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March 16, 2018

MEMORANDUM FOR EXECUTIVE DIRECTOR, FEDERAL ACCOUNTING STANDARDS  
ADVISORY BOARD

SUBJECT: Proposed Exposure Draft Statement of Federal Financial Accounting Standards,  
“Classified Activities”

We appreciate the opportunity to respond to the proposed Exposure Draft Statement of Federal Financial Accounting Standards, “Classified Activities.” We have reviewed the document as requested, below is our response to the “Questions for Respondents.” Should you have any questions or require additional assistance, please contact me or Ms. Debie Alford of my staff at [debra.alford@dodig.mil](mailto:debra.alford@dodig.mil) or 703-601-5396.

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Q1. Classified information is prohibited from public release and the Board is proposing an approach for protecting classified information from unauthorized disclosure. The proposed Statement would provide general guidance for protecting classified information and, when detailed guidance is needed, the Board proposes to provide classified Interpretations<sup>1</sup> of existing standards. GPFRR modified pursuant to this Statement and related Interpretations would be considered in accordance with generally accepted accounting principles.

Do you agree or disagree with the Board's overall proposed approach for protecting classified information? Please provide the rationale for your answer.

A1. We agree that disclosing classified information in a way that could protect national security is an important matter that should be addressed. However, we disagree with the proposed approach for several reasons that we explain in our answers below. Where possible, we offer alternative solutions that we believe would better maintain the meaningfulness of published financial statements.

- 1. Purpose of a financial statement.** The proposed guidance appears to allow entities to misrepresent their public financial statements to protect classified information. This proposal conflicts with the AICPA requirement that an auditor assess whether an entity's financial statements can be considered a fair representation of its use of Federal resources, regardless if the entity followed the accounting framework. The Board did not fully explain how it concluded that the optimal solution would be to allow reporting entities to issue unclassified, publically available financial statements that may or may not include modifications for classified transactions. It does not appear that the Board considered and coordinated other options that could be combined with current Federal standards, such as entities and auditors developing solutions that protect classified information, redacting classified information and transactions, classifying parts of the Government-wide financial statements, or requiring fewer entities to publish financial statements. These alternatives would have an effect similar to the Board's proposed solution because these options would also protect the release of classified information. The significant difference is that, with these other options, financial managers would be able to comply with the current accounting standards. In our view, these alternatives are preferable to a general practice of presenting financial statements according to a basis of accounting that only a select few understand. The Board should consider explaining its rationale for establishing nontraditional accounting practices over other generally accepted alternatives for protecting classified information.
- 2. Further analysis that this proposal protects national security.** As written, paragraphs 5 and 6 of the draft standard appear to conclude that incorporating summary-level classified dollar amounts in the overall financial statement would result in public release of classified information. We do not agree that incorporating summary-level dollar amounts in the overall statements will necessarily result in the release of classified information. Further, we are not aware of any requirement or standard that the detailed dollar amounts included in a summary financial statement must be released to the public. We believe a better alternative would be for the entity and its auditors to discuss the

overall financial statement reporting of classified transactions and determine how to account for classified information in the published financial statements while still maintaining fair presentation of the statements and complying with GAAP. We request that the Board consider including this option in a revised version of this guidance.

Additionally, the Board's proposed guidance does not include consideration of other options that the DoD currently uses to protect classified information, such as issuing classified accounting reports and using redaction as a means to protect classified information. As written, it appears that the Board concluded that the only option was for agencies to prepare financial reports using accounting methods that are not considered GAAP.

Finally, the proposed guidance does not address how reporting classified dollar amounts in a different account protects the nature of the transactions, which would still be reported on the financial statement. As this draft standard states in the beginning, disclosure of dollar amounts are subject to public release. Therefore, it remains unclear how including classified transactions in nontraditional accounts prevents it from public release. The Board should clearly explain how entities would prevent public release of the information. We do not understand how reporting classified information through non-traditional accounts would protect national security.

3. **Apparent conflict with FASAB mission.** This proposed standard (including any subsequent interpretations) coupled with the lack of specific footnote disclosures, jeopardizes the financial statements' usefulness and provides financial managers with an arbitrary method of reporting accounting information. This conflicts with FASAB's accounting mission that Federal financial statement reporting be useful in assessing the:
  - Government's accountability and its efficiency and effectiveness, and
  - economic, political, and social consequences—whether positive or negative—of the allocation and various uses of Federal resources.

This proposed guidance is a major shift in Federal accounting guidance and, in our view, the potential impact is so expansive that it represents another comprehensive basis of accounting. The Board should reconsider this proposed guidance and explore other options for reporting and auditing classified information that allow entities and auditors to work together to ensure that information is protected and financial statement information is accurately and completely reported.

4. **Challenges in auditing the restated balances.** The proposed guidance, as written, does not address circumstances in which classified adjustments (misstatements) result in situations where auditors express concerns that go beyond presentation to concerns about

existence and completeness of account balances. The proposed guidance discusses presentation but not how displaying classified transactions in nontraditional accounts could impact an auditor's view of the existence and completeness management assertions. It is unclear how an entity that knowingly reports classified transactions in nontraditional accounts while at the same time reporting non-classified transactions in accordance with current GAAP can only be considered to have a presentation issue (captured under this proposed standard), but not also have completeness and existence issues for the accounts being represented.

Q2. The proposed Statement permits reporting entities to modify unclassified financial statement presentations, disclosures, and required supplementary information (RSI) to protect classified information. The modifications are (1) those that do not change the net results of operations and net position and (2) the inclusion of an organization in a manner that would not reveal classified information.

- a. Do you agree or disagree with permitting reporting entities to modify presentations to protect classified information when it does not change net results of operations and net position? Please provide the rationale for your answer.
- b. Do you agree or disagree with permitting certain modifications when applying the provisions of SFFAS 47, *Reporting Entity*, when necessary to protect classified information? Please provide the rationale for your answer.
- c. Do you agree or disagree with permitting modifications to disclosures and required supplementary information? Please provide the rationale for your answer.

A2a. We disagree for the reasons stated in answers 1 through 4 above. Specifically, allowing reporting entities to modify presentations—such as presenting amounts associated with one account in another nontraditional account and not disclosing this departure—raises questions and concerns about accounting treatment of classified transactions. These concerns include balancing the risk of releasing classified information with the need to prepare meaningful financial statements, diminishing the ability for entities and auditors to work together to fairly state and protect classified information, advocating any accounting treatment for classified transactions, and demonstrating how this proposed standard protects classified information better than current practices.

This draft standard does not adequately explain how reporting certain amounts in a nontraditional account, as opposed to the GAAP compliant account, would not present the same national security risk of releasing classified information to the public. Without more information included in this standard, users would not be able to determine the accuracy of the financial statements, with the exception of a few select individuals. As a result, financial statements would not be meaningful or comply with GAAP. As discussed in Answer 1, a better solution would be to restrict the public release of specified and documented financial statements.

A2b. We disagree for the same reasons stated in A2a.

A2c. The revisions proposed do not provide enough information for us to determine the potential impact of those omissions or non-disclosures to provide an informed response.

Q3. In the future, the Board may issue classified Interpretations of existing standards. The Interpretations would permit other presentation and disclosure options as needed to produce unclassified GPPFR. The other options would protect specific financial statement elements from unauthorized disclosure in an unclassified GPPFR. The classified Interpretations would be developed following a due process involving:

- a. development of classified proposals,
- b. comment on the proposals from individuals and organizations holding appropriate clearances,
- c. consideration of comments, and
- d. issuance of Interpretations to individuals and organizations holding appropriate clearances. (See par. A9 and A10 for a more detailed discussion of the process.)

Do you agree or disagree with the proposed approach? Please provide the rationale for your answer.

A3. We disagree. Paragraph 8 of the proposed Standard states that the Board may issue Interpretations of existing Statements permitting other unclassified presentation and disclosure options as needed. Such options may modify net results of operations and net position. In our view, the use of Interpretations in this manner overreaches the purpose of an Interpretation since the Interpretation will result in non-public standards. Specifically, FASAB states that Interpretations clarify original meaning, add definitions, and provide other guidance for existing SFFAS—the Interpretations should be narrow in scope. Interpretations are not intended to change or conflict with existing standards. However, if FASAB issues classified interpretations that modify net results of operations and net position of the entity, then the Interpretation changes the published standards.

In addition, as discussed in A1, this approach would likely make the financial statements misleading to all but a select few individuals that are aware of the Interpretation. If this is the Board's approach, we recommend that it change the type of accounting to "applicable financial reporting framework" since we believe there would be uncertainty whether this approach fits into the framework of current GAAP because some much information would be unknown, entities could have different uses, and the applications of the Standard are too vague.

Q4. The Board is proposing that recorded amounts related to classified information reconcile in aggregate to schedules or other documentation subject to audit. Documentation must be retained in the appropriate environment and/or domain to adequately support classified information.

Do you agree or disagree with the conditions necessary to apply the proposed Statement? Please provide the rationale for your answer.

A4. Without additional information, we cannot agree or disagree. Specifically, the intent of this requirement appears to be to provide the public assurance that, even though the financial statements and disclosures are not a fair representation of the reporting entity, the underlying transactions are audited. However, perhaps in part because of the lack of specificity in this proposed standard, a financial statement auditor might not apply audit procedures to the classified information at all, or in as rigorous a manner as the unclassified transactions. For example, it is possible that, because the entity elected to present classified transactions in a nontraditional account, those transactions would not be audited using the same procedures as the non-classified transactions in the same account. A financial statement audit only opines and audits transactions as the entity presents them in the financial statements. Generally Accepted Government Auditing Standards do not allow for another mechanism to provide any assurance other than the fair presentation of the published financial statements. We recommend that the Board consider adding specific reporting requirements related to those reconciliations, and ensure that the reconciliation process is audited or reviewed in some manner.

In addition, it is unclear what the Board or an entity would expect a “reconciliation” or “schedule” to require. Since agencies would not be prohibited from using nontraditional accounts to report classified balances, it is unclear whether the Board would permit unusual balances to be included so that classified information is not disclosed to the public. The Board should clarify whether this proposed standard, or subsequent Interpretations, could permit entities to record misstated amounts in the financial statements to mislead readers with the stated purpose of protecting classified information. We believe that no accounting guidance should allow this type of accounting entry.

Q5. The Board has considered how to inform readers of GPFFRs regarding the potential modifications given the classified nature of the modifications themselves.

a. Do you agree or disagree with the disclosure requirements (see par. 10-14)? Please provide the rationale for your answer.

b. Do you agree or disagree that component reporting entities may choose to consistently disclose that certain presentations may have been modified? Please provide the rationale for your answer.

c. Alternatively, do you believe every component reporting entity of the federal government should be required to disclose that certain presentations may have been modified? Please provide the rationale for your answer.

A5a and b. We disagree. As we disagree with the proposed basis of accounting the Board introduced, we cannot agree that entities should disclose that certain information may have been modified to protect classified information. Allowing components to state, "Certain presentations may have been modified to protect classified information," would lead the reader to conclude that the information in the financial statements is not reliable. This disclosure casts doubt on the value of the financial statements and the related audit.

A5c. We disagree for the same reason we stated in A5a and b. In addition, this could be an inaccurate or misleading disclosure if that particular entity does not report classified transactions or if the entity followed established GAAP. This disclosure risks making all entity financial statements appear unreliable. Further, we do not believe that this disclosure—or the Board's proposed guidance—would effectively protect classified information, comply with GAAP, or serve the public interest.