

December 29, 2017

Marybel Batjer, Secretary
California Government Operations Agency
915 Capitol Mall, Suite 200 Sacramento, CA
95814

Dear Ms. Marybel Batjer,

In accordance with the State Leadership Accountability Act (SLAA), the Franchise Tax Board submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2017.

Should you have any questions please contact Jeanne Harriman, Chief Financial Officer, at (916) 845-6431, jeanne.harriman@ftb.ca.gov.

BACKGROUND

In 1929, the Legislature created the office of the Franchise Tax Commissioner to administer California's new Bank and Corporation Franchise Tax Act. This was the first agency created for tax administration since the 1879 adoption of the Constitution of the State of California. Before that, the State Board of Equalization and the State Controller administered all tax programs. In 1950, California abolished the office of the Franchise Tax Commissioner and created the Franchise Tax Board that we know today. Our department is part of the California Government Operations Agency.

Franchise Tax Board's mission is to provide the services and information to help taxpayers file accurate and timely tax returns and pay the proper amount owed. To accomplish this mission, we develop knowledgeable and engaged employees, administer and enforce the law with fairness and integrity, and responsibly manage the resources allocated to us.

FTB's strategic goals are:

- Taxpayer Centric Service – We will enhance our services to help taxpayers fulfill their tax obligations.
- Effective Compliance – We will fairly administer the law to ensure that all taxpayers meet their obligations to file and pay the correct amount owed.
- Strong Organization – We will invest in our employees, challenge and empower them to be experts in their field, and help them achieve their full potential.
- Operational Excellence – We will optimize processes, products, services, and resources to better serve our customers.

The primary function of the Franchise Tax Board is to administer the California Revenue and Taxation Code. FTB administers two major tax programs, the Personal Income Tax and the Corporation Income Tax, as well as other non-tax programs such as Political Reform Act Audits, Delinquent Vehicle Registration, Court Ordered Debt, and Labor Law Violations.

We administer programs that bring in roughly \$93 billion annually—more than 77 percent of California's annual General Fund revenue. Each year, our department processes more than 18 million personal income tax returns and more than 1.5 million business entity tax returns. We currently employ over 5600 permanent and over 500 seasonal and intermittent employees nationwide.

FTB coordinates the development of tax forms based on legislation and input from various FTB bureaus, relays new forms data to the Office of State Printing (OSP) for printing and distribution, and coordinates the availability of tax forms on the FTB Website. We offer tax help through our toll-free telephone assistance line, and we provide a wealth of information on our website 24/7. We also provide public service (e.g., filing assistance, receiving payments, and releasing levies) during normal business hours at our six California field offices. Furthermore, we provide filing assistance to various groups through our Volunteer Program, which includes volunteer income tax assistance, tax counseling for the elderly, and military tax preparation assistance.

FTB's tax audit activities include examining taxpayer income tax returns, determining the correctness of tax liabilities, notifying taxpayers of assessments, and resolving taxpayer disputes.

In addition to FTB's automated billing process, our collection staff conducts manual collection efforts to collect unpaid personal and corporation income tax, as well as other debts entrusted to us. Collection efforts include but are not limited to: locating the debtor, attaching assets, referring cases to collection agencies, responding to critical correspondence and calls, providing information, negotiating resolution, filing bankruptcy and probate claims, processing excess collections, and issuing refunds.

ONGOING MONITORING

As the head of Franchise Tax Board, Selvi Stanislaus, Executive Officer, is responsible for the overall establishment and maintenance of the internal control and monitoring systems.

EXECUTIVE MONITORING SPONSOR(S)

The executive monitoring sponsor responsibilities include facilitating and verifying that the Franchise Tax Board internal control monitoring practices are implemented and functioning as intended. The responsibilities as the executive monitoring sponsor(s) have been given to: Selvi Stanislaus, Executive Officer, Allan Loucks, SLAA Administrator, Paula Adams, Assistant Bureau Director, Chrissy Casale, Section Manager, Jeanne Harriman, Chief Financial Officer, Jozel Brunett, Chief Counsel, Steve Abeyta, Senior Information Systems Analyst (Lead), and Christopher Johnson, Unit Supervisor.

MONITORING ACTIVITIES

Through our continuous monitoring processes, FTB routinely reviews, evaluates, and where necessary, implements improvements to the effectiveness of internal controls and monitoring processes. FTB's enterprise risk management control process, as an iterative process, continually seeks to improve its internal control processes.

ADDRESSING VULNERABILITIES

Internal control deficiencies detected through monitoring activities are reported to executive management. Corrective actions are taken to ensure identified vulnerabilities are corrected, weaknesses identified, and proactive measures are taken. As such FTB has determined that it is in compliance with California Government Code 13401, Sections 13400-13407, the State Leadership Accountability Act.

COMMUNICATION

Monitoring roles are communicated throughout the entity on an ongoing basis. Risk assessments are conducted by the risk owners to monitor and evaluate their controls. The team considers the ability to manage the risk, the risk exposure against the risk tolerance thresholds, and the risk exposure relative to other risks.

Continuous risk activity assessment provides an opportunity to review all open risks for validity and to close risks whose timeframe has passed, or whose risk has been mitigated. The SLAA Coordinator works with each risk owner to review new risks and existing risks for possible changes to status or controls on a regular basis, and no less than quarterly.

The results of FTB's Enterprise Risk Management (ERM) program activities are communicated by updates provided to executive management on a quarterly basis. The ERM program provides a comprehensive review of the existing enterprise risks and watch points, as well as emerging risks and vulnerabilities.

ONGOING MONITORING COMPLIANCE

The Franchise Tax Board has implemented and documented the ongoing monitoring processes as outlined in the monitoring requirements of California Government Code sections 13400-13407. These processes include reviews, evaluations, and improvements to the Franchise Tax Board systems of controls and monitoring.

RISK ASSESSMENT PROCESS

The following personnel were involved in the Franchise Tax Board risk assessment process: Executive Management, Middle Management, Front Line Management, and Staff.

RISK IDENTIFICATION

FTB completes enterprise wide risk assessments to address strategic, tactical, and operational risks through FTB's executive management, action committees, and the Governance Council (GC).

The GC is a decision-making body responsible for managing information technology (IT) and business issues at the departmental level. FTB's governance structure has evolved toward setting a strategic focus for the entire department for issues that have impacts crossing administrative/divisional lines. The GC is comprised of the Executive Officer, FTB Chief Counsel and six Division Chiefs over the Accounts Receivable Management, Administrative Services, Audit, Filing, Finance & Executive Services, and Technology Services Divisions.

FTB's maturing enterprise risk process consists of components to assist FTB management with the accurate collection of risk data and the appropriate identification of enterprise risks. The risk management framework is designed to ensure that risk management decisions are based on assessments that are conducted using a consistent methodology and that common terminology and understanding is utilized across FTB.

Initial risk identification is completed on an ongoing basis through a thorough, analytical review of existing watch point reports, as well as management's identification of emerging risks not otherwise identified on a watch point report. The risk assessment provides an opportunity to review all open risks for continuing validity and to close risks whose timeframe has passed, or whose risk has been mitigated. Risks are evaluated using quantitative methods (for example, using probability, impact, and timeframe to prioritize the risk).

Once classified as a risk, the risk is then submitted for tracking and management. Risks are monitored to determine whether a risk trigger or threshold is exceeded, the risk timeframe has passed and whether the risk

no longer warrants monitoring. All operational or strategic risks are monitored by the risk owner to insure that mitigation strategies are progressing. The results of the ongoing monitoring of FTB's risks are reported quarterly to the Governance Council. Through our ongoing monitoring processes, FTB reviews, evaluates, and improves our systems of internal controls and monitoring processes.

RISK RANKING

The GC's risk assessment is management's determination of FTB's greatest vulnerabilities. An annual deep dive discussion of risks is conducted to determine new risks, as well as prioritize the most pressing risk issues for the department and to assess the impact and probability of any risks that may impact the FTB operations or strategic goals. Risk owners are assigned to each risk, strategies are developed to resolve the issue and reduce risk, and actions are taken to mitigate the risks.

RISKS AND CONTROLS

RISK: OPERATIONS – INTERNAL – STAFF—KEY PERSON DEPENDENCE, WORKFORCE PLANNING Enterprise Workforce/Critical Knowledge Retention

Enterprise Workforce/Critical Knowledge Retention includes all aspects of recruitment, training, and retaining of employees in our organization. Of significant importance is the succession planning component which focuses on preparing our employees to step into roles and responsibilities being vacated through either retirements or the loss of staff to other jobs – whether internal or external to FTB. Failure to properly execute enterprise workforce planning action items could result in the loss of staff and associated knowledge base without having other individuals sufficiently prepared to step into those roles.

This potential loss of institutional knowledge is caused by a combination of 1) employees who have immediate eligibility to retire (based on age and the required number of service years); 2) employees who can/will advance or move internally within the organization, and; 3) employees who could take jobs in other government or private industry organizations. We need to make sure we have the necessary programs and knowledge transfer strategies in place to offset these anticipated losses of staff and their associated knowledge.

Without mitigation by rolling out and monitoring the effectiveness of workforce planning items within the next 12-18 months, the result could negatively impact our ability to continue efficiently and effectively carrying out our department's mission. This is identified as a top priority of our overall Talent Management program.

CONTROL A

Roll out and monitor effectiveness of workforce planning items, such as: managing risk for critical positions; expanding knowledge transfer; developing exit interviews, and; developing recruitment pipelines. This is also identified as a top priority of our talent management process, and is to be focused on and carried out within the next 12-18 months.

RISK: OPERATIONS – EXTERNAL – BUSINESS INTERRUPTION, SAFETY CONCERNS Inability to Recover Critical Systems and Service

If FTB's critical IT services and systems are disrupted, public service and mission critical business functions are likely to be interrupted, potentially resulting in negative impacts to customer service and revenue producing activities. There is

always the potential of a major disruption in the IT systems and services that support the department's mission critical business functions.

Potential sources of disruption include, but are not limited to: loss of power; loss of facility; loss of access to the facility; equipment failure; denial of service attack; and, loss of key personnel.

Without mitigation, taxpayers and other external customers may not be able to access FTB's self-service web functionality; and, internal applications used by FTB staff could be unavailable. Additionally, tax returns and payments may not be received and/or processed in a timely manner; and, other workloads may be interrupted, resulting in delayed revenue to the state's General Fund.

CONTROL A

- Update FTB's Remote Recovery plan to reflect the department's current business model and technical configurations.
- Conduct Business and Technology Recovery exercises on a regular basis.
- Update the department's Business Impact Analysis (BIA) to reflect current mission critical business functions.
- Update Business and Technology Recovery plans to reflect additional system dependencies.
- Determine the optimal replacement strategy for the existing Technology Recovery application, due to End-of-Life.

RISK: OPERATIONS – EXTERNAL – TECHNOLOGY—DATA SECURITY

Data Security and Privacy

Intentional external acts threaten the confidentiality, integrity, and privacy of taxpayer data. Today's world of cyber-attacks and data breaches is in a constant state of change and has evolved into a multi-million dollar business for cyber criminals. Today, 80 percent of black hat hackers are affiliated with organized crime (cybercrime). In 2015, cybercrime went from individual hackers trying to infiltrate systems to organized cybercriminals that are set up as full blown organizations. These organizations employ highly skilled developers/hackers that bring innovation into malware. These attacks provide cybercriminals with the ability to find more ways to get around an organization's security measures. It is predicted that cybercrime will become a \$2.1 trillion problem by 2019.

In order to protect critical data, FTB must become more sophisticated in identifying threats and blocking such threats from accessing FTB's network. The information FTB collects, processes and stores is extremely valuable to identity theft criminals to commit financial fraud which includes tax fraud. Identity theft is on the rise in the United States. The 2017 Identity Fraud Study, released by Javelin Strategy and Research, found that \$16 billion was stolen from 15.4 million U.S. Consumers in 2016, compared with \$15.3 billion and 13 million victims a year earlier. In the past six years, identity thieves have stolen over \$107 billion.

Despite deploying numerous controls and deploying a defense in depth strategy, dedicated hackers can breach most systems and gain access to confidential information. In addition, with the state mandate of a cloud first directive,

data security will become even more critical, as we will be transferring some of the operational responsibilities to the cloud vendors, but we are still legally liable for securing the data. FTB has also seen a change in the way bad actors attempt to access our systems. Historically, hackers would attempt to enter our systems through our firewalls and other lines of defenses. This continues today however, with the significant breaches of data in recent years and the

subsequent selling of this data on the black market, bad actors now have enough valid personal information to come into our systems with credentials or a return that appears to be from a 'valid' taxpayer.

This adds another layer of complexity and requires deployment of additional resources to monitor cyber details from every transaction to identify anomalies in order to detect bad actors attempting to access our system. If FTB's systems or data were breached, potentially millions of taxpayers' data would be disclosed to unauthorized individuals. FTB would lose public trust, the department may face the financial cost of credit monitoring and breach response and recovery, and California's income tax system, which is based on self-assessment, could suffer. If the income tax system suffers, this could mean reduction in revenue for the state.

CONTROL A

- Enforce strong information security policies.
- Build security into the system development life cycle, rather than add it later.
- Perform internal and external vulnerability assessments and conduct risk remediation.
- Perform security intrusion detection and monitoring activities.
- Continue and constantly improve an effective risk management program (i.e., security patch management, risk assessment, etc.) which includes third party risk management (i.e., contractors, HVAC, supplier, cloud vendors etc.).
- Apply appropriate technical controls to compensate potential risks.
- Continue to enhance our security intelligence program.
- Seek resources as appropriate.

RISK: OPERATIONS – EXTERNAL – OVERSIGHT OF OR PROGRAM COORDINATION WITH OTHERS

Cannabis

In 2018, licensing will begin at the state level for adult recreational use cannabis.

This is an evolving industry with several unknowns, including the volume of new businesses that will enter the market. In addition, since banking is generally not available to these businesses, many entities are cash intensive.

There is currently no statewide solution to address this banking problem. This presents a risk that our current practices will not be able to accommodate the volume of new payments that FTB will receive. Cash payments lead to increased safety risks for employees and taxpayers, is bulky to store and is resource intensive to process.

CONTROL A

- Collaborate with other agencies and industry groups to share knowledge and expertise and to leverage efforts.
- Augment staff, tools, funds to support a safe environment for taxpayers and FTB staff dealing with cash payments.
- Complete business process analysis to identify opportunities or weaknesses.
- Conduct active education and outreach efforts to provide businesses with tools and resources to comply with income tax obligations and rules supporting acceptance of cash payments.

- Monitor developments at the federal and state levels for this industry and determine possible impacts to FTB.
- Monitor licensing of all cannabis businesses to predict and adjust to the handling of cash for this industry.

CONCLUSION

The Franchise Tax Board strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising controls to prevent those risks from happening. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

Selvi Stanislaus, Executive Officer

CC: California Legislature [Senate (2), Assembly (1)]

California State Auditor

California State Library

California State Controller

Director of California Department of Finance

Secretary of California Government Operations Agency