June 18, 2009

The Honorable Robert F. Hale  
Under Secretary of Defense (Comptroller) / Chief Financial Officer  
Department of Defense


Dear Mr. Hale:

The Department of the Army paid about $4.7 billion in federal payroll taxes for approximately 638,900 active duty military servicemembers for calendar year 2007, from the active duty Army military personnel appropriation. The Secretary of the Army relies on the Defense Finance and Accounting Service–Indianapolis (DFAS-IN) for processing and accounting support in paying the taxes for active duty servicemembers. This support includes calculating and reporting federal payroll taxes for active duty Army servicemembers to the Internal Revenue Service (IRS) and paying those taxes to the Department of the Treasury. Federal payroll taxes are amounts withheld from employees' wages for federal income taxes, Social Security, and Medicare (Hospital Insurance) taxes, as well as the employer's mandatory matching contributions for Social Security and Medicare taxes.

GAO's five standards of internal control provide the overall framework for establishing and maintaining internal control in the federal government. These standards help management identify and address major performance and management challenges and areas at greatest risk of fraud, waste, abuse, and mismanagement. Further, the Office of Management and Budget Circular No. A-123, Management's Responsibility for Internal Control, relies on GAO's standards to provide the specific requirements for federal

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1The Director, DFAS, delegated the responsibility for the accounting functions of the Department of the Army, including the active duty Army military personnel pay, to the Director, DFAS-IN.

2Employers are required to withhold from their employees’ salaries amounts for individual federal income taxes and for Federal Insurance Contribution Act taxes (26 U.S.C. ch. 21), which include Old-Age, Survivors, and Disability Insurance (Social Security) and Hospital Insurance (Medicare Part A) taxes. Taxes for Social Security and the Hospital Insurance are placed into two separate trust funds. For the purposes of our report, we refer to the Hospital Insurance (Medicare Part A) taxes as Medicare taxes.


agencies, such as the Department of Defense (DOD), to assess and report on controls. The scope of this review comprises control activities and monitoring—two of the five standards for internal control.

Our prior reviews of the DOD budget requests for military personnel appropriations identified possible inaccuracies in the processing of the active duty Army military personnel federal payroll taxes and potential weaknesses in control activities at DFAS-IN. Following that identification of possible inaccuracies, under the authority of the Comptroller General to conduct evaluations under his own initiative, we conducted this performance audit to determine whether DFAS-IN has effective controls in place for processing of the active duty Army military personnel federal payroll taxes. We also assessed whether DFAS-IN conducted periodic monitoring of its processing of federal payroll taxes. We focused our review on federal payroll taxes for the period January 2004 through June 2008.

To address our objective, we gained an overall understanding of DFAS-IN's federal payroll tax processing by examining key documents and interviewing DFAS-IN representatives involved in that processing. We also examined selected controls over the active duty Army military personnel federal payroll taxes with regard to IRS employer tax guidance. Specifically, we compared DFAS-IN written procedures, tax worksheets, and tax reports with applicable IRS employers’ tax guidance, including IRS publications, forms, and instructions to determine whether DFAS-IN control activities were sufficient to provide reasonable assurance of meeting that guidance. We also reviewed DOD's Financial Management Regulation 7000-14.R (DOD FMR) to assess DFAS-IN controls according to these criteria. We discussed with Defense Finance and Accounting Service (DFAS) and DFAS-IN officials their perspectives about the roles and responsibilities for performing internal reviews and evaluating external reviews of the DFAS-IN federal payroll tax processing. We used GAO's Standards for Internal Control in the Federal Government in assessing DFAS-IN policies and procedures. We do not provide a conclusion regarding DFAS-IN’s overall compliance with the Standards for Internal Control because we did not conduct tests for each of the five standards. We assessed two of the five standards—control activities and monitoring. Control activities are the policies, procedures, techniques and mechanisms that enforce management directives. Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

We used our analysis of DFAS documents and its payroll processing and reporting procedures, and IRS guidance, to assess the effectiveness of existing control activities and monitoring. We examined DFAS-IN active duty Army military personnel federal payroll tax reports and supporting data. These federal payroll tax reports and supporting data included employers’ quarterly reports and various reports generated by the active duty Army military personnel pay system for calendar years 2004 through 2007 and the

5IRS Publication 15 (Circular E), Employer’s Tax Guide, updated annually, explains the employer’s tax responsibilities for withholding, depositing, reporting, paying, and correcting federal payroll taxes. The IRS Instructions for Form 941, Employer’s QUARTERLY Federal Tax Return, identifies the employers who must file Form 941 and instructs when and how to deposit federal payroll taxes withheld. Also, IRS Forms W-2 and W-3 and the related instructions contain guidance for reporting individual employees’ federal payroll taxes.

6DOD FMR prescribes financial reporting roles and responsibilities (vol. 6A, ch. 2) and military pay reconciliations (vol. 7C, ch. 2).
first two quarters of 2008, and servicemembers’ individual W-2 data for 2004 through 2007. We recalculated the payroll taxes independently using DFAS-IN source data and the IRS federal payroll tax guidance, such as the instructions for the IRS Form 941, and then compared our results with the DFAS-IN payroll tax reports. We confirmed that DFAS-IN used the payroll tax data generated by the active duty Army military personnel pay system as its supporting data. We also used the active duty Army military personnel pay system year-end tax data to assess the accuracy of DFAS-IN’s Social Security and Medicare tax withholding for active duty Army servicemembers.

We conducted this performance audit from September 2007 through June 2009, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Brief

DFAS-IN lacked effective controls for processing and accounting for active duty Army military personnel federal payroll taxes because of weaknesses in its procedures for information processing and accurate and timely documentation of transactions. We found that DFAS-IN did not systematically reconcile payroll taxes; it made numerous calculation and data entry errors in its worksheets; and in numerous instances, it incorrectly calculated and reported Social Security and Medicare withholding amounts for servicemembers. We were not able to determine the extent to which individual servicemembers identified errors in their pay statements and requested corrections. However, we determined that the underlying control weaknesses that resulted in errors and untimely calculation and reporting of payroll data have continued for several years.

DFAS-IN further lacked effective procedures to ensure the accuracy and timeliness of transaction documentation. In addition, neither DFAS nor DFAS-IN internal review staff performed periodic monitoring of the processing of federal payroll taxes for the 2004-2008 time period to assure that the related internal controls were operating effectively, and neither has developed plans to conduct such reviews. As a result of these control weaknesses, some servicemembers had too much tax withheld, while others had too little withheld. Additionally, DFAS-IN did not follow IRS employer tax guidance. As a result, the Department of the Army may be owed refunds from the IRS due to erroneous overpayments of federal payroll taxes; or the Army may owe additional payments to the IRS due to erroneous underpayments of federal payroll taxes. If there were erroneous overpayments, the Army will have lost the opportunity to use those funds for other pressing needs. In the case of underpayments, the general fund of the Treasury will ultimately be subsidizing the Social Security and Hospital Insurance trust funds to make

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7 IRS Form W-2 is the Wage and Tax statement that each employer must file for wages paid to each employee from whom income, Social Security, or Medicare taxes were withheld.
8 In April 2008, we suspended this audit to perform work for higher priority reviews. In August 2008, we resumed our work for this performance audit.
up for amounts that are owed by employers but not collected. Because of DFAS-IN’s lack of effective procedures for documentation of its transactions, and errors in calculating and recording payroll taxes, neither the Army nor the IRS can be certain of the Army’s current payroll tax liabilities. Lastly, as a result of the lack of periodic monitoring or plans to perform the monitoring, DFAS-IN is unable to take prompt corrective actions to resolve any weaknesses in its control activities.

We are making recommendations to the Under Secretary of Defense (Comptroller) / Chief Financial Officer to strengthen DFAS-IN internal control and monitoring activities over active duty Army military personnel payroll.

Background

GAO first designated DOD financial management as high risk in 1995. GAO’s biennial reports on high-risk areas are meant to bring focus to specific areas needing added attention. Areas are identified, in some cases, as high risk due to their greater vulnerabilities to fraud, waste, abuse, and mismanagement. Since 1995, weaknesses in DOD’s financial management have adversely affected not only the reliability of reported financial data, but also the efficiency and effectiveness of its business operations. The department has annually acknowledged that pervasive, long-standing weaknesses in business systems, processes, and controls have prevented auditors from determining the reliability of reported financial statement information. Weaknesses in Army military pay systems, processes, and controls have contributed to this problem.

Overview of Internal Controls

As federal managers strive to achieve their agencies’ missions and goals and to provide accountability for their operations, they need to establish, continually assess, and evaluate their internal control structure to ensure that it is well designed and operating effectively, and is appropriately updated to meet changing conditions. Internal control should be an integral component of an organization’s management, and it should provide reasonable assurance that the following objectives are being achieved:

- effectiveness and efficiency of operations, including the use of the entity’s resources;
- reliability of financial reporting, including reports on budget execution,
- financial statements, and other reports for internal and external use; and
- compliance with applicable laws and regulations.

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Control activities are the policies, procedures, techniques, and mechanisms used to help ensure that agency objectives are met. Control activities include proper authorization, controls over information processing, and accurate and timely recording of transactions and events. Managers need to review control activities and key controls to determine how well an agency is performing, how the agency may be improved, and the degree to which such review may help identify and address major risks for fraud, waste, abuse, and mismanagement. Ongoing monitoring occurs during normal operations and includes regular management and supervisory activities, such as reviewing and approving supporting documentation. Monitoring also includes the policies and procedures to promptly resolve any internal or external review findings and recommendations.

IRS Guidance Regarding Federal Payroll Taxes

The IRS collects federal taxes, including payroll taxes, processes tax returns, and enforces the nation’s tax laws. To comply with federal payroll tax requirements, employers, such as the Department of the Army, must do the following:

- For each pay period, employers must withhold employees’ federal income, Social Security and Medicare tax liabilities, add the employer’s mandatory matching contribution for Social Security and Medicare, and deposit the employer’s and employees’ amounts with the IRS or an authorized financial institution.

- For each calendar quarter, employers must summarize the monthly federal payroll tax liabilities on IRS Form 941, Employer’s QUARTERLY Federal Tax Return, broken out by various amounts, including total wages, taxable Social Security and Medicare wages, and total deposits for the quarter. Employers must submit the Form 941 to the IRS with a signature attesting that the report is true, correct, and complete.

- For each calendar year, employers must prepare and submit IRS Forms W-2 to each employee with the annual totals of wages, taxable wages, Social Security and Medicare taxes withheld, and other data.

- At any time, when employers discover errors on previously filed IRS Forms 941, the employers must file an IRS Form 941-X, Adjusted Employer’s QUARTERLY Federal Tax Return or Claim for Refund, to request a claim or adjustment of amounts overreported, and to pay amounts underreported.\footnote{Beginning January 1, 2009, IRS Form 941-X replaced IRS Form 941c, Supporting Statement To Correct Information. Previously, when employers discovered errors on already filed IRS Forms 941, employers were required to file an amended Form 941 in conjunction with a Form 941c explaining the corrections. After December 31, 2008, employers are only required to file a Form 941-X to make amendments.} To the extent the employers’ corrections affect amounts already reported on IRS Forms W-2, the employers must report the corrections on IRS Forms W-2c and submit the forms to the Social Security Administration (SSA) and the employees.
Management Roles and Responsibilities

Various stakeholders are responsible for DOD’s financial management related to the processing of federal payroll taxes for the active duty Army military personnel appropriation (Military Personnel, Army). These stakeholders and their roles and responsibilities include the following:

- The Under Secretary of Defense (Comptroller) / Chief Financial Officer develops and establishes DOD policy on financial reports and provides oversight of the issuance and implementation of such policies in accordance with the DOD FMR,\(^{11}\) to include the establishment of internal controls and audit trails required for preparing financial reporting, processing associated transactions, and reconciling accounts with financial balances. Further, the Under Secretary of Defense (Comptroller) / Chief Financial Officer prescribes the financial management responsibilities of the DOD components, such as the Secretary of the Army and the Director, DFAS.

- The Secretary of the Army manages the active duty Army military personnel appropriations. The Assistant Secretary for Financial Management and Comptroller verifies that the data and reports are accurate and certifies the annual year-end closing statement, including obligations and disbursements.\(^{12}\) Further, the Secretary of the Army provides Army-generated data, which must be accurate, complete, timely, and supported by documentation, for the finance and accounting systems that are maintained by DFAS.

- The Director, DFAS, who has overall responsibility for DOD’s accounting functions, delegates to the Director, DFAS-IN, the responsibility for the Department of Army’s accounting functions, including the processing and accounting of active duty Army military personnel pay and the processing of active duty Army military personnel federal payroll taxes.

- The Director, DFAS-IN, establishes procedures to prepare consistent, timely, and auditable financial reports and control totals to provide for the accuracy of financial management reports.

Active Duty Army Military Personnel Pay System

DFAS-IN administers active duty Army military pay through the DFAS Defense Joint Military Pay System—Active Component (DJMS-AC), including calculating pay and entitlements and paying individual servicemembers. Managed by the Director, DFAS Denver, the system is a database of master military pay accounts, one for each servicemember paid through this system. The data contained in each active duty Army master military pay account are managed by DFAS-IN, which, in turn, relies on the accuracy and timeliness of changes in individual servicemembers’ pay and entitlements provided to DFAS-IN by the Army’s personnel system. In addition to paying individual servicemembers, this system generates numerous periodic financial reports summarizing

\(^{11}\)DOD FMR, vol. 1, ch. 1, paras. 0103 and 0107, and vol. 6A, ch. 2, paras. 0201, 020102, 020201A.

\(^{12}\)DOD FMR, vol. 6A, ch. 4, paras. 0401, 0402, 040206, 0405, 040506, and 040507.
the Military Personnel, Army appropriation obligations and disbursements, including periodic summary reports of the results of pay transactions and federal payroll tax amounts withheld by each month and year, for both individual servicemembers and the appropriation totals.

**DFAS-IN Lacked Effective Controls for Assuring the Accuracy of Active Duty Army Military Personnel Federal Payroll Taxes**

For the period of January 2004 through June 2008, DFAS-IN did not use effective controls to report the active duty Army's federal payroll taxes reliably and in accordance with IRS guidance, particularly with regard to (1) information processing of employer and employee tax records, and (2) accurate and timely documentation of transactions. Additionally, neither DFAS nor DFAS-IN internal review staff performed periodic monitoring of their controls for the processing of federal payroll taxes, and neither has developed plans to conduct such reviews in the near or long term.

**DFAS-IN Lacked Effective Information Processing of Employer and Employee Tax Records**

DFAS-IN lacked effective procedures for information processing of the active duty Army military federal payroll taxes for the Department of the Army. DFAS-IN did not systematically reconcile payroll taxes, it made numerous calculation and data entry errors in its worksheets, and in numerous instances it incorrectly calculated and reported Social Security and Medicare withholding amounts for servicemembers.

To assure accurate accounting and reliable financial reporting, an agency must process its information correctly and completely. Reconciling tax worksheet amounts with payroll data is a key control activity in this area. DFAS-IN performs the accounting functions, including federal payroll taxes, for the Secretary of the Army, who is accountable for the active duty Army military personnel appropriation. From January 2005 through December 2007, DFAS-IN did not properly reconcile the active duty Army pay records with its quarterly federal tax returns and year-end annual federal tax reports, as would be needed to confirm that it reported correct amounts for year-end tax liabilities. Instead, DFAS-IN reported liability amounts from the year-end annual federal tax reports that were not supported by its monthly worksheets or the quarterly and year-end forms that are required by the IRS. DFAS-IN did not use the supporting data needed to determine the correct tax liabilities for the Department of the Army. Also, from January 2004 through December 2007, DFAS-IN incorrectly reported Social Security and Medicare tax withholding amounts for numerous active duty Army servicemembers, overwithholding from some and underwithholding from others. Further, DFAS-IN supervisors certified monthly tax worksheets prepared by the DFAS-IN staff that

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15The reason we distinguish our discussion of the 2004-2007 and 2005-2007 time spans is as follows. Although DFAS failed to properly resolve unreconciled differences between its worksheets and year-end federal tax reports in both time spans, DFAS-IN reported its tax liability using different source data for the two time spans. In 2004, DFAS-IN reported tax liability amounts based on incorrect amounts in its monthly worksheets. In 2005-2007, DFAS-IN reported tax liability amounts based on unsupported year-end federal tax reports.
contained data entry or calculation errors. As a result, all 16 of the DFAS-IN employers’ quarterly reports to the IRS during the 4-year period were incorrect.

Reconciliations

DFAS-IN staff did not perform systematic payroll tax reconciliations, as required by a DFAS-IN standard operating procedure and the DOD FMR.\textsuperscript{14} For calendar years 2004 through 2007, DFAS-IN did not properly reconcile the active duty Army pay records with the active duty Army quarterly federal tax returns and year-end annual federal tax reports. Such reconciliation is necessary to confirm that DFAS-IN reported correct amounts for year-end tax liabilities. Instead of calculating year-end tax liabilities for calendar years 2005 through 2007, DFAS-IN staff reported liability amounts from the year-end annual federal tax reports. The year-end annual federal tax report is comprised of servicemembers’ individual end-of-year tax data, as reported annually to the SSA. DFAS-IN staff told us they do not know exactly what tax data are included in the monthly disbursement reports, so they do not know whether any adjustments are needed or how to adjust those amounts to ensure the accuracy of the tax liabilities for IRS reporting. Table 1 shows the unreconciled active duty Army military personnel Social Security and Medicare wages and taxes we identified for calendar years 2004 through 2007.

Table 1: Unreconciled Active Duty Army Military Personnel Social Security and Medicare Wages and Taxes, Calendar Years 2004 through 2007

<table>
<thead>
<tr>
<th>Description</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security wages reported to SSA</td>
<td>$16,224,643,204</td>
<td>$16,864,717,600</td>
<td>$17,637,279,525</td>
<td>$18,500,310,465</td>
</tr>
<tr>
<td>Social Security wages reported on the monthly disbursement reports</td>
<td>16,229,951,922</td>
<td>16,853,396,020</td>
<td>17,628,012,814</td>
<td>18,492,989,529</td>
</tr>
<tr>
<td><strong>Unreconciled Social Security Wages</strong></td>
<td>($5,308,718)</td>
<td>$11,321,580</td>
<td>$9,266,711</td>
<td>$7,320,936</td>
</tr>
<tr>
<td>Social Security withholding taxes reported to SSA</td>
<td>1,005,945,305</td>
<td>1,045,599,318</td>
<td>1,093,491,375</td>
<td>1,147,012,601</td>
</tr>
<tr>
<td>Social Security withholding taxes reported on the monthly disbursement reports</td>
<td>1,005,592,573</td>
<td>1,045,226,281</td>
<td>1,093,412,169</td>
<td>1,146,943,272</td>
</tr>
<tr>
<td><strong>Unreconciled Social Security Withholding Taxes</strong></td>
<td>$352,732</td>
<td>$373,037</td>
<td>$79,206</td>
<td>$69,329</td>
</tr>
<tr>
<td>Medicare wages reported to SSA</td>
<td>16,266,923,238</td>
<td>16,913,652,210</td>
<td>17,684,362,925</td>
<td>18,546,557,443</td>
</tr>
<tr>
<td>Medicare wages reported on the monthly disbursement reports</td>
<td>16,256,691,438</td>
<td>16,903,095,743</td>
<td>17,675,002,424</td>
<td>18,539,092,738</td>
</tr>
<tr>
<td><strong>Unreconciled Medicare Wages</strong></td>
<td>$10,231,800</td>
<td>$10,556,468</td>
<td>$9,360,501</td>
<td>$7,464,704</td>
</tr>
<tr>
<td>Medicare withholding taxes reported to SSA</td>
<td>235,869,963</td>
<td>245,248,947</td>
<td>256,419,967</td>
<td>268,924,325</td>
</tr>
<tr>
<td>Medicare withholding taxes reported on the monthly disbursement reports</td>
<td>235,786,959</td>
<td>245,168,276</td>
<td>256,399,871</td>
<td>268,908,035</td>
</tr>
<tr>
<td><strong>Unreconciled Medicare Withholding Taxes</strong></td>
<td>$83,004</td>
<td>$80,671</td>
<td>$20,096</td>
<td>$16,290</td>
</tr>
</tbody>
</table>

Source: GAO analysis of DOD data.

Note: Totals may not add because of rounding.

\textsuperscript{14}DOD FMR, vol. 6A, ch. 2, paras. 020202 and 020204; vol. 7C, ch. 2, paras. 0204 and 0205.
Calculation and Data Entry Errors in Worksheets

In accordance with its internal criteria, DFAS-IN used the payroll tax data generated by the active duty Army military pay system as its supporting data for processing tax reports, from January 2004 through June 2008—the period of our review. However, DFAS-IN staff members made numerous errors in calculations or data entries in the worksheets for all 54 months of this period. The resulting incorrect amounts were used in reporting the Army’s federal payroll taxes on the quarterly IRS Forms 941. On 34 of the 54 worksheets supporting its IRS Form 941 reports, DFAS-IN staff improperly included as current-year amounts those that had been identified by the Army military pay system as prior-period payroll tax adjustments. Further, 43 of the 54 DFAS-IN worksheets contained incorrect formulas for calculating federal taxable wage amounts. DFAS-IN personnel entered data in the worksheets that did not correspond to the data generated by the Army military pay system reports, and DFAS-IN supervisors certified these incorrectly processed worksheets. Although the reports generated by the pay system had control totals, DFAS-IN did not reconcile its calculations recorded on the worksheets with the control totals to ensure accuracy. For example, in January 2008, DFAS-IN entered federal wages for Army cadets into its worksheet as $394,000, while the Army military pay system report identified the amount as $3.94 million—a discrepancy of $3.5 million. Lastly, although DFAS-IN supervisors certified monthly tax worksheets prepared by the DFAS-IN staff, these worksheets also contained data entry or calculation errors. As a result of the lack of adequate supervisory review, all the DFAS-IN employers’ quarterly reports to the IRS during the period were incorrect.

As a result of these errors and omissions, DFAS-IN filed incorrect IRS Forms 941 for the active duty Army military personnel federal payroll taxes for the period January 2004 through June 2008. From January 2004 through September 2007, DFAS did not prepare and submit accurate and timely amended IRS Forms 941 and supporting IRS Forms 941c, Supporting Statement to Correct Information. For that period, DFAS-IN incorrectly included prior-year correction amounts in its IRS Forms 941 instead of amending its earlier IRS Forms 941 on IRS Forms 941c. After we identified and discussed these errors during our September 2007 visit, DFAS-IN properly excluded the prior-year correction amounts in its processing of federal tax liabilities for October 2007 through June 2008.

Withholding Errors

DFAS-IN incorrectly calculated Social Security and Medicare tax withholding amounts in each year of the 4-year period for 2004 through 2007 for some active duty Army servicemembers. IRS guidance and the DOD FMR specifically identify the percentage amounts of taxable wages that DFAS-IN should have withheld for Social Security and Medicare. However, we found about 1,500 errors in the 2.5 million wage and tax statements for active duty Army servicemembers prepared during the 4-year period. We found examples of over- and underwithholding of individuals’ Social Security and

15The amounts of Social Security and Medicare taxes that DFAS-IN should have withheld for each employee are percentages of taxable wages, from 6.2 percent up to the yearly limits for wages subject to Social Security taxes and 1.45 percent for Medicare taxes. IRS Publication 15 (Circular E), Employer’s Tax Guide for 2004, 2005, 2006, and 2007, and DOD FMR vol. 7A, ch. 45.
Medicare taxes in each year of the 4-year period. As detailed below, DFAS-IN

- overwithheld as much as $2,170 in Social Security taxes from 380 active duty Army servicemembers’ pay accounts, and underwithheld as much as $5,580 of these taxes from 435 servicemembers’ pay accounts;

- overwithheld Social Security taxes from the pay accounts of 35 servicemembers whose wages exceeded the taxable wage base limits;

- improperly withheld Social Security taxes from the pay accounts of 13 servicemembers who had no Social Security taxable wages;

- improperly withheld Medicare taxes from the pay accounts of 21 servicemembers who had no Medicare taxable wages; and

- overwithheld Medicare taxes from the pay accounts of 305 servicemembers and underwithheld Medicare taxes from the pay accounts of 421 servicemembers.

We analyzed the information in the original DFAS-IN year-end tax reports, as reported to the SSA, for 2004 through 2007. DFAS-IN officials told us they have submitted corrected W-2, Wage and Tax Statement, data in later filings to the SSA, and that those filings may have corrected the errors we found in the original filings. Although it is possible that individual servicemembers may have identified errors and requested corrections on their W-2s, there is no assurance that all errors were corrected. DFAS-IN does not have a process in place for identifying and correcting errors in tax withholding. Further, as shown in table 2, DFAS-IN repeated the same types of Social Security and Medicare tax withholding errors over the 4-year period.
Table 2: Active Duty Army Military Personnel Payroll Taxes: Social Security and Medicare Tax Withholding Errors Identified for Calendar Years 2004-2007

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of individual W-2s for the year</td>
<td>627,136</td>
<td>621,266</td>
<td>629,364</td>
<td>638,860</td>
<td>2,516,626</td>
</tr>
<tr>
<td>Social Security overwithholding errors</td>
<td>120</td>
<td>91</td>
<td>91</td>
<td>78</td>
<td>380</td>
</tr>
<tr>
<td>Social Security underwithholding errors</td>
<td>75</td>
<td>88</td>
<td>139</td>
<td>133</td>
<td>435</td>
</tr>
<tr>
<td>Total Social Security tax withholding errors</td>
<td>195</td>
<td>179</td>
<td>230</td>
<td>211</td>
<td>815</td>
</tr>
<tr>
<td>Dollar value of Social Security tax withholding errors</td>
<td>$35,035</td>
<td>$24,275</td>
<td>$31,538</td>
<td>$24,184</td>
<td>$115,032</td>
</tr>
<tr>
<td>Medicare tax overwitholding error</td>
<td>54</td>
<td>92</td>
<td>83</td>
<td>76</td>
<td>305</td>
</tr>
<tr>
<td>Medicare tax underwithholding error</td>
<td>70</td>
<td>87</td>
<td>136</td>
<td>128</td>
<td>421</td>
</tr>
<tr>
<td>Total Medicare tax withholding errors</td>
<td>124</td>
<td>179</td>
<td>219</td>
<td>204</td>
<td>726</td>
</tr>
<tr>
<td>Dollar value of Medicare tax withholding errors</td>
<td>$3,160</td>
<td>$5,400</td>
<td>$7,233</td>
<td>$6,701</td>
<td>$22,494</td>
</tr>
<tr>
<td>Total Social Security and Medicare tax withholding errors</td>
<td>319</td>
<td>358</td>
<td>449</td>
<td>415</td>
<td>1541</td>
</tr>
<tr>
<td>Dollar value of Social Security and Medicare tax</td>
<td>$38,195</td>
<td>$29,675</td>
<td>$38,771</td>
<td>$30,885</td>
<td>$137,526</td>
</tr>
<tr>
<td>Frequency of selected tax withholding errors:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individuals whose Social Security tax withheld was greater</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>was than the maximum Social Security tax: $5,449.80 for 2004, $5,580.00 for 2005, $5,840.00 for 2006, and $6,045 for 2007</td>
<td>65</td>
<td>3</td>
<td>1</td>
<td>0</td>
<td>69</td>
</tr>
<tr>
<td>Individuals whose Social Security wages were taxed over</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>the applicable limits: $87,900 for 2004, $90,000 for 2005, $94,200 for 2006, and $97,500</td>
<td>11</td>
<td>13</td>
<td>10</td>
<td>1</td>
<td>35</td>
</tr>
<tr>
<td>for 2007</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individuals who had Social Security taxes withheld, even</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>though they had no Social Security taxable wages</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>3</td>
<td>13</td>
</tr>
<tr>
<td>Individuals who had Medicare taxes withheld, even</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>though they had no Medicare taxable wages</td>
<td>3</td>
<td>7</td>
<td>6</td>
<td>5</td>
<td>21</td>
</tr>
</tbody>
</table>

Source: GAO analysis of DOD data.

Notes: Tax withholding errors in this table are those where the Social Security or Medicare taxes withheld exceeded $1.00 on individual W-2s to allow for normal rounding required because both Social Security and Medicare taxes are percentages of Social Security and Medicare taxable wages, respectively. Totals may not add because of rounding.

The errors identified in table 2 are based on unverified W-2 wage information. As discussed previously and shown in table 1, there are millions of dollars of unreconciled differences between W-2 information and the monthly worksheets. Therefore, to the extent there are errors in the W-2 data, the magnitude of Social Security and Medicare tax withholding errors could be greater.

DFAS-IN Lacked Accurate and Timely Documentation of Transactions

DFAS-IN lacked effective procedures to ensure the accuracy and timeliness of documenting its transactions. An agency must document its transactions promptly, completely, and accurately to meet the objective of reliable reporting. According to the Standards for Internal Control, transactions should be promptly recorded to maintain
their relevance and value to management in controlling operations and making decisions. In addition, all documentation and records should be properly managed and maintained.\textsuperscript{16}

DFAS-IN did not accurately or promptly document in its files its corrections to prior years’ tax returns, instead erroneously including them in its current-year reports. Further, DFAS-IN did not provide any documentation to show that it paid the IRS a $2.0 million tax liability for 2004. According to DFAS-IN officials, they paid the $2.0 million after our September 2007 visit; however, they could not provide us documentation of the payment, and it was not recorded on the IRS tax transcripts, as of September 18, 2008.

Another example of inaccurate documentation involves refunds. Among the refunds that DFAS-IN received but did not properly or promptly record was a refund for $4.6 million that should have been recorded as deposited in the Military Personnel, Army appropriation account, but instead was recorded in a suspense account.\textsuperscript{17} Since DFAS-IN did not record these refunds properly, the remaining appropriation balances were understated.

DFAS Has Not Monitored Its Processing of Federal Payroll Taxes

Although DFAS internal review identified similar problems in its 2003 audit,\textsuperscript{18} neither DFAS nor DFAS-IN internal review office staff reviewed the processing of federal payroll taxes during the 2004-2008 time period or developed a plan to conduct the reviews in the near or long term. In accordance with the \textit{Standards for Internal Control}, an agency must periodically monitor its control activities over time and take corrective actions to resolve the findings.

\section*{Conclusions}

As a result of the lack of effective procedures for information processing, documenting transactions, and performing periodic reviews regarding the active duty Army military personnel federal payroll taxes, the Department of the Army may in some cases be owed refunds from the IRS due to erroneous overpayments of federal payroll taxes, and in other cases may owe additional payments to the IRS due to erroneous underpayments of federal payroll taxes. If there were erroneous overpayments, the Army will have lost the opportunity to use those funds for other pressing needs. Additionally, in the case of underpayments, the general fund of the Treasury will ultimately be subsidizing the Social Security and Hospital Insurance trust funds to make up for amounts that are owed but

\textsuperscript{16}GAO/AIMD-00-21.3.1.
\textsuperscript{17}A suspense account is defined as combined receipt and expenditure accounts established to temporarily hold funds that are later refunded or paid into another government fund when an administrative or final determination as to the proper disposition is made. GAO, \textit{A Glossary of Terms Used in the Federal Budget Process}, GAO-05-734SP (Washington, D.C.: September 2005).
not collected. Neither the Army nor the IRS can be certain of the Army’s current payroll tax liabilities, and the documented amounts may be inaccurate.

**Recommendations for Executive Action**

To strengthen internal control and monitoring activities over active duty Army military personnel payroll, we recommend that the Under Secretary of Defense (Comptroller) / Chief Financial Officer require the Director, DFAS, in conjunction with the Director, DFAS-IN, to take the following actions:

- Review and correct DFAS-IN’s procedures for information processing of federal payroll taxes to include the following:
  - Perform reconciliations of active Army military pay system reports with the quarterly federal payroll tax returns and year-end annual federal tax reports.
  - Review individual servicemembers’ tax withholding and correct any errors.
- Review and correct DFAS-IN’s procedures for accurate and timely documentation of federal payroll tax transactions.
- Establish procedures and plans to periodically monitor the processing of federal payroll taxes.

**Agency Comments and Our Evaluation**

We provided our draft report to DOD and the IRS. In response to the draft, DOD concurred with each of our recommendations and provided us with written comments describing corrective actions it is taking to implement them. We have reprinted these comments in enclosure I. The IRS indicated that it had no comments in response to the draft of the report.

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We are providing this letter to relevant congressional defense committees, the Secretary of Defense, and the Secretary of the Army. In addition, the report will be available at no charge on the GAO Web site at [http://www.gao.gov](http://www.gao.gov).
If you or your staff have any questions about this report, please contact either Brenda Farrell at (202) 512-3604, e-mail farrellb@gao.gov, or Asif Khan at (202) 512-9095, e-mail khana@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this letter. GAO staff who made key contributions are Deborah Yarborough, Assistant Director; Ronald Bergman; Gayle Fischer; Robert Mandigo; Grant Mallie; Lonnie McAllister; Rebecca Shea; Thomas Short; and Cheryl Weissman.

Brenda S. Farrell  
Director, Defense Capabilities and Management

Asif A. Khan  
Director, Financial Management and Assurance
Comments from the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

JUN 3 2009

Ms. Brenda S. Farrell
Director, Defense Capabilities and Management
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Ms. Farrell,


The Department appreciates the opportunity to comment on the draft report. My staff point of contact on this matter is Ms. Jacqueline Jenkins. She may be reached by e-mail at jacqueline.jenkins@osd.mil or telephone at (703) 602-0126.

Sincerely,

[Signature]

Mark E. Easton
Deputy Chief Financial Officer

Enclosure:
As stated
RECOMMENDATION 1: The GAO recommends that the Under Secretary of Defense (Comptroller)/Chief Financial Officer require the Director, Defense Finance and Accounting Service, in conjunction with the Director, Defense Finance and Accounting Service – Indianapolis (DFAS-IN), to review and correct DFAS-IN’s procedures for information processing of federal payroll taxes to include the following:

- Perform reconciliations of active Army military pay system reports with the quarterly federal payroll tax returns and year-end annual federal tax reports.
- Review individual servicemembers’ tax withholding and correct any errors.

DOD RESPONSE: Concur. The Deputy Chief Financial Officer directed the Director, Defense Finance and Accounting Service (DFAS) to review and correct DFAS-Indianapolis procedures for information processing of federal payroll taxes. The Director, DFAS was also directed to perform reconciliations of active Army military pay system reports with the quarterly federal payroll tax returns and year-end annual federal tax reports and to review individual servicemembers’ tax withholding and correct any errors.

RECOMMENDATION 2: The GAO recommends that the Under Secretary of Defense (Comptroller)/Chief Financial Officer require the Director, Defense Finance and Accounting Service (DFAS), in conjunction with the Director, DFAS-Indianapolis (DFAS-IN), to review and correct DFAS-IN’s procedures for accurate and timely documentation of federal payroll tax transactions.

DOD RESPONSE: Concur. The Deputy Chief Financial Officer directed the Director, Defense Finance and Accounting Service (DFAS), to review and correct DFAS-Indianapolis procedures for accurate and timely documentation of federal payroll tax transactions.

RECOMMENDATION 3: The GAO recommends that the Under Secretary of Defense (Comptroller)/Chief Financial Officer require the Director, Defense Finance and Accounting Service (DFAS), in conjunction with the Director, DFAS-Indianapolis, to establish procedures and plans to periodically monitor the processing of federal payroll taxes.

DOD RESPONSE: Concur. The Deputy Chief Financial Officer directed the Director, Defense Finance and Accounting Service, to establish procedures and plans to periodically monitor the processing of federal payroll taxes.
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