



August 18, 2017

Memorandum

To: Members of the Board

From: Wendy M. Payne, Executive Director
Monica Valentine, Assistant Director
Ross Simms, Assistant Director

Subj: Financial Reporting and Classified Activities – **Tab C**¹

MEMBER ACTIONS REQUESTED:

- Respond to staff questions (p.7) by August 28th

MEETING OBJECTIVES

- Provide staff direction so that an exposure draft can be approved at or before the next Board meeting

BRIEFING MATERIAL

This memo explains the concerns regarding financial reporting by component reporting entities engaged in classified activities and options for resolving those concerns.

Attachment 1 provides a preliminary draft exposure draft.

BACKGROUND

The federal members and staff were contacted by the Department of Defense (DoD) regarding options for ensuring that publicly available financial reports would not reveal classified information. While financial reports are highly aggregated, classification authorities within DoD concluded that some of the aggregated amounts are likely to be too revealing.

The matter of budgetary information regarding classified activities has been debated extensively; particularly since the 9/11 Commission review of intelligence activities including oversight of such activities. After the 9/11 Commission recommendations, Public Law 110-53 (Section 601(a)) directed that "Not later than 30 days after the end of each fiscal year beginning with fiscal year 2007, the Director of National Intelligence shall disclose to the public the aggregate amount of funds appropriated by Congress for

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

the National Intelligence Program for such fiscal year." Similar disclosure is required for the DoD intelligence funding. Such amounts are referred to as the "topline budget numbers." All but these budget numbers remain classified.

The following remarks by then Director of Central Intelligence George Tenet explain the general arguments against revealing budgetary information:

Disclosure of the budget request reasonably could be expected to provide foreign governments with the United States' own assessment of its intelligence capabilities and weaknesses. The difference between the appropriation for one year and the Administration's budget request for the next provides a measure of the Administration's unique, critical assessment of its own intelligence programs. A requested budget decrease reflects a decision that existing intelligence programs are more than adequate to meet the national security needs of the United States. A requested budget increase reflects a decision that existing intelligence programs are insufficient to meet our national security needs. A budget request with no change in spending reflects a decision that existing programs are just adequate to meet our needs.²

Contrary to the decision made to only reveal the topline budget numbers, accrual based financial statements reveal more than the funding in aggregate as discussed above. For example, financial statements reveal the amount invested in assets, expenses for each of the disaggregated components or goals selected for presentation, and important trends. Because of the public nature of Board deliberations, we will not offer many examples of the problems posed by financial reports.

The Board does not itself have the authority to determine what information is classified. (Such authority is referred to as original classification authority (OCA).) At each meeting on this topic, we will be supported by representatives of the intelligence community (IC) and the Department of Defense (DoD). We will rely on their OCA and expertise to determine what we can discuss and what we cannot discuss in the meeting as well as in an official Board publication. Of course, they will respond to your questions to the extent feasible in an open meeting. Please keep this in mind as you raise questions.

STAFF RECOMMENDATIONS

Develop an SFFAS on Classified Activities

To address the conflict between financial reporting and national security requirements, FASAB would follow the existing due process established through the Memorandum of Understanding by the sponsors; the Office of Management and Budget, the Department of the Treasury and the Government Accountability Office. As a first step, a publicly available standard – a Statement of Federal Financial Accounting Standards (SFFAS) - would establish general guidance regarding financial information considered classified.

² "Declaration of George Tenet," *Aftergood v. CIA*, U.S. District Court for the District of Columbia, Civ. No. 98-2107, April, 1999

Our preliminary efforts suggest that more than general guidance will be needed. However, classification experts from the entities involved have advised us that some detailed guidance itself should be classified. As a first step, staff proposes the Board establish general guidance with detailed classified guidance to follow as needed.

The general guidance in the SFFAS should accomplish the following:

1. Allow certain types of departures from other standards when needed to protect classified information (that is, those that can be acknowledged in publicly available standards)
2. Acknowledge that departures from other standards may be approved by the Board if needed to prevent disclosure of classified information
3. Limit the application of this draft statement to publicly available (unclassified) general purpose federal financial reports (GPFRR) which otherwise would reveal classified information
4. Require 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.

The attached draft exposure draft was developed with the assistance of the affected entities. The departures it would allow include altering the presentation of information on the statements of net cost and changes in net position as well as the balance sheet. However, departures would be limited to those not affecting bottom line amounts for the net results of operations for the period and the net position at the end of the period. When the guidance is appropriately applied, the resulting financial reports would be considered to be in accordance with GAAP. Staff supports this approach.

An alternative is to limit the general SFFAS to addressing items 2, 3, and 4 above. In which case, all approved departures would be addressed in more detailed interpretations of the general SFFAS. Staff advises against this approach. Identifying techniques that are permitted to be discussed in a public SFFAS is reasonable. Also, doing so would provide timely guidance for stakeholders.

Another alternative may be to not permit departures at all. DoD considered alternative approaches without success. Hence, staff is persuaded that this is not a viable alternative.

Establish a Process to Issue Classified Interpretations of the SFFAS

To provide the needed detailed guidance through a classified document, the Board would use processes appropriate to classified information. The existing due process would be followed but subject to constraints applied to all classified information and

contemplated in the Federal Advisory Committee Act.³ The result would be classified interpretations available to reporting entity staff with appropriate clearances and a need for the guidance.

We would follow the existing process for interpretations subject to limitations appropriate to the classified nature of the deliberations and related documents. The existing process is described below:

1. Identification of accounting issues and agenda decisions
2. Preliminary deliberations
3. Preparation of initial documents (discussion memorandums and/or issue papers)
4. Release of documents for comment (e.g., exposure drafts) to the public, public hearings when necessary, and consideration of comments
5. Further deliberations and consideration of comments
6. A majority vote to approve interpretations
7. Approved interpretations are submitted to the members representing Treasury, OMB, and GAO. If, within 45 days after its submission, none of these members object, then it shall be announced in the Federal Register and issued by FASAB.

Each of the steps above that involve public information or open meetings would be altered to ensure classified information (which might include even the title of the interpretation) is not made public. However, stakeholders with appropriate clearances would be engaged to the greatest degree possible during development of the guidance. Cleared stakeholders might include CFOs; inspectors general; Congressional committee members and staff; representatives from other oversight bodies such as OMB, Treasury, and GAO; and representatives of independent public accounting firms.

Developing detailed guidance would ensure a reasonably consistent and effective approach to protecting financial information related to classified activities while producing GPFFR. Such guidance would reside in official interpretations of the SFFAS. However, as noted above, these interpretations would be classified.

For each process step, FASAB would seek input from DoD and ODNI classification experts regarding the need to:

1. Close meetings of the board through a process established in the Federal Advisory Committee Act that requires public notice of closed meetings and the reason for the closed meeting
2. Conform to security requirements applicable to any communications and documents related to the development of classified guidance.
3. Classify the resulting guidance (most likely as “secret”) as needed

³ Staff and general counsel have confirmed that other advisory committees produce materials that are classified and do so following procedures for closed sessions and classified reports.

As members know, we have requested security clearances for each member. This step is not yet complete. However, we can work on the general guidance and prepare for development of classified interpretations in the interim.

QUESTIONS FOR THE BOARD

At the meeting, members will have an opportunity to ask questions about the need for classified information. It would be helpful to know what questions you have before the meeting. Please contact staff before the meeting to discuss your questions. The primary point of contact for this project is Monica Valentine. She can be reached at valentinem@fasab.gov or 202.512.7362.

Please be prepared to address the following questions during the meeting:

- 1. Do members support the approach proposed (that is, developing a general SFFAS followed by classified interpretations providing detailed guidance)?**
- 2. Do members support the conditions necessary to apply the SFFAS (that is, classified information must be protected from disclosure in a publicly available GPFRR and recorded amounts related to classified information must reconcile in aggregate to schedules or other documentation subject to audit)?**
- 3. When departures from other standards are needed to protect classified information, do members agree that departures that do not alter the results of operations for the reporting period should be permitted?**
- 4. When departures from other standards are needed to protect classified information, do members agree that departures that do not alter the net position at the end of the reporting period should be permitted?**

TAB C – ATTACHMENT 1

DRAFT PROPOSED STANDARDS – CLASSIFIED ACTIVITIES

EXECUTIVE SUMMARY

WHAT IS THE BOARD PROPOSING?

The Board is proposing accounting treatment to protect classified and sensitive information or activities in the General Purpose Federal Financial Report (GPFRR).

HOW WOULD THIS PROPOSAL IMPROVE FEDERAL FINANCIAL REPORTING AND CONTRIBUTE TO MEETING THE FEDERAL FINANCIAL REPORTING OBJECTIVES?

Align financial presentation and disclosure to budgetary integrity to appropriately accommodate end user needs in a manner that does not impede national security.

Materiality

The provisions of this Statement need not be applied to immaterial items. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

PROPOSED STANDARDS

SCOPE

1. This Statement applies to federal entities that present general purpose federal financial reports, including the consolidated financial report of the U.S. Government (CFR), in conformance with generally accepted accounting principles, as defined by paragraphs 5 through 8 of Statement of Federal Financial Accounting Standards (SFFAS) 34, The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board.

DEFINITIONS

2. **CLASSIFIED** National Security Information, also known as "classified information" is any information that has been determined pursuant to Executive Order 12958, as amended; or any successor orders, to require protection against unauthorized disclosure and is marked to indicate its classified status. Information may be classified at one of the following three levels:
 - a. **TOP SECRET**, which is applied to information, the unauthorized disclosure of which reasonably could be expected to cause exceptionally grave damage to the national security that the original classification authority is able to identify or describe;
 - b. **SECRET**, which is applied to information, the unauthorized disclosure of which reasonably could be expected to cause serious damage to the national security that the original classification authority is able to identify or describe; and
 - c. **CONFIDENTIAL**, which is applied to information, the unauthorized disclosure of which reasonably could be expected to cause damage to the national security that the original classification authority is able to identify or describe.
3. **Original classification authority** is an individual authorized in writing, either by the President, the Vice President, or by agency heads or other officials designated by the President, to classify information in the first instance.

APPLICATION OF STANDARDS AND DISCLOSURES

1. Classified information is prohibited from public release. Classified information is determined by an Original Classification Authority (OCA).
2. A reporting entity's unclassified GPFRR may not reveal classified information. Therefore, unclassified reports should be presented in a manner that protects the information. The entity may modify unclassified financial statement presentations, disclosures and Required Supplementary Information (RSI) required by other standards to protect the information if the modification does not change the net results of operations or net position.
3. The Board may issue interpretations permitting other unclassified presentations and disclosure options as needed.
4. Recorded amounts related to classified information must 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.

COMPONENT REPORTING ENTITY DISCLOSURES

FINANCIAL REPORT OF THE US GOVERNMENT DISCLOSURES

EFFECTIVE DATE

4. The requirements of this Statement are effective for reporting periods beginning after September 30, 2017.

APPENDIX A: BASIS FOR CONCLUSIONS

This appendix discusses some factors considered significant by Board members in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others. The standards enunciated in this Statement—not the material in this appendix—should govern the accounting for specific transactions, events, or conditions.

PROJECT HISTORY

- A.1. In August 2016, the Department of Defense (DoD or the Department) identified several areas for the Federal Accounting Standards Advisory Board’s consideration where the application of general accepted accounting principles may result in the exposure of classified information. As the DoD was preparing to commence full-scope financial statement audits, it identified specific accounting standard requirements that could conflict with its responsibility to prevent the unauthorized disclosure of information in accordance with Executive Order (EO) 13526 of December 29, 2009, “Classified National Security Information.”
- A.2. Specifically, EO 13526 recognizes, “Our democratic principles require that the American people be informed of the activities of their Government. Also, our Nation’s progress depends on the free flow of information both within the Government and the American people. Nevertheless, throughout our history, the national defense has required that certain information be maintained in confidence in order to protect our citizens, our democratic institutions, our homeland security, and our interactions with foreign nations. Protecting information critical to our Nation’s security and demonstrating our commitment to open Government through accurate and accountable application of classification standards and routine, secure, and effective declassification are equally important priorities.”
- A.3. Criteria for the type of activities to be protected included within Title 18 U.S. Code Sections 798, and Executive order 13526, SEC 1.4 are:
- military plans, weapons systems, or operations;
 - foreign government information;
 - intelligence activities (including covert actions), intelligence sources or methods, or cryptology;
 - foreign relations or foreign activities of the United States, including confidential sources;
 - scientific, technological, or economic matters relating to the national security;
 - United States Government programs for safeguarding nuclear materials or facilities;
 - vulnerabilities or capabilities of systems, installations, infrastructures, projects, plans, or protection services relating to the national security; or
 - the development, production, or use of weapons of mass destruction.
- A.4. There are many federal departments and agencies engaged in classified activities such as those described above. In the recent past, information regarding the total amount budgeted for classified activities was not publicly disclosed. However, in the last decade, changes were made so that the topline budget numbers for such activities would be made available. Details remain classified including the amount of funding for particular components within the intelligence community and other departments or agencies. Disclosure of the funding details at lower levels of detail may harm the national security interests.
- A.5. This Statement and future related interpretations would allow reporting entities to issue

unclassified, publically available financial statements that comply with accounting standards. Without this Statement, there is a risk that reporting entities may need to classify their financial statements to comply with existing accounting standards.

- A.6. This Statement does not include the reporting of financial information within the GPFFR in the classified environment and only applies when the information is presented in the unclassified environment. This does not relieve reporting entities from their requirements and responsibilities to comply with existing accounting standards in the appropriate environment as it relates to internal records and non-public reports.

Proposed Approach to Reporting on Classified Activities

- A.7. This proposed Statement permits certain techniques for protecting information within the GPFFR related to classified activities. Certain other techniques are expected to be addressed through classified guidance issued as Interpretations of this Statement. The Board will establish a process to engage cleared stakeholders in due process regarding classified Interpretations of this Statement. The process will engage users of information related to classified activities.
- A.8. This approach balances the public's interest in financial information with the need to protect classified information. Further, the Board's role in promulgating classified guidance will appropriately guide and constrain the techniques used.
- A.9. Because the techniques approved as GAAP will be applied to publicly available financial reports, internal records and non-public financial reports will continue to be subject to adequate internal controls. Information provided to elected officials in non-public reports will conform to GAAP without application of related classified Interpretations.
- A.10. The Board may issue interpretations and implementation guidance in the classified environment.