PART 4:

OTHER ACCOMPANYING INFORMATION

APPENDICES

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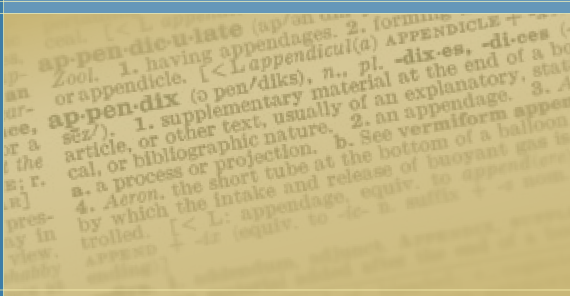
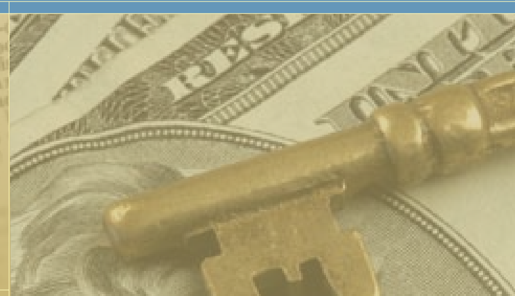
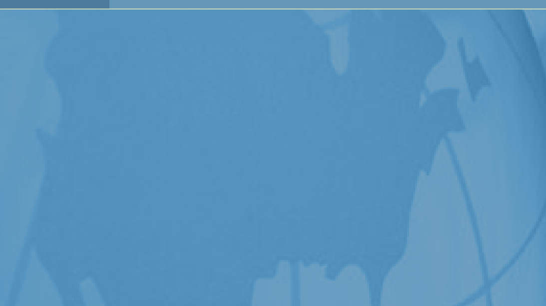
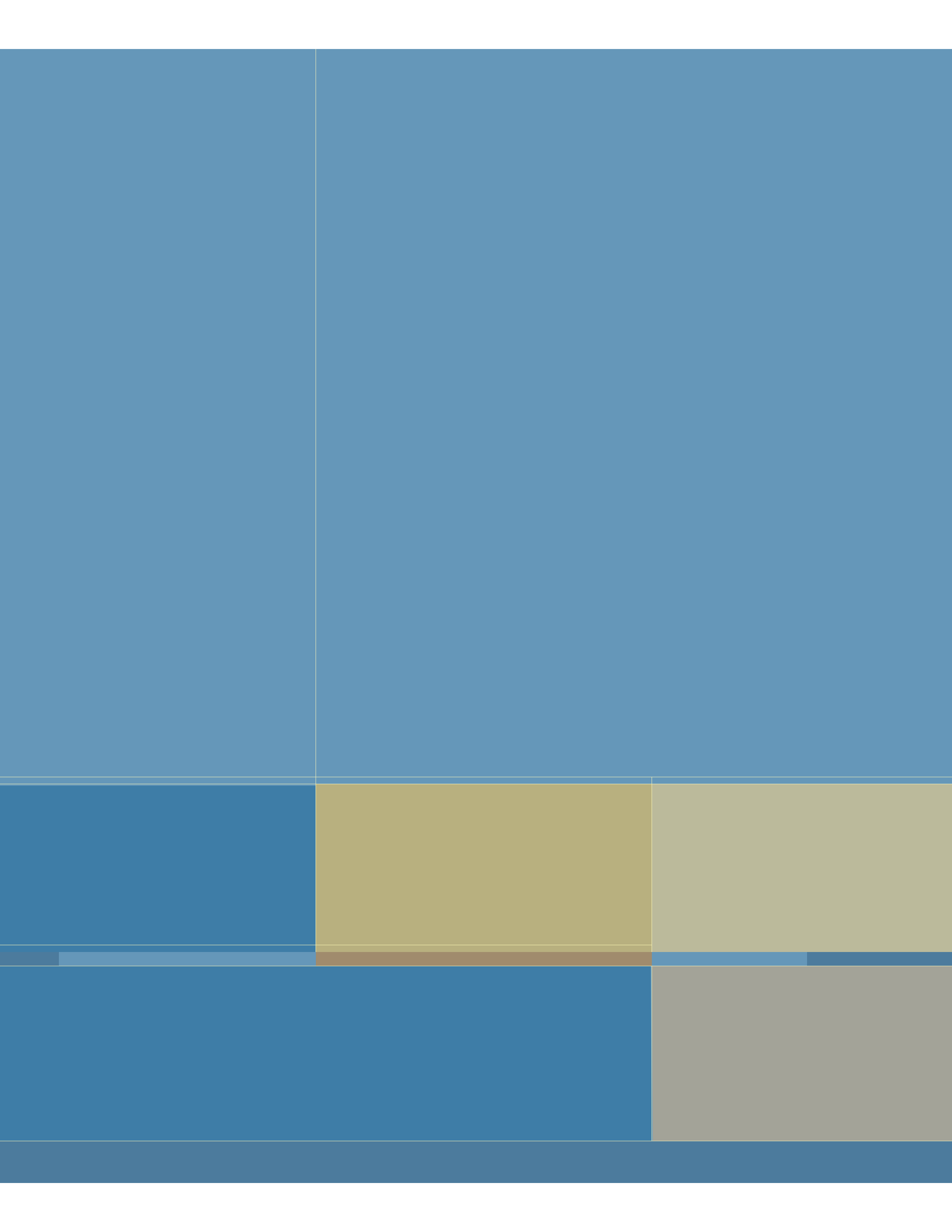






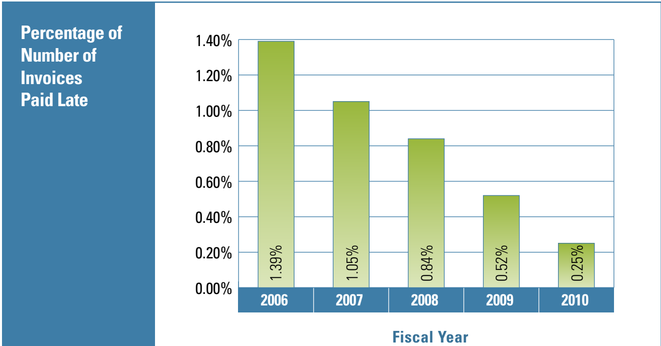


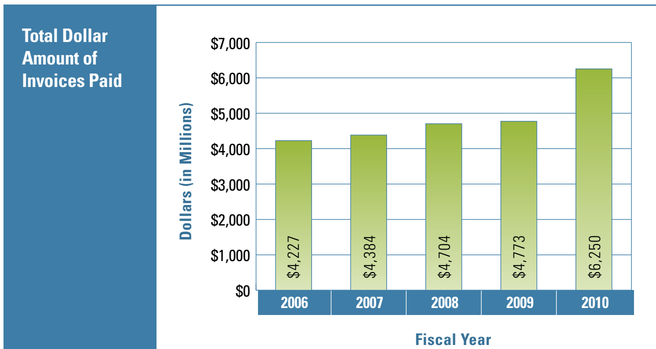
APPENDIX A:
OTHER ACCOMPANYING INFORMATION (UNAUDITED)

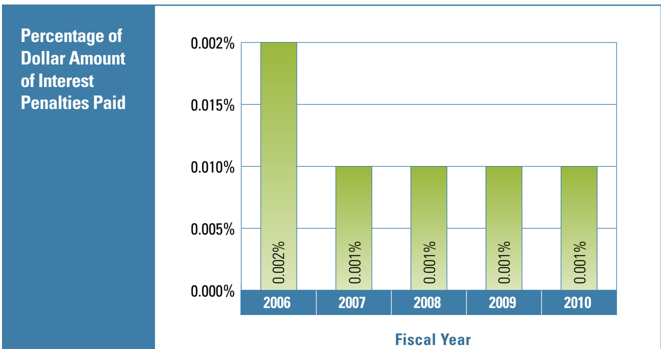
This section provides Other Accompanying Information as prescribed by OMB Circular No. A-136, *Financial Reporting Requirements*.

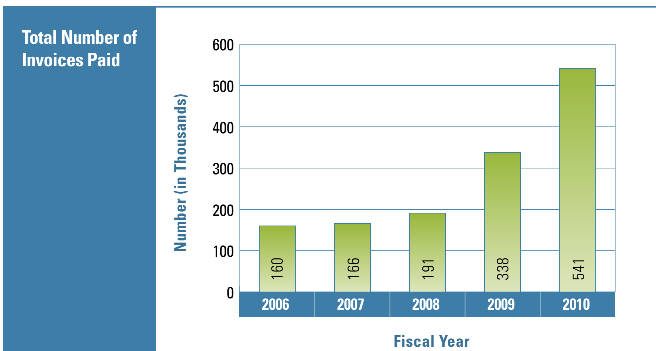
Prompt Payment

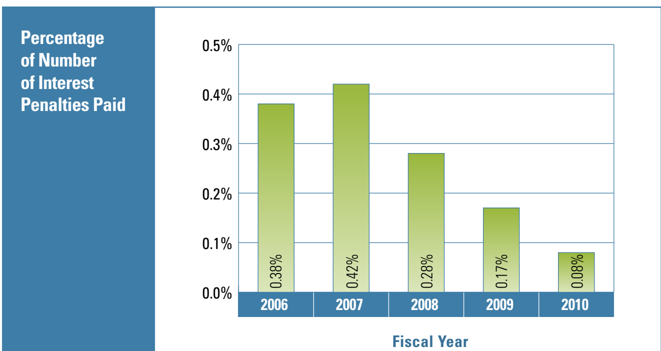
The *Prompt Payment Act* requires Federal agencies to make timely payments to vendors for supplies and services, to pay interest penalties when payments are made after the due date, and to take cash discounts only when they are economically justified. Treasury bureaus report Prompt Payment data on a monthly basis to the Department, and periodic quality control reviews are conducted by the bureaus to identify potential problems.











Tax Gap

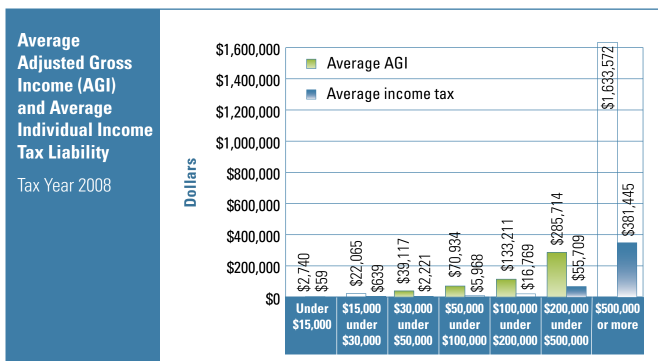
Reducing the tax gap is at the heart of IRS' enforcement programs. The tax gap is the difference between what taxpayers should pay and what they actually pay due to not filing tax returns, not paying their reported tax liability on time, or failing to report their correct tax liability. The tax gap, about $345 billion based on updated fiscal year 2001 estimates, represents the amount of noncompliance with the tax laws. Underreporting tax liability accounts for 82 percent of the gap, with the remainder almost evenly divided between non-filing (8 percent) and underpaying (10 percent). The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

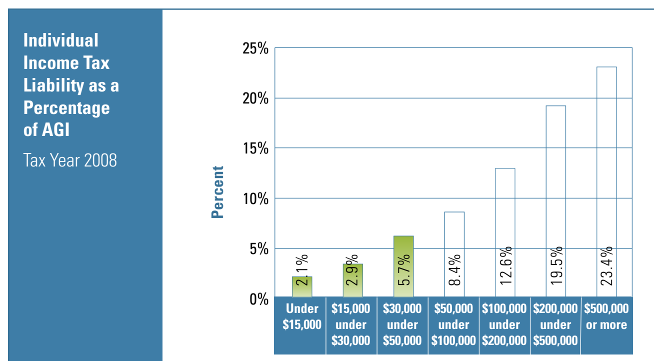
The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the non-filing gap), underreporting the correct amount of tax on timely filed returns (the underreporting gap), and not paying on time the full amount reported on timely filed returns (the underpayment gap). Of these three components, only the underpayment gap is observed; the non-filing gap and the underreporting gap must be estimated. Each instance of noncompliance by a taxpayer contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Obviously, some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from unintentional mistakes.

The collection gap is the cumulative amount of tax, penalties, and interest that has been assessed over many years, but has not been paid by a certain point in time, and which the IRS expects to remain uncollectible. In essence, it represents the difference between the total balance of unpaid assessments and the net taxes receivable reported on the IRS' balance sheet. The tax gap and the collection gap are related and overlapping concepts, but they have significant differences. The collection gap is a cumulative balance sheet concept for a particular point in time, while the tax gap is like an income statement item for a single year. Moreover, the tax gap estimates include all noncompliance, while the collection gap includes only amounts that have been assessed (a small portion of all noncompliance).

Tax Burden

The Internal Revenue Code provides for progressive rates of tax, whereby higher incomes are generally subject to higher rates of tax. The following graphs and charts present the latest available information on income tax and adjusted gross income (AGI) for individuals by AGI level and for corporations by size of assets. For individuals, the information illustrates, in percentage terms, the tax burden borne by varying AGI levels. For corporations, the information illustrates, in percentage terms, the tax burden borne by these entities by various sizes of their total assets. The graphs are only representative of more detailed data and analysis available from the Statistics of Income (SOI) office.

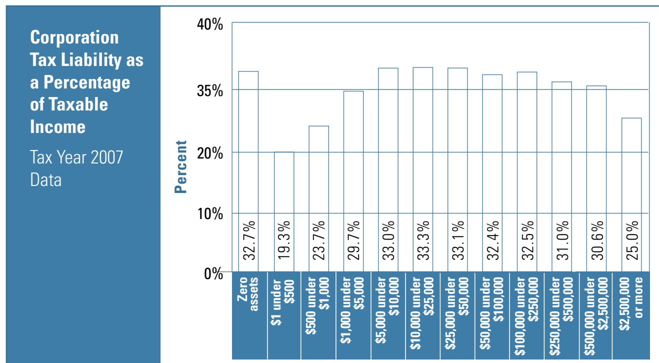




INDIVIDUAL INCOME TAX LIABILITY

Tax Year 2008

Adjusted gross income (AGI)	Number of taxable returns (in thousands)	AGI (in millions)	Total income tax (in millions)	Average AGI per return (in whole dollars)	Average income tax per return (in whole dollars)	Income tax as a percentage of AGI
Under $15,000	37,970	$ 104,025	$ 2,227	$ 2,740	$ 59	2.1%
$15,000 under $30,000	29,687	655,035	18,958	22,065	639	2.9%
$30,000 under $50,000	25,641	1,002,998	56,953	39,117	2,221	5.7%
$50,000 under $100,000	30,926	2,193,691	184,554	70,934	5,968	8.4%
$100,000 under $200,000	13,851	1,845,103	232,270	133,211	16,769	12.6%
$200,000 under $500,000	3,477	993,427	193,700	285,714	55,709	19.5%
$500,000 or more	899	1,468,581	342,919	1,633,572	381,445	23.4%
Totals	142,451	$ 8,262,860	$ 1,031,581			



CORPORATION TAX LIABILITY
Tax Year 2007

Total Assets (in thousands)	Income subject to tax (in millions)	Total income tax after credits (in millions)	Percentage of income tax after credits to taxable income
Zero Assets	$ 26,280	$ 8,593	32.7%
$1 under $500	8,205	1,582	19.3%
$500 under $1,000	4,292	1,017	23.7%
$1,000 under $5,000	15,577	4,628	29.7%
$5,000 under $10,000	10,008	3,299	33.0%
$10,000 under $25,000	16,650	5,547	33.3%
$25,000 under $50,000	13,139	4,347	33.1%
$50,000 under $100,000	16,621	5,392	32.4%
$100,000 under $250,000	27,977	9,100	32.5%
$250,000 under $500,000	35,046	10,876	31.0%
$500,000 under $2,500,000	145,944	44,586	30.6%
$2,500,000 or more	928,546	232,408	25.0%
Total	$ 1,248,285	$ 331,375	26.5%

APPENDIX B: IMPROPER PAYMENTS INFORMATION ACT AND RECOVERY AUDITING ACT

The *Improper Payments Information Act of 2002* (IPIA) requires agencies to review their programs and activities annually to identify those susceptible to significant improper payments. According to the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments* (A-123, Appendix C), "significant" means that an estimated error rate and a dollar amount exceed the threshold of 2.5 percent and $10 million of total program funding. A-123, Appendix C also requires the agency to implement a corrective action plan that includes improper payment reduction targets.

The government-wide Chief Financial Officers Council developed an alternative for meeting IPIA requirements for federal programs that are so complex that developing an annual error rate is not feasible. Agencies may establish an annual estimate for a high-risk component of a complex program (e.g., a specific program population) with OMB approval. Agencies must also perform trend analyses to update the program's baseline error rate in the interim years between detailed program studies. When development of a statistically valid error rate is possible, the reduction targets are revised and become the basis for future trend analyses.

I. Description of the Department's risk assessment(s) performed subsequent to compiling its full program inventory and risk-susceptible programs

Each year, the Department develops a comprehensive inventory of the funding sources for all programs and activities and distributes it to the Treasury bureaus and offices. If program or activity funding is at least $10 million, risk assessments are required at the payment type level (e.g., payroll, contracts, vendors, travel, etc.). The Department's risk assessment follows the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Integrated Framework. The framework includes:

1. Internal Control Environment
2. Risk Assessment
3. Internal Control Activities
4. Information and Communications
5. Monitoring

Within the COSO Integrated Framework, the factors addressed to determine risk levels include:

- **Operating Environment –** Existence of factors which necessitate or allow for loosening of financial controls; any known instances of fraud
- **Payment Processing Controls –** Management's implementation of internal controls over payment processes including existence of current documentation, the assessment of design and operating effectiveness of internal controls over payments, the identification of deficiencies related to payment processes, and whether or not effective compensating controls are present
- **Quality of Internal Monitoring Controls –** Periodic internal program reviews to determine if payments are made properly; strength of documentation requirements and standards to support testing of design and operating effectiveness for key payment controls
- **Human Capital –** Experience, training, and size of payment staff; ability of staff to handle peak payment requirements; level of management oversight and monitoring against fraudulent activity

- **Complexity of Program –** Length of time program has been operating; complexity and variability of interpreting and applying laws, regulations, and standards required of the program

For those payment types resulting in high-risk assessments that comprise at least 2.5 percent and $10 million of a total funding source, (1) statistical sampling must be performed to determine the actual improper payment rate, and (2) a corrective action plan must be developed and submitted to the Department and OMB for approval.

Responses to the risk assessments produce a score that falls into pre-determined categories of risk. The following table describes the actions required at each risk level:

Risk Level	Required Action(s)
High Risk ≥ 2.5% Error Rate & > $10 Million	Corrective Action Plan
Medium Risk	Review Payment Controls for Improvement
Low Risk	No Further Action Required

The risk assessments performed across the Department in fiscal year 2010 resulted in all programs and activities as low and medium risk susceptibility for improper payments except for the Internal Revenue Service's (IRS) Earned Income Tax Credit (EITC) program. The EITC's high-risk status is well-documented, having been previously identified in the former Section 57 of OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, and has been deemed a complex program for the purposes of the IPIA.

In addition to the risk assessments monitored under IPIA, the Department continued its review of initial risk assessments related to the *American Recovery and Reinvestment Act of 2009* (Recovery Act) and required reassessments of high-risk Recovery Act programs.

II. Describe the statistical sampling process conducted to estimate the improper payment rate for each program identified

Earned Income Tax Credit

The EITC is a refundable federal tax credit that offsets income taxes owed by low-income workers and, if the credit exceeds the amount of taxes owed, provides a lump-sum payment to those who qualify.

The section below describes how the IRS currently develops its erroneous payment projections. The most recent projection is based on a tax year 2006 reporting compliance study that estimated the level of improper overclaims for fiscal year 2010 to range between $15.3 to $18.4 billion and 23.9 percent (lower bound) to 28.7 percent (upper bound) of approximately $64.2 billion in total program payments.

National Research Program (NRP) Analysis

The complexity of the EITC program, the nature of tax processing, and the expense of compliance studies preclude statistical sampling on an annual basis to develop error rates for comparison to reduction targets. The estimates are based primarily on information from the National Research Program (NRP) reporting compliance study of individual income tax returns for tax year 2006—the most recent year for which compliance information from a statistically valid, random sample of individual tax returns is available. The approach is nearly identical to that used for earlier years.

Under the tax year 2006 NRP reporting compliance study, individual income tax returns filed during calendar year 2007 for tax year 2006 were randomly selected for examination.[1] This selection method allows the measures for the individual income tax

1 The NRP used a stratified, random sample design. Returns are grouped into predefined categories or "strata" and selected randomly within each stratum.

return filing population to be estimated from the results of the NRP sample returns. Because one of the objectives of the NRP is to provide data for compliance measurement, NRP procedures and data collection differed from those followed in standard examination programs. NRP classification and examination procedures were more comprehensive in scope and depth than those for standard examination programs. These expanded procedures were designed to provide a more thorough determination of what taxpayers should have reported on their returns.

The tax year 2006 NRP individual income tax return study covered filers of all types of individual income tax returns. About 2,200 of the returns in the regular NRP sample were EITC claimants. The NRP study results for this EITC claimant subset of NRP returns were the primary source of data for the improper payments estimates. Other data and information sources used for the estimates included the IRS Enforcement Revenue Information System (ERIS), which tracks assessments and collections from IRS enforcement-related activities; Treasury Department estimates of the effect of the EITC provisions in the *Economic Growth and Tax Relief Reconciliation Act of 2001* on erroneous EITC claims; and Treasury Department fiscal year 2010 EITC budget estimates.

III. Describe the Corrective Action Plans for reducing the estimated rate of improper payments for the EITC program

Base Program

In 2010, the IRS prevented more than $3.7 billion from being paid in error. The prevention activity primarily focused on three areas:

- **Examinations –** IRS identifies tax returns for examination and holds the EITC portion of the refund until an audit can be conducted. This is the only ongoing IRS audit program where exams are conducted before a refund is released. The examination closures and enforcement revenue protected in the charts below do not include test initiatives
- **Math Error –** Refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer. Congressional approval is required for math error use
- **Document Matching –** Involves comparing income information provided by the taxpayer with matching information (e.g., W-2s, 1099s) from employers to identify discrepancies

The chart below shows significant results from fiscal year 2005 through an estimate of fiscal year 2011. In fiscal year 2010 alone, the IRS conducted over 474,000 examinations, issued 300,000 math error notices, and closed over 900,000 document matching reviews.

Compliance Activities (thousands)

	FY05*	FY06*	FY07*	FY08*	FY09*	FY10**	FY11***	FY05-FY11 Total
Examination Closures	527,969	517,617	503,267	503,755	508,180	474,092	475,000	3,509,880
Math Error Notices**	515,890	460,316	393,263	432,797	355,416	300,000	250,000	2,707,682
Document Matching****	324,419	364,020	734,603	727,916	688,087	904,920	900,000	4,643,965
Amended Returns[1]				32,473	25,395	19,400	20,000	97,268

* Restated actual

** Preliminary estimates

*** Estimate based on fiscal year 2011 preliminary data.

**** Fiscal year 2007 and fiscal year 2008 restated to include enterprise data. In prior years, data included Wage and Investment data only. Small Business and Self-Employed data have been added.

[1] Amended returns are a subset of Examination Closures.

These activities had a significant effect. Treasury projects that continued enforcement efforts will protect over $23 billion in revenue through fiscal year 2011.

Enforcement Revenue Protected ($ billions)								
	FY05*	FY06*	FY07*	FY08*	FY09*	FY10**	FY11***	FY05-FY11 Total
Examination Closures	1.35	1.50	1.49	2.00	2.15	1.96	1.96	12.41
Math Error Notices**	0.52	0.46	0.41	0.44	0.40	0.34	0.28	2.85
Document Matching****	0.53	0.60	1.29	1.23	1.17	1.43	1.43	7.68
Amended Returns				0.07	0.07	0.06	0.06	0.26
TOTAL	2.40	2.56	3.19	3.74	3.79	3.79	3.73	23.20

* Restated actual
** Preliminary estimates
*** Estimate based on fiscal year 2011 preliminary data
**** Fiscal year 2007 and fiscal year 2008 restated to include enterprise data

Testing New Business Processes

The IRS continues to build new solutions for existing business processes and to use other activities to combat program error including:

Pilot Concept – Assessing State Data for Validating EITC Eligibility

Treasury proposes a Partnership Fund pilot to assess the availability, quality, completeness, and overall usefulness of state-administered benefits data, as well as state benefits screening processes, to help validate EITC eligibility. The pilot would address whether state data could identify both ineligible individuals who receive improper EITC payments and eligible individuals who are not claiming the EITC. The assessment will be conducted separate from, but parallel to, normal federal EITC operations. The IRS's actual eligibility results based on EITC claims in a pilot state will be compared to simulated eligibility results based on analysis of existing state data and potential state data that could be collected from new benefits enrollment questions. The results of the pilot will be used to develop administrative changes and statutory proposals to improve EITC payments nationally.

Maximize Current Business Processes

- Increase the activities associated with a suite of EITC paid preparer treatments, based on risk-based selections, including due diligence audits, visits by revenue and criminal investigation agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers to influence the accuracy of EITC returns filed. Analyze short-term outcomes, including penalties and accuracy of returns
- Continuing the partnership with members from two key tax software associations to identify software enhancements and collaborative efforts that can help reduce EITC errors and assist preparers in meeting their EITC due diligence requirements
- Assess the 2010 EITC marketing/awareness campaigns that target EITC eligible and non-compliant populations to refine/focus efforts and to incorporate recent tax law changes on eligibility and benefits to increase overall participation and improve compliance

IV. EITC Improper Payment Reduction Outlook

The reduction outlook for EITC improper payments is as follows:

Improper Payment (IP) Reduction Outlook ($ in billions)															
Program	PY Outlays	PY %	PY $	CY Outlays	CY IP%	CY IP$	CY+1 Est Outlays	CY+1 IP%	CY+1 IP$	CY+2 Est Outlays	CY+2 IP%	CY+2 IP$	CY+3 Est Outlays	CY+3 IP%	CY+3 IP$
EITC Upper Bound Estimate	$48.1	28.0%	$13.3	$64.2	28.7%	$18.4	$64.1	28.7%	$18.4	$58.2	28.7%	$16.7	$58.3	28.7%	$16.7
EITC Lower Bound Estimate	$48.1	23.0%	$11.2	$64.2	23.9%	$15.3	$64.1	23.9%	$15.3	$58.2	23.9%	$13.9	$58.3	23.9%	$13.9

Outlays: The amounts shown are projections of total payments for the EITC, estimated by the Office of Tax Analysis within the Department of the Treasury. Following prior methodology, the amount shown is the total EITC claimed.

IP % and IP $: These estimates follow the prior approach which provided a range for improper payments.

Note: The Improper Payment percentage and Estimated Outlay columns reflect a constant error rate pending the development of an annual error rate measurement.

CY and CY+1 estimates include Recovery Act EITC provisions which expand the EITC for families with three children and increase the beginning of the phaseout range for couples filing a joint return.

CY: Current year; PY: Prior year

V. Management Accountability

The Secretary of the Treasury has delegated responsibility for addressing improper payments to the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO). Improper payments fall under the Department's management and internal control program. A major component of the internal control program is risk assessments, which are an extension of each bureau's annual improper payment review process. Under Treasury Directive 40-04, *Treasury Internal (Management) Control Program*, executives and other managers are required to have management control responsibilities as part of their annual performance plans. With oversight mechanisms such as the Treasury CFO Council and the IRS's Financial and Management Controls Executive Steering Committee, managerial responsibility and accountability in all management and internal control areas are visible and well-documented.

Improper payments also have been monitored for improvement as a significant deficiency under the *Federal Managers' Financial Integrity Act*. Executives who are responsible and accountable for reducing the level of EITC overclaims have been identified, while other senior and mid-level officials have responsibility for monitoring progress in this area as bureau and program internal control officers.

VI. Resources Requested in the Fiscal Year 2011 Budget Submission to Congress

The fiscal year 2011 President's Budget submission included no new initiatives related directly to the EITC program.

VII. Limiting Statutory and Regulatory Barriers

A number of factors continue to serve as barriers to reducing overclaims in the EITC program. These include:

- Complexity of the tax law
- Structure of the Earned Income Tax Credit
- Confusion among eligible claimants
- High turnover of eligible claimants
- Unscrupulous return preparers
- Fraud

No one of these factors can be considered the primary driver of program error. Furthermore, the interaction among the factors makes addressing the credit's erroneous claims rate, while balancing the need to ensure the credit makes its way to taxpayers who are eligible, extremely difficult.

VIII. Executive Order 13520 - Reducing Improper Payments and Eliminating Waste in Federal Programs

On November 20, 2009, President Barack Obama issued Executive Order 13520 - *Reducing Improper Payments and Eliminating Waste in Federal Programs* (EO 13520). According to EO 13520, the purpose of the order is to *"reduce improper payments by intensifying efforts to eliminate payment error, waste, fraud, and abuse in the major programs administered by the Federal Government, while continuing to ensure that Federal programs serve and provide access to their intended beneficiaries*."

The EITC has been identified as a "high-priority program" under EO 13520. Due to the "high-priority program" status, certain requirements must be met. OMB developed these requirements to promote accountability and transparency by the agency program and federal government to the public for its use of public funds. Requirements include but are not limited to:

- Designation of a Senate-confirmed accountable official
- Establishment of annual or semi-annual targets for reducing improper payments
- Report on agency methodology for identifying and measuring improper payments by the agency's high-priority program(s)
- Agency plan for meeting the reduction targets for improper payments in the high-priority program(s)
- Agency plan for ensuring that initiatives undertaken do not unduly burden program access and participation by eligible beneficiaries

Periodic reviews and analysis of the progress of remediation plans will be addressed with the accountable program officials, Inspector General, Chief Financial Officer, and OMB. Treasury submitted the required plan and informational documents as required by 13520.

Recovery Auditing Act

IX. Treasury's Recovery Auditing Program

Section 831 of the *Defense Authorization Act* for fiscal year 2002 added a new subchapter to U.S. Code (31 U.S.C 3561-3567), also known as the Recovery Auditing Act, that requires agencies that enter into contracts with a total value in excess of $500 million in a fiscal year to carry out a cost-effective program for identifying errors made in paying contractors and for recovering amounts erroneously paid to the contractors. A required element of such a program is the use of recovery audits and recovery activities. In accordance with OMB Circular A-123, Appendix C, reporting on recovery auditing is required annually.

In fiscal year 2010, Treasury issued contracts totaling $6.4 billion. Treasury's annual IPIA risk assessment process includes a review of pre-payment controls that minimize the likelihood and occurrence of improper payments. For Recovery Auditing Act compliance, Treasury requires each bureau and office to review their post-payment controls and report on recovery auditing activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use recovery auditing firms to perform many of the steps in their recovery auditing program and identify candidates for recovery action.

Treasury considers both pre-payment and post-payment reviews to identify payment errors a sound management practice that should be included among basic payment controls. All of Treasury's bureaus use some form of recovery auditing techniques to identify improper payments during post-payment reviews. At times, bureaus may use the services of recovery auditors to help them identify payment anomalies and target areas for improvement. However, Treasury has extensive contract payment controls that are applied at the time each payment is processed, making recovery activity minimal. The low level of improper payments in 2010 did not require any Treasury bureau to develop a management improvement program under Recovery Auditing Act guidance.

Recovery Auditing Information Fiscal Year 2004 - Fiscal Year 2010

Agency	Amount Subject to Review for CY Reporting	Actual Amount Reviewed and Reported CY	Amount Identified for Recovery CY	Amount Recovered CY*	Amount Identified for Recovery PY	Amount Recovered PY	Cumulative Amts. Identified for Recovery (CY+PYs)	Cumulative Amts. Recovered (CY+PYs)
Treasury	$6,388,181,812	$5,825,819,856	$466,792	$518,000	$1,475,232	$1,357,672	$7,200,597	$6,018,579

Note: CY: Current year; PY: Prior year
* Includes amounts identified for recovery in prior years.

For fiscal year 2010, the total number of contracts subject to review was 33,069; the total number reviewed was 25,479, for a total recovery auditing program cost of approximately $1.2 million dollars.

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APPENDIX C:
MANAGEMENT AND PERFORMANCE CHALLENGES AND RESPONSES

In accordance with the *Reports Consolidation Act of 2000*, the Inspectors General issue Semiannual Reports to Congress that identify specific management and performance challenges facing the Department. At the end of each fiscal year, the Treasury Office of Inspector General (OIG) and the Treasury Inspector General for Tax Administration (TIGTA) send an update of these management challenges to the Secretary and cite any new challenges for the upcoming fiscal year.

Under the *Emergency Economic Stabilization Act of 2008* (Pub. Law No. 110-343), the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) is not required to provide the Secretary with a semi-annual report or annual update on management and performance challenges.

The Appendix contains the incoming management and performance challenges letters from OIG and TIGTA and the Secretary's responses describing actions taken and planned to address the challenges.

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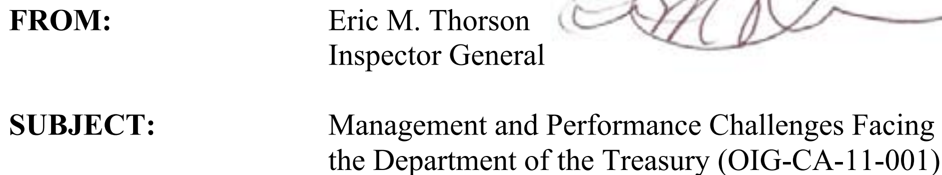
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON

October 22, 2010

INFORMATION MEMORANDUM FOR SECRETARY GEITHNER



FROM: Eric M. Thorson
Inspector General

SUBJECT: Management and Performance Challenges Facing the Department of the Treasury (OIG-CA-11-001)

In accordance with the Reports Consolidation Act of 2000, we are providing you with our perspective on the most serious management and performance challenges facing the Department of the Treasury.

This year we have combined three challenges reported last year into two, renamed those two and expanded them to reflect significant economic events and new responsibilities given to Treasury. Specifically, we have:

- renamed the challenge previously reported as "Regulation of National Banks and Thrifts" to "Transformation of Financial Regulation." We have also expanded this challenge to incorporate significant events and changes that have taken place since last year, most notably those related to Treasury's new responsibilities under the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.
- renamed the challenge previously reported as "Management of Treasury's New Authorities Related to Distressed Financial Markets" to "Management of Treasury's Authorities Intended to Support and Improve the Economy." This challenge encompasses the previously reported challenge entitled "Management of Recovery Act Programs" and has been expanded to recognize Treasury's new responsibilities and authorities related to the recently enacted Small Business Jobs Act of 2010.

We also continue to report two challenges from last year.

- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement
- Management of Capital Investments

Challenge 1: Transformation of Financial Regulation

In response to the need for financial reform, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in July 2010. Dodd-Frank established new responsibilities for Treasury and created new offices tasked to fulfill those responsibilities.

A critical challenge in the near term is Treasury's role in standing up the Bureau of Consumer Financial Protection (BCFP). Established by Dodd-Frank, the purpose of BCFP is to implement and, where applicable, enforce federal consumer financial law consistently to ensure that all

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consumers have access to markets for consumer financial products and services and that those markets are fair, transparent, and competitive. Eventually, BCFP will be an independent bureau of the Board of Governors of the Federal Reserve System (the Board of Governors). However, the Treasury Secretary is charged with supporting the creation and management of BCFP until a Director is confirmed. On September 17, 2010, the President appointed Elizabeth Warren to serve as Assistant to the President and Special Advisor to the Secretary of the Treasury on BCFP. At this time, it is uncertain when a BCFP Director will be confirmed. In the mean time, much needs to be done to set up the BCFP. While BCFP remains in Treasury, it will be under the audit and investigative oversight of my office. We are, however, coordinating those oversight efforts with the Office of Inspector General of the Board of Governors.

Dodd-Frank also established the Financial Stability Oversight Council (FSOC), which is chaired by the Treasury Secretary. FSOC held its inaugural meeting on October 1, 2010. FSOC's mission is to identify risks to financial stability that could arise from the activities of large, interconnected financial companies; respond to any emerging threats to the financial system; and promote market discipline. The Council of Inspectors General on Financial Oversight (CIGFO), which I chair, facilitates the sharing of information among inspectors general with a focus on reporting our concerns that may apply to the broader financial sector and ways to improve financial oversight. Accordingly, CIGFO will be an important source of independent, unbiased analysis to FSOC. In the future, CIGFO may also vote to convene a working group to evaluate the effectiveness and internal operations of the FSOC. We held our inaugural meeting on October 21, 2010.

Dodd-Frank also established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO). OFR is to be a data collection, research and analysis arm of FSOC. OFR will operate under a confirmed Director while the Director of FIO will be appointed by the Treasury Secretary. Among other things, the Director of OFR is to report to Congress annually on the office's activities and its assessments of systemic risk. FIO is to monitor the insurance industry, including identifying gaps or issues in the regulation of insurance that could contribute to a systemic crisis in the insurance industry or financial system. The Director of FIO will advise FSOC on insurance matters.

Intended to streamline the supervision of depository institutions and holding companies, Dodd-Frank transfers the powers and duties of the Office of Thrift Supervision (OTS) to the Office of the Comptroller of the Currency (OCC), the Board of Governors, and the Federal Deposit Insurance Corporation (FDIC) no later than July 21, 2011. Dodd-Frank requires OCC, OTS, the Board of Governors, and FDIC to jointly submit a plan within 180 days of the enactment of Dodd-Frank to their respective Inspectors General and Congress detailing the steps they will take to implement the transfer. The respective Inspectors General will evaluate that plan and jointly provide a written report to OCC, OTS, the Board of Governors, and FDIC, with a copy to Congress, on whether it conforms to the provisions of Dodd-Frank. Our joint report will be issued within 60 days of receiving the plan. In addition, we will jointly report on the status of the implementation of the plan every 6 months thereafter until all aspects of the plan are implemented.

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Clearly, the intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on our economy. In order to accomplish this, Dodd-Frank has placed a great deal of responsibility within Treasury and on the Treasury Secretary. The management challenge from our perspective is to implement an effective FSOC process supported by the newly created offices within Treasury and the streamlined banking regulatory structure that timely identifies and strongly responds to emerging risks. This is especially important in times of economic growth and financial institution profitability when such government action is likely to be unpopular. Our future work plans will include reviews to look at how well Treasury establishes the new offices and undertakes its other critical roles.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 90 Treasury-regulated financial institutions have failed, with estimated losses to the Deposit Insurance Fund of approximately $36 billion. This is an increase of 51 financial institutions and $9 billion in losses since my last challenges letter. More financial institutions are expected to fail over the next 2 years.

Although many factors contributed to the turmoil in the financial markets, our work found that OCC and OTS did not identify early or force timely correction of unsafe and unsound practices by numerous institutions under their respective supervision. The irresponsible lending practices of many institutions are now well-recognized—including reliance on risky products, such as option adjustable rate mortgages, and degradation of underwriting standards. At the same time, financial institutions engaged in other high-risk activities, including high asset concentrations in commercial real estate and overreliance on unpredictable brokered deposits to fund rapid growth. Recently, the unprecedented speed at which servicers were foreclosing on defaulted mortgages has revealed flaws in the processing of those foreclosures. A number of the largest banks with servicing functions have voluntarily placed moratoriums on foreclosures either in certain states or nationwide until these matters are resolved. While the depth and extent of these problems are not fully known at the time of this writing, this is yet another troubling development in the manner in which financial institutions have been operating. I am also concerned about the impact this could have on an already stressed housing market. Addressing this issue could be the first major challenge for the FSOC.

The banking industry will continue to be stressed over the next several years. In the 2010 interagency Shared National Credits (SNC) review, OCC, OTS, and the other federal banking regulators found that credit quality improved from 2009 but remained weak with respect to the $2.5 trillion in large ($20 million or more) loans and loan commitments held by domestic bank organizations, foreign bank organizations, and nonbank entities such as securitization pools, hedge funds, insurance companies, and pension funds. The review, which covered $1 trillion of the $2.5 trillion SNC portfolio, identified total losses of $15 billion, down from total losses of $53 billion in 2009. Criticized assets declined to $448 billion from $642 billion and represented nearly 18 percent of the SNC portfolio, compared with 22 percent in 2009. The volume of poorly underwritten credits originated in 2006 and 2007 continued to adversely affect the overall credit quality of the portfolio. Refinancing risk within the portfolio is also significant, with nearly 67 percent of criticized assets maturing between 2012 and 2014.

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Our office is mandated to review the failures of Treasury-regulated financial institutions that result in material losses to the Deposit Insurance Fund. Since 2007, we have completed 21 such reviews and are engaged in 31 others. These reviews identify the causes of the failures and assess supervision exercised over failed institutions. Both OCC and OTS have been responsive to our recommendations for improving supervision. Dodd-Frank now mandates that our office also review failures that result in non-material losses to the Deposit Insurance Fund. To that end, we have completed 28 such reviews. However, neither the material nor non-material reviews address the broader supervisory effectiveness of the federal banking regulators as a whole or the effectiveness of the supervisory structure. It is therefore essential that OCC and OTS continue to take a critical look at their supervisory processes to identify why those processes did not prevent or mitigate the practices that led to the current crisis and what can be done to better protect the financial health of the banking industry and consumers going forward.

Since implementation of Dodd-Frank is in its early stages, Treasury and its two federal bank regulators, OCC and OTS, will need to work in concert with the other affected federal bank regulators to ensure a smooth and effective transition to the new regulatory structure and requirements.

Challenge 2: Management of Treasury's Authorities Intended to Support and Improve the Economy

Congress provided Treasury with broad authorities to address the financial crisis under the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA) enacted in 2008, the American Recovery and Reinvestment Act of 2009 (Recovery Act), and the Small Business Jobs Act of 2010. Certain authorities in HERA and EESA have now expired but challenges still remain in managing Treasury's outstanding investments. To an extent, Treasury's program administration under these two Acts has matured. In contrast, program administration for the Recovery Act is still evolving, and the Small Business Jobs Act programs must be stood up. Our discussion of this challenge will begin with the most recent Act passed to support and improve the economy and then discuss the other new programs Treasury is responsible for.

Management of the Small Business Lending Fund and State Small Business Credit Initiative

In late September 2010, Congress enacted the Small Business Jobs Act of 2010 creating within Treasury a $30 billion Small Business Lending Fund (SBLF) and providing $1.5 billion to be allocated by Treasury to approved states for eligible state programs through the State Small Business Credit Initiative (SSBCI). The Act represents a key initiative of the Administration to increase lending to small business and thereby support job creation. The challenge for Treasury will be to get these two programs up and running quickly while maintaining proper control to ensure transparency, equitable treatment of all participants, and program results. Our office is specifically directed in the Act to exercise vigorous oversight. To that end, I am establishing an Office of Small Business Lending Fund Oversight to be headed by a Special Deputy Inspector General.

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SBLF Under SBLF, Treasury will make capital investments in eligible financial institutions (e.g., banks with total assets of $10 billion or less and not on FDIC's problem bank list) after consultation with the institution's regulator. Eligible institutions are permitted to refinance securities issued to Treasury under the Troubled Asset Relief Program (TARP) Capital Purchase Program (CPP) as long as they are current on their CPP obligations. Treasury's capital investment may be up to 5 percent of the institution's risk-weighted assets depending on the institution's size. During the first 4½ years of Treasury's investment, participating institutions initially pay dividends to Treasury of 5 percent but that rate may be reduced to as low as 1 percent based on their demonstrated increase in small business lending (after 4 ½ years, the dividend rate increases to 9 percent and Treasury's investment is expected to be repaid within 10 years although there are provisions for extending repayment beyond that time).

As of this writing, Treasury has not published specific policies and guidance for program administration. It is critically important that a strong control structure along with commensurate staffing be established on the front-end of this effort. It is also critical in setting up this program that Treasury build on its experience with CPP. For example, in a recent (October 2010) report on TARP, GAO observed that applicants that withdrew from consideration for CPP in response to a request from their regulator received no review by Treasury or other regulators. GAO recommended that if Treasury administers programs containing elements similar to those of CPP, such as SBLF, that Treasury should implement a process for monitoring all applicants that regulators recommend for withdrawal to ensure that similar applicants are treated equitably. Treasury agreed to consider the GAO recommendation, and we believe that this should be a component of the control structure that Treasury establishes for SBLF. Another key provision of the Act is that banking regulators publish guidance by the end of November 2010 regarding prudent underwriting standards that must be used for loans made by participating institutions; these standards will need to be in place so that participating institutions have a clear understanding on how the funds are to be used. Furthermore, it is important that Treasury and regulators coordinate to ensure that participating institutions comply with the terms and conditions of the investments, to include validation of increased small business lending in return for reduced dividend rates on Treasury investments.

SSBCI On October 8, 2010, Treasury announced individual SSBCI funding allocations totaling $1.46 billion for the 50 States, the District of Columbia, and the U.S. territories, intended to support new small business lending through local programs. Under the SSBCI, states may apply for federal funds for programs that partner with private lenders to extend greater credit to small businesses. SSBCI allows states to build upon existing state-level small business lending programs. If a State does not have an existing small business lending program, the state can establish one in order to access SSBCI funding. States must provide plans for utilizing their funding allocations to Treasury for review and approval and report quarterly and annually on results. Another key feature is that participating states receive their allocations in 1/3 increments. Treasury may withhold a successive increment to a State pending the results of an audit by our office.

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The Act also details specific expectations of Treasury for program administration to include consulting with the Small Business Administration and federal banking agencies; establishing minimum national standards for approved State programs; providing technical assistance and disseminating best practices; managing, administering, and performing necessary program integrity functions; and ensuring adequate oversight of approved State programs, including oversight of the cash flows, performance, and compliance of each approved State program. As with SBLF, Treasury will be challenged to stand this program up quickly with an adequate control structure and commensurate staffing to meet these expectations and make the federal funds available to the states.

A common theme we have seen in recent years, most notably with TARP and Recovery Act programs, is that Treasury first attempts to administer new and complex programs with minimal staffing only to find that more resources need to be devoted to program administration after problems start to surface. We cannot stress enough that a similar approach be avoided with SBLF and SSBCI.

Management of Recovery Act Programs

Treasury is responsible for overseeing an estimated $150 billion of Recovery Act funding and tax relief. Treasury's oversight responsibilities include grants for specified energy property in lieu of tax credits, grants to states for low-income housing projects in lieu of tax credits, increased Community Development Financial Institutions Fund grants and tax credits, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens.

Many of these programs were new to Treasury in 2009 and involve very large dollar amounts. It is estimated that Treasury's Recovery Act payments in lieu of tax credit programs—for specified energy property and to states for low-income housing projects—will cost more than $20 billion over their lives. To date, Treasury has already awarded more than $6 billion under these programs and has yet to implement comprehensive monitoring procedures. In 2009, we reported that Treasury had dedicated only a small number of staff to award and monitor these funds. That has not changed and we continue to have concerns that the current staffing level is not commensurate with the size of these programs. Payments made to recipients under the specified energy property program alone comprise more than $5 billion of the funds awarded to date and the number of applicants continues to grow. We initiated and plan a number of audits of recipients of payments under the specified energy property program to ensure funds were properly awarded to eligible applicants for eligible properties. Our audits of these recipients, however, should not be viewed as a substitute for appropriate and comprehensive management oversight and monitoring of the program.

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Management of the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act

Through several HERA and EESA programs, Treasury injected much needed capital into financial institutions and businesses.

Under HERA, Treasury continues to address the distressed financial condition of Fannie Mae and Freddie Mac which are under the conservatorship of the Federal Housing Finance Agency. In order to cover the continuing losses of the two entities and their ability to maintain a positive net worth, Treasury agreed to purchase senior preferred stock, and as of June 30, 2010, had purchased $145 billion. Treasury also purchased and is still holding $184 billion of mortgage-backed securities issued by two entities under a temporary purchase program that expired in December 2009. Through the Housing Finance Agency Initiative supporting state and local finance agencies, Treasury purchased securities in Fannie Mae and Freddie Mac backed by state and local Housing Finance Agency bonds (New Issue Bond Program) and a participation interest in the obligations of Fannie Mae and Freddie Mac (Temporary Credit and Liquidity Program). Prior to expiring in December 2009, Treasury purchased $15.3 billion of securities under the New Issue Bond Program and provided $8.3 billion under the Temporary Credit and Liquidity Program. Even with this assistance, both entities remain in a weakened financial condition and may require prolonged assistance. Dodd-Frank requires the Secretary of the Treasury to conduct a study on ending the conservatorship of Fannie Mae and Freddie Mac and minimizing the cost to taxpayers. The report on this study is to be presented to Congress no later than January 31, 2011.

TARP, established under EESA, gave Treasury the authorities necessary to bolster credit availability and address other serious problems in the domestic and world financial markets. Treasury's Office of Financial Stability administers TARP, and through several of its programs, made purchases of direct loans and equity investments in many large financial institutions and other businesses, as well as guaranteed other troubled mortgage-related and financial assets. On October 3, 2010, the authority to make new investments under the TARP program expired. Treasury will, however, continue making payments for programs which have existing contracts and commitments. TARP is expected to be less costly than first thought. Treasury has recently estimated that the total cost of TARP will be about $50 billion. As the life-cycle of TARP is maturing, Treasury's challenge in this area is morphing from standing-up and running TARP programs to winding them down. That means Treasury must now focus on managing and exiting from its current TARP investments. These investments include, but are not limited to, AIG and General Motors. In this regard, at the time of this writing, it has been reported that AIG announced a restructuring plan that will accelerate the timeline for repaying the government, and General Motors is planning an initial public offering for later this year.

EESA also established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and GAO.

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As conditions improve, Treasury will need to continue to work with its partners to disassemble the structure established to support recovery efforts and ensure that federal funds no longer needed for those efforts are returned in an orderly manner to the Treasury general fund.

Challenge 3: Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

Treasury faces unique challenges in carrying out its responsibilities under the Bank Secrecy Act (BSA) and USA Patriot Act to prevent and detect money laundering and terrorist financing. The Financial Crimes Enforcement Network (FinCEN) is the Treasury bureau responsible for administering BSA. However, a large number of other federal and state entities participate in efforts to ensure compliance with BSA, including the five federal banking regulators, the Internal Revenue Service, the Securities and Exchange Commission, the Department of Justice, and state regulators. Many of these entities also participate in efforts to ensure compliance with U.S. foreign sanction programs administered by Treasury's Office of Foreign Assets Control (OFAC).

Treasury must coordinate the efforts of these multiple entities. To this end, FinCEN and OFAC have entered into memoranda of understanding with many federal and state regulators in an attempt to build a consistent and effective process. In 2009, FinCEN had memoranda of understanding with 43 percent of federal and state regulators. While important to promote coordination and cooperation, it should be noted that these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed. Furthermore, the USA Patriot Act has increased the types of financial institutions required to file BSA reports. In fiscal year 2009, financial institutions filed approximately 15 million BSA reports. The number is lower than 2008, which Treasury has attributed primarily due to a change in law that increased currency transaction report exemptions. FinCEN needs to work with regulators to ensure that financial institutions establish effective BSA compliance programs and file BSA reports, as required.

Adding to this risk in the current environment is that financial institutions and their regulators may have decreased their attention to BSA and OFAC program compliance as they address safety and soundness concerns during the current economic crisis. FinCEN's analysis of suspicious activity report data also found non-bank lenders and originators initiated many of the mortgages associated with suspicious activity reports filed for possible mortgage fraud. Furthermore, evidence suggests a link between mortgage fraud and money laundering. In that regard, FinCEN is considering applying anti-money laundering and suspicious activity report regulations to these non-bank institutions.

FinCEN also has a particularly difficult challenge in dealing with money services businesses (MSB). FinCEN has to balance the needs of certain consumers who depend on access to MSBs (particularly the unbanked), with potentially unfettered access to the financial system that non-transparent MSBs create for those engaged in money laundering and terrorist financing. FinCEN has been working with the IRS to ensure MSBs comply with BSA registration and report filing requirements. IRS serves as the examining agency for MSBs but does not have the resources to annually inspect all MSBs or even identify unregistered MSBs, estimated to be in the tens of

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thousands. Within this framework, FinCEN has been concerned with MSBs that use informal value transfer systems and with MSBs that issue, redeem, or sell prepaid (or stored value) cards. MSBs using informal transfers have been identified in several attempts to launder proceeds of criminal activity or finance terrorism. Similarly, prepaid cards can make it easier for some to engage in money laundering or terrorist financing. In September 2010, FinCEN notified financial institutions to be vigilant and file suspicious activity reports on MSBs that may be inappropriately using informal transfers, when they use financial institutions to store currency, clear checks, remit and receive funds, and obtain other financial services. Also this year, FinCEN proposed revising definitions and other regulations pertaining to prepaid access to close regulatory gaps.

In September 2010, to add transparency to possible illicit wire transfer use of the financial system, FinCEN proposed a regulatory requirement for certain depository institutions and MSBs to report cross-border electronic transmittals of funds (CBETF). FinCEN determined that establishing a centralized database will greatly assist law enforcement in detecting and ferreting out transnational organized crime, multinational drug cartels, terrorist financing, and international tax evasion. If implemented, ensuring financial institutions, particularly MSBs, comply with the CBETF reporting requirements, as well as managing this new database, will be a significant challenge for FinCEN.

To ensure efficient management, safeguarding, and use of BSA information, FinCEN also plans to modernize BSA information management. BSA data is currently maintained by IRS and access to the database is generally handled through an IRS system known as WebCBRS. FinCEN believes modernization will provide increased data integrity and analytical tools, and maximize value for state and federal partners. BSA Information Technology (IT) Modernization is also discussed in challenge 4.

Given the criticality of this management challenge to the Department's mission, we continue to consider anti-money laundering and combating terrorist financing programs as inherently high-risk. Mandatory work, particularly material loss reviews of failed banks and thrifts, prevented us from performing any audits in this area in Fiscal Year 2009 and in 2010 we were limited to completing audits started years earlier. With legislated changes to the financial loss threshold for performing material loss reviews, we expect to be able to increase audit coverage of anti-money laundering and terrorist financing programs in Fiscal Year 2011.

Challenge 4: Management of Capital Investments

Managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. In prior years, we reported on a number of capital investment projects that either failed or had serious problems. This year, we identified challenges in 4 on-going investments, 2 of which were identified by the Office of Management and Budget (OMB) as high-risk projects.

Replacement telecommunications platform The Information Technology Infrastructure Telecommunications investment with an overall value of $3.7 billion was rated as poorly

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performing by the Acting Chief Information Officer (CIO) and a high-risk project by OMB. This investment includes the Treasury's replacement telecommunications platform, TNet, as a major component. Treasury was originally to have begun implementation of TNet in November 2007 but was delayed until August 2009 and is still in transition. Additionally, TNet does not currently incorporate all OMB security requirements, and many Treasury components have reported performance concerns with the network.

Treasury implementation of a common identity management system OMB also recognized Treasury's Consolidated Enterprise Identity Management system as a high-risk project. This system is a $147 million effort to implement the requirements of the Homeland Security Presidential Directive 12. This directive requires deployment of a common identity standard. This initiative was identified as being more than $40 million over budget and significantly behind schedule.

Data Center Consolidation OMB initiated the Federal Data Center Consolidation Initiative to consolidate the number of federal data centers. Treasury has over 60 data centers around the country. Treasury is currently in the planning phase of a significant effort to reduce the number of data centers by 2015. This effort would require restructuring of Treasury's IT infrastructure over a relatively short time. Relocating and consolidating data centers is a major investment that requires careful planning to address security concerns, disaster recovery, and infrastructure support.

FinCEN's BSA IT Modernization As discussed in Challenge 3, Treasury, through FinCEN, is undertaking a major project known as BSA IT Modernization. Already underway, the project is expected to cost about $120 million. This project requires coordination between FinCEN and IRS, which has historically maintained the BSA database, and effective oversight by the Treasury Office of the CIO. A prior attempt, from 2004 to 2006, to develop a new BSA system ended in failure with over $17 million wasted because of shortcomings in project planning, management, and oversight.

Treasury's decentralized management of IT investments presents a significant hurdle to the successful implementation of major department-wide and government-wide initiatives. Large initiatives are often tasked to individual bureaus for overall management with some direction provided by the Treasury Office of the CIO. Coordination issues between bureaus can delay and disrupt implementation of department-wide policies and systems or prevent necessary changes from proceeding. Accordingly, Treasury should exercise continuous vigilance in managing the investments described above and others due to previously reported problems with large capital investments, and billons of procurement dollars at risk.

We would be pleased to discuss our views on these management and performance challenges in more detail.

cc: Daniel Tangherlini
Assistant Secretary for Management, Chief Financial Officer, and
Chief Performance Officer

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 15, 2010

MEMORANDUM FOR ERIC M. THORSON
INSPECTOR GENERAL

FROM: Timothy F. Geithner

SUBJECT: Management and Performance Challenges Facing the Department of the Treasury

I am responding to your October 22, 2010, memorandum describing the most serious management and performance challenges facing the Department of the Treasury. This memorandum provides information on the actions completed in fiscal year (FY) 2010 and the actions planned for FY 2011 to address these challenges.

Treasury has established effective control structures to monitor the implementation of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act) and the *Small Business Jobs Act of 2010*, to ensure the Acts achieve their intended purposes, as well as provide unprecedented accountability and transparency. The Department is committed to staying vigilant about the risks associated with all of our programs and to adjust our strategies based on changing circumstances to achieve financial stability, economic security, and protection of the taxpayer. We look forward to working with you to further address these challenges.

Challenge 1 – Transformation of Financial Regulation

On July 21, 2010, the President signed into law the historic Dodd-Frank Act. The comprehensive financial regulatory reforms enacted under the Dodd-Frank Act include new requirements for enhanced prudential supervision of financial firms that could threaten financial stability; the creation of a Financial Stability Oversight Council (FSOC) to monitor emerging threats to the stability of the financial system; the establishment of a new Consumer Financial Protection Bureau (CFPB) to protect consumers against unfair, deceptive, or abusive financial practices and ensure consumers have the information they need to choose financial products that best meet their needs. The Act also includes reforms that bring transparency and regulation to the over-the-counter derivatives markets for the first time; and the creation of a resolution regime for large, highly interconnected financial firms to allow these firms to fail while protecting taxpayers and the economy. These reforms will help guard against many of the gaps, lapses, and inconsistencies in supervision of financial firms that clearly contributed to the recent financial crisis. More broadly, these reforms will help set a new foundation for a pro-investment and pro-growth financial system.

In implementing the Dodd-Frank Act, Treasury is working hard to ensure that the new rules provide necessary protections against financial excess while preserving the benefits of financial innovation. To that end, Treasury has adopted the following guiding principles for implementation:

- Reforms are implemented as quickly as possible to provide clarity to the public and the markets, recognizing that implementation will be complex in some cases

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- Full transparency and disclosure are provided in the implementation process through publication of draft rules, available opportunities for public comment, and consultation with a broad range of groups and individuals
- Regulations are streamlined and simplified where possible to minimize duplication and eliminate rules that do not work
- Implementation is coordinated with other federal agencies to ensure new rules across government work together, not against, each other
- Every effort is made to create a more level playing field, both between banks and non-banks in the U.S., as well as between major financial institutions globally
- Freedom of innovation is protected to ensure economic growth

Treasury has been working to implement the reforms of the Dodd-Frank Act since enactment. Immediately after passage, Treasury put in place a governance structure to oversee the Department's implementation of the reforms. Generally, Treasury developed implementation teams dedicated to each of its core responsibilities, such as helping to establish the FSOC, laying the groundwork for the Office of Financial Research (OFR), launching the CFPB, and creating a Federal Insurance Office (FIO). These teams update a steering committee of senior Treasury officials who meet daily to consider options, make decisions, move implementation forward, and, where appropriate, make recommendations.

Consumer Financial Protection Bureau

Title X of the Dodd-Frank Act establishes the CFPB within the Federal Reserve System to protect consumers against unfair, deceptive, or abusive financial practices and ensure consumers have the information necessary to choose consumer financial products and services that best meet their needs. The Dodd-Frank Act consolidates core authorities currently fragmented across seven federal agencies into a single, dedicated, and independent federal consumer protection watchdog. The CFPB will implement rules for consumer financial products and services and develop supervision programs to regularly examine the most critical bank and nonbank financial services providers. In addition, the CFPB will develop programs to promote greater financial literacy and establish a nationwide consumer complaint response unit, which will include a dedicated website and hotline for receiving consumer complaints about financial services.

Under the Dodd-Frank Act, the Department is responsible for standing up the new agency until the first CFPB Director is confirmed by the Senate. The Department has designated July 21, 2011, as the "designated transfer date," which is the date on which the CFPB will assume existing authorities of seven federal agencies. Treasury has made substantial progress preparing the CFPB to incorporate staff and assume authorities from those agencies.

Financial Stability Oversight Council

On October 1, 2010, the FSOC held its first meeting at which it took a number of important steps to fulfill its mandate under the Dodd-Frank Act. As established under the Act, the FSOC will provide, for the first time,

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comprehensive monitoring to ensure the stability of our nation's financial system. The FSOC is charged with identifying threats to the financial stability of the U.S., promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.

At its inaugural meeting, in addition to adopting organizational documents, the FSOC approved resolutions to seek public comment on the criteria for designating nonbank financial companies for heightened supervision, as well as to inform recommendations the FSOC will make on how to implement statutory restrictions on banking institutions' proprietary trading and investments in private funds (the "Volcker Rule"). In addition, the FSOC must also study and make recommendations for implementing the concentration limit, the macroeconomic effects of risk retention requirements, and the economic implications of financial regulation. Work on those studies is underway.

Office of Financial Research

The OFR is housed within the Treasury Department and will ultimately support the FSOC and its member agencies by providing them with better financial data, information, and analysis so policymakers and market participants have a more complete understanding of risk in the financial system. The OFR will be headed by a director nominated by the President and confirmed by the Senate. A Treasury staff team has begun to plan the OFR's functions and gather input from regulators and private stakeholders.

In FY 2011, Treasury will conduct a census of existing data standardization initiatives and existing sources of reference data. Once completed, the OFR team will move quickly to draw up detailed plans for OFR to facilitate and advance these initiatives without duplication or unnecessary burden. Treasury is also developing an organizational structure, hiring procedures and pay structures, information technology, and other requirements.

Federal Insurance Office

The Dodd-Frank Act established the FIO to monitor important domestic and international insurance matters and coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters. As part of the Department, FIO will monitor all aspects of the insurance industry, including identifying issues and gaps in the regulation of insurance that could contribute to a systemic crisis in the insurance industry or within the broader U.S. financial system. The FIO will also use its authority to negotiate, together with the U.S. Trade Representative, international insurance agreements on prudential measures. The FIO director will serve on the FSOC as a nonvoting member in an advisory capacity.

Treasury officials and staff are engaging frequently with interested parties and developing a framework within which FIO and the states, which would remain as the functional regulators, can work together. In FY 2011, Treasury will stand up the office, appoint a director, and hire key staff. Treasury will also begin to engage with representatives of other countries on insurance prudential issues as well as working closely with the U.S. Trade Representative.

Transfer and Abolishment of OTS

The Dodd-Frank Act abolishes the Office of Thrift Supervision (OTS), transferring its duties to the Office of the Comptroller of the Currency (OCC), Federal Reserve, and Federal Deposit Insurance Corporation. These reforms streamline the regulatory system and reduce potential for regulatory arbitrage. OCC's and OTS's current on-site supervisory assessments, which focus on the quality of credit risk management practices (including effective credit risk rating systems and problem loan identification), adequacy of loan-loss reserves, and effective loan work-out strategies, will continue in the new regulatory structure to prevent a repeat of the current crisis. In addition, in the new regulatory structure, OCC will continue to perform individual bank examinations on a variety of other activities aimed at identifying and responding to systemic trends and emerging risks that could adversely affect asset quality or the availability of credit at national banks and the banking system, and fair access to financial services. In FY 2011, Treasury will work closely with the OCC, OTS, and other federal financial regulatory agencies to implement the Dodd-Frank Act reforms and to monitor and respond to any residual threats to a robust economic recovery of the U.S. financial system.

Challenge 2 – Management of Treasury's Authorities Intended to Support and Improve the Economy

Small Business Lending Fund

Treasury's Office of Financial Institutions is working expeditiously to finalize and promulgate policy guidance for the Small Business Lending Fund (SBLF). More specifically, Treasury's stand-up team has drafted term sheets and applications, which soon will be posted to a newly created Treasury website for the SBLF. Additionally, Treasury is working with the federal banking agencies (FBAs) to come to agreement on a process for the intake and review of applications and lending plans (which are required pursuant to the *Small Business Jobs Act of 2010*). Once Treasury and the FBAs have agreed on the process, Treasury will post the term sheets and applications publicly.

As the Treasury team works to stand up the SBLF, careful consideration is being given to suggestions from the Government Accountability Office (GAO) and other oversight bodies.

State Small Business Credit Initiative

Treasury is also implementing the State Small Business Credit Initiative (SSBCI). Staffing and hiring are integral components of this process. Accordingly, Treasury has formulated a detailed hiring plan with full-time equivalent estimates, as well as the functional competencies that will be needed to support this initiative, including legal, analytical, and programmatic oversight support. Treasury is in the process of posting position descriptions for new hires and will likely engage contract support in the near term while hiring continues. This will provide the SSBCI with an adequate control structure and sufficient staff to meet the needs of the program.

Management of Recovery Act Programs

The Department of the Treasury played a pivotal role in implementing the *American Recovery and Reinvestment Act of 2009* (Recovery Act). By providing targeted investments and implementing tax provisions to benefit both

businesses and individuals, the Department continued to stimulate the U.S. economy, create and sustain jobs, and build the foundation for long-term economic growth. Of the $787 billion provided by the Recovery Act, Treasury is managing programs that will contribute nearly $300 billion in benefits to the American people through 2019. These programs, once implemented, will have a significant, positive impact on the lives of millions of Americans.

Treasury's Recovery Act programs include investments in renewable energy and low income housing, local and state government support, and the implementation of approximately 60 tax incentives for households and businesses. The tax incentive programs include the Making Work Pay Credit, which by the end of calendar year 2010, will provide an estimated $49 billion in refundable tax credits to working individuals and married taxpayers filing joint returns; and Build America Bonds, which in FY 2010 provided over $107 billion in financing to state and local governments throughout the country to help finance schools, utilities, public safety programs, and transportation.

Treasury has managed the low income housing and specified energy property programs by supplementing a small, core staff in the Departmental Offices with support from Treasury bureaus, including IRS. For the energy program, Treasury entered into an interagency agreement with the Department of Energy to assist with the technical aspects of that program. As a result, Treasury successfully implemented both of these programs in five months and has made awards to date in excess of $10 billion.

In FY 2010, the Department implemented compliance monitoring programs for both the low-income housing and specified energy property programs. For the housing program, Treasury staff conducted reviews of state housing agencies, either by conducting in-person site visits or desk reviews. These reviews will continue in FY 2011. For the energy program, Treasury implemented an annual reporting process through an automated system, which provides information and supporting documentation necessary for Treasury to evaluate compliance with the program's terms and conditions. This process will be ongoing throughout the program's five year compliance period. Additionally, the IRS has plans to initiate a compliance initiative project relative to the energy property program in FY 2011. This project is being designed to ensure that recipients do not also claim a tax credit with respect to the same property and that recipients have properly stated their basis. Further, Treasury has and will continue to inform IRS of particular areas of concern related to energy property compliance for their consideration as IRS designs the project.

Treasury expanded the Recovery Act implementation team in FY 2010 with the addition of two senior managers. The Recovery Act team facilitates all Recovery Act implementation efforts department-wide and interfaces with the broader Recovery Act community. As part of this broad responsibility, the Team establishes internal processes, addresses external data requirements, manages risk inherent in Recovery Act implementation, and coordinates Treasury Recovery Act audits.

Management of the Housing and Economic Recovery Act and the Emergency Economic Stabilization Act

Treasury used the authority provided by the *Emergency Economic Stabilization Act* (EESA) to implement the Troubled Asset Relief Program (TARP) and strengthen the U.S. financial system, restore credit markets for

businesses and consumers, and address foreclosures in the housing market. During FY 2010, as the financial system stabilized and the Department began to wind down its activities, Treasury closed five programs to new investments: the CPP, the Targeted Investment Program, the Asset Guarantee Program, the Term Asset-Backed Securities Loan Facility (part of the Consumer and Business Lending Initiative), and the Public-Private Investment Program. In FY 2010, Treasury implemented two new programs: the Small Business Administration (SBA) 7a Purchases Program and the Community Development Capital Initiative, both part of the Consumer and Business Lending Initiative.

Treasury also introduced several initiatives in FY 2010, which together comprise the Treasury Housing Programs under TARP. These include the Hardest-Hit Fund, the Federal Housing Administration (FHA) Refinance Program, and subprograms under the Home Affordable Mortgage Program (HAMP). Subprograms under HAMP, the first lien loan modification program, include the Principal Reduction Alternative Waterfall Program, the Unemployment Program, and the Home Affordable Foreclosure Alternatives Program, as well as programs under the Making Home Affordable Program including the FHA-HAMP Program, the Second Lien Program, the FHA-Refinance Program, and the U.S. Department of Agriculture-HAMP Program. As additional focus turns to winding down the TARP investments, other dispositions will occur in FY 2011, including the possible conversion of Capital Purchase Senior Preferred loans to those offered through the SBLF.

As of September 30, 2010, $475 billion of EESA had been designated for particular TARP programs. Of that amount, over $474 billion had been obligated to specific institutions under signed agreements, over $387 billion of those funds had been disbursed, and $204 billion of TARP investments were repaid with income received on TARP investments totaling over $28 billion.

Treasury Departmental Offices played a critical role in contributing to a well-functioning Office of Financial Stability (OFS), which oversees all EESA investments. Since its inception, OFS has aggressively implemented the programs listed above and has grown into an organization of 215 full-time employees. For each program, OFS designed, planned, and implemented sound controls and oversight. The Assistant Secretary for Management has provided support services such as accounting, information technology, administration, and human resources on a reimbursable basis. OFS has prepared separate financial statements on its programs for which GAO gave an unqualified opinion. GAO also provided an unqualified opinion on OFS's internal controls and identified no material weaknesses.

Under the additional purchase authorities granted by the *Housing and Economic Recovery Act of 2008*, Treasury's Office of Debt Management purchased mortgage-backed securities (MBS) guaranteed by Fannie Mae and Freddie Mac from September 2008, until the authority's expiration on December 31, 2009. Treasury purchased over $220 billion face value of agency MBS through two expert asset managers, Barclays Global Investors (now Blackrock) and State Street Global Advisors. Through August 2010, Treasury received $69.8 billion in principal and interest payments with $164 billion of unpaid principal balance remaining. For increased transparency, the Department publishes aggregate information on its holdings of agency MBS monthly on FinancialStability.gov.

Challenge 3 - Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

The Department faces unique challenges in carrying out its responsibilities under the *Bank Secrecy Act* (BSA) and the *USA PATRIOT Act* to prevent and detect money laundering and terrorist financing. The Financial Crimes Enforcement Network (FinCEN) has overall authority for BSA enforcement and compliance, and delegates examination authority to the Internal Revenue Service (IRS), OCC, OTS, and other federal banking agencies. The following paragraphs highlight actions taken by FinCEN, IRS, OCC, and OTS, in coordination with other federal and state authorities, in FY 2010, and actions planned in FY 2011 related to this challenge.

In the last several years, FinCEN has focused on effective and efficient administration, outreach, and engagement of existing industries covered by the BSA. However, new payment systems and industries vulnerable to money laundering continually evolve, such as prepaid access products, non-bank mortgage lenders and originators, and hedge funds. In FY 2011 and beyond, FinCEN will expand BSA regulations to new industry sectors, consistent with the Administration's priorities. Increasingly, FinCEN's regulations focus on risks involving transactions and institutions for which there is no federal regulator or, in some cases not even a state regulator, and for which any existing regulators or delegated supervisory functions will require significant guidance and support from FinCEN.

In FY 2009, FinCEN published a proposal simplifying the organizational structure of BSA requirements, and expects to implement it fully in FY 2011. FinCEN worked with the IRS and state regulators to develop a Money Services Business (MSB) examination manual. FinCEN initially released the manual in FY 2009, and translated it into Spanish in FY 2010. FinCEN facilitated the development of training materials on this manual, and fostered training for IRS and state examiners in FY 2010. Additionally, FinCEN issued an assessment in FY 2010 showing that regulatory changes in FY 2009 simplifying the appropriate exemption of customers from currency transaction reporting requirements resulted in higher value for law enforcement and efficiency for financial institutions. FinCEN also continued to promote electronic filing of BSA reports in FY 2010, issuing a brochure highlighting the benefits of e-filing and initiating a phased outreach approach to financial institutions that continue to file BSA reports on paper that has met with positive industry response.

To enhance the efficiency and effectiveness of the BSA regulatory framework, FinCEN also issued final rules in FY 2010 to accomplish the following:

- Expand the successful "314(a) program" to certain foreign law enforcement agencies, U.S. state and local law enforcement agencies, and certain other components within the Department of the Treasury
- Move to streamline mutual fund BSA requirements by allowing mutual funds to file currency transaction reports

FinCEN, in close cooperation with law enforcement and regulatory authorities, developed and issued a proposed rule in FY 2010 that proposes to establish a more comprehensive regulatory framework for non-bank prepaid access. The proposed rule focuses on prepaid programs that pose the greatest potential risks of money laundering and terrorist financing. Also in FY 2010, FinCEN issued a proposed rule that would require certain depository

institutions and MSBs to affirmatively provide records to FinCEN of certain cross-border electronic transmittals of funds (CBEFT). FinCEN issued this proposal to meet the requirements of the *Intelligence Reform and Terrorism Prevention Act of 2004*. In addition, FinCEN reviewed comments received on a wide range of questions pertaining to the possible application of anti-money laundering (AML) program and suspicious activity reporting rules to non-bank residential mortgage lenders and originators in response to an Advance Notice of Proposed Rulemaking. In FY 2011, FinCEN will continue working toward finalizing these proposals, as well as proposed and/or final regulations related to:

- Clarifying the confidentiality of suspicious activity reports (SARs) and accompanying guidance to financial institutions on sharing SAR information within their organizational structure
- Clarifying foreign bank account reporting requirements
- Implementing regulations related to due diligence in correspondent banking pursuant to the *Comprehensive Iran Sanction, Accountability, and Divestment Act of 2010*

Outreach plays an important role in effectively administering the BSA. The Bank Secrecy Act Advisory Group (BSAAG) serves as the principal forum to discuss BSA issues among regulators, law enforcement, and industry. OCC, OTS, and other federal banking agencies actively participate on various BSAAG subcommittees. In FY 2010, FinCEN continued outreach to specific financial institutions, visiting several small depository institutions and insurance companies, and plans to conduct further outreach to additional industry segments in FY 2011.

Active engagement with other regulators is also critical to meeting this challenge. By the end of FY 2010, FinCEN had established 59 memoranda of understanding (MOU) with federal and state regulators to enhance the sharing of information derived from compliance examinations. FinCEN shared analytic reports in the form of BSA data profiles with these federal and state regulators, and surveyed its MOU partners to determine the impact of the information exchanged. Eighty-six percent of respondents indicated the information shared with them was valuable. As these MOUs mature, the information exchanged will help FinCEN improve BSA examination consistency and compliance. In FY 2011, FinCEN will pursue MOUs with additional state regulators, focusing specifically on state insurance regulators.

To enhance regulated financial industry understanding of and compliance with BSA requirements, in FY 2010, FinCEN, with input from OCC, OTS and other agencies, published a range of financial institution advisories and regulatory guidance, including an advisory for financial institutions on key terms to use when filing SARs regarding loan modification and foreclosure rescue scams, an updated advisory on informal value transfer systems, a distillation of existing guidance on obtaining and retaining beneficial ownership information, guidance to casinos on compliance program risk indicators, and advisories to financial institutions on several international issues including statements from the Financial Action Task Force and changes to Mexican currency regulations. In FY 2010, OCC and OTS collaborated with FinCEN and other federal banking agencies to issue guidance on the impact of new, more transparent messaging standards being adopted by industry via measures undertaken by the Society for Worldwide Interbank Financial Telecommunication. In FY 2011, FinCEN, OCC and OTS will

continue to work with other federal banking agencies to issue guidance to institutions as needed and additional financial institution advisories as risks emerge.

In FY 2010, FinCEN conducted strategic analytical studies and published reports promoting greater awareness of emerging money laundering trends and vulnerabilities. Those analytic products included an assessment of suspicious activity reporting by insurance companies and casinos/card clubs, and several reports analyzing SARs related to mortgage loan and loan modification fraud. In FY 2011, FinCEN will continue to publish analytic products, which assess trends and patterns in mortgage fraud. Other analytic studies planned for FY 2011 include strategic assessments of suspicious activities which involve title and escrow companies, prepaid access devices, remote deposit capture, debt settlement and debt relief fraud, commercial real estate fraud, and identify theft.

A primary strategy for meeting the goal of a safer, more transparent financial system includes effective examination for any potential money laundering, terrorist financing, and BSA issues in supervised institutions. OCC and OTS continue to examine compliance with BSA, *USA PATRIOT Act*, and other AML provisions through a process which consists of on-site examinations conducted every 12-18 months, supplemented by off-site monitoring and follow-up to address identified supervisory issues. Additionally, in FY 2010 FinCEN and the IRS finalized a referral process to implement a more effective BSA examination regime for non-bank financial institutions that the IRS examines. Implementation of this process is part of a broader strategy implemented in FY 2010 to better enable FinCEN to develop cases and pursue enforcement actions based, in part, on its own analytical efforts and information from law enforcement. FinCEN will build upon current initiatives through FY 2011; work will include coordinating with the IRS to develop stronger relationships with state regulatory agencies, particularly with regard to non-bank financial institution examinations.

Throughout FY 2010, FinCEN, OCC, and OTS continued to work with the Federal Financial Institution Examination Council (FFIEC) agencies to ensure examination consistency, and to provide guidance and training to financial institutions and examiners regarding AML and BSA requirements. This collaboration helps achieve a consistent examination approach that is risk focused and provides uniform guidance to financial institutions on regulatory expectations. In April 2010, OCC, OTS, and the other federal banking agencies, in consultation with FinCEN, issued an updated FFIEC BSA/AML Examination Manual. The 2010 version was the fourth revision of the manual. OCC and OTS joined the other federal banking agencies in a webinar hosted by the American Bankers Association to provide an overview of significant revisions to the manual for the banking industry. In August 2010, the FFIEC, with participation from OCC, OTS and FinCEN, continued to enhance advanced BSA/AML training for banking examiners through the fourth FFIEC Advanced BSA/AML Specialists Conference in August 2010. Also, in FY 2010, the FFIEC agencies, in consultation with FinCEN, completed the development of a software application used by examiners to analyze BSA data for purposes of improving the scoping of BSA examinations.

Ensuring financial institutions comply with the BSA, AML, *USA PATRIOT Act*, and related regulations is critical to protecting the integrity of the U.S. financial system and combating money laundering and terrorist financing. In FY 2010, FinCEN, OCC, OTS, and IRS worked collectively and with other federal banking agencies to

review examination results and take enforcement actions, as appropriate, against institutions that egregiously violated regulatory requirements. In March 2010, FinCEN and OCC, in conjunction with the Department of Justice, reached settlement on the largest civil penalty action to date under the BSA. These bureaus and agencies will continue to work together in FY 2011 to ensure financial institutions comply with AML and BSA requirements and protect the integrity of the financial system.

Challenge 4 - Management of Capital Investments

The Department takes its investment management role very seriously and remains committed to improving the management of information technology (IT). In support of this commitment, the Office of the Chief Information Officer (OCIO) is actively engaged in the following activities:

Infrastructure Optimization/Data Center Consolidation and Shared Services

In August 2010, the Department submitted its strategy for reducing the number of Treasury data centers to the Office of Management and Budget (OMB). In support of this strategy, the Treasury CIO Council approved proposals of specific initiatives to consolidate and optimize the Department's data centers. Data center consolidation efforts will focus on coordinating planning among those bureaus (e.g., Bureau of the Public Debt, Financial Management Service, OCC, OTS, and IRS) that have begun to work together to consolidate their operations. The Department expects to increase the efficiency of its data centers in support of energy reduction and release of real property. Enterprise Content Management will be a key shared service that will foster collaboration across the Department for a variety of administrative activities such as records management and correspondence tracking. In FY 2011, the Department will continue to focus on data center consolidation and shared services as key strategies to better manage costs of IT investments.

Monthly Evaluation of IT Investments

The Treasury OCIO continues to evaluate, on a monthly basis, the degree to which major IT investments achieve cost control, schedule, and other performance goals. The OCIO inputs and monitors progress made on these goals via an OMB website. The public transparency and the increased frequency of assessments have resulted in increased executive attention to IT investment management, which in turn results in more consistent management of the Treasury IT budget.

Taking advantage of the potential cost savings and/or cost avoidance from these efforts is not only good management, but is necessary if the Department is to effectively field the new capabilities required to support the Department's expanding financial and economic missions.

INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

October 15, 2010

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2011

The *Reports Consolidation Act of 2000*[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2010,* its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS). The issues described in this document are derived from a variety of activities conducted and reviewed by TIGTA. In addition to external factors, such as those that will be discussed that relate to recent attacks and threats to the IRS, each year TIGTA strategically evaluates IRS programs, activities, and functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2011, the top 10 challenges in order of priority are:

1. Security;
2. Modernization;
3. Tax Compliance Initiatives;
4. Implementing Health Care and Other Tax Law Changes;
5. Providing Quality Taxpayer Service Operations;
6. Human Capital;
7. Erroneous and Improper Payments and Credits;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Leveraging Data to Improve Program Effectiveness and Reduce Costs.

While TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2011 has remained relatively unchanged from the prior fiscal year, one significant change did occur. Due to recent events at IRS facilities and the potentially expanding role of the IRS, Security has replaced Modernization as the top challenge facing the IRS. Notwithstanding this change, Modernization remains a major challenge for the IRS. For Fiscal Year 2011, we have also expanded the Implementing Tax Law

[1] 31 U.S.C. Section 3516(d).

Changes challenge to include the tax-related health care provisions of the *Patient Protection and Affordable Care Act.*[2]

Although not listed, complexity of the tax law remains a serious, underlying issue that has wide-ranging implications for both the IRS and taxpayers. This complexity, including frequent revisions to the Internal Revenue Code, makes it increasingly difficult for the IRS to explain and enforce the tax laws and more costly and time consuming for taxpayers who want to comply. As elected officials continue to effect broad policy changes using the Internal Revenue Code, the IRS will continue to face the challenge of responding quickly by shifting resources and altering established plans.

The following is a discussion of each of the most serious management and performance challenges facing the IRS during Fiscal Year 2011.

SECURITY

In addition to safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and more than 700 facilities throughout the country. Attacks and threats against IRS employees and facilities have risen steadily in recent years. The February 2010 attack on an IRS facility in Austin, Texas, is a stark reminder of the dangers that IRS employees face every day in trying to perform their jobs. Animosity towards the tax collection process is nothing new, but the Austin incident and other recent events point to a surge of hostility towards the Federal Government. According to the Anti-Defamation League, the militia movement has almost quadrupled in size in the past two years, growing to more than 200 groups across the country.[3] The Southern Poverty Law Center has reported that anti-government and hate groups have grown from 149 groups in 2008 to 512 groups in 2009, a 244 percent increase.[4] The ongoing public debate regarding the recently enacted health care legislation may also lead to increased threats against IRS employees and facilities, underscoring the need for continuing vigilance in the area of physical security.

As a result of these and other threats, the IRS is developing the Threat Information and Critical Incident Response Center (TIRC), which will be supported by TIGTA and other law enforcement agencies. The TIRC will encourage effective review and dissemination of threat information to IRS stakeholders in support of the critical employee-safety mission, an unprecedented effort to marshal resources and potentially lifesaving information in real time. The TIRC will also serve as a focal point for the timely and efficient sharing of threat information, including cyber- and Internet-based threats, to maximize the IRS's ability to engage in appropriate threat mitigation.

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[2] Pub. L. 111-148, 124 Stat. 119 (2010), as amended by the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152, 124 Stat. 1029).
[3] Anti-Defamation League, *The Militia Movement in 2010: A Snapshot,* http://www.adl.org/main_Extremism/Hutaree_Militia_Facts.htm?Multi_page_sections=sHeading_2 (posted March 29, 2010).
[4] Mark Potok, *Rage on the Right: The Year in Hate and Extremism*, Southern Poverty Law Center Intelligence Report, Spring 2010.

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Concurrent with the IRS's monitoring of threats against its employees and facilities, the IRS must also remain vigilant with regard to computer security, particularly as it relates to safeguarding the privacy of confidential taxpayer information. As computer usage continues to be inextricably integrated into core business processes, the need for effective information system security becomes essential to ensure the confidentiality, integrity, and availability of data. The IRS relies extensively on its computer systems to carry out the demanding responsibilities of administering the Nation's tax laws, including processing Federal tax returns and collecting Federal taxes. IRS computer systems process hundreds of millions of tax returns and contain confidential tax information for over 100 million taxpayers. From a security standpoint, the IRS is responsible for maintaining effective information security controls to protect confidential taxpayer information from inadvertent or deliberate misuse, improper disclosure, or destruction.

The IRS is specifically required by Federal law to keep taxpayer data confidential and prevent unauthorized disclosure or browsing of taxpayer records.[5] Each tax return contains Personally Identifiable Information, such as the filer's name, address, Social Security Number, and other personal information. Because of the volume and type of data it maintains, the IRS is an attractive target for criminals with the intent to commit identity theft by stealing and using someone's personal information for their own financial gain. In February 2010, the Federal Trade Commission reported that, for the 10th year in a row, identity theft was the number one consumer complaint nationwide.[6]

From a law enforcement perspective, the migration of Federal tax administration operations into the Internet and electronic environment increases internal and external vulnerabilities that can be exploited by criminals. For example, we have seen attacks on the integrity of the system launched from around the world, and we have also seen the amount of exposure and damage that can be done by a single individual employee whether intentional or accidental.[7] Hackers and foreign governments increasingly attempt sophisticated intrusions into computer networks. If an intrusion is successful, it could result in substantial economic disruption.

The *Federal Information Security Management Act* (FISMA)[8] requires each Federal Government agency to report annually to the Office of Management and Budget and to the Congress on the effectiveness of its security programs and to perform an annual independent evaluation of its information security program and practices. The IRS has made steady progress in complying with FISMA requirements since the law's enactment in 2002 and continues to place a high priority on efforts to improve its security program. However, the IRS still needs to take additional actions in the areas of certification and accreditation and configuration management to better secure its systems and data.

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[5] 26 U.S.C. Sections 6103, 7213, 7213A, 7431 (2006).

[6] *Consumer Sentinel Network Data Book for January – December 2009*, Federal Trade Commission, dated February 2010.

[7] Recently, in a case worked jointly with the IRS Criminal Investigation Division, individuals were arrested for their participation in an online international phishing scheme to steal income tax refunds intended for U.S. taxpayers. After taxpayers uploaded their tax information seeking refunds for Federal and State taxes, co-conspirators in Belarus collected the data and altered the returns so that legitimate tax refund payments would be redirected to U.S. bank accounts under their control.

[8] 107 Pub. L. 347, 116 Stat. 2899 (2002), codified as amended in 44 U.S.C. Sections 3541 – 3549.

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Additionally, we have reported that the IRS prematurely closed the security roles and responsibilities component of its computer-security material weakness.[9] As a result, the IRS cannot ensure all IRS and contract employees will carry out their responsibilities to protect the confidentiality, integrity and availability of taxpayer data

MODERNIZATION

The Business Systems Modernization Program (Modernization Program or Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would last up to 15 years and incur contractor costs of approximately $8 billion. The Program is now in its 12th year and has received approximately $3.24 billion for contractor services, plus an additional $474 million for internal IRS costs.[10] These amounts represent increases of approximately $540 million (20 percent) in contractor services and approximately $121 million (34 percent) in internal IRS costs from Fiscal Year 2009. The total amount for contractor services and for internal IRS costs increased by approximately $661 million (22 percent) from Fiscal Year 2009.

Factors that characterize the IRS's complex information technology environment include widely varying inputs from taxpayers (from simple concise records to complex voluminous documents), seasonal processing with extreme variations in processing loads, transaction rates on the order of billions per year, and data storage measured in trillions of bytes. The Modernization Program is working toward providing improved benefits to taxpayers that include:

- Issuing refunds, on average, five days faster than existing legacy systems;
- Offering electronic filing capability for large corporations and small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;
- Delivering web-based services for tax practitioners, taxpayers, and IRS employees; and
- Providing IRS customer service representatives with faster and improved access to taxpayer account data with real-time data entry, validation, and updates of taxpayer addresses.

The Modernization Program has continued to help improve IRS operations and is refocusing its efforts to improve business practices with new information technology solutions. However, project development activities have not always effectively implemented planned processes or delivered all planned system capabilities to achieve the Program's expectations. Management of the Program's cost and schedule has

[9] Treasury Inspector General for Tax Administration, Ref. No. 2010-20-084, *More Actions Are Needed to Correct the Security Roles and Responsibilities Portion of the Computer Security Material Weakness* (2010).
[10] Treasury Inspector General for Tax Administration, Ref. No. 2010-20-094, *Annual Assessment of the Business Systems Modernization Program* (2010).

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improved since the previous year, but more attention must be paid to the development and management of Program requirements.

Further, resolution has not yet been completely achieved for security vulnerabilities affecting two significant systems. The IRS revised its Modernization Program and is currently testing a prototype[11] database concept for all taxpayer data. The new approach will require the IRS to increase its employees' information technology-related skills, tools, and operations to effectively deliver the revised program.

Since November 2001, TIGTA has reported nine assessments on annual accomplishments and activities of the Modernization Program. In developing the assessments, TIGTA formulated four primary challenges the IRS must overcome to be successful:

1. Implement planned improvements in key management processes and commit necessary resources to enable success;
2. Manage the increasing complexity and risks of the Program;
3. Maintain the continuity of strategic direction with experienced leadership; and
4. Ensure effective management of contractor performance and accountability.

Notwithstanding recent progress made by the IRS, TIGTA continues to take the position that these four challenges still need to be met to achieve program success. We are encouraged by the actions the IRS has planned and taken to refocus the Program; however, we believe the IRS should consider the overall Modernization Program a material weakness at this time.

TAX COMPLIANCE INITIATIVES

Another serious challenge confronting the IRS is tax compliance. Despite an estimated voluntary compliance rate of 84 percent and IRS enforcement efforts, a significant amount of income remains unreported and unpaid. Tax compliance initiatives include the administration of tax regulations, collection of the correct amount of tax from businesses and individuals, and the oversight of tax-exempt and government entities. Increasing voluntary taxpayer compliance and reducing the Tax Gap[12] continue to be the focus of many IRS initiatives. The IRS continues to face significant challenges in obtaining complete and timely compliance data, and in developing methods necessary to interpret the data. Even with improved data collection, however, the IRS needs broader strategies and more research to determine what actions are most effective in addressing taxpayer noncompliance. The IRS's strategy for reducing the Tax Gap is largely dependent on funding for additional compliance resources and legislative changes. In its Fiscal Year 2011 budget submission, the IRS has requested a 5.3 percent increase in enforcement funds over its Fiscal Year 2010 request.

[11] This prototype is an approach to system development using an iterative process of discovering requirements, designing, and building a trial model, examining the results, and repeating the process until the desired solution is attained.
[12] The IRS defines the Tax Gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely paid for a tax year.

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Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2001 – the most current figures to date – to be approximately $345 billion. Underreporting of taxes, which is comprised of four major components (individual income tax, employment tax, corporate income tax and estate and excise taxes), is estimated at $285 billion and accounts for the largest portion of the Tax Gap. Overall, the underreporting of individual income tax and employment tax constitute over 70 percent of the gross Tax Gap. The misclassification of millions of employees as independent contractors is a nationwide problem that continues to grow and contribute to the Tax Gap. In a report issued in Fiscal Year 2010,[13] we determined that the IRS has opportunities to enhance compliance in its Employment Tax Program by 1) taking measures to ensure employment tax forms are not misused to avoid paying taxes, and 2) regularly sharing the results of worker classification examinations to ensure the greatest possible use of the agency's resources when addressing the underreporting Tax Gap. Our audit identified over 74,000 taxpayers who may have avoided paying approximately $26 million in Social Security and Medicare taxes.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on ensuring that tax-exempt organizations comply with applicable laws and regulations to qualify for tax-exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's non-profit or tax-exempt organizations. For example, the January 2010 Supreme Court decision *Citizens United v. Federal Election Commission*,[14] could lead to additional expenditures by those tax-exempt organizations that advocate the election or defeat of Federal candidates.

Since more than $15 trillion in United States assets are currently controlled by tax-exempt organizations or held in tax-exempt retirement programs and financial instruments, the IRS recognized in its most recent strategic plan that careful oversight over the non-profit and tax-exempt sector is more important than ever before. In its Fiscal Year 2011 budget submission, the IRS reemphasized the importance of maintaining a strong enforcement presence in the tax-exempt sector to ensure that charitable organizations are compliant with the Internal Revenue Code and not used for non-charitable or illegal purposes.

In a report issued in Fiscal Year 2010,[15] we determined that the IRS has taken significant actions to identify Section 527 political organizations[16] that do not timely notify the IRS of their existence or timely submit reports of their contributions and

[13] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-025, *Employment Tax Compliance Could Be Improved With Better Coordination and Information Sharing* (2010).
[14] 130 S.Ct. 876 (2010).
[15] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-018, *Improvements Have Been Made, but Additional Actions Could Ensure That Section 527 Political Organizations More Fully Disclose Financial Information* (2010).
[16] Political organizations include political parties; campaign committees for candidates for Federal, State, or local office; and political action committees. 26 U.S.C. Section 527 (2006).

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expenditures. However, the IRS has not fully addressed noncompliance among political organizations. For example, one out of every four Political Organization Report of Contributions and Expenditures (IRS Form 8872) that we reviewed had incomplete or missing contributor or recipient information. While some of these filings may later be deemed acceptable, we determined the IRS is not reviewing these filings to determine if they are complete or if penalties should be assessed.

Also, the IRS is not always timely issuing notices that include all information needed by political organizations to become compliant. Lastly, the IRS is not following up on information it has requested from political organizations to verify compliance.

Tax Return Preparers

An increasing number of taxpayers are turning to tax return preparers for assistance. In Calendar Year 2009, the IRS processed approximately 83.1 million individual Federal income tax returns prepared by paid preparers. However, these preparers were not required to meet or comply with any national standards before selling tax preparation services to the public.

A series of reports strongly suggesting a need to regulate those who prepare Federal tax returns, including reviews conducted by TIGTA, the Government Accountability Office and other agencies, led the IRS to launch its Return Preparer Review in June 2009. The following December, after its own six-month study of the problem, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. The reforms proposed by the IRS include the development of requirements for registration, competency testing, continuing professional education, ethical standards, and enforcement. The new preparer requirements will take several years to implement, and will be phased in through Calendar Year 2014, at which time all preparers will be subjected to suitability and competency tests. In the meantime, the IRS plans to develop and implement a management information system to gather data on preparers and establish a database to assist taxpayers in identifying qualified preparers. Further, the IRS is planning to ensure that taxpayers understand the new requirements and the importance of using only registered preparers to prepare their tax returns.[17]

IMPLEMENTING HEALTH CARE AND OTHER TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by the Congress. Most individual taxpayers file their income tax returns during this annual January through April period and contact the IRS with questions about specific tax laws or filing procedures. Correctly implementing late tax law changes remains a significant challenge because the IRS must often act quickly to assess the changes and determine the necessary actions to ensure all legislated requirements are satisfied. In addition, the IRS must often create new or revise existing tax forms, instructions and publications; revise internal operating procedures; and reprogram major computer systems used for processing tax returns. For example, on November 6, 2009, the

[17] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (2010).

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Worker, Homeownership, and Business Assistance Act of 2009 (WHBAA)[18] was enacted. The WHBAA, among other things, extended the First-Time Homebuyer Credit to May 1, 2010. In order to implement this legislation for the 2010 Filing Season, the IRS organized an executive task group to oversee revisions to the Form 5405 (First-Time Homebuyer Credit), its related instructions, and the extensive computer programming changes necessary to process the tax returns claiming the credit. The IRS completed revisions and released the Form 5405 and Instructions on January 15, 2010. However, due to the extensive programming changes required to process tax returns claiming the credit, the IRS had to postpone processing these returns until February 15, 2010. Refunds for these returns were subsequently delayed until mid-March 2010.

The Congress frequently changes the tax laws, so some level of change has become a normal part of the IRS's operating environment. Although the IRS has generally been able to adapt and react to tax law changes, the new laws do have a major effect on how the IRS conducts its activities, determines resource requirements, and progresses toward meeting its strategic goals. While the IRS has recognized the increasing complexity of tax administration in formulating its strategic plan, it has also acknowledged the impossibility of predicting with 100 percent accuracy the timing and extent of the impact of changes in the tax laws. As such, the IRS will continue to face significant challenges in its efforts to respond quickly, accurately, and effectively to tax law changes.

Health Care

The recently enacted health care reform legislation[19] contains an extensive array of tax law changes that will be a continuing source of challenge for the IRS in the coming years. While the Department of Health and Human Services will have the lead role in the policy provisions of the *Patient Protection and Affordable Care Act*, the IRS will administer the law's numerous tax provisions. The IRS estimates that at least 42 provisions will either add to or amend the tax code and at least eight will require the IRS to build new processes that do not exist within the current tax administration system. Examples of new IRS responsibilities resulting from this law include:

- Providing tax credits to businesses and individuals to assist in covering the cost of health coverage;
- Administering the mandate for individuals to purchase health coverage or be subject to a penalty on their individual Federal tax returns; and
- Administering multiple tax provisions designed to raise revenues to offset the cost of health care reform.

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[18] *Worker, Homeownership, and Business Assistance Act of 2009* (Pub. L. No. 111-92, 123 Stat. 2984 (2009).
[19] *Patient Protection and Affordable Care Act* (Pub. L. 111-148, 124 Stat. 119 (2010), as amended by the *Health Care and Education Reconciliation Act of 2010* (Pub. L. 111-152, 124 Stat. 1029).

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American Recovery and Reinvestment Act

The *American Recovery and Reinvestment Act of 2009* (Recovery Act)[20] was enacted on February 17, 2009. The Recovery Act presents significant challenges to all Federal agencies as they move to implement provisions quickly while attempting to minimize risk and meet increased standards for transparency and accountability. With its 56 tax provisions (20 related to individual taxpayers and 36 related to business taxpayers), the Recovery Act poses significant challenges to the IRS as the Nation's tax collection agency and administrator of the tax laws. These provisions will continue to challenge the IRS as it implements the required changes over multiple filing seasons.

TIGTA has issued numerous reports related to the IRS's efforts to implement Recovery Act tax provisions. Some examples include:

- In a review of the IRS's implementation of mandated Health Coverage Tax Credit provisions, we determined that the IRS executed the provisions appropriately, but some project management practices need improvement.[21]
- In a review of the IRS's controls surrounding the First-Time Homebuyer Credit, we determined that although the IRS had taken positive steps to strengthen controls, 1) weaknesses allowed fraudulent claims filed by prison inmates to be processed, 2) multiple claims for the same home were allowed, and 3) claims were allowed for homes purchased prior to the dates allowed by law.[22]
- In a review of the IRS's 2010 Filing Season, we identified inadequate controls and incomplete and inaccurate programming related to certain Recovery Act tax benefits. Although the IRS executed an aggressive outreach campaign to alleviate confusion and prevent errors with the First-Time Homebuyer and the Making Work Pay Credits, we identified over 120,000 taxpayers claiming nearly $100 million in erroneous credits.[23]
- In a review of the IRS's readiness to implement the planning, awarding and reporting of Recovery Act-funded procurements, we determined that although the IRS took proactive steps prior to the enactment of the Recovery Act, it still does not have the necessary controls in place to ensure future procurements will comply with Recovery Act requirements.[24]
- In a review of the IRS's controls to ensure that direct subsidies for Build America Bonds were accurate and timely and whether controls prevented disbursement of erroneous payments, we determined that, generally, all complete requests for

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[20] *American Recovery and Reinvestment Act of 2009* (Pub. L. No. 111-5, 123 Stat. 115).
[21] Treasury Inspector General for Tax Administration, Ref. No. 2010-21-057, *Recovery Act Provisions for the Health Coverage Tax Credit Were Implemented, but Development Processes Could Be Improved* (2010).
[22] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-069, *Additional Steps Are Needed to Prevent and Recover Erroneous Claims for the First-Time Homebuyer Credit* (2010).
[23] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-128, *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (2010).
[24] Treasury Inspector General for Tax Administration, Ref. No. 2010-11-071, *Additional Actions Are Needed to Ensure Readiness to Comply With the American Recovery and Reinvestment Act of 2009 Procurement Requirements* (2010).

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payment of the Build America Bond Federal subsidies were processed accurately, timely and without indications of fraudulent or erroneous disbursement.[25]

TIGTA continues to support the Recovery Accountability and Transparency Board (Recovery Board) in fulfilling its responsibilities for providing transparency for Recovery Act-related funds and for preventing and detecting fraud, waste and mismanagement. We also continue to evaluate the IRS's compliance with Recovery Act and Office of Management and Budget guidance. Additionally, we have evaluated multiple Recovery Board leads that contain allegations of misuse of Recovery Act funds.

Other Tax Law Changes

Implementing legislation for the 2010 Filing Season required the IRS to update many tax products and perform extensive programming in an effort to ensure that tax returns would be processed accurately. We identified 71 tax products (33 tax forms, 12 instructions, and 26 publications) requiring updates due to new legislation. Although tax law changes challenged the IRS during the 2010 Filing Season, the IRS still completed the processing of tax returns on schedule and issued taxpayer refunds within 45 calendar days of the April 15, 2010, due date. However, implementation of some new tax law provisions did cause problems resulting in increases in error inventories from taxpayer errors, payment of erroneous claims, and the inability to identify and prevent erroneous claims at the time tax returns were processed.[26]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

In July 2005, the Congress requested that the IRS develop a five-year plan, including an outline of how the IRS will improve the service it provides to taxpayers and a detailed list of which services the IRS should provide. The IRS developed the plan – the Taxpayer Assistance Blueprint – which focuses primarily on services that support the needs of taxpayers who file or should file the Form 1040 series tax returns.[27] The Blueprint includes performance measures, service improvement initiatives and an implementation strategy for improving future service investment decisions. The IRS has begun implementing the Blueprint, but much of its implementation depends on the availability of future funding.

The Department of the Treasury and the IRS recognize that the delivery of effective taxpayer service has a significant impact on voluntary tax compliance. Answering taxpayers' questions to assist them to correctly prepare their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service

[25] Treasury Inspector General for Tax Administration, Ref. No. 2010-11-083, *Initial Build America Bond Subsidy Payments Were Processed Accurately and Timely* (2010).
[26] Treasury Inspector General for Tax Administration, Ref. No. 2010-41-128, *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (2010).
[27] The Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as the U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040-A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

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also reduces unintentional noncompliance and shrinks the need for future collection activity. The IRS continues to focus on the importance of improving service by emphasizing it as a main goal in its strategic plan, including seeking innovative ways to simplify or eliminate processes that unnecessarily burden taxpayers or government resources.

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset. At a time when the Federal Government is preparing for increased retirements and taking on such challenges as health care reform, the recruitment of new employees and retention of existing employees plays a key role in ensuring the maintenance of a quality workforce capable of meeting the needs of the American public. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent because of a large number of retirements expected over the next several years. Of the approximately 100,000 employees, including 9,100 managers that the IRS employs, more than half have reached age 50 and can retire within 10 years. In addition, 39 percent of IRS executives are already eligible for retirement. Replacing these employees represents a significant challenge since many possess unique skills and institutional knowledge that will be difficult to replace.

The IRS has taken significant actions to improve its ability to recruit qualified candidates. These improvements have enabled the IRS to report that it is on target to meet its mission-critical occupational,[28] geographic and diversity hiring goals. However, improving recruiting activities will require long-term commitment and focus, as some improvements are still in process.

The IRS's challenge of having the right people in the right place at the right time is made more difficult by many complex internal and external factors. The work performed by IRS employees continually requires greater expertise as tax laws become more complex, manual systems used to support tax administration become computer-based, and attempts by taxpayers and tax practitioners to evade compliance with the tax laws become more sophisticated. The IRS must also compete with other government agencies and private industry for the same human resources, which becomes more complicated as younger generations of employees move between jobs more frequently than employees in the past. Furthermore, budget constraints, legislative changes and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

ERRONEOUS AND IMPROPER PAYMENTS AND CREDITS

As defined by the *Improper Payments Information Act of 2002,*[29] an improper payment is any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative or other legally applicable requirements. Improper payments include any payment to an ineligible recipient, any payment for an ineligible service, any duplicate

[28] Mission-critical occupations are those positions critical to front-line enforcement and direct support to front-line operations needed to meet the stated IRS goals.
[29] Pub. L. No. 107-300, 116 Stat. 2350.

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payment, payments for services not received and any payment that does not account for credit for applicable discounts. The Administration has emphasized the importance of reducing improper payments. In November 2009, the President issued Executive Order 13520, which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable and creating strong incentives for compliance.[30] Recently, the *Improper Payments Elimination and Recovery Act of 2010*[31] placed additional requirements on Federal agencies to reduce improper payments. Erroneous and improper payments involving the IRS generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability below zero and, thus, receive a tax refund even if no income tax was withheld or paid. Two significant refundable credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit. The Recovery Act also authorized several new refundable credits, examples of which include the First-Time Homebuyer Credit and the Making Work Pay Credit.

The EITC remains the main refundable credit and continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error and resulting from fraud. Each year a substantial number of taxpayers claim the EITC. For example, in a population of 154 million Tax Year 2007 individual income tax returns, 24.5 million returns claimed $48.5 billion in Earned Income Tax Credits. Although numerous changes have been made to the EITC qualifications to reduce the amount of fraud associated with the claims, recent estimates indicate an EITC improper payment rate between 23 percent and 28 percent, or roughly $11 billion to $13 billion each year.[32]

In a recent review of the IRS's EITC Paid Preparer Strategy,[33] we determined that the IRS has made strides in its effort to increase EITC tax return preparer compliance. However, the IRS could further improve the effectiveness of identifying high-risk EITC tax return preparers by expanding risk factors and using the computed probability score. Although the IRS developed a process that appropriately weighs the significance of risk factors used to compute a probability

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[30] Executive Order 13520, 74 Fed. Reg. 62201 (Nov. 25, 2009). TIGTA has an ongoing audit related to assessing the IRS's efforts to implement this Executive Order. We initiated this audit to comply with the requirement under the Executive Order to evaluate the IRS's methodology for quantifying, preventing and recovering Earned Income Tax Credit improper payments. This audit is included in our Fiscal Year 2011 Annual Audit Plan.
[31] Pub. L. No. 111-204, 124 Stat. 2224.
[32] http://www.paymentaccuracy.usaspending.gov/content/programs-not-reported (last visited October 14, 2010).
[33] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-116, *Actions Can Be Taken to Improve the Identification of Tax Return Preparers Who Submit Improper Earned Income Tax Credit Claims* (2010).

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score to identify potentially noncompliant tax return preparers, the score was not used exclusively when identifying and selecting preparers for a due diligence visit.[34]

Contract and Other Payments

Federal contract spending has more than doubled since 2002. In Fiscal Year 2008, the Federal Government spent approximately $540 billion to acquire goods and services. Similarly, contract spending by the IRS represents a significant outlay of funds. As of March 2010, the IRS administered more than 839 contracts with a value of approximately $48 billion over the life of the contracts. Numerous past TIGTA audits have identified millions of dollars in questioned costs and several instances of contractor fraud.

We recently analyzed TIGTA audit findings related to the IRS's acquisition process from audit reports that were issued from January 1999 through June 2009. We identified several findings that continued to exist throughout the 10-year period, and which, if not corrected, could affect the IRS's ability to effectively prevent erroneous and improper payments and credits. Among TIGTA's findings: 1) the IRS did not have sufficient monitoring controls or processes to ensure contractors were meeting the contract terms and conditions; 2) contractors did not provide adequate documentation to support invoice charges; and, 3) invoices included unallowable labor and travel charges.[35]

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. International business holdings and investment in the United States have grown from nearly $188 billion in 1976 to over $14.5 trillion in 2007, while U.S. business and investment grew from nearly $368 billion to nearly $15 trillion over the same period. As technology continues to advance and cross-border transactions rise, the IRS is increasingly challenged by economic globalization. Technological advances have provided opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

The number of taxpayers who conduct international business transactions – individuals, businesses and tax-exempt organizations – continues to grow. The IRS is challenged by a lack of information reporting on many cross-border transactions. In addition, the varying legal requirements imposed by different jurisdictions result in complex business structures that make it difficult to determine the full scope and effect of cross-border transactions.

Over the past few years, the Federal Government has taken actions to better coordinate international tax compliance issues. The IRS has developed a strategic plan specifically for international tax issues with two major goals: 1) enforce the law to ensure all taxpayers meet their obligation to pay taxes and 2) improve service to make voluntary compliance less burdensome. The IRS has also worked with the U.S. Department of

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[34] A due diligence visit is an examination to determine whether a paid preparer is in compliance with all four due diligence requirements. 26 U.S.C. Section 6695.
[35] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-088, *Procurement Audit Results Indicate Problems Continue to Exist After Corrective Actions Were Implemented* (2010).

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Justice on tax evasion cases that involve foreign countries with bank secrecy laws that prevent the U.S. from obtaining information on taxpayer transactions. Additionally, the President's Fiscal Year 2010 budget contained several proposals to change offshore tax strategies.[36] The proposals targeted both businesses and individuals with a particular emphasis on increasing transparency. This year, the IRS announced that it would realign and rename its Large and Mid-Size Business division to create a more centralized organization dedicated to improving international tax compliance. The IRS expects that the realigned division, now referred to as the Large Business and International division, will improve international tax compliance by allowing the IRS to focus on high-risk issues and cases with greater consistency and efficiency.

As capital markets become increasingly global, U.S. investors may be able to benefit from a corresponding increase in international investment opportunities. In this environment, the Securities and Exchange Commission (SEC) believes that U.S. investors would benefit from an enhanced ability to compare financial information of U.S. companies with that of non-U.S. companies. The SEC believes the International Financial Reporting Standards (IFRS)[37] have the potential to best provide the common platform on which companies can report and investors can compare financial information. In November 2008, the SEC proposed a "Roadmap" that would potentially require U.S. domestic issuers of annual reports to the SEC to use the IFRS. The "Roadmap" sets forth several milestones that, if reached, could lead to the mandatory use of the IFRS by U.S. issuers in their filings with the SEC in Calendar Year 2015 at the earliest. In Fiscal Year 2010, we assessed the IRS's progress in preparing for the tax issues and implications of potentially converting from United States Generally Accepted Accounting Principles to the IFRS. Our report noted the IRS's progress in this area.[38]

In another recent audit related to globalization, we reviewed the processing of U.S. Nonresident Alien Income Tax Returns (Form 1040NR) to determine whether controls were in place to ensure that taxpayers receiving refunds are entitled to those refunds. Our audit revealed significant control weaknesses in the processing of refunds claimed on Forms 1040NR. If the IRS does not take immediate steps to address these control weaknesses, the problem could increase significantly. We also found a lack of consistency by the IRS when applying tax treaty provisions regarding the taxability of gambling income and a need for clarification regarding the designation of certain income earned through U.S.-based, multi-level marketing companies as "U.S. Source Income."[39]

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[36] *General Explanations of the Administration's 2010 Budget Proposal.* Department of the Treasury (Issued May 2009).
[37] The IFRS, issued by the International Accounting Standards Board, are a set of accounting standards that serve as a framework for financial reporting. The IFRS are rapidly gaining worldwide acceptance and are now used for public reporting purposes in more than 100 countries.
[38] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-112, *Actions Are Being Taken to Address the Impact That International Financial Reporting Standards Will Have on Tax Administration* (2010).
[39] Treasury Inspector General for Tax Administration, Ref. No. 2010-40-121, *Improvements Are Needed to Verify Refunds to Nonresident Aliens Before the Refunds Are Sent Out of the United States* (2010).

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TAXPAYER PROTECTION AND RIGHTS

The IRS must ensure that tax compliance activities are balanced against the rights of taxpayers to receive fair and equitable treatment. The IRS continues to dedicate significant resources and attention to implementing the taxpayer rights provisions of the *IRS Restructuring and Reform Act of 1998* (RRA 98).[40] Annual audit reports are mandated for the following taxpayer rights provisions:

- Notice of Levy;
- Restrictions on the Use of Enforcement Statistics to Evaluate Employees;
- Fair Debt Collection Practices Act Violations;
- Notice of Lien;
- Seizures;
- Illegal Protestor Designations;
- Assessment Statute of Limitations;
- Restrictions on Directly Contacting Taxpayers Instead of Authorized Representatives; and
- Separated or Divorced Joint Filer Requests.

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. The IRS has shown improvement over prior years when documenting that taxpayers were informed of their rights. However, the IRS did not fully comply with requirements concerning the use of records of tax enforcement results to evaluate employees,[41] and did not always follow procedures for mailing notices to taxpayers or their representatives in Federal tax lien cases.[42]

Some IRS management information systems do not track cases that require mandatory annual audit coverage.[43] Thus, neither TIGTA nor the IRS could evaluate the IRS's compliance with certain RRA 98 provisions.

LEVERAGING DATA TO IMPROVE PROGRAM EFFECTIVENESS AND REDUCE COSTS

While the IRS has made progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. The IRS lacks a comprehensive, integrated system that provides accurate, relevant and timely financial and operating data that can be used to evaluate performance measures, productivity and the associated costs of IRS programs. In addition, the IRS cannot produce timely,

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[40] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[41] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-076, *Fiscal Year 2010 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (2010).
[42] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-072, *Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2010).
[43] Treasury Inspector General for Tax Administration, Ref. No. 2010-30-026, *Fiscal Year 2010 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2010) and Treasury Inspector General for Tax Administration, Ref. No. 2010-30-060, *Fiscal Year 2010 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2010).

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accurate and useful information needed for day-to-day decisions, hindering its ability to address financial management and operational issues to fulfill its responsibilities.

TIGTA and GAO have continued to report that various IRS management information systems are insufficient to enable IRS management to measure costs, determine if performance goals have been achieved, or monitor progress in achieving program goals. In its most recent financial statement audit,[44] GAO reported that the IRS's financial management systems do not comply with *Federal Financial Management Improvement Act of 1996* (FFMIA)[45] requirements. In addition, GAO noted that the IRS continues to have material weaknesses in internal controls over information security and unpaid assessments.

While the IRS has made measurable progress in addressing the issues causing its noncompliance with the FFMIA, our review of the IRS's September 30, 2009, FFMIA remediation plan identified that the IRS continues to experience difficulties in developing resource estimates for remediation actions related to information security. In addition, the IRS informed us that it does not expect to become compliant with the FFMIA and address the material weakness relating to unpaid assessments until approximately November 2014.[46]

CONCLUSION

These are the 10 major management and performance challenges for the IRS in Fiscal Year 2011. TIGTA's *Fiscal Year 2011 Annual Audit Plan* and *Inspections and Evaluations Plan* contain our proposed reviews and are organized by these challenges. If you have questions or wish to discuss TIGTA's views on the challenges in greater detail, please contact me at (202) 622-6500.

cc: Deputy Secretary
Assistant Secretary for Management and Chief Financial Officer
Commissioner of Internal Revenue

[44] U.S. Government Accountability Office, GAO-10-176, *Financial Audit: IRS's Fiscal Years 2009 and 2008 Financial Statements* (2009).
[45] Pub. L. No. 104-208, 110 Stat. 3009.
[46] Treasury Inspector General for Tax Administration, Ref. No. 2010-10-065, *Measurable Progress Has Been Made in Addressing Federal Financial Management Improvement Act Noncompliance; However, Significant Challenges Remain* (2010).

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 15, 2010

MEMORANDUM FOR J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

FROM: Timothy F. Geithner

SUBJECT: Response to Management and Performance Challenges Facing the Internal Revenue Service

I am responding to your October 15, 2010, memorandum describing the Internal Revenue Service's (IRS) most serious management and performance challenges. This memorandum provides information on the actions completed in fiscal year (FY) 2010 and the actions planned for FY 2011 to address these challenges.

Challenge 1 – Security

In FY 2010, IRS implemented a number of security enhancements at IRS buildings nationwide as a result of the February incident in Austin in which an IRS employee perished and several others were injured. The IRS placed guards on a 24/7 basis in 11 of the Austin offices, and security guards at all of the 401 taxpayer assistance centers (TACs). The IRS also established a more vigilant security posture at all buildings through increased canine patrols, random searches, and guard vigilance. In addition, IRS is conducting in-depth risk assessments at all 669 facilities that house IRS employees to identify any security countermeasures that would enhance security.

The IRS's Criminal Investigation Division (CI) enhanced its partnerships with the Treasury Inspector General for Tax Administration and Federal Protective Service to share information on potential threats so IRS can institute appropriate countermeasures. The IRS included physical security briefings for all employees in mandatory annual security awareness briefings.

During FY 2010, IRS expanded efforts to detect and prevent security threats and to protect access to taxpayer information, identifying and mitigating over 5,200 individual cyber incidents which could have compromised the integrity of the IRS to address computer security. The IRS combated online fraud schemes by monitoring, identifying, and mitigating fraudulent sites and phishing scams, shutting down 4,109 phishing sites (899 domestic and 3,210 international) in FY 2010, up from 3,444 sites shut down in 2009. The IRS has a team of capable "first responders" who are organized, trained, and equipped to identify, contain, and eradicate cyber threats targeting IRS computing assets.

The IRS continues to take the issue of identity theft very seriously. In FY 2010, IRS flagged more than 284,000 accounts of identity theft victims with "markers" that indicated to an employee that they were dealing with a substantiated case of identity theft. In addition, IRS ensured that identity theft indicators and business rules isolated returns for additional screening to validate whether the true taxpayer filed the return. More than 82,000 returns were selected for additional screening and closed, and more than $245 million was protected from being refunded to perpetrators on thousands of fraudulent returns.

In FY 2011, IRS will deploy additional account "markers" that will improve the processing of taxpayer accounts impacted by identity theft. The IRS will also complete the development of a CI Disaster Recovery Site in Martinsburg, WV which will be used to prepare for, respond to, and recover from a disaster or emergency incident.

Challenge 2 – Modernization

In FY 2010, IRS modernization efforts continued to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and to IRS employees. The Customer Account Data Engine (CADE), Modernized e-File (MeF), and Account Management Services (AMS) modernization projects delivered the changes necessary for a successful filing season, and continued to support implementation of the tax provisions of the *American Recovery and Reinvestment Act of 2009* (Recovery Act).

In FY 2010, IRS revised its CADE strategy (CADE 2) to implement a new taxpayer account database for the 2012 filing season that provides for daily updating of individual taxpayer accounts to improve taxpayer service and accuracy, reduce interest paid on late refunds, improve data security, and allow the development of new tools to combat fraud and improve enforcement activities. Completion of the taxpayer account database is the prerequisite for other major initiatives, including significant expansion of online services and transactions and the next generation of enforcement technologies.

The IRS deployed an additional release of MeF that enabled acceptance of additional forms and schedules to reach 61 percent of the e-file population, and with enhanced disaster recovery capabilities to manage operational risk. In addition, IRS deployed the final release of AMS, enabling users to view correspondence images online, eliminating manual processing, and reducing case cycle time from 10-14 days to zero days. AMS also facilitated the identification of unallowable or fraudulent claims for First-Time Home Buyer Credits claimed by taxpayers filing amended returns.

In FY 2011, IRS will continue to focus on modernization of the tax administration systems to provide additional benefits to taxpayers. The IRS will further develop CADE 2 to accommodate tax law changes in the 2012 filing season.

Challenge 3 – Tax Compliance Initiatives

During FY 2010, IRS continued to focus on improving voluntary compliance in support of Treasury's goal of reducing the tax gap, ensuring businesses and individuals pay the correct amount of tax and overseeing tax-exempt and government entities. The IRS Research Community Strategic Plan, released in FY 2010, focuses on research efforts aimed at effectively determining ways to address taxpayer compliance. Specifically, IRS will develop several new estimates of taxpayer compliance, undertake research to support efficient methods to enhance compliance, and use analytically based technologies to provide tools for detecting and reducing noncompliance.

Businesses and Individuals

In FY 2010, IRS continued to make closing the tax gap, especially the portion attributable to underreporting of individual and business income tax, a major priority. While enforcement efforts are crucial, IRS also recognized the need to better identify noncompliant taxpayers, conduct exams more efficiently and with less taxpayer burden, and to engage and monitor tax return preparers, who are uniquely situated to impact taxpayer behavior and compliance.

The IRS requested increases in its FY 2011 Treasury budget submission to support the Presidential priority of addressing international tax evasion. The IRS's planned initiatives build on the work started in FY 2010, allowing IRS to continue the multi-year investment in international tax compliance activities. Increases in the coverage of the most strategically important international issues, including complex enterprise structures and transactions, promote greater compliance in high net-worth individuals and large enterprises, including those with international components, operated by businesses and investors through multiple interrelated financial and tax entities. The IRS will also be able to continue directing significant resources to examining returns from the Offshore Voluntary Disclosure Initiative and to the development of cases built upon data received from UBS for taxpayers who did not voluntarily disclose ownership of offshore accounts.

The IRS is continuing the individual National Research Program in order to update case scoring models to better identify noncompliant taxpayers. In FY 2011, IRS plans to use the improved case scoring models to identify a sample population on which to conduct examinations beginning in FY 2012.

During FY 2010, while IRS continued to take enforcement actions crucial to closing the tax gap, it also took steps to conduct exams more efficiently and with less taxpayer burden. In FY 2010, IRS began using new software that reduces the taxpayer burden of printing records stored electronically in response to business owners and tax professionals who have been advocating for the acceptance of taxpayer records in electronic format. The new software will allow IRS to retain a complete set of the taxpayer's accounting records. As a result, IRS anticipates a decrease in the size and complexity of initial document requests during an examination and in follow-up requests to taxpayers. The new software also has the potential to allow IRS to resolve audits more quickly due to increased efficiency in the analysis and testing of the books and records in electronic format.

For the first time since the early 1980s, IRS embarked on a three-year Employment Tax Compliance Study to determine the employment tax gap and employment tax compliance rates. The IRS developed new forms designed to provide a clearer procedure for workers who are being incorrectly classified as contractors by their employers. In FY 2011, systemic changes will identify returns that have incomplete forms attached, reducing the number of forms filed with incorrect Social Security and Medicare taxes reported. The IRS will report the results of the Employment Tax Compliance study once three years of data are available to develop robust compliance estimates, and will use the results to develop processes to correct the problem of misclassification of employees.

Tax-Exempt Entities

During FY 2010, IRS continued to recognize the importance of maintaining a strong enforcement presence in the tax-exempt sector and ensured that tax-exempt organizations met their requirements under federal tax law. In FY 2010, IRS improved the filing of required Forms 8871, *Political Organization Notice of Section 527 Status*, and 8872, *Political Organization Report of Contributions and Expenditures*, to better identify non-compliance by Section 527 political organizations. In FY 2011, IRS will continue to focus on these organizations by revising form instructions to improve the guidance provided to filers, developing procedures to both periodically sample forms submitted for compliance and to conduct reviews of responses received to compliance notices, and seeking to correct systemic issues related to the issuance of Form 8872 notices.

In FY 2010, IRS assisted the Department of Justice (DOJ) in fraud and conspiracy investigations related to municipal bond contracts and initiated examination projects in identified areas of noncompliance. One notable accomplishment is that compliance contacts for tax-exempt and government entities increased 19.7 percent in FY 2010 when compared to the previous year.

During FY 2010, international tax compliance continued to challenge IRS. In FY 2010, IRS addressed international compliance issues, including internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, and cross-border commerce using Indian reservations and casinos. In FY 2011, IRS will continue to ensure tax-exempt organizations comply with applicable laws and regulations, as well as continue to address international compliance issues.

In FY 2010, IRS released an interim report on the compliance of colleges and universities for unrelated business taxable income and compensation. The Colleges and Universities project is part of an ongoing effort by IRS to review the largest, most complex organizations in the tax-exempt sector to identify issues that warrant additional guidance or scrutiny. Based on responses to compliance questionnaires sent to 400 public and private colleges and universities, IRS has opened several dozen examinations focusing on unrelated business income and executive compensation and will issue a final report in FY 2011.

Tax Return Preparers

The IRS recognizes that return preparers are a critical component of tax administration and are uniquely situated to impact taxpayer behavior and improve compliance with tax laws. In FY 2010, IRS emphasized compliance among return preparers through a variety of methods, including due diligence and "knock and talk" visits, as well as examinations of cases where potential preparer violations were identified. As discussed further below, in 2010 IRS also began to lay a foundation for ensuring the quality and integrity of professional tax return preparation through a program of registration, competency testing, and continuing professional education.

Challenge 4 – Implementing Health Care and Other Tax Law Changes

Health Care

The *Affordable Care Act* (ACA) was signed into law on March 23, 2010, and later amended by the *Health Care and Education Reconciliation Bill of 2010* on March 30, 2010. ACA represents the largest set of tax law changes in more than 20 years, with more than 40 provisions that amend the tax laws. Although the new law goes into effect gradually over many years, numerous provisions required IRS to take immediate action, including the Small Business Health Care Tax Credit, the Qualifying Therapeutic Discovery Credit, the expanded Adoption Credit, and numerous tri-departmental ACA market reform regulations and subregulatory guidance issued jointly by the Department of Health and Human Services (HHS), Department of Labor, and Treasury (with IRS).

To implement various ACA provisions that are effective in 2010 and 2011, IRS established teams, organized by affected taxpayer groups: individual taxpayers, small businesses, large industry, and tax-exempt and government entities. During FY 2010, IRS focused on:

- Developing new systems and business processes for near-term provisions
- Conducting initial planning for longer-term provisions, and
- Defining appropriate outreach activities for each affected group

The IRS and HHS partnered to form a Coordinating Committee to assess cross-cutting policy considerations. Also, interagency working teams have formed to assess operational needs such as data infrastructure, eligibility, enrollment, customer service, communications, and payment of premium tax credits.

Provisions taking effect in later years (including the individual responsibility requirement and premium tax credit), when new options for buying health insurance through state-sponsored exchanges go into effect, place significant new administrative responsibilities on IRS. In preparation for these provisions, in FY 2010, IRS began to design and develop the requisite complex new systems and business processes and coordinate with other federal and state entities.

Recovery Act

The IRS is faced with implementing tax law changes each filing season, and in FY 2010 IRS successfully implemented the FY 2010 provisions of the Recovery Act. In response to the fraud that sometimes accompanies major tax law changes, IRS identified erroneous and fraudulent First-Time Homebuyer Credit claims through new system programming and pre-refund filters that rejected returns where claims in excess of the maximum allowable credit were made or claims in excess of allowable amounts for taxpayers with adjusted gross income exceeded income limitations. The IRS continues to take a strategic approach to this credit which includes both aggressive compliance and outreach components. From October to December 2010, IRS plans to send a series of notices to the millions of taxpayers who benefited from the program to remind them of the requirements on repayment and recapture of the credit. The IRS will also send notices to taxpayers who may have disposed of their home within the three years, reminding them of the requirement to report the disposition for the year it occurred. The IRS is also moving forward with its plans to use third party data to identify non-compliance and to address the areas of non-compliance already identified.

In FY 2010, IRS provided detailed Recovery Act training to employees responsible for developing Recovery Act-funded requirements to ensure the necessary controls were in place to comply with procurement requirements. The IRS also increased staff to ensure full coverage of required procurement activities. In FY 2011, IRS will continue to assess staffing throughout the procurement lifecycle to maintain adequate internal control functions.

Other Tax Law Changes

In FY 2010, taxpayers continued to use IRS.gov in record numbers to get real-time, updated information on available tax credits as they filed their returns. Taxpayers used the site to find answers to tax law questions through an Interactive Tax Assistant and updated phone tools to obtain information on the one-time $250 Economic Recovery payment.

In FY 2011, IRS will continue to monitor proposed changes to the tax laws and prepare accordingly to ensure taxpayers have the necessary forms and information for the filing season. Based on preliminary analysis of the Affordable Care Act, IRS will prepare to implement the Act, including the revision of more than 17 tax forms and the creation of three new forms.

Challenge 5 – Providing Quality Taxpayer Service Operations

During the 2010 filing season, IRS.gov remained the preferred source of information for taxpayers seeking answers to their questions on preparing and filing their tax returns accurately and timely and on new legislation. The IRS added more automated self-help web tools and services; e.g., an application for taxpayers to obtain a personal identification number to satisfy e-filing signature requirements and a multilingual website to facilitate participation in the tax system by individuals who do not speak English. These improvements are a part of IRS's continued implementation of the Taxpayer Assistance Blueprint (TAB) service improvements.

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The IRS and its partners provided free tax assistance to the elderly, disabled, and limited English proficient individuals and families at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites during the filing season. Volunteers at over 12,000 VITA and TCE sites throughout the nation prepared more than 3.1 million tax returns, including 360,500 returns for individuals with disabilities and/or families with disabled dependents.

During FY 2010, IRS and its partners hosted five Open House events at 200 TACs and partner sites, including at least one in every state, in an effort to assist taxpayers during the economic downturn. The goal of these events was to improve the taxpayer's experience by creating seamless case resolution on a variety of tax issues and to assist taxpayers in preparing their tax returns. As a result, they served more than 31,400 taxpayers and prepared over 7,700 returns. Included in the 2010 events were assistors trained to help taxpayers who owed delinquent taxes, especially those who were having difficulties meeting their tax obligations because of unemployment or other financial problems. Services offered to taxpayers included added flexibility for missed installment agreement payments and streamlined processing for offers in compromise.

In FY 2011, IRS will continue to implement its TAB service improvements and provide greater access to service on non-workdays through events such as Open Houses. The IRS will also use IRS.gov to disseminate information to taxpayers quickly, continue to simplify forms to comply with the *Plain Writing Act of 2010*, and look for additional ways to improve the tax filing process.

Challenge 6 – Human Capital

In FY 2010, IRS completed its Human Capital Business Plan for 2010-2014, which describes how IRS will work toward further improving its ranking as a "best place to work in government."

To attract the best and most qualified applicants, IRS enhanced its recruitment programs and introduced a new recruitment brand – "Count on Me!" – on print materials, USAjobs.gov, the IRS Careers website, Internet advertisements, and social media. A job search tool on YouTube helped provide the public with information on employment opportunities. The IRS also took steps to streamline its hiring process to make it faster and more efficient, while reducing applicant burden.

In FY 2010, IRS had noteworthy hiring accomplishments, including meeting its goal of hiring 1,000 military veterans for the third year in a row, with veterans comprising 11 percent of total hires, up from 9 percent in FY 2009, and 7 percent in FY 2008. The IRS achieved this goal by working with veterans' organizations and other government agencies to hold targeted job fairs.

Also, IRS developed an overall strategy for improving coaching and mentoring skills at all leadership levels, including implementation of an internal coaching certification program and core workshops for all leaders to develop, promote, and retain IRS leaders. The IRS also completed 41 of 58 recommendations outlined in its 2009

Workforce of Tomorrow (WOT) report, helping to resolve some of the most significant recruitment and retention workforce challenges facing current employees and managers.

In FY 2011, IRS will implement additional WOT recommendations, as well as an Accelerated Leadership Program pilot to test a "fast track" training program for identified high-potential candidates. The IRS will also continue to use cutting edge technologies and communication tools to increase the breadth of recruitment in an effort to attract the best and brightest applicants and will continue efforts to streamline the hiring process.

Challenge 7 – Erroneous and Improper Payments and Credits

Refundable Credits

During FY 2010, IRS continued to focus on refundable credits and the Earned Income Tax Credit (EITC) as areas for reducing erroneous payments. The IRS protected over $3.7 billion in revenue through EITC enforcement efforts, which included the examination of over 474,000 original and amended returns claiming the EITC, 900,000 document matching reviews, and 300,000 math error process corrections. The IRS also identified more than 405,555 fraudulent returns claiming over $3.0 billion in refunds, and stopped over $2.6 billion in fraudulent claims using the Electronic Fraud Detection System, with an average refund of $8,230.

In FY 2011, IRS will continue to address EITC noncompliance through its aggressive compliance program which includes examinations, reviews of income misreporting, systemic corrections during return processing, and focus on paid return preparers, who prepare 66 percent of EITC returns. The IRS believes the implementation of new preparer requirements for registration, competency testing, continuing education, and compliance checks will improve EITC compliance, decrease fraud, and reduce overall program noncompliance.

Contracts and Other Payments

In FY 2010, IRS emphasized the importance of the role of the Contracting Officer's Technical Representative (COTR) in contract administration and contract monitoring by providing on-line reference resources and developing more comprehensive training. The training is a mandatory requirement for all managers and employees involved in contract administration. It includes courses that separate the receipt and acceptance processes to clarify the requirements. The IRS has also established an automated system to ensure only properly certified employees serve as COTRs. To further assist COTRs in the contractor invoice review and approval process, detailed procedures include a requirement to verify contractor employee qualifications against the contract labor categories and descriptions prior to approval of any voucher for payment.

Challenge 8 – Globalization

During FY 2010, IRS continued to focus on taxpayers who shift income abroad and engage in offshore tax evasion schemes to hide their wealth and avoid paying taxes. With cross-border transactions on the rise, IRS more than

doubled its offshore presence by opening new offices in Asia and Central America, placing additional personnel at its existing offices throughout the world, and expanding its interaction with key international organizations involved in tax and financial law compliance.

In FY 2010, IRS used audit results and intelligence from ongoing offshore initiatives to refine case identification and selection methods and to identify promoters, facilitators, and participants in abusive offshore arrangements. The IRS also began mining the information from participants of its offshore voluntary disclosure program, started in 2009, to identify financial institutions, advisors, and others who promoted or otherwise helped U.S. taxpayers hide assets and income offshore. This mined data will be used in FY 2011 to develop additional strategies to prohibit promoters and facilitators from soliciting new clients.

As part of a continuing effort to ensure the issues with erroneous and fraudulent refund claims on Forms 1040NR, *U.S. Nonresident Alien Income Tax Return*, are not widespread, IRS has developed new procedures for reviewing and processing the refund claims, assisted by recently passed legislation that extends the timeframe allowed for review. In FY 2011, a new database will be developed to provide for better tracking and validity reviews, and new criteria will be established to assist in the validation of claims. The IRS also plans to take steps to recover erroneous refunds through enforcement. The IRS continued to address emerging compliance issues with internationally sponsored pension plans, the movement of in-kind charitable gifts offshore, and adherence by charities to requirements for foreign bank accounts.

Challenge 9 – Taxpayer Protection and Rights

Taxpayer protection is a top priority for IRS. In FY 2010, IRS continued to monitor compliance with the taxpayer rights provisions of the *IRS Restructuring and Reform Act of 1998* (RRA 98), including quarterly managerial certifications and annual independent reviews of the RRA 98 Section 1204 provisions. The certification process serves to ensure management does not use enforcement statistics to evaluate employees and drive behavior in conflict with taxpayer rights. The IRS issued new policy guidance and developed an improved briefing on the retention standard to ensure that the fair and equitable treatment of taxpayers remains a critical factor in evaluating employees.

During FY 2010, IRS began laying the groundwork to ensure the quality and integrity of professional tax return preparation, which most taxpayers rely on in one form or another. The IRS successfully implemented an application process to comply with the mandate that all paid tax return preparers obtain a preparer tax identification number. In FY 2011, IRS will proceed with additional requirements related to competency testing and continuing professional education.

The notice of federal tax lien process is an important component of the IRS recovery strategy to protect the government's interest on unpaid tax liabilities. The IRS has taken several steps to address systemic and procedural

concerns identified with the notice of federal tax lien process, including system enhancements, Internal Revenue Manual procedural updates, and operational reviews. The IRS continually examined and improved processes to ensure the protection of taxpayer rights. In FY 2011, IRS will implement automation tools to address notice requirements.

Challenge 10 – Leveraging Data to Improve Program Effectiveness and Reduce Costs

In FY 2010, IRS continued to make progress in financial management, particularly with use of its managerial cost accounting system that provides timely, accurate, and useful data across multiple business units. Currently, the system has five years of data that provide managers with useful cost information for decision making related to their programs and activities. The IRS has used its Integrated Financial System cost module to determine the full cost of a number of compliance activities at the program level, including the EITC program, and to develop cost-benefit analyses on other enforcement programs.

The IRS implemented the Redesign Revenue Accounting Control System (RRACS) in January 2010, bringing the revenue financial system substantially compliant with the United States Standard General Ledger. The requirement that RRACS provide transaction traceability for unpaid tax assessments to the sub-ledger prevents closure of the unpaid assessment material weakness at this time. Closure of this material weakness depends on implementation of CADE 2 (Transition State 2) to provide the capability to properly categorize unpaid assessment data and provide an audit trail to the detailed transactions residing in modernized and legacy operating systems.

APPENDIX D:
MATERIAL WEAKNESSES, AUDIT FOLLOW-UP, FINANCIAL SYSTEMS, AND RECOVERY ACT RISK MANAGEMENT

This section consists of detailed descriptions of Treasury's material weakness inventory, including a summary of actions taken and planned to resolve the weaknesses; tracking and follow-up activities related to Treasury's GAO, OIG, TIGTA, and the Special Inspector General for the Troubled Asset Relief Program audit inventory; an analysis of potential monetary benefits arising from audits performed by Treasury's Inspectors General; an update on Treasury's financial systems framework; and an overview of Treasury's risk management activities related to the *American Recovery and Reinvestment Act of 2009* (Recovery Act).

1. Treasury's Material Weaknesses

Management may declare audit findings or internal situations as a material weakness whenever a condition exists that may jeopardize the Treasury mission or continued operations. Reporting on material weaknesses is required in these instances by the *Federal Managers' Financial Integrity Act of 1982* (FMFIA) and the *Federal Financial Management Improvement Act of 1996* (FFMIA).

Federal Managers' Financial Integrity Act of 1982 (FMFIA)

The FMFIA requires agencies to establish and maintain internal controls. The Secretary must annually evaluate and report on the controls (FMFIA Section 2) and financial systems (FMFIA Section 4 and FFMIA) that protect the integrity of federal programs. The requirements of the FMFIA serve as an umbrella under which other reviews, evaluations, and audits should be coordinated and considered to support management's assertion about the effectiveness of internal control over operations, financial reporting, and compliance with laws and regulations.

As of September 30, 2010, Treasury has four material weaknesses under Section 2 of the FMFIA, summarized as follows:

Summary of FMFIA and FFMIA Material Weaknesses	Section 2	Section 4	Total
Balance at the Beginning of FY 2010	5	0	5
Closures/Downgrades during FY 2010	1	0	1
Reassessed during FY 2010	0	0	0
New MW declared during FY 2010	0	0	0
Balance at the End of FY 2010	4	0	4

Below are detailed descriptions of Treasury's four material weaknesses:

Material Weakness Description

INTERNAL REVENUE SERVICE - Improve Modernization Management Controls and Processes

The IRS needs to improve its management of the Business Systems Modernization program. Key elements:

- Assess the recommendations from the Special Studies and Reviews of the Business Modernization program and projects
- Implement and institutionalize procedures for validating contractor-developed costs and schedules
- Establish effective contract management practices
- Complete a human capital strategy
- Improve configuration management practices

Actions Completed	What Remains to be Done
☑ Deployed release 5.2 of the Customer Account Data Engine (CADE) in January 2010, delivering the tax year 2009 filing season tax law changes affecting individual taxpayers, and providing technical improvements to the infrastructure and availability of current CADE	☐ Allow assessment time to observe long-term effect of actions completed and demonstrate sustained improved performance
☑ Deployed Modernized e-File (MeF) release 6.1 in January 2010, delivering all functionality and tax law changes for corporate, partnership, and non-profit/tax exempt returns; and the build-out of the infrastructure to include a more robust disaster recovery capability to support 1040 processing	☐ Targeted Downgrade/Closure: Fiscal year 2011
☑ Deployed Account Management Services (AMS) release 2.1 in September 2009, providing all AMS users the ability to view correspondence images online and on demand, eliminating users' reliance on manual processes to obtain copies of images.	
☑ Exited CADE 2 Transition State 1 milestone 0-2 in February 2010; implemented CADE 2 Acquisition Strategy and Plan which provides oversight for all CADE 2 acquisition tasks	

Material Weakness Description

INTERNAL REVENUE SERVICE - Computer Security

The IRS has various computer security controls that need improvement. Key elements:

- Adequately restrict electronic access to and within computer network operational components
- Adequately ensure that access to key computer application and systems is limited to authorized persons for authorized purposes
- Adequately configure system software to ensure the security and integrity of system programs, files, and data
- Appropriately delineate security roles and responsibilities within functional business operating and program units, as required by the *Federal Information Security Management Act*
- Appropriately segregate system administration and security administration responsibilities
- Sufficiently plan or test the activities required to restore certain critical business systems where unexpected events occur
- Effectively monitor key networks and systems to identify unauthorized activities and inappropriate system configurations
- Provide sufficient technical, security-related training to key personnel
- Certify and accredit 90 percent of all systems

Actions Completed	What Remains to be Done
☑ Security roles and responsibilities	☐ Systems/Application access controls
☑ Security/System Administration segregation of duties	☐ Systems software configuration access controls
☑ Security training	☐ Contingency planning
☑ Certification and Accreditation	☐ Audit trails
☑ Network access controls	☐ Targeted Downgrade/Closure: Fiscal year 2012

Material Weakness Description	
INTERNAL REVENUE SERVICE – Unpaid Assessments (remaining portions of Financial Accounting of Revenue – Custodial) The IRS needs to improve its internal control over Unpaid Assessments. Key elements: • Subsidiary ledger does not track and report one Trust Fund Recovery Penalty (TFRP) balance • Untimely posting of TFRP assessments and untimely review of TFRP accounts • IRS' general ledger for its custodial activities does not use the standard federal accounting classification structure	
Actions Completed	**What Remains to be Done**
☑ Implemented the Redesign Revenue Accounting Control System (RRACS) in January 2010, which enabled the custodial financial management system to substantially comply with the United States Standard General Ledger (USSGL) chart of accounts to address noncompliance with FFMIA. ☑ RRACS now records all tax revenue and refunds using the USSGL format and for the first time records the taxes receivable and allowance for doubtful accounts addressing this component of the material weakness	☐ Achievement of CADE 2 Transition State 2 target of a single, data-centric solution system which provides for daily processing of taxpayer accounts ☐ Targeted Downgrade/Closure: Fiscal year 2015

Material Weakness Description	
FINANCIAL MANAGEMENT SERVICE - Consolidated Government-wide Financial Statements The government does not have adequate systems, controls, and procedures to properly prepare the Consolidated Government-wide Financial Statements. Key elements: • The government lacks a process to obtain information to effectively reconcile the reported excess of net costs over revenue with the budget deficit, and when applicable, a reported excess of revenue over net costs with the budget surplus • Weaknesses in financial reporting procedures in internal control over the process for preparing the Consolidated Financial Statements	
Actions Completed	**What Remains to be Done**
☑ Partially reconciled fiscal year 2009 operating revenues with budget receipts ☑ Developed a model to provide analysis of unreconciled transactions that affect the change in net position ☑ Accounted for intra-governmental differences through formal consolidating and elimination accounting entries using all reciprocal fund categories including the General Fund ☑ Federal agencies submit complete closing packages to GAO ☑ Establish traceability from agency footnotes to the Consolidated Financial Statements (CFS) for completeness	☐ Complete reconciliation of operating revenues to budget receipts ☐ Complete reciprocal category for the Treasury General Fund ☐ Implement changes identified by the Office of the Fiscal Assistant Secretary as a result of its review of the Reporting Entity definitions per the Financial Accounting Standards Advisory Board criteria ☐ Include all disclosures as appropriate ☐ Include all loss contingencies as appropriate ☐ Targeted Downgrade/Closure: Fiscal year 2014

II. Audit Follow-up Activities

During fiscal year 2010, Treasury placed renewed emphasis on both the general administration of internal control issues throughout the Department and the timely resolution of findings and recommendations identified by the Office of the Inspector General (OIG), the Treasury Inspector General for Tax Administration (TIGTA), the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), the Government Accountability Office, and external auditors. During the year, Treasury continued to implement enhancements to the tracking system called the "Joint Audit Management Enterprise System" (JAMES). JAMES is a Department-wide, interactive, web-based system accessible to the OIG, TIGTA, SIGTARP, bureau management, Departmental management, and others. The system tracks information on audit reports from issuance through completion of all corrective actions required to address findings and recommendations contained in an audit report. JAMES is the official system of record for Treasury's internal control program.

Potential Monetary Benefits

The *Inspector General Act of 1978*, as amended, Public Law 95-452, require the Inspectors General and the Secretaries of Executive Agencies and Departments to submit semiannual reports to the Congress on actions taken on audit reports issued that identify potential monetary benefits. The Department consolidates and analyzes all relevant information for inclusion in this report. The information contained in this section represents a consolidation of information provided separately by the OIG, TIGTA, and Department management.

In the course of their audits, the Inspectors General periodically identify questioned costs, make recommendations that funds be put to better use, and identify measures that demonstrate the value of audit recommendations to tax administration and business operations. "Questioned costs" include a:

- Cost that is questioned because of an alleged violation of a provision of a law, regulation, contract, or other requirement governing the expenditure of funds
- Finding, at the time of the audit, that such costs are not supported by adequate documentation (i.e., an unsupported cost)
- Finding that expenditure of funds for the intended purpose is unnecessary or unreasonable

The Department regularly reviews progress made by the bureaus in realizing potential monetary benefits identified in audit reports, and coordinates with the auditors as necessary to ensure the consistency and integrity of information on monetary benefit recommendations being tracked.

The statistical data in the following summary table and charts represent audit report activity for the period from October 1, 2009 through September 30, 2010. The data reflect information on reports that identified potential monetary benefits issued by the OIG and TIGTA.

Audit Report Activity With Potential Monetary Benefits for Which Management Has Identified Corrective Actions (OIG and TIGTA)
October 1, 2009 through September 30, 2010
(Dollars in Millions)

	Disallowed Costs		Funds Put to Better Use		Revenue Enhancements		Totals	
	Reports	Dollars	Reports	Dollars	Reports	Dollars	Report Total	Total Dollars
Beginning Balance	10	$36.9	6	$159.1	11	$2,536.3	27	$2,732.3
New Reports	2	.4	11	2,818.7	11	3,929.0	23	6,748.1
Total	12	37.3	17	2,977.8	22	6,465.3	50	9,480.4
Reports Closed	8	4.3	4	155.2	5	906.4	16	1,065.9
a. Realized or Actual	6	1.1	2	29.2	3	16.1	10	46.4
b. Unrealized - Written off	7	3.2	3	126.0[1]	5	890.3[2]	15	1,019.5
Ending Balance	4	$33.0	13	$2,822.6	17	$5,558.9	34	$8,414.5

1 This category includes one report, with $125.66 million written off, for which IRS management did not concur with TIGTA's projected benefits.

2 This category includes one report, with $209 million written off, for which IRS management did not concur with TIGTA's projected benefits; and one report, with $539.6 million written off, for which TIGTA does not agree with the IRS that the benefits have not been realized.

The following table presents a summary of OIG and TIGTA audit reports with potential monetary benefits that were open for more than one year as of the end of fiscal years 2008, 2009, and 2010.

Number of Reports with Potential Monetary Benefits Open for More than One Year

	PAR Report Year	9/30/2008	9/30/2009	9/30/2010
OIG	No. of Reports	1	0	1
	$ Projected Benefits	$29.4 million	$0 million	$10.5 million
TIGTA	No. of Reports	12	10	12
	$ Projected Benefits	$661.5 million	$673.8 million	$1,783.7 million

The following table presents a summary of TIGTA and OIG audit reports, broken out by year of report issuance, on which management decisions were made on or before September 30, 2009, but the final actions had not been taken as of September 30, 2010.

Details of the Audit Recommendations with Potential Monetary Benefits on Which Management Decisions Were Made On or Before September 30, 2009, But Final Actions Have Not Been Taken as of September 30, 2010
(Dollars In Thousands)

Bureau	Report Number	Report Issue Date	Brief Description	Disallowed Costs	Funds Put to Better Use	Revenue Enhancement	Total	Due Date
IRS	2004-20-142	8/26/2004	The IRS should ensure the Storage Strategy Study addresses the data storage capacity deficiency and recommends a cost-effective virtual tape system solution to reduce maintenance and tape shipping costs.		$ 200.0		$ 200.0	Due 12/31/2010
FY 2004	1				$ 200.0		$ 200.0	
IRS	2006-1c-142	9/25/2006	The IRS Contracting Officer (CO) should use the results of the Defense Contract Auditing Agency (DCAA) report to fulfill his/her duties in awarding and administering contracts.	$ 32,373.8			$ 32,373.8	Delayed to 10/15/2011
FY 2006	1			$ 32,373.8			$ 32,373.8	
IRS	2007-1c-149	9/24/2007	The IRS will work with DCAA and the contractor to resolve the questioned costs applicable to IRS contracts.	$ 62.2			$ 62.2	Delayed to 8/31/2011
FY 2007	1			$ 62.2			$ 62.2	

table continued on next page

Details of the Audit Recommendations with Potential Monetary Benefits on Which Management Decisions Were Made On or Before September 30, 2009, But Final Actions Have Not Been Taken as of September 30, 2010
(Dollars In Thousands)

Bureau	Report Number	Report Issue Date	Brief Description	Disallowed Costs	Funds Put to Better Use	Revenue Enhancement	Total	Due Date
FY 2008	N/A	N/A		—	—	—	—	N/A
DO	OIG-09-024	1/7/2009	Treasury should reactivate the state-held federal unclaimed assets recovery program with appropriate policies, procedures, and controls.			$ 10,500.0	$ 10,500.0	Due 6/30/2012
IRS	2009-10-107	7/24/2009	IRS should develop procedures requiring that workstation sharing levels are included in space needs assessments. When implementing these procedures the IRS should adjust its space needs to reflect workstation sharing and take action to release any unneeded space identified, where appropriate.		$ 30,000.0		30,000.0	Due 1/15/2011
IRS	2009-30-068	5/28/2009	As resources become available, the IRS should initiate actions to develop compliance strategies for ensuring more Commodity Credit Corporation income payments are properly reported.			92,200.0	92,200.0	Due 3/15/2011
IRS	2009-30-106	8/18/2009	IRS should coordinate with the respective functional areas to ensure employees receive periodic computer alerts to review large dollar frozen taxpayer accounts for credits that can be reelased and the freeze on accounts is systematically released when credits fall below the $10 million threshold by implementing agreed-upon computer programming modifications.		92,600.0		92,600.0	Due 1/15/2011
IRS	2009-40-112	8/6/2009	IRS should explore the feasibility of making greater use of mortgage interest data to pursue additional nonfilers and underrerporters for audit.			1,426,735.7	1,426,735.7	Due 12/15/2011
IRS	2009-40-137	9/24/2009	IRS should develop processes to identify erroneous Health Coverage Tax Credit claims based on criteria used to select taxpayers for examination and reject e-filed tax returns or forward paper-filed tax returns to the Error Resolution function at the time the tax return is filed.		9,000.0		9,000.0	Due 1/15/2011
IRS	2009-40-138	9/23/2009	IRS should discontinue providing the option to taxpayers of self-identifying by annotating a tax return with "Combat Zone" and continue to provide individuals the option of self-identifying by telephone or electronically.			1,100.7	1,100.7	Due 1/15/2012
IRS	2009-1c-134	9/28/2009	IRS should use the DCAA results in fulfilling the awarding and administration of IRS contracts.	$ 145.6			145.6	Due 10/15/2012
FY 2009	8			$ 145.6	$ 131,600.0	$ 1,530,536.4	$ 1,662,282.0	
TOTAL	11			$ 32,581.6	$ 131,800.0	$ 1,530,536.4	$ 1,694,918.0	

The following table provides a snapshot of OIG and TIGTA audit reports with significant recommendations reported in previous semiannual reports for which corrective actions had not been completed as of September 30, 2009 and September 30, 2010, respectively. OIG and TIGTA define "significant" as any recommendation open for more than one year. There were no "Undecided Audit Recommendations" during the same periods.

Audit Reports with Significant Unimplemented Recommendations				
	9/30/2009		9/30/2010	
	OIG	TIGTA	OIG	TIGTA
No. of Reports	8	26	6	24

III. Financial Management Systems Framework

Overview

The Department of the Treasury's financial management systems structure consists of financial and mixed systems maintained by the Treasury bureaus and the Department-wide Financial Analysis and Reporting System (FARS). The bureau systems process and record the detailed financial transactions and submit summary-level data to FARS on a scheduled basis. FARS maintains the key financial data necessary for consolidated financial reporting. In addition, the FARS modules also maintain data on the status of audit-based corrective actions. Under this systems structure, the bureaus are able to maintain financial management systems that meet their specific business requirements. On a monthly basis, the required financial data submitted to FARS to meet Departmental analysis and reporting requirements. The Department uses FARS to produce its periodic financial reports as well as the annual Performance and Accountability Report (PAR). This structured financial systems environment enables Treasury to receive an unqualified audit opinion and supports its required financial management reporting and analysis requirements.

The FARS structure consists of the following components:

- Bureau core and financial management systems that process and record detailed financial transactions
- Treasury Information Executive Repository (TIER) that consolidates bureau financial data
- CFO Vision that produces monthly financial statements and performs financial analysis
- Joint Audit Management Enterprise System (JAMES) that tracks information on audit findings, recommendations, and planned corrective actions

Bureaus submit summary-level financial data to TIER on a monthly basis, within three business days of the month-end. These data are then used by CFO Vision to generate financial statements and reports on both a Department-wide and bureau-level basis. This structure enables the Department to produce its audited annual financial statements and monthly management reports. During fiscal year 2010, Treasury continued to upgrade its FARS applications to take advantage of technology improvements such as information security and the technical environment.

As part of the Department's enhancement effort, 14 Treasury bureaus and reporting entities are cross-serviced for financial systems by the Bureau of the Public Debt's (BPD) Administrative Resource Center (ARC). Cross-servicing enables these bureaus to have access to core financial systems without having to maintain the necessary technical and systems architectures. In an ongoing effort to streamline its financial systems environment, Treasury continues to work with the bureaus to evaluate plans for continuous improvement to their financial management systems structure.

Continued Improvement

Treasury's target financial management systems structure continues to build upon the current FARS foundation. Treasury has enhanced FARS to support new financial and performance requirements and continues to provide management with the appropriate tools needed to align the Department's goals and objectives.

In fiscal year 2010, Treasury established a TIER Focus Group to improve communication with the bureaus and to coordinate changes impacting financial management systems and financial operations. Treasury enhanced the FARS applications to be Section 508 compliant, which assists users with disabilities in accessing reports and performing data entry. In addition, Treasury upgraded the FARS servers to improve performance.

The IRS continued to modernize the tax administration systems, improving the speed in which the IRS processes tax returns. In fiscal year 2010, the Customer Account Data Engine (CADE) posted more than 41.2 million tax returns and more than 35.8 million refunds. The Account Management Services System, which stores taxpayer information, has been enhanced to eliminate the processing of paper and reduce case cycle time from 14 days to recognizing real-time submissions; and IRS upgraded the servers which host the financial management system that accounts for $11.5 billion in IRS funding.

BPD/ARC continued to improve the effectiveness of providing efficient financial management systems and financial operations services to 14 Treasury bureaus and offices by implementing best practices in financial management. In fiscal year 2010, BPD/ARC upgraded the core financial management systems platform to increase its responsiveness in producing financial management reports and to adhere to financial reporting governance standards. BPD/ARC also provides administrative services in the areas of accounting, travel, payroll, human resources, and procurement to Treasury bureaus and offices and to other federal entities to support core business activities.

The Bureau of Engraving and Printing (BEP) enhanced its manufacturing system to be fully integrated into its existing financial management system to support capturing performance data into the managerial cost accounting process. BEP also participated in a pilot program with the Bureau of the Public Debt (BPD) for intra-governmental transactions, utilizing a secure, web-based electronic invoicing and payment information system provided by the Treasury's Financial Management Service.

Federal Financial Management Improvement Act (FFMIA) of 1996 Compliance

With the exception of the IRS, all Treasury bureaus are in compliance with FFMIA. As required by FFMIA, the IRS has a remediation plan in place to correct the deficiencies. For each FFMIA recommendation, the remediation plan identifies specific remedies, target dates, responsible officials, and resource estimates required for completion. This plan is reviewed and updated quarterly.

The IRS made significant progress in fiscal year 2010 toward achieving FFMIA compliance by implementing the Redesign Revenue Accounting Control System (RRACS), which enabled the custodial financial management system to substantially comply with the United States Standard General Ledger (USSGL) chart of accounts. RRACS now records all tax revenue and refunds using the USSGL format and, for the first time, records the taxes receivable and allowance for doubtful accounts. The IRS also implemented automated interfaces which enabled traceability for 98.6 percent of the over $2.3 trillion in revenue collections.

IV. Recovery Act Risk Management Activities

Upon the enactment of the Recovery Act in February 2009, just weeks after the new Administration took office, Treasury quickly designed and implemented a robust risk management program to support the Department's implementation of the Act. Following OMB's Recovery Act implementation guidance, Treasury required the programs' senior accountable officials in the bureaus to certify that they had taken the following actions for each Recovery Act program:

- Identified and documented program-specific risks
- Identified and documented applicable current process internal controls
- Determined the risk level (high, medium, or low) by using Treasury's Recovery Act risk and impact assessment questionnaire
- Determined additional controls needed, if any
- Developed (or updated existing) and implemented a risk mitigation plan for each program with a risk level of medium or high
- Performed ongoing monitoring and testing

Treasury created a Recovery Act Risk Management Council that continued to meet regularly during fiscal year 2010 to discuss the progress and status of each bureau's Recovery Act risk management activities.

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APPENDIX E:
GLOSSARY OF ACRONYMS

Glossary of Acronyms	
ABS	Asset-Backed Securities
ACA	Patient Protection and Affordable Care Act
ACD	Advanced Counterfeit Deterrent
ACH	Automated Clearing House
AD	Audit Division
ADR	Alternative Dispute Resolution
AFR	Agency Financial Report
AGP	Asset Guarantee Program
AIFP	Automotive Industry Financing Program
AIG	American International Group
AML	Anti-money laundering
AMS	Account Management Services
APR	Annual Performance Report
ARC	Administrative Resource Center
ASM/CFO	Assistant Secretary for Management & Chief Financial Officer
ATFC	Afghanistan Threat Finance Cell
AUR	Automated Underreporter
BCPO	Bureau Chief Procurement Officer
BEA	Bank Enterprise Award
BEP	Bureau of Engraving and Printing
BPD	Bureau of the Public Debt
BSA	Bank Secrecy Act
BSM	Business Systems Modernization
CADE	Customer Account Data Engine
CAMELS	Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk
CAP	Capital Assistance Program
CAP	Compliance Assurance Process
CAR	Collection Activity Report
CBP	U.S. Customs and Border Patrol
CBLI	Consumer and Business Lending Initiative
CBO	Congressional Budget Office
CCMM	Collections and Cash Management Modernization
CDCI	Community Development Capital Initiative
CDE	Community Development Entities
CDFI	Community Development Financial Institutions
CDS	Credit Default Swaps
CFPB	Consumer Financial Protection Bureau
CFO	Chief Financial Officer
CFS	Consolidated Financial Statements
CFT	Counter-terrorist financing
CFTC	Commodity Futures Trading Commission

Glossary of Acronyms	
CHCO	Chief Human Capital Officer
CHIPRA	Children's Health Insurance Program Reauthorization Act of 2009
CI	Criminal Investigators
CIF	Climate Investment Funds
CIGFO	Council of Inspectors General on Financial Oversight
CIO	Chief Information Officer
CMBS	Commercial Mortgage Backed Securities
CMF	Capital Magnet Fund
CO	Contracting Officer
COBRA	Consolidated Omnibus Budget Reconciliation Act of 1985
COLA	Certificate of Label Approval
COP	Congressional Oversight Panel
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CPP	Capital Purchase Program
CRA	Community Reinvestment Act
CRE	Commercial Real Estate
Credit CARD Act	Credit Card Accountability, Responsibility and Disclosure Act of 2009
CSI	Customer Service Index
CSR	Customer Service Representative
CSRS	Civil Service Retirement System
CTF	Clean Technology Fund
DASHR/CHCO	Office of the Deputy Assistant Secretary for Human Resources/Chief Human Capital Officer
DASMB	Deputy Assistant Secretary for Management and Budget
DASPTR	Deputy Assistant Secretary Privacy, Transparency, and Records
DCAA	Defense Contract Auditing Agency
DCFO	Deputy Chief Financial Officer
DCIA	Debt Collection Improvement Act of 1996
DCP	Office of D.C. Pensions
DIP	Debtor-in-Possession
DISC	Discontinued
DMAS	Debt Management Account System
DO	Departmental Offices
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DOJ	Department of Justice
EBRD	European Bank for Reconstruction and Development
ECM	Enterprise Content Management
EEO	Equal Employment Opportunity
EESA	Emergency Economic Stabilization Act of 2008

Glossary of Acronyms	
EFT	Electronic Funds Transfer
EFTPS	Electronic Federal Tax Payment System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act
EITC	Earned Income Tax Credit
EO	Executive Order
ERP	Economic Recovery Payment
ESF	Exchange Stabilization Fund
ETD	Error Tracking Database
EU	European Union
FAET	Firearms and Ammunition Excise Tax
Fannie Mae	Federal National Mortgage Association
FARS	Financial Analysis and Reporting System
FASAB	Federal Accounting Standards Advisory Board
FATF	Financial Action Task Force
FCDA	Foreign Currency Denominated Assets
FCRA	Federal Credit Reform Act
FDIC	Federal Deposit Insurance Corporation
FEC	Financial Education and Counseling
FECA	Federal Employees' Compensation Act
FERS	Federal Employees' Retirement System
FEGLI	Federal Employees Group Life Insurance
FEHBP	Federal Employees Health Benefits Program
FFB	Federal Financing Bank
FFETF	Financial Fraud Enforcement Task Force
FFIEC	Federal Financial Institutions Examination Council
FFMIA	Federal Financial Management Improvement Act
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FinCEN	Financial Crimes Enforcement Network
FinTRACA	Financial Transactions and Reports Analysis Center of Afghanistan
FIO	Federal Insurance Office
FISMA	Federal Information Security Management Act
FIRST	Financial Information and Reporting Standardization
FIST	Fraud Investigative Strike Team
FIT	Office of Financial Innovation and Transformation
FIU	Financial Intelligence Unit
FMFIA	Federal Managers' Financial Integrity Act
FMIS	Financial Management Information System
FMS	Financial Management Service
FOIA	Freedom of Information Act
FONL	Formulas Online
FR	Consolidated Financial Report of United States Government
FRB	Federal Reserve Bank
FRBNY	Federal Reserve Bank of New York

Glossary of Acronyms	
Freddie Mac	Federal Home Loan Mortgage Corporation
FSB	Financial Stability Board
FSOB	Financial Stability Oversight Board
FST	Floor Stocks Tax
FTO	Fine Troy Ounce
FY	Fiscal Year
G-7	Group of Seven
G-20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GAB	General Arrangement to Borrow
GAFSP	Global Agriculture and Food Security Program
GAIS	Government Agency Investment Services
GAO	Government Accountability Office
GEF	Global Environmental Facility
GFRA	General Fund Receipt Account
Ginnie Mae	Government National Mortgage Association
GM	General Motors
GMAC	General Motors Acceptance Corporation
GSA	General Services Administration
GSE	Government Sponsored Enterprises
GWA	Government-wide Accounting
HAMP	Home Affordable Modification Program
HCTC	Health Coverage Tax Credit
HEAT	Health Care Fraud Prevention and Enforcement Action Team
HECM	Home Equity Conversion Mortgage
HERA	Housing and Economic Recovery Act
HFA	Housing Finance Agency
HFFI	Healthy Food Financing Initiative
HHF	Hardest Hit Fund
HHS	Department of Health and Human Services
HIRE	Hiring Incentives to Restore Employment Act of 2010
HRF	Haitian Reconstruction Fund
HSPD	Homeland Security Presidential Directive
HUD	Department of Housing and Urban Development
I&E	Inspections and Evaluations
IAP	International Assistance Programs
ID	Investigation Division
IDB	Inter-American Development Bank
IEEPA	International Emergency Economic Powers Act
IFI	International Financial Institution
IFSR	Iranian Financial Sanctions Regulations
IG	Inspector General
IMF	International Monetary Fund
IPIA	Improper Payments Information Act
IRIS	Integrated Revenue Information System
IRISL	Islamic Republic of Iran Shipping Lines

Glossary of Acronyms	
IRS	Internal Revenue Service
IRS-CI	Internal Revenue Service - Criminal Investigations
ISO	International Organization for Standardization
IT	Information Technology
ITR	Iranian Transactions Regulations
JAMES	Joint Audit Management Enterprise System
LMSB	Large and Mid Sized Businesses
MBS	Mortgage-Backed Securities
MDB	Multilateral Development Banks
MeF	Modernized Electronic File
MHA	Making Home Affordable Program
MINT	U.S. Mint
MOU	Memorandum of Understanding
MRADR	Market Risk Adjusted Discount Rate
MSB	Money services business
MV&S	Modernization, Vision, and Strategy
NAB	New Arrangement to Borrow
NACA	Native American CDFI Assistance
NDIC	National Drug Intelligence Center
NEI	National Export Initiative
NIBP	New Issue Bond Program
NMTC	New Markets Tax Credit
NOL	Net Operating Loss
NPRM	Notice of Proposed Rulemaking
NRC	National Revenue Center
NRP	National Research Program
NTDO	Non-Treasury Disbursing Office
OA	Office of Audits
OCC	Office of the Comptroller of the Currency
ODM	Office of Debt Management
OECD	Organization for Economic Co-operation and Development
OFAC	Office of Foreign Assets Control
OFAS	Office of the Fiscal Assistant Secretary
OFP	Office of Fiscal Projections
OFPP	Office of Federal Procurement Policy
OFR	Office of Financial Research
OFS	Office of Financial Stability
OI	Office of Investigations
OIA	Office of Intelligence and Analysis
OID	Original Issue Discount
OIG	Office of Inspector General
OMB	Office of Management and Budget
OPCL	Office of Privacy and Civil Liberties
OPE	Office of the Procurement Executive
OPEB	Other Post Employment Benefits
OPM	Office of Personnel Management

Glossary of Acronyms	
ORB	Other Retirement Benefits
OTC	Over-the-Counter
OTS	Office of Thrift Supervision
PACT Act	Prevent All Cigarette Trafficking Act of 2009
PAM	Payments Application Modernization
PAR	Performance and Accountability Report
PB	President's Budget
PCA	Planned Corrective Actions
PCC OTC	Paper Check Conversion Over-the-Counter
PII	Personal Identifiable Information
PONL	Permits Online
PP&E	Property, Plant, and Equipment
PPIF	Public-Private Investment Fund
PPIP	Public-Private Investment Program
PSPA	Preferred Stock Purchase Agreements
PTIN	Preparer tax identification number
QEO	Qualified Equity Offering
QFI	Qualified Financial Institution
QTDP	Qualified Therapeutic Discovery Project
Recovery Act	American Recovery and Reinvestment Act of 2009
RMBS	Residential Mortgage Backed Securities
RRACS	Redesign Revenue Accounting Control System
S&ED	Strategic and Economic Dialogue
S.A.F.E. Act	Secure and Fair Enforcement for Mortgage Licensing Act of 2008
SAR	Suspicious Activity Report
SAS	Statement on Auditing Standards
SBA	Small Business Administration
SBLF	Small Business Lending Fund
SBR	Statement of Budgetary Resources
SCAP	Supervisory Capital Assessment Program
SCF	Strategic Climate Fund
SCMA	Strategic Cash Management Agreements
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission
SES	Senior Executive Service
SFFAS	Statement of Federal Financial Accounting Standards
SFP	Supplementary Financing Program
SIG	Special Inspector General
SIGTARP	Special Inspector General for TARP
SME	Small and Medium-sized Enterprise
SNC	Statement of Net Cost
SOMA	System Open Market Account
SPSPA	Senior Preferred Stock Purchase Agreements
SPV	Special Purpose Vehicle
SSBCI	State Small Business Credit Initiative

Glossary of Acronyms	
SSG	Senior Supervisors' Group
SSP	Shared Service Provider
SSP	Stable Share Price
STR	Suspicious Transaction Report
TAC	Taxpayer Assistance Center
TAIFF	Troubled Assets Insurance Financing Fund
TALF	Term Asset-Backed Securities Loan Facilities
TARP	Troubled Asset Relief Program
TCE	Tax Counseling for the Elderly
TCLP	Temporary Credit and Liquidity Program
TE/GE	Tax Exempt and Government Entities
TEOAF	Treasury Executive Office for Asset Forfeiture
TFF	Treasury Forfeiture Fund
TFFC	Office of Terrorist Financing and Financial Crimes
TFI	Terrorism and Financial Intelligence
TFR	Thrift Financial Reports
TFTP	Terrorist Finance Tracking Program
TIER	Treasury Information Executive Repository
TIGTA	Treasury Inspector General for Tax Administration
TIP	Targeted Investment Program
TIPS	Treasury Inflation-Protected Securities
TOP	Treasury Offset Program
TPP	Trans-Pacific Partnership
TRIA	Terrorism Risk Insurance Act
TTB	Alcohol and Tobacco Tax and Trade Bureau
TWEA	Trading with the Enemy Act
UN	United Nations
UNSCR	United Nations Security Council Resolution
UP	Unemployment Program
USA PATRIOT Act	Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001
USDA	United States Department of Agriculture
USPS	United States Postal Service
USSGL	United States Standard General Ledger
VA	Department of Veteran's Affairs
VITA	Volunteer Income Tax Assistance
WHBAA	Worker, Homeownership, and Business Assistance Act of 2009
WMD	Weapons of Mass Destruction
WTO	World Trade Organization

WEBSITE INFORMATION

Treasury On-line	www.treas.gov
Treasury Performance and Accountability Reports	www.treasury.gov/offices/management/dcfo/accountability-reports
Alcohol and Tobacco Tax and Trade Bureau	www.ttb.gov
Community Development Financial Institutions Fund	www.cdfifund.gov
Comptroller of the Currency	www.occ.treas.gov
Bureau of Engraving & Printing	www.bep.treas.gov
Financial Crimes Enforcement Network	www.fincen.gov
Financial Management Service	www.fms.treas.gov
Internal Revenue Service	www.irs.gov
U.S. Mint	www.usmint.gov
Bureau of the Public Debt	www.publicdebt.treas.gov
Office of Thrift Supervision	www.ots.treas.gov
The Financial Stability Plan	www.financialstability.gov
Help for America's Homeowners	www.makinghomeaffordable.gov
Recovery Act Spending	www.recovery.gov

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