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Defense Primer: Understanding the Process for Auditing the Department of Defense

The Chief Financial Officers Act of 1990 (CFO Act, P.L. 101-576) requires annual audits of financial statements for federal agencies. Under the CFO Act, audits of federal agencies are the responsibility of the agency's inspector general (IG), but the IG may contract with one or more external auditors to perform the audit.

While a number of Department of Defense (DOD) components already undergo annual audits (e.g., the U.S. Army Corps of Engineers, Defense Contract Audit Agency, and National Reconnaissance Office), DOD is undergoing its first-ever agency-wide financial audit in FY2018.

Generally, the process and standards used to audit DOD are the same as those used to audit other federal agencies. Understanding why and how the DOD audit is conducted can help Congress evaluate the results and usefulness of the audit.

DOD has contracted with external accounting firms to conduct its FY2018 audit. Different components within DOD are currently being audited by different firms.

DOD expects to spend more than \$340 million to conduct the FY2018 audit and to release the results in November 2018. It is to submit a full report to Congress by March 31, 2019. Thereafter, final audit reports are to be issued annually in November, covering the prior fiscal year.

Why an Audit?

Government entities, including the United States government as a unitary entity, issue annual reports that present the current financial position and condition, and discuss key financial topics and trends. An audit of the financial information provides accountability over the use of public resources by government agencies to Congress, oversight bodies, and the public.

Financial audits aim to provide reasonable assurance that the financial statements of an entity are free of material misstatements whether caused by error or fraud.

DOD's financial management has been on the Government Accountability Office's (GAO) High-Risk list since 2015. High-Risk list agencies or programs are considered vulnerable to fraud, waste, abuse, and mismanagement, or at most in need of transformation. An audit of DOD can provide critical insight into the reliability of financial data, and efficiency and effectiveness of internal operations; review compliance with statutes and financial regulations; and uncover potential problems. With such information, DOD and Congress could take steps to improve the efficiency and effectiveness of internal operations.

While it is too early to estimate with any confidence potential financial and operational benefits of an audit, there is general consensus that DOD will gain valuable information from the effort. The Department has anticipated spending more than \$550 million to address potential audit findings.

How Are Audits Done?

For each line item on a financial statement and notes to the financial statement, an auditor will examine a sample of the underlying economic events to determine the accuracy of the information reported. The auditor is expected to give an unbiased professional opinion on whether the financial statements and related disclosures are fairly stated in all material respects for a given period of time in accordance with Generally Accepted Accounting Principles (GAAP). While the Federal Accounting Standards Advisory Board (FASAB) promulgates the financial reporting and accounting standards for federal government entities, GAO is responsible for establishing auditing standards for federal government agencies, including federal grant recipients in state and local governments.

Material misstatement in financial reporting can be defined as information on a financial statement that could potentially affect the reader's decision or the conclusions drawn by a reader about the financial status of an agency

Auditing Standards

GAO issues the Generally Accepted Government Auditing Standards (GAGAS), also commonly known as the "Yellow Book," which provides a framework for conducting federal government audits. The Yellow Book requires auditors to consider the visibility and sensitivity of government programs in determining the materiality threshold. Similar to the requirements in the private sector, GAGAS requires federal financial reporting to disclose compliance with laws, regulations, contracts, and grant agreements that have a material effect on the entities' financial statements.

Some organizations within the federal government use a hybrid of external and internal auditors. Whether external or internal auditors perform the function, they are required to adhere to the standards established under GAGAS.

In addition to examining the financial information, an audit evaluates the management's assertion of the internal control over financial reporting. Audit of internal control includes audit of computer systems at the entity-wide, system, and application levels. GAGAS recommends using specific frameworks for internal control policies and procedures,

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including certain evaluation tools created specifically for federal government entities.

Types of Audit Opinions

Auditors form audit opinions by first examining the types of risks an organization might face and the types of controls that exist to mitigate those risks. Once the risks and controls to mitigate those risks have been determined, the auditors will examine the supporting evidence and determine if management is presenting the financial statements fairly in all material respects. Although many entities in the federal government will usually receive an unqualified opinion, the auditor may express other types of opinions based on the circumstances. There are four different types of audit opinions an auditor may express:

Unqualified Opinion. An unqualified opinion states that the financial statements present fairly, in all material respects, the consolidated balance sheets, the related consolidated statements of net cost and changes in net position, the combined statements of budgetary resources, and the related notes to the consolidated financial statements in accordance with GAAP. This is the opinion expressed in the standard report. In certain circumstances, explanatory language might be added to the auditor's standard report, while not affecting the auditor's unqualified opinion on the financial statements.

Qualified Opinion. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly in all material respects in conformity with GAAP.

Adverse Opinion. An adverse opinion states that the financial statement(s) do not present fairly in accordance with GAAP.

Disclaimer of Opinion. A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. The auditor's report should give all of the substantive reasons for the disclaimer. Some of the reasons for a disclaimer of opinion include, financial statements not conforming to GAAP and financial management and feeder systems that are unable to provide sufficient evidence for the auditor to express an opinion.

Limitation of Audits

Independent audit opinions do not fully guarantee that financial statements are presented fairly in all material respects, but provide reasonable assurance for the following reasons.

- Auditors use statistical methods for random sampling and look at only a fraction of economic events or documents during an audit. It is cost- and time-prohibitive to recreate or sample all economic events.
- Some line items on the financial statements involve subjective decisions or a degree of uncertainty as a result of using estimates.
- Audit procedures cannot eliminate potential fraud, though it is possible an auditor may find fraud during the audit process.

Considerations for Congress

The United States government is currently unable to receive an unqualified opinion on its unitary Financial Report of the United States Government since agencies with significant assets and budgetary costs such as the DOD, Department of Housing and Urban Development, and Railroad Retirement Board each received a disclaimer of opinion on their FY2017 financial statements.

DOD is not generally expected to receive an unqualified opinion on its first-ever, agency-wide audit in FY2018; many organizations do not receive an unqualified audit opinion during the initial audit. Instead, it is anticipated that the November 2018 audit report will identify areas for corrective action, help inform DOD decision-making, and reveal needed process improvements.

The Department's assets total more than \$2 trillion, making this likely the largest financial audit ever undertaken. Along with sheer size, there exists significant complexity. However, these are not reasons to delay the audit; they are reasons to begin. Where we find problems, we will also find opportunities. Remediating audit findings is at the center of our financial improvement strategy.”
David L. Norquist, Under Secretary of Defense Comptroller/CFO

As an organization improves its financial reporting process, it can achieve an unqualified opinion if it dedicates sufficient resources and management focus to the effort. Congress may consider reviewing the results of the FY2018 DOD audit and using the findings to enhance oversight of DOD's remediations. Steps could include implementation of process improvements, investments in information technology systems, and changes in accounting practices.

CRS Products

CRS Report R44894, *Accounting and Auditing Regulatory Structure: U.S. and International*, by Raj Gnanarajah

CRS In Focus IF10701, *Introduction to Financial Services: Accounting and Auditing Regulatory Structure, U.S. and International*, by Raj Gnanarajah

Other Resources

Office of the Under Secretary of Defense (Comptroller)/ Chief Financial Officer, *Financial Improvement and Audit Readiness (FIAR) Plan Status Report*, November 2017

Office of the Under Secretary of Defense (Comptroller)/ Chief Financial Officer, *Defense Budget Overview*, Fiscal Year 2019 Budget Request, February 13, 2018

U.S. Government Accountability Office, *High-Risk Series*, GAO-17-317, February 15, 2017, p. 282

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