Part 3
Other Accompanying Information

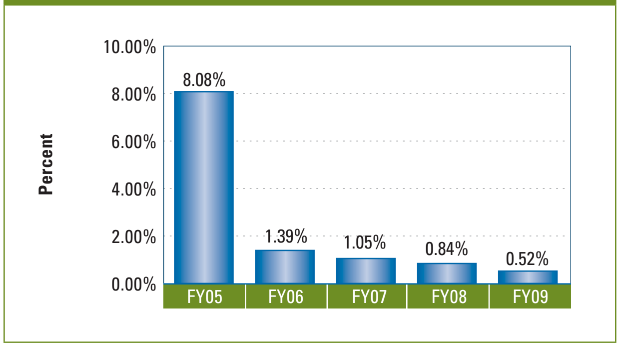
Appendix A:
Other Accompanying Information (Unaudited)

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

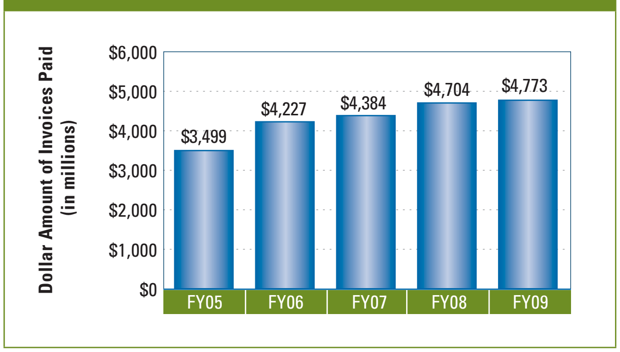
PROMPT PAYMENT

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

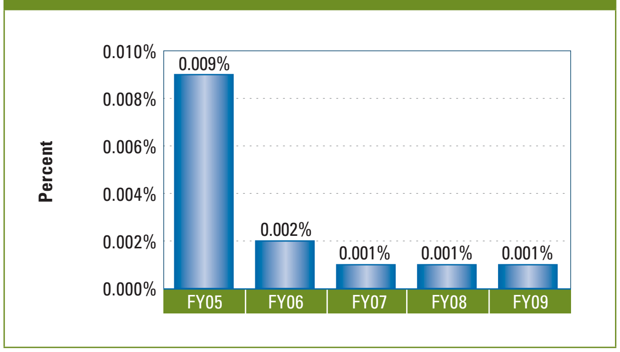
Percentage of Number of Invoices Paid Late



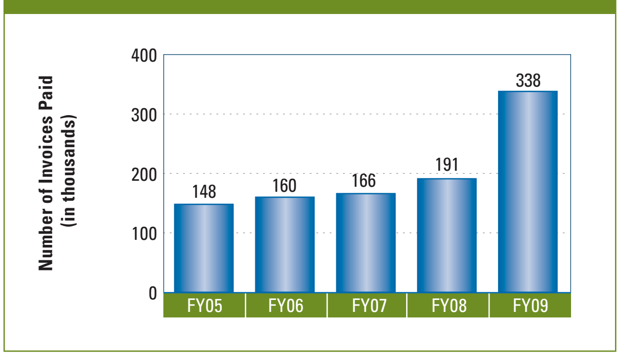
Total Dollar Amount of Invoices Paid (in millions)



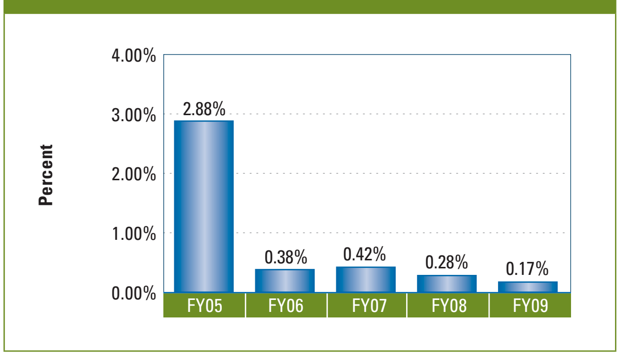
Percentage of Dollar Amount of Interest Penalties Paid



Total Number of Invoices Paid (in thousands)



Percentage of Number of Interest Penalties Paid



TAX GAP

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

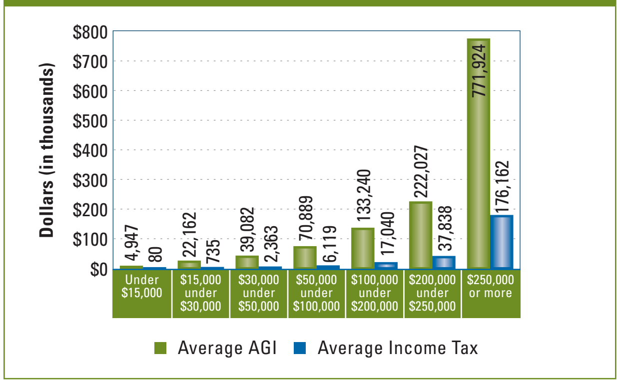
The tax gap is the aggregate amount of tax (i.e., excluding interest and penalties) that is imposed by the tax laws for any given tax year but is not paid voluntarily and timely. The tax gap arises from the three types of noncompliance: not filing required tax returns on time or at all (the non-filing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

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

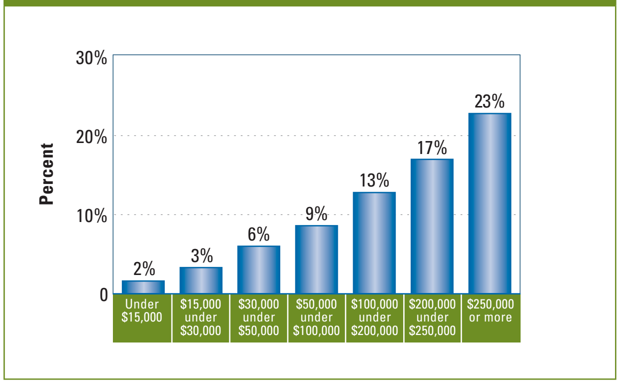
TAX BURDEN

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

Average Individual Income Tax Liability and Average Adjusted Gross Income (AGI) Tax Year 2007



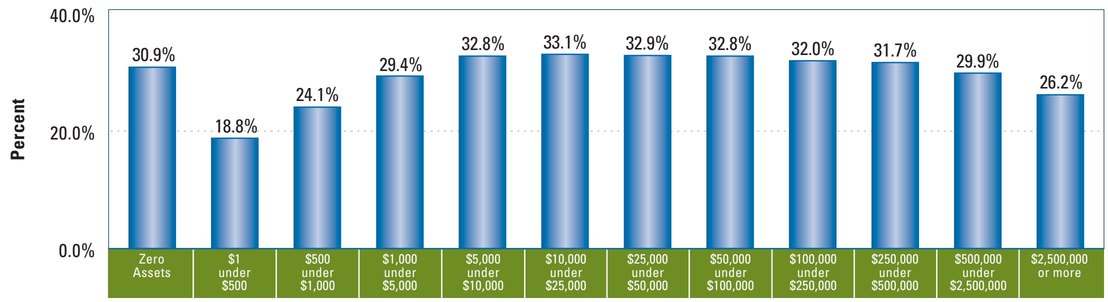
Individual Income Tax Liability as a Percentage of AGI Tax Year 2007



INDIVIDUAL INCOME TAX LIABILITY TAX YEAR 2007

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	37,597	$186,000	$3,022	$4,947	$80	1.6%
$15,000 under $30,000	30,229	669,932	22,211	22,162	735	3.3%
$30,000 under $50,000	25,978	1,015,283	61,396	39,082	2,363	6.0%
$50,000 under $100,000	31,260	2,216,021	191,293	70,890	6,119	8.6%
$100,000 under $200,000	13,463	1,793,835	229,415	133,242	17,040	12.8%
$200,000 under $250,000	1,501	333,309	56,802	222,058	37,843	17.0%
$250,000 or more	3,002	2,317,016	528,770	771,824	176,139	22.8%
Total	143,030	8,531,396	1,092,909			

Corporation Tax Liability as a Percentage of Taxable Income Tax Year 2006 Data



CORPORATION TAX LIABILITY TAX YEAR 2006

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	$17,500	$5,399	30.9%
$1 under $500	9,519	1,787	18.8%
$500 under $1,000	4,659	1,123	24.1%
$1,000 under $5,000	16,790	4,933	29.4%
$5,000 under $10,000	10,019	3,286	32.8%
$10,000 under $25,000	16,070	5,321	33.1%
$25,000 under $50,000	14,181	4,661	32.9%
$50,000 under $100,000	16,626	5,457	32.8%
$100,000 under $250,000	32,623	10,431	32.0%
$250,000 under $500,000	36,396	11,531	31.7%
$500,000 under $2,500,000	181,767	54,367	29.9%
$2,500,000 or more	935,281	244,788	26.2%
Total	$1,291,431	$353,084	27.3%

Appendix B: Improper Payments Information Act and Recovery Auditing Act

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

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

I. DESCRIPTION OF THE DEPARTMENT'S RISK ASSESSMENT(S) PERFORMED SUBSEQUENT TO COMPILING ITS FULL PROGRAM INVENTORY AND RISK-SUSCEPTIBLE PROGRAMS.

Each year, the Department develops a comprehensive inventory of the funding sources for all programs and activities and distributes it to the Treasury bureaus and offices. If program or activity funding is at least $10 million, Risk Assessments are required at the payment type level (e.g., payroll, contracts, vendors, travel, etc.). For those payment types resulting in high risk assessments that comprise at least 2.5 percent and $10 million of a total funding source, (1) statistical sampling must be performed to determine the actual improper payment rate, and (2) a corrective action plan must be developed and submitted to the Department and OMB for approval.

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

RISK LEVEL	REQUIRED ACTION(S)
High Risk > 2.5% Error Rate & > $10 Million	Corrective Action Plan
Medium Risk	Review Payment Controls for Improvement
Low Risk	No Further Action Required

The Risk Assessments performed across the Department in fiscal year 2009 resulted in all programs and activities as low and medium risk susceptibility for improper payments except for the Internal Revenue Service's (IRS)

Earned Income Tax Credit (EITC) program. The EITC's high-risk status is well-documented, having been previously identified in the former Section 57 of OMB Circular A-11, *Preparation, Submission, and Execution of the Budget,* and has been deemed a complex program for the purposes of the IPIA.

II. DESCRIBE THE STATISTICAL SAMPLING PROCESS CONDUCTED TO ESTIMATE THE IMPROPER PAYMENT RATE FOR EACH PROGRAM IDENTIFIED.

EARNED INCOME TAX CREDIT

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

The next section explains how the IRS currently develops its erroneous payment projections. The most recent projection is based on a tax year 2001 reporting compliance study that estimated the level of improper overclaims for fiscal year 2009 to range between $11.2 - $13.3 billion and 23 percent (lower bound) to 28 percent (upper bound) of approximately $48.1 billion in total program payments.

NATIONAL RESEARCH PROGRAM (NRP) ANALYSIS

The complexity of the EITC program, the nature of tax processing, and the expense of compliance studies preclude statistical sampling on an annual basis to develop error rates for comparison to reduction targets. The estimates are based primarily on information from the National Research Program (NRP) reporting compliance study of individual income tax returns for tax year 2001—the most recent year for which compliance information from a statistically valid, random sample of individual tax returns is available. The approach is nearly identical to that used for earlier years. The difference is that the estimates make use of more recent EITC payment data from the President's fiscal year 2010 Budget.

Under the tax year 2001 NRP reporting compliance study, individual income tax returns filed during calendar year 2002 for tax year 2001 were randomly selected for examination.[1] 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 differed from those followed in standard examination programs. NRP classification and examination procedures were more comprehensive in scope and depth than those for standard examination programs. These expanded procedures were designed to provide a more thorough determination of what taxpayers should have reported on their returns.

The tax year 2001 NRP individual income tax return study covered filers of all types of individual income tax returns. About 6,400 of the approximately 44,400 returns in the regular NRP sample were EITC claimants.[2] The NRP study results for this EITC claimant subset of NRP returns were the primary source of data for the improper payments estimates. Other data and information sources used for the estimates included the IRS Enforcement Revenue Information System (ERIS), which tracks assessments and collections from IRS enforcement-related activities; Treasury Department estimates of the effect of the EITC provisions in the Economic Growth and Tax

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

2 About 1,600 other returns (the "calibration sample") were included in the tax year 2001 NRP Individual Income Tax Study. These returns went through a somewhat different examination process and they were not used for these calculations.

Relief Reconciliation Act of 2001 (EGTRRA) on erroneous EITC claims, and Treasury Department fiscal year 2010 EITC budget estimates.

Enacted in 2001, EGTRRA contains several provisions related to the EITC that became effective for tax year 2002. These provisions are believed to influence taxpayer behavior in a number of ways, among them increased claims and improved compliance for EITC claimants.[3] Since the improper payment rate is derived from pre-EGTRRA taxpayer behavior (tax year 2001), it must be adjusted to reflect the estimated impact of the EITC-related EGTRRA provisions. Treasury Department economists conducted an analysis of the EITC-related EGTRRA provisions, concluding that the provisions reduced EITC erroneous claims by about 13 percent and increased claims by about 5 percent.[4] To account for these effects, the NRP-based estimate of the improper payment rate for tax year 2001 was adjusted by reducing the of the *Amount of EITC Overclaimed* by 13 percent and increasing the *Amount of EITC Claimed on all Returns* by 5 percent.

The general approach for developing the fiscal year 2009 set of EITC improper payments estimates involved the following steps: (1) estimating an improper payment rate for tax year 2001 using the NRP data, (2) adjusting the tax year 2001 rate to reflect the estimated impact of the EITC-related EGTRRA provisions, (3) estimating EITC claims for fiscal year 2009 through fiscal year 2012 by projecting tax year 2001 claims forward using the growth rates implicit in Treasury Department budget outlay estimates, and (4) multiplying the adjusted improper payment rate by the estimated claims to calculate estimated improper payments for each fiscal year.

The error rate estimate from the EITC component of the tax year 2006 NRP study will be completed during fiscal year 2010. The updated error estimate will help inform business decisions about program administration and meets IPIA standards for measuring and reporting on improper payments.

III. DESCRIBE THE CORRECTIVE ACTION PLANS FOR REDUCING THE ESTIMATED RATE OF IMPROPER PAYMENTS FOR THE EITC PROGRAM.

The IRS uses a two-pronged approach to reduce erroneous EITC payments:

1. Continually seek opportunities to increase program efficiency within existing resources – in other words, make the base program better; and
2. Test potential business process enhancements to reduce error and then request implementation funding if the tests prove successful.

BASE PROGRAM

In 2009, the IRS prevented more than $3.0 billion from being paid in error. The prevention activity is primarily focused in three areas:

- **Examinations** – the 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

3 For example, EGTRRA implemented a uniform definition of a "qualifying child" and simplified the rule for determining which taxpayer was eligible to claim the qualifying child in potentially ambiguous cases (the AGI tiebreaker rule). The simpler rules were expected to enhance compliance by reducing the number of claims arising from misinterpretation of the tax law and to increase the number of claims by those who were deterred by its complexity.

4 The estimates were in 1999 dollars.

conducted before a refund is released. The examination closures and enforcement revenue protected in the charts below do not include test initiatives.

- **Math Error** – this refers to an automated process in which the IRS identifies math or other statistical irregularities and automatically prepares an adjusted return for a taxpayer. Congressional approval is required for math error use.
- **Document Matching** – involves comparing income information provided by the taxpayer with matching information (e.g., W-2s, 1099s) from employers to identify discrepancies.

The chart below shows significant results from fiscal year 2004 through fiscal year 2010. In fiscal year 2009 alone, the IRS conducted over 500,000 examinations, issued 350,000 math error notices, and closed over 300,000 document matching reviews.

COMPLIANCE ACTIVITIES (THOUSANDS)

	FY04*	FY05*	FY06*	FY07	FY08*	FY09**	FY10***	FY04-FY10 Total
Examinations	472,022	527,969	517,617	503,267	503,755	508,398	500,000	3,533,028
Math Error Notices**	624,590	515,890	460,316	393,263	432,797	350,000	350,000	3,126,856
Document Matching	300,000	324,419	364,020	394,217	377,327	314,469	325,000	2,399,452
Amended Returns					32,473	25,395	25,000	82,868

*Restated actual
**Preliminary estimates
***Estimate based on fiscal year 2009 preliminary data

These activities had a significant effect. Treasury projects that continued enforcement efforts will protect a total of $19 billion in revenue through fiscal year 2010.

ENFORCEMENT REVENUE PROTECTED ($ BILLIONS)

	FY04	FY05*	FY06*	FY07*	FY08*	FY09**	FY10***	FY04-FY10 Total
Examinations	1.12	1.35	1.50	1.49	2.00	2.15	2.15	11.76
Math Error Notices**	0.62	0.52	0.46	0.41	0.44	0.38	0.38	3.21
Document Matching	0.25	0.53	0.60	0.73	0.74	0.63	0.65	4.13
Amended Returns					0.07	0.07	0.07	0.21
TOTAL	1.99	2.40	2.56	2.63	3.25	3.23	3.25	19.31

*Restated actual
**Preliminary estimates
***Estimate based on fiscal year 2009 preliminary data

TESTING NEW BUSINESS PROCESSES

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

- Continuing the partnership with members from two key tax software associations to identify software enhancements and collaborative efforts that can help reduce EITC errors and assist preparers in meeting their EITC due diligence requirements
- Implementing an on-line training module for paid preparers on EITC preparer due diligence requirements and standards
- Further refining and completing activities associated with a suite of EITC paid preparer treatments, based on risk-based selections, including due diligence audits, visits by revenue and criminal investigation agents, streamlined injunctions, first-time paid preparer treatments to influence the accuracy of EITC returns filed, and analyzing short-term outcomes, including penalties and accuracy of returns.

IV. EITC IMPROPER PAYMENT REDUCTION OUTLOOK

The reduction outlook for EITC improper payments is as follows:

IMPROPER PAYMENT (IP) REDUCTION OUTLOOK ($ IN BILLIONS)

Program	PY Outlays	PY %	PY $	CY Outlays	CY IP%	CY IP$	CY+1 Est Outlays	CY+1 IP%	CY+1 IP$	CY+2 Est Outlays	CY+2 IP%	CY+2 IP$	CY+3 Est Outlays	CY+3 IP%	CY+3 IP$
EITC Upper Bound Estimate	$47.6	28%	$13.1	$48.1	28%	$13.3	$60.7	28%	$16.8	$58.5	28%	$16.2	$49.4	28%	$13.7
EITC Lower Bound Estimate	$47.6	23%	$11.1	$48.1	23%	$11.2	$60.7	23%	$14.2	$58.5	23%	$13.6	$49.4	23%	$11.5

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

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

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

CY+1 and CY+2 estimates include ARRA EITC provisions which expand EITC for families with three children and increase the beginning of the phaseout range for couples filing a joint return.

CY: Current year; PY: Prior year

RECOVERY AUDITING ACT

V. TREASURY'S RECOVERY AUDITING PROGRAM

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

In fiscal year 2009, Treasury issued contracts totaling $5.0 billion. The annual Improper Payments Information Act Risk Assessment process includes a review of pre-payment controls that minimize the likelihood and occurrence of improper payments. For Recovery Auditing Act compliance, Treasury requires each bureau and office to review their post-payment controls and report on recovery auditing activities, contracts issued, improper payments made, and recoveries achieved. Bureaus and offices may use recovery auditing firms to perform many of the steps in their recovery auditing program and identify candidates for recovery action.

Treasury considers both pre-payment and post-payment reviews to identify payment errors a good management practice that should be included among basic payment controls. All of Treasury's bureaus use some form of recovery auditing techniques to identify improper payments during post-payment reviews. At times, bureaus may use the services of recovery auditors to help them identify payment anomalies and target areas for improvement. However, Treasury has extensive contract payment controls that are applied at the time each payment is processed, making recovery activity minimal. The low level of improper payments in 2009 did not require any Treasury bureau to develop a management improvement program under *Recovery Auditing Act* guidance.

RECOVERY AUDITING INFORMATION FISCAL YEAR 2004 - FISCAL YEAR 2009

Agency	Amount Subject to Review for CY Reporting	Actual Amount Reviewed and Reported CY	Amount Identified for Recovery CY	Amount Recovered CY*	Amount Identified for Recovery PY	Amount Recovered PY	Cumulative Amts. Identified for Recovery (CY+PYs)	Cumulative Amts. Recovered (CY+PYs)
Treasury	$5,254,751,759	$4,661,539,275	$1,475,232	$1,357,672	$825,279	$839,818	$6,733,805	$5,500,579

Note: CY: Current year; PY: Prior year

* Includes amounts identified for recovery in prior years.

For fiscal year 2009, the total number of contracts subject to review was 34,855; the total number reviewed was 32,311, for a total program cost of approximately $1.2 million dollars.

VI. MANAGEMENT ACCOUNTABILITY

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

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

VII. RESOURCES REQUESTED IN THE FISCAL YEAR 2010 BUDGET SUBMISSION TO CONGRESS

The IRS fiscal year 2010 President's Budget submission included no new initiatives related directly to the EITC program.

VIII. LIMITING STATUTORY AND REGULATORY BARRIERS

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

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

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

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Appendix C: Management and Performance Challenges and Responses

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

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

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

October 29, 2009

INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Eric M. Thorson
Inspector General

SUBJECT: Management and Performance Challenges Facing the Department of the Treasury (OIG-CA-10-001)

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

This year, we are reporting one new challenge:

- Management of Recovery Act Programs

This challenge relates to the significant additional responsibilities and funding received by Treasury through the American Recovery and Reinvestment Act of 2009 (Recovery Act) for a variety of programs.

We also continue to report four challenges from last year:

- Management of Treasury's New Authorities Related to Distressed Financial Markets
- Regulation of National Banks and Thrifts
- Management of Capital Investments
- Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

We removed two previously reported challenges:

- Corporate Management
- Information Security

Challenge 1: Management of Treasury's New Authorities Related to Distressed Financial Markets

As we reported last year, Treasury, along with the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Federal Housing Finance Agency, has taken unprecedented actions to address the current financial crisis. To assist in those efforts, Congress passed the Housing and Economic Recovery Act in July 2008, which gave Treasury broad new authorities to address the distressed financial condition of Fannie Mae and Freddie Mac. Less than 6 weeks later, the Federal Housing Finance Agency put both entities into conservatorship.

Page 2

Treasury agreed to purchase senior preferred stock in Fannie Mae and Freddie Mac, established a new secured line of credit available to them, and initiated a temporary program to purchase new mortgage-backed securities issued by them. According to Treasury data, as of June 30, 2009, Treasury had purchased $86.5 billion in preferred stock of the two entities to cover their continuing losses and maintain a positive net worth. Treasury also purchased $154.2 billion of mortgage-backed securities issued by Fannie Mae and Freddie Mac. Even with this assistance, both entities remain in a weakened financial condition and may require more assistance.

As the turmoil in the financial markets increased, Treasury and the Federal Reserve took additional actions to deal with the situation, including rescuing Bear Stearns and American International Group. Treasury also sought and obtained additional authorities through passage of the Emergency Economic Stabilization Act (EESA) in October 2008. EESA, commonly known as the Troubled Assets Relief Program (TARP), gave the Treasury Secretary $700 billion to, among other things, (1) purchase capital in qualifying U.S.-controlled financial institutions and (2) buy, maintain, and sell toxic mortgage-related assets from financial institutions. These authorities were intended to bolster credit availability and address other serious problems in U.S. and world financial markets.

After EESA was enacted, the Department aggressively moved forward to loosen the credit market by purchasing senior preferred stock in nine of the nation's largest financial institutions. Since then, hundreds of other financial institutions have also participated in the Capital Purchase Program (CPP). To date, some CPP participants have repurchased preferred shares and warrants totaling more than $70 billion. However, a small but growing number of CPP recipients are failing to make their 5 percent dividend payments due to Treasury.

The Department implemented a number of other mechanisms to carry out its other authorities and responsibilities under TARP, including the Public-Private Investment Program and the Home Affordable Modification Program. To administer TARP, Treasury established the Office of Financial Stability.

EESA established a special inspector general for TARP and imposed oversight and periodic reporting requirements on both the special inspector general and the Government Accountability Office (GAO). Under EESA, GAO is also responsible for performing the annual financial statement audit of TARP. Recently, GAO reported that at the 1-year mark, TARP in general and CPP in particular, along with other efforts by the Federal Reserve and FDIC, had made important contributions to help stabilize credit markets. However, GAO also reported that many challenges and uncertainties remain—for example, whether Treasury will fully recoup TARP assistance to the automobile industry and AIG, among others. GAO further noted that other programs, such as the Public-Private Investment Program and the Home Affordable Modification Program, still face implementation or operational challenges. GAO recommended that as Treasury considers further action under TARP, including whether to extend the program beyond December 31, 2009, the Department should evaluate the program in the broader context of efforts by the Federal Reserve and FDIC to stabilize the financial system.

Page 3

At the time of this writing, it should also be noted that the Department is working through several significant accounting issues involving some very complex TARP transactions. As a result, the Department, in consultation with our office and GAO, has requested an extension from the Office of Management and Budget for its fiscal year 2009 annual financial reporting submission.

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

Challenge 2: Regulation of National Banks and Thrifts

Since September 2007, 39 Treasury-regulated financial institutions have failed, with estimated losses to the deposit insurance fund exceeding $27 billion. Even more financial institutions are expected to fail over the next 2 years.

Although many factors have contributed to the turmoil in the financial markets, Treasury's Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) did not identify early or force timely correction of unsafe and unsound practices by institutions under their supervision. The irresponsible lending practices of many institutions are now well-recognized—including reliance on risky products, such as option adjustable rate mortgages, and degradation of underwriting standards. At the same time, financial institutions engaged in other high-risk activities, including high asset concentrations in commercial real estate and overreliance on unpredictable brokered deposits to fund rapid growth. There have also been instances of certain ailing thrifts backdating capital contributions.

The banking industry will continue to be stressed over the next several years. In their 2009 interagency Shared National Credits (SNC) review, OCC, OTS, and the other federal banking regulators found that credit quality had deteriorated to record levels with respect to the $2.9 trillion in large ($20 million or more) loans and loan commitments held by U.S. bank organizations, foreign bank organizations, and nonbank entities such as securitization pools, hedge funds, insurance companies, and pension funds. The review, which covered $1.2 trillion of the $2.9 trillion SNC portfolio, identified total losses of $53 billion. That amount exceeded the combined losses reported in the previous eight SNC reviews and was nearly triple the amount of the previous high, identified in 2002. The next substantial stresses to financial markets may result from troubled credit card debt and further deterioration in commercial real estate loans and could significantly affect financial institutions that had limited exposure to the housing crisis.

Our office is mandated to review failures of Treasury-regulated financial institutions that result in material losses to the deposit insurance fund. Since 2007, we have completed 12 such reviews and are engaged in 19 others. These reviews identify the causes of the failures and assess supervision exercised over failed institutions. Both OCC and OTS have been responsive to our recommendations for improving supervision. For example, OTS has issued guidance addressing concentration issues and the appropriate accounting treatment for capital contributions. However, these reviews do not address the broader supervisory effectiveness of the federal banking regulators as a whole or the effectiveness of the supervisory structure. It is therefore essential that OCC and OTS continue to take a critical look at their supervisory processes to identify why those processes did not prevent or mitigate the practices that led to the current crisis and what can be done to better protect the financial health of the banking industry and consumers going forward.

Recognizing that the focus of EESA and the Recovery Act is on the current crisis, another consideration is the need to identify, monitor, and manage emerging domestic and global systemic economic risks. Moreover, these emerging risks may go beyond the current U.S. regulatory structure. As we reported last year, Treasury and its regulatory partners must continue to diligently monitor both regulated and unregulated products and markets for new systemic risks that may require action.

Finally, in response to the current crisis, both the administration and Congress are considering proposals for regulatory reform, ranging from the creation of a single financial regulator to a more limited approach calling for oversight councils composed of the existing regulators and consolidating OTS and OCC. (Consolidating OTS and OCC is a common feature of the proposals and has been advocated by the Department.) Also under consideration is transferring responsibility for consumer financial protection functions to a new regulatory agency. Although it is too soon to know which direction regulatory reform will take, Treasury, OCC, and OTS will need to work in concert with the other affected federal bank regulators to ensure a smooth and effective transition to the new regulatory structure that emerges.

Challenge 3: Management of Recovery Act Programs

Treasury is responsible for overseeing an estimated $150 billion of Recovery Act funding and tax relief. Treasury's oversight responsibilities include grants for specified energy property in lieu of tax credits, grants to states for low-income housing projects in lieu of tax credits, increased Community Development Financial Institutions Fund grants and tax credits, economic recovery payments to social security beneficiaries and others, and payments to U.S. territories for distribution to their citizens. Many of these programs are new to Treasury and involve very large dollar amounts. As a result, Treasury faces immense challenges in ensuring that the programs achieve their intended purposes, provide for accountability and transparency, and are free from fraud and abuse.

It is estimated that Treasury's Recovery Act grants in lieu of tax credit programs—for specified energy property and to states for low-income housing projects—will cost almost $20 billion over their lives. Treasury has dedicated only a small number of staff to award and monitor these funds. We have concerns that the current staffing level is not commensurate with the size of these programs.

To date, we have issued two audit reports on Treasury's Recovery Act programs. The first, issued in August 2009, discussed progress made and additional steps necessary to operate the specified energy property program more effectively. The second, issued in October 2009, discussed our concerns with a survey the Department completed for the Recovery Accountability and Transparency Board on Recovery Act staffing levels, qualifications, and training. We concluded that the information provided in the survey response was unreliable. Although these two early audits identified problems, the Deputy Secretary and the Senior Accountability Officer (the Assistant Secretary for Management, Chief Financial Officer, and Chief Performance Officer) have shown a strong commitment to implementing an effective control structure over Recovery Act activities and strong support for our oversight effort. We will work with the Department and the Treasury Inspector General for Tax Administration to help ensure that appropriate controls are in place.

Challenge 4: Management of Capital Investments

Managing large capital investments, particularly information technology investments, is a difficult challenge for any organization, whether public or private. In prior years, we have reported on a number of capital investment projects that either failed or had serious problems. Treasury is now making the transition to a new, mission-critical telecommunications system, TNet. The overall value of the TNet contract is estimated at $270 million. Treasury was originally to have begun the transition in February 2008. It is now expected to begin in December 2009, nearly 2 years late. In light of this delay, previously reported problems with large capital investments, and hundreds of millions of procurement dollars at risk, Treasury must exercise continuous vigilance in managing such investments.

Challenge 5: Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

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

Treasury faces significant challenges in coordinating the efforts of these multiple entities, many external to Treasury. FinCEN and OFAC have entered into memoranda of understanding with many federal and state regulators in an attempt to build a consistent and effective process. However, these instruments are nonbinding and carry no penalties for violations, and their overall effectiveness has not been independently assessed. Furthermore, the USA Patriot Act has increased the types of financial institutions required to file BSA reports. In fiscal year 2008, financial institutions filed approximately 18 million BSA reports.

Page 6

Although BSA reports are critical to law enforcement, past audits have shown that many contain incomplete or erroneous data and that examination coverage by financial institution regulators of BSA compliance has been limited. In a response to our 2008 management challenges letter, Secretary Paulson said that FinCEN had published interpretive guidance in fiscal year 2008 to address many issues, including common errors noted in suspicious activity reports. The response also stated that FinCEN, OCC, OTS, and other federal banking regulators had studied and made adjustments to the risk-based examination process. We have not had the opportunity to assess these or other recent changes.

Given the criticality of this management challenge to the Department's mission, we continue to consider BSA and OFAC programs as inherently high-risk. Adding to this risk in the current environment is the risk that financial institutions and their regulators may decrease their attention to BSA and OFAC program compliance as they address safety and soundness concerns. As the administration and Congress consider what could be sweeping changes to the financial regulatory structure, those changes must ensure that BSA and OFAC compliance examination coverage is sufficient. Mandatory work, particularly material loss reviews of failed banks and thrifts, prevented us from performing any audits in this area in fiscal year 2009 and we do not expect to provide significant audit coverage in this area in fiscal year 2010.

Challenges Removed

We removed corporate management as an overarching management challenge, first identified as a challenge in 2004, because the Department has made significant progress in building up a sustainable corporate control structure. This progress was evident in the relatively smooth transition that occurred with the change in administrations this year. Treasury nevertheless remains a highly decentralized organization, and recent economic events have increased the number and complexity of its missions. Possible regulatory reforms could subject the Department's missions and structure to further change. In addition, Treasury has yet to fill many key leadership positions. Given these matters, senior leadership will need to ensure that the Department's corporate control structure remains strong and in place.

We removed information security as a management and performance challenge because Treasury has made significant strides in improving and institutionalizing its information security controls. We noted this progress in our two most recent annual Federal Information Security Management Act independent evaluations. Information security requires continued and strong management attention, however, so that policies remain current and practices do not deteriorate.

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

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

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 11, 2009

MEMORANDUM FOR ERIC M. THORSON
INSPECTOR GENERAL

FROM: Timothy F. Geithner

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

I am responding to your memorandum of October 29, 2009, describing your perspective on the most serious management and performance challenges facing the Department of the Treasury. The Department appreciates your independent assessment of progress in addressing these challenges.

Fiscal year (FY) 2009 brought a new management challenge, *Management of Recovery Act Programs*. The Department has established effective control structures to monitor the implementation of our Recovery Act programs to ensure they achieve their intended purposes, as well as to provide unprecedented accountability and transparency.

I want to thank you for recognizing our efforts in resolving *Corporate Management and Information Security* issues and for removing them from your listing of the Department's management challenges. We have taken, and will continue to take, appropriate actions to address those and remaining management challenges.

The Department is committed to remain vigilant about the risks associated with all of our programs and to adjust our strategies based on changing circumstances to achieve financial stability, economic security, and protection of the taxpayer. We look forward to working with you to further address these challenges.

Challenge 1 – Treasury's New Authorities Related to Distressed Financial Markets

The financial system and the economy are showing signs of stability. The cost of borrowing has declined to pre-crisis levels for many businesses, states and local governments, the government sponsored enterprises (GSEs), and the banks. Housing markets have shown signs of stabilization, and home prices have ticked up in recent months, after three straight years of declines. The economy grew in the third quarter, and most private economists predict it will grow for the remainder of this year and next. That improvement in the economic and financial outlook since the spring reflects a broad and aggressive policy response that included the financial stability policies implemented under the Troubled Asset Relief Program (TARP), efforts to bolster confidence in the housing and mortgage markets under the Housing and Economic Reform Act (HERA), other financial stability policies implemented by the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System (Federal Reserve), accommodative monetary policy, and the Obama Administration's fiscal stimulus package implemented under the American Recovery and Reinvestment Act of 2009.

Despite TARP's positive record to date, and the improving financial and economic outlook, significant challenges remain for the financial sector and our economy. While the economy is growing again, jobs are still being lost and credit losses in some parts of the financial system are still accelerating. The pace of bank failures, which tends to lag economic cycles, remains elevated. Foreclosure rates also remain high. Bank lending continues to contract, with credit standards tight and demand still down. Small businesses rely heavily on such lending, as they do not have the ability to raise capital through debt issuance in securities markets. Further, commercial real estate losses weigh heavily on many banks, especially those that are small, impairing their ability to extend new loans. While a number of TARP initiatives have begun to wind down, Treasury continues to focus on stabilizing the housing markets as well as improving access to credit for small businesses. Based on the need for continuing work in these areas and also the need to ensure an orderly close out of the TARP Program, we have extended TARP authority to October 3, 2010. Following is additional information on actions we have taken and continue to take in addressing this challenge.

The Department of the Treasury's Office of Debt Management (ODM) has purchased over $200 billion in Mortgage Backed Securities (MBS) guaranteed by Fannie Mae and Freddie Mac through two expert asset managers, Barclays Global Investors and State Street Global Advisors. The Housing and Economic Recovery Act of 2008 granted Treasury the authority to make these purchases. That authority expires December 31, 2009. For increased transparency, the Department publishes aggregate information on its holdings of Agency MBS on FinancialStability.gov (***http://www.financialstability.gov/roadtostability/homeowner.html***). Treasury holds monthly executive committee meetings chaired by the Acting Under Secretary for Domestic Finance to discuss program implementation, and is actively seeking advanced risk management tools beyond those provided by the asset managers for the maintenance stage of the program. These tools will be in place by January 1, 2010.

We have tested the Government Sponsored Enterprises Credit Facility (GSECF) in a development environment and the Office of the Fiscal Assistant Secretary has established robust procedures for its use. The GSECF has not been used to date, nor do we expect it to be before its December 31, 2009 expiration date.

In October 2008, the Emergency Economic Stabilization Act authorized a total of $700 billion for Treasury to purchase or to insure troubled assets. Treasury used this authority to implement the Troubled Asset Relief Program (TARP) to strengthen the U.S. financial system, restore credit markets for businesses and consumers, and address foreclosures in the housing market. In fiscal year 2009, the Department rolled out eight programs: Capital Purchase Program; Targeted Investment Program; American International Group Investment Program (formerly known as the Systemically Significant Failing Institution Program); Automotive Industry Financing Program (including the Auto Suppliers Support Program and the Auto Warranty Program); Asset Guarantee Program; Term Asset-Backed Securities Loan Facility, as part of the Consumer and Business Lending Initiative; Public-Private Investment Program; and the Home Affordable Modification Program. As of September 30, 2009, over $521 billion had been designated for particular TARP programs. Of that amount, over $444 billion had been obligated to specific institutions under signed agreements, with over $365 billion of those funds already disbursed.

Treasury Departmental Offices and bureaus played a critical role in establishing a well-functioning Office of Financial Stability (OFS) to implement these programs. Over the past year, while aggressively implementing the programs listed above, OFS has grown into an organization of 212 full-time employees who support the TARP. Initially, several key Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) personnel were detailed to OFS positions to provide assistance in setting up accounting, finance, and reporting systems. They also assisted in developing information technology, procurement, and risk management processes. The infrastructure put in place to support the TARP mitigates risk for the taxpayer. For each TARP operational program, sound controls and oversight have been properly designed, planned, and implemented for the longer term.

TARP was designed as an emergency response to a major financial crisis. Because financial conditions have begun to improve, Treasury has already started the process of exiting from some emergency programs. Although Treasury and other government institutions have accomplished a great deal in a relatively short time, more work lies ahead. As necessary, TARP will maintain capacity to address new developments until financial stability and economic health have been fully restored.

Challenge 2 - Regulation of National Banks and Thrifts

Both the Administration and Congress are in the midst of reviewing numerous proposals for financial regulatory reform. Treasury Departmental Offices, OCC, and OTS are working closely with other federal financial regulators to ensure a smooth transition to a new regulatory structure. The Department also expects to devote resources in 2010 toward implementing the recommendations of its working groups on the conduct of financial supervision and regulation and on the regulatory capital regime.

Regulation of National Banks

In fiscal year 2009, 13 OCC-supervised and regulated national banks failed, with estimated losses to the deposit insurance fund totaling approximately $3.7 billion. All 13 are community banks and the majority of these failures were the result of high concentrations in acquisition, development, and construction lending to the residential construction industry. In addition to taking actions to address the recommendations contained in the four Material Loss Review reports issued by your office during fiscal year 2009, the OCC conducted its own reviews of the national bank failures. Lessons learned included the need to reinforce adherence to OCC's policy on the timely use of and follow through on "Matters Requiring Attention," and the need to ensure that bank management and boards of directors provide effective oversight and adequate controls over risk. The OCC reports that the results of these critical reviews were used to communicate areas of concern to examiners and to adjust supervisory processes to better protect the safety and soundness of the national banking system.

During fiscal year 2009, the OCC introduced a program for its large national bank population that emphasized more intensive, ongoing monitoring of bank liquidity, standardization of liquidity measures across institutions, and evaluation of banks' liquidity cushions and contingency plans in the regular course of their OCC supervision.

In June the federal banking agencies released for comment the proposed *Interagency Guidance on Funding and Liquidity Risk Management*, which would effectively extend the features of the OCC's program to all domestic financial institutions. In September the federal banking agencies also released for comment proposed *Interagency Guidance on Correspondent Concentration Risks*. More broadly, the OCC worked with other financial supervisors, both domestically and internationally, to identify areas where risk management practices at financial institutions and supervisory expectations or requirements need to be strengthened. In this regard, the OCC is actively involved in efforts underway by the Basel Committee on Banking Supervision to strengthen and enhance international capital standards and liquidity risk management. The Comptroller continued to serve as co-chairman of the Financial Stability Board's working group on provisioning.

In the area of consumer regulation and protection, the OCC issued guidance to national banks on the Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009; Final Rules and Guidelines to Promote

Accurate Reports about Consumers; and Final Rules and Guidelines Implementing Accuracy and Integrity Provisions of the Fair and Accurate Credit Transactions Act. The OCC also issued Consumer Advisories.

The OCC's Bank Supervision Operating Plan describes several key objectives for 2010. Effective credit risk and liquidity risk management, as well as the quality of capital and level of regulatory capital to absorb unexpected losses are areas of focus. Supervisory attention will also focus on corporate governance and compliance functions, the capability of bank management to manage risk, and the effective resolution of problem banks. The OCC will also encourage banks to continue to meet the needs of credit worthy borrowers and comply with consumer compliance laws and regulations.

Regulation of Thrifts

During fiscal year 2009, 14 OTS-regulated thrifts were placed in receivership with estimated losses to the deposit insurance fund of approximately $11 billion. Many of these failures were the result of poor risk management practices and excessive concentrations in high risk assets.

In addition to responding to Material Loss Review recommendations from your office, the OTS conducts internal reviews following the receivership of failed thrifts. The objective of the internal assessment is to review the chronology of events leading to the failure, identify the causes of the failure, evaluate OTS supervision and enforcement activities, and provide recommendations for addressing the findings of the review. The OTS completed seven such reviews in fiscal year 2009, and has made significant progress implementing the recommendations from these reviews.

During 2009, the OTS supplemented and improved staff guidance to address concentration risks, enforcement actions, capital contributions, downgraded securities, examination follow-up, and other key supervisory issues. The OTS also emphasized the importance of comprehensive loan modification programs to provide solutions for borrowers who cannot afford their current mortgage payments. In August, the OTS released Thrift Bulletin 85, *Regulatory and Accounting Issues Related to Modifications and Troubled Debt Restructurings of 1-4 Residential Mortgage Loans*, to update thrift management on accounting and regulatory issues associated with loan modification programs.

Also in 2009, the OTS issued a final rule prohibiting a series of unfair credit card practices under the Agency's authority to issue regulations under Section Five of the Federal Trade Commission Act banning unfair and deceptive acts and practices. The economic downturn will continue to have a significant affect on the performance of the thrift industry over the next several years.

To meet the challenges that will arise during fiscal year 2010, OTS has emphasized the following priorities in thrift supervision. During each regular examination OTS staff will review each thrift's operations to ensure it is properly managing any concentration risk in its portfolio, has sufficient capital commensurate with its operations, has appropriate and effective risk management controls, and has sufficient liquidity levels and contingency liquidity plans. The OTS will continue to work on an inter-agency basis with the other federal banking regulators to ensure fair and balanced regulation that includes appropriate counter-cyclical and systemic risk measures.

Reform efforts

As part of a comprehensive package of financial regulatory reform, Treasury has proposed legislation to overhaul the structure of federal supervision and regulation, including consolidating the OCC and OTS into one agency. Treasury's proposals would also make sure that all financial firms that own banks are subject to robust consolidated supervision by closing gaps and loopholes in the Bank Holding Company Act and requiring thrift holding companies to become bank holding companies. Other elements of the comprehensive reform include requiring all firms whose failure could threaten financial stability to submit to strong prudential supervision regardless of whether they own a bank; creating a Financial Services Oversight Council (FSOC) to monitor emerging threats; establishing a new Consumer Financial Protection Agency; and creating a resolution regime for large, highly interconnected financial firms to allow these firms to fail while protecting taxpayers and the economy.

Treasury also continues to work with the OCC, OTS, and other federal financial agencies to analyze lessons learned from the financial crisis and pursue appropriate reforms that do not require legislative action. Following on the release of the Treasury's regulatory reform legislative proposals, Treasury is leading working groups on regulatory capital and on the future of financial supervision and regulation. These working groups will make further proposals for strengthening the conduct of supervision and addressing shortcomings in rules and regulations. The Treasury expects that implementing their recommendations will require the commitment of all of these agencies in the next two years.

Challenge 3 – Management of Recovery Act Programs

Under the American Recovery and Reinvestment Act of 2009 (ARRA, or Recovery Act), Treasury administers grants, cash assistance in lieu of tax credits, economic recovery payments, and some 60 tax relief provisions which will deliver over $300 billion in relief to American families and businesses.

Treasury recognizes the immense challenges in managing its Recovery Act programs in a manner that ensures the programs achieve their intended purpose, provide for unprecedented accountability and transparency, and are free from fraud and abuse.

In implementing ARRA, the Department must ensure that we balance and meet the objectives of speed, quality and accountability. To achieve these objectives, Treasury established a Recovery Act implementation team responsible for working with the program offices across the Department. The Recovery Act team facilitates all Recovery Act implementation Department-wide and interfaces with the broader Recovery Act community. As part of this broad responsibility, the team establishes internal processes, addresses external data requirements, manages risk inherent in Recovery Act implementation, and coordinates Treasury Recovery Act audits. The team works closely with the Office of Management and Budget (OMB) and the Recovery Implementation Office to document progress on Recovery Act implementation and assists in implementing OIG/TIGTA/GAO recommendations.

Internally, the Recovery Act team developed detailed spend plans for its major programs and documents reporting responsibility for executing those initiatives. Treasury monitors and reviews those spend plans with bureau and Senior-accountable officials. This review focuses on items such as percent on-time performance for project activities, obligations and outlays versus plan, acquisition competition and contract types, performance measure actual values versus targets, and accountability metrics. Corrective and preventive actions, established as a result of the reviews, are tracked for implementation. We also review risk assessments and the implementation of mitigation plans to minimize the probability of fraud and abuse.

Page 6

Treasury keeps the public informed through both agency and bureau websites and press releases, and monitors timely submissions to both the Recovery.gov and Treas.gov Recovery Act web pages.

ARRA established a number of innovative new programs to ease the impact of the credit crunch on state and local government budgets. One such program, which has been implemented very successfully by the Department of the Treasury, is the Build America Bond program (BAB). BABs are taxable bonds issued by state and local governments with a 35 percent interest subsidy paid directly to the issuer by the federal government. This bond program has allowed states to raise capital needed for crucial infrastructure projects by attracting new investors to the municipal bond market and reducing the issuer's debt cost. $47 billion in Build America Bonds were issued from the program's inception in April 2009 through the end of October, representing 21 percent of all municipal issuances in that time frame. A total of 42 states have participated in the program with over 500 separate issues. In addition to giving issuers access to much needed capital, the program has succeeded in making municipal debt attractive to new investors such as pension funds and foreign investors. By bringing in new investors, BABs have relieved supply pressure and have helped reduce borrowing costs on traditional tax-exempt municipal debt.

You expressed concern that Treasury staffing for two of our Recovery Act programs (cash assistance to states for low-income housing projects in lieu of tax credits and cash assistance for specified energy property in lieu of tax credits) is not commensurate with the size of these programs. The Office of the Fiscal Assistant Secretary assembled a core staff of five full-time employees to manage these programs. Although this is a small staff in relation to the size of the programs, we are achieving success by ensuring that this staff has appropriate skill sets and by leveraging the skills and expertise of others, both within and outside the Department. Staff members from several other offices within Treasury, including the IRS, are devoting time to these two programs. Additionally, we entered into an Interagency Agreement with the Department of Energy to provide necessary technical expertise in implementing the energy cash assistance program. We successfully implemented both of these programs in five months and have made awards to date in excess of $4 billion.

We recognize that staffing needs may change over the life of the programs, particularly as we move into the post-award monitoring phase. We therefore will continue to evaluate workforce needs and make adjustments as necessary.

Challenge 4 - Management of Capital Investments

The Department takes investment management very seriously and remains committed to improving the management of Information Technology (IT). In support of this commitment, the Department-level Executive Investment Review Board (E-Board), chaired by the Deputy Secretary and the Assistant Secretary for Management and Chief Financial Officer (ASM/CFO), met twice in fiscal year 2009. In support of the E-Board's efforts and to fulfill its IT Governance role, the Office of the Chief Information Officer (CIO) is actively engaged in the following activities:

Infrastructure Optimization – In July 2009, the Treasury E-Board endorsed a multi-faceted strategy for reducing the Department's IT infrastructure costs. To support this strategy, the Treasury CIO Council is developing a proposal of specific initiatives which will achieve cost savings by maximizing all infrastructure optimization and consolidation opportunities.

Monthly Evaluation of IT Investments – In July 2009, the Treasury CIO began monthly evaluations on the degree to which major IT investments met cost, schedule, and other performance goals. This information is made possible via a website hosted by OMB. The public transparency and increased frequency of assessments have resulted in increased executive attention to IT investment management, which in turn results in more consistent management of the Treasury IT budget.

Oversight of the Treasury Network (TNet) Transition – Recognizing the challenges associated with critical infrastructure investments, the Office of the CIO is actively overseeing the transition to Treasury's new consolidated wide area network project, TNet, and making a concerted effort to stay on schedule.

Challenge 5 - Anti-Money Laundering and Terrorist Financing/Bank Secrecy Act Enforcement

The Department does face unique challenges in carrying out its responsibilities under the Bank Secrecy Act (BSA) and the USA PATRIOT Act to prevent and to detect money laundering and terrorist financing, and we are focused on executing our mission as effectively as possible to protect the integrity of the financial system. The Financial Crimes Enforcement Network (FinCEN) has overall authority for BSA enforcement and compliance.

In the last several years, FinCEN has focused on effective and efficient administration, outreach, and engagement of existing industries covered by the BSA. The subsequent paragraphs highlight the actions FinCEN, in coordination with other federal and state authorities, completed in fiscal year 2009 with regard to existing industries. However, new payment systems and industries vulnerable to money laundering continually evolve, such as stored value cards, non-bank mortgage lenders, and hedge funds. In fiscal year 2010 and beyond, FinCEN will expand BSA regulations to new industry sectors, consistent with the Administration's priorities.

In fiscal year 2009, FinCEN published a proposal simplifying the organizational structure of BSA requirements. In addition, OCC, OTS, and FinCEN worked with other federal banking agencies to continue to enhance the Federal Financial Institutions Examination Council's *Bank Secrecy Act/Anti-Money Laundering Examination Manual*, first issued in 2005, with revisions to be issued in fiscal year 2010. Following up on the success of this manual, FinCEN worked with the IRS and state regulators to develop a Money Services Business (MSB) examination manual, released in fiscal year 2009. FinCEN facilitated the development of training materials on this manual, and fostered training for state examiners in fiscal year 2009, with further training scheduled in fiscal year 2010. Additionally, FinCEN issued a final rule in fiscal year 2009 simplifying the appropriate exemption of customers from currency transaction reporting requirements.

To enhance the efficiency and effectiveness of the BSA regulatory framework, FinCEN also initiated several rulemaking proposals in fiscal year 2009, including issuing notices of proposed rulemaking to accomplish the following:

- help ensure suspicious activity reports (SARs) are subject to appropriate protection and simultaneously issued proposed guidance to expand the ability of financial institution to share SAR information within their organizational structures;
- revise the regulatory definition of MSBs to make the determination of which businesses qualify as MSBs more straightforward; and
- move to streamline mutual fund BSA requirements by allowing mutual funds to file currency transaction reports.

FinCEN also sought comment on a wide range of questions pertaining to the possible application of anti-money laundering (AML) program and SAR rules to non-bank residential mortgage lenders and originators. In fiscal year 2010, FinCEN will continue working on these proposals, as well as regulations regarding stored value, as mandated by the CARD Act.

Outreach plays an important role in effectively administering the BSA. The Bank Secrecy Act Advisory Group (BSAAG) serves as the principal forum to discuss BSA issues among regulators, law enforcement, and the industry. FinCEN's Data Management Council enables government users of the BSA database to have a more direct role in providing advice about their information needs and helping FinCEN prioritize adjustments to the database. In fiscal year 2009, FinCEN continued outreach to specific financial institutions, visiting several large MSBs. We plan to conduct further outreach to additional industry segments in fiscal year 2010.

Active engagement with other regulators is also critical to meet our challenges. FinCEN established 55 memoranda of understanding (MOU) with federal and state regulators to enhance the sharing of information derived from compliance examinations, and by signing a MOU with the Commodity Futures Trading Commission (CFTC) in fiscal year 2009, FinCEN has now finalized MOUs with all federal functional regulators. FinCEN shared analytic reports in the form of BSA data profiles with these federal and state regulators, and surveyed its MOU partners to determine the impact of the information exchanged; 82 percent of respondents indicated the information shared with them was valuable. As these MOUs mature, the information exchanged will help FinCEN improve BSA examination consistency and compliance. In fiscal year 2010, FinCEN will pursue MOUs with additional state regulators.

To enhance regulated financial industry understanding of and compliance with BSA requirements, in fiscal year 2009 FinCEN published a range of interpretive guidance, including guidance to financial institutions on filing SARs regarding loan modification and foreclosure rescue scams; guidance on the scope of permissible information sharing covered by Section 314(b) safe harbor of the USA PATRIOT Act, and an educational pamphlet on the currency transaction reporting requirements. In fiscal year 2010, FinCEN will conduct strategic analytical studies and publish reports promoting both greater awareness of emerging money laundering trends, vulnerabilities, and avoidance of compliance expenditures that are not commensurate with actual risks. These initiatives will include additional analysis on mortgage loan and loan modification fraud.

A primary strategy for meeting the goal of a safer, more transparent financial system includes effective examination for any potential money laundering, terrorist financing, and BSA issues in OTS and OCC-supervised institutions. OTS and OCC continue to examine compliance with BSA, USA PATRIOT Act, and other anti-money laundering provisions through a process which consists of on-site examinations conducted every 12-18 months, supplemented by off-site monitoring and follow-up to address identified supervisory issues. Additionally, in fiscal year 2009 FinCEN and the IRS continued implementing a strategy for developing and implementing a more effective BSA examination regime for non-bank financial institutions that the IRS examines. Implementation of this strategy and other efforts, including enhancements to the non-compliance referral process, will continue through fiscal year 2010.

Challenge 5 also refers to Office of Foreign Assets Control (OFAC) programs and discusses OFAC MOUs with state and federal regulators. It is true that financial institutions' OFAC compliance programs are critical to the implementation of sanctions, and OFAC will continue to work with regulators and the regulated community to ensure attention to OFAC compliance is not lessened in the current environment. Substantively, the MOUs with Federal and State regulators are working as intended. OFAC keeps a financial institution's regulator fully informed about any apparent violation of OFAC regulations by that institution. This information is used to help the regulators develop the scope of the OFAC examination to which the institution should be subject. OFAC also requests and receives information from the regulators about the sufficiency of a financial institution's OFAC compliance program. This information is used as a factor in determining what level of enforcement action to take against a financial institution for an apparent violation of OFAC regulations. In addition to these formal requests, the regulators may contact OFAC if they have particular concerns about an institution.

cc: The Deputy Secretary
Assistant Secretary for Management and Chief Financial Officer

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL for TAX ADMINISTRATION

October 15, 2009

MEMORANDUM FOR SECRETARY GEITHNER

FROM: J. Russell George J. Russell George
Inspector General

SUBJECT: Management and Performance Challenges Facing the Internal Revenue Service for Fiscal Year 2010

The Reports Consolidation Act of 2000[1] requires that the Treasury Inspector General for Tax Administration (TIGTA) summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2009*, its perspective on the most serious management and performance challenges confronting the Internal Revenue Service (IRS or Service). The top 10 challenges in order of priority are:

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

TIGTA's assessment of the major IRS management challenge areas for Fiscal Year 2010 has changed from the prior year. The changes include reorganizing the priority of challenges four through nine, revising the titles of three challenges to better reflect their current emphasis, and adding a new challenge entitled "Globalization."

Although not listed as challenges, two issues – tax law complexity and proposed healthcare reform legislation – warrant additional consideration. While "Complexity of the Tax Law" does not appear on this year's list of challenges because it has been overtaken by other concerns, it remains a serious, underlying issue with wide-ranging implications for both the IRS and taxpayers. Tax law complexity and frequent revisions to the Internal Revenue Code make it more difficult for the IRS to explain and enforce

[1] 31 U.S.C. § 3516(d).

the tax laws and more costly for taxpayers who want to comply. However, as the IRS lacks the authority to enact changes to the tax law, it can do little but continue to react to the frequently changing Internal Revenue Code while the debate over many significant issues continues.

Similarly, numerous tax law changes are contained in the healthcare reform legislation presently working its way through Congress. The proposals include a number of provisions that could have a significant effect on the IRS in the coming year. As policies under consideration continue to look toward the Internal Revenue Code to effect changes, the IRS potentially faces the challenge of responding quickly by shifting resources and altering established plans. However, in doing so, there is some risk to the IRS's overall mission if the actions taken cause a decline in the quality and effectiveness of service or taxpayer perception.

The following is a discussion of each of the most serious management and performance challenges facing the IRS during Fiscal Year 2010.

Modernization

The Business Systems Modernization Program (Modernization Program or Program) is a complex effort to modernize IRS technology and related business processes. It involves integrating thousands of hardware and software components while replacing outdated technology and maintaining the current tax system. The IRS originally estimated that the Modernization Program would last up to 15 years and incur contractor costs of approximately $8 billion.[2] The Program is now in its 11th year and has received approximately $2.7 billion for contractor services, plus an additional $353 million for internal IRS costs.

TIGTA reviews have identified weaknesses in program management processes throughout the life of the Modernization Program. While the IRS has improved its controls over these processes as the Program has continued to mature, several weaknesses continue to exist. Recent TIGTA audits have identified continued problems in requirements development and management, program management, contract management and security controls.

Although the Modernization Program has continued to help improve IRS operations, project development activities have not always implemented planned processes effectively or delivered all planned system capabilities. The past year's Program performance did not continue the trend of improvement it demonstrated in the prior three years. For example, from May 2008 to May 2009, five of the 17 project milestones scheduled for completion were significantly over budget, and three of 17 milestones were significantly behind schedule.

The Modernization Program has experienced significant and frequent turnover of high-level IRS and Program executives. Since the Program began in 1999, three

[2] Treasury Inspector General for Tax Administration, Ref. No. 2009-20-136, *Annual Assessment of the Business Systems Modernization Program* (2009).

Commissioners, five Chief Information Officers, and, recently, a Chief Technology Officer have overseen the Program. Many of these executives have made major changes to the Program's direction and strategies during their tenure. These changes in direction and strategy have made it challenging to achieve continuity and long-term success.

The IRS has recognized that it faces challenges in meeting the requirements of the next phase of project development and system integration. As a result, the IRS has stated that a strategy correction is needed to meet changing business needs, have a more agile information technology environment, and reduce risks with associated costs to build and maintain systems.

The immediate challenge recognized by the IRS is the future of the Customer Account Data Engine,[3] the acknowledged centerpiece of the Modernization Program. Since the IRS initiated the Customer Account Data Engine project in 1999, after spending $335 million in development costs, it has been able to process only about 30 percent of the individual income tax returns filed. Limitations in Customer Account Data Engine capabilities, including those reported by TIGTA and the Government Accountability Office (GAO) in previous years, have resulted in the IRS's effort to reengineer processing of individual taxpayer accounts and the ability to use downstream systems to improve customer service. With the pending changes and the yet to be determined implementation of a reengineered process, the risks to the success of the Modernization Program are significant.

Since 1995, the IRS has identified and reported the Modernization Program as a material weakness. The Program and processes have not progressed enough to eliminate the material weakness designation. Until the IRS is able to show consistent progress and improvement in the management of its Modernization Program and adequately addresses past TIGTA and GAO recommendations, the Program will remain a high risk for the IRS and will continue to be considered a material weakness.

Security

Millions of taxpayers entrust the IRS with sensitive financial, personal, and other data that are processed by and stored on IRS computer systems. Reports of identity theft from both the private and public sectors have heightened awareness of the need to protect these data. The risk that taxpayers' identities could be stolen by exploiting security weaknesses in the IRS's computer systems continues to increase, as does the risk that IRS computer operations could be disrupted. Internal factors (such as the increased connectivity of computer systems and increased use of portable laptop

[3] The Customer Account Data Engine is the foundation for managing taxpayer accounts in the IRS Modernization plan. When completed, it will consist of databases and related applications that will replace the existing IRS Master File processing systems and will include applications for daily posting, settlement, maintenance, refund processing, and issue detection for taxpayer tax account and return data.

computers) and external factors (such as the volatile threat environment resulting from increased terrorist and hacker activity) require strong security controls.

Homeland Security Presidential Directive-20[4] requires Federal Government agencies to develop business continuity plans[5] to enable the recovery of critical functions after a disaster or emergency. To comply with the Directive, the IRS must develop and continually update its business continuity plans to protect employees and recover critical business processes, data, and information technology systems. The IRS must protect large amounts of sensitive taxpayer data in addition to more than 100,000 employees and contractors in more than 660 facilities throughout the country. In reviews of these plans,[6] we determined that the IRS's business continuity planning efforts have not been sufficient to ensure that critical business processes and systems may be efficiently restored in the event of a disaster. We also found a majority of the incident management, business resumption, and disaster recovery plans lacked detailed planning information and recovery strategies.

The Federal Information Security Management Act (FISMA)[7] requires each Federal Government agency to report annually to the Office of Management and Budget and to Congress on the effectiveness of its security programs and to perform an annual independent evaluation of its information security program and practices. The number of incidents reported by Federal agencies has increased dramatically over the past three fiscal years, from 5,503 incidents in 2006 to 16,843 incidents in 2008.[8] The IRS has made steady progress in complying with FISMA requirements since the law's enactment in 2002 and continues to place a high priority on efforts to improve its security program. However, the IRS needs to do more to adequately secure its systems and data. Past audits have shown that the most significant areas of concern are compliance with mandated security configurations, implementation of access controls for computer systems, and use of audit trails to detect computer intrusions and misuse.

The introduction of malware,[9] also known as malicious code or malicious software, into the IRS network continues to present a growing security concern. Although the IRS has

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[4] *National Continuity Policy*, dated May 4, 2007 (also known as National Security Presidential Directive-51). This Directive establishes a comprehensive national policy on the continuity of Federal Government structures and operations.

[5] IRS business continuity plans include an Occupant Emergency Plan, which provides instructions to safely evacuate employees and visitors from a facility or shelter them in place; an Incident Management Plan, which addresses the overall command structure that would be implemented in an emergency; a Business Resumption Plan, which provides instructions for recovering and restoring disrupted business processes; and a Disaster Recovery Plan, which addresses recovery and restoration of information technology systems and data.

[6] Treasury Inspector General for Tax Administration, Ref. No. 2009-20-038, *Better Emergency Preparedness Planning Could Improve Business Continuity Efforts* (2009).

[7] Federal Information Security Management Act of 2002, 44 U.S.C. §§ 3541–3549.

[8] U.S. Government Accountability Office, GAO-09-701T, *Information Security: Agencies Make Progress in Implementation of Requirements, but Significant Weaknesses Persist* (2009).

[9] Malware refers to a program inserted into a computer with the intent of compromising the confidentiality, integrity, or availability of an organization's data, applications, or operating systems.

had success in preventing serious infections, the number of malware incidents within the IRS continues to rise. Malware is difficult to combat because it is delivered through commonly used applications and devices, such as e-mail, the Internet, and portable media devices. Without sufficient controls to prevent the introduction of malware, IRS computers and the sensitive taxpayer data stored on them are at risk of compromise that could result in identity theft and fraud.

Identity theft and phishing[10] schemes are also growing security concerns. TIGTA works closely with the IRS to identify and investigate these schemes. Attempts at identity theft and phishing related to Federal income taxes continue to rise with incidents growing more than seven times in 2008.[11] In its 2009-2013 Strategic Plan, the IRS identifies the explosion in electronic data, online interactions, and related security risks as a major trend expected to affect the Service over the next five years.

Tax Compliance Initiatives

Another compelling challenge confronting the IRS is tax compliance. 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 compliance and reducing the Tax Gap[12] are currently the focus of many IRS initiatives. Nevertheless, the IRS is facing significant challenges in obtaining more complete and timely data, and developing the methods necessary to interpret the data.

Businesses and Individuals

The IRS estimated the gross Tax Gap for Tax Year (TY) 2001 to be approximately $345 billion. Underreporting of taxes, which is comprised of four major components (individual income tax, employment tax, corporate income tax, and estate and excise taxes), is estimated at $285 billion and accounts for the largest portion of the Tax Gap. Overall, the underreporting of individual income tax and employment tax constitute over 70 percent of the gross Tax Gap.

In August 2007, the Department of the Treasury and the IRS issued a report entitled *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, which details the strategy being taken to address the Tax Gap by increasing voluntary compliance.[13] TIGTA provided an evaluation of this strategy in 2008 and reported that the long-term success of the strategy will, in large part, be dependent

[10] Phishing is the act of sending an e-mail to a user falsely claiming to be an established, legitimate enterprise in an attempt to scam the user into surrendering private information that could be used for identity theft.
[11] Internal Revenue Service Strategic Plan 2009-2013.
[12] The IRS defines the Tax Gap as the difference between the estimated amount taxpayers owe and the amount they voluntarily and timely paid for a tax year.
[13] An updated report providing an overview of efforts to close the Tax Gap was issued in July 2009.

on addressing several risk factors, including some that are beyond the control of the IRS.[14]

The IRS's Fiscal Year 2010 budget submission requests $603 million above its Fiscal Year 2009 enacted budget. More than half of this amount, $332 million, is intended for additional compliance initiatives that will target the Tax Gap. The IRS must continue to seek accurate measures for the various components of the Tax Gap and the effectiveness of the actions taken to reduce it. Broader strategies and better research are needed to determine what actions are most effective in addressing noncompliance.

Tax-Exempt Entities

The IRS continues to face challenges in administering programs focused on ensuring that tax-exempt organizations comply with applicable laws and regulations to qualify for tax-exempt status. The number of organizations granted tax-exempt status each year continues to increase. With more than $15 trillion in assets currently controlled by tax-exempt organizations or held in tax-exempt retirement programs and financial instruments, the IRS recognized in its 2009-2013 Strategic Plan that it must provide more careful oversight and advisory support than ever before. In addition, the IRS's Fiscal Year 2010 budget submission recognizes the importance of maintaining a strong enforcement presence in the tax-exempt sector to ensure charitable organizations are not used for non-charitable or illegal purposes, including financing terrorist activities.

In a report issued in Fiscal Year 2009, we determined that the Federal Government is at risk of losing future tax revenue because the IRS has not developed or implemented the processes necessary to identify and address noncompliance with State volume cap limits for tax-exempt private activity bonds. Without these processes, tax-exempt private activity bonds could be issued in excess of federally mandated yearly State dollar limits without the IRS detecting and addressing the noncompliance.[15]

Implementing Tax Law Changes

Each filing season tests the IRS's ability to implement tax law changes made by Congress. It is during the filing season that most individuals file their income tax returns and contact the IRS with questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer systems used for processing returns. Changes to the tax laws have a major effect on how the IRS conducts its activities, what resources are required, and how much progress can be made on strategic goals.

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[14] Treasury Inspector General for Tax Administration, Ref. No. 2008-30-094, *Additional Actions Are Needed to Effectively Address the Tax Gap* (2008).
[15] Treasury Inspector General for Tax Administration, Ref. No. 2009-10-097, *Future Tax Revenues Are at Risk Because Certain Tax-Exempt Bonds May Exceed Annual Dollar Limits Without Detection* (2009).

Congress frequently changes the tax laws, so some level of change is a normal part of the IRS environment. However, certain types of changes and the timing of those changes can significantly affect the IRS in terms of the quality and effectiveness of its service and how taxpayers perceive the IRS. In its 2009-2013 Strategic Plan, the IRS identifies the increasing complexity of tax administration, which includes responding to new tax provisions and adjusting to expiring ones, as a major trend expected to affect the Service over the next five years.

American Recovery and Reinvestment Act

The American Recovery and Reinvestment Act of 2009[16] (Recovery Act) was signed into law on February 17, 2009. The Recovery Act presents significant challenges to all Federal agencies as they move to implement provisions quickly while attempting to minimize risk and meet increased standards for transparency and accountability. With its numerous tax provisions, the Recovery Act poses significant challenges to the IRS as the Nation's tax collection agency and administrator of the tax laws. These provisions, which impact both individual and business taxpayers, will challenge the IRS as it attempts to implement the required changes over multiple filing seasons.

Other Tax Law Changes

Other recent legislation that has affected the IRS includes the Housing and Economic Recovery Act of 2008,[17] the Emergency Economic Stabilization Act of 2008,[18] and the Economic Stimulus Act of 2008.[19] These three Acts contained numerous tax law changes that challenged the IRS during the 2009 Filing Season. Despite these challenges, the 2009 Filing Season was generally successful, although the Recovery Rebate Credit, part of the Economic Stimulus Act of 2008, did cause significant taxpayer confusion. Although the IRS initiated a number of efforts to educate and assist individuals in computing the Recovery Rebate Credit, the Credit still resulted in millions of taxpayer errors. Two significant issues that could affect the IRS's 2010 Filing Season include Alternative Minimum Tax relief and the proposed healthcare legislation.

Providing Quality Taxpayer Service Operations

Since the late 1990's, the IRS has increased its delivery of quality customer service to taxpayers. In July 2005, Congress requested that the IRS develop a five-year plan, including an outline of which services the IRS should provide and how it will improve services for taxpayers. The IRS developed the plan – the Taxpayer Assistance Blueprint – which focuses on services that support the needs of individual filers who file

[16] Pub. L. No. 111-5, 123 Stat. 115.
[17] Pub. L. No. 110-289, 122 Stat. 2654.
[18] Pub. L. No. 110-343, 122 Stat. 3766.
[19] Pub. L. No. 110-185, 122 Stat. 613.

or should file the Form 1040 series tax returns.[20] The Blueprint includes performance measures, service improvement initiatives, and an implementation strategy for improving future service investment decisions. The IRS has begun implementing the initiatives, but many are dependent on future funding.

Despite having a plan in place to improve service, providing quality service to taxpayers remains a significant challenge for the IRS. For example, the Toll-Free Telephone Program only achieved a 58.8 percent Level of Service[21] during the 2009 Filing Season (through March 7, 2009) because of increased call demand for prior year Adjusted Gross Income and the Recovery Rebate Credit. Furthermore, the average speed to answer taxpayers' calls was 586 seconds (9.8 minutes), and the number of blocked calls during the 2009 Filing Season increased more than seven times over the 2008 Filing Season.[22] Taxpayer Assistance Centers[23] answered only 67 percent of tax law questions accurately and 82 percent of tax account[24] questions accurately.[25] Additionally, the Volunteer Program, which plays an increasingly important role in the IRS's efforts to improve taxpayer service and facilitate participation in the tax system, accurately prepared only 59 percent of TIGTA's test tax returns.

The Department of the Treasury and the IRS recognize that effective taxpayer service has a significant impact on voluntary tax compliance. Assisting taxpayers in preparing their returns by answering tax questions reduces the burden of notices and correspondence that taxpayers might have received if they made errors on their returns. Taxpayer service also reduces overall unintentional noncompliance and the need for compliance activity in the future. The IRS continues to focus on the importance of improving service by emphasizing it as one of the two main goals in its 2009-2013 Strategic Plan.

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[20] The Form 1040 series tax returns include any IRS tax forms that begin with "1040" such as the U.S. Individual Income Tax Return (Form 1040), U.S. Individual Income Tax Return (Form 1040-A), and Income Tax Return for Single and Joint Filers With No Dependents (Form 1040EZ).

[21] Level of Service is the IRS's primary measure of providing taxpayers with access to an assistor. Level of Service reflects the relative success rate of taxpayers who call the 20 Customer Account Services toll-free telephone lines seeking assistance from an assistor. It measures the success rate of access to the telephone system using the number of calls answered by IRS assistors.

[22] A blocked call is one that cannot be connected immediately because either: 1) no circuit is available at the time the call arrives (i.e., the taxpayer receives a busy signal); or 2) the system is programmed to block calls from entering the queue when the queue backs up beyond a defined threshold (i.e., the taxpayer receives a recorded announcement to call back at a later time). The IRS refers to the latter type of blocked call as a courtesy disconnect. The IRS blocked more calls during the filing season rather than allow more callers to wait on hold.

[23] Taxpayer Assistance Centers are walk-in sites where taxpayers can obtain answers to both account and tax law questions, as well as receive assistance in preparing their tax returns.

[24] A tax account is a record of a taxpayer's tax and tax-related data recorded on the IRS's Master File database.

[25] Treasury Inspector General for Tax Administration, Ref. No. 2009-40-058, *Interim Results of the 2009 Filing Season* (2009).

Human Capital

Since 2001, the GAO has designated strategic human capital management as a high-risk area within the Federal Government. In its 2009 update, the GAO reported that despite significant progress over the last few years the area remains a high risk because of a continuing need for a government-wide framework to advance human capital reform.[26]

The Commissioner of Internal Revenue (Commissioner) indicated his recognition of the need for greater attention to human capital. The Commissioner established the Workforce of Tomorrow Task Force to address recruitment and retention issues so that the IRS has the necessary leadership and workforce in place to address future challenges. Beginning in Fiscal Year 2008, TIGTA developed a broad audit strategy for addressing human capital at an IRS agency-wide level using the Human Capital Assessment and Accountability Framework[27] as a guide.

Like many other Federal Government agencies, the IRS has experienced workforce challenges over the past few years, including recruiting, training, and retaining employees, as well as an increasing number of employees who are eligible to retire. More than half of the IRS's employees and managers have reached age 50, and 39 percent of IRS executives are currently eligible for retirement. To fill the projected shortage in leadership, the IRS has stated that it must recruit one manager a day for the next 10 years. Furthermore, the rate at which new recruits in mission critical occupations are leaving the IRS during the first and second year of employment has increased since Fiscal Year 2005. The pending loss of institutional knowledge and expertise at all levels and the challenge of retaining a highly skilled workforce increase the risk that the IRS may not be able to achieve its mission.

The IRS's challenge of having the right people in the right place at the right time is made more difficult by many complex internal and external factors. The work performed by IRS employees continually requires greater expertise as tax laws become more complex, manual systems used to support tax administration become computer based, and attempts by taxpayers and tax practitioners to evade compliance with the tax laws become more sophisticated. The IRS must also compete with other Government agencies and private industry for the same human resources, complicated by the fact that younger generations of employees move between jobs more frequently than employees in the past. Furthermore, budget constraints, legislative changes, and economic shifts can create unforeseen challenges for the IRS in addressing its long-term human capital issues. In its 2009-2013 Strategic Plan, the IRS identifies human capital challenges as a major trend expected to affect the Service over the next five years.

[26] U.S. Government Accountability Office, GAO-09-271, *High Risk Series: An Update* (2009).
[27] The Framework was established by the United States Office of Personnel Management. It provides consolidated guidance for agencies to transform human capital management and understand what is to be done, how it can be done, and how to gauge progress and results. It also presents the expectations that guide the agency's assessment of human capital efforts.

Erroneous and Improper Payments and Credits

As defined by the Improper Payments Information Act of 2002,[28] an improper payment is any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements. It includes any payment to an ineligible recipient, any payment for an ineligible service, any duplicate payment, payments for services not received, and any payment that does not account for credit for applicable discounts. For the IRS, improper and erroneous payments generally involve improperly paid refunds, tax return filing fraud, or overpayments to vendors or contractors.

Refundable Credits

The IRS administers numerous refundable tax credits. These refundable credits allow individual taxpayers to reduce their tax liability below zero and, thus, receive a tax refund even if no income tax was withheld or paid. Two significant refundable credits are the Earned Income Tax Credit (EITC) and the Additional Child Tax Credit. The recently enacted American Recovery and Reinvestment Act of 2009 also authorized several new refundable credits, examples of which include the Making Work Pay Credit and First-Time Homebuyer Credit.

The EITC remains the main refundable credit and continues to be vulnerable to a high rate of noncompliance, including incorrect or erroneous claims caused by taxpayer error and resulting from fraud. The IRS has successfully developed a number of processes to identify erroneous EITC payments prior to issuance. However, because compliance resources are limited and alternatives to traditional compliance methods have not been developed, the majority of the potentially erroneous EITC claims identified continue to be paid in error. The IRS reports $10 billion to $12 billion annually in erroneous EITC payments.[29]

Contract and Other Payments

Each year, the Federal Government spends billions of dollars to acquire goods and services. In Fiscal Year 2008, Federal contracting outlays were more than $500 billion. Similarly, contract spending by the IRS represents a significant outlay of Service funds. Numerous past TIGTA audits have identified millions of dollars in questioned costs and several instances of contractor fraud. A summary of our work in this area over a period of approximately four years concluded that an incomplete invoice verification process resulted in the IRS paying approximately $7.5 million in questionable contract charges. In addition, an analysis of Defense Contract Audit

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[28] Pub. L. No. 107-300, 116 Stat. 2350.
[29] Treasury Inspector General for Tax Administration, Ref. No. 2009-40-024, *The Earned Income Tax Credit Program Has Made Advances; However, Alternatives to Traditional Compliance Methods Are Needed to Stop Billions of Dollars in Erroneous Payments* (2008).

Agency reports issued in Fiscal Years 2006 and 2007 identified approximately $167 million in questionable charges directly related to IRS contracts.[30]

Globalization

The scope, complexity, and magnitude of the international financial system present significant enforcement challenges for the IRS. As technology continues to advance and cross-border transactions rise, the IRS faces the growing challenge created by economic globalization. Technological advances have provided opportunities for offshore investments that were once only possible for large corporations and wealthy individuals.

Taxpayers with international activities – individuals, businesses, and tax-exempt organizations – continue to grow in number and variety. Examples of this trend include: 1) United States-based corporations more than tripled their foreign profits between 1994 and 2004, from $89 billion to $298 billion, with 58 percent of those profits earned in low-tax or no-tax jurisdictions; 2) the number of multinational corporations worldwide has grown from an estimated 3,000 in 1990 to over 63,000 in 2007; 3) the total income reported for 2005 from active foreign corporations owned by United States taxpayers exceeded $1.8 trillion; and 4) the percentage of Americans' income originating from foreign sources doubled between 2001 and 2006.

The IRS is challenged by a lack of information reporting on many cross-border transactions. In addition, the varying legal requirements imposed by different jurisdictions result in the formation of complex business structures that make it difficult to determine the full scope and effect of cross-border transactions. However, over the past few years, the IRS has taken actions to better coordinate international tax compliance issues. In September 2007, the IRS announced a Service-wide Approach to International Tax Administration highlighted by three strategic goals: 1) improving taxpayer service; 2) enhancing enforcement and modernizing the IRS for improving voluntary compliance with international tax provisions; and 3) reducing the Tax Gap attributable to international transactions. In addition, the Commissioner has emphasized that international issues will be a top priority during his tenure. The IRS has also made other changes to its structure and processes, including increasing cooperation and outreach efforts to foreign governments. In its 2009-2013 Strategic Plan, the IRS identifies accelerating globalization as a major trend expected to affect the Service over the next five years.

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

[30] Treasury Inspector General for Tax Administration, Ref. No. 2008-10-092, *Procurement's Control Environment Was Ineffective and Did Not Prevent Overpayments to Contractors* (2008).

IRS Restructuring and Reform Act of 1998 (RRA 98).[31] Annual audit reports are mandated for the following taxpayer rights provisions:

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

In general, the IRS has improved its compliance with these statutory taxpayer rights provisions. The IRS has shown improvement over prior years when documenting that taxpayers were informed of their rights. However, there were still instances in which there was no documentation in the related case files to show that taxpayers were advised of their rights regarding assessment statute extensions,[32] and the IRS did not always follow procedures for mailing notices to taxpayers or their representatives in Federal Tax Lien cases.[33]

Some IRS management information systems do not track cases that require mandatory annual audit coverage.[34] Thus, neither TIGTA nor the IRS could evaluate the Service's compliance with certain RRA 98 provisions.

Leveraging Data to Improve Program Effectiveness and Reduce Costs

While the IRS has made some progress in using its data to improve program effectiveness and reduce costs, this area continues to be a major challenge. The IRS lacks a comprehensive, integrated system that provides accurate, relevant, and timely financial and operating data that describes performance measures, productivity, and associated costs of IRS programs. In addition, the IRS cannot produce timely, accurate, and useful information needed for day-to-day decisions, which hinders its

[31] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[32] Treasury Inspector General for Tax Administration, Ref. No. 2009-30-113, *Fiscal Year 2009 Statutory Audit of Compliance With Notifying Taxpayers of Their Rights When Requested to Extend the Assessment Statute* (2009).
[33] Treasury Inspector General for Tax Administration, Ref. No. 2009-30-089, *Additional Actions Are Needed to Protect Taxpayers' Rights During the Lien Due Process* (2009).
[34] Treasury Inspector General for Tax Administration, Ref. No. 2009-30-046, *Fiscal Year 2009 Statutory Review of Disclosure of Collection Activity With Respect to Joint Returns* (2009) and Treasury Inspector General for Tax Administration, Ref. No. 2009-30-054, *Fiscal Year 2009 Statutory Review of Restrictions on Directly Contacting Taxpayers* (2009).

ability to address financial management and operational issues to fulfill its responsibilities.

TIGTA and the GAO have continued to report that various IRS management information systems are insufficient to enable IRS management to measure costs, determine if performance goals have been achieved, or monitor progress in achieving program goals. In its most recent financial statement audit, the GAO noted that the IRS continues to face several key issues that represent material weaknesses in internal control, including not having current and reliable ongoing cost information to support management decision making and to prepare cost-based performance measures.[35] In addition, our analysis of the IRS's December 31, 2008, Federal Financial Management Improvement Act of 1996 (FFMIA)[36] remediation plan found that the IRS did not include remediation actions to address certain GAO findings and recommendations related to the IRS's noncompliance with the FFMIA. These findings and recommendations related to the IRS's Integrated Financial System, which provides the Service with an integrated accounting system to account for and control resources.[37]

Conclusion

The above are the ten major management and performance challenges for the IRS in Fiscal Year 2010. TIGTA's Fiscal Year 2010 Annual Audit Plan contains our planned reviews and is organized by these challenges. If you have questions or wish to discuss TIGTA's views on the IRS's challenges in greater detail, please contact me at (202) 622-6500.

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

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[35] U.S. Government Accountability Office, GAO-09-119, *Financial Audit: IRS's Fiscal Years 2008 and 2007 Financial Statements* (2009).
[36] Pub. L. No. 104-208, 110 Stat. 3009.
[37] Treasury Inspector General for Tax Administration, Ref. No. 2009-10-094, *The Internal Revenue Service's Federal Financial Management Improvement Act Remediation Plan As of December 31, 2008* (2009).

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

December 11, 2009

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

FROM: Timothy F. Geithner

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

I am responding to your October 15, 2009, memorandum describing the most serious management and performance challenges facing the Internal Revenue Service (IRS). The Department appreciates your independent assessment of progress in addressing these challenges. This memorandum provides information on the actions completed in Fiscal Year (FY) 2009 and the actions planned for fiscal year 2010 to address these challenges.

Challenge 1 - Modernization

In fiscal year 2009, IRS continued to execute on its long-term plan to modernize the technological underpinnings of the nation's tax system. The Customer Account Data Engine (CADE), Modernized e-File (MeF), and Account Management Services (AMS) modernization projects delivered the changes necessary for a successful tax filing season, supported implementation of the American Reinvestment and Recovery Act (ARRA) provisions, and provided audit trails to enhance the security posture of IRS systems.

Also in fiscal year 2009, the IRS enhanced its strategy to accelerate completion of a consolidated taxpayer account database, in part based on feedback from TIGTA. Contingent upon funding, the IRS plans to implement the new taxpayer account database for the 2012 filing season. The new database will support daily processing and result in faster refunds for all individual refund filers. Daily updating of individual taxpayer accounts by 2012 also will improve taxpayer service and accuracy, reduce interest paid on late refunds, improve data security, and create new tools to combat fraud and improve enforcement activities. Completion of the taxpayer account database is the prerequisite for other major initiatives, including significant expansion of online services and transactions and next generation of enforcement technologies.

Challenge 2 - Security

In fiscal year 2009, the IRS expanded its efforts to detect and prevent security threats. By securing infrastructure, data, and applications, the IRS protected access to taxpayer information. For example, every laptop at the IRS is equipped with sophisticated disk encryption software to protect against unauthorized use of sensitive data.

The IRS also maintained an agency-wide information security program and made major enhancements to its Disaster Recovery Program to ensure the continuity and resiliency of IRS critical business processing systems. An Emergency Management and Preparedness Executive Steering Committee was established to direct an IRS-wide emergency management program, and the Physical Security and Emergency Preparedness office focuses on management of the IRS continuity planning program.

The IRS takes the issue of Identity Theft very seriously. In fiscal year 2009, to preserve and enhance public confidence, the IRS established specialized units and dedicated toll-free telephone lines to provide guidance and assistance to taxpayers affected by identify theft. In the first year, the IRS responded to more than 120,000 calls and opened nearly 34,000 cases of suspected identity theft for further investigation. The IRS also placed markers on more than 231,300 taxpayer accounts to alert employees the account belongs to a substantiated identity theft victim. In fiscal year 2009, the IRS sent nearly 79,600 letters to individuals to inform them their personal information was used by another individual to file a return or may have been compromised through phishing scams. The IRS also eliminated the use of Social Security Numbers (SSNs) on more than 8 million forms, notices, and letters issued. This is the first large-scale effort to eliminate and reduce the use of SSNs on taxpayer correspondence. Over the next two to five years IRS will eliminate the use of SSNs on more than 90 million notices and forms sent to individual and business taxpayers.

To address the challenges of malicious code or software into the network, the Computer Security Incident Response Center (CSIRC) provides the IRS with a team of capable "first responders" organized, trained, and equipped to identify, contain, and eradicate cyber threats targeting IRS computing assets. In fiscal year 2009, the IRS repelled more than 35 million unauthorized access attempts, with about one-third of this malicious activity originating from outside the United States.

In fiscal year 2010, the IRS will continue to develop and update its business and continuity plans to protect employees and to recover the critical business processes, data, and information technology systems. A test and exercise program is in development that integrates all four business continuity plans used to prepare for, respond to, and recover from a disaster or emergency incident.

Challenge 3 - Tax Compliance Initiatives

During fiscal year 2009, the IRS focused on targeting its enforcement efforts on high-risk categories of non-compliance to support the overall goal of reducing the tax gap. In addition to the specific programs outlined below, the IRS continued work on a reporting compliance study for individual taxpayers that will provide updated and more accurate audit selection tools as the first of an ongoing series of individual studies using a rolling multi-year methodology. Studies in subsequent tax years will allow the IRS to make more frequent updates to its voluntary compliance estimates.

The IRS has a seven-part, multi-year strategy to address the Tax Gap as presented in the July 2009 Tax Gap Report. The strategy outlines a series of initiatives designed to reduce opportunities for tax evasion by implementing more stringent reporting requirements, making a commitment to providing more useful, up-to-date estimates of the tax gap, and continuing to make improvements in information technology to help make early detection and intervention efforts more effective. Additional strategies include supporting a sustained focus in the areas of greatest risk including international enforcement, improved compliance programs for business and high-income individuals, and providing innovative on-line services and streamlined written communication to enhance taxpayer services. Reform and simplification of the tax law includes the continuing effort to simplify tax forms and publications and taxpayer burden reduction actions. The multi-pronged strategy also includes ensuring ethical standards of conduct for tax preparers to improve taxpayer compliance.

IRS actions to address compliance by businesses and individuals in fiscal year 2009 included expanded enforcement presence in the international field and continued pursuit of high net-worth noncompliant taxpayers.

The IRS also developed a tax preparer strategy to identify recommendations to ensure consistent standards for tax preparer qualifications, ethics and service. The recommendations will be developed from information obtained from a large and diverse constituent community that included those licensed by state and federal authorities, unlicensed tax preparers, software vendors, consumer groups and taxpayers. Over 450 taxpayers and tax professionals along with 600 employees responded to the IRS request for comments to help better leverage the tax return preparer community with the twin goals of increasing taxpayer compliance and ensuring uniform and high ethical standards of conduct for tax preparers.

In fiscal year 2010 the IRS will significantly expand international enforcement, implement significant new information reporting authorities into compliance programs, and move toward higher standards in the tax practitioner community.

Challenge 4 – Implementing Tax Law Changes

The IRS is faced with implementing tax law changes each filing season. In response to recent revisions to the tax laws, the IRS helped taxpayers file correct tax returns by providing education and outreach through automation, face-to-face contact, and the media. In fiscal year 2009, taxpayers continued to use the IRS website, IRS.gov, in record numbers to get current information. Passage of the First-Time Homebuyer Credit and ARRA, as well as questions on the Recovery Rebate Credit resulted in the IRS providing real-time, updated information to taxpayers as they filed their returns.

The IRS also delivered outreach and education to the tax professional community, industry partners, and small business and self-employed taxpayers through a wide range of strategies, outreach products and communication vehicles such as Webinars, tax practitioner institutes, and National Tax Forums. In addition, the IRS website was expanded to include an online version of the Small Business Resource Guide and Small Business Tax Center; an interactive Spanish application for "How much was my Stimulus Payment?"; and a Spanish Tax Practitioner Tool Kit.

American Recovery and Reinvestment Act

The IRS expedited completion of tax products to address ARRA provisions. Before enactment, the IRS initiated work on the tax-related provisions to ensure timely implementation, including releasing forms, schedules and guidance three days after enactment; developing new publications to explain the tax provisions to individual and business filers; and informing taxpayers of the tax credits they may be entitled to using multiple communication channels including press releases, television commercials, and updated information on the irs.gov website. For the first time, the IRS launched a YouTube video site and an ITunes podcast site to provide information on ARRA, tax tips, and how-to videos. This comprehensive approach to administering the provisions of ARRA allowed the IRS to meet taxpayer and stakeholder expectations for these important tax law changes.

Other Tax Law Changes

Other recent legislation contained tax law changes, including the Housing and Economic Recovery Act of 2008; the Emergency Economic Stabilization Act of 2008; the Economic Stimulus Act of 2008; and the Worker, Retiree, and Employer Recovery Act of 2008. The IRS delivered a successful 2009 filing season despite the substantial number of legislative actions (500 actions affecting 203 tax products) required from these Acts.

Although resources were strained, 95 percent of the critical individual filing season products and over 96 percent of the tax-exempt and business tax products were delivered timely.

The IRS provided taxpayers with online access to tax law information, including tax law changes, in an easily understandable format on IRS.gov. In fiscal year 2009, taxpayers used the site to find out about the Rebate Recovery Credit. More than 54 million taxpayers used the "Where's My Refund?" calculator to check on the status of their tax refund, an increase of 38 percent, and over 430,000 taxpayers used the Spanish version. Over 650,000 taxpayers who did not receive a stimulus payment in 2008 used the new Recovery Rebate Credit calculator to help them determine if they were eligible for the credit, and if so, how much they could claim.

In fiscal year 2010, the IRS will continue to monitor proposed changes to the tax laws, including Alternative Minimum Tax relief and the proposed health-care legislation, and prepare accordingly to ensure taxpayers have the necessary forms and information for the filing season.

Challenge 5 - Providing Quality Taxpayer Service Operations

In fiscal year 2009, the IRS continued the implementation of Taxpayer Assistance Blueprint (TAB) service improvements. A new group was created to identify and coordinate enterprise-wide service improvements from the taxpayer's perspective. The initiatives included the implementation of an online tool which provides taxpayers with tax- law information in an easily navigable format, the creation of 332 "talking Tax Forms" for visually impaired taxpayers, and the launch of Spanish versions of the Free File Program.

The IRS provided extensive media coverage and expanded electronic outreach activities to make taxpayers aware of new credits, deductions, and exclusions for which they qualified. A second "Super Saturday" event was held in fiscal year 2009, and the IRS provided over 11,000 taxpayers with tax assistance and return preparation. The event was the largest one-day outreach service event in IRS history.

The IRS also provided assistance to millions of taxpayers by expanding partnerships with nonprofit and community organizations, opening more than 12,100 free tax preparation sites nationwide. Volunteers at these sites prepared over 3.0 million returns for low-income and elderly taxpayers. The IRS also served 6.2 million taxpayers at the Taxpayer Assistance Centers (TACs).

In fiscal year 2010, the IRS will continue to provide quality taxpayer service by implementing additional improvements outlined in the TAB, including greater access to available services on non-workdays through events like "Super Saturday." The IRS also will improve the taxpayer's filing experience by implementing new quality standards at the TACs and volunteer return preparation sites through reviews of selected prepared returns to determine accuracy.

Challenge 6 - Human Capital

In fiscal year 2009, the IRS engaged in an extensive enforcement hiring initiative, resulting in an enforcement staffing increase of more than 3,000 employees. To ensure coordination at all levels, the IRS established a governance structure to provide oversight of the hiring initiative and created a centralized office to coordinate all recruiting efforts. For the first time, candidates who applied for multiple jobs in different locations were ranked and interviewed only once, and competing organizations collaborated on selections to ensure the best-skilled individual was hired for each position. The IRS also increased its veteran hiring by 85 percent from 901 in fiscal year 2006 to 1,669 in fiscal year 2009 with targeted recruitment efforts.

The report of the IRS Workforce of Tomorrow (WOT) Task Force was released in August 2009. The report included initiatives to improve the hiring process to ensure continued success in filling critical enforcement positions. Highlights included creation of a detailed workforce planning model that can be embedded into the existing planning processes, a centralized recruiting organization and corporate recruiting strategy that ensures consistent brand messaging and engagement of local leaders, an enhanced hiring process implemented in phases that can cut hiring time by 50 percent, reduction of managerial burden initiatives, enhanced training and support for managers, and a leadership development process to identify and develop leaders across the IRS.

In fiscal year 2010, the IRS will implement additional WOT recommendations, implement streamlined hiring, and pilot an accelerated leadership program for high potential candidates.

Challenge 7 - Erroneous and Improper Credits and Payments

The IRS has a balanced and comprehensive plan, including compliance activities and systemic changes, to reduce improper payments.

Refundable Credits

In fiscal year 2009, the IRS protected over $3.2 billion in revenue through EITC enforcement efforts, including examination of over 500,000 returns and 25,000 amended returns claiming EITC, 314,000 document matching reviews, and 300,000 math error process corrections. The IRS also identified more than 123,000 fraudulent returns claiming over $361 million in refunds and stopped over $90 million in fraudulent claims using the Electronic Fraud Detection System (EFDS).

The IRS also completed activities associated with the EITC Return Preparer Study, including analyzing short-term outcomes from due diligence visits, developing new education and compliance notices, making phone calls to first-time EITC preparers to make sure they understand the program guidelines, and adjusting the timing of EITC paid preparer due diligence visits to clarify procedures. These improvements resulted in a 5 percent increase in due diligence visits over 2008 and proposed penalties of $462,500. Additionally, the IRS continued to identify and investigate high-impact EITC fraud and tax scheme promoters and identified research-based approaches to improve EITC participation and minimize taxpayer errors.

The manner and means by which individuals deploy fraudulent refund schemes are constantly evolving and are becoming more complex and sophisticated. The Questionable Refund Program (QRP), a nationwide multifunctional program designed to identify fraudulent returns and to stop payment of fraudulent refunds, continued to show positive results. In fiscal year 2009, the IRS identified over 414,000 potentially fraudulent returns claiming over $2.7 billion in total refunds and initiated 418 investigations with an 86.6 percent conviction rate, a 78.8 percent incarceration rate, and an 87.2 percent publicity rate on adjudicated cases.

In fiscal year 2010, the IRS will continue to identify and investigate EITC tax scheme promoters and preparers through improved data matching, while utilizing automated under-reporter data to identify outreach and education opportunities for identified patterns of noncompliance. In addition, the IRS will improve the accuracy of EITC returns by refining the due diligence audit process, conducting visits by revenue and criminal investigation agents, streamlined injunctions, and notice and phone contact treatments.

Contract and Other Payments

To properly account for contract spending, the IRS developed templates for documenting contract type decisions and rationale when Performance-Based Acquisition methods are not used. In addition, a module entitled, "Types of Work Statements, Appropriate Contract Types and Risk," will be included in the annual Advance Acquisition Planning conference to emphasize the importance of the acquisition team selecting the appropriate contract type. The IRS will continue to utilize the Contract Review Board established in fiscal year 2008 to review all information technology acquisitions meeting established dollar thresholds.

Challenge 8 - Globalization

International compliance is a key challenge as reflected by its recent enforcement initiatives, as well as its prominence in the IRS Strategic Plan.

The IRS has placed unprecedented focus on detecting and bringing to justice those who hide assets overseas to avoid paying tax. As part of an overall IRS strategy to improve offshore compliance, new initiatives were implemented to identify US taxpayers that engaged in offshore tax evasion schemes.

The IRS established an Offshore Voluntary Disclosures/Penalty Framework for taxpayers to voluntarily disclose their offshore activities. The framework provides taxpayers the opportunity to calculate the total cost of resolving all offshore tax issues; become compliant with U.S. tax laws; make voluntary disclosures that will be used to further the IRS understanding of how foreign accounts and foreign entities are promoted to U.S. taxpayers as ways to avoid or evade tax; and provide data to be used in developing additional IRS strategies to inhibit promoters and facilitators from soliciting new clients. Thousands of taxpayers with offshore accounts voluntarily came forward to disclose information as a result of this initiative.

In fiscal year 2010, the IRS will continue its focus on international tax enforcement. In addition, the IRS will use audit results and intelligence from ongoing offshore initiatives to refine case identification and selection methods and to identify promoters, facilitators and participants in abusive offshore arrangements. The IRS will also improve the way compliance risks are identified and addressed in large, complex global businesses and high wealth individuals.

Challenge 9 - Taxpayer Protection and Rights

Taxpayer protection is a top priority for the IRS. In fiscal year 2009, the IRS continued to monitor compliance with the taxpayer rights provisions of the IRS Restructuring and Reform Act of 1998 (RRA 98), including quarterly managerial certifications and annual independent reviews of the RRA 98 Section 1204 provisions. The certification process serves to ensure management does not use enforcement statistics to evaluate employees and drive behavior in conflict with taxpayer rights. As TIGTA indicated in its report, the IRS has shown improvement over prior years that taxpayers were informed of their rights.

In fiscal year 2009, the IRS also completed an oversight review/approval process for preparer penalties to ensure uniform and consistent application of penalties; continued efforts to remove or redact Social Security Numbers from outgoing correspondence; and completed an analysis of excluding all Social Security Administration (SSA) recipients below certain income levels from the Federal Payment Levy Program.

Actions planned for fiscal year 2010 and beyond include the implementation of a low-income filter that will exclude taxpayers that are more likely to experience a hardship if included in the Federal Payment Levy Program. The IRS also will identify parameters for contractors regarding the protection of taxpayer Personally Identifiable Information (PII) for inclusion in all publishing contracts. Additionally, adoption of a broad set of recommendations around regulation of tax preparers will be at the forefront of IRS efforts.

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

In fiscal year 2009, the IRS continued to make significant progress in financial management, particularly in the development and provision of cost information across multiple business units. As a result, in its audit of the fiscal year 2009 IRS financial statements, GAO determined that the remaining issues regarding Financial Reporting no longer constituted a material weakness and that the remaining issues regarding Tax Revenue and Refunds no longer constituted a significant deficiency.

In fiscal year 2010, the IRS will continue its use of the managerial cost accounting system to conduct cost-benefit analyses that provide timely, accurate, and useful data for decision making by the major business units.

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Appendix D: Material Weaknesses, Audit Follow-Up, Financial Systems, and Recovery Act Risk Management

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

TREASURY'S MATERIAL WEAKNESSES

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

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT OF 1982 (FMFIA)

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

As of September 30, 2009, Treasury has five material weaknesses under Section 2 of the FMFIA, summarized as follows:

SUMMARY OF FMFIA AND FFMIA MATERIAL WEAKNESSES	SECTION 2	SECTION 4	TOTAL
Balance at the Beginning of FY 2009	4	0	4
Closures/Downgrades during FY 2009	0	0	0
Reassessed during FY 2009	0	0	0
New MW declared during FY 2009	1	0	1
Balance at the End of FY 2009	5	0	5

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

MATERIAL WEAKNESS DESCRIPTION	
Internal Revenue Service - Improve Modernization Management Controls and Processes	
The IRS needs to improve its Business Systems Modernization program. Key elements: • Assess the recommendations from the Special Studies and Reviews of the Business Modernization program and projects • Implement and institutionalize procedures for validating contractor-developed costs and schedules • Establish effective contract management practices • Complete a human capital strategy • Improve configuration management practices	
Actions Completed	**What Remains to be Done**
✓ Deployed Release 4.2 of the Customer Account Data Engine (CADE) in January 2009. CADE added capabilities to process prior-year and decedent returns, remittances, estimated tax payments, requests for extensions, and surname changes ✓ Deployed Modernized e-File (MeF) release 5.5 that included the redesigned Form 990 (Return of Organization Exempt from Income Tax) in time for the filing season ✓ Completed the 2009 releases of Account Management Services (AMS) providing additional real-time changes to CADE	❍ Allow assessment time to observe long-term effect of actions completed and demonstrate sustained improved performance ❍ Targeted Downgrade/Closure: FY 2011

MATERIAL WEAKNESS DESCRIPTION	
Internal Revenue Service - Computer Security	
The IRS has various computer security controls that need improvement. Key elements: • Adequately restrict electronic access to and within computer network operational components • Adequately ensure that access to key computer application and systems is limited to authorized persons for authorized purposes • Adequately configure system software to ensure the security and integrity of system programs, files, and data • Appropriately delineate security roles and responsibilities within functional business operating and program units, as required by the Federal Information Security Management Act • Appropriately segregate system administration and security administration responsibilities • Sufficiently plan or test the activities required to restore certain critical business systems where unexpected events occur • Effectively monitor key networks and systems to identify unauthorized activities and inappropriate system configurations • Provide sufficient technical, security-related training to key personnel • Certify and accredit 90 percent of all systems	
Actions Completed	**What Remains to be Done**
✓ Security roles and responsibilities ✓ Security/System Administration segregation of duties ✓ Security training ✓ Certification and Accreditation	❍ Network access controls ❍ Systems/Application controls ❍ Systems software configuration access controls ❍ Contingency planning ❍ Audit trails ❍ Targeted Downgrade/Closure: FY 2012

MATERIAL WEAKNESS DESCRIPTION

Internal Revenue Service - Financial Accounting of Revenue – Custodial

The IRS needs to have detail data to support custodial financial reporting of revenue. Key elements:

- Inability to provide detailed support for large types of revenue for employment and excise taxes
- Lack of effective custodial supporting systems/subsidiary detail
- 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
- Lack of a single, integrated general ledger to account for tax collection activities and the costs of conducting those activities
- IRS's general ledger for its custodial activities does not use the standard federal accounting classification structure

Actions Completed	What Remains to be Done
✓ Masterfile Custodial Detail Database (CDDB) Trace ID in production and the production of mismatch reports for the reconciliation process put in place ✓ Completion of CDDB release to load frozen credits ✓ Proper crediting of payments to all associated parties on TFRP accounts created since October 2001	❍ Completion of CDDB Releases to provide a single, integrated subsidiary ledger using standard federal accounting classification structure ❍ Targeted Downgrade/Closure: FY 2010

MATERIAL WEAKNESS DESCRIPTION

Financial Management Service - Consolidated Government-wide Financial Statements

The Federal Government does not have adequate systems, controls, and procedures to properly prepare the Consolidated Government-wide Financial Statements. Key elements:

- The government lacks a process to obtain information to effectively reconcile the reported excess of net costs over revenue with the budget deficit, and when applicable, a reported excess of revenue over net costs with a budget surplus
- Weaknesses in financial reporting procedures in internal control over the process for preparing the Consolidated Financial Statements

Actions Completed	What Remains to be Done
✓ Partially reconciled FY 2008 operating revenues with budget receipts ✓ Developed a model to provide analysis of unreconciled transactions that affect the change in net position. ✓ Accounted for intra-governmental differences through formal consolidating and elimination accounting entries using all reciprocal fund categories including the General Fund ✓ Federal agencies submit complete closing packages to GAO ✓ Established traceability from agency footnotes to the Consolidated Financial Statements for completeness	❍ Complete reconciliation of operating revenues to budget receipts ❍ Complete reciprocal category for the Treasury General Fund ❍ Implement changes identified by the Office of the Fiscal Assistant Secretary as a result of its review of the Reporting Entity definitions per the Financial Accounting Standards ❍ Include all disclosures as appropriate ❍ Include all loss contingencies as appropriate ❍ Targeted Downgrade/Closure: FY 2012

MATERIAL WEAKNESS DESCRIPTION

Treasury Departmental Offices - Financial Management Practices

The Office of Accounting and Internal Control (AIC) has not fully developed sufficient internal control over the underlying financial data included in the consolidated balance sheet to ensure it is complete and accurate. This is due in part because the financial infrastructure for the financial reporting responsibilities of the Treasury Department is inadequately staffed for such a large and complex Executive Agency. Key elements:

- AIC has not developed clear, step-by-step procedures for performance of the financial statements analyses or clearly explained and presented the methodogy used for preparation of these analyses.
- AIC has not clearly documented procedure manuals or process flow documentation.
- Key senior financial management and budget staff positions were vacant during critical time periods
- Lack of continuity with historical knowledge and experience caused significant delays in audit deliverables as well as in addressing accounting issues.

Actions Completed	What Remains to be Done
✓ Initiated development of standard operating procedures and cross-training of staff on financial statement process ✓ Filled AIC credit reform accountant and two senior accounting positions ✓ Obtained authorization for two additional staff accountant positions in AIC ✓ Filled three staff positions in the Office of Financial Management ✓ Filled two Budget Execution positions ✓ Brought contractors aboard to assist with GSE transactions	❍ Study existing analytical and review processes, then develop/revise policy and procedures ❍ Fill two new AIC accountant positions ❍ Review current funding, staffing, skill competencies, contract support, and training, and determine proper levels needed to fully perform daily operations ❍ Based on results of review, hire additional staff, establish additional contract service support, and/or establish agreements with Treasury bureaus for detailees ❍ Provide additional training and guidance to staff ❍ Targeted Downgrade/Closure: FY 2010

AUDIT FOLLOW-UP ACTIVITIES

During fiscal year 2009, Treasury placed renewed emphasis on both the general administration of internal control issues throughout the Department and the timely resolution of findings and recommendations identified by the Office of the Inspector General (OIG), the Treasury Inspector General for Tax Administration (TIGTA), the Special Inspector General for the Troubled Asset Relief Program (SIG TARP), the Government Accountability Office, and external auditors. During the year, Treasury continued to implement enhancements to the tracking system called the "Joint Audit Management Enterprise System" (JAMES). JAMES is a Department-wide, interactive, web-based system accessible to the OIG, TIGTA, SIG TARP, bureau management, Departmental management, and others. The system tracks information on audit reports from issuance through completion of all corrective actions required to address findings and recommendations contained in an audit report. JAMES is the official system of record for Treasury's internal control program.

POTENTIAL MONETARY BENEFITS

The *Inspector General Act Amendments of 1988*, Public Law 101-504, require the Inspectors General and the Secretaries of Executive Agencies and Departments to submit semiannual reports to the Congress on actions taken on audit reports issued that identify potential monetary benefits. The Department consolidates and analyzes all relevant information for inclusion in this report. The information contained in this section represents a consolidation of information provided separately by the OIG, TIGTA, and Department management.

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

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

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

The statistical data in the following summary table and charts represent audit report activity for the period from October 1, 2008 through September 30, 2009. The data reflect information on reports that identified potential monetary benefits issued by the OIG and TIGTA.

AUDIT REPORT ACTIVITY WITH POTENTIAL MONETARY BENEFITS FOR WHICH MANAGEMENT HAS IDENTIFIED CORRECTIVE ACTIONS (OIG AND TIGTA)
OCTOBER 1, 2008 THROUGH SEPTEMBER 30, 2009
(DOLLARS IN MILLIONS)

	Disallowed Costs		Better Used Funds		Revenue Enhancements		Totals	
	Reports	Dollars	Reports	Dollars	Reports	Dollars	Report Total	Total Dollars
Beginning Balance	11	$ 35.1	4[1]	$ 17.2[1]	10	$ 753.2	25	$ 805.5
New Reports	9	2.9	5	9,058.9	11	2,766.2	25	11,828
Total	20	38.0	9	9,076.1	21	3,519.4	50	12,633.5
Reports Closed	10	1.1	3	8,917.0	10	983.1	23	9,901.2
a. Realized or Actual	6	.7	1	.1	3	12.2	10	13.0
b. Unrealized - Written off	5	.4	2	8,916.9[2]	7	970.9[3]	14	9,888.2
Ending Balance	10	$ 36.9	6	$ 159.1	11	$ 2,536.3	27	$ 2,732.3

[1] The beginning balances for better used funds were adjusted to reflect TIGTA's removal of one report for $3.7 million.

[2] This category includes two reports, with $8,916.9 million written off, for which IRS management did not concur with TIGTA's projected benefits.

[3] This category includes four reports, with $939.3 million written off, for which IRS management was undecided or did not concur with TIGTA's projected benefits.

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, 2008, and September 30, 2009, respectively. OIG and TIGTA define as "significant" any recommendation open for more then one year. There were no "Undecided Audit Recommendations" during the same periods.

SIGNIFICANT UNIMPLEMENTED RECOMMENDATIONS

	9/30/2008		9/30/2009	
	OIG	TIGTA	OIG	TIGTA
	No. of Reports	No. of Reports	No. of Reports	No. of Reports
Unimplemented	6	40	8	26

The following table presents a summary of OIG and TIGTA audit reports that were open for more than a year with potential monetary benefits at the end of fiscal years 2007, 2008, and 2009.

NUMBER OF REPORTS WITH POTENTIAL MONETARY BENEFITS OPEN FOR MORE THAN ONE YEAR

	AFR Report Year	9/30/2007	9/30/2008	9/30/2009
OIG	No. of Reports	1	1	0
	$ Projected Benefits	$29.4 million	$29.4 million	$0 million
TIGTA	No. of Reports	10	12	10
	$ Projected Benefits	$ 66.5 million	$661.5 million	$673.8 million

The following tables present a summary of TIGTA audit reports, broken out by year of report issuance, on which management decisions were made on or before September 30, 2008, but the final actions had not been taken as of September 30, 2009. (Note: There are no OIG audit reports for this category.)

DETAILS OF THE AUDIT REPORTS WITH POTENTIAL MONETARY BENEFITS ON WHICH MANAGEMENT DECISIONS WERE MADE ON OR BEFORE SEPTEMBER 30, 2008, BUT FINAL ACTIONS HAVE NOT BEEN TAKEN AS OF SEPTEMBER 30, 2009 (DOLLARS IN THOUSANDS)

Bureau	Report Number	Report Issue Date	Brief Description	Disallowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2004-20-142	8/26/2004	The IRS should ensure the Storage Strategy Study addresses the data storage capacity deficiency and recommends a cost-effective virtual tape system solution to reduce maintenance and tape shipping costs.		200.0		200.0	Due 12/31/2010
FY 2004	1				200.0		200.0	
IRS	2006-1c-142	9/25/2006	The IRS Contracting Officer (CO) should use the results of the Defense Contract Auditing Agency (DCAA) report to fulfill his/her duties in awarding and administering contracts.	32,373.8			32,373.8	Delayed to 9/30/2010
FY 2006	1			32,373.8			32,373.8	
IRS	2007-1c-040	3/8/2007	The IRS CO will work with DCAA and the contractor to resolve the questioned costs applicable to IRS contracts.	103.6			103.6	Due 2/15/2010
IRS	2007-1c-041	3/8/2007	The IRS CO will work with DCAA and the contractor to resolve the questioned costs applicable to IRS contracts.	2,247.0			2,247.0	Due 3/15/2010
IRS	2007-30-062	3/30/2007	Ensure the revised Form 4137 is used effectively to identify and assess the employer's share of Social Security and Medicare taxes on unreported tip income.			541,124.0	541,124.0	Delayed to 1/15/2010
IRS	2007-1c-149	9/24/2007	The IRS CO will work with DCAA and the contractor to resolve the questioned costs applicable to IRS contracts.	62.2			62.2	Due 9/15/2010
IRS	2007-1c-154	9/24/2007	The IRS CO will work with DCAA and the contractor to resolve the questioned costs applicable to IRS contracts.	1.2			1.2	Due 9/15/2010
FY 2007	5			2,414.0		541,124.0	543,538.0	
IRS	2008-30-155	8/22/2008	The IRS should revise computer programming to automatically reissue an undelivered refund check when an address change is reflected on a taxpayer's account.		36.2		36.2	Due 1/15/2010

Continued on next page

DETAILS OF THE AUDIT REPORTS WITH POTENTIAL MONETARY BENEFITS ON WHICH MANAGEMENT DECISIONS WERE MADE ON OR BEFORE SEPTEMBER 30, 2008, BUT FINAL ACTIONS HAVE NOT BEEN TAKEN AS OF SEPTEMBER 30, 2009 (DOLLARS IN THOUSANDS)

Bureau	Report Number	Report Issue Date	Brief Description	Disallowed Costs	Funds Put to Better Use	Revenue Enhance-ment	Total	Due Date
IRS	2008-40-087	3/28/2008	The IRS should develop and implement strategies to bring noncompliant taxpayers back into compliance.			52,100.0	52,100.0	Due 1/15/2010
			The IRS should consider using the indicator shown on Form 5498 to identify taxpayers who are subject to required minimum distributions.			94.4	94.4	Due 1/15/2010
IRS	2008-40-167	8/29/2008	The IRS should develop a process to identify those employers that do not adequately withhold taxes from their employees after receiving a lock-in letter.			45,500.0	45,500.0	Due 12/15/2009
FY 2008	3				36.2	97,694.4	97,730.6	
TOTAL	10			34,787.8	236.2	638,818.4	673,842.4	

FINANCIAL MANAGEMENT SYSTEMS FRAMEWORK

Overview

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

The FARS structure consists of the following components:

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

Bureaus submit summary-level financial data to TIER on a monthly basis, within three business days of the month-end. These data are then used by CFO Vision to generate financial statements and reports on both a Department-wide and bureau-level basis. This structure enables the Department to produce its audited annual financial statements and monthly management reports. During fiscal year 2009, Treasury continued to upgrade its FARS applications to take advantage of improvements in system technology. This included completing the roll-out of CFO Vision to Treasury bureaus. CFO Vision provides the bureaus with direct system access for enhanced reporting capabilities and financial analysis.

The Department continues to eliminate redundant and outdated financial management systems with the goal of consolidating financial management activities to improve productivity. As of September 30, 2009, the number of financial management systems decreased to 55, down from 60 at the end of fiscal year 2008. This reduction is due in part to bureaus migrating to the Bureau of the Public Debt Administrative Resource Center (BPD ARC) for these services.

As part of the Department's enhancement effort, 14 Treasury bureaus and reporting entities are cross-serviced for core financial systems by BPD ARC. Cross-servicing enables these bureaus to have access to core financial systems without having to maintain the necessary technical and systems architectures. In an effort to continue to streamline its financial systems environment, Treasury will work with the remaining bureaus to develop plans to migrate to Treasury's Shared Service Provider for core financial systems in accordance with the Financial Management

Line of Business requirements. In addition, as part of the Department's implementation of the e-Travel initiative, bureaus have eliminated their legacy travel systems.

In fiscal year 2009, to improve management's decision making process concerning the FARS applications projects, Treasury enhanced its risk management controls. Treasury identifies and monitors the risks and the potential threats to the FARS applications, surveys FARS customers to measure application satisfaction, and identifies areas needing improvement. The Department continues to modernize the capabilities of the FARS applications by implementing solutions to provide timely and useful financial and program data. FARS applications have been expanded to support new organizations and new functionality as the Department has assumed new responsibilities resulting from the recent economic conditions. For example, Treasury expanded the JAMES to support the initiatives of the Office of the Special Inspector General for Trouble Asset Relief Program (SIGTARP), the Internal Revenue Service/Taxpayer Advocate Service, and the Office of Financial Stability (OFS). To support OFS's financial reporting needs, the FARS application CFO Vision was modified to produce stand-alone financial statements for OFS. This expanded use of CFO Vision, combined with OFS's use of a cross-serviced core financial system provided by BPD ARC, reduces the need for OFS to develop or purchase its own core financial system.

Continued Improvement

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

Treasury completed the rollout of CFO Vision to the bureaus, modified FARS to support the requirements of the new Troubled Asset Relief Program (TARP), enhanced TIER to support the month-end financial close and preparation of the monthly financial statements and reports, and established a disaster recovery site for the FARS applications to provide business continuity in case of an emergency or disaster.

The Internal Revenue Service (IRS) continued work on the Integrated Financial System (IFS). IFS is the IRS's administrative financial management system. It accounts for $11.5 billion in IRS funding and provides timely financial statements for budgeting, analysis, and government-wide reporting. Fiscal year 2009 IFS accomplishments include:

- Interfaced with GovTrip, the Department's automated travel system
- Significantly reduced user access to the mainframe by migrating legacy system reports to the business warehouse, retired legacy processes, and trained users on reporting capabilities
- Implemented automated tax withholding for employee tuition assistance, created employee invoices, and automatically posted all payments received through ***pay.gov*** (Treasury's secure electronic payments system to federal agencies)
- Updated contingency plans, and completed penetration and disaster recovery testing
- Exceeded the average system uptime target of 97 percent.

The IRS successfully deployed the Customer Account Data Engine (CADE), Release 4.2 in January 2009. CADE is used to electronically process tax returns. With the implementation of Release 4.2, capabilities were added to process prior year and decedent returns, remittances, estimated tax payments, requests for extensions, and surname changes. In fiscal year 2009, CADE processed over 40 million returns, issued more than 34.9 million refunds using a modernized account database, and processed over 7 million payments totaling $58.6 billion. The IRS developed a comprehensive Audit Trail Plan and requirements for CADE, which are necessary to account for assets and processes across the IRS.

As previously indicated, BPD ARC cross-services 14 Treasury bureaus and reporting entities for core financial systems. In addition to the cross-servicing for core financial systems, Treasury bureaus are also cross-serviced for other financial management services, such as electronic travel and human resource processing. This cross-servicing has resulted in a reduction in the number of financial management systems maintained by the Department. In fiscal year 2009, BPD ARC's accomplishments include:

- Selected by OMB as one of four government Shared Service Centers to perform information technology system Certification and Accreditation work under the Information Systems Security Line of Business (ISSLOB) initiative
- Provided system and processing support to 14 of Treasury's bureaus for human resource management and travel management
- Utilized information technology services to implement best practices for managing IT operations and improving quality and support in a cost effective manner
- Conducted a customer satisfaction survey - two-thirds of the customer agencies responded and the results showed an overall customer satisfaction score of 89 percent
- Enhanced GovTrip, Treasury's electronic travel system, to improve audit and expense descriptions and added new functionality to support user needs and improve security
- Participated in the Department of the Treasury's annual continuity exercise to assess BPD ARC's ability to perform essential functions during various emergency scenarios, and identified areas for improvement

FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT (FFMIA) COMPLIANCE

As of September 30, 2009, the Department of the Treasury's financial management systems were not in substantial compliance with FFMIA due to deficiencies with the IRS's financial management systems. The IRS has a remediation plan in place to correct the deficiencies. For each FFMIA recommendation, the remediation plan identifies specific remedies, target dates, responsible officials, and resource estimates required for completion. This plan is reviewed and updated quarterly.

The IRS made significant progress in fiscal year 2009 toward the financial management systems being in FFMIA compliance by implementing the final release of the Custodial Detail Database (CDDB). CDDB contains detailed records of IRS revenue, refunds, and unpaid assessments. It addresses an IRS material weakness by providing detail data to support custodial financial reporting and was used by GAO during the fiscal year 2009 financial statements audit.

The IRS developed and tested a replacement revenue accounting system that is planned for implementation in fiscal year 2010. This system was designed to incorporate the United States Standard General Ledger (USSGL); and add traceability between the revenue, refunds, and unpaid assessments summary record and the IRS processing system's detail records.

RECOVERY ACT RISK MANAGEMENT ACTIVITIES

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

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

Treasury created a Recovery Act Risk Management Council that meets monthly to discuss the progress and status of each bureau's Recovery Act risk management activities.

Appendix E
Glossary of Acronyms

GLOSSARY OF ACRONYMS	
ABS	Asset-Backed Securities
AFR	Agency Financial Report
AGP	Asset Guarantee Program
AIFP	Automotive Industry Financing Program
AIG	American International Group
AIIP	Automotive Industry Investment Program
APR	Annual Performance Report
ARC	Administrative Resource Center
ASC	Accounting Standards Codification
ASM/CFO	Assistant Secretary for Management & Chief Financial Officer
BEP	Bureau of Engraving and Printing
BPD	Bureau of the Public Debt
BSA	Bank Secrecy Act
BSM	Business Systems Modernization
CADE	Customer Account Data Engine
CAP	Competitiveness Assessment Process
CAP	Capital Assessment Program
CBLI	Consumer and Business Lending Initiative
CDDB	Custodial Detail Database
CDE	Community Development Entities
CDFI	Community Development Financial Institutions
CDS	Credit Default Swaps
CFPA	Consumer Financial Protection Agency
CFO	Chief Financial Officer
CFS	Consolidated Financial Statements
CFTC	Commodities Futures Trading Commission
CMBS	Commercial Mortgage Backed Securities
CO	Contracting Officer
COP	Congressional Oversight Panel
CPP	Capital Purchase Program
CSRS	Civil Service Retirement System
CTF	Clean Technology Fund

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GLOSSARY OF ACRONYMS	
DASHR/CHCO	Office of the Deputy Assistant Secretary for Human Resources/Chief Human Capital Officer
DCAA	Defense Contract Auditing Agency
DCP	Office of D.C. Pensions
DIP	Debtor-in-Possession
DO	Departmental Offices
DHS	Department of Homeland Security
EESA	Emergency Economic Stability Act of 2008
EFTPS	Electronic Federal Tax Payment System
EGTRRA	Economic Growth and Tax Relief Reconciliation Act
EITC	Earned Income Tax Credit
ESF	Exchange Stabilization Fund
Fannie Mae	Federal National Mortgage Association
FARS	Financial Analysis and Reporting System
FASAB	Federal Accounting Standards Advisory Board
FATF	Financial Action Task Force
FCDA	Foreign Currency Denominated Assets
FCRA	Federal Credit Reform Act
FDIC	Federal Deposit Insurance Corporation
FECA	Federal Employees' Compensation Act
FERS	Federal Employees' Retirement System
FEGLI	Federal Employees Group Life Insurance
FEHBP	Federal Employees Health Benefits Program
FFB	Federal Financing Bank
FFMIA	Federal Financial Management Improvement Act
FHFA	Federal Housing Finance Agency
FHLB	Federal Home Loan Bank
FinCEN	Financial Crimes Enforcement Network
FMFIA	Federal Managers' Financial Integrity Act
FMIS	Financial Management Information System
FMS	Financial Management Service
FRB	Federal Reserve Bank
FRBNY	Federal Reserve Bank of New York
Freddie Mac	Federal Home Loan Mortgage Corporation
FTO	Fine Troy Ounce
FY	Fiscal Year
G-7	Group of Seven

(continued)

GLOSSARY OF ACRONYMS	
G-20	Group of Twenty
GAAP	Generally Accepted Accounting Principles
GAB	General Arrangement to Borrow
GAO	Government Accountability Office
GFRA	General Fund Receipt Account
GM	General Motors
GMAC	General Motors Acceptance Corporation
GSA	General Services Administration
GSE	Government Sponsored Enterprises
GSECF	Government Sponsored Enterprise Credit Facility
HAMP	Home Affordable Modification Program
HCTC	Health Coverage Tax Credit
HERA	Housing and Economic Recovery Act
HUD	Department of Housing and Urban Development
IAP	International Assistance Programs
IFS	Integrated Financial System
IMF	International Monetary Fund
IPIA	Improper Payments Information Act
IRACS	Interim Revenue Accounting Control System
IRS	Internal Revenue Service
IT	Information Technology
JAMES	Joint Audit Management Enterprise System
LIBOR-OIS	London Inter-Bank Offered Rate-Overnight Index Swap
MBS	Mortgage-Backed Securities
MDB	Multilateral Development Banks
MeF	Modernized Electronic File
MINT	U.S. Mint
MRADR	Market Risk Adjusted Discount Rate
MV&S	Modernization, Vision, and Strategy
NAB	New Arrangement to Borrow
NACA	Native American CDFI Assistance
NMTC	New Markets Tax Credit
NRC	National Revenue Center
NRP	National Research Program
OCC	Office of the Comptroller of the Currency
OFS	Office of Financial Stability

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GLOSSARY OF ACRONYMS	
OIG	Office of Inspector General
OMB	Office of Management and Budget
ONI	Office of National Insurance
OPEB	Other Post Employment Benefits
OPM	Office of Personnel Management
ORB	Other Retirement Benefits
OTC	Over-the-Counter
OTS	Office of Thrift Supervision
PB	President's Budget
PCA	Planned Corrective Actions
PP&E	Property, Plant, and Equipment
PPIF	Public-Private Investment Fund
PPIP	Public-Private Investment Program
PSPA	Preferred Stock Purchase Agreements
QEO	Qualified Equity Offering
QFI	Qualified Financial Institution
RRACS	Redesign Revenue Accounting Control System
SAR	Suspicious Activity Report
SBA	Small Business Administration
SBR	Statement of Budgetary Resources
SCAP	Supervisory Capital Assessment Program
SDR	Special Drawing Rights
SEC	Securities and Exchange Commission
SED	Strategic Economic Dialogue
SFFAS	Statement of Federal Financial Accounting Standards
SFP	Supplementary Financing Program
SIGTARP	Special Inspector General for TARP
SOMA	System Open Market Account
SPSPA	Senior Preferred Stock Purchase Agreements
SPV	Special Purpose Vehicle
SSP	Shared Service Provider
SSP	Stable Share Price
TAIFF	Troubled Assets Insurance Financing Fund
TALF	Term Asset-Backed Securities Loan Facilities
TARP	Troubled Asset Relief Program
TFF	Treasury Forfeiture Fund

(continued)

GLOSSARY OF ACRONYMS	
TIER	Treasury Information Executive Repository
TIGTA	Treasury Inspector General for Tax Administration
TIP	Targeted Investment Program
TIPS	Treasury Inflation-Protected Securities
TRES	Treasury Retail E-Services
TRIA	Terrorism Risk Insurance Act
TTB	Alcohol and Tobacco Tax and Trade Bureau
USSGL	United States Standard General Ledger
VITA	Volunteer Income Tax Assistance

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Website Information

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

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