PART 3:

Other Accompanying Information

(UNAUDITED)

SECTION A: SCHEDULE OF SPENDING

The following Schedule of Spending (SOS) presents an overview of the funds available for the Department to spend and how the Department spent these funds as of and for the fiscal year ended September 30, 2012. The financial data used to populate this schedule is the same underlying data used to populate the Department's Statement of Budgetary Resources (SBR). Accordingly, the budgetary financial information in this schedule is presented on a combined basis rather than on a consolidated basis. Specifically, the SOS presents "Total Resources" (or "Total Budgetary Resources" per the SBR), "Total Spending" (or "Outlays, Gross" per the SBR), and "Total Amounts Agreed to be Spent" (or "Obligations Incurred" per the SBR).

		2012
What Money is Available to Spend?		
Total Resources	$	816,061
Less: Amount Available, But Not Agreed to be Spent		(255,227)
Less: Amount Not Available to be Spent		(84,371)
Total Amounts Agreed to be Spent	$	**476,463**
How was the Money Spent?		
Interest and Dividends[i]	$	376,631
Grants, Subsidies, and Contributions[ii]		55,023
Investments and Loans[iii]		25,415
Personnel Compensation and Other Related Benefits		11,557
Other Contractual Services		4,183
Other		9,285
Total Spending		482,094
Amounts Remaining to be Spent		(5,631)
Total Amounts Agreed to be Spent	$	**476,463**

[i] *Interest and Dividends is primarily comprised of Interest on the Public Debt and interest expense related to credit reform activities.*

[ii] *Grants, Subsidies, and Contributions is primarily comprised of cash payments to States, other political subdivisions, corporations, associations, and individuals; credit reform program related subsidies ; and contributions to foreign countries.*

[iii] *Investments and Loans primarily include $18.5 billion of liquidity payments made to the Government Sponsored Enterprises under the Senior Preferred Stock Purchase Agreements (Note 8), along with other investments made in connection with loans issued for credit reform and non-credit reform activities.*

SECTION B: TAX GAP AND TAX BURDEN

TAX GAP

Reducing the tax gap is at the heart of IRS' enforcement and service programs. The tax gap is the difference between the tax (not interest and penalties) imposed on taxpayers by law for a given tax year and what they actually pay on time. The tax gap arises from three types of noncompliance: not filing required tax returns on time or at all (the nonfiling 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 nonfiling gap and the underreporting gap must be estimated. The tax gap, about $450 billion based on updated Tax Year 2006 estimates, is defined as underpayments net of overpayments of true tax liability. However, it excludes illegal economic activity. IRS limits its estimates of the tax gap to tax due on legal-sector activity only. The tax gap is not synonymous with the so-called "underground economy," though there is some overlap. The underground economy is made up of activities that are not very visible to tax and other government authorities. Some of these activities are legal-sector and some are illegal-sector activities. While some of the tax gap arises from legal-sector income generated by underground economy participants, some of it arises from noncompliance that is completely unrelated to the underground economy – such as claiming the wrong filing status or overstating exemptions or tax credits. So, while there is substantial overlap between the tax gap and the underground economy, it is best to maintain the distinction between these two concepts.

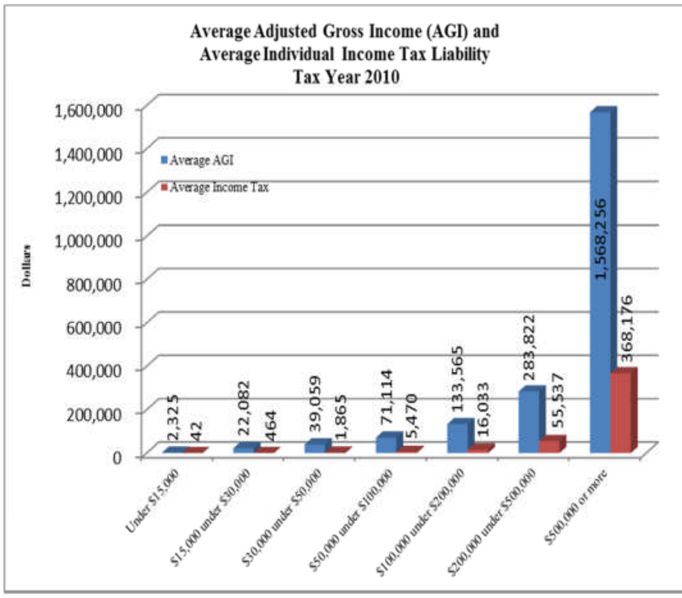
The underreporting gap accounts for 84 percent of the gross tax gap, with the remainder divided between the nonfiling gap (6 percent) and the underpayment of reported tax liability (10 percent). The IRS remains committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time.

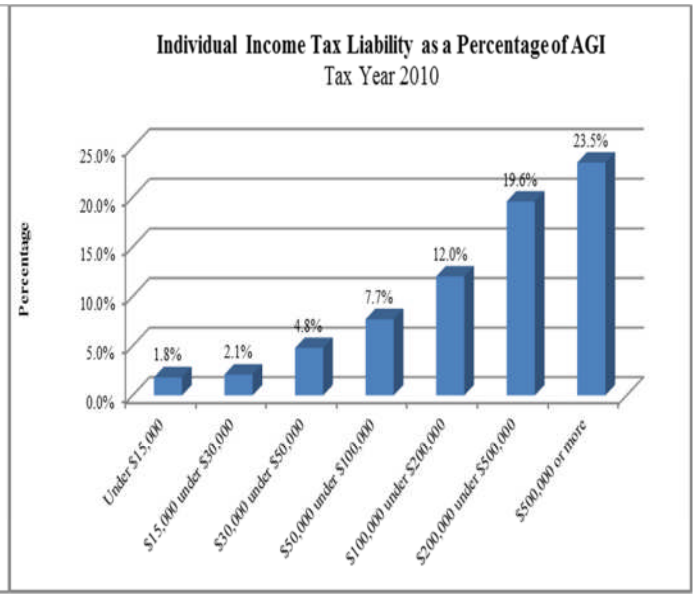
Each instance of noncompliance by a taxpayer at the time the tax is due contributes to the tax gap, whether or not the IRS detects it, and whether or not the taxpayer is even aware of the noncompliance. Obviously, some of the tax gap arises from intentional (willful) noncompliance, and some of it arises from mistakes caused by not applying sufficient due diligence to meet the tax obligation fully.

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 (IRC) provides for progressive definitions of taxable income and 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 reported income tax and adjusted gross income (AGI) for individuals by reported AGI level and for corporations by size of reported assets. For individuals, the information illustrates, in percentage terms, the reported tax burden borne by various reported AGI levels. For corporations, the information illustrates, in percentage terms, the reported tax burden borne by these entities by various sizes of their reported total assets. The graphs are only representative of more detailed data and analysis available from the IRS's Statistics of Income Division.

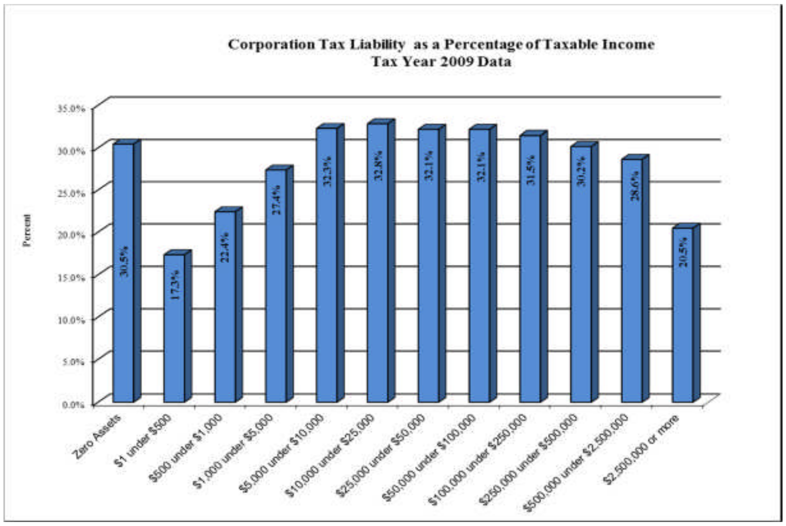




INDIVIDUAL INCOME TAX LIABILITY

Tax Year 2010

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	37,602	$ 87,421	$ 1,587	$ 2,325	$ 42	1.8%
$15,000 under $30,000	30,858	681,419	14,314	22,082	464	2.1%
$30,000 under $50,000	25,605	1,000,098	47,754	39,059	1,865	4.8%
$50,000 under $100,000	30,533	2,171,323	167,026	71,114	5,470	7.7%
$100,000 under $200,000	13,998	1,869,639	224,423	133,565	16,033	12.0%
$200,000 under $500,000	3,472	985,431	192,826	283,822	55,537	19.6%
$500,000 or more	825	1,293,811	303,745	1,568,256	368,176	23.5%
Total	**142,893**	**$ 8,089,142**	**$ 951,675**	-	-	-



CORPORATION TAX LIABILITY

Tax Year 2009

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	$	45,444	$	13,840	30.5%
$1 under $500		6,280		1,088	17.3%
$500 under $1,000		3,273		734	22.4%
$1,000 under $5,000		11,116		3,043	27.4%
$5,000 under $10,000		6,206		2,002	32.3%
$10,000 under $25,000		9,865		3,237	32.8%
$25,000 under $50,000		8,968		2,883	32.1%
$50,000 under $100,000		12,209		3,925	32.1%
$100,000 under $250,000		20,445		6,430	31.5%
$250,000 under $500,000		24,838		7,492	30.2%
$500,000 under $2,500,000		91,990		26,347	28.6%
$2,500,000 or more		654,215		133,974	20.5%
Total	**$**	**894,849**	**$**	**204,995**	-

SECTION C: MANAGEMENT AND PERFORMANCE CHALLENGES IDENTIFIED BY THE INSPECTORS GENERAL AND THE SECRETARY'S 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 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. SIGTARP does not provide the Secretary with a semiannual report or annual update on management and performance challenges. This section 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.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

October 25, 2012

INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Eric M. Thorson
Inspector General

SUBJECT: Management and Performance Challenges Facing the Department of the Treasury (OIG-CA-13-002)

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.

In assessing the Department's most serious challenges, we are mindful of the fragile state of the economy. Despite the efforts of the Administration and the Congress, the economic recovery in the United States has been slow, in part, because of economic conditions in other parts of the world such as the European Union and China. Last year, we acknowledged that, in looking for ways to address this country's budget deficit, cuts to programs and operations were likely although the extent of and the specific nature of any cuts were unknown. That situation remains the same today. Very soon, the Administration and the Congress will need to address the "fiscal cliff" as it relates to the expiration of the Bush-era tax cuts, the payroll tax "holiday," and the automatic spending cuts from the sequestration agreement reached as part of the debt ceiling compromise last year. While the results of the upcoming national election may bring some clarity as to the direction the federal government will take to address these matters, that direction is expected to require significant sacrifices.

With that as a backdrop, Treasury has, in recent years, had to administer additional responsibilities intended to support and improve the country's economy. In order to do so, in nearly every case, the Department had to start up and administer these new responsibilities with very thin staffing and resources. In July of this year, the Department was given another new responsibility – the Gulf Coast Restoration Trust Fund – with no additional resources to administer it. I know that the Department's senior leadership is fully cognizant of these pressures and the need for strong management. That said, if the Department is faced with reduced funding, my office will monitor and examine the effect on Treasury's programs and operations. Like last year, we cannot emphasize enough to the Department's stakeholders the critical importance that Treasury is resourced sufficiently to maintain a strong control environment.

This year we are reporting four challenges, three of which are repeated from last year.

- Transformation of Financial Regulation (Repeat Challenge)
- Management of Treasury's Authorities Intended to Support and Improve the Economy (Repeat Challenge)
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement (Repeat Challenge)
- Gulf Coast Restoration Trust Fund Administration (New Challenge)

We removed one challenge from last year – Management of Capital Investments – as the Department demonstrated improved governance in the development of two major investments, Treasury Network (TNet) and the Financial Crimes Enforcement Network (FinCEN) Bank Secrecy Act Information Technology Modernization (BSA IT Mod) program. While the removal of this challenge is a major accomplishment, we caution that going forward, engaged senior management involvement is essential to any successful systems development effort.

In addition to the above challenges, we are reporting elevated concerns about three matters – cyber security, currency and coin production, and documenting key activities and decisions. We also note the actions Treasury is undertaking to consolidate and restructure the Bureau of the Public Debt (BPD) and the Financial Management Service (FMS) into the Bureau of the Fiscal Service (BFS).

2012 Management and Performance Challenges

Challenge 1: Transformation of Financial Regulation (Repeat Challenge)

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.

Dodd-Frank established the Financial Stability Oversight Council (FSOC), which you chair as the Treasury Secretary. 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. FSOC accomplished a number of things over the last year.

Annual reporting - As required, FSOC issued its second annual report in July 2012. The report contained recommendations to (1) further reforms to address structural vulnerabilities in key markets, (2) heighten risk management and supervisory attention in specific areas, (3) take steps to address reform of the housing finance market, and (4) ensure implementation and coordination on financial regulatory reform.

Designation of systemically significant financial market utilities[4] - In July 2012, FSOC designated eight financial market utilities as systemically important. The financial market utilities are subject to (1) risk management standards governing the operations related to the payment, clearing, and settlement activities and (2) additional examinations and reporting requirements, as well as potential enforcement actions.

Ruling for designating nonbank financial institutions for consolidated supervision - Dodd-Frank calls for consolidated supervision and heightened prudential standards for large, interconnected nonbank financial companies. In this regard, the Board of Governors of the Federal Reserve System (FRB) is responsible for supervising these firms and adopting specific prudential rules. In April 2012, FSOC adopted a final rule and interpretative guidance related to designating nonbank financial companies for consolidated supervision.

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[4] The term "financial market utility" means any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and that person. However, the term does not include entities such as national securities exchanges, national securities associations, and many others.

FSOC still has quite a bit of work ahead to meet all of its responsibilities. For example, it is still in the process of designating the first group of nonbank financial institutions for consolidated supervision. That said, FSOC continues its work monitoring the stability of U.S. and European markets. Additionally, we note that you as the Secretary of the Treasury recently released a letter on the urgent need for money market fund reform to be completed either by the Securities and Exchange Commission or FSOC.

The Council of Inspectors General on Financial Oversight (CIGFO), which I chair, was also established by Dodd-Frank. It facilitates the sharing of information among member 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 is an important source of independent analysis to FSOC. As required, CIGFO met quarterly and issued its second annual report in July 2012. CIGFO also established its first working group in December 2011. This working group evaluated FSOC controls over non-public information and the manner in which FSOC, as a whole, safeguarded information from unauthorized sources. The working group issued its report in June 2012 which highlighted several areas for FSOC's consideration as it moves forward. In the future, CIGFO will continue reviewing FSOC's compliance with Dodd-Frank to ensure continued rigorous oversight of the U.S. financial system.

Dodd-Frank also established two new offices within Treasury: the Office of Financial Research (OFR) and the Federal Insurance Office (FIO).[5] OFR is the data collection, research and analysis arm of FSOC. In December 2011, the President nominated Mr. Richard Berner to serve as Director. The Director position currently remains vacant while Mr. Berner's confirmation is under consideration in the Senate. Among other duties, the OFR Director is to report to Congress annually on the office's activities and its assessments of systemic risk, with the first report due in July 2012. Despite not having a confirmed Director, OFR issued its annual report. Furthermore, in June 2012, we completed a review of the stand-up of OFR and reported that in the 21 months since OFR was created, efforts to establish the office were still in progress. The officials responsible for establishing OFR initially engaged in high-level strategic and organizational planning and sought to hire key personnel. They also focused their attention on developing and facilitating the global acceptance of a universal Legal Entity Identifier (LEI).[6] In the summer of 2011, after key operational personnel were brought on board, we noted that progress toward establishing a comprehensive implementation planning and project management process accelerated. This culminated in the approval of a methodology in January 2012, a strategic framework in March 2012, and a strategic "roadmap" in April 2012. While well over a year had passed since OFR was established, we concluded that these documents and methodology, taken together, finally provide OFR with a comprehensive implementation plan. This plan lays out the expected evolution of OFR's capabilities, reaching a mature state by fiscal year 2016. Concurrent with the development of its comprehensive implementation plan, OFR also began to develop its analytic and data support for FSOC, and its Research and Analysis Center has sponsored seminars and published two working papers on risk assessment topics.

[5] It should be noted that Dodd-Frank also established two other new offices within Treasury – the Offices of Minority and Women Inclusion at Departmental Offices and at the Office of the Comptroller of the Currency. Our future work plan includes reviews of these new offices.
[6] LEI is being developed as the universal standard for identifying all parties to financial contracts. It is a key element in OFR's efforts to understand and monitor risks to financial stability and meet its statutory mandate to develop and promote data standards.

The FIO is charged with monitoring 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 FIO Director, whom you appointed in March 2011, is to advise FSOC on insurance matters. We are currently reviewing the stand-up of FIO.

The other regulatory challenges that we discussed last year still remain. Specifically, since September 2007, 126 financial institutions supervised by the Office of the Comptroller of the Currency (OCC) or the former Office of Thrift Supervision (OTS) have failed, with estimated losses to the Deposit Insurance Fund of approximately $35.3 billion. This is an increase of 13 financial institutions since my last challenges memorandum. With more than 450 banks on the Federal Deposit Insurance Corporation's troubled bank list, we anticipate bank failures to continue into the foreseeable future but at a lower rate than in recent years.

Although many factors contributed to the turmoil in the financial markets, our failed bank reviews generally found that OCC and the former OTS did not identify early or force timely correction of unsafe and unsound practices by numerous failed institutions under their respective supervision. Furthermore, in 2010, the unprecedented speed at which servicers foreclosed on defaulted mortgages revealed flaws in the processing of those foreclosures. In response, the federal banking regulators completed a review of foreclosure practices at major mortgage servicers. The review found deficiencies in the servicers' foreclosure processes including weak management oversight, foreclosure document deficiencies, poor oversight of third parties involved in the foreclosure process, and inadequate risk control systems. As a result, the federal banking regulators issued formal enforcement actions against 14 mortgage servicers and 2 third party providers subject to the review. We are currently reviewing OCC's oversight of the servicers' efforts to comply with the enforcement actions. While it is too soon to tell whether these servicing deficiencies have been addressed, at the time, the foreclosure crisis did not help an already stressed housing market.

In my last memorandum, I noted that Treasury was successful in standing up the Bureau of Consumer Financial Protection (CFPB). CFPB is an independent bureau of FRB but Treasury has a unique role in its operations. Specifically, until a Director is confirmed by the Senate, you are charged with exercising some, but not all, of the Director's authorities. In January 2012, the President made a recess appointment of Mr. Richard Cordray as Director. However, recess appointments expire at the end of the Senate's next session – accordingly Mr. Cordray's appointment will end in late 2013, or when formally confirmed by the Senate, or when another individual is nominated, confirmed, and permanently appointed to the position. Legislation has also been proposed to change the form of governance over CFPB. The FRB Inspector General is designated by Dodd-Frank to provide oversight of CFPB. However, given Treasury's statutory role, our office will coordinate with the FRB Office of Inspector General when necessary on CFPB oversight matters.

Clearly, as we have said in the past, the intention of Dodd-Frank is most notably to prevent, or at least minimize, the impact of a future financial sector crisis on the U.S. economy. To accomplish this, Dodd-Frank has placed great responsibility within Treasury and with the Treasury Secretary. This management challenge from our perspective is to maintain an effective FSOC process supported by OFR and FIO within Treasury and build a 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 generally unpopular.

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

Congress provided Treasury with broad authorities to address the recent 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 remain in managing Treasury's outstanding investments. To a large extent, Treasury's program administration under these acts has matured. However, the long-term impact on small business lending resulting from investment decisions under the Small Business Jobs Act programs are still not clear. Our discussion of this challenge will begin with this act and then address the others for which Treasury is responsible.

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

Enacted in September 2010, the Small Business Jobs Act created a $30 billion Small Business Lending Fund (SBLF) within Treasury and provided $1.5 billion to Treasury to allocate to eligible state programs through the State Small Business Credit Initiative (SSBCI). These represent key initiatives of the Administration to increase lending to small businesses, and thereby support job creation. Both programs were slow to disburse funds, with Treasury approving the majority of SBLF and SSBCI applications during the last quarter of fiscal year 2011. Because the majority of applicants waited until near the application deadlines to apply, Treasury encountered significant delays in implementing the two programs. As a result, Treasury was rushed in making a number of SBLF investment decisions in order to meet the funding deadlines, and disbursed the initial installment of SSBCI funds without establishing clear oversight obligations of participating states. Now that Treasury has completed the approval process for these two programs, the challenge for Treasury is to exercise sufficient oversight to ensure that funds are used appropriately, SBLF dividends owed Treasury are paid, and programs achieve intended results.

SBLF – As of September 2011, Treasury had disbursed more than $4 billion to 332 financial institutions across the country. Of the institutions funded, 41.3 percent used SBLF funds to refinance securities issued under the Troubled Asset Relief Program (TARP) Capital Purchase Program. Institutions receiving investments under the SBLF program pay dividends to Treasury at rates that decrease as the institutions increase their qualified small business lending activity. During the first 4½ years of Treasury's investment, participating institutions initially pay dividends to Treasury of up to 5 percent, but that rate may be reduced to as low as 1 percent based on institutions' self-reported increases in small business lending. Institutions are under no obligation to make dividend payments as scheduled or to pay off previously missed payments before exiting the program. There are provisions for increased restrictions as dividends are missed, including a prohibition against an institution paying dividends on common stock and a provision for Treasury to appoint one or two members to the bank's board of directors. The effectiveness of these measures, however, can be affected if the institution's regulator has restricted it from making dividend payments.

Treasury faces challenges in measuring program performance and ensuring that the SBLF program meets its intended objective of increasing lending to small businesses. The intent of the authorizing legislation was to stimulate lending to small businesses, but participating institutions are not required to report how they use Treasury's investments and are under no obligation to increase their small business lending. Once participating institutions commingle SBLF disbursements with other funds, it is difficult to track how the funds are used.

Additionally, Treasury relies on unverified information on small business lending reported by participating institutions to measure performance and to make dividend rate adjustments.

SSBCI – As of September 2012, 56 states, territories, and eligible municipalities (participating states) had been awarded $1.4 billion in SSBCI funding. Funds awarded are disbursed in one-third increments. To date, Treasury disbursed $533 million of the $1.4 billion awarded. States participating in SSBCI may use funds awarded for programs that partner with private lenders to extend credit to small businesses. Such programs may include those that finance loan loss reserves; and provide loan insurance, loan guarantees, venture capital funds, and collateral support. States were required to provide Treasury with plans for using their funding allocations and report quarterly and annually on their use of funds. We conduct audits of participating states to determine whether SSBCI funds are being used as intended. In this regard, the Small Business Jobs Act requires Treasury to recoup funds we identify as having been recklessly or intentionally misused, and Treasury may withhold disbursements from a state based on the audit results.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. The states are required to provide Treasury with quarterly assurances that their programs approved for SSBCI funding comply with program requirements. However, Treasury will face challenges in holding states accountable for the proper use of funds as it has not clearly communicated the prohibited uses of funds and has changed program guidelines frequently, making it difficult for states to ensure the proper use of funds. Treasury has also not defined what constitutes a material adverse change in a state's financial or operational condition that the state must report to Treasury. As a result, Treasury will have difficulty finding states to be in default of program requirements and holding states accountable should our office find that a state has intentionally or recklessly misused funds.

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 programs that provide payments for specified energy property in lieu of tax credits, payments to states for low-income housing projects in lieu of tax credits, grants and tax credits through the Community Development Financial Institutions (CDFI) Fund, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens. Approximately $20 billion of the $22 billion provided for non-Internal Revenue Service (IRS) programs has been disbursed to recipients under Treasury's payments in lieu of tax credit programs – to persons for specified energy properties and to states for low-income housing projects. To date, all funds have been disbursed under the low-income housing program and the specified energy property program is beginning to wind down. In the past, we expressed concern about the small number of Treasury staff dedicated to these programs. However, we noted there was a process for the Department of Energy's National Renewable Energy Laboratory to perform a technical review of payment applications and advise Treasury on award decisions. Also, for larger dollar payments, Treasury requires the applicant to obtain a review of project costs by an independent public accounting firm. Nevertheless, Treasury must continue to ensure recipient compliance with award agreements for an extended period of time. Additionally, our Office of Investigations had several open matters involving claims for specified energy property projects.

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 continued to support the financial solvency of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) which are under the conservatorship of the Federal Housing Finance Agency. To cover the losses of the two government sponsored enterprises (GSE) and maintain a positive net worth, Treasury agreed to purchase senior preferred stock as necessary. As of June 30, 2012, Treasury invested a total of $187 billion in the two GSEs. The maximum amount available to each GSE under its agreement with Treasury is based on a formulaic cap which will set on December 31, 2012, at no less than $200 billion per enterprise. For the first time since being placed under conservatorship, Fannie Mae and Freddie Mac reported a positive net worth in the first and second quarters of 2012. The future of both GSEs is still in question and prolonged assistance may be required. However, as noted above, the funding cap will set on December 31, 2012.

Prior to the expiration of its purchase authority in December 2009, Treasury acquired $225 billion of mortgage-backed securities (MBS) issued by the two GSEs under a temporary purchase program. In light of improved market conditions, Treasury started to sell its MBS in March 2011. In March 2012, Treasury completed its sale of remaining MBS and reported that overall, cash returns of $250 billion were received from the MBS portfolio through sales, principal, and interest.

Through the Housing Finance Agency Initiative supporting state and local finance agencies, Treasury purchased $15.3 billion of securities issued by Fannie Mae and Freddie Mac backed by state and local Housing Finance Agency bonds (New Issue Bond Program) and committed $8.2 billion for a participation interest in the obligations of Fannie Mae and Freddie Mac (Temporary Credit and Liquidity Program). Treasury received payments of principal and interest on its securities and currently holds an investment of approximately $14 billion. Additionally, several state and local housing agencies opted out of the Temporary Credit and Liquidity Program reducing Treasury's commitment to about $5 billion. Treasury continues to monitor its investment in the Housing Finance Agency Initiative.

As required by Dodd-Frank, Treasury and the Department of Housing and Urban Development conducted a study on ending the conservatorship of Fannie Mae and Freddie Mac and minimizing the cost to taxpayers. The report on this study was presented to Congress in February 2011. Regarding the long-term structure of housing finance, the report provided three options for consideration without recommending a specific option. The three options are (1) a privatized system of housing finance with the government insurance role limited to the Federal Housing Administration (FHA), the U.S. Department of Agriculture (USDA), and the Department of Veterans Affairs (VA) with assistance for narrowly targeted groups of borrowers; (2) a privatized system of housing finance with assistance from FHA, USDA, and VA for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis; and (3) a privatized system of housing finance with FHA, USDA, and VA assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital. Although specific legislation has been proposed in the Congress, the legislative process for housing finance reform is still in a formative stage and it is difficult to predict what lies ahead for winding down the Fannie Mae and Freddie Mac conservatorships and reforming housing finance.

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 financial institutions and other businesses, as well as guaranteed other troubled mortgage-related and financial assets. Authority to make new investments under the TARP program expired on October 3, 2010. Treasury, however, is continuing to make payments for programs which have existing contracts and commitments. One Treasury challenge in this area is managing and winding down its various investment programs. To date, Treasury has reported positive returns from the sale of its investments in the banking industry and the American International Group (AIG), and reduced its investments in the auto industry. Treasury is also still managing various housing programs to provide mortgage relief to homeowners and prevent avoidable foreclosures. Unless current conditions change and while we acknowledge the continuing difficulties facing Treasury with the housing programs, in recognition of the substantial progress the Department has made in exiting its investments we do not plan to report on TARP in future management and performance challenges memoranda. We also note EESA established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and Government Accountability Office.

Unmet Mandate

In addition to SBLF and SSBCI, the Small Business Jobs Act of 2010 provided Treasury with authority to guarantee the full amounts of bonds and notes issued for community and economic development activities not to exceed 30 years. Under this authority, Treasury may issue up to 10 guarantees of no less than $100 million each, but may not exceed $1 billion in total aggregate guarantees in any fiscal year. As the program administrator, CDFI Fund was tasked with setting regulations and implementing the program by September 27, 2012. CDFI Fund is experiencing challenges in standing up the program and has missed the program's statutory implementation date. Our office plans to assess the progress of the program's implementation in 2013.

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

As we have reported in the past, ensuring criminals and terrorists do not use our financial networks to sustain their operations and/or launch attacks against the U.S. continues to be a challenge. Treasury's Office of Terrorism and Financial Intelligence (TFI) is dedicated to disrupting the ability of terrorist organizations to fund their operations. TFI brings together intelligence gathering and analysis, economic sanctions, international cooperation, and private-sector cooperation to identify donors, financiers, and facilitators supporting terrorist organizations, and disrupt their ability to fund them. Enhancing the transparency of the financial system is one of the cornerstones of this effort. Treasury carries out its responsibilities to enhance financial transparency through the Bank Secrecy Act (BSA) and USA Patriot Act. FinCEN is the Treasury bureau responsible for administering BSA.

Over the past decade, TFI has made good progress in closing the vulnerabilities that allowed money launderers and terrorists to use the financial system to support their activities. Nonetheless, significant challenges remain. One challenge is ensuring the continued cooperation and coordination of all the organizations involved in its anti-money laundering and combating terrorist financing efforts. A large number of federal and state entities participate with FinCEN to ensure compliance with BSA, including the four federal banking agencies, IRS, the Securities and Exchange Commission, the Department of Justice, and all the 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).

To be effective, Treasury must establish and maintain working relationships with these numerous entities. Neither FinCEN nor OFAC have the resources or capability to maintain compliance with their programs without significant help from these other organizations. To this end, FinCEN had signed memoranda of understanding with 7 federal and 52 state regulators to ensure that information is exchanged between FinCEN and the entities charged with examining for BSA compliance. While important to promote the cooperation and coordination needed, it should be noted that these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed.

Last year, financial institutions filed approximately 17 million BSA reports, including over 1.5 million suspicious activity reports (SAR). While the number of SARs has been increasing since 2001, that alone does not necessarily indicate everything is going well. Our audits have found problems with the quality of the data reported. Other audits have also identified gaps in the regulatory examination programs of the bank regulators and examining agencies.

Recently the vulnerability in large institutions' monitoring of transactions for money laundering and terrorist financing was revealed. In 2012, OCC filed a consent cease and desist order against Citigroup for failure to adopt and implement a compliance program that adequately covers the required BSA/anti-money laundering program elements due to its inadequate system of internal controls and ineffective independent testing. The bank did not develop adequate due diligence on foreign correspondent bank customers and failed to file SARs related to its remote deposit capture/international cash letter instrument activity in a timely manner. OCC also found weaknesses with other large banks' BSA programs. In July 2012 testimony related to a critical congressional report on OCC's oversight of HSBC's BSA program, the Comptroller of the Currency mentioned several actions that OCC was planning to take going forward. One such action was to assure BSA deficiencies are fully considered in a safety and soundness context and taken into account as part of the "management" component of a bank's CAMELS rating.[7]

FinCEN needs to continue its efforts to work with regulators and examining agencies to ensure that financial institutions establish effective BSA compliance programs and file accurate and complete BSA reports, as required. Furthermore, FinCEN needs to complete work to issue anti-money laundering regulations, as it determines appropriate, for some non-bank financial institutions, such as vehicle dealers; pawnbrokers; travel agents; finance companies; real estate closing and settlement services; and financial services intermediaries, such as investment advisors.

FinCEN faces the continuing challenge to enhance financial transparency in order to strengthen efforts to combat financial crime. So far, in this effort, FinCEN's attention has been on clarifying and strengthening customer due diligence (e.g., know your customer) regulatory requirements and supervisory expectations. This includes requiring

[7] CAMELS is a system used by federal banking agencies for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern. A financial institution is assigned a composite rating and ratings on six components: Capital adequacy, quality of Assets, the capability of the board of directors and Management, the quality and level of Earnings, the adequacy of Liquidity, and Sensitivity to market risk.

institutions to identify beneficial ownership of their accountholders so that the true identities of their customers are not hidden. FinCEN issued an advance notice of proposed rulemaking in March 2012 to address this.

FinCEN became the authoritative source for BSA data when it transitioned the collection, processing, and storage of all BSA data from IRS in January 2012. FinCEN's BSA IT Mod program, begun in 2008, is being built to ensure efficient management, safeguarding, and use of BSA information. BSA IT Mod will reengineer BSA data architecture, update the infrastructure, implement more innovative web services and enhanced electronic filing, and provide increased analytical tools. FinCEN believes modernization will provide increased data integrity, and maximize value for its state and federal partners. We completed two audits of the program in which we concluded that FinCEN is generally meeting schedule and cost milestones, and had an appropriate oversight structure in place. As the modernization effort moves toward completion, FinCEN needs to continue to maintain heightened oversight of this program.

FinCEN mandated the use of its BSA E-Filing network effective July 2012, and for all BSA reports, March 2013. BSA E-Filing allows financial institutions to file reports with FinCEN electronically. We anticipate that this will improve data quality in that data will be more quickly entered into the database and that some of the errors or omissions that previously occurred through paper filings should be reduced if not eliminated. However, until this can be verified, FinCEN will need to continue to monitor data quality. We noted that FinCEN has a particularly difficult challenge in dealing with money service businesses (MSB). To that end, FinCEN has taken steps to improve MSB examination coverage and compliance. For example, in past years, FinCEN finalized new rules and increased enforcement designed to ensure MSBs comply with BSA requirements, including registration and report filing requirements. However, ensuring MSBs register with FinCEN has been a continuing challenge. Furthermore, IRS serves as the examining agency for MSBs, but has limited resources to inspect MSBs or even identify unregistered MSBs. FinCEN engaged the states to participate in joint MSB examinations with IRS, and for outreach programs aimed at these nonbank institutions. FinCEN, IRS, and the states need to work together to ensure that MSBs operating in this country are identified, properly registered, and in compliance with all applicable laws and regulations.

FinCEN has also been concerned with MSBs that use informal value transfer systems and with MSBs that issue, redeem, or sell prepaid access, through physical (cards or other devices) or non-physical (e.g., code, electronic serial number, mobile identification number, and/or personal identification number) means. MSBs using informal value transfers have been identified in a number of attempts to launder proceeds of criminal activity or finance terrorism. Similarly, prepaid access 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 SARs on MSBs that may be inappropriately using informal value transfers when they use financial institutions to store currency, clear checks, remit and receive funds, and obtain other financial services. In 2011, FinCEN issued a final rule applying customer identification, recordkeeping, and reporting obligations to providers and sellers of prepaid access, and continues to issue clarifying guidance for institutions to implement the requirements. Ensuring institutions properly implement these rules and maintain compliance will be a major challenge.

To detect possible illicit wire transfer use of the financial system, FinCEN also proposed a regulatory requirement for certain depository institutions and MSBs to report cross-border electronic transmittals of funds. 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. Ensuring financial institutions, particularly MSBs, comply with the cross-border electronic transaction reporting requirements, as well as managing this new database, is another significant challenge for FinCEN. It should be noted that this system cannot be fully implemented until FinCEN completes work on its BSA IT Mod program, scheduled for 2014.

Other matters of concern are beginning to appear or are on the horizon. One concern we reported before is that the focus on safety and soundness resulting from the recent financial crisis may have reduced the attention financial institutions have given to BSA and OFAC compliance. Another concern is the increasing use of mobile devices for banking, internet banking, internet gaming, and peer-to-peer transactions. FinCEN, OFAC, and other regulatory agencies will need to ensure that providers of these services ensure transactions are transparent and conform to BSA requirements. Monitoring the transactions of tomorrow may prove to be increasingly difficult for Treasury.

Given the criticality of this management challenge to the Department's mission, we continue to consider anti-money laundering and combating terrorist financing as inherently high-risk. In this regard, we have on-going BSA-related audits of FinCEN's MSB compliance program and OCC's BSA and USA Patriot Act examinations and enforcement actions. With respect to OFAC, we are reviewing its licensing program (where OFAC may grant exceptions to a sanction program as allowed under law) and performing a case study review of its Libyan sanctions program. We plan to complete these audits in fiscal year 2013.

Challenge 4: Gulf Coast Restoration Trust Fund Administration

In response to the Deepwater Horizon oil spill, Congress enacted as part of P.L. 112-141, the Resources and Ecosystems Sustainability, Tourist Opportunities, and Revived Economies of the Gulf Coast States Act of 2012 (Restore Act). This law established within Treasury the Gulf Coast Restoration Trust Fund and requires Treasury to deposit in the Trust Fund, 80 percent of administrative and civil penalties paid by responsible parties for the Deepwater Horizon oil spill. It is estimated that the Trust Fund could receive tens of billions of dollars from these penalties to be distributed for eligible activities affecting the Gulf Coast states (Alabama, Florida, Louisiana, Mississippi, and Texas). Treasury, in consultation with the Departments of the Interior and Commerce, is required to develop policies and procedures to administer the Trust Fund by January 2, 2013. The procedures are to include (1) procedures to assess whether programs and activities comply with applicable requirements, (2) auditing requirements to ensure that amounts in the Trust Fund are expended as intended, and (3) procedures for identification and allocation of funds available to Treasury under other provisions of law that may be necessary to pay administrative expenses directly attributable to the management of the Trust Fund. The Restore Act authorizes our office to conduct, supervise, and coordinate audits and investigations of projects, programs and activities funded under this legislation. Neither Treasury nor our office was provided specific funding in the act for carrying out our respective responsibilities.

The Restore Act established the allocation of available amounts in the Trust Fund during any fiscal year.

- 35 percent to the Gulf Coast states, in equal shares, for expenditure for ecological and economic restoration of the Gulf Coast region

- 30 percent to the Gulf Coast Ecosystem Restoration Council (Gulf Restoration Council)[8] pursuant to the council's approval of its comprehensive plan to undertake projects and programs using the best available science that would restore and protect the Gulf Coast region's natural resources, ecosystems, fisheries, marine and wildlife habitats, beaches, coastal wetlands, and economy
- 30 percent to the Gulf Restoration Council for allocation to the Gulf Coast states for eligible oil spill restoration activities, pursuant to the council's approval of the state's plan to improve the ecosystems or economy of the Gulf Coast region, using a regulatory formula
- 2.5 percent to the National Oceanic and Atmospheric Administration for its Gulf Coast Ecosystem Restoration Science, Observation, Monitoring, and Technology Program. This program is to be established by January 2013 to carry out research, observation, and monitoring to support the long-term sustainability of the ecosystem, fish stocks, fish habitat, and the recreational, commercial, and charter fishing industry in the Gulf of Mexico
- 2.5 percent to the Gulf Coast states, in equal shares, for competitive grant awards to nongovernmental entities and consortia in the Gulf Coast region, including public and private institutions of higher education, to establish centers for excellence to conduct Gulf Coast region research

The Restore Act prescribes how each distribution of funds will be further distributed and the conditions that must be met to receive funds. These conditions include that the amounts distributed be used in accordance with the legislation, that procurement rules and regulations be followed, and that the Secretary of the Treasury has the authority to withhold funding if the conditions are not met.

Treasury's Office of the Fiscal Assistant Secretary (OFAS) is currently developing regulations for the new program. We have been meeting with OFAS staff and providing our perspectives on controls as the regulations are being developed. What makes the administration of the act so challenging is that (1) regulations and associated policies and procedures need to be established and put into place quickly; (2) many of the entities/councils that are to receive and further allocate funding were not created before the enactment of the legislation and need to establish their own policies and procedures; and (3) there are many entities/councils that must cooperate for the funds to be distributed and spent in an appropriate manner. Treasury is also challenged by the fact that it must use existing resources to administer its responsibilities for the Trust Fund, and it is not a member of the entity, the Gulf Restoration Council, that will directly control how over half of the available amounts are spent.

[8] The Gulf Restoration Council consists of the following members, or designees: (1) at the federal level, the Secretaries of the Interior, Army, Commerce, Agriculture, the head of the department in which the Coast Guard is operating (currently the Secretary of Homeland Security), and the Administrator of the Environmental Protection Agency; and (2) at the state level, the Governors of Alabama, Florida, Louisiana, Mississippi, and Texas.

Challenge Removed

Management of Capital Investments

As we have reported in past years, managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. In the past, we have also reported on a number of capital investment projects that either failed or had serious problems. However, we believe Treasury's implementation activities for two capital investments, TNet and FinCEN's BSA IT Mod, while not perfect, demonstrated that the Department has made sufficient, sustainable improvement in managing and mitigating investment risk to warrant removal of this area from our list of the most serious management and performance challenges.

> <u>TNet</u> - Treasury plans to spend $3.7 billion during the life cycle of its Information Technology Infrastructure Telecommunications Systems and Services investment. Treasury was originally to have begun implementation of TNet, a major component, in November 2007 but the project was delayed until August 2009. In September 2011, we reported serious problems with the initial contracting and project management of TNet that contributed to the delay and the unnecessary expenditure of $33 million to maintain the prior telecommunications system in the interim. TNet is now operational across Treasury. While it is not yet fully compliant with all Federal security requirements, Treasury has committed to correcting the weaknesses in a timely manner and has taken other steps to strengthen security.

> <u>FinCEN BSA IT Mod</u> - As discussed in Challenge 3, Treasury, through FinCEN, is undertaking the BSA IT Mod program and achieved a major milestone when it successfully transitioned BSA data from IRS in January 2012. The project is expected to cost about $120 million and is on track to be completed in 2014. Pursuant to a Congressional directive, we completed two in a series of audits of BSA IT Mod. The first audit reported that FinCEN had developed a sound business case for the program and the Department and FinCEN had implemented a strong governance system. The audit did identify one issue dealing with the mapping of BSA data from the new system to legacy IRS systems, which was addressed. The second audit found that the program was on schedule and within budgeted cost. We did note a concern with changes in program oversight, which we concluded had not adversely impacted the program so far but would be an area of follow-up in our work going forward.

We do note that we have started or planned audits of two on-going and costly capital investments to determine whether sound project management and effective governance are in place.

> <u>BEP Enterprise</u> - BEP Enterprise, or BEN, is intended to integrate the Bureau of Engraving and Printing's (BEP) manufacturing and administrative components in a unified platform to simplify and standardize procedures, increase efficiency, and eliminate unnecessary processes. The goals are to increase quality, reduce spoilage, and improve accountability. The cost for BEN is estimated at $123 million for initial implementation and $400 million over the 10-year life of the project. We initiated an audit of BEN in 2012 which we anticipate completing in fiscal year 2013.

> <u>Common identity management system</u> - The Treasury Enterprise Identity, Credential and Access Management (TEICAM) is an effort to implement Homeland Security Presidential Directive 12 requirements for a common

identity standard. Started in 2007, the investment's targeted life cycle is through 2018. The estimated TEICAM cost is $178 million as of this writing, which has increased $31 million since the estimate in my last challenges memorandum. Although recently Treasury reported the investment is on schedule, within cost, and operating as planned, the investment has incurred significant schedule variances. As of August 2012, the Treasury Chief Information Officer assessed the investment as medium risk. We plan to begin an audit of TEICAM in fiscal year 2013.

While removed as a challenge, because of the billions of dollars at risk both in terms of procurement and mission effectiveness, Treasury should continue to exercise vigilance in managing the capital investments described above and others it has underway and may undertake in the future.

Matters of Concern

Although we are not yet reporting these as management and performance challenges, we want to highlight areas of concern – cyber security, currency and coin production, and documenting key activities and decisions.

<u>Cyber Security</u>

Not surprisingly, Treasury's systems are interconnected and critical to the core functions of government and the Nation's financial infrastructure. Information security remains a constant area of concern and potential vulnerability for Treasury's systems.

As a result, an economic and national security challenge for which Treasury must be prepared, is to provide leadership to defend against the full spectrum of threats against financial institutions in particular, and the financial sector in general. Many U.S. banks face cyber threats to their infrastructure on a continuous basis. Recent examples include denial of service attacks against a number of large U.S. banks. Organized hacking groups leverage known and new vulnerabilities and use different methods to make attacks hard to detect and even harder to prevent. Given the evolving cyber-threat environment, Treasury will need to build on existing partnerships among financial institutions, regulators, and private entities in the financial sector, in order to be well-positioned to identify and respond to emerging cyber threats against financial institutions and the broader financial sector.

<u>Currency and Coin Production</u>

We have issued two reports related to the delayed introduction of the NexGen $100 notes caused by creasing in some of the finished notes. Our first report, issued in May 2011, discussed deficiencies related to the physical security over notes and sheets in the production facilities; we noted that BEP promptly addressed those matters. Our second report, issued in January 2012, reported on deficiencies with BEP's NexGen $100 note production process, project management, and the need to complete a comprehensive cost-benefit analysis for the disposition of the 1.4 billion finished NexGen $100 notes already printed but not accepted by FRB. Originally planned to be issued in February 2011, a decision still needs to be made regarding the introduction of the NexGen $100 note into circulation although production has resumed. In this regard, FRB, as the issuing authority, will make that determination. Another matter related to currency redesign that should be kept in mind is meaningful access to U.S. currency for blind and visually impaired individuals. In response to a court ruling on that matter, you discussed several methods that Treasury plans to use to provide such access. Among them, you described the inclusion of raised tactile features and high-contrast numerals that would help them distinguish denominations of U.S. currency notes. The lessons learned with NexGen $100 note underscore the need for sound and comprehensive project management as BEP undertakes this redesign effort.

Challenges also exist with coin production. In recent years, the Mint reported that the cost of producing penny and nickel coins were double their face value and that metal prices have caused the production costs to be higher than the coins' face value for the past 6 years. Treasury also suspended production of the dollar coins to save money in production and storage costs due to excess supplies on-hand and low demand for the coins. Even though the demand is not there, the fiscal year 2011 production costs of the dollar coin were approximately a fifth of the coin's face value.

In the medium- to long-term future, the impact of alternative payment systems and other technological advances – such as stored value cards, the Internet, and smartphones – to BEP's and the Mint's respective business models and practices must be considered. This is especially the case in light of the profound effect that such technology had on the U.S. Postal Service's business model. Accordingly, it will become more and more imperative that BEP and the Mint factor this into their business model and future planning and interactions with their customer, FRB.

Documenting Key Activities and Decisions

Two recently completed audits by my office highlighted lapses by the Department in maintaining a complete and concurrent record of key activities and decisions.

One audit involved the selection of financial agents for Treasury's investment in Fannie Mae and Freddie Mac MBS. The other audit involved Treasury's consultative role with the Department of Energy's Solyndra loan guarantee. In both cases, while some documentation was available, we were only able to piece together what had happened through extensive interviews with personnel and email reviews. It was only then that we could conclude that in the case of the selection of financial agents, that Treasury followed a reasonable approach, and in the case of the Solyndra loan guarantee, that a consultation by Treasury did occur, albeit rushed.[9] On-going work by my office shows that these are not isolated instances. We are often told that the exigencies at the time precluded the preparation of more complete documentation. While we appreciate the pressures that are involved, especially during times of economic crisis, maintaining proper documentation is a fundamental tenet of government accountability and transparency. Maintaining proper documentation is also in the best long-term interest of the Department, should, at a later date, it want to repeat its actions or they be called into question. In this regard, appropriate documentation can be as simple as contemporaneous notes providing a record of why decisions were made, the way they were made, and how the government satisfied itself that the decisions were the best course. We do note that Treasury has issued policy that addresses documentation requirements, such as

[9] *Treasury's Financial Agent Selection Process for the Agency Mortgage Backed Securities Purchase Program Was Not Fully Documented* (OIG-12-061; issued July 31, 2012); *Consultation on Solyndra Loan Guarantee Was Rushed* (OIG-12-048; issued April 3, 2012)

Treasury Directive Publication 80-05, *Records and Information Management Program*. In our view, this is a matter of Treasury management personnel needing to remain aware and vigilant, especially during times of economic crisis.

We have a final observation and this regards the Department's October 2012 consolidation and restructuring of BPD and FMS into BFS. Expected to save money in the long run, the initiative is laudable. Furthermore, early indications from our on-going review of the consolidation, is that planning for the consolidation, as well as communication with affected personnel, has been extensive. That said, such consolidations do entail risk as separate processes, systems, and workplace cultures are meshed together. Comprehensive planning and the involvement of senior leadership has been key to other recent and successful restructurings of government operations, such as with CFPB and the transfer of the functions of the former OTS. At this stage, we encourage Treasury's senior leadership to at least maintain its current level of effort in this important undertaking.

We would be pleased to discuss our views on the management and performance challenges and the other matters in this memorandum in more detail.

cc: Nani A. Coloretti
Acting Assistant Secretary for Management

INSPECTOR GENERAL
FOR TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20005

October 15, 2012

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2013

The *Reports Consolidation Act of 2000*[10] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2013*, its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS).

Each year, TIGTA evaluates IRS programs, operations, and management functions to identify the areas of highest vulnerability to the Nation's tax system. For Fiscal Year 2013, the top management and performance challenges in order of priority are:

1. Security for Taxpayer Data and Employees;
2. Tax Compliance Initiatives;
3. Modernization;
4. Implementing the Affordable Care Act and Other Tax Law Changes;
5. Fraudulent Claims and Improper Payments;
6. Providing Quality Taxpayer Service Operations;
7. Human Capital;
8. Globalization;
9. Taxpayer Protection and Rights; and
10. Achieving Program Efficiencies and Cost Savings.

While TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2013 has remained relatively unchanged from the prior fiscal year, we decided to distinguish the significance of Tax Compliance Initiatives from Modernization. Last year, Tax Compliance Initiatives and Modernization were both ranked as number two. However, with the demand for accountability to the American taxpayer, we believe it is more important than ever for the IRS to efficiently and effectively collect taxes owed to the Federal Government. Lastly, the Implementing Tax Law

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[10] 31 U.S.C. § 3516(d) (2006).

Changes challenge area was expanded to encompass the *Patient Protection and Affordable Care Act* (Affordable Care Act),[11] and is now titled Implementing the Affordable Care Act and Other Tax Law Changes.

Although not listed, complexity of the tax laws 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 trying to comply.

The following information detailing these management and performance challenges is being provided to promote economy, efficiency, and effectiveness in the IRS's administration of the Nation's tax laws.

SECURITY FOR TAXPAYER DATA AND EMPLOYEES

As our Nation's tax collector and administrator of the Internal Revenue Code, the IRS received more than 234 million tax returns, of which 143 million were from individual taxpayers, and collected more than $2.4 trillion in revenue in Fiscal Year 2011. Information from these tax returns is converted into electronic format, processed, and maintained in 178 computer system applications for use by IRS employees.

The IRS faces the daunting task of securing its computer systems against the growing threat of cyberattacks. Effective information systems security becomes essential to ensure that data are protected against inadvertent or deliberate misuse, improper disclosure or destruction, and that computer operations supporting tax administration are secured against disruption or compromise. According to the Department of Homeland Security's U.S. Computer Emergency Readiness Team, Federal agencies reported 43,889 cyberattacks in Fiscal Year 2011, an increase of about five percent since Fiscal Year 2010.[12]

Computer security has been problematic for the IRS since 1997, when the IRS initially reported computer security as a material weakness during its annual evaluation of internal accounting and administrative controls under the *Federal Managers' Financial Integrity Act of 1982*.[13] TIGTA continues to identify significant security weaknesses in this area. In addition, the Government Accountability Office reported that security deficiencies identified in conjunction with its review of the IRS's financial statement audits for Fiscal Years 2010 and 2011 are the basis of its determination that the IRS had a material weakness in internal controls over financial reporting related to information security.[14] While the IRS has made progress in the area of computer security, it still needs to continue to place a high priority on improvements.

Beyond safeguarding a vast amount of sensitive financial and personal data, the IRS must also protect approximately 100,000 employees and contractors working in approximately 630 facilities throughout the country. The IRS has enhanced security nationwide, including acquiring new or additional guard services at IRS facilities. Additionally, the

[11] Pub. L. No. 111-148, 124 Stat. 119 (2010) (codified as amended in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029.
[12] Office of Management and Budget, Fiscal Year 2011 Report to Congress on the Implementation of The Federal Information Security Management Act of 2002 (Mar. 2012).
[13] 31 U.S.C. §§ 1105, 1113, and 3512. The *Federal Managers' Financial Integrity Act* (FMFIA) requires that agency management establish and maintain effective internal controls to achieve the objectives of: 1) effective and efficient operations, 2) reliable financial reporting, and 3) compliance with applicable laws and regulations. The FMFIA also requires the head of each Executive agency to report annually to the President and Congress on the effectiveness of the internal controls and to identify any material weaknesses in those controls. Reporting material weaknesses under the FMFIA is not limited to weaknesses over financial reporting.
[14] GAO, Ref. No. GAO-12-165, *Financial Audit: IRS's Fiscal Years 2011 and 2010 Financial Statements* (Nov. 2011).

IRS obtained the services of an outside consultant to provide an independent review of its physical security. However, TIGTA determined that the IRS did not receive the in-depth, independent assessment regarding the security posture of its facilities as required by the contract, and the contractor declined to provide a validation of the acceptability of the IRS's security posture.[15]

During the last three years, threats to the IRS have increased 24 percent. Physical violence, harassment, and intimidation of IRS employees continue to pose significant challenges to the implementation of a fair and effective system of tax administration.

During Fiscal Year 2011, TIGTA evaluated in excess of 2,700 threat-related complaints. This resulted in the initiation of 1,400 threat investigations that required TIGTA Special Agents to promptly respond to mitigate those threats and to determine whether criminal prosecutions of the perpetrators making the threats were warranted.

Additionally, the ongoing public debate regarding the health care law and continued concern over the country's economy could fuel threats against the Federal Government, including IRS employees and facilities. These are challenging operating conditions for the IRS that underscore the need for continued vigilance in the area of physical and personnel security.

TAX COMPLIANCE INITIATIVES

Another serious challenge confronting the IRS is tax compliance. Despite an estimated voluntary compliance rate of approximately 83 percent in the IRS's January 2012 updated Tax Gap[16] estimates 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 oversight of tax-exempt and government entities.

Increasing voluntary taxpayer compliance and reducing the Tax Gap are the focus of many IRS initiatives. Although the IRS reported that the Tax Gap is caused by both unintentional taxpayer errors (whether due to tax law complexity, confusion, or carelessness) and willful tax evasion or cheating, the IRS does not have sufficient data to distinguish the amounts attributable to each. The IRS also reported that a meaningful improvement in the voluntary compliance rate requires a long-term, focused effort involving taxpayer service, modernization, and enforcement. 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 2013 budget submission, the IRS requested a 7.6 percent increase in enforcement funds over its Fiscal Year 2012 enacted level.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year 2006 to be approximately $450 billion. The underreporting of taxes, which is comprised of four major components (individual income tax, employment tax, corporate income tax, and estate and excise taxes), was estimated at $376 billion and accounted for the largest portion (approximately 84 percent) of the Tax Gap. The underpayment of taxes was approximately 10 percent, and the

[15] TIGTA, Ref. No. 2012-10-075, *An Independent Assessment of Facility Physical Security Was Not Performed in Compliance With Contract Requirements* (July 2012).
[16] 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.

nonfiling of taxes was approximately six percent. The IRS will need to address the following impediments to more effectively address the Tax Gap:

- **Incomplete compliance research** that does not identify all the sources of noncompliance so that IRS resources can be targeted properly.
- **Insufficient compliance strategies** that do not always address the areas of highest risk of noncompliance. The IRS reported it is working to reengineer examination and collection procedures based on improved data from its National Research Project study of individual taxpayers.
- **Incomplete document matching programs** because the IRS does not have reliable third-party data for all taxpayer sectors and for all types of tax returns, most notably income earned by the self-employed. The IRS reported that, without these data, it cannot easily detect errors or potential fraud except through expensive and intrusive examinations.
- **Insufficient enforcement resources** to handle a growing caseload. The IRS has identified noncompliance and potential fraud cases it did not have the resources to work, allowing billions of dollars to be fraudulently refunded each year.

Tax-Exempt Entities

The IRS's challenge related to tax-exempt and government entities is providing assistance to those entities that provide a societal benefit while ensuring that the entities remain in compliance with the tax laws associated with their tax-exempt status. Legislative changes and judicial decisions contribute to a constantly changing environment affecting today's nonprofit and tax-exempt organizations. The *Pension Protection Act of 2006* [17] mandates that tax-exempt organizations file certain information electronically with the IRS. Previously, these organizations were not required to file an annual information return unless their gross receipts exceeded certain dollar thresholds. The Act further requires the IRS to publish and maintain a list of organizations whose tax-exempt status has been automatically revoked.

TIGTA reported that the Exempt Organizations function educated tax-exempt organizations on the requirements of the Act and identified and informed organizations that their tax-exempt status had been automatically revoked. However, the Exempt Organizations function did not identify all organizations that should have been informed about their revocations and did not clearly inform organizations on how to regain their tax-exempt status if they were still operating.[18] TIGTA also reported that while the Exempt Organizations function has greatly improved its timeliness with regard to acknowledging complaints against tax-exempt organizations, referrals were not always controlled or processed timely. If referrals are not properly accounted for or worked timely, the Exempt Organizations function may not identify tax-exempt organizations that are potentially in violation of Federal tax law or have referrals ready when new examination cases are needed.[19]

[17] Pub. L. No. 109-280, 120 Stat. 780.
[18] TIGTA, Ref. No. 2012-10-027, *Appropriate Actions Were Taken to Identify Thousands of Organizations Whose Tax-Exempt Status Has Been Automatically Revoked, but Improvements Are Needed* (Mar. 2012).
[19] TIGTA, Ref. No. 2012-10-058, *Implementing Better Management Controls Would Improve the Exempt Organizations Function's Ability to Oversee and Timely Process Referrals* (June 2012).

Tax Return Preparers

Every year, more than half of all taxpayers pay someone else to prepare their Federal income tax returns. During the 2012 Filing Season,[20] the IRS processed approximately 71 million individual Federal income tax returns prepared by paid tax return preparers.

In December 2009, the IRS announced a suite of proposed reforms to improve oversight of the return preparer community. In September 2010, TIGTA reported that it will take years for the IRS to implement the Return Preparer Program and to realize its impact.[21] In December 2011, TIGTA reported that improvements are ongoing to ensure that the preparer registration process has effective controls and system validations.[22] However, not until January 2014 will all preparers be subjected to all suitability and competency tests.

MODERNIZATION

The Business Systems Modernization Program (Modernization 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 completion of the Modernization Program would take up to 15 years and incur contractor costs of approximately $8 billion. The Modernization Program was funded for $330.2 million for Fiscal Year 2012 and the President's Budget request for Fiscal Year 2013 was also $330.2 million. The Modernization Program's goals include:

- Issuing refunds, on average, five days faster than existing legacy systems;
- Offering electronic filing capability for individuals, large corporations, small businesses, tax-exempt organizations, and partnerships, with dramatically reduced processing error rates;
- Delivering web-based services for tax practitioners, taxpayers, and IRS employees;
- Implementing data analytics to reduce improper payments and fraudulent refunds; 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 IRS's modernization efforts continue to focus on core tax administration systems designed to provide more sophisticated tools to taxpayers and IRS employees. These efforts will provide the foundation for implementing a real-time tax system, reducing improper payments and fraudulent refunds, and providing the technology infrastructure and architecture that will enable taxpayers and other stakeholders the capability to securely access tax account information. These complex efforts continue to pose significant technological and business challenges for the IRS.

Since January 2012, the IRS has implemented daily updating of taxpayer accounts and daily processing of returns; however, the implementation of the Customer Account Data Engine 2 (CADE-2) relational database designed to

[20] The period from January 1 through April 15 when most individual income tax returns are filed.
[21] TIGTA, Ref. No. 2010-40-127, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact* (Sept. 2010).
[22] TIGTA, Ref. No. 2012-40-010, *More Tax Return Preparers Are Filing Electronically, but Better Controls Are Needed to Ensure All Are Complying With the New Preparer Regulations* (Dec. 2011).

replace the 1960s-era Individual Master File is at risk of not meeting timeframes for providing data to other systems. Additionally, while the IRS has upgraded the Modernized e-File system to accept and process over 125 new individual tax forms, performance issues threaten goals to retire the legacy electronic filing system and have delayed the implementation of employment-related business forms. Modernizing legacy tax administration systems to receive and process CADE-2 data and to process new legislative changes, such as the Affordable Care Act, will continue to be a major challenge for the IRS.

The IRS has identified and reported the Modernization Program as a material weakness since 1995. However, in a June 2011 memorandum to the Department of the Treasury, the IRS Commissioner stated that the previously identified internal and management control issues have been fully addressed and that the Modernization Program no longer warranted being identified as a material weakness. The Department of the Treasury agreed to downgrade the material weakness. While we support the IRS's decision, we believe the Modernization Program remains a major management challenge, and the IRS should continue to stress improvements in its overall processes and performance.

IMPLEMENTING THE AFFORDABLE CARE ACT AND OTHER TAX LAW CHANGES

Each filing season tests the IRS's ability to implement tax law changes made by Congress. 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 that 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 computer systems to accurately and timely process tax returns affected by the new tax law changes. Sometimes, despite all of its efforts, the IRS may have to delay the processing of some tax returns or quickly correct computer programming if early processing errors surface. Effective implementation of tax-related provisions of the Affordable Care Act and changes to tax laws will continue to challenge IRS resources.

Affordable Care Act

The Affordable Care Act contains an extensive array of tax law changes that will present a continuing source of challenges 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 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 provisions will require the IRS to build new processes that do not exist within the current system of tax administration. 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;
- Administering multiple tax provisions designed to raise revenues to offset the cost of health care reform; and,
- Protecting additional data entrusted to the IRS from the risk of loss or identity theft.

Results of TIGTA audits illustrate the need for continued oversight of the IRS's administration of many of these tax-related provisions. TIGTA recently reported that the IRS did not require sufficient information to determine whether taxpayers claiming Small Business Health Care Tax Credits filed required employment taxes when these taxpayers entered into a contractual relationship with professional employment organizations to manage human resources.[23] TIGTA also determined that the IRS did not take adequate steps to ensure that taxpayers potentially liable for the indoor tanning excise tax were aware of the new tax law, particularly after the number of taxpayers filing tax returns reporting the excise tax for tanning services was much lower than expected.[24]

TIGTA also reported that taxpayers erroneously received millions of dollars in Adoption Credits. A provision in the Affordable Care Act increased the Adoption Credit and made the tax credit refundable.[25] Although the IRS requires taxpayers to attach documentation to their tax returns supporting Adoption Credit claims, it does not have the authority to deny the credits if documentation is not provided. As a result, tax returns without required documentation must be sent to the Examination function. As of December 23, 2011, the IRS had received 101,627 Adoption Credit claims totaling more than $1.2 billion for Fiscal Year 2010. We reported that 4,258 taxpayers received almost $49.3 million in Adoption Credits without sufficient supporting documentation.[26] Of these 4,258 taxpayers, TIGTA estimated that 953 tax returns claiming more than $11 million in Adoption Credits were erroneous.

Other Tax Law Changes

More than 1.5 million taxpayers who purchased a home between April 9 and December 31, 2008, and claimed the First-Time Homebuyer Credit (Homebuyer Credit), were required to begin repaying the credit on their Tax Year 2010 tax return. The credit is intended to be repaid over 15 years, in equal annual installments. However, the IRS experienced difficulties in implementing the repayment process. As of May 2, 2012, the IRS had inaccurately processed 66 percent (3,819 of 5,756) of taxpayer accounts for which the taxpayer filed a joint tax return with his or her spouse when the Homebuyer Credit was claimed but the ownership of the property was later transferred as part of a divorce settlement. As a result of incorrectly overstating the new Homebuyer Credit repayment obligation, the IRS incorrectly assessed more than $650,000 in additional tax for 136 tax accounts. The IRS also understated the net Homebuyer Credit repayment obligation for 3,683 taxpayers and erroneously reduced the amount these taxpayers were required to repay by more than $13.1 million.[27]

FRAUDULENT CLAIMS AND IMPROPER PAYMENTS

The *Improper Payments Information Act of 2002*[28] defines an improper payment as any payment that should not have been made or that was made in an incorrect amount (both overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. The Administration has emphasized the

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[23] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).
[24] TIGTA, Ref. No. 2011-40-115, *Affordable Care Act: Number of Taxpayers Filing Tanning Excise Tax Returns Is Lower Than Expected* (Sept. 2011).
[25] A refundable tax credit is a tax credit that is treated as a payment and can be refunded to the taxpayer. Refundable credits can create a Federal tax refund that is larger than the amount a person actually paid in taxes during the year.
[26] TIGTA, Ref. No. 2012-40-065, *Processes to Address Erroneous Adoption Credits Result in Increased Taxpayer Burden and Credits Allowed to Nonqualifying Individuals* (June 2012).
[27] TIGTA, Ref. No. 2012-40-119, *The Majority of Individual Tax Returns Were Processed Timely, but Not All Tax Credits Were Processed Correctly During the 2012 Filing Season* (Sept. 2012).
[28] Pub. L. No. 107-300, 116 Stat. 2350.

importance of reducing improper payments. On November 20, 2009, the President signed Executive Order 13520,[29] which included a strategy to reduce improper payments by increasing transparency, holding agencies accountable, and creating strong incentives for compliance. In addition, the *Improper Payments Elimination and Recovery Act of 2010* [30] placed additional requirements on Federal agencies to reduce improper payments. Erroneous and improper payments issued by the IRS generally involve improperly paid refunds, tax-return filing fraud, or improper payments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability to 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 and the Additional Child Tax Credit.

During Tax Years 2006 through 2009, taxpayers claimed almost $470 billion in refundable credits. Due to post-refund examinations, taxpayers were required to repay more than an estimated $2.3 billion in erroneous credits. By the end of December 2011, the IRS had recovered an estimated $1.3 billion, of which more than 70 percent was collected through refund offsets.

Refunds for the Additional Child Tax Credit processed in Fiscal Year 2010 totaled $28.3 billion, and TIGTA reported that the IRS paid $4.2 billion for this credit in Processing Year 2010 to individuals who were not authorized to work in the United States. Taxpayers also repeatedly claimed erroneous Additional Child Tax Credits after being disallowed the credit in the previous year. TIGTA determined that the IRS could have saved an additional $108 million by reviewing claims made by taxpayers who were previously disallowed the credit. In addition, the IRS could have prevented issuance of approximately $419 million in erroneous Additional Child Tax Credit refunds had it reviewed the Additional Child Tax Credit at the same time the Earned Income Tax Credit was being reviewed.[31]

Fraudulent Payments

Identity theft is escalating and poses significant challenges for the IRS. In Calendar Year 2011, the IRS identified over 1.1 million incidents of identity theft that affected the Nation's tax system.[32] The IRS has stepped up its efforts against refund fraud and identity theft. These efforts include designing new identity-theft-screening filters that the IRS believes will improve its ability to identify false tax returns before they are processed and before fraudulent refunds are issued. As of April 19, 2012, the IRS reported that it has stopped the issuance of $1.3 billion of potentially fraudulent tax refunds as a result of the new identity-theft filters. However, TIGTA determined that the impact of identity theft on tax administration is significantly higher than the amount the IRS

[29] Executive Order No. 13,520, 74 Fed. Reg. 62201 (Nov. 25, 2009), *Reducing Improper Payments and Eliminating Waste in Federal Programs.*
[30] Pub. L. No. 111-204, 124 Stat. 2224.
[31] TIGTA, Ref No. 2012-40-105, *Expansion of Controls Over Refundable Credits Could Help Reduce the Billions of Dollars of Improperly Paid Claims* (Aug. 2012).
[32] This includes incidents in which taxpayers contacted the IRS alleging that they were victims of identity theft, as well as instances where the IRS identified identity theft. Many of the taxpayers that the IRS identified were not aware they were victims of identity theft because they either did not file tax returns or did not have filing requirements.

detects and prevents. Our analysis of Tax Year 2010 tax returns identified more than $5.2 billion in tax refunds issued to individuals filing tax returns with characteristics of identity-theft cases confirmed by the IRS.[33]

Contract and Other Payments

The IRS expends approximately $2.1 billion annually in contract spending, an area which continues to experience several risks for fraud and abuse. Previous TIGTA investigations and audits have identified millions of dollars in questioned costs and several instances of contractor fraud. During Fiscal Years 2010 and 2011, TIGTA's criminal investigative efforts contributed to court-ordered civil settlements which required Government contractors to pay $156 million and $113 million, respectively, to the U.S. treasury. These payments were the result of Federal procurement law violations that occurred with work contracted with multiple Federal agencies, including the IRS.

During these investigations, two recurring trends emerged: contracting officer's representatives were frequently overwhelmed by their workloads, and current business practices have not enhanced the IRS's ability to identify anomalies warranting additional review.

TIGTA recently performed an assessment of the IRS's controls over contract invoice review, approval, and payment processes to identify whether improper payments were made to contractors. TIGTA reported that the IRS did not have documentation supporting $384,430 of the invoiced labor hours that were paid. Applying the results to the population of labor charges, we estimate a total of $927,992 may have been erroneously paid.[34]

Another TIGTA review identified that the IRS is not always charging other entities for the full costs of the work performed on reimbursable agreements. We identified more than $28 million in costs incurred by the IRS that were not reimbursed. When the IRS is reimbursed less than the cost of performing reimbursable work, it must fund this work using its own operating budget, thereby reducing the funds available for tax administration.[35]

PROVIDING QUALITY TAXPAYER SERVICE OPERATIONS

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 in correctly preparing their returns reduces the need to send notices and correspondence when taxpayers make errors. Taxpayer service 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 Federal Government resources.

Although the number of identity-theft cases is increasing, TIGTA found that the IRS is not effectively providing assistance to victims of identity theft. Identity-theft cases are not worked timely and can take more than a year to resolve. Communications between the IRS and victims are limited and confusing, and victims are asked multiple times to substantiate their identity, increasing the burden to these taxpayers. IRS guidelines are inconsistent and not

[33] TIGTA, Ref. No. 2012-42-080, *There Are Billions of Dollars in Undetected Tax Refund Fraud Resulting From Identity Theft* (July 2012).
[34] TIGTA, Ref. No. 21012-11-101, *Deficiencies Continue to Exist in Verifying Contractor Labor Charges Prior to Payment* (Aug. 2012).
[35] TIGTA, Ref. No. 2011-10-076, *The Full Costs of Work Performed on Reimbursable Agreements Are Not Always Charged, Resulting in Reduced Funds Available for Tax Administration* (July 2012).

all functions within the IRS have guidelines for handling identity-theft issues. In November 2011, the IRS established a Taxpayer Protection Unit to manage identity-theft cases. However, during the 2012 Filing Season, taxpayers found it difficult to reach employees in this unit. The unit received more than 86,000 calls during the Filing Season, but was only able to answer about 21,000 of these calls. The average wait time for taxpayers was almost one hour.

The IRS assisted approximately 2 million individuals at its walk-in Taxpayer Assistance Centers during the 2012 Filing Season. In addition, more taxpayers are calling the IRS's toll-free telephone lines every year, with approximately 90 million calls attempted to the various toll-free telephone assistance lines during the 2012 Filing Season. However, as a result of budget constraints, tax return preparation was provided only on a limited number of days per week, and the IRS did not provide the planned extended hours for the Taxpayer Assistance Centers. Additionally, a reduction in funding for toll-free telephone and correspondence services resulted in a Level of Service goal for Fiscal Year 2012 of 61 percent, compared to the 70 percent the IRS achieved in Fiscal Year 2011.

Furthermore, our recent review of the Taxpayer Advocate Service's toll-free telephone lines determined that the Taxpayer Advocate Service does not have a formalized process to track or analyze the calls received by the ASK-TAS1 toll-free line to assess the effectiveness of its outreach efforts in generating cases meeting Taxpayer Advocate Service case criteria. Taxpayers specifically requesting Taxpayer Advocate Service assistance have several telephone options, including the ASK-TAS1 toll-free line staffed by Taxpayer Advocate Service personnel. Additional documentation and analysis is necessary to evaluate the impact of the ASK-TAS1 toll-free line and ensure that proposed changes to the line provide the expected benefits without adversely affecting taxpayers.[36]

HUMAN CAPITAL

Human capital is the Federal Government's most critical asset. At a time when agencies are preparing for increased retirements and taking on such challenges as implementing the numerous health care tax provisions, the recruitment and retention of employees plays a key role in maintaining a quality workforce. Like many Federal agencies, the IRS is faced with the major challenge of replacing existing talent caused by a large number of retirements expected over the next several years. In five years, about one-third of the IRS's workforce of approximately 100,000 employees will be eligible to retire. In the leadership ranks, over two-thirds of IRS executives will be eligible for retirement in five years. Adding to this challenge, the IRS offered early retirement and buyouts to more than 2,200 employees in Fiscal Year 2012.

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 and as attempts by taxpayers and tax practitioners to evade compliance with the tax laws grows and becomes more sophisticated. The IRS must also compete with other Federal agencies and private industry for the same human resources, which becomes more complicated as younger generations of employees move between jobs more frequently than their predecessors. Further, budget constraints, legislative changes, and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues.

While the IRS is improving its human capital management practices and has developed a comprehensive agency-wide recruitment strategy, there is still much work to be done. TIGTA recently reported that the IRS has improved its

[36] TIGTA, Ref. No. 2012-10-052, *The Taxpayer Advocate Service's ASK-TAS1 Toll-Free Line Has Evolved Over Time, but Additional Steps Are necessary to Evaluate Its Impact* (June 2012).

process for onboarding new employees; however, managers interviewed by TIGTA indicated they were not following best practices, as identified in the comprehensive guidance the IRS developed for them. As a result, some best practices that would help new employees become more productive were not fully implemented. Improved processes would reduce the substantial cost of replacing employees who leave the IRS and would help the IRS meet its mission by ensuring that employees quickly become productive.[37]

The IRS is also at risk when the workforce turns over at a high rate resulting in the loss of experience. This loss of experience needs to be offset by strong managerial oversight and internal controls or it can foster an environment where employee misconduct and criminal acts can go unreported and undetected. All employees need to be aware and vigilant in their responsibilities for maintaining the highest degree of integrity within the Federal Government.

GLOBALIZATION

The scope, complexity, and magnitude of the international financial system presents 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 during the same period. The number of taxpayers conducting international business transactions continues to grow as technological advances provide opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

As technology continues to advance and cross-border transactions rise, the IRS is increasingly challenged by economic globalization. The IRS is confronted with 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.

The IRS has developed a strategic plan specifically for international tax issues with two major goals: (1) enforce the law to ensure that all taxpayers meet their obligation to pay taxes and (2) improve service to make voluntary compliance less burdensome. The IRS continues to realign and expand its international efforts under its Large Business and International Division. The IRS expects that these efforts will improve international tax compliance by allowing it to focus on high-risk issues and work cases with greater consistency and efficiency.

A top priority for the IRS has been to stop offshore tax cheating and bring these taxpayers, especially high net-worth individuals, back into the tax system. The IRS offered Offshore Voluntary Disclosure Initiatives in 2009 and 2011 to encourage taxpayers with hidden offshore assets and income to come back into the tax system using the IRS's Voluntary Disclosure Program. According to the IRS, these initiatives have resulted in the collection of over $4 billion. Due to the success of the first two initiatives, the IRS offered a third opportunity in 2012 for delinquent taxpayers to disclose their hidden offshore assets. In a review of the IRS's 2009 Offshore Voluntary Disclosure Initiative, TIGTA determined that the IRS's disclosure practices increased taxpayer compliance. However, additional oversight is necessary to ensure that information obtained from the voluntary disclosures is accurate and complete to

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[37] TIGTA, Ref. No. 2012-10-091, *The Onboarding Process Has Improved, but Additional Steps Should Be Taken to Ensure Employees Have the Tools, Resources, and Knowledge to be Successful and Productive* (Aug. 2012).

assist the IRS in identifying additional taxpayers and promoters who continue to defraud the Federal Government with their offshore activities.[38]

Another challenge that the IRS currently faces is the implementation of the *Foreign Account Tax Compliance Act* (FATCA).[39] The FATCA was enacted to combat tax evasion by U.S. persons holding investments in offshore accounts. Under this Act, a U.S. taxpayer with financial assets outside the United States will be required to report those assets to the IRS. In addition, foreign financial institutions will be required to report to the IRS certain information about financial accounts held by U.S. taxpayers or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. The FATCA is being phased in by the IRS over several years. Individual taxpayers with an aggregate balance of more than $50,000 in foreign financial assets are required to file a disclosure statement with their income tax return.

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] The following audits related to taxpayer rights provisions are mandated annually: Notices of Levies; Restrictions on the Use of Enforcement Statistics to Evaluate Employees; *Fair Debt Collection Practices Act* [41] Violations; Notices of Liens; Seizures; Illegal Protestor Designations; Assessment Statute of Limitations; Collection Due Process Appeals; Denial of Requests for Information; 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 and in documenting that taxpayer rights were protected. However, TIGTA continues to identify the same deficiencies in the IRS's processing of collection due process cases. TIGTA reported in July 2012[42] that the Office of Appeals did not always classify taxpayer requests properly and, as a result, some taxpayers received the wrong type of hearing. TIGTA also identified an increase in errors relating to the determination of the Collection Statute Expiration Data on taxpayer accounts. In addition, TIGTA reported that Appeals personnel continue to fail to document their impartiality in all cases. These deficiencies may result in taxpayers not receiving their full rights during an appeal hearing.

As previously noted, the IRS is seeing a significant growth in identity-theft cases. Identity theft remains the single largest type of complaint submitted to the Federal Trade Commission's Consumer Sentinel Network.[43] The Federal Trade Commission estimates that as many as nine million Americans have their identities stolen each year. Identity

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[38] TIGTA, Ref. No. 2011-30-118, *The 2009 Offshore Voluntary Disclosure Initiative Increased Taxpayer Compliance, but Some Improvements Are Needed* (Sept. 2011).
[39] Pub. L. No. 111-147, Subtitle A, 124 Stat 71, *96-116 (2010)(codified in scattered sections of 26 U.S.C.).
[40] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered section 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] 15 U.S.C. §§1601 note, 1692-1692o (2006).
[42] TIGTA, Ref. No. 2012-10-077, *Office of Appeals Errors in the Handling of Collection Due Process Cases Continue to Exist* (July 2012).
[43] The Federal Trade Commission's Consumer Sentinel Network is an investigative cyber tool and complaint database, restricted to law enforcement use, that provides civil and criminal enforcement organizations immediate and secure access to identity theft and other consumer-related complaints.

theft affects the IRS and tax administration in two ways – fraudulent tax returns and misreporting of income.[44] Both can potentially harm taxpayers who are the victims of identity theft.

ACHIEVING PROGRAM EFFICIENCIES AND COST SAVINGS

Given the current economic environment and the increased focus by the Administration, Congress, and the American people on Federal Government accountability and efficient use of resources, the American people must be able to trust that their Government is taking action to stop wasteful practices and ensure that every tax dollar is spent wisely. During the Fall of 2011 through Summer 2012, numerous Department of the Treasury, Office of Management and Budget, and Presidential Executive Orders and other guidance documents were issued to ensure that the Government is a good steward of taxpayer money by identifying opportunities to promote efficient and effective spending and eliminating excess spending on conferences and travel.

This management challenge is even more compelling given the IRS's Fiscal Year 2012 budget, which was reduced over $300 million from Fiscal Year 2011, approximately a 2.5 percent cut. As a result, the IRS reduced its administrative costs, offered early outs and buy outs, and made difficult decisions in taxpayer service and enforcement operations.

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. In a recent audit, we assessed the IRS's progress in achieving real estate cost savings to meet the President's Fiscal Year 2012 Federal real estate cost savings goals. On June 10, 2010, President Obama directed Government agencies to eliminate excess properties and achieve $3 billion in savings by the end of Fiscal Year 2012. Our review found that the IRS achieved some cost savings in support of the President's goal. However, these efforts are impeded by the lack of an established policy and effective strategy on implementing workstation sharing by IRS employees who telework. A policy requiring employees who telework to share workstations would allow the IRS to further reduce its long-term office space needs and achieve additional cost savings. This would allow the IRS to reduce its office space needs by almost 1 million square feet, resulting in potential rental savings of approximately $111.4 million over five years.[45]

CONCLUSION

This memorandum is provided as our annual summary of the most serious major management and performance challenges confronting the IRS in Fiscal Year 2013. TIGTA's *Fiscal Year 2013 Annual Audit Plan* contains our proposed reviews, which are organized by these challenges. If you have any questions or wish to discuss our views on the challenges in greater detail, please contact me at (202) 622-6500.

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

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[44] The Federal Trade Commission's Identity Theft website, *What is Identity Theft?* (http://www.ftc.gov/bcp/edu/microsites/idtheft/consumers/about-identity-theft.html#Whatisidentitytheft).
[45] TIGTA, Ref. No. 2012-10-100, *Significant Additional Real Estate Cost Savings Can be Achieved by Implementing a Telework Workstation Sharing Strategy* (Aug. 2012).

**MANAGEMENT'S RESPONSE TO THE
MANAGEMENT AND PERFORMANCE CHALLENGES IDENTIFIED BY THE
TREASURY INSPECTOR GENERAL
AND
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**

In their memoranda dated October 25 and 15, 2012, the Treasury Inspector General (IG) and Treasury Inspector General for Tax Administration (TIGTA), respectively, identified the major challenges facing management. The Department of the Treasury concurs with the IG and TIGTA on these challenges. These challenges do not necessarily indicate deficiencies in performance; rather, some represent inherent risks that must be monitored continuously. Moving forward, Treasury will continue to address these issues proactively. The following tables summarize the major management and performance challenges facing the Department of Treasury, and provide information on the actions taken by Treasury in fiscal year 2012 and planned for fiscal year 2013 and beyond. The IG's matters of concern are also addressed below.

Timothy F. Geithner
Secretary of the Treasury
November 15, 2012

RESPONSE TO OIG

OIG CHALLENGE NO. 1	SUMMARY OF MAJOR ISSUES
Transformation of Financial Regulation	• Maintain an effective Financial Stability Oversight Council process supported by the Office of Financial Research and Federal Insurance Office within Treasury • Build a streamlined banking regulatory structure that timely identifies and strongly responds to emerging risks

Financial Stability Oversight Council (Council)

Fiscal Year 2012 Accomplishments

- Held 11 meetings of the FSOC (Council) to discuss and analyze emerging market developments and financial regulatory issues
- Initiated monitoring for potential risks to U.S. financial stability, with a focus on significant financial market developments and structural issues within the financial system
- Began to evaluate certain nonbank financial companies for supervision by the Federal Reserve and enhanced prudential standards
- Designated eight financial market utilities to be subject to enhanced prudential standards and supervisory requirements
- Published the following studies and reports on:
    - Feasibility, benefits, costs, and structure of a contingent capital requirement for nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies
    - Actions taken in response to the U.S. Government Accountability Office's report entitled, *National Credit Union Administration: Earlier Actions are Needed to Better Address Troubled Credit Unions*
- Continued to build out the Council's institutional framework, adopting rules of operation, releasing proposed regulations implementing Freedom of Information Act obligations, adopting a transparency policy, and passing a budget for the Council operations

Actions Planned or Underway

- Coordinate with the Council member agencies to consult with the Federal Reserve on developing rules for establishing enhanced prudential standards
- Continue identification of specific nonbank financial companies for supervision by the Federal Reserve and enhanced prudential standards

- Coordinate issuance of final regulations implementing the Volcker Rule with member agencies and on credit risk retention for asset-backed securities with member agencies
- Continue monitoring for potential risks to U.S. financial stability, with a focus on significant financial market developments and structural issues within the financial system

Office of Financial Research (OFR)

Fiscal Year 2012 Accomplishments

- Issued its first Annual Report to Congress, containing analysis and tools for monitoring threats to U.S. financial stability
- Provided analytical and data-related support to the Council and its member agencies, focusing initially on nonbank financial company designations and support for the Council's annual report
- Provided Council with the initial Financial Stability Monitor – a dashboard of financial stability metrics and indicators
- Supported the Council's Data Committee as a forum for Council-wide coordination on data-related issues, including data sharing, data standardization, and data security
- Continued to play a leadership role in achieving the global Legal Entity Identifier
- Launched a Working Paper Series and a Research Seminar Series
- Cohosted OFR-Council Conference, "The Macroprudential Toolkit: Measurement and Analysis" and conducted a workshop on stress testing
- Finalized preparations for an advisory committee under the Federal Advisory Committee Act procedures
- Established a comprehensive strategic planning and performance management system based on the OFR's first Strategic Framework and comprehensive implementation planning tools to ensure the OFR's research, data, human resources, budget, and other operational activities are aligned with and support its long-term goals
- Established foundational operational policies and procedures, including those related to information security
- Accelerated ramp-up in staffing (from 20 to 120), began build-out of core information technology (IT) and business infrastructure, and established foundational controls and procedures

Actions Planned or Underway

- Conduct essential research on risks to financial stability and evaluate responses to those risks in collaboration with outside researchers, with a particular focus on evaluating metrics for measuring risks to financial stability; evaluating stress tests that may prove useful in financial stability analysis; and promoting best practices in financial institution risk management
- Expand analytical and data-related support to the Council, including work to support the Council's designations of nonbank financial companies, providing data for the Council's use in connection with its Annual Report on financial stability, and by supporting work of the Council's Data Committee
- Build on the OFR's secure analytical environment through core investments in long-term IT infrastructure and collaboration tools
- Map the OFR's data security classification to other Council members as the basis for data sharing
- Continue to expand communication, including enhancements to the OFR website
- Update and implement the OFR's fiscal year 2012-2014 Strategic Framework, including the tracking of foundational performance measures tied to the Framework's established goals
- Continue the momentum to achieve the steady-state staffing projected for fiscal years 2014-2015

Federal Insurance Office (FIO)

Fiscal Year 2012 Accomplishments

- Drafting reports required by the Dodd-Frank Act, specifically the insurance regulatory modernization report and the annual report on the insurance industry
- Acted as leading insurance expert on the Council
    - Helped develop the Council's final rulemaking on determination of nonbank financial companies for consolidated supervision by the Federal Reserve and enhanced prudential standards
    - Provided insurance expertise in Council committees and working groups
    - Led the Stage 2 analysis of one nonbank financial company in connection with the Council's consideration of nonbank financial companies for supervision by the Federal Reserve and enhanced prudential standards

  - Contributed to the development of the Stage 2 analysis for another nonbank financial company being considered by the Council for supervision by the Federal Reserve and enhanced prudential standards
- Represented the U.S on the International Association of Insurance Supervisors (IAIS)
  - Played leading role in developing IAIS methodology for identifying globally significant international insurers (G-SIIs)
  - Collected and analyzed data for U.S. insurance firms being considered for designation as G-SIIs
  - Played leading role in developing policy measures to be applied to G-SIIs
  - Served on IAIS Executive Committee and Macro-Prudential Surveillance Working Group
- Initiated a European Union-U.S. Dialogue with the objective of comparing the design and efficiency of the respective supervisory regimes in order to promote consumer protection, business opportunity and effective regulation
  - The Dialogue has been guided by a Steering Committee that included the FIO Director and leaders from the European Commission, European Insurance and Occupational Pensions Authority, the Financial Services Authority, as well as the state regulators
  - Its work, conducted by separate technical committees, has included the analysis of the two regulatory regimes on the basis of eight key topics (professional secrecy/confidentiality, group supervision, solvency and capital requirements, reinsurance and collateral requirements, supervisory reporting, data collection and analysis, supervisory peer reviews, and independent third party review and supervisory on-site inspections)
- Continued to gather input on FIO's functions, authorities, and strategic priorities, including by engaging with state government leaders, consumer advocates, industry leaders, and international counterparts
- Convened the first Federal Government Insurance Forum in March 2012
- Developed data collection and analysis processes with OFRSelect members, convened and supported the first Federal Advisory Committee on Insurance
- Attended and participated in the Strategic and Economic Dialogue with China

Actions Planned or Underway

- Serve as the IAIS's Chairman of Technical Committee
- Release the studies and reports required by the Dodd-Frank Act
- Continue and expand participation in the Council and its supporting committees
- Support and provide leadership for IAIS initiatives, including the Executive Committee, the Financial Stability Committee, and the Technical Committee
- Develop indicia to measure, and implement processes to collect data, when determining affordability and accessibility of insurance to traditionally underserved communities
- Develop limits of FIO subject matter jurisdiction, in coordination with the Department of Health and Human Services
- Further develop insurance sector data collection and analysis processes with OFR
- Expand bi-lateral supervisory relationships in Asia and South America
- Further build and develop staff and resources

Office of the Comptroller of the Currency (OCC)

Fiscal Year 2012 Accomplishments

- Published final rule that addresses section 939A of the Dodd-Frank Act by removing references to credit ratings from OCC's regulations dealing with topics other than capital requirements replacing it with a new non-ratings based creditworthiness standard (i.e., investment grade standard)
- Published final market risk rule that implements various enhancements adopted by the Basel Committee on Banking Supervision to strengthen the capital requirements that apply to banks' trading activities
- Published a set of proposals that revised the agencies' current "advanced approaches" risk-based capital rules and replaced the agencies' current generally applicable risk-based capital rules with rules that implement various enhancement adopted by the Basel Committee
- Published a Notice of Proposed Rulemaking to implement the company-run stress tests for banks with assets greater than $10 billion and timeline for implementation stress test based on the size of the institution

- Issued interagency guidance on stress testing principles for banks with assets greater than $10 billion.
- Issued proposed rules implementing section 619 of the Dodd-Frank Act prohibiting and limiting the ability of a banking entity and a nonbank financial company supervised by the FRB to engage in propriety trading and to have certain interests in, or relationships with, a hedge fund or private equity fund (Volcker Rule)
- Adopted an interim final rule amending its lending limit rule to apply to certain credit exposures arising from derivative transactions and securities financing transactions, in response to a Dodd-Frank revision in the statutory definition of loans and extensions of credit to include certain exposures arising from derivative, repurchase and securities transactions
- Issued proposed rules for appraisals on higher-risked mortgages
- Developed rulemaking proposals to harmonize rules in the context of OCC-Office of Thrift Supervision (OTS) integration in the areas of securities, compliance and real estate, bank operations, and licensing
- Continued active participation in the Council and its various operating committees
- Signed Memorandum of Understanding with the Consumer Financial Protection Bureau (CFPB) implementing the coordination requirements for supervisory activities
- With other regulatory agencies, issued a statement on measurement of total assets of an insured bank, thrift or credit union for purposes of determining supervisory and enforcement responsibilities under the Dodd-Frank Act, referencing the CFPB's examination and enforcement authority regarding certain consumer financial laws over institutions with total assets of more than $10 billion, and their affiliates
- Developed and issued a semi-annual risk perspectives report that provides the industry and other interested parties the OCC's perspectives on issues that pose threats to the safety and soundness of those financial institutions regulated by the OCC
- Initiated an Independent Foreclosure Review process for people seeking review of their mortgage foreclosures, increased communication efforts to inform affected parties, and extended the deadline for review requests to December 31, 2012, pursuant to comprehensive OCC 2011 enforcement orders against four large national bank mortgage servicers regarding mortgage servicing and foreclosure deficiencies
- Completed operational integration of OTS and OCC staff and offices which included continued integration of OCC and OTS policies and examination handbooks
- Utilized a variety of supervisory and enforcement tools that resulted in the recapitalization of a total of 15 problem institutions through capital injections, merger, or acquisition

Actions Planned or Underway

- Continue to conduct on-site supervisory assessments of national banks and Federal savings associations, focusing on the quality of corporate governance, risk management practices, adequacy of loan-loss reserves, and capital
- 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 federal savings associations and the banking system, and fair access to financial services
- Continue to integrate OCC national bank and OTS federal savings association rules under OCC regulations
- Work closely within Treasury and with other federal financial regulatory agencies to implement the Dodd-Frank Act reforms, and to monitor and respond to emerging risks to the stability of the U.S. financial system
- Continue to pursue a range of strategies to rehabilitate/recapitalize problem institutions
- Continue strategies to resolve problem banks effectively by identifying problems at the earliest possible stage; clearly communicating concerns and expectations to bank management and the Board of Directors; using focused enforcement actions to require the necessary corrective actions; and ensuring timely follow-up on the implementation and effectiveness of corrective actions
- Continue to use supervisory analytical tools, filters and risk based analytics to provide early identification of banks that may be vulnerable to existing or emerging risks

OIG CHALLENGE NO. 2	SUMMARY OF MAJOR ISSUES
Management of Treasury's Authorities Intended to Support and Improve the Economy	• Protect the taxpayer from unnecessary risk associated with the implementation and administration of programs intended to support and improve the economy, including the provisions of the: - *Small Business Jobs Act of 2010* - *American Recovery and Reinvestment Act of 2009* - *Housing and Economic Recovery Act of 2008* - *Emergency Economic Stabilization Act of 2008*

Small Business Lending Fund (SBLF)

Fiscal Year 2012 Accomplishments

- SBLF supports the Treasury strategic goal, "repair and reform the financial system and support the recovery of the housing market." In total, the SBLF provided $4.03 billion to 332 community banks and community development loan funds
- In fiscal year 2012, the SBLF program office transitioned from its fiscal year 2011 focus on application review and transaction execution activities to asset management, operations, compliance and controls, and outreach and reporting activities
- Specifically, the SBLF program office focused on the following activities:
    - <u>Asset Management</u>: Monitored the SBLF investment portfolio and made recommendations to senior Treasury officials on decisions related to investment performance and activities; all participants have made all expected dividend or interest payments
    - <u>Operations</u>: Managed the program's data and information in connection with participant reporting, dividend and interest payments, capital repayments, and correspondence
    - <u>Compliance and Controls</u>: Developed a compliance program which monitors participant conformance with program terms, including lending data, certification requirements, and other requirements provided for by the SBLF Securities Purchase Agreement. SBLF also developed and executed internal control procedures for processes across SBLF program office functions
    - <u>Reporting and Outreach</u>: Continued its outreach and reporting efforts in fiscal year 2012, as these activities included reporting to Congress on the program's transactions, costs, and the participants' use of funds as well as developing and distributing the program's first annual lending survey (As of June 30 2012, SBLF participants have increased small business lending by $6.7 billion over a $36.0 billion baseline)

Actions Planned or Underway

- For fiscal year 2013 and forward, the SBLF program office plans to continue its focus on asset management, dividend and interest operations, compliance and oversight, and outreach and reporting
- Specifically, the SBLF program office will focus on the following activities:
    - <u>Asset Management</u>: Plans continue to monitor the SBLF investment portfolio and make recommendations to senior Treasury officials on decisions related to investment performance and activities
    - <u>Operations</u>: Plans continue to manage the program's data and information in connection with participant reporting, dividend and interest payments, capital repayments, and correspondence
    - <u>Compliance and Controls</u>: (1) Plans continue to execute a compliance program to monitor participant conformance with program terms, including lending data, certification requirements, and other requirements provided for by the SBLF Securities Purchase Agreement; and (2) Plans continue to execute internal control procedures for processes across SBLF program office functions
    - <u>Reporting and Outreach</u>: Plans continue its outreach and reporting efforts in fiscal year 2013, as these activities include reporting to Congress on the program's transactions, costs, and the participants' use of funds as well as publishing the results of the program's first annual lending survey and issuing the second annual survey

State Small Business Credit Initiative (SSBCI)

Fiscal Year 2012 Accomplishments

- Approved 18 states for $300 million in SSBCI allocations in 2012 (As of September 30, 2012 Treasury had approved 57 states, territories, the District of Columbia, and consortia of municipalities (Participating States) for $1.44b in Allocated Funds. Of the 57 Participating States, 56 had received their first of three disbursements of funds; and 5 had received their second disbursement)
- Processed requests from Participating States to modify Approved State Programs for 8 states
- Published National Compliance Standards to recommend best practices to meet or exceed the compliance expectations that Treasury has for that Participating States in terms of oversight, supervision, and accountability
- Revised Frequently Asked Questions (FAQ) in response to OIG recommendations including the addition of an FAQ defining a material adverse change in a state's fiscal or operational condition that must be reported to Treasury
- Held a national conference attended by 160 managers and stakeholders from 53 Participating States
- Conducted three open conference calls to build awareness and understanding of the National Compliance Standards and the revised and new FAQs, and to provide guidance for compliance related questions
- Implemented an on-line reporting system for Participating States to utilize in order to submit quarterly and annual reports
- Initiated compliance sampling of transactions which were reported by Participating States in the December 31, 2011 annual report
- Provided ongoing technical assistance to Participating States, including 33 site visits

Actions Planned or Underway

- Host a second national conference of Participating State managers and other key stakeholders in October 2012, in Chicago
- Process modification and disbursement requests from Participating States on an ongoing basis
- Continue to provide guidance and prompt responses to questions initiated by Participating States

Management of Recovery Act Programs

Fiscal Year 2012 Accomplishments

- Managed the low income housing and specified energy property programs, including the extension of the specified energy property program by one year under Section 707 of the Job Creation Act, by supplementing a small core staff in Departmental Offices with support from Treasury bureaus
- Provided follow-up and support as necessary to Recovery Act Community Development Financial Institutions (CDFI) Program and Native American CDFI Assistance Program awardees with remaining federal reporting requirements in fiscal year 2012 (35 of original 69 Recovery Act awardees), to ensure timely reporting to Federal Reporting.gov (100 percent on-time rate was achieved for fiscal year 2012)
- Provided follow-up and support as necessary to all 69 Recovery Act CDFI Program and Native American CDFI Assistance Program awardees, to ensure timely receipt of quarterly reports to the CDFI Fund (99 percent on-time reporting was achieved for fiscal year 2012)
- Verified final report submission to Federal Reporting.gov by 13 Recovery Act CDFI Program and Native American CDFI Assistance Program awardees
- Continued an interagency agreement for the energy program with the Department of Energy to assist with the technical aspects of that program
- Implemented an annual reporting process for the low-income housing program to ensure projects funded under the program remain qualified

Actions Planned or Underway

- Continue to provide follow-up and support to 22 remaining Recovery Act CDFI Program and Native American CDFI Assistance Program awardees with federal reporting requirements, to ensure 100 percent on-time reporting
- Provide follow-up and support to all 69 Recovery Act CDFI Program and Native American CDFI Assistance Program awardees to ensure on- time reporting of quarterly reports submission to the CDFI Fund
- Continue the compliance monitoring programs related to the low-income housing and specified energy property programs

- Continue to coordinate with IRS's compliance initiative project regarding the energy program
- Continue assessment of staffing needs

Management of the Housing and Economic Recovery Act (HERA) and the Emergency Economic Stabilization Act (EESA)

Fiscal Year 2012 Accomplishments

- Continued to manage the wind-down of remaining Troubled Asset Relief Program (TARP) investments in a manner that balanced exiting investments as soon as practicable with maximizing returns for taxpayers
- Collected 88.5 percent of the $417.6 billion in program funds disbursed under TARP
- Continued to implement the housing programs funded under TARP, which are designed to prevent avoidable foreclosures; these efforts have directly helped more than one million people avoid foreclosure and indirectly helped millions more by setting new standards throughout the mortgage servicing industry

Actions Planned or Underway

- Continue to manage the wind-down of remaining TARP investments in a manner that balances exiting as soon as practicable with maximizing returns for taxpayers
- Continue to implement the housing programs funded under TARP, which are designed to prevent avoidable foreclosures

OIG CHALLENGE NO. 3	SUMMARY OF MAJOR ISSUES
Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act (BSA) Enforcement	• Prevent and detect money laundering and terrorist financing • Promote U.S. and international financial systems that are safe and transparent • Ensure continued cooperation and coordination of all organizations involved in anti-money laundering and combatting terrorist financial efforts • Create safeguards over the use of BSA information

FinCEN

Fiscal Year 2012 Accomplishments

- Continued to enhance the sharing of information derived from compliance examinations through: 69 memoranda of understanding (MOU) with federal and state regulators; coordination with State regulators and the IRS on examination and risk targeting of non-bank financial institutions [particularly money service businesses (MSB)]; and agreement with the National Association of Insurance Commissioners to include examination for compliance with FinCEN's regulations within the scope of State insurance regulator examinations
- Subjected non-bank residential mortgage lenders and originators to requirements to establish anti-money laundering programs and file suspicious activity reports (SARs), worked with the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators on a joint examination framework, and issued guidance on regulatory expectations for bank mortgage lending affiliates subject to examination by Federal banking regulators
- Required mandatory electronic filing of most BSA reports by June 30, 2012, subject to certain limited exemptions and exceptions, and released new unified reporting templates for all industries to file SARs and Currency Transaction Reports, which will become mandatory by March 2013, and further improve the quality of reported information
- Issued Notice of Proposed Rulemakings that would apply anti-money laundering (AML) program and SAR rules to housing government-sponsored enterprises, applied reporting requirements on the international transport of certain tangible prepaid access devices, and applied certain special measures under Section 311 of the USA PATRIOT Act; also issued an Advance Notice of Proposed Rulemaking to solicit public comment on questions related to the development of a customer due diligence (CDD) regulation that would clarify, consolidate, and strengthen existing CDD obligations and incorporate collection of beneficial ownership information
- Conducted strategic analytical studies and published reports promoting greater awareness of emerging money laundering trends and vulnerabilities, including assessments related to mortgage fraud, title and escrow companies, and the gaming industry, and issued analytical reports to state regulatory authorities on activities involving MSBs in addition to overall BSA filing trends within their jurisdictions

Actions Planned or Underway

- Continue cooperative efforts with Federal and State regulatory agencies, pursuing memorandum of understandings with additional state insurance regulators, and promoting greater leveraging of resources between the IRS and state regulatory agencies on non-bank financial institution examinations – including implementation of compliance strategies for industries that have been recently subject to FinCEN's regulations
- Continue working towards finalizing rulemaking proposals, as well as proposed and/or final regulations related to AML program and SAR rules for investment advisers, proposed and/or final regulations pursuant to Section 311 of the USA PATRIOT Act, and various technical and other regulatory amendments in conjunction with review of existing regulations
- Continue to implement the BSA IT Modernization Program, and continue the transition of remaining paper filers to electronic filing and all filers to the new unified reporting formats
- Continue to issue guidance to institutions as needed and to issue additional financial institution advisories as risks emerge
- Continue to publish analytic products, which assess trends and patterns in mortgage fraud and other financial crimes as appropriate, and develop new processes to streamline recurring analytic reports using FinCEN modernization tools in order to provide faster turnarounds to customers
- Continue to exercise enforcement authorities for violations of FinCEN's regulations, where appropriate

OCC

Fiscal Year 2012 Accomplishments

- Examined national banks and Federal savings associations to combat money laundering and terrorist financing, and to protect the integrity of the U.S. financial system through banks' compliance with the BSA, AML, and USA PATRIOT Act laws and regulations, taking enforcement actions when appropriate
- Issued a cease and desist order against Citibank, N.A., Sioux Falls, South Dakota, for violating the BSA and its underlying regulations (The order required the bank to take comprehensive corrective actions to improve its BSA compliance program)
- Worked with the Federal Financial Institutions Examination Council to issue a statement on outsourced Internet cloud computing services that discusses key risk considerations associated with these activities
- Continued to review training, staffing, recruitment, policies, and interagency coordination to make improvements to the BSA/AML supervision program
- Continued to work closely with the Treasury's Office of Terrorism and Financial Intelligence, FinCEN and Office of Foreign Assets Control to promote the implementation of sound international anti-money laundering and counter terrorist financing standards
- Revised and clarified the operation of the cross-functional Large Bank BSA Review Team to bring different perspectives to bear and react more timely where a bank has multiple instances of Matters Requiring Attention or apparent violations of the required components of the BSA/AML program
- Developed directions to examiners to view serious deficiencies in a bank's BSA/AML compliance area, including program violations, as presumptively adversely affecting a bank's Management component rating and provided guidance on how to document application of this approach in determining the Management component rating

Actions Planned or Underway

- Revise approach to citing BSA/AML violations in order to provide more flexibility for individual pillar violations to be cited, and identified steps to more promptly obtain a holistic view of a bank's BSA/AML compliance
- Continue examination, enforcement activities, and cooperative efforts with FinCEN and other federal banking agencies

OIG CHALLENGE NO. 4	**SUMMARY OF MAJOR ISSUES**
Gulf Coast Restoration Trust Fund Administration	• Monitor regulations and associated policies and procedures that need be established • Coordinate with many entities/councils that are to receive and further allocate funding, and need to establish policies and procedures • Use Treasury's existing resources to administer its responsibilities for the Trust Fund

Fiscal Year 2012 Accomplishments

- Ongoing consultation with Departments of Commerce and Interior
- Obtained anomaly for the fiscal year 2013 continuing resolution
- Discussed issues and questions with Gulf Restoration Council members including all five states
- Discussed issues and questions with other external stakeholders such as the Florida Association of Counties and several environmental groups
- Briefed staff of five Senators on current thinking regarding required Treasury regulation
- Ongoing discussions with OMB and White House Council on Environmental Quality
- Drafted Treasury regulation

Actions Planned or Underway

- Obtain OMB approval of draft regulation
- Continue to brief staff for interested Congress members, as requested
- Share draft regulation with Gulf Restoration Council members prior to public comment
- Provide for 30-day comment period
- Publish final (or interim final) rule in January 2013
- Work with OMB to establish trust fund account structure
- Develop memorandum of understanding with Federal members of the Gulf Restoration Council
- Develop policies and procedures for ongoing review/oversight of program

Matters of Concern No. 1	**SUMMARY OF MAJOR ISSUES**
Cyber Security	• Build on existing partnerships among financial institutions, regulators, and private entities in the financial sector • Identify and respond to emerging cyber threats against financial institutions and the broader financial sector

Fiscal Year 2012 Accomplishments

- Partners: (1) Strengthened the public/private partnership by clarifying roles and improving the leadership model; and (2) Commissioned a review of the system of the sector coordinating council (Financial Services Sector Coordinating Council for Critical Infrastructure Protection, FSSCC), the sector communications utility (Financial Services Information Sharing and Analysis Center, FS-ISAC), and the regulatory committee (Financial and Banking Information Infrastructure Committee, FBIIC)
- Information Sharing: (1) Piloted an information-sharing platform, to exchange sensitive information between the financial sector and the defense industrial base (Global Information Sharing Framework); (2) Launched an initiative to adapt a defense industrial base sensors program [Defense Enhanced Cyber security Services (DECS)] to help protect the financial sector; and (3) Extended the communications networks beyond the specialists in the largest, most active firms to executives at various levels and to firms of all sizes
- Policy Development: (1) Provided substantial input on key Administration cyber security proposals, including legislation, potential executive orders, and potential policy directives; (2) Provided insights and potential solutions regarding the stated and imputed positions of industry and regulators; and (3) Pursued opportunities for bridging sector-specific options and cross-sector options, often by participating in interagency-led programs

- Identification of Emerging Threats: (1) Convened classified discussions with 60 Chief Information Officers and Chief Information Security Officers from 30 firms to identify and address emerging threats; and (2) Collaborated with private and public sector partners to assess the emerging risks associated with the Internet Corporation for Assigned Names and Numbers proposal to delegate new financial Internet suffixes, including ".bank", ".mortgage", ".insurance", and ".retirement"
- Response to Emerging Threats: (1) Coordinated government and industry responses to attacks on individual institutions and on major sub-sectors of financial services; and (2) Facilitated requests for Technical Assistance and existing Memoranda of Understanding to deploy government resources in defense of critical infrastructure

Actions Planned or Underway

- Partners: Promoting heightened capabilities among partners, including supporting enhanced access, staffing and automation at the sector communications utility (Financial Services Information Sharing and Analysis Center, FS-ISAC)
- Information Sharing: (1) Partnering with Department of Homeland Security (DHS) to adapt the defense industrial base sensors program (DECS) to meet the needs of the financial sector and all of the other critical infrastructure sectors; (2) Partnering with DHS, the intelligence community and law enforcement to build a cyber-intelligence capability dedicated to protecting the financial sector; and (3) With the FSSCC and FS-ISAC, enlisting the trade associations to extend effective crisis management and communications to firms of all sizes
- Policy Development: (1) Continuing to provide input on key Administration cyber security proposals, as well as actively pursuing the implementation of adopted policies; and (2) Supporting and institutionalizing the integration of financial services-specific efforts with DHS' cross-sector activities
- Identification of Emerging Threats: (1) Commissioning and managing a multi-year research project with the Institute for Defense Analyses, to identify, assess and address emerging systemic threats to critical infrastructure; (2) Continuing to provide input on the potential risk of domain name expansion (e.g. ".bank"); and (3) Actively collaborating with private and public sector stakeholders to address the risks and to capitalize on any opportunities
- Response to Emerging Threats: (1) Continuing to address individual incidents and patterns of attack; and (2) Pursue long-term improvement in the processes by which the federal government assists in the defense of the financial sector

Matters of Concern No. 2	**SUMMARY OF MAJOR ISSUES**
Currency and Coin Production	• Oversee issues related to BEP's redesign of NexGen $100 note while engaging in sound and comprehensive project management • Oversee the United States Mint's costs associated of producing penny, nickel coins, and the suspended production of the dollar coins

Fiscal Year 2012 Accomplishments

- The Bureau of Engraving and Printing (BEP) established a Portfolio and Project Management Office that will develop and institutionalize standardized project management processes
- The BEP implemented a Production Validation protocol in collaboration with the Federal Reserve Board (FRB) and the United States Secret Service, to ascertain whether preproduction testing met agreed upon standards (Validation at the Western Currency Facility (WCF) was successful and the NexGen $100 note was put back into production; in fiscal year 2012, the WCF delivered 1.1 billion NexGen $100 notes to the FRB)
- The United States Mint created a Research and Development (R&D) Center at its facility in Philadelphia to improve capacity to conduct ongoing R&D as it relates to coin production and any opportunities that will create efficiencies

Actions Planned or Underway

- The BEP production validation for the NexGen $100 note will commence in Washington, DC with production expected to commence by mid-year
- The United States Mint will deliver an alternative coinage materials report to Congress in fiscal year 2013 that will provide an assessment for both metal and production costs
- The BEP will continue to work with the FRB, as they are the issuing authority for all currency and will determine the release date for the NexGen $100 note
- The BEP is working with the Office of Personnel Management to create a multi-tier candidate assessment tool to identify the most qualified candidates for the Portfolio and Project Management Office

Matters of Concern No. 3	**SUMMARY OF MAJOR ISSUES**
Documenting Key Activities and Decisions	• Promote an effective records management program to ensure Treasury management personnel remain aware and vigilant

Fiscal Year 2012 Accomplishments

- The Department received the 2012 Archivist Achievement Award which recognizes the Federal agencies that are collaborative, use technology in innovative ways to solve records management challenges, and demonstrates support of the Presidential Memorandum--Managing Government Records goals to improve performance, policies and practices; promote openness; and accountability by better documenting agency actions and decisions
- The Treasury Learning Management System is now available for all Treasury bureaus to increase awareness among all Treasury employees and contractors regarding their roles and responsibilities to preserve and manage Treasury's records and information in accordance with a variety of laws, regulations, and Treasury directives
- The Office of Treasury Records, in conjunction with the Treasury Printing & Graphics Division, partnered to offer high-quality digitization services to offices within the Department of Treasury which is a cost-effective paper-to-electronic solution that minimizes records storage facility fees
- The Department sponsored 29 records management related training sessions during April 2012 that attracted 590 participants from 43 Federal government agencies including the Department of the Treasury
- Ensured compliance with Federal records regulations, Treasury's Office of Treasury Records conducted reviews of each bureau records management program, documented findings, and made recommendations to improve the effectiveness and efficiency in the respective programs

Actions Planned or Underway

- Updating the Department's policy for records management, to address the use, retention, and disposition of social media and web 2.0 technologies
- Continue receiving quarterly reports from the Treasury bureaus on the status of their Plans of Action and Milestones pursuant to the bureau assessments conducted for ensuring Departmental senior level awareness of the status of bureaus' records management program efforts

Matters of Concern No. 4	**SUMMARY OF MAJOR ISSUES**
Consolidation of Bureau of the Public Debt (BPD) and Financial Management Service (FMS) into Bureau of the Fiscal Service (BFS)	• Ensure the consolidation and restructuring of BPD and FMS into BFS that its separate processes, systems, and workplace cultures are integrated

Fiscal Year 2012 Accomplishments

- Drafted a comprehensive consolidation implementation plan
- Communicated extensively with affected personnel, the National Treasury Employees Union, Congress, and other key stakeholders
- Implemented the initial organizational structure
- Established a new mission and vision

Actions Planned or Underway

- Focus on assisting employees during this transition by providing training and professional outplacement services
- Continue to manage risks by training employees to take on mission-critical functions and clearly communicating organizational structure and reporting relationships
- Continue to engage employees and involve senior leadership in the planning and implementation

RESPONSE TO TIGTA

TIGTA CHALLENGE NO. 1	SUMMARY OF MAJOR ISSUES
Security for Taxpayer Data and Employees	Promote measures for appropriate physical security and protection of financial, personal, and other information

Fiscal Year 2012 Accomplishments

- For the fiscal year 2012 financial statement audit, GAO reported a downgrade of the Information Security material weakness to a significant deficiency based on the results of their testing confined to the generally accepted accounting principles (GAAP) statements; due to the difference in scope as a result of the requirements of the Federal Managers Financial Integrity Act (FMFIA) and the IRS testing completed as of June 30, 2012, IRS will continue to report Information Security as a material weakness; internal testing will continue in order to substantiate an internal downgrade of the existing material weakness
- Realized significant progress in masking Social Security Numbers (SSN) on IRS notices to taxpayers; through the use of Two-Dimensional Barcode Technology, the IRS has reduced the use of SSNs on 46 nonpayment notices, affecting 18.9 million annual taxpayer notices based on the fiscal year 2011 actual
- Deployed the Criminal Investigation Disaster Recovery environment (including servers, networking, and Storage Area Network) at the Martinsburg Enterprise Computing Center that will provide recovery of IT infrastructure and systems
- Integrated the enterprise Authorization (e-Authentication) service with IRS.Gov and the Registered User Portal to allow taxpayers online access to register, request, and obtain an official electronic tax transcript
- Installed Enterprise Physical Access Control System (ePACS) solutions in several IRS locations to ensure secure and reliable forms of identification and access control via the use of SmartID credentials
- Identified, mitigated, and responded to thousands of cyber incidents
- Produced hundreds of advisories and bulletins informing responsible system administrators and users of mitigation actions to address current vulnerabilities and threats impacting IRS systems

Actions Planned or Underway

- Reduce the use of SSNs on an additional 12 notices, increasing the total number of masked nonpayment notices to 58, impacting 20.4 million taxpayer notices
- Build on existing e-Authentication system to provide an additional layer of security for taxpayers and the IRS and support integration of new applications and conversion of existing applications
- Support the new Registered User Portal Initiative and position new Affordable Care Act (ACA) applications by integrating the e-Authentication system with the new portal infrastructure to provide standardized security services in ACA applications with external entities

TIGTA CHALLENGE NO. 2	SUMMARY OF MAJOR ISSUES
Tax Compliance Initiatives	Improve compliance and fairness in the application of the tax laws

Businesses and Individuals

Fiscal Year 2012 Accomplishments

- Conducted research studies to improve voluntary compliance and to allocate resources more effectively including:
  - Revised existing workload selection systems and new machine-learning aids developed based on sample data derived from the Tax Year 2006 National Research Program (NRP) study
  - Delivered for audit review the first returns from the NRP sample of corporate income taxpayers; this was the first reporting compliance study of corporate taxpayers in 30 years
  - Delivered the initial sample returns for a new study involving fuel excise compliance research
- Continued testing soft notices as alternatives to traditional Automated Underreporter (AUR) contacts, mailing several thousand notices from inventory selected from the analytics tool
- Transitioned the Compliance Assurance Program to a permanent element of the IRS compliance strategy and added taxpayer instructions to IRS.gov
- Implemented a cross-functional compliance and outreach plan to address prisoner tax noncompliance

- Improved Questionable Refund Program (QRP) filters for selection criteria, increasing referrals 134 percent
- Produced a new analytical tool, Tier Structure Tool (TST), to aid enforcement of pass-through entities; TST provides the ability to identify the ultimate owners of partnerships, increases the early resolution of tax issues and enhances the administration of Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) procedures

Actions Planned or Underway

- Continue to improve and develop new examination case selection models
- Increase compliance presence and implement actions to combat high levels of noncompliance among Individual Tax Identification Number (ITIN) returns improperly claiming Additional Child Tax Credit
- Analyze the results from the fiscal year 2012 and fiscal year 2013 AUR High Income High Wealth test to expedite classification should the work prove to be productive
- Proceed with Small Business Tax Workshop translations for the following languages: Chinese, Korean, Portuguese, Russian, Polish, French Creole, and Arabic

Tax-Exempt Entities

Fiscal Year 2012 Accomplishments

- Developed the Select Check tool, an on-line search tool that allows users to select an exempt organization and check certain information about its federal tax status and filings, and their eligibility to receive tax-deductible charitable contributions
- Developed a virtual workshop used at stakeholder liaison meetings, to provide guidance to exempt organizations impacted by auto-revocation
- Revised automatic revocation notice to include contact information for organizations seeking to regain tax-exempt status
- Identified and addressed non-compliant exempt organizations based upon data from the redesigned Form 990 (Return of Organization Exempt from Income Tax)

Actions Planned or Underway

- Conduct promoter investigations on tax-exempt and government entity issues
- Support the Security and Exchange Commission's new Office of Municipal Securities to promote compliance with federal tax and securities rules and deter securities fraud
- Identify noncompliant retirement plans based upon risk-modeling data
- Complete implementation of recommendations to improve the staggered determination letter process for employee plans

Tax Return Preparers

Fiscal Year 2012 Accomplishments

- Implemented Phase 2 of the Return Preparer Strategy:
  - Initiated competency testing for paid return preparers seeking to become Registered Tax Return Preparers, conducted more than 31,000 tests and approved applications from approximately 570 continuing education providers
  - Completed the first Preparer Tax Identification Number (PTIN) renewal season; there are approximately 730,000 return preparers with a valid PTIN
  - Began issuance of Registered Tax Return Preparer (RTRP) credentials, a new professional designation for all paid tax return preparers who are not attorneys, Certified Public Accountants, or Enrolled Agents
  - Created Complaint Referral Process to enable both the public and other tax professionals to report claims of improper behavior by a return preparer on Form 14157 (Return Preparer Complaint)
  - Continued to administer a Facebook page, which has thousands of regular followers, and launched a LinkedIn page

Actions Planned or Underway

- Enhance the way the IRS identifies and addresses preparers with the highest risk of noncompliance by using more focused data gathering from the NRP and expanding the treatment methods

TIGTA CHALLENGE NO. 3	**SUMMARY OF MAJOR ISSUES**
Modernization	Improve taxpayer service and efficiency of operations

Fiscal Year 2012 Accomplishments

- Deployed CADE 2 Transition State 1, successfully moving to a daily processing cycle for tax processing and posting of individual taxpayer accounts
  - Allowed faster refunds for more taxpayers
  - Produced more timely account updates (viewable by IRS customer service representatives within 48 hours versus an average of nine days in filing season 2011)
  - Issued taxpayer notices faster (2.79 million notices sent to taxpayers with accounts processed daily versus approximately 284,000 in filing season 2011)
  - Processed over 3 billion transactions and issued 123.4 million refunds totaling $373 billion
- Deployed Modernized e-file (MeF) Release 7 for filing season 2012 and included the rollout of over 130 remaining 1040-family schedule and forms; enhancements expanded MeF reach to 100 percent of the e-File population, or approximately 98.3 million fliers; to date, IRS processed over 101.7 million 1040-related returns and over 11.1 million Business Master File returns through MeF
- Deployed the “Send My Transcript” application, which allows taxpayers to make online requests to send official tax return and tax account transcripts to banks and other financial institutions; initiated the Proof of Concept (PoC) program with multiple vendors and financial institutions

Actions Planned or Underway

- Complete feed from the CADE 2 Database to the Integrated Data Retrieval System, after completion of filing season 2013
- Based on findings and recommendations from the four month pilot study, implement improvements to the “Send My Transcript” PoC application to offer new functionality and attract new adoptees
- Complete Phase II of the Data Center Consolidation Initiative plan

TIGTA CHALLENGE NO. 4	**SUMMARY OF MAJOR ISSUES**
Implementing the Affordable Care Act and Other Tax Law Changes	Effectively implement new tax provisions, including tax-related health care provisions of the *Patient Protection and Affordable Care Act* (ACA), and the *American Recovery and Reinvestment Act* (Recovery Act)

Affordable Care Act (ACA)

Fiscal Year 2012 Accomplishments

- Completed the second filing season for the Small Business Health Care Tax Credit
  - Continued compliance activities on selected tax returns
  - Revised Form 8941 (Credit for Small Business Health Insurance Premiums) to reduce burden on filers and enable IRS to better focus compliance efforts
  - Prepared implementation of phase two of the credit that takes effect in 2014
  - Continued extensive outreach including webinars and reached out to stakeholders including insurance agents/brokers and Hispanic Chambers of Commerce
- Completed the second year of the ACA industry fees for Branded Prescription Drugs collecting $2.8 billion for calendar year 2012
  - Implemented Release 2 of the Branded Prescription Drug Industry Fee Project, which included revisions to Form 8947 (Report of Branded Prescription Drug Information), enhanced due diligence processes, and fee calculation adjustments
- Continued implementation of the new ACA hospital requirements set forth in §501(r)
  - Identified the universe of 3,377 hospital organizations in order to conduct community benefit reviews once every three years
  - Completed 1,406 planned reviews in fiscal year 2012

  - Published proposed regulations on financial assistance policies, limitations on charges, and billing and collection practices of tax-exempt hospital organizations

- Published a revenue procedure and proposed/temporary regulations on the tax exemption of 501(c)(29) organizations (co-op health insurance issuers)
- Published guidance on 22 ACA tax provisions, including Premium Tax Credit, employer provisions, and requirements for group health plans
- With the Department of Health & Human Services (HHS) and other federal agencies, developed new information technology systems that will allow health insurance exchanges beginning in October 2013 to receive federal tax information necessary to make determinations of income-based eligibility for government health programs (e.g., Medicaid) or other financial assistance (e.g., advance premium tax credits)
- Continued ACA outreach activities emphasizing information that taxpayers and tax preparers need to know for 2012 tax return preparation, upcoming developments for filing season 2013, and the major changes for the health insurance exchange system that impact the 2014 tax return (filing season 2015)
- Continued implementation of other ACA mid-horizon provisions
- Analyzed results from a soft letter mailing and federal-state data matching to estimate the indoor tanning services non-filer population; conducted data matching study to identify entities that were liable for tanning tax but had not filed a return and referred cases for audit as appropriate

Actions Planned or Underway

- Continue implementation of ACA mid-horizon provisions including Hospital Insurance Tax on High Income Taxpayers, Net Investment Income Tax, and Industry Fees (Patient-Centered Outcomes Research Trust Fund, and Health Insurance Providers)
- Launch the IRS portion of the HHS/IRS IT interface along with establishing data sharing agreements in support of the 2013 Exchange system Open Season
- Continue working with Federal and State agencies on implementation leading to October 2013 Exchange open season, including outreach, guidance, information technology, and safeguarding of federal tax data
- Continue ACA outreach to stakeholders including individuals, employers, states, insurers, tax professionals, and other third parties

Other Tax Law Changes

Fiscal Year 2012 Accomplishments

- Revised computer programming to ensure the accuracy of First-Time Homebuyer Credit repayment data and updated processing procedures to ensure repayments of the credit are correctly processed
- Implemented a non-compliant withholding (federal income tax withholding that is claimed on a tax return, but which was not actually withheld) rule to prevent the erroneous payment of noncompliant withholding on Social Security Benefits, as well as any refundable credit claimed on returns with noncompliant withholding
- Implemented new American Opportunities Tax Credit rules to prevent the erroneous payment of the Refundable American Opportunities Tax Credit
- Continued to partner with the Software Developers Working Group to improve tax preparation software to help preparers meet their due diligence requirements and reduce errors on Earned Income Tax Credit (EITC) returns
- Completed testing the AUR system for the implementation of the new merchant card and security cost basis reporting, wrote Internal Revenue Manual (IRM) instructions, developed training material to support new security cost basis legislation, and developed the data collection instruments that will be used in the test
- Revised Form 5695 (Residential Energy Credits) to request additional information to support eligibility requirements

Actions Planned or Underway

- Plan activities to add additional issues, such as Fuel Tax Credit and Notice to Shareholder for Long Term Capital Gains, to the noncompliant withholding rule
- Continue to address the duplicate use of addresses and bank account information as a source of scheming and clustering regarding Social Security Numbers (SSNs) and Individual Tax Identification Numbers (ITINs)
- Identify, work, and monitor cases for both Merchant Card and Security Cost Basis Reporting

TIGTA CHALLENGE NO. 5	SUMMARY OF MAJOR ISSUES
Fraudulent Claims and Improper Payments	Effective use of taxpayer funds

Refundable Credits

Fiscal Year 2012 Accomplishments

- Identified more than one thousand Questionable Refund Program (QRP) schemes, comprised of more than two million individual tax returns with billions of potentially fraudulent refund claims, which were detected prior to refunds being issued
- Partnered with the United States Postal Inspection Service and other law enforcement partners to recover tax refund checks and prepaid cards issued in connection with identity theft related returns
- Began multiple duplicate taxpayer identification number (multi-DUPTIN) testing and completed a review of Earned Income Tax Credit (EITC) recertification no-change and default cases
- Influenced the accuracy of EITC returns filed by focusing on EITC paid preparer treatments, including due diligence audits, visits by agents, streamlined injunctions, and educational and compliance notices to first-time and experienced preparers
- Updated EITC Central on IRS.gov (www.eitc.irs.gov), which provides educational and marketing outreach tools for partners, practitioners and media
- Implemented the Automated Questionable Credit (AQC) Program, a streamlined statutory notice process that extends compliance coverage to untreated or under-treated categories of refund fraud or noncompliance cases
- Required EITC paid preparers to complete and attach Form 8867 (Paid Preparer's Earned Income Credit Checklist) to their client's return to meet EITC due diligence requirements
- Collaborated with the Treasury Department in a Partnership Fund project to determine if state data could aid the IRS in administering the EITC

Actions Planned or Underway

- Modify the filters using the pre-certification selection criteria that indicates relationship and residency for EITC recertification
- Complete stand-up and training of two AQC operational groups
- Develop pre-refund examination filters to ensure historical information is available and used to identify taxpayers who claim erroneous refundable credits

Fraudulent Payments

Fiscal Year 2012 Accomplishments

- Conducted an Identity Theft Sweep Week working with the Justice Department's Tax Division and local U.S. Attorneys' offices, resulting in 105 targeted individuals in 23 states; the sweep included 939 criminal charges filed in connection with 69 Indictment/Information filings related to identity theft
- Implemented new filters to detect ID theft before returns were processed and formed a Taxpayer Protection Unit (TPU); TPU customer service representatives' efforts have led to the selection of 387,000 potential identity theft cases, of which 219,000 were confirmed to be identity theft or misled cases, protecting revenue of over $1.49 billion for the IRS
- Created an Identity Theft Clearinghouse to develop and refer identity theft refund fraud schemes for investigation
- Developed the Identity Theft Victim Disclosure Waiver pilot project in Florida, allowing the disclosure of returns and return information associated with accounts of known and suspected victims of identity theft to designated state and/or local law officials, with the express written consent of those victims
- Increased the effectiveness of the identity protection filters and indicators resulting in the isolation of over 450,000 returns and preventing the payout of $1.85 billion in fraudulent refunds, a 45 percent increase over the prior year
- Implemented several new filters to detect ID Theft before returns were processed
- Accelerated the matching of individual tax returns and related information returns to better identify fraudulent returns prior to processing
- Coded the accounts of deceased taxpayers whose SSNs were previously used by identity thieves to file fraudulent returns, and marked accounts of deceased taxpayers whose final tax returns have already been filed

- Revised the 1040 series electronic tax forms to allow for the entry of an Identity Protection Personal Identification Number (IP PIN), and provided IP PINs to over 250,000 taxpayers for the 2012 filing season to ensure taxpayers who were subject to identity theft did not encounter delays in processing their tax returns
- Established a cooperative agreement with more than 100 financial institutions to reject questionable refund deposits

Actions Planned or Underway

- Conduct audits for the multi-DUPTIN program and coordinate with Submission Processing to address the processing of returns with questionable TINs for dependency exemptions
- Continue analyses of Entity Theft and Entity Fabrication issues to prevent non-compliant or fraudulent refund claims
- Enhance the effectiveness of the IP PIN by confirming the address of the impacted taxpayer and issuing the preliminary and actual IP PIN notices earlier to the taxpayer; double the number of IP PINs issued this filing season from 250,000 to 500,000
- Expand Disclosure Waiver Program to include additional states: New York, New Jersey, Pennsylvania, Georgia, Alabama, Oklahoma, Texas, and California
- Collaborate with Social Security Administration (SSA) to more timely use the information related to deceased taxpayers provided to us by SSA, and on a potential change to the routine release of information contained in the Death Master File

Contract and Other Payments

Fiscal Year 2012 Accomplishments

- Developed and disseminated both a User Guide and a Manager Guide to assist business units in performing and monitoring Receipt and Acceptance according to established guidelines, processes, and controls
- Provided guidance on oversight and enforcement responsibilities, and evaluated whether current span of control provides appropriate oversight and made changes, as appropriate
- Developed and provided clear guidance to Credit Card Services on performance of their oversight and enforcement responsibilities for compliance with Purchase Card Program procedures
- Developed interim guidance on reimbursable work cost estimates to augment the Reimbursable Operating Guidelines, ensuring business units submit any and all supporting documentation on costing prior to agreement signature in accordance with the revised guidance

Actions Planned or Underway

- Develop and implement processes to mark or exclude false Forms W-2 (Wage and Tax Statement) from the automated verification process
- Conduct an on-going, full review of all reimbursable agreements
- Reinforce existing policies and procedures governing effective contract management with revamped training for Contracting Officer's Technical Representatives (COTRs) across the IRS

TIGTA CHALLENGE NO. 6	SUMMARY OF MAJOR ISSUES
Providing Quality Taxpayer Service Operations	Improve taxpayer service

Fiscal Year 2012 Accomplishments

- Achieved a Level of Service of 67.6 percent while answering 30.8 million assistor calls
- Launched IRS2Go v2 Smartphone application, with three new features that allow taxpayers to request their transcripts, get the latest news, and watch IRS videos; IRS2Go is available for both iOS and Android devices and has been downloaded by over 450,000 users
- Launched a redesigned IRS.gov website, transitioning the main navigation from role-based (i.e. individual, business, or retirement plan administrator) to intent-based (i.e., file a return, pay a tax bill, check refund status), providing a more efficient path for taxpayers to achieve their goals
- Deployed telephone typewriter One Call Solution, which allows deaf and hard of hearing taxpayers to make a single call to the IRS and gain access to a customer service representative
- Continued to develop new multilingual documents to deliver content about tools and services available to Limited English Proficiency (LEP) taxpayers; translated 47 notices into the top five LEP languages of Spanish, Korean, Chinese, Russian, and Vietnamese and posted to the Multilingual Gateway

- Engaged partners and provided greater access to available services through Saturday service events and other special service days like EITC awareness days
- Completed Virtual Service Delivery (VSD) pilot offering virtual face-to-face service to taxpayers at 15 Taxpayer Assistance Centers nationwide, and two Stakeholder Partnerships, Education, and Communication partner sites
- Continued to provide extended service hours at several locations and alternative service delivery methods to expand service to taxpayers

Actions Planned or Underway

- Continue to monitor VSD activity in the pilot sites, use performance metrics and surveys of taxpayers to gauge satisfaction with the process, and implement 18 more potential VSD sites
- Develop a Spanish version of the IRS2Go Smartphone application
- Re-engineer the next e-services product, Taxpayer Identification Number Matching, which will increase match rate results using search rules modeled after return processing rules
- Formalize the process to track and analyze the impact of targeted outreach on the Taxpayer Advocate Service toll-free assistance line (1-877-ASK-TAS1)

TIGTA CHALLENGE NO. 7	**SUMMARY OF MAJOR ISSUES**
Human Capital	Enable the IRS to achieve its mission

Fiscal Year 2012 Accomplishments

- Reduced time-to-hire to 61.4 days, well below IRS's Hiring Reform's goal of 80 days
- Increased use of cutting edge technologies such as Facebook, Twitter, GovLoop, SecondLife, and LinkedIn to reach wide and diverse applicant pools, promote IRS as an employer of choice, and develop talent pipelines
- Initiated IRS Disability Connection Recruitment Council to obtain valuable feedback from internal and external partners to improve on-boarding process of persons with disabilities
- Increased virtual career fair opportunities, reducing travel costs, and continuing to leverage partnerships and building the applicant pipeline
- Provided service-wide guidance to corporate and embedded human resources staffs and hiring managers with focus on the new Pathways Program
- Continued to use the "Face of the IRS" Program to educate and promote IRS to internal and external applicant pools through recruiting events in which current employees assist in identifying highly interested attendees, speak about work experiences, and provide feedback to recruiters after the event
- Continued the Executive Sponsor Program, which allowed IRS Executives to meet with high level staff on college campuses and participate on non-IRS employment advisory boards, teach in the classroom, and lead case competition projects while recruiting for the IRS
- Implemented Geographic Leadership Communities initiative, which comprises of cross-functional groups of executives that host development opportunities and community building workshops in specific geographic areas
- Received the Bersin & Associates 2012 Learning Leaders Award for utilizing innovative, efficient, and effective approaches to employee learning and talent management

Actions Planned or Underway

- Develop a Service-wide onboarding strategy; the strategy should include components such as: a checklist with step-by-step guidance that should be completed by both new employees and managers during the onboarding process; a process to collect feedback; and additional measures and analyses to evaluate the process
- Enhance IRS Career sites to showcase resources, tools, training, and other information available for managers and HR teams with emphasis on recruitment of veterans and persons with disabilities
- Reassess methods and tools for gathering, analyzing, and monitoring data to determine the right number and skills of the acquisition workforce as resources/tools become available

TIGTA CHALLENGE NO. 8	SUMMARY OF MAJOR ISSUES
Globalization	Increase the outreach efforts to foreign governments on cross-border transactions

Fiscal Year 2012 Accomplishments

- Collected more than $5.5 billion in back taxes, interest, and penalties from the 38,000 voluntary disclosures made under the first two IRS offshore voluntary disclosure initiatives (OVDI) of 2009 and 2011; approximately 1,500 entity disclosures were made through June 2012 under the new program announced in January 2012
- Implemented procedures to conduct a 100 percent review of inputs to the E-Trak Offshore Voluntary Disclosure Program system
- Administered Exchange of Information provisions of U.S tax treaties and tax information exchange agreements (TIEAs) by coordinating specific requests to and from foreign governments
- Created the Advance Pricing and Mutual Agreement Program , a critical component of Transfer Pricing Operations, to develop and share resources and expertise for greater efficiencies and improved case presentation
- Improved cross-border relationships and interactions through participation in organizations such as the Organization for Economic Cooperation and Development , and the Inter-American Center of Tax Administrations
- Continued developing the Gifts-in-Kind project, an international exam-related project that deals with the movement of in-kind charitable gifts offshore
- Collaborated on global outreach, compliance, and guidance issues with key stakeholders, including the Department of Labor and the Pension Benefit Guaranty Corporation to expand joint US Territory compliance and virtual outreach efforts
- Opened new international money laundering investigations, via the Global Illicit Financial Team, that focused on large institutions that facilitate global money laundering
- With FBI, Secret Service, and Homeland Security, developed additional targets in the concealment of illegal proceeds through International financial Institutions and other professional money laundering organizations in the International Money Laundering arena

Actions Planned or Underway

- Continue offshore compliance programs focused on abusive arrangements involving offshore transactions
- Gather information about foreign accounts held by U.S. taxpayers via TIEAs and implementation of the Foreign Account Tax Compliance Act
- Expand the Joint Audit Initiative with foreign tax administrations and taxpayers by coordinating with treaty partner jurisdictions to determine whether there is interest in taking specific Joint Audits forward
- Develop cases on global money launderers through partnership with the Treasury's Office of Terrorism and Financial Intelligence

TIGTA CHALLENGE NO. 9	SUMMARY OF MAJOR ISSUES
Taxpayer Protection and Rights	Apply the tax laws fairly

Fiscal Year 2012 Accomplishments

- Reinforced taxpayer protection and rights through leadership messages at all levels of the organization
- Created a cross-functional team to address the increasing volume of identity theft cases and the incomplete processes used to resolve victim issues
- Developed a waiver to share perpetrator information with local law enforcement, enabling state and local law enforcement officials with evidence of identity theft involving fraudulently filed federal tax returns to obtain return information with the consent of identity theft victims
- Decreased legitimate returns as a percentage of total unposted returns over a three year period from a peak of 79 percent to a current rate of 30 percent; also decreased the average number of days to manually review a legitimate return over the same time period from 85 days to 25 days.
- Released 22 redesigned notices to clearly explain the collection process and options available to taxpayers

Actions Planned or Underway

- Enhance the expertise of employees resolving identity theft cases by establishing specialized identity theft groups and implementing procedure enhancements
- Expand the partnerships for data exchanges regarding prevention of identity theft with additional states
- Develop a refresher class on the topic of determining timeliness of Collection Due Process (CDP) and equivalent hearing requests; the class will be made available as a Continuing Professional Education topic to Appeals technical employees who work CDP cases
- Identify additional process efficiencies from the barcode technology

TIGTA CHALLENGE NO. 10	SUMMARY OF MAJOR ISSUES
Achieving Program Efficiencies and Cost Savings	Use resources to focus on producing the best value for stakeholders

Fiscal Year 2012 Accomplishments

- Implemented a shared workstation program for telework employees
- Began multi-year space optimization/rent reduction initiative to significantly reduce real estate footprint. Initiating 72 projects has reduced space by 603,000 square feet, resulting in annual rent savings of over $13.1 million
- Met or exceeded all "green target goals" on the Department of the Treasury scorecard for Sustainability and Energy
- Implemented a paperless Time and Attendance Reporting system, eliminating nearly 3 million pieces of paper with a cost savings of approximately $146,000
- With the IRS operating divisions, prepared cost-based performance measures to provide timely, accurate, and useful data for decision making for several major IRS programs, including Field Collection and Automated Collection System
- Expanded the use of cost accounting information to improve program efficiency, including the analysis of the cost per hour of Correspondence and Field exams
- Eliminated Section 1204 (Basis for Evaluation of Employees) program travel costs and reduced managerial burden by conducting all independent reviews virtually

Actions Planned or Underway

- Complete 62 additional space optimization/rent reduction projects, for projected annualized savings of $15.5 million and space reduction of 542,000 square feet
- Collaborate with operating divisions to identify additional cost-based performance measures oriented towards enforcement activities

SECTION D: SUMMARY OF FINANCIAL STATEMENT AUDIT AND MANAGEMENT ASSURANCES

SUMMARY OF FINANCIAL STATEMENT AUDIT

Audit Opinion	Unqualified				
Restatement	No				
Material Weakness	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Material Weakness in Internal Control Over Financial Reporting at the IRS	1	0	0	0	1

SUMMARY OF MANAGEMENT ASSURANCES

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Qualified					
Material Weakness	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS – Unpaid Tax Assessments	1	0	0	0	0	1

Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
IRS – Computer Security	1	0	0	0	0	1
FMS – Systems, Controls, and Procedures to Prepare the Government-wide Financial Statements	1	0	0	0	0	1
Total Material Weaknesses (FMFIA § 2)	3	0	0	0	0	3

Conformance with Financial Management System Requirements (FMFIA § 4)						
Statement of Assurance	Systems conform to financial management system requirements					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Total Non-conformances	0	0	0	0	0	0

Compliance with Federal Financial Management Improvement Act (FFMIA)		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. System Requirements	No	
2. Accounting Standards	No	
3. USSGL at the Transaction Level	Yes	

SECTION E: IPIA (AS AMENDED BY IPERA)

On July 22, 2010, President Obama signed into law the *Improper Payments Elimination and Recovery Act* (IPERA, Pub. L. 111-204). IPERA amends the *Improper Payments Information Act* (IPIA), generally repeals the *Recovery Auditing Act*, and significantly increases agency payment recapture efforts by expanding the types of payments to be reviewed and lowering the dollar threshold of annual payments that requires agencies to conduct payment recapture audit programs. Agencies continue to be required to review their programs and activities annually to identify those susceptible to significant improper payments. OMB Circular No. A-123, *Management's Responsibility for Internal Control,* Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments* (A-123, Appendix C), amended April 14, 2011, defines "significant improper payments" as gross annual improper payments in a program exceeding both the threshold of 2.5 percent and $10 million of total program outlays or $100 million regardless of the improper payment percentage. A-123, Appendix C, also requires agencies with programs susceptible to significant improper payments to implement corrective action plans that include improper payment root cause identification, reduction targets, and accountable officials.

Section 2(B) of IPERA allows the development of an alternative for meeting the requirements for obtaining a statistically valid estimate of the annual amount of improper payments 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. RISK ASSESSMENT

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. The bureaus and offices must perform risk assessments at the payment type level (e.g., payroll, contracts, vendors, travel, etc.). The Department's risk assessment process 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

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

Internal Monitoring Activities – 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

Prior to the enactment of the IPERA changes to IPIA, Treasury maintained and performed a robust improper payment risk assessment process in which the new IPERA payment types were included. During fiscal year 2011, Treasury enhanced its risk assessment tool by expanding the scope of risk assessment factors which were included in the revised A-123, Appendix C, and continued using this tool in fiscal year 2012.

For those payment types resulting in high-risk assessments that comprise at least 2.5 percent and $10 million in total program outlays or $100 million at any rate, (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 or $100,000,000	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 2012 resulted in all programs and activities being of low or medium risk susceptibility for improper payments, except for the IRS's Earned Income Tax Credit (EITC) program. The EITC's high-risk status is well-documented, having been identified previously in the former Section 57 of OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget*, and has been deemed a complex program for the purposes of the IPIA. OMB's guidance requires additional reporting on programs deemed high-risk; that information, for the EITC program only, follows.

II. STATISTICAL SAMPLING

EITC Program

This section describes how the IRS currently develops its erroneous payment projections for the EITC.

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 refund to those who qualify. The most recent projection is based on a tax year 2008 reporting compliance study that estimated the level of improper overclaims for fiscal year 2012 to range between $11.6 to $13.6 billion and 21.0 percent (lower bound) to 24.6 percent (upper bound) of approximately $55.4 billion in total program payments.

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 IRS's National Research Program (NRP) reporting compliance study of individual income tax returns for tax year 2008—the most recent year for which compliance information from a statistically valid, random sample of individual tax returns is available.

Under the tax year 2008 NRP reporting compliance study, which reviewed individual income tax returns filed during calendar year 2009 for tax year 2008, 2,300 of the returns in the regular NRP sample were EITC claimants randomly selected for examination.

This selection method allows the measures for the individual income tax 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 differ from those followed in standard examination programs. NRP classification and examination procedures are 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 2008 NRP individual income tax return study covered filers of all types of individual income tax returns.

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, which tracks assessments and collections from IRS enforcement-related activities, and Treasury Department fiscal year 2012 EITC budget estimates.

III. Corrective Actions

This section describes the ongoing and planned corrective actions to reduce the improper payment rate for Treasury's only high-risk susceptible program, the EITC.

Root Causes

The root causes of EITC improper payments are from the following sources:

Authentication – An estimated 75 percent or $9.5 billion in improper payments result from authentication errors. These errors include errors associated with the inability to authenticate qualifying child eligibility requirements, mainly relationship and residency requirements, filing status, when married couples file as single or head of household, and eligibility in nontraditional and complex living situations. Authentication is completed on a portion of this error category during pre-refund examinations.

Verification – An estimated 25 percent or $3.1 billion in improper payments result from verification errors. These errors relate to improper income reporting which allows claimants to fall within the EITC income limitations and qualify for the EITC. The errors include both underreporting and overreporting of income by both wage earners and taxpayers who report being self-employed. Income reported through information returns such as Forms W-2, Forms 1099, etc., which can be used for verification of some income, becomes available only after tax returns are processed. Under law IRS must process income tax returns within 45 days of receipt or pay interest to taxpayers.

Base Program

In 2012, the IRS prevented approximately $4 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 irregularities and automatically prepares an adjusted return for a taxpayer. Legislation 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 and other third parties to identify discrepancies

The chart below shows significant results from fiscal year 2007 through an estimate of fiscal year 2013. In fiscal year 2012 alone, the IRS conducted an estimated 487,491 examinations, issued approximately 275,000 math error notices, and closed nearly 1 million document matching reviews.

Compliance Activities

	FY07	FY08	FY09	FY10	FY11*	FY12**	FY13***	FY07-FY13 Total
Examination Closures	503,267	503,755	508,180	473,999	483,574	487,491	487,000	2,960,266
Math Error Notices	393,263	432,797	355,416	341,824	293,450	275,000	240,000	2,331,750
Document Matching ****	734,603	727,916	688,087	904,920	1,178,129	985,172	985,000	5,218,827
Amended Returns[1]		32,473	25,395	19,347	14,317	13,287	13,000	104,819

* Restated actual.
** Preliminary estimates.
*** Estimate based on fiscal year 2012 preliminary data.
**** Document Matching includes enterprise data. Enterprise data not available for fiscal year 2007.
[1] Amended returns are a subset of Examination Closures.

These compliance activities had a significant effect. Treasury projects that continued enforcement efforts will protect a total of approximately $26 billion in revenue through fiscal year 2013, as shown below.

Enforcement Revenue Protected (Dollars in Billions)

	FY07	FY08	FY09	FY10	FY11*	FY12**	FY13***	FY07-FY13 Total
Examination Closures	$ 1.49	$ 2.00	$ 2.15	$ 1.97	$ 2.04	$ 2.05	$ 2.05	$ 13.75
Math Error Notices	$ 0.41	$ 0.44	$ 0.40	$ 0.41	$ 0.35	$ 0.32	$ 0.28	$ 2.61
Document Matching ****	$ 1.29	$ 1.23	$ 1.17	$ 1.43	$ 1.32	$ 1.55	$ 1.55	$ 9.54
Amended Returns		$ 0.07	$ 0.07	$ 0.06	$ 0.04	$ 0.04	$ .04	$ 0.32
TOTAL	$ 3.19	$ 3.74	$ 3.79	$ 3.87	$ 3.75	$ 3.96	$ 3.92	$ 26.22

* Restated actual.
** Preliminary estimates.
*** Estimate based on fiscal year 2012 preliminary data.
**** Document Matching includes enterprise data. Enterprise data not available for fiscal year 2007.

Maximizing Current Business Processes

- In fiscal year 2012, IRS completed activities associated with a suite of EITC paid preparer treatments, selected from a risk-based model, that include letters and notices, Knock and Talk Visits, traditional Due Diligence Visits, and Streamlined Injunctions. The IRS also conducted a Real-Time Preparer Pilot that used real-time data to assess EITC preparer risk and test the effectiveness of compliance treatments both before and during the filing season.
- IRS completed strategic studies to update the estimates of the two key EITC performance measures, participation rate and error rate, which comply with the *Government Performance and Results Act of 1993*. IRS also delivered estimates of EITC participation for tax year 2009, using a Census-IRS match. In addition, IRS used research data from the fiscal year 2011 enterprise research strategy to develop a fiscal year 2012 strategy in partnership with internal organizations to better focus EITC compliance and outreach activities.
- The IRS continued its partnership with members from two key tax software associations to reduce EITC errors and assist preparers in meeting their EITC due diligence requirements. This year the team recommended revisions to Form 8867, Paid Preparer's Earned Income Credit Checklist. The team also strengthened Volunteer Income Tax Assistance preparer due diligence by improving the intake questionnaire and addressed opportunities to provide guidance to preparers of Household Help returns.

IV. Improper Payment Reporting

The following table provides the improper payment reduction outlook for Treasury's only high risk susceptible program, the EITC:

Improper Payment (IP) Reduction Outlook (Dollars in Billions)

Program	2011 Outlays	2011 %	2011 $	2012 Outlays	2012 IP%	2012 IP$	2013 Est. Outlays	2013 IP%	2013 IP$	2014 Est. Outlays	2014 IP%	2014 IP$	2015 Est. Outlays	2015 IP%	2015 IP$
EITC Upper Bound Estimate	$64.7	25.8%	$16.7	$55.4	24.6%	$13.6	$57.9	24.6%	$14.2	$51.8	24.6%	$12.7	$52.7	24.6%	$13.0
EITC Lower Bound Estimate	$64.7	21.2%	$13.7	$55.4	21.0%	$11.6	$57.9	21.0%	$12.2	$51.8	21.0%	$10.9	$52.7	21.0%	$11.1

The term "Outlays" equals "Estimated Claims."
Estimated Claims: Estimated total claims for the EITC are based on projections of EITC tax expenditures plus outlays as estimated by the Office of Tax Analysis within the Department of the Treasury, adjusted to account for the difference between taxpayer claims and accounts received by taxpayers due to return processing and enforcement.
IP % and IP $: These estimates follow the prior approach which provided a range for the error rate (%) and improper payments amounts ($).

Underpayments are not included in the estimate of improper payments. Underpayments do not appear with sufficient frequency in the statistically valid test data to have a measurable effect on the estimate.

V. Recapture of Improper Payments Reporting

In accordance with IPERA and OMB Circular No. A-123, Appendix C, Treasury performs and reports annually on its payment recapture program. In fiscal year 2011, Treasury incorporated the IPERA amendments into the existing Treasury payment recapture (recovery audit) program, and continued to address them in fiscal year 2012. Prior to the enactment of the IPERA changes to IPIA, Treasury maintained and performed a robust improper payment risk assessment process which already included the new IPERA payment types.

During fiscal year 2012, Treasury issued contracts and other reviewed payments totaling approximately $10 billion. The amended act expanded the payment types reviewed beyond just contracts to include grants, benefits, loans, and miscellaneous payments.

Treasury's annual risk assessment process includes a review of pre-payment controls that minimize the likelihood and occurrence of improper payments. Treasury requires each bureau and office to conduct post-award audits and report on payment recapture activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use payment recapture audit contingency firms to perform many of the steps in their payment recapture auditing program and identify candidates for payment recapture action. However, no Treasury bureaus used contractors to perform recapture activities. Treasury employees performed this work.

Treasury considers both pre- and post-reviews to identify payment errors a sound management practice that should be included among basic payment controls. All Treasury bureaus have a process in place to identify improper payments during post-reviews. At times, bureaus may use the results of IG and GAO reviews to help identify payment anomalies and target areas for improvement. However, Treasury applies extensive payment controls at the time each payment is processed, making recapture activity minimal.

Payment Recapture Audit Reporting

Type of Payment	Amount Subject to Review for 2012 Reporting	Actual Amount Reviewed and Reported (2012)	Amount Identified for Recovery (2012)	Amount Recovered (2012)	% of Amount Recovered out of Amount Identified (2012)	Amount Outstanding (2012)	% of Amount Outstanding out of Amount Identified (2012)
Contracts	$ 7,088,266,898	$ 7,278,612,256	$ 464,722	$ 358,490	77%	$ 343	0.07%
Grants	$ 664,056,873	$ 664,056,873	$ 489,042	$ 489,042	100.%	$ 0	0%
Benefits	$ 629,912,653	$ 2,576,496	$ 13,530	$ 1,369	0%	$ 12,161	90%
Loans	$ 802,974,000	$ 0	$ 0	$ 0	0%	$ 0	0%
Other	$ 2,473,854,277	$ 2,226,897,695	$ 2,953,097	$ 2,839,482	96%	$ 7,052	0.24%

Type of Payment	Amount Determined Not to be Collectable (2012)	% of Amount Determined Not to be Collectable out of Amount Identified (2012)	Amounts Identified for Recovery (2005-2011)	Amounts Recovered (2005-2011)	Cumulative Amounts Identified for Recovery (2005-2012)	Cumulative Amounts Recovered (2005-2012)	Cumulative Amounts Outstanding (2005-2012)	Cumulative Amounts Determined Not to be Collectable (2005-2012)
Contracts	$ 0	0%	$ 7,503,026	$ 6,295,392	$ 7,967,748	$ 6,653,882	$ 343	$ 75,130
Grants	$ 0	0%	$ 428,274	$ 428,274	$ 917,316	$ 917,316	$ 0	$ 0
Benefits	$ 0	0%	$ 1,438	$ 1,438	$ 14,968	$ 1,438	$ 12,161	$ 0
Loans	$ 0	0%	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Other	$ 685	.02%	$ 46,380	$ 46,256	$ 2,999,477	$ 2,885,738	$ 7,052	$ 685

During fiscal year 2012, four Treasury entities determined that conducting a Payment Recapture Audit on various programs would not be cost effective. The Bureau of the Public Debt – Debt Activity Programs, the Financial Management Service – International Assistance Programs, the Treasury Executive Office of Asset Forfeiture – Forfeiture Payments and the Office of Financial Stability – Hardest Hit Fund Housing Finance Agency Program.

The Bureau of the Public Debt's Debt Activity Programs reflected a low level of risk in every group and payment type in fiscal year 2012.

The Financial Management Service's non- federal payments to the Multilateral Development Bank are submitted by either a voucher on a letter of credit administered by the Federal Reserve Bank of New York or through direct cash payments via the Secure Payment System. These payments present a low level of improper payment risk based on the number of payments annually and the quality of third party controls.

The Treasury Executive Office of Asset Forfeiture's program payments to state and local law enforcement agencies are intergovernmental payments that represent a low risk of improper payment. In addition, the Treasury Executive Office of Asset Forfeiture staff reviews payments monthly for accuracy.

In accordance with legal agreements, the Office of Financial Stability's Hardest Hit Fund Housing Finance Agency Program submits advance payments to state housing finance agencies who disburse to the final recipients. OFS performs compliance reviews designed to evaluate the overall control environment of the state housing finance agency administration of the program and recommends improvements as appropriate.

Based on the justifications submitted by the four Treasury bureaus, payment recapture audits for these programs were not deemed cost effective.

In fiscal year 2012, Treasury's payment recapture audit activities identified $685 in uncollectible travel voucher overpayments. Treasury determined that it was not cost-effective to pursue collection of this immaterial amount.

Payment Recapture Audit Targets

The payment recapture audit targets listed below are preliminary estimates developed by Treasury bureaus and offices based on historical performance and current payment recapture audit programs.

Type of Payment	2012 Amount Identified	2012 Amount Recovered	2012 Recovery Rate (Amount Recovered / Amount Identified)	2013 Recovery Rate Target	2014 Recovery Rate Target	2015 Recovery Rate Target
Contracts	$ 464,722	$ 358,490	77%	85%	85%	85%
Grants	$ 489,042	$ 489,042	100%	85%	85%	85%
Benefits	$ 13,530	$ 0	0%	85%	85%	85%
Loans	$ 0	$ 0	0%	85%	85%	85%
Other	$ 2,953,097	$ 2,839,482	96%	95%	95%	95%

Aging of Outstanding Overpayments

Type of Payment (contract, grant, benefit, loan, or other)	CY Amount Outstanding (0-6 months)	CY Amount Outstanding (6 months – 1 year)	CY Amount Outstanding (Over 1 year)
Contracts	$ 343	$ 0	$ 28
Grants	$ 0	$ 0	$ 0
Benefits	$ 0	$ 0	$ 1,369
Loans	$ 0	$ 0	$ 0
Other	$ 5,933	$ 1,127	$ 0

Disposition of Recaptured Funds

Type of Payment (Contracts, Grants, Benefits, Loans, other)	Agency Expenses to Administer the Program	Payment Recapture Auditor Fees	Financial Management Improvement Activities	Original Purpose	Office of the Inspector General	Returned to Treasury
Contracts	$ 0	$ 0	$ 0	$ 267,542	$ 0	$ 28
Grants	$ 0	$ 0	$ 0	$ 489,042	$ 0	$ 0
Benefits	$ 0	$ 0	$ 0	$ 0	$ 0	$ 1,369
Loans	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Other	$ 0	$ 0	$ 0	$ 31,473	$ 0	$ 0

Overpayments Recaptured Outside of Payment Recapture Audit

Source of Recovery	Amount Identified CY	Amount Recovered CY	Amount Identified PY	Amount Recovered PY	Cumulative Amount Identified (CY + PY)	Cumulative Amount Recovered (CY+PY)
Statistical Samples	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Post Payment Reviews or Audits	$ 112	$ 112	$ 0	$ 0	$ 112	$ 112
OIG Reviews	$ 8	$ 8	$ 6,234	$ 3,113	$ 6,242	$ 3,121
Single Audit Reports	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0
Self-Reported	$ 2,896,776	$ 2,896,776	$ 0	$ 0	$ 2,896,776	$ 2,896,776
Reports from Public	$ 155,484	$ 149,402	$ 0	$ 0	$ 155,484	$ 149,401

VI. 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 elimination and recovery review process, as required under A-123, Appendix C. 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 (FMC ESC), managerial responsibility and accountability in all management and internal control areas are visible and well-documented. Treasury has identified executives who are responsible and accountable for reducing the level of EITC overclaims, while other senior and mid-level officials have responsibility for monitoring progress in this area as bureau and program internal control officers.

VII. Information Systems and other Infrastructure

Overall, Treasury has the internal controls, human capital, and information systems and other infrastructure it needs to reduce improper payments to the targeted levels.

VIII. Limiting Statutory and Regulatory Barriers

Treasury's overall management assessment of IPERA did not uncover any limiting statutory or regulatory barriers with the exception of the high-risk EITC program.

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

- Complexity of the tax law (including the need for Congressional authorization of math error authority)
- Structure of the EITC
- 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.

IX. Additional Comments

In fiscal year 2012, the OIG issued Report Number OIG-12-044, *Treasury was Not in Compliance with IPERA for Fiscal Year 2011*, which covered the IPERA program as presented in Treasury's fiscal year 2011 Agency Financial Report. During fiscal year 2012, the Department partially implemented corrective actions to address the findings and recommendations in the OIG report.

SECTION F: MATERIAL WEAKNESSES AND AUDIT FOLLOW-UP

This section provides detailed descriptions of Treasury's material weakness inventory, including summaries of actions taken and planned to resolve the weaknesses; tracking and follow-up activities related to Treasury's GAO, OIG, TIGTA, and SIGTARP audit inventory; an analysis of potential monetary benefits arising from audits performed by Treasury's three IGs; and an update on Treasury's financial management systems framework.

I. 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. The FMFIA requires agency reporting on material weaknesses.

FMFIA and FFMIA

The FMFIA requires agencies to establish and maintain internal controls. The Secretary must evaluate and report annually on the operations and financial reporting 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, 2012, Treasury had three material weaknesses under Section 2 of the FMFIA, summarized as follows:

Summary of FMFIA Material Weaknesses			
Balance at the Beginning of FY 2012	3	0	3
Reassessed during FY 2012	0	0	0
Balance at the End of FY 2012	3	0	3

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

<table>
<tr><td colspan="2"></td></tr>
<tr><td colspan="2">Internal Revenue Service – Unpaid Tax Assessments

The IRS needs to improve its internal control over Unpaid Assessments. Original 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 - closed
• General ledger cannot accurately report the Taxes Receivable balance without a statistical estimation process</td></tr>
<tr><td></td><td></td></tr>
<tr><td>✓ Improved the financial classification of individual multi-officer/multi-corporation accounts by splitting the account to a greater level of detail
✓ Improved financial classification of single assessments involving multiple individual CSED balance due returns in Taxes Receivable, Compliance Assessments and Write-offs</td><td>☐ Implement the financial classification of business multi-officer/multi-corporation accounts by splitting the account to a greater level of detail (2013)
☐ Implement single assessments involving multiple business CSED balance due returns in Taxes Receivables, Compliance Assessments and Write-offs (2013)
☐ Perform "look-back" analysis on FY 2010 audit sampled items to assess accuracy of the business rules for classifying unpaid assessments (2013)
☐ Determine process improvements for entering data into IDRS to decrease errors posting to Master File (2013)
☐ Target Downgrade/Closure: Fiscal year 2015</td></tr>
</table>

Material Weakness Description	
Internal Revenue Service - Computer Security The IRS has various computer security controls that need improvement. Original key elements: • Adequately restrict electronic access to and within computer network operational components – closed • Adequately ensure that access to key computer applications 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, per Federal Information Security Management Act (FISMA) - closed • Appropriately segregate system administration and security administration responsibilities - closed • 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 - closed • Certify and accredit 90 percent of all systems – closed • Additional internal control testing to substantiate resolution of material weakness	
Actions Completed in FY 2012	**What Remains to be Done**
✓ Established and maintain metrics for system and computer application - Access Control ✓ Established and maintain metrics for security and integrity of system programs, files, and data – System Software Configuration ✓ Established and maintain metrics for restoring critical business systems – IT Contingency Planning ✓ Established Metrics Plan. Successfully measuring compliance of each Top Level domain – Audit Trails	☐ Develop application monitoring capability for Release 2 Supplement – Audit Trails ☐ Network and system monitoring for Release 3 – Audit Trails ☐ Deployment of Release 3 – Audit Trails ☐ Develop a centralized capability for External Entities for Release 3 – Audit Trails ☐ Enhance procedures for monitoring internal controls over IRS automated systems identified as material to the financial reporting process ☐ Develop procedures for conducting internal controls review of externally controlled financial systems providing data identified as material to IRS financial statements ☐ Target Downgrade/Closure: Fiscal year 2014

Material Weakness Description	
Financial Management Service – Systems, Controls, and Procedures to Prepare the Government-wide Financial Statements The government does not have adequate systems, controls, and procedures to properly prepare the Consolidated Government-wide Financial Statements. Original 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 in FY 2012	**What Remains to be Done**
✓ Partially reconciled fiscal year 2011 budget deficit to agency financial reporting ✓ Refined analysis model for 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 ✓ Completed closing package submitted to GAO by federal agencies ✓ Developed an approach for implementation of the Treasury General Fund and related General Ledger system ✓ Established traceability from agency financial statements and footnote disclosures to the Consolidated Financial Statements (CFS) for completeness	☐ Complete timely reconciliation of annual budget deficit to agency financial reporting ☐ Complete reciprocal category for the Treasury General Fund ☐ Implement changes identified by the FASAB Reporting Entity Task Force once it completes its review and finalize procedures for inclusion of current non-reporting entities, e.g., legislative and judicial branches ☐ Implement the Treasury General Fund ☐ Include all disclosures related to criminal debt and risk assumed ☐ Include all loss contingencies related to treaties ☐ Targeted Downgrade/Closure: Fiscal year 2014

II. Audit Follow-up Activities

During fiscal year 2012, Treasury continued to place emphasis on both the general administration of internal control issues throughout the Department and the timely resolution of findings and recommendations identified by GAO, OIG, TIGTA, SIGTARP, external auditors, and management. 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 management, OIG, TIGTA, SIGTARP, 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 audit follow-up program.

Potential Monetary Benefits

The *Inspector General Act of* 1978, as amended, Public Law 95-452, requires the IGs and 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 OIG, TIGTA, SIGTARP, and Treasury management.

In the course of their audits, the IGs periodically identify questioned costs, recommend 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 to realize 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 tracked in JAMES.

The statistical data in the following summary tables represent audit report activity for the period from October 1, 2011 through September 30, 2012. The data reflect information on OIG, TIGTA, and SIGTARP reports that identified potential monetary benefits.

Audit Report Activity With Potential Monetary Benefits for Which Management Has Identified Corrective Actions (OIG, TIGTA, and SIGTARP) October 1, 2011 through September 30, 2012 (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	$72.2	11	$9,905.2	8	$3,735.7	29	$13,713.1
New Reports	7	10.0	12	22,066.6	8	327.4	27	22,404.0
Total	17	82.2	23	31,971.8	16	4,063.1	56	36,117.1
Reports Closed	3	2.1	12	22,672.1	8	2,015.5	23	24,689.7
a. Realized or Actual[1]	3	0.3	5	49.5	1	3.1	9	52.9
b. Unrealized or Written off[1]	1	1.8	10	22,622.7[2]	8	2,012.3[3]	19	24,636.8
Ending Balance	**14**	**$80.1**	**11**	**$9,299.7**	**8**	**$2,047.6**	**33**	**$11,427.4**

[1] *Report numbers in categories a and b may not equal the Reports Closed. One report can be included in one or both categories.*

[2] *This figure includes six TIGTA reports, with $22.2 billion written off, for which IRS management did not concur with TIGTA's projected benefits; and four TIGTA reports with $406.3 million written off, for which TIGTA does not agree with the IRS that the benefits have not been realized.*

[3] *This figure includes five TIGTA reports, with $1.6 billion written off, for which IRS management did not concur with TIGTA's projected benefits; and two TIGTA reports, with $406.2 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, TIGTA, and SIGTARP audit reports with potential monetary benefits that were open for more than one year as of the end of fiscal years 2010, 2011, and 2012.

Number of Reports with Potential Monetary Benefits Open for More than One Year (Dollars In Millions)

	PAR/AFR Report Year	9/30/2010	9/30/2011	9/30/2012
OIG	No. of Reports	1	0	0
	$ Projected Benefits	$ 10.5	$ 0	$0
TIGTA	No. of Reports	12	11	9
	$ Projected Benefits	$ 1,783.7	$ 4,384.6	$10,018.5
SIGTARP	No. of Reports	0	0	2
	$ Projected Benefits	$ 0	$ 0	$8.7

The following table presents a summary of the audit reports containing potential monetary benefits, broken out by year of report issuance, on which management decisions were made on or before September 30, 2011, but the final actions had not been taken as of September 30, 2012.

Details of the Audit Reports with Potential Monetary Benefits on Which Management Decisions Were Made On or Before September 30, 2011, But Final Actions Have Not Been Taken as of September 30, 2012 (Dollars In Millions)

Bureau	Report No.	Report Issue Date	Brief Description	Dis-allowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2006-1c-142	9/25/2006	The IRS Contracting Officer (CO) should use the results of the Defense Contract Audit Agency (DCAA) report to fulfill his/her duties in awarding and administering contracts.	$ 32.4	-	-	$ 32.4	10/15/2012
FY 2006	**1**			**$ 32.4**			**$ 32.4**	
FY 2007	**N/A**			-	-	-	-	N/A
FY 2008	**N/A**			-	-	-	-	N/A
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, IRS should adjust its space needs to reflect workstation sharing and take action to release any unneeded space identified, where appropriate.	-	30.0	-	30.0	1/15/2014
IRS	2009-1c-134	9/28/2009	The IRS CO should use the results of the DCAA report to fulfill his/her duties in awarding and administering contracts.	0.1	-	-	0.1	10/15/2012
FY 2009	**2**			**$ 0.1**	**$ 30.0**	**$ 0**	**$30.1**	
IRS	2010-40-117	9/14/2010	IRS should revise the criteria used to determine who will receive a notice to include individuals identified by the Duplicate TIN Use database when (1) a TIN is used as a secondary taxpayer on one tax return and as a dependent and/or for the EITC on another tax return, and (2) a TIN is	-	1,297.6	-	1,297.6	1/15/2013

			used as a qualifying child for the child and dependent care credit, adoption credit, education credits, and child tax credit.					
FY 2010	**1**			**$ 0**	**$ 1,297.6**	**$0**	**$1,297.6**	
IRS	2011-1c-017	2/24/2011	IRS should use the DCAA audit report to fill his/her duties in awarding and administering contracts. When negotiations are completed, the CO will provide the TIGTA a copy of the Price Memorandum or other documentation of the actual cost savings achieved.	0.2	-	-	0.2	2/24/2016
IRS	2011-1c-080	8/23/2011	The IRS CO should use the DCAA report in the administration of the contract and determine whether the questioned costs should be recovered.	0.1	-	-	0.1	8/31/2016
IRS	2011-41-083	9/16/2011	IRS should revise the Form 8863 to require taxpayers to provide identifying information for the educational institution that the student(s) being claimed for the education credits attended.	-	6,829.5	-	6,829.5	1/15/2013
IRS	2011-30-112	9/26/2011	IRS should consider reducing the time between each Master File notice by seven days.	-	-	1,800.0	1,800.0	1/15/2013
IRS	2011-1c-122	9/28/2011	The IRS CO should use the DCAA report in the administration of the contract and determine whether the questioned costs should be recovered.	28.6	-	-	28.6	9/30/2016
OFS	SIG-AR-11-003	4/14/2011	OFS should review previously paid legal fee bills to identify unreasonable or unallowable charges, and seek reimbursement for those charges, as appropriate.	0.7	-	-	0.7	4/30/2013
OFS	SIG-AR-11-004	9/28/2011	OFS should determine the allowability in questioned, unsupported legal fees and expenses paid to specified law firms.	8.1	-	-	8.1	11/11/2012
FY 2011	**7**			**$37.7**	**$6,829.5**	**$1,800.0**	**$8,667.2**	
Total	**11**			**$70.2**	**$8,157.1**	**$1,800.0**	**$10,027.3**	

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, 2011 and September 30, 2012, 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				
	9/30/2011		9/30/2012	
	OIG	TIGTA	OIG	TIGTA
No. of Reports	7	12	5	17

The following table provides a snapshot of the number of recommendations made in SIGTARP audit reports and quarterly reports for which corrective actions had not been completed as of September 30, 2011 and September 30, 2012, respectively. SIGTARP defines a recommendation as "unimplemented" if it is listed as "partially implemented," "in process," or "not implemented" in SIGTARP's quarterly report.

Unimplemented SIGTARP Recommendations		
	9/30/2011	9/30/2012
No. of Unimplemented Recommendations	12	25

APPENDIX:
GLOSSARY OF ACRONYMS

Glossary of Acronyms	
ABS	Asset-Backed Securities
ACA	Patient Protection and Affordable Care Act
ACH	Automated Clearing House
AD	Audit Division
AFR	Agency Financial Report
AGI	Adjusted Gross Income
AGP	Asset Guarantee Program
AIFP	Automotive Industry Financing Program
AIG	American International Group, Inc.
AML	Anti-money laundering
APG	Agency Priority Goal
AQC	Automated Questionable Credit
ARC	Administrative Resource Center
ASM/CFO	Assistant Secretary for Management & Chief Financial Officer
AUR	Automated Underreporter
BEA	Bank Enterprise Award
BEP	Bureau of Engraving and Printing
BPD	Bureau of the Public Debt
BSA	Bank Secrecy Act
BYOD	Bring Your Own Device
CADE 2	Customer Account Data Engine 2
CAP	Capital Assistance Program
CAP	Compliance Assurance Process
CDCI	Community Development Capital Initiative
CDD	Customer Due Diligence
CDDB	Custodial Detail Database
CDE	Community Development Entity
CDFI	Community Development Financial Institutions
CDLF	Community Development Loan Fund
CDP	Collection Due Process
CE	Continuing Education
CFIUS	Committee on Foreign Investment in the United States
CFPB	Consumer Financial Protection Bureau
CFO	Chief Financial Officer
CFS	Consolidated Financial Statements
CIGFO	Council of Inspectors General on Financial Oversight
CMBS	Commercial Mortgage Backed Securities
CO	Contracting Officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
Council	Financial Stability Oversight Council

Glossary of Acronyms	
CPP	Capital Purchase Program
CRS	Centralized Receivables Services
DCAA	Defense Contract Audit Agency
DCFO	Deputy Chief Financial Officer
DCP	Office of D.C. Pensions
DIP	Debtor-in-Possession
DO	Departmental Offices
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DOL	Department of Labor
EESA	Emergency Economic Stabilization Act of 2008
EFTPS	Electronic Federal Tax Payment System
EITC	Earned Income Tax Credit
ESF	Exchange Stabilization Fund
EU	European Union
Fannie Mae	Federal National Mortgage Association
FARS	Financial Analysis and Reporting System
FASAB	Federal Accounting Standards Advisory Board
FATCA	Foreign Account Tax Compliance Act
FCDA	Foreign Currency Denominated Assets
FCRA	Federal Credit Reform Act
FDIC	Federal Deposit Insurance Corporation
FECA	Federal Employees' Compensation Act
FEHBP	Federal Employees Health Benefits Program
FFB	Federal Financing Bank
FFMIA	Federal Financial Management Improvement Act
FHA	Federal Housing Administration
FHFA	Federal Housing Finance Agency
FinCEN	Financial Crimes Enforcement Network
FIO	Federal Insurance Office
FMD	Financial Management Services/Miscellaneous
FMFIA	Federal Managers' Financial Integrity Act
FMIS	Financial Management Information System
FMS	Financial Management Service
FMU	Financial Market Utilities
FPA	Federal Program Activities
FRB	Federal Reserve Bank
FRBNY	Federal Reserve Bank of New York
Freddie Mac	Federal Home Loan Mortgage Corporation
FSB	Financial Stability Board
FTO	Fine Troy Ounce
FY	Fiscal Year
G-7	Group of Seven

Glossary of Acronyms	
G-20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GAB	General Arrangement to Borrow
GAFSP	Global Agriculture and Food Security Program
GAO	Government Accountability Office
GM	General Motors Company
GSA	General Services Administration
G-SIFI	Global Systematically Important Financial Institution
GSE	Government Sponsored Enterprise
GTAS	Government-wide Treasury Account Symbol Adjusted Trial Balance System
GWA	Government-wide Accounting
HAMP	Home Affordable Modification Program
HERA	Housing and Economic Recovery Act
HFA	Housing Finance Agency
HHF	Hardest Hit Fund
HHS	Department of Health and Human Services
HUB	Historically Underutilized Business
HUD	Department of Housing and Urban Development
IA	International Affairs
IAIS	International Association of Insurance Supervisors
IG	Inspector General
IMF	International Monetary Fund
IPERA	Improper Payments Elimination and Recovery Act of 2010
IPIA	Improper Payments Information Act of 2002
IPP	Invoice Processing Platform
IRC	Internal Revenue Code
IRS	Internal Revenue Manual
IRS	Internal Revenue Service
IT	Information Technology
ITIN	Individual Tax Identification Number
JAMES	Joint Audit Management Enterprise System
LEI	Legal Entity Identifier
LEP	Limited English Proficiency
LIBOR	London Interbank Offered Rate
LIC	Low-Income Community
MBS	Mortgage-Backed Security
MDB	Multilateral Development Bank
MeF	Modernized Electronic File
MHA	Making Home Affordable Program
MOU	Memorandum of Understanding
MRADR	Market Risk Adjusted Discount Rate
MSB	Money Services Businesses
NAB	New Arrangement to Borrow
NACA	Native American Community Development Financial Institutions Assistance
NIBP	New Issue Bond Program

Glossary of Acronyms	
NMTC	New Markets Tax Credit
NRP	National Research Program
NS/EP	National Security and Emergency Preparedness
NTPI	Non-tax Paperless Initiative
NYSE	New York Stock Exchange
OAS	Office of International Affairs
OCC	Office of the Comptroller of the Currency
OFAC	Office of Foreign Assets Control
OFAS	Office of the Fiscal Assistant Secretary
OFIT	Office of Financial Innovation and Transformation
OFR	Office of Financial Research
OFS	Office of Financial Stability
OIG	Office of Inspector General
OMB	Office of Management and Budget
OPEB	Other Post-Employment Benefits
OPM	Office of Personnel Management
ORB	Other Retirement Benefits
OTA	Office of Technical Assistance
OTC	Over-the-Counter
OTS	Office of Thrift Supervision
PB	President's Budget
P.L.	Public Law
POC	Proof of Concept
PP&E	Property, Plant, and Equipment
PPIF	Public-Private Investment Fund
PPIP	Public-Private Investment Program
PTIN	Preparer Tax Identification Number
QFI	Qualified Financial Institution
QRP	Questionable Refund Program
Recovery Act	American Recovery and Reinvestment Act of 2009
RMBS	Residential Mortgage Backed Securities
RMLO	Regulatory Mortgage Lenders and Originators
RTRP	Registered Tax Return Preparer
S&ED	Strategic and Economic Dialogue
SAR	Suspicious Activity Report
SBA	Small Business Administration
SBLF	Small Business Lending Fund
SBR	Statement of Budgetary Resources
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards
SIG	Special Inspector General
SIGTARP	Special Inspector General for TARP
SOS	Statement of Spending

Glossary of Acronyms	
SPSPA	Senior Preferred Stock Purchase Agreements
SPV	Special Purpose Vehicle
SSBCI	State Small Business Credit Initiative
SSC	Shared Services Council
SVC	Stored Value Card
TAA	Trade Adjustment Assistance
TAC	Taxpayer Assistance Center
TAIFF	Troubled Asset Insurance Finance Fund
TALF	Term Asset-Backed Securities Loan Facilities
TARP	Troubled Asset Relief Program
TCLP	Temporary Credit and Liquidity Program
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TEICAM	Treasury Enterprise Identity Credential and Access Management
TEOAF	Treasury Executive Office for Asset Forfeiture
TFF	Treasury Forfeiture Fund
TFI	Terrorism and Financial Intelligence
TFTP	Terrorist Finance Tracking Program
TGA	Treasury General Account
TIEA	Tax Information Exchange Agreement
TIER	Treasury Information Executive Repository
TIGTA	Treasury Inspector General for Tax Administration
TIPS	Treasury Inflation-Protected Securities
TNET	Treasury Network
TOP	Treasury Offset Program
TPU	Taxpayer Processing Unit
TRIA	Terrorism Risk Insurance Act
TST	Tier Structure Tool
TRuPS	Trust Preferred Securities
TTB	Alcohol and Tobacco Tax and Trade Bureau
UA	Unpaid Assessment
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
USC	United States Code
USPS	United States Postal Service
USSGL	United States Standard General Ledger
VA	Department of Veterans Affairs
VSD	Virtual Service Delivery
WHBAA	Worker, Homeownership, and Business Assistance Act of 2009
WMD	Weapons of Mass Destruction

Website Information

Treasury	www.treasury.gov
Alcohol and Tobacco Tax and Trade Bureau	www.ttb.gov
Bureau of Engraving & Printing	www.bep.gov
Bureau of the Public Debt	www.publicdebt.treas.gov
Community Development Financial Institutions Fund	www.cdfifund.gov
Financial Crimes Enforcement Network	www.fincen.gov
Financial Management Service	www.fms.treas.gov
Internal Revenue Service	www.irs.gov
Office of the Comptroller of the Currency	www.occ.gov
U.S. Mint	www.usmint.gov
The Financial Stability Plan	www.financialstability.gov
Making Home Affordable Program	www.makinghomeaffordable.gov
The Recovery Act	www.recovery.gov
Office of Inspector General	www.treasury.gov/oig
Treasury Inspector General for Tax Administration	www.tigta.gov
Office of the Special Inspector General for the Troubled Asset Relief Program	www.sigtarp.gov

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