940 are included in the calculation of UTF administrative expenses.

**Management's Response:** IRS management agreed and will determine, on an annual basis, the completeness of the Wage and Investment Division list of all versions of Form 940 and ensure those versions are included in the calculation of the UTF administrative expenses through the review process.

### ***The Internal Revenue Service's Financial Accounting System Cannot Directly Record or Calculate the Overall Cost of Unemployment Trust Fund Administrative Expenses***

In our FY 2003 report, we recommended the IRS ensure that the ability to record and report administrative expenses be incorporated into the Integrated Financial System to allow for a documented and repeatable process which can provide reliable information on the estimated UTF administrative costs. At that time, management indicated that the Integrated Financial System would contain a cost accounting module that would provide greater traceability of financial data



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to the existing management information system data, thus providing for a more reliable source of expense data.

Although the IRS has improved its cost accounting capabilities since our last review, it still does not have the ability to readily track and record expenses specifically relating to the UTF through the Integrated Financial System. Currently, information regarding direct labor hours and production data regarding the number of Federal unemployment tax returns processed must be gathered from multiple information systems. Gathering this data requires actions on the part of five different IRS business units and must ultimately be manually combined with data from the Integrated Financial System by CFO staff. As a result, the calculation of quarterly UTF expenses is still a cumbersome and time consuming process, with a high risk for errors.

In addition, as a result of the limitations of the Integrated Financial System, the IRS calculates the full cost of administering the UTF for the Department of Labor by first manually compiling direct labor resource expense data calculated and submitted by the responsible business units and then applying a single overhead rate<sup>6</sup> to those direct labor resource costs. Although this two-step process for determining UTF administrative expenses is relatively simple, the use of manual processes increases the risk of calculation errors. Further, the IRS must still comply with Federal accounting standards which require that the full cost of outputs, such as services performed or customers served, be recognized and matched with the costs for producing those outputs. However, the only costs directly identified as related to the UTF are direct labor. The cost of all other items, including costs of items such as printing and mailing Federal unemployment tax returns and publications, are included in the general overhead rate.

The IRS informed us that it is currently in the process of developing the requirements for its future financial accounting system. We believe that the IRS should closely monitor the development of future financial accounting system requirements in order to ensure the capability to integrate all of the information needed to readily track and record UTF expenses is fully considered. In addition, management stated the IRS developed its current overhead rate methodology based on a determination of cost effectiveness and believes the amount of effort necessary to incorporate the more specific data available would exceed the potential benefit, as well as increase the potential for errors by adding more manual steps to the calculation of the overhead rate. While we believe the IRS' current approach is reasonable given the limitations of its current financial system, the IRS will be able to more precisely calculate program costs by incorporating the capability to readily track and record specific UTF expenses into future financial accounting system requirements.

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<sup>6</sup> The UTF overhead rate applied to direct labor resources in FY 2009 was 74.55 percent (i.e., for every dollar identified as having been spent performing UTF-related work, approximately 75 cents was added for the IRS' calculation of administrative expenses).



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## **Recommendation**

The IRS CFO should:

**Recommendation 5:** Ensure a cost accounting capability that supports the ability to readily track, record, and report UTF expenses is considered during the development of future financial accounting system requirements.

**Management's Response:** IRS management agreed and will determine the feasibility of identifying workload management data and integrating it with its financial accounting system to support the tracking, recording, and reporting of UTF expenses in future financial accounting system requirements.



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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine whether the IRS has developed and implemented a methodology to reasonably and accurately calculate the cost of UTF administrative expenses using data from appropriate business unit sources. To accomplish our objective, we:

- I. Documented procedures to identify, record, and report UTF administrative expenses, including established internal controls.
  - A. Identified through discussions with responsible officials and a review of applicable procedures how costs associated with performing the roles and responsibilities for UTF processing are determined.
  - B. Reviewed all Department of the Treasury and IRS policies and guidance for identifying, recording, and reporting administrative expenses.
  - C. Identified processing risks and related internal controls.
- II. Determined whether the IRS' current methodology is reasonable based on cost accounting policies/requirements/regulations.
  - A. Ascertained whether policies established by the IRS, if implemented as described, can be relied upon to produce reasonably accurate, current, and reliable data for the purpose of capturing UTF administrative expenses.
  - B. Interviewed key business unit contacts which submit UTF administrative expenses to determine if the methodology used to calculate UTF administrative expenses is consistent and adheres to policies and procedures currently implemented by the IRS.
- III. Assessed whether the IRS is in compliance with the Department of the Treasury reporting requirements when submitting reports containing UTF administrative expenses to the Bureau of the Public Debt.
- IV. Determined whether UTF administrative expenses reported by the IRS are accurately calculated and substantiated by complete and reliable supporting documentation.
  - A. Obtained the quarterly, year-end, and 10-year projection reports for the periods under review. For purposes of this test, the fiscal year-end 2008 report, 10-year projection, and the first 3 quarters of FY 2009 were initially reviewed. We subsequently expanded our review to include the period FY 2005 through FY 2008.



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- B. Reviewed supporting documentation associated with quarterly UTF expenses reported by the IRS for the first three quarters of FY 2009.
  - C. Compared reported summary amounts to those included in the detailed documentation.
  - D. To test data reliability, we analyzed Form 940 document volume counts processed in the IRS Submission Processing campuses<sup>1</sup> from the Submission Processing Measures Analysis and Reporting Tool database. The audit period we used was FY 2009 (October 2008 – September 2009). The percentage of deviation to overall volume counts was negligible and the IRS data are considered sufficiently reliable for our audit purposes. We did not make any projections in this review.
- V. Followed up on prior audit recommendations to determine whether the IRS had implemented our recommendations related to UTF administrative expenses.
- A. Reviewed written procedures developed by the CFO to document the methodology, including the identification of all systems and sources of information, that would ensure the most reasonable and timely means of identifying and reporting all expenses associated with the IRS' administration of the UTF.
  - B. Determined whether controls are in place to ensure that any amounts reported to the Bureau of the Public Debt are reviewed and approved by a senior level IRS executive.
  - C. Evaluated whether the Integrated Financial System has the ability to record and report UTF administrative expenses.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS' policies, procedures, and practices for calculating the cost of UTF administrative expenses. We evaluated these controls by interviewing management and reviewing applicable documentation.

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<sup>1</sup> Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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**Appendix II**

*Major Contributors to This Report*

Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations)  
Jeffrey M. Jones, Director  
Diana Tengesdal, Acting Director  
Anthony J. Choma, Audit Manager  
Seth A. Siegel, Lead Auditor  
James S. Mills, Jr., Senior Auditor  
Melvin Lindsey, Auditor



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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Small Business/Self-Employed Division SE:S  
Commissioner, Wage and Investment Division SE:W  
Deputy Chief Financial Officer CFO  
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    Commissioner, Small Business/Self-Employed Division SE:S  
    Commissioner, Wage and Investment Division SE:W  
    Chief Financial Officer CFO  
    Senior Operations Advisor, Small Business/Self-Employed Division SE:S:CCS  
    Senior Operations Advisor, Wage and Investment Division SE:W:CAS



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*Internal Accounting Errors Reduced the Federal Funding  
Available for Unemployment Benefits by \$63 Million  
During Fiscal Years 2005 Through 2009*

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## Appendix IV

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Cost Savings, Recommendation That Funds Be Put to Better Use – Actual; \$69,989,070 (see page 4).

#### **Methodology Used to Measure the Reported Benefit:**

The IRS incorrectly based its calculation of administrative costs for the UTF (filing and processing costs of the Employer's Annual Federal Unemployment Tax Return (Form 940)), in part, on the costs of taxpayers filing the Employer's Quarterly Federal Tax Return (Form 941). However, the Form 941 is used by employers to report their quarterly employment tax obligations and is not related to the Form 940. As a result, it should not have been included in the calculation. The IRS also did not include all versions of the Form 940 in the calculation of administrative costs or always properly calculate the salary allocation for certain personnel assigned to UTF-related work.

These errors in the calculation of IRS administrative expenses resulted in both yearly overcharges and undercharges for the period FY 2005 through the second quarter of FY 2009 of \$100,813,988. Following identification of these errors, the IRS recalculated its administrative expenses for the period and submitted revised reports to the Bureau of the Public Debt. Due to the offsetting nature of the 2 types of errors, the IRS' revised submission to the Bureau of the Public Debt represented a net overstatement of administrative expenses of \$63,368,413 for the period. This \$63,368,413 overstatement represents the amount the UTF was underfunded during the period FY 2005 through the second quarter of FY 2009.

We identified \$6,620,657 in additional erroneous administrative expense calculation overcharges occurring during the third quarter of FY 2009. These calculations had been submitted to the CFO from the business units and had not yet been formally submitted by the CFO to the Bureau of the Public Debt. We informed the IRS of these erroneous administrative expense calculations and the IRS was able to correct its calculations prior to submitting its administrative expenses to the Bureau of the Public Debt and, as such, no formal revisions were required.



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The total value of our Cost Savings measure represents the sum of the amount of IRS administrative expense overstatements during the period FY 2005 through the second quarter of FY 2009 and the amount we identified in the preliminary third quarter billings (\$63,368,413 + \$6,620,657 = \$69,989,070).



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**Appendix V**

*Management's Response to the Draft Report*



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

March 8, 2010

**RECEIVED**  
MAR 09 2010

BY: *DA*.....

MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *Alison L. Doone*  
Alison L. Doone  
Chief Financial Officer

SUBJECT: Draft Audit Report – Internal Accounting Errors Reduced the Federal Funding Available for Unemployment Benefits by \$63 Million During Fiscal Years 2005 through 2009 (Audit # 200910020)

We reviewed the draft report and agree with all five recommendations which address improving the accuracy of Unemployment Trust Fund (UTF) expense calculations.

We concur with the described benefit included in the report.

Attached are our detailed responses to your recommendations. If you have any questions, please contact William H. Maglin, Associate Chief Financial Officer for Internal Financial Management, at (202) 435-5540.

Attachment

cc: Director, Office of Legislative Affairs



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Attachment

**RECOMMENDATION 1:**

The IRS CFO should update the procedures used by the IRS business units to calculate their UTF administrative expenses. At a minimum, the procedures should be updated to include, by name, all types of Form 940 in use; recognize current business unit alignments and responsibilities; and specify the documentation necessary to be maintained in the audit file.

**CORRECTIVE ACTION:**

IRS agrees with this recommendation and will issue new procedures to the business units. The updated procedures will address all types of Forms 940 in use; recognize current business unit alignments and responsibilities; and specify the documentation necessary to be maintained in the audit file.

**IMPLEMENTATION DATE**

October 1, 2010

**RESPONSIBLE OFFICIAL**

Chief Financial Officer

**CORRECTIVE ACTION MONITORING PLAN**

N/A



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Attachment

2

**RECOMMENDATION 2:**

The IRS CFO should instruct that the audit file and the supporting documentation be maintained in a central location, such as the Business Unit Financial office, to facilitate the effective location and retrieval of the files when performing a review. The supporting documentation in the audit file should be maintained for a minimum time period, such as three years.

**CORRECTIVE ACTION**

IRS agrees with this recommendation and will include in the new procedures the requirement to maintain the audit file in the business unit finance office for a minimum of three years.

**IMPLEMENTATION DATE**

October 1, 2010

**RESPONSIBLE OFFICIAL**

Chief Financial Officer

**CORRECTIVE ACTION MONITORING PLAN**

N/A



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Attachment

3

**RECOMMENDATION 3:**

The IRS CFO should implement a policy to routinely review documentation supporting the summary cost reports submitted to the CFO by the IRS business units to ensure the accuracy of the information submitted in the summary reports.

**CORRECTIVE ACTION**

IRS agrees with this recommendation and will institute periodic reviews of business unit trust fund expense submissions and the underlying supporting data for those submissions. The reviews will be conducted each quarter on a rotating schedule by CFO analysts. The reviews will be included in the new procedures.

**IMPLEMENTATION DATE**

October 1, 2010

**RESPONSIBLE OFFICIAL**

Chief Financial Officer

**CORRECTIVE ACTION MONITORING PLAN**

The results of the review of business unit documentation will be submitted to the Associate Chief Financial Officer, Internal Financial Management (ACFO) (IFM) each quarter.



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Attachment

4

**RECOMMENDATION 4:**

The IRS CFO should determine, on an annual basis in coordination with the Wage and Investment Division, if new versions of the Form 940 are developed, incorporate any new versions of the Form 940 into its procedures, and review summary cost reports submitted by the Wage and Investment Division to ensure new versions of the Form 940 are included in the calculation of UTF administrative expenses.

**CORRECTIVE ACTION**

IRS agrees with this recommendation and will determine, on an annual basis, the completeness of the Wage and Investment Division list of all versions of Form 940 and ensure those versions are included in the calculation of the UTF administrative expenses through the review process. This process will be included in the new procedures.

**IMPLEMENTATION DATE**

October 1, 2010

**RESPONSIBLE OFFICIAL**

Chief Financial Officer

**CORRECTIVE ACTION MONITORING PLAN**

During the preparation of the estimate of administrative costs for the second quarter each year, the ACFO (IFM) will review the list of all versions of Form 940 provided by W&I.



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*Internal Accounting Errors Reduced the Federal Funding Available for Unemployment Benefits by \$63 Million During Fiscal Years 2005 Through 2009*

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Attachment

5

**RECOMMENDATION 5:**

The IRS CFO should ensure a cost accounting capability that supports the ability to readily track, record, and report UTF expenses is considered during the development of future financial accounting system requirements.

**CORRECTIVE ACTION**

IRS agrees with this recommendation and will conduct an analysis to determine the feasibility of identifying workload management data and integrating it with our financial accounting system to support the tracking, recording, and reporting of UTF expenses in future financial accounting system requirements.

**IMPLEMENTATION DATE**

October 1, 2010

**RESPONSIBLE OFFICIAL**

Chief Financial Officer

**CORRECTIVE ACTION MONITORING PLAN**

N/A