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Defense Primer: FY2018 Department of Defense Audit Results

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.

The Department of Defense's (DOD) IG conducted the first-ever agency-wide financial audit of DOD in FY2018. A number of DOD components have previously undergone annual audits (e.g., the U.S. Army Corps of Engineers, Defense Contract Audit Agency, and National Reconnaissance Office). The agency-wide audit was conducted by nine Independent Public Accounting (IPA) firms contracted by DOD IG. The IPAs conducted 24 separate audits within DOD.

The DOD released the results of the FY2018 audit on November 15, 2018. DOD received a disclaimer of opinion—meaning auditors could not express an opinion on the financial statements because the financial information was not sufficiently reliable. DOD is expected to submit a full report to Congress on this effort by March 31, 2019. Going forward, DOD has stated that it will be audited annually, with audit results expected to be issued in November for the prior fiscal year.

DOD spent \$413 million to conduct the FY2018 audit: \$192 million on audit fees for the IPAs and \$221 million on government costs to support the audit. DOD spent an additional \$406 million on audit remediation and \$153 million on financial system fixes.

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 was conducted can help Congress evaluate the first agency-wide audit results and usefulness of the audit.

Why an Audit?

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

Financial audits aim to provide reasonable assurance that the audited firm's financial statements are free of material misstatements whether caused by error or fraud. DOD audits can provide critical insight into (1) the reliability of its financial data; (2) the efficiency and effectiveness of internal operations; and (3) its compliance with statutes and financial regulations. With such information, DOD and

Congress could take steps to improve DOD's performance in these areas.

DOD's financial management has been on the Government Accountability Office's (GAO's) High-Risk list since 1995. Those on the High-Risk list are considered more vulnerable to fraud, waste, abuse, and mismanagement.

How Are Audits Done?

For each line item on a financial statement and notes to the financial statement, an auditor is to examine a sample of underlying economic events to determine the accuracy of the information reported. The auditor is expected to give an unbiased 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) sets the financial reporting and accounting standards for the federal government, GAO is responsible for establishing auditing standards for federal agencies, including for 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 financial information, an audit evaluates management's assertion of 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, including certain evaluation tools created specifically for federal government entities.

Types of Audit Opinions

Auditors form opinions by 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 supporting evidence to determine if management is presenting the financial statements fairly in all material respects. Although many entities in the federal government usually receive unmodified opinions, auditors may express other types of opinions based on the circumstances. There are four types of audit opinions:

Unmodified Opinion. An unmodified opinion (clean opinion) states that the financial statements present fairly, in all material respects, the consolidated balance sheets, related consolidated statements of net cost and changes in net position, combined statements of budgetary resources, and related notes to the consolidated financial statements in accordance with GAAP. This opinion is expressed in a standard report. In certain circumstances, explanatory language might be added to the auditor's standard report, which does not affect the unmodified opinion.

Modified Opinion. A modified opinion states that, except for the effects of the matter(s) identified in the opinion, 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 systems that are unable to provide sufficient evidence for the auditor to express an opinion.

Limitation of Audits

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

- 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; and
- Audit procedures cannot eliminate potential fraud, though it is possible that an auditor may find fraud during the audit process.

Considerations for Congress

The federal government is unable to receive an unmodified opinion on its Financial Report of the entire United States Government because agencies with significant assets and budgetary costs such as DOD, Department of Housing and Urban Development, and Railroad Retirement Board have each received a disclaimer of opinion in recent fiscal years.

DOD receiving a disclaimer of opinion on its first-ever, agency-wide audit in FY2018 was not unexpected; many organizations do not receive an unmodified audit opinion during the initial audit. It is estimated that it could take DOD up to 10 years to receive an unmodified audit opinion. The November 2018 audit report identified areas for corrective action and revealed 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

Congress may consider reviewing the results of the FY2018 DOD audit and using the findings to enhance oversight of DOD's remediation of issues identified in it. Possible policy responses could include implementation of process improvements, investments in information technology systems, and changes in accounting practices. (Note: this In Focus was originally co-authored by former CRS Specialist in Defense Acquisition Moshe Schwartz.)

CRS Resources

CRS Seminar, *Understanding the DOD Audit*, by Moshe Schwartz and Raj Gnanarajah, January 11, 2019

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, *Department of Defense Agency Financial Report FY 2018*, November 2018

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

Department of Defense Office of Inspector General, *Understanding the Results of the Audit of the DoD FY2018 Financial Statements*, January 8, 2019

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