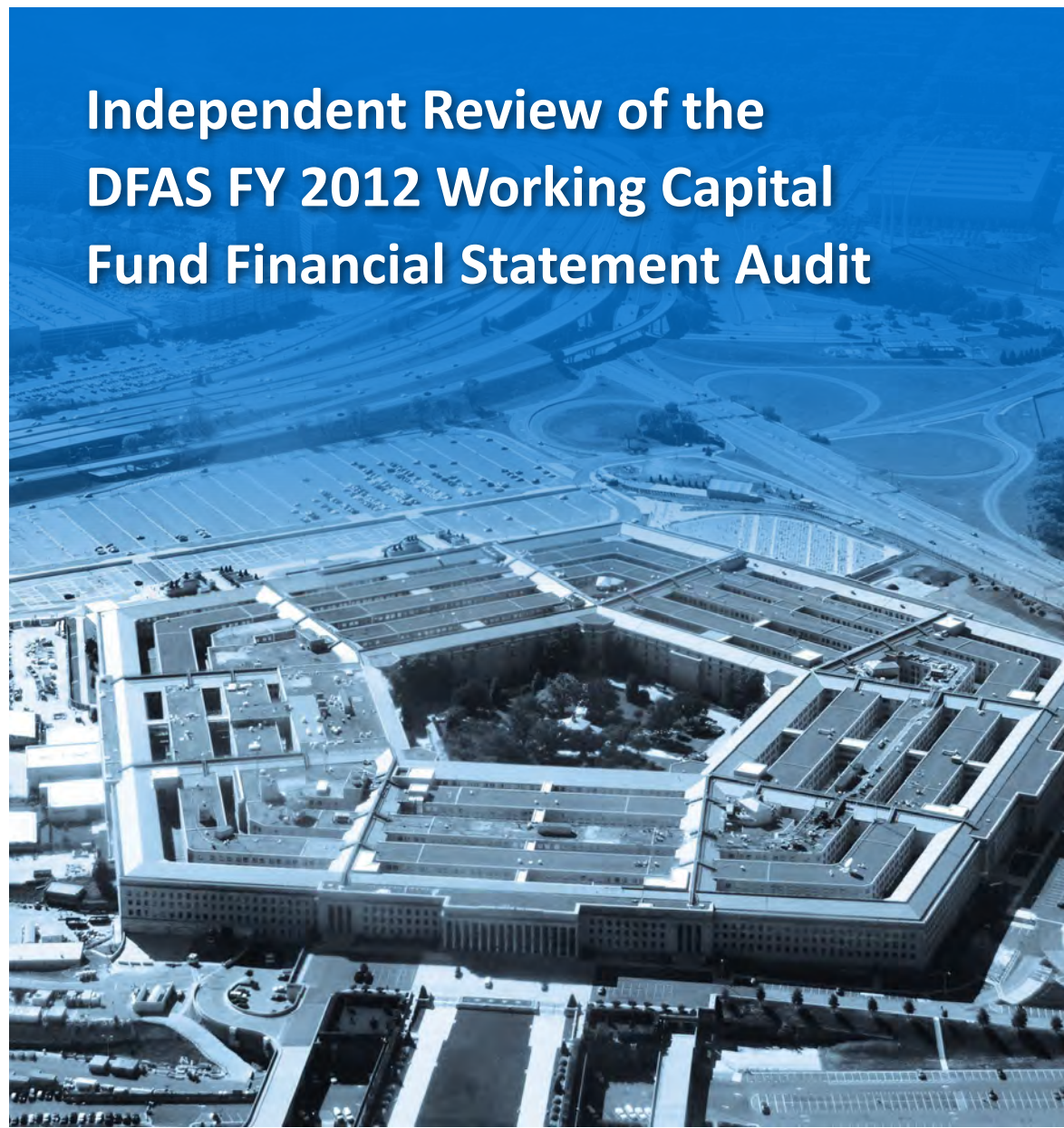




INSPECTOR GENERAL

U.S. Department of Defense

MARCH 12, 2015



Independent Review of the DFAS FY 2012 Working Capital Fund Financial Statement Audit

INTEGRITY ★ EFFICIENCY ★ ACCOUNTABILITY ★ EXCELLENCE

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**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

March 12, 2015

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
PRINCIPAL PARTNER, CLIFTONLARSONALLEN LLP

SUBJECT: Independent Review of the DFAS FY 2012 Working Capital Fund Financial
Statement Audit (Report No: DODIG-2015-091)

We are providing this report for your information and use. Other than not meeting audit documentation requirements contained in AICPA AU Section 339, our review did not identify any other instances in which CliftonLarsonAllen, LLP (CLA) did not comply in all material respects with AICPA standards, GAGAS, or the U.S. Government Accountability Office Financial Audit Manual, when auditing the statement of budgetary resources, statement of net costs, statement of changes in net position, and the balance sheet. However, some of CLA's audit procedures could be improved to lower future audit risk.

Repeated attempts to obtain CLA's audit documentation were unsuccessful, which led to the issuance of a subpoena to obtain CLA's audit documentation, contributing to delays in completing the post-audit review. Additionally, holding numerous meetings with CLA to discuss its position and obtain clarification on its work also contributed to delays in completing the post-audit review. However, this report is relevant because the DFAS Working Capital Fund (WCF) financial statements are audited on an annual basis and CLA is still the auditor of record. We considered CLA's comments on a draft of this report when preparing the final report. We do not require additional comments.

We appreciate the courtesies extended to the staff. Please direct any questions to me at (703) 601-5945 (DSN 329-5945).

A handwritten signature in blue ink that reads "Lorin T. Venable".

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting





**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500**

March 12, 2015

MEMORANDUM FOR DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE
PRINCIPAL PARTNER, CLIFTONLARSONALLEN LLP

SUBJECT: Independent Review of the DFAS FY 2012 Working Capital Fund Financial
Statement Audit (Report No: DODIG-2015-091)

On July 20, 2010, the Department of Defense Office of Inspector General (OIG) issued a policy memorandum, which established that the DoD OIG would conduct post-audit reviews on a sample of DoD entities financial statement audits for which we do not provide oversight. On February 01, 2012, the Defense Finance and Accounting Service (DFAS) exercised its contract option for CliftonLarsonAllen, LLP (CLA) to perform the audit of its FY 2012 Working Capital Fund (WCF) financial statements.

DFAS is required to prepare its financial statements in accordance with Generally Accepted Accounting Principles. The contract required CLA to perform the audit in accordance with generally accepted government auditing standards (GAGAS). CLA issued an unqualified opinion on the DFAS FY 2012 financial statements. Our responsibility was to determine whether the procedures performed by CLA were conducted in accordance with GAGAS as well as other criteria required to fulfill the contract requirements. We reviewed the audit work performed by CLA on the material financial statement line items, including property, plant, and equipment; accounts payable; and the accrued payroll and benefits line items on the balance sheet. Additionally, we reviewed CLA's audit work related to the fund balance with treasury account, as well as the statement of budgetary resources, statement of net costs, and the statement of changes in net position.

We conducted our review in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA) and GAGAS. A review is substantially less in scope than an examination, which the objective is to express an opinion and, accordingly, we express no such opinion. We believe that our review provides a reasonable basis for our conclusions regarding CLA's audit procedures.

Other than not meeting audit documentation requirements contained in AICPA AU Section 339,¹ our review did not identify any other instances in which CLA did not comply in all material respects with AICPA standards, GAGAS, or the U.S. Government Accountability Office Financial Audit Manual, when auditing the statement of budgetary resources, statement of net costs, statement of changes in net position, and the balance sheet. Throughout the review, we noted some instances where the quality of CLA's audit documentation did not meet standards. AICPA AU Section 339, "Audit Documentation," states audit documentation must be prepared in sufficient detail to provide a clear understanding of the work performed, the audit evidence obtained, and the conclusions reached. AU Section 339 also states audit documentation assists an auditor who reviews a predecessor auditor's audit documentation. For example, CLA referred us to its completion of notice of findings related to payroll internal control testing for accrued payroll and benefits, and internal control testing procedures for cash disbursements within fund balance with treasury. However, the notice of findings that CLA referenced were not related to the payroll internal control testing or internal control testing procedures for cash disbursements. Furthermore, the notice of findings related to these issues did not exist in CLA's audit documentation. Additionally, CLA stated it reviewed the Checklist for Federal Accounting (FAM 2010); however, CLA did not provide the reference in its audit documentation to support their review and subsequent documentation provided did not support CLA conclusions.

Some of CLA's audit procedures could be improved to lower future audit risk. Specifically:

- CLA did not set the trivial amount at a level where it is likely that in aggregate (total) the misstatements would not be material. AICPA AU Section 312, "Audit Risk and Materiality in Conducting an Audit," states "trivial" amounts designated by the auditor need not be accumulated (totaled). Section 312 further states this amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements are considered. CLA's trivial amount equaled 7.5 percent of planning materiality. Other Independent Public Accountant's conducting audits of DoD entities have set the trivial amount between 1 and 5 percent. However, setting the trivial amount at this level is not required by AICPA standards or the FAM.

¹ In our draft report, we referred to AICPA AU-C Section 230, "Audit Documentation." This standard applies to audits of financial statements for periods on or after December 15, 2012. We updated the final report with AICPA AU Section 339, "Audit Documentation," to reflect the standard applicable to the audit time period.

- CLA used the most likely error as opposed to the upper-error limit for sample results based on monetary unit sampling (MUS) methodology. The IDEA² manual, “Sampling with IDEA—Beyond the Mechanics,” encourages the use of larger sample sizes and specifically states the larger the sample, the more likely the projection is closer to the true misstatement in the population. The manual states:

A robust sample that has a small precision (for example, a precision of 1-2 percent) is best to use as an estimator of the true value. A small sample with a wide upper limit may not provide the best support for recording a financial statement amount. Unless the sample size is very large, when the projected misstatement is close to the tolerable misstatement, the upper limit of such an estimate would likely be well above the tolerable misstatement. Without further evidence that the populations are free of material misstatement or a correction of some of the known and projected amount of misstatement, the auditor cannot conclude at a low risk that the financial statements are free of material misstatements. When statistical techniques are used, the auditor can conclude through the upper limit which is associated with a confidence level, whether the evidence supports acceptance of test results, adjustments are required, and whether the auditor achieved their assurance level when designing the test.

Additionally, for undelivered orders and accounts payable, CLA used classical variable sampling to determine its estimated error.³ Table 1 compares the estimated error used by CLA and the upper-error limit amount using the MUS methodology applied by CLA during their audit.

Table 1. Estimated Error Used by CLA Compared to the Upper-Error Limit Using Monetary Unit Sampling

	Estimated Error Used by CLA	Upper-Error Limit
Additions (June 30 testing)	\$755,740	\$9,062,414
Construction In Progress/Work in Progress 1832 (June 30 testing)	\$1,259,096	\$7,802,112
Repairs & Maintenance*	\$0	\$10,968,816
Undelivered Orders	\$7,700,000**	\$12,092,186
Accounts Payable	\$516,000**	\$896,285
Total	\$10,230,836	\$40,821,813

* MUS sampling was performed for both June 30 and Sept 30 testing. DoD OIG statisticians calculated the combined upper-error limit for repairs and maintenance for the entire year.

** Classical variable sampling was used and CLA’s estimated error was carried forward to the Schedule of Uncorrected Misstatements.

² IDEA is data analysis software that CLA used to select samples using the monetary unit sampling methodology.

³ CLA calculated the estimated error rate by using the rounded midpoint for undelivered orders (\$3,369,790 and \$12,092,186) and accounts payable (\$136,685 and \$896,285). The rounded midpoint is the average between the point estimate and the upper-error limit.

CLA carried forward proposed adjustments of \$7.7 million for undelivered orders and \$516,000 for accounts payable to the Schedule of Uncorrected Misstatements. CLA proposed a \$7.7 million adjustment to DFAS for undelivered orders. CLA did not require DFAS to adjust its financial statements because this amount was below both the design materiality of \$10.2 million and the reporting materiality of \$22.9 million. DFAS personnel chose not to make the recommended adjustment because they were not material to the financial statements as a whole, and the correction window for making adjustments had passed. If DFAS made the proposed adjustment, CLA would have had greater assurance that the DFAS FY 2012 Financial Statements were free of material misstatements. CLA did not propose the adjustment of \$516,000 for accounts payable because it was below CLA's trivial amount threshold of \$2.3 million.

- CLA did not consider the aggregate value of nonsampled items when they performed judgmental sampling for property, plant, and equipment. CLA used a combination of MUS and judgmental sampling techniques to conduct its testing. The totals of the unaudited and untested balances where CLA used judgmental sampling are \$13.7 million, which was above the design materiality threshold of \$10.2 million. Table 2 details the results of CLA's judgmental samples.

Table 2: Results of Unaudited/Untested Balances

	Amount Not Sampled	Amount Sampled	Total Population
Additions (September 30 testing)	\$3,773,200	\$2,190,843	\$5,964,043
Deletions (June 30 testing)	\$1,864,407	\$0	\$1,864,407
Deletions (September 30 testing)	\$1,483,511	\$2,969,384	\$4,452,895
CIP/WIP 1750.3 (September 30 testing)	\$2,433,178	\$5,291,744	\$7,724,922
CIP/WIP 1832 (September 30 testing)	\$4,151,903	\$5,192,788	\$9,344,691
Total	\$13,706,199	\$15,644,759	\$29,350,958

FAM section 540.01 states the auditor should evaluate misstatements individually and in the aggregate; however, there was no evidence in the audit working papers that CLA considered the sum of the unaudited and untested balances when evaluating misstatements. CLA cited FAM section 540.04 that states:

To evaluate the aggregate effects of misstatements on the financial statements, the auditor should accumulate known and likely misstatements.... Per AU 312.42, the auditor may designate an amount below which misstatements are not accumulated. The auditor should set this trivial or de minimis amount so that any such misstatements, either individually or when aggregated with all other misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

However, FAM 540.11 states:

In addition to the total likely uncorrected misstatements, the auditor should evaluate the risk of further misstatement, which is due to the imprecision of audit procedures as discussed in FAM 230.12. This risk includes the allowance for sampling risk (the combined precision of all sampling applications), an allowance for imprecision of analytical and other substantive audit procedures, and an allowance for unaudited immaterial account balances. The statistician should compute the combined precision for all sampling applications.

- CLA did not maintain evidence to support that it reviewed and tested the detailed transactions in the DFAS–Columbus Cash Accountability System as part of the audit procedures for Fund Balance with Treasury (FBWT). While CLA personnel performed detail testing of cash collections and cash disbursement transactions, CLA's audit documentation indicated it only tested transactions from DFAS' internal accounting system. AICPA AU Section 350.24 and 350.17, "Audit Sampling," states:

Sample items should be selected in a way that the sample can be expected to be representative of the population; therefore, all items in the population should have an opportunity to be selected. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective.

Additionally, FAM Section 350 states that the auditor should use a combination of audit procedures to obtain sufficient, appropriate audit evidence regarding the operating effectiveness of controls. According to CLA's audit documentation, CLA compared summary collection and disbursement amounts from the DFAS accounting system to summary amounts from the DFAS Cash Management Report (CMR)⁴ and noted that those summary amounts agreed with immaterial differences. Although it is not explicitly required by audit standards or the FAM, re-performing the DFAS FBWT reconciliations is a key audit step that helps obtain assurance that the account balance is correct and the processes are effectively capturing all receipts and disbursements. To re-perform the DFAS FBWT reconciliations, CLA would have to retrieve the disbursement and collections transactions supporting the summary amounts on the CMR and reconcile those transactions to the detail disbursements and collections reported in the accounting system. By performing this key audit step, CLA would reduce their audit risk; however, without re-performing these procedures, CLA would not have assurance that the population they sampled included unauthorized and unrecorded transactions. An appropriate sampling plan would involve sampling from an entire population of transactions.

⁴ The CMR is similar to an account summary that a commercial bank reports to a customer's individual monthly bank statement. However, unlike a monthly bank statement, the CMR does not contain a list of the individual transactions charged to the account during the month. Instead, the CMR reports only the summary amounts for each appropriation.

- CLA did not document the effect that the absolute value⁵ of the undistributed account would have on the financial statements. CLA personnel did not have assurance that the population they sampled included unauthorized and unrecorded transactions that a proper FBWT reconciliation would detect. FAM 921 states that auditors should determine the magnitude of the entity's gross unreconciled differences at year end by analyzing their aggregate absolute values and resulting impact on the financial statements. Undistributed transactions represent potential misstatements, and CLA personnel relied on the summary undistributed amount without aggregating each of these potential misstatements in the absolute form. The OIG obtained a file of DFAS undistributed transactions as of September 30, 2012, and calculated an absolute value of \$8.9 million of these undistributed transactions. Although these DFAS-provided transactions did not exceed CLA's \$10.2 million design materiality threshold, CLA did not perform the work to identify the absolute value of those transactions as required by FAM 921. While the total of the undistributed transactions were immaterial, additional testing performed by CLA would have reduced the audit risk associated with this approach.

CLA Comments and Our Review

We provided a draft of this report to CLA, who provided comments that we considered in preparing this final report. See Attachment 1 for a summary of CLA's comments and our response and Attachment 2 for the full text of CLA comments.

This report will be made publicly available pursuant to section 8M, paragraph (b)(1)(A) of the Inspector General Act of 1978, as amended. However, this report is intended solely for the information and use of Congress; the OMB; the U.S. Government Accountability Office; the Under Secretary of Defense (Comptroller)/Chief Financial Officer, DoD; the Director, Defense Finance and Accounting Service; and the DoD Office of Inspector General. It is not intended to be used and should not be used by anyone else.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945 or (DSN) 329-5945.



Lorin T. Venable, CPA

Assistant Inspector General

Financial Management and Reporting

Attachment:

As stated

⁵ Absolute value is the sum of the positive values of the debit and credit transactions without regard to the sign (plus or minus).

Attachment 1

CLA Comments and Our Response

We fully considered CLA's comments on our draft report; however, CLA did not provide any additional information that would change our conclusions for this review. Therefore, we did not revise our final report. This report did not include any findings that represent personal preferences; it represents conclusions based on our review of the CLA working papers and professional judgment. We disagree with CLA that our conclusions were "substantially factually inaccurate." Our report, as well as our responses to CLA's comments, illustrates our concerns over the quality of CLA's audit documentation.

Materiality Parameters

The Principal Partner, CLA stated he disagreed with our conclusion that certain areas of CLA's audit documentation were not in compliance with professional standards. Specifically, the Principal Partner stated that we failed to define the materiality parameters for the PP&E, accounts payable, and the accrual payroll and benefits line items or indicate relevant DFAS amounts that served as the basis of such parameters.

Our Response

We performed an attestation-level review to determine whether the procedures performed by the Independent Public Accounting firm for the audit of the DFAS FY 2012 Working Capital Fund financial statements were conducted in accordance with the generally accepted government auditing standards, as well as other criteria required to fulfill the contract requirements. The Principal Partner consistently refers to our conclusions as findings; however, attestation-level review reports require the auditor to express a conclusion about whether any information came to the auditors' attention that indicates the subject matter is not in conformity with the criteria. In addition, the standards of reporting for an attestation engagement do not require the auditor to discuss materiality parameters.

Our scope for this review was limited to CLA's audit procedures for the material line items on the balance sheet that totaled \$311.2 million to include:

- property, plant, and equipment, totaling \$307.4 million;
- accounts payable, totaling \$54.1 million; and
- accrued payroll and benefits, totaling \$78.6 million.

We reviewed CLA's materiality calculations as documented in the CLA working papers. We also reviewed and considered all working papers provided by CLA, as well as the supplemental information provided by CLA that was not in the working papers, to answer and support questions raised during the review. Additionally, the scope of our review covered the Statement of Budgetary Resources, the Statement of Net Cost and the Statement of Changes in Net Position.

The FBWT account was not on the balance sheet; however, information pertaining to the FBWT account is associated with the SBR, and the FBWT account is a significant factor in the reliability of the financial statements. Therefore, we added FBWT to the other financial statement items that we reviewed.

Audit Documentation

The Principal Partner, CLA stated he disagreed with our conclusion that certain areas of CLA's audit documentation were not in compliance with professional standards. The Principal Partner stated that our report did not state the specific section of AU 230 or the Government Accountability Office (GAO), "Government Auditing Standards," December 2011 that supports the conclusion that CLA's documentation was not adequate. The Principal Partner stated that AU Section 230.A5, paragraph 08 describes the broad means of documenting audit procedures but does not specifically require that copies of a report or other detailed lists evaluated in the audit be included in the audit working papers.

The Principal Partner, CLA stated he disagreed with our conclusion that certain areas of CLA's audit conclusions were not supported by its audit documentation. He stated CLA's audit of DFAS's financial statements was performed holistically, conceptually discussed in FAM 200 (Planning Phase). He stated the CLA audit conclusions were based on all testing performed in each audit area, not just a single or group of working papers. The Principal Partner stated that the CLA working papers were well organized and included detailed and referenced audit programs and summary memorandums for each audited area.

The Principal Partner also stated that throughout the 18 months of our review, we repeatedly discussed with CLA that we could not re-perform their work or come to the same conclusions documented in their working papers. However, he stated that we did not provide the specific sections of the standards that we used to come to our conclusions.

In addition, the Principal Partner stated that Notice of Finding (NOF) No. 12-02, September 4, 2012, which was related to journal voucher activity, was dated well after this summary memo was signed off by the audit manager in July 2012. The Principal Partner stated that this example was an inconsequential referencing error and not a reasonable example for us to conclude that CLA's audit documentation was not in accordance with professional standards.

The Principal Partner also stated there was no requirement in AU 230 or the GAO Yellow Book for CLA, the service auditor, to leave detailed lists and other reports in the working papers for an outside auditor reviewer to re-perform the work. He said that it was sufficient to merely refer to these reports because it is understood that the report could be obtained again from the client. The Principal Partner stated a review performed in accordance with professional standards only required CLA to leave a trail so that the same steps could be performed with the same tests results. The Principal Partner stated CLA left that trail in its audit program sign offs and individual working papers. He added that we could have obtained these reports and other documents from DFAS if we wanted to re-perform CLA's work.

The Principal Partner stated that CLA prepared over 3,000 working papers and, with the exception of our materiality concerns, he was only aware of four instances where CLA's audit documentation was determined to not meet standards. The Principal Partner stated these four instances were professional judgment disagreements over the level of documentation and certain materiality calculations that were not sufficient enough for us to conclude that the CLA working papers did not meet auditing standards. He added that CLA's audit working papers clearly and specifically documented the basis of its materiality judgment.

Lastly, the Principal Partner stated that standards do not require auditors to include the financial statements completeness checklist in its working papers. Instead, he stated that auditors were required to explain in the audit working papers that it was completed along with the results of the review. The Principal Partner further stated that on several occasions, CLA showed us in the working papers in which the auditors documented their audit process and conclusion. He also said that we have not responded yet to his requests for the professional standards reference that specifically required the checklist be included in the working papers or explain why the documented approach was not sufficient.

Our Response

As the Principal Partner acknowledged, we discussed with CLA throughout our review that the audit documentation they prepared did not meet standards. Specifically, we discussed with the Principal Partner AICPA AU Section 339.08, "Audit Documentation," which states that the audit documentation should assist an auditor who reviews a predecessor auditor's documentation. We also discussed with the Principal Partner and provided the specific working paper references when we could not re-perform CLA's work or come to the same conclusions it made in the working papers.

While CLA stated there were over 3,000 working papers, we found more than 4 instances when the audit documentation did not meet standards and provided the references to CLA during our review. AICPA AU Section 150.01 states that auditing standards provide a

measure of audit quality. In our professional judgment, CLA auditors did not leave a trail in the working papers so that the same steps could be performed with the same results. Some of the specific examples that we discussed with the Principal Partner during our review are shown below.

- CLA referenced in the working papers a completion of notice of findings related to payroll internal control testing for accrued payroll and benefits and internal control testing procedures for cash disbursements within fund balance with treasury. However, the notice of findings that CLA referenced was not related to the payroll internal control testing or the internal control testing procedures for cash disbursements. In fact, the notice of findings related to these testing procedures did not exist in CLA's audit documentation.
- CLA did not maintain evidence in the working papers to support that it reviewed and tested the detailed transactions in the DFAS Columbus Cash Accountability System as part of the audit procedures for Fund Balance with Treasury (FBWT). This is a key audit step that helps obtain assurance that the account balance is correct and the processes are effectively capturing all receipts and disbursements.
- Although CLA personnel performed detail testing of cash collections and cash disbursement transactions, CLA's audit documentation indicated it only tested transactions from DFAS' internal accounting system. To have an adequate audit trail for the reconciliation of the FBWT account, it is essential to have both the transactions supporting the amounts on the CMR and the transactions in the accounting system. CLA did not document the effect that the absolute value of the undistributed account would have on the financial statements. Each undistributed amount represents a potential misstatement, and the roll-up and netting of charges and credits can, therefore, significantly understate the total outstanding differences.
- CLA personnel did not document how they had assurance that the population they sampled included unauthorized and unrecorded transactions that a proper FBWT reconciliation would detect. Effective reconciliations serve as a detection control to identify unauthorized and unrecorded transactions at the entities and at Treasury.
- CLA stated that it reviewed the Checklist for Federal Accounting (FAM 2010) in the working papers; however, CLA did not provide the reference in its audit documentation to support its review, and subsequent documentation provided did not support CLA conclusions.

Although audit standards do not explicitly require that the auditors include a copy of the checklist in the working papers, CLA's audit documentation did not provide procedures for or specify by cross reference sufficient support for their conclusion. It is our professional opinion that the audit documentation be sufficient to enable an experienced auditor to understand the results of the audit procedures performed, audit evidence obtained, and conclusions reached. As referenced earlier, AICPA AU Section 339.10 states the auditor

should prepare audit documentation that enables an experienced auditor having no previous connection with the audit to understand the results of the audit procedures performed, the audit evidence obtained, and the conclusions reached. Additionally, the auditor may consider it helpful to prepare and retain as part of the audit documentation a summary memorandum, often referred to as the completion memorandum, which describes the significant findings or issues identified during the audit and how they are addressed. The memorandum can also be cross-referenced to other relevant supporting audit documentation that provides information on issues identified during the audit.

As part of the CLA audit documentation, CLA auditors completed the GAO Audit Completion Checklist that required the checklist preparer assert that they had reviewed two other checklists—the checklist for Federal Accounting (FAM 2010) and the checklist for Federal Reporting and Disclosures (FAM 2020). These two checklists are significant because they document conformity with U.S. generally accepted accounting principles (GAAP). In addition, CLA documented the receipt and review of the OSD Standard Guidance Checklist (SGC) completed by DFAS. CLA explained that DFAS used the OUSD SGC in lieu of the FAM 2010/2020 checklist. According to the document, the CLA auditor stated that they reviewed the SGC and noted that all applicable parts of the checklist were completed. The CLA auditor also documented that they reviewed the SGC to determine whether DFAS properly included all necessary disclosures. The CLA auditor concluded there were no significant matters, DFAS appeared to be in compliance with OUSD reporting guidance, and requirements, and U.S. GAAP. No additional testing was deemed necessary.

However, our review of this same document found that procedures performed were not sufficient to support CLA's conclusion. CLA should have performed additional substantive analytical procedures as discussed in the FAM to satisfy the completeness assertion. Simply reviewing a checklist without verifying that the answers were accurate was not adequate to conclude that there were no significant matters and that DFAS was in compliance with OSD reporting guidance. FAM Section 470.02 states that the auditor's objective in applying substantive procedures is to determine whether assertions are materially misstated. Additionally, FAM Section 475.01 states substantive analytical procedures consist of evaluations of information made by a study of plausible relationships of nonfinancial data. At a minimum, CLA should have compared the current year SGC to the prior year checklist to determine whether the DFAS responses remained the same. Performing this analytical procedure would have been an indicator as to whether any additional investigation may be necessary.

We also reviewed all the steps of the CLA audit program and determined this audit procedure was not in the audit program. Because CLA did not provide evidence that it performed the additional test, we concluded CLA did not support its conclusions reached in the working paper.

As stated earlier in our response, we discussed with CLA throughout the review numerous instances where the quality of CLA's audit documentation did not meet standards.

AICPA AU Section 150.01 states that auditing standards provide a measure of audit quality. We provided CLA with numerous examples, also discussed earlier, where we identified and discussed with the Principal Partner the audit documentation that did not meet auditing standards. These examples were more than typographical and referencing errors as the Principal Partner claimed. Additionally, audit standards do not require the reviewer to quantify the quality of audit documentation.

Based on these and other examples and our professional judgment, we affirm that the CLA audit documentation did not meet GAGAS requirements.

Trivial Amount for Materiality

The Principal Partner, CLA stated he disagreed with our finding that CLA did not set the trivial amount at a level that in aggregate would not be material. He requested that this be removed from the report. He said that our audits of other entities should not have served as a basis for CLA's development of its plan for the DFAS audit. Specifically, the Principal Partner stated our suggestion to set the trivial amount between one and five percent of planning materiality, or no more than five percent of design materiality, was not warranted or consistent with the FAM.

The Principal Partner stated CLA determined it was unrealistic to set a trivial amount for the DFAS audit at \$300,000 on a \$1.5 billion federal entity. Instead, CLA used the trivial amount of \$2.3 million. He said that the FAM states that the auditor should use professional judgment in determining the trivial amount and such judgment should be specific and unique to the audit being performed, knowledge of the entity, and audit risks evaluated throughout the audit, and in the context of providing an opinion on the entity's financial statements as a whole. He added that CLA, as the service auditors, was supposed to follow published professional standards, not unwritten best or industry practices.

The Principal Partner stated that CLA requested that we provide them with the reports we used as the basis for determining the best or industry practices in our report. He said that based on his research from our website that our oversight audits of other entities were not similar to the DFAS audit. The Principal Partner stated it appears that we are holding CLA to an audit standard or preference that is not applicable to other complicated and high risk audits it has overseen, but that is not relevant to factors CLA has professionally determined to apply in performing the DFAS audit.

Our Response

As stated in our report, setting the trivial materiality amount between one and five percent was not required by AICPA standards; however, in aggregate, this level would provide greater assurance that any total misstatements would not be material. In our professional judgment, setting the trivial amount at 7.5 percent as CLA did, in aggregate, could have been material to the DFAS financial statement after the possibility of further undetected misstatements were considered.

We disagree with the Principal Partner's claim that our results were conflicting. We have performed the oversight of other IPA audits of DOD financial statements for 9 years. These oversight audits are comparable in complexity and risk of misstatement due to the volume and relationship of transactional information. In addition, the IPAs performing these audits set the trivial amount between one and five percent to support their audit opinion.

Contrary to the Principal Partner's assertion that we are holding CLA to a different standard or preference, we expect the same methodology be applied during the DFAS audit as with other DoD entities of comparable complexity and risk.

Sampling Methodology for Property, Plant and Equipment

The Principal Partner, CLA stated he disagreed that CLA should have used the "upper-error limit" for the sample results method discussed in the IDEA manual rather than the "most likely error" methodology used during their audit. The Principal Partner stated in CLA's judgment, the "most likely error" methodology was the best estimate available at the time of the audit. He stated that IDEA is not an audit standard and should be used based on the objectives of the work. He said that IDEA sampling was just one means CLA used to audit the DFAS financial statements in accordance with professional audit standards. He explained that this multi-faceted audit approach was in direct contrast to other uses of IDEA where IDEA could be the only method of quantification or validation used to meet other user's objectives.

The Principal Partner stated that we overlooked the breadth of the CLA audit procedures, both financial and information technology related, in assessing the adequacy of CLA's work as a whole. The Principal Partner also stated that CLA requested we review two PP&E audit programs dated June 30, 2012 and September 30, 2012, the PP&E Summary Memoranda, and referenced working papers on the analytical procedures of property accounts to obtain a full understanding of their audit procedures. He noted that in September 2014, he provided us with a duplicate package containing the PP&E working papers.

The Principal Partner stated CLA control tests prior to the June 30, 2012 substantive procedures on PP&E accounts and concluded that controls were functioning properly and could be relied upon to reduce the nature and extent of detailed substantive audit procedures. He said that these tests, along with the low level of activity in the last quarter of FY 2012, warranted less sophisticated sampling methods of PP&E account activity for the quarter ended September 30, 2012. In addition, the Principal Partner stated CLA concluded that an allowance for sampling risk as referred to in the FAM for PP&E was not material and, therefore, no adjustments to PP&E were needed to be included in the FY 2012 Schedule of Uncorrected Misstatements.

Our Response

Throughout our review, the DoD OIG Quantitative Methods Division (QMD) was an integral part of the audit team and advised on the statistical sampling procedures performed by CLA. In a May 2014 meeting, we discussed with CLA the IDEA data analysis tool. During that meeting, we communicated to CLA that the IDEA manual stated that the “upper-error limit” was the only defensible method to use when considering the value of unsampled transactions in the aggregate. These unsampled transactions should have included the amounts from the PP&E accounts that CLA did not test, regardless that the error rate was low.

While we agree that the IDEA manual is not an audit standard it is our professional judgment that the auditor could not conclude at a low risk that the financial statements were free of material misstatement had they not used the “upper-error limit” for the sample results method discussed in the manual. Specifically, the IDEA manual states that the statistical term used in IDEA for projected misstatement is the “most likely error.” It is highly likely the true misstatement is more or less than this amount. The “upper-error limit” of such an estimate would likely be well above tolerable misstatement.

Without further evidence that the population was free of material misstatement or a correction of some of the known and projected amount of misstatement in the financial statements was made, the auditor could not conclude at a low risk that the financial statements are free of material misstatement. The IDEA manual further states that when statistical techniques are used, the auditor can quantify through the “upper-error limit,” which is associated with a confidence level, whether the evidence supports acceptance of the test results, whether adjustments are required, and whether the auditor has achieved the assurance he or she sought when designing the test. Nonstatistical samples, such as CLA performed on the PPE account, did not provide confidence levels or upper limit results.

We thoroughly reviewed the CLA PP&E working papers referenced in the audit program to include the financial and information technology audit documentation. Our concern has always been that the sample size used by CLA was not large enough to be statistically valid. For example, for June 30, 2012 testing for additions, CLA selected a sample of six transactions valued at \$3.7 million out of a possible \$23.8 million, or 16 percent of the population. Also, for June 30, 2012 testing for the construction in progress/work in progress account, CLA selected a sample of three transactions valued at \$1.2 million out of a possible \$12.2 million, or 10 percent of the population.

We did not overlook “the breadth of all of CLA’s audit procedures” as the Principal Partner suggests when we assessed the adequacy of CLA’s work. We thoroughly reviewed CLA’s working papers, and it is still our conclusion that CLA should have increased its sample sizes or followed the IDEA manual criteria and used the upper limit as the “most likely error.” Although allowable by audit standards, the samples CLA used were inadequate to draw a valid statistical conclusion because the sample could not be supported or defended as producing statistically valid results, especially when MUS sample sizes were as low as three and errors still existed in the population. Additionally, CLA did not document in the working papers how it judgmentally sampled amounts that were aggregated and considered for the Schedule of Uncorrected Misstatements.

Further, CLA relied on information technology related testing conducted in FY 2010; however, the testing performed was general and application control testing, which did not validate whether the information being entered into the system was correct. Rather, the testing only determined that once the information was entered into the system it was secure and could not be manipulated. The testing by CLA was not sufficient to conclude that controls were functioning properly and could be relied upon.

Proposed Adjustments and Greater Assurance

The Principal Partner, CLA stated that he disagreed with our conclusion that CLA should have required DFAS to adjust its financial statements to have greater assurance that the financial statements were free of material misstatements. He said that obtaining the greater assurance would not have changed the opinion that CLA issued and would have resulted in the over-auditing of DFAS.

Our Response

We did not state in our report that CLA *needed* to obtain greater assurance that the DFAS financial statements were free of material misstatement. Rather, we concluded that if CLA would have recommended DFAS to make the \$7.7 million adjustment CLA had proposed to undelivered orders, CLA could have been more certain that the DFAS FY 2012 financial statements were free of material misstatements.

According to the working papers, CLA proposed these adjustments based on the results of the sample testing they performed. Although the proposed adjustment of \$7.7 million was above the trivial amount of \$2.3 million, it was below CLA's design and reporting materiality of \$10.2 million and \$22.9 million, respectively. The statements made by the Principal Partner that obtaining greater assurance on the financial statements would not have resulted in CLA "over-auditing" DFAS and was unfounded because CLA had already performed the work needed to propose the adjustments to DFAS.

Aggregate Value of Non-Sampled Items

The Principal Partner, CLA stated that he disagreed with our conclusion that CLA did not consider the aggregate value of nonsampled transactions when it performed judgmental sampling for property, plant, and equipment. The Principal Partner stated that we failed to acknowledge the other important audit procedures CLA performed that supplemented the detailed testing procedures summarized in Table 2 of our report. He said that CLA did not agree with our assessment of the accumulation of potential uncorrected misstatements.

Additionally, the Principal Partner stated that based on the PP&E accounts and prior years audit testing results, CLA did not consider PP&E a high-risk audit area in FY 2012. The Principal Partner stated that CLA evaluated the PP&E errors both quantitatively and qualitatively and concluded that an allowance for sampling risk was not material for the PP&E accounts not tested. He said that CLA concluded that it was not necessary to bring forward any of the untested amounts to the Schedule of Uncorrected Misstatements. The Principal Partner noted that CLA's overall conclusions were documented in the PP&E and overall Year End Substantive Phase Summary Memoranda.

Further, the Principal Partner stated that CLA included the midpoint of the point estimate of \$516,000 and upper bound amount of \$7.7 million in the likely misstatements section of the Schedule of Uncorrected Misstatements. He said that these amounts were in excess of the amounts normally required and statistically calculated point estimate often referred to as "most likely error." He explained that the excess was effectively an allowance for sampling risk and that CLA determined this to be the best estimate of the likely misstatement based on FAM 0540.03. The Principal Partner stated that for us to conclude that the upper bound of \$896,285 and \$12.1 million to DFAS to adjust their financial statements is unsupported by professional standards. He added that we did not take into consideration the low likelihood that the error would actually be the "upper-error limit" amount.

Our Response

CLA did not provide evidence in its working papers that it aggregated the potential adjustments to the Schedule of Uncorrected Misstatements to consider the impact on the financial statements taken as a whole. Additionally, CLA did not document the aggregated errors that were above the trivial amount it set at \$2.3 million but below its design materiality of \$10.2 million. In our professional judgment, CLA took undue risk by not including these potential adjustments on the Schedule of Uncorrected Misstatements, which increased the likelihood of material misstatements in the DFAS financial statements.

Although the Principal Partner stated that CLA considered prior-year testing results, it did not adequately document its reliance on the work performed in prior years in its FY 2012 audit documentation. AICPA AU Section 339.08 states audit documentation enables the audit team to demonstrate that it is accountable for its work by documenting the procedures performed and the conclusions reached. AU Section 339.08 also states audit documentation assists an auditor who reviews a predecessor auditor's audit documentation.

While the individual line items for PP&E were not material to the allowance for sampling risk as shown in Table 2 of the report, when combined, the line items totaled \$13.7 million, which was above the design materiality threshold of \$10.2 million. Because CLA used nonstatistical sampling procedures, it chose not to perform tests of \$13.7 million of the \$29.3 million in transactions, or 47 percent of the population. FAM section 540.01 states that auditors should evaluate misstatements individually and in the aggregate.

We could not verify whether amounts that were not statistically tested were aggregated and carried forward to the schedule of uncorrected misstatements because the CLA working papers did not show evidence that it had aggregated the non-sampled amounts and determined the impact on the DFAS financial statements.

Fund Balance With Treasury Testing Procedures

The Principal Partner, CLA stated that he disagreed with our conclusion that the audit procedures in the FBWT account were insufficient. He stated that the FBWT balance of the DFAS working capital fund should be zero on September 30, 2012. He concluded that the tests of and reliance on receipt and disbursement controls were critical to CLA's conclusion that the zero FBWT balance at September 30, 2012 was reasonable in the context of DFAS' FY 2012 financial statements as whole. The Principal Partner stated that CLA reconciled the collection and disbursement detail listings at April 30, 2012 to DFAS' eBiz⁶ trial balance amount to ensure completeness of the populations. He said that CLA reconciled the collection and disbursement accounts to the immaterial amounts of \$1.5 million and \$1 million, respectively, and also performed analytical procedures on the totals which it documented in the working papers.

⁶ e-Biz is a DFAS internal accounting system.

The Principal Partner also stated that all AU sections, including section 350, assume such principles were applied to material balances. He said that the absolute value of undistributed transactions in question was \$8.9 million and, since the amount was less than design materiality threshold of \$10 million, professional standards did not require that CLA perform detailed testing of the balance. He added that CLA analytically reviewed the undistributed balance of FBWT and found it to be reasonable.

Our Response

Based on our review of the working papers that documented the CLA internal control testing procedures, we found that CLA did obtain the cash receipts and cash disbursements samples from e-Biz. The working papers showed that CLA only performed testing on the transactions in the DFAS accounting system, which, in principle, reconciled DFAS' detailed transactions to the activity recorded in DFAS' own accounting system.

A complete, transaction-level FBWT reconciliation should have included the transactions that were not in the accounting system but disbursed or collected by the U.S. Treasury and subsequently reported on the Cash Management Report. The reconciliation should have ensured that the two universes from e-Biz and the DFAS–Columbus Cash Accountability System at the detail level matched. The CLA working papers did not contain evidence that it reviewed and tested the transactions in the Columbus Cash Accountability System as part of its audit procedures for FBWT. Although CLA's FBWT audit program indicated that the steps were performed to determine the amount of the undistributed transactions, there was no documentation of these procedures.

AICPA AU-C Section 339.08 states audit documentation enables the audit team to demonstrate that it is accountable for its work by documenting the procedures performed and the conclusions reached. AU-C Section 339.08 also states audit documentation assists an auditor who reviews a predecessor auditor's audit documentation. The CLA working papers did not contain that it considered the effect the absolute value of the undistributed account had on the DFAS financial statements. We obtained a file from DFAS of the undistributed transactions as of September 30, 2012, and calculated an absolute value of \$8.9 million of the undistributed transactions. CLA calculated design materiality was \$10.2 million. The Principal Partner agreed that the \$8.9 million of the undistributed amount should have been documented in their working papers. The Principal Partner stated that the FBWT audit program was clear that CLA considered the undistributed amount. However, the CLA working papers did not summarize or explain the basis for its opinion and the rationale for not accumulating the uncorrected misstatements.

Attachment 2

CLA's Response to Draft Report



CliftonLarsonAllen

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October 24, 2014

Ms. Lorin T. Venable
Department Of Defense
Office of Inspector General
Assistant Inspector General, Financial
Management and Reporting
Mark Center
4800 Mark Center Drive
Alexandria, VA 22350

Dear Ms. Venable:

We have read the final draft of the DoD Office of Inspector General (OIG) Post Audit Review Report (Report) dated October 10, 2014, and find it to be substantially factually inaccurate and not reflective of the quality of our audit of the fiscal year (FY) 2012 financial statements of Defense Finance and Accounting Service (DFAS) Working Capital Fund (WCF).

We disagree with the OIG's conclusions in its report that our audit documentation in certain areas of our audit, and certain materiality levels used in the audit, were not in compliance with professional standards. We also disagree with the OIG's conclusion that we did not adequately summarize potential errors in accounts tested at June 30, 2012 and September 30, 2012.

However, we are pleased that the OIG has not noted any concerns with the sampling methodology (including sample sizes) used in the areas of Accounts Payable and Undelivered Orders, for which the OIG had expressed concern in connection with a review it performed in connection with our FY 2009 financial statements audit.

In **Appendix A** attached to this letter, we have provided a detailed account of each finding in the OIG Report, and have explained the basis of our disagreement noted in the second paragraph above. We believe that our audit of the DFAS WCF financial statements at September 30, 2012 was conducted in compliance with all professional standards.

The following is a brief summary of the basis of our disagreement with the draft OIG Report conclusions. Such summary was derived from information provided in **Appendix A** to this letter, which had been provided to the OIG on several occasions during the eighteen months it took to conduct its review. Accordingly, such Appendix is an integral part of our response.

1. **Appendix A, Section 1** - To fully understand the relative significance of the OIG findings in its report, it is critical for the reader of the OIG Report to understand the following key DFAS FY 2012 financial statistics relevant to CLA's audit of the DFAS WCF:

- Gross Operational Program Cost - \$1.5 billion,
- Revenue Earned from DoD Component Agencies - \$1.2 billion,
- Total Budgetary Resources of \$1.4 billion.

CLA's Response to Draft Report (cont'd)

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2. Appendix A, Section 4 - Using the financial information above and our thorough understanding of DFAS's financial accounting and information technology operations, we designed the approach for the DFAS audit using materiality calculations and audit approach methodology requirements specifically detailed in AICPA and Government Auditing Standards, and in the Government Accountability Office (GAO) Financial Audit Manual (FAM).

The OIG apparently did not fully consider these requirements in critiquing our work, utilizing information from unrelated high risk and more complicated DoD component agencies audits (performed by other auditing firms for which the OIG provided oversight) performed after the commencement of the DFAS FY 2012 audit. The OIG has apparently applied audit risk assessments made by those firms for those unrelated higher risk component agencies to the DFAS audit. This approach is contrary to AICPA and FAM standards/guidelines, which require that audit approaches be developed by the auditor after a thorough understanding of the entity, its systems and its personnel carrying out critical accounting functions.

We complied in all material respects with professional standards in carrying out our audit of the DFAS FY 2012 financial statements. This compliance was thoroughly documented in over 3,000 audit workpapers.

3. Appendix A, Section 2, 3 & 8 - With respect to audit documentation (workpapers), we followed professional standards. The AICPA Statement of Auditing Standards are clear on audit documentation requirements. Section 230.08 of those standards state that "*The Auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*
 - a) *the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;*
 - b) *the results of the audit procedures performed, and the audit evidence obtained; and*
 - c) *significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.*"

Our DFAS audit was performed holistically, conceptually discussed in FAM 200 (Planning Phase). This means that audit conclusions are to be based on **all** testing done in each audit area, not just a single or group of workpapers. Such testing includes tests of internal control (IT and Financial) and detailed transaction\balances testing at both June 30 and September 30, 2012, using professional auditor judgment and other tests contemplated in FAM 300 (Internal Control Phase) and 400 (Testing Phase), respectively.

Our workpapers (WP) are well organized and detailed, and include detailed Audit Programs and Summary Memoranda for each audit area. Our Audit Programs were very detailed by audit area, and specifically reference where work was performed and conclusions reached. Summary Memoranda for each audit area lists multiple workpaper

CLA's Response to Draft Report (cont'd)

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references to other audit analysis and other relevant documentation examined to support our conclusions.

4. Appendix A, Section 4 - With respect to the OIG's concern in its Report (page 2, first bulleted paragraph) over our quantification of one of the materiality amounts we used in our audit (Trivial Amount), the OIG does indicate at the end of that paragraph the following: *"However, setting the trivial amount at this level is not required by AICPA standards or the FAM."* We have used professional judgment throughout the implementation of the audit and have documented such judgment throughout the audit workpapers, including on this matter.
5. Appendix A, Section 5 & 7 - Pursuant to FAM 480 and 540, we appropriately quantified actual and potential errors in DFAS accounts at September 30, 2013 including, pursuant to FAM 540.11, an allowance for sampling risk in all material accounts tested.
6. Appendix A, Section 6 - CLA's opinion on DFAS' FY 2012 financial statements indicated that *"the WCF financial statements referred to above present fairly, in all material respects, the financial position of DFAS' WCF as of September 30, 2012...in conformity with accounting principles generally accepted in the U.S."* CLA believes that obtaining the "greater assurance" suggested by the OIG in its report would not have changed that "present fairly" opinion. Respectfully, obtaining the "greater assurance" desired by the OIG would not have changed our audit opinion, would have resulted in CLA over-auditing, and would likely increase the cost of the DFAS audit in future years.

In Conclusion - Except for the OIG's concern over one conceptual materiality matter discussed in item 4 above, we are only aware of four instances (as noted in the OIG Report - relating to Payroll, FBWT Undistributed Account, financial checklists, and property sampling allowance) where CLA's audit documentation allegedly "did not meet standards." We do not believe these four instances of alleged inadequate audit documentation are sufficient to warrant such a negative audit workpaper-wide conclusion by the OIG; i.e., that such workpapers in total did not meet professional standards as a whole (Report page 1, 4th paragraph).

We respectfully request that the OIG substantially revise its Report (and provide us with a revised report) to be more relevant to the professional standards that all auditors are required to comply based on the entity being audited, remove Findings that represent personal preferences of the OIG review team, and evaluate the significance of all Findings in the context of the DFAS WCF financial statements audit as a whole when making overall conclusions in your Report. Otherwise, please attach this Official Response letter to your final published Report.

Sincerely,



Sal P. Ercolano, CPA
Principal
CliftonLarsonAllen, LLP

CLA's Response to Draft Report (cont'd)

Appendix A

CliftonLarsonAllen, LLP (CLA) Response to DoD OIG Report Dated October 10, 2014
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In support of CLA's Official Response to the draft OIG Report dated October 10, 2014, CLA has taken excerpts from the OIG Report and provided evidence to support CLA's position that it has complied with all professional standards in the conduct of CLA's audit of the DFAS WCF financial statements at September 30, 2012 contrary to the OIG findings. Such evidence was derived from professional auditing and accounting standards and from the over 3,000 audit workpapers (WP) available for review by the OIG during its eighteen month review. **This Appendix (with section # cross-referenced from the forepart of this letter – pages 1 to 3) is an integral part of CLA's Official Response to the DoD OIG Report, beginning of page 1 of this document.**

CLA provided many of these explanations and audit workpaper documentation references to the OIG previously; however, the OIG has not yet provided an explanation to CLA as to which specific professional standard was being used by the OIG to support its conclusion that such explanation and documentation was not adequate.

Section

1. OIG Report Excerpt – Page 1, Paragraph 2

"We reviewed the audit work performed by CLA on the material financial statement line items, including property, plant, and equipment; accounts payable; and the accrued payroll and benefits line items on the balance sheet."

CLA Response

The OIG failed to define the materiality parameters of its review, or indicate relevant DFAS amounts that served as the basis of such parameters. To fully understand the relative magnitude of the OIG findings in their report, it is critical for the reader of the Report to understand key DFAS FY 2012 financial statistics relevant to CLA's audit:

- Gross Operational Program Cost - \$1.5 billion,
- Revenue Earned from DoD Component Agencies - \$1.2 billion,
- Total Budgetary Resources of \$1.4 billion.

2. OIG Report Excerpt – Page 1, Paragraph 4

"Other than not meeting audit documentation requirements contained in AICPA AU Section 230, our review did not identify any other instances in which CLA did not comply in all material respects with AICPA standards, GAGAS, or the U.S. Government Accountability Office Financial Audit Manual, when auditing the statement of budgetary resources, statement of net costs, statement of changes in net position, and the balance sheet. Throughout the review, we noted instances where the quality of CLA's audit documentation did not meet standards. AICPA AU-C Section 230, "Audit Documentation," states audit documentation enables the engagement team to demonstrate that it is accountable for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached. AU-C Section 230 also states audit documentation assists an auditor who reviews a predecessor auditor's audit documentation."

CLA's Response to Draft Report (cont'd)

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CLA Response

The OIG does not state the specific section of AU 230, and/or the Government Accountability Office (GAO) Yellow Book, which supports its conclusion that CLA's specific forms of documentation were not adequate. AU Section 230.A5 (ref: par. 08) describes the broad means of documenting audit procedures, and does not specifically require that copies of a report or other detailed lists evaluated in the audit be included in the audit workpapers. "Analysis" and "Summaries of significant findings and issues" are specifically mentioned as appropriate types of documentation in AU 230. Specifically, AU section 230.08 states that *"The Auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:*

- a) the nature, timing, and extent of the audit procedures performed to comply with GAAS and applicable legal and regulatory requirements;*
- b) the results of the audit procedures performed, and the audit evidence obtained; and*
- c) significant findings or issues arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions."*

The GAO Yellow Book (section 5.16, 6.79) defines an experienced auditor as *"an individual (whether internal or external to the audit organization) who possesses the competencies and skills to be able to perform the examination engagement. These competencies and skills include an understanding of (1) the performance audit processes, (2) GAGAS and applicable legal and regulatory requirements, (3) the subject matter associated with achieving the audit objectives, and (4) issues related to the audited entity's environment."* Based on the questions posed to CLA by the OIG team during the eighteen months of their review, certain members of the OIG team did not appear to meet this experience definition.

CLA's audit of DFAS's financial statements was performed holistically, conceptually discussed in FAM 200 (Planning Phase). This means that audit conclusions are to be based on **all** testing done in each audit area, not just a single or group of workpapers. Such testing includes tests of internal control (IT and Financial) and detailed transaction/balances testing at both June 30 and September 30, 2012, using professional auditor judgment and other tests contemplated in FAM 300 (Internal Control Phase) and 400 (Testing Phase), respectively.

CLA's workpapers are well organized and detailed, and include detailed Audit Programs and Summary Memoranda for each audit area. CLA's Audit Programs were very detailed by audit area, and specifically reference where work was performed and conclusions reached. CLA's Summary Memoranda are very detailed for each audit area, listing multiple workpaper references to other audit analysis and other relevant documentation examined to support its conclusions. The OIG provided some explanation as to why, as noted at several meetings, "we feel" CLA's audit documentation was inadequate. However, the OIG failed to inform CLA of the specific professional standard sections

CLA's Response to Draft Report (cont'd)

Appendix A

CliftonLarsonAllen, LLP (CLA) Response to DoD OIG Report Dated October 10, 2014
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that require all auditors to perform an audit in accordance with how "they feel" an audit should be documented.

It is also important to note that there is no requirement in AU 230 or the GAO Yellow Book for the service auditor to leave detailed lists and other reports in the workpapers for an outside auditor reviewer to re-perform the work of the service auditor. It is sufficient documentation to merely refer to said report because it is understood that the report could be obtained again from the client. During CLA's discussion with the OIG team throughout the eighteen months of its review, OIG team members repeatedly indicated that they could not re-perform CLA's work to validate CLA's conclusions documented in certain of CLA's audit workpapers. However, a review performed in accordance with professional standards only requires the service auditor to leave a trail to follow, such that if the reviewer did the same steps they would be able to obtain the same tests results. CLA left that trail in its audit program sign offs and individual workpapers, and the OIG was allowed to obtain reports and other documents from DFAS if they wanted to re-perform CLA's work. The OIG also requested DFAS management, at various times during its review, to provide accounting reports CLA reviewed in its audit. CLA documented in its audit workpapers the procedures performed on those reports, but, as allowed by professional standards, did not always maintain such reports in its workpaper files. CLA is not aware of any exceptions identified by the OIG in such re-performance. However, it appears that the OIG's need for DFAS reports and other supporting documents being maintained in CLA's audit workpapers to easily re-perform CLA's work may have lead to some of the findings in its Report.

Based on the contents of the Report, "throughout the review" of over 3,000 workpapers, except for materiality matters discussed in the next paragraph, we are only aware of the four instances (as noted in the OIG Report - relating to Payroll, FBWT Undistributed Account, financial checklists, and property sampling allowance) where CLA's audit documentation allegedly "did not meet standards." CLA has responded to each of these OIG findings later in this CLA response document.

With respect to materiality findings noted in the OIG Report (discussed in section 4 of this CLA response), such findings relate to the application of professional auditor judgment. The OIG has not provided an authoritative basis for the materiality amounts it determined to be applicable in its review and noted in its Report. CLA's audit workpapers clearly and specifically document the basis of its materiality judgment. This documentation began with the preparation of the required Government Accountability Office (GAO) Federal Audit Manual's (FAM) Audit Strategy Memorandum (ASM).

Respectfully, four instances of alleged inadequate audit documentation and professional judgment disagreements over the level of documentation and certain materiality calculations is not sufficient to warrant such a negative audit workpaper-wide conclusion by the OIG – "*Other than not meeting audit documentation requirements contained in AICPA AU Section 230, our review did not identify any other instances in which CLA did not comply in all material respects.*"

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3. a) OIG Report Excerpt – Page 2, Paragraph from Bottom of Page 1

"For example, CLA referred us to its completion of notice of findings related to payroll internal control testing for accrued payroll and benefits, and internal control testing procedures for cash disbursements within fund balance with treasury. However, the notice of findings that CLA referenced were not related to the payroll internal control testing or internal control testing procedures for cash disbursements. Furthermore, the notice of findings related to these issues did not exist in CLA's audit documentation. Additionally, CLA stated it reviewed the Checklist for Federal Accounting (FAM 2010); however, CLA did not provide the reference in its audit documentation to support its review, and subsequent documentation provided did not support CLA conclusions."

- b) *"Additionally, CLA stated it reviewed the Checklist for Federal Accounting (FAM 2010); however, CLA did not provide the reference in its audit documentation to support its review, and subsequent documentation provided did not support CLA conclusions."*

CLA Response

- a) This matter relates to the Payroll Internal Control Testing Summary at audit workpaper (WP) 0507.50, which indicates that *"We have issued NOF 12-02 as a result of these findings."* However, following this statement, this CLA memo concludes on the payroll testing as follows: *"Overall, it was concluded that payroll internal controls are functioning as expected as the above findings only relate to missing forms, not inaccurate data. Accordingly, we can rely on such controls to reduce the nature and extent of substantive procedures. Therefore, the substantive testing approach for payroll detailed in the Audit Strategy Memo will be carried out as planned at 6/30/12."*

Notice of Finding (NOF) 12-02 relates to journal voucher activity, and was dated September 4, 2012, well after this summary memo was signed off by the audit manager (July 2012). Accordingly, the first sentence noted above is an inconsequential referencing error given the explanation after the sentence referring to a NOF, and is not a reasonable example of a reason for the OIG to indicate that CLA's audit documentation was not in accordance with professional standards. This obvious workpaper typographical error is not significant to the audit work in this area of the audit, and should not be used to support the OIG's draft report conclusion that *"Throughout the review, we noted instances where the quality of CLA's audit documentation did not meet standards."*

- b) FAM section 2020 states that: *"These checklists are designed to assist federal entities in preparing their financial statements in accordance with U.S. GAAP, and (ii) auditors in auditing them in accordance with U.S. generally accepted government auditing standards (GAGAS). Neither the entities nor the auditors are required to use this checklist and may develop their own checklists. However, entities should document how they are satisfied that their financial statements conform with U.S."*

CLA's Response to Draft Report (cont'd)

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GAAP. Likewise, auditors should document the basis for accepting that the entity's financial statements are in conformity with U.S. GAAP if they do not use the checklist."

Standards do not require auditors to put a Financial Statements completeness checklist in its WPs; however, auditors are required to explain in the audit workpapers that it was completed along with the results of its review of such checklist. On several occasions, CLA pointed out WP 0750 (Financial Statements Audit Program, pages 1 to 10) to the OIG, as well as WP 0750.38 (Review of OUSD Standard Guidance Checklist Memorandum), which documented that audit process and conclusion.

In the conclusion section of WP 0750.38, CLA stated that *"The OUSD checklist serves as a reasonable substitute for the GAO FAM Accounting checklist. OMB A-136 provides a resource for determining disclosure requirements for updated regulations from when the GAO FAM checklist was last updated. We noted no significant exceptions per the above reviews. As such, we concur with DFAS' checklist conclusions and note that the footnotes appear to be complete. DFAS appears to be in compliance with OUSD reporting guidance and requirements and U.S. GAAP. No additional testing considered necessary."*

CLA requested the OIG to provide the professional standards reference that specifically requires that this checklist be included in the workpapers or otherwise explain why the documented approach was not sufficient for its purposes. However, the OIG has yet to respond to that request.

4. OIG Report Excerpt – Page 2, 1st Bulleted Paragraph

"CLA did not set the trivial amount at a level where it is likely that in aggregate (total) the misstatements would not be material. AICPA AU Section 312, "Audit Risk and Materiality in Conducting an Audit," states "trivial" amounts designated by the auditor need not be accumulated (totaled). Section 312 further states this amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements are considered. CLA's trivial amount equaled 7.5 percent of planning materiality. Other audits of DoD entities conducted by independent public accountants have set the trivial amount between 1 and 5 percent. However, setting the trivial amount at this level is not required by AICPA standards or the FAM."

CLA Response

The OIG Report notes that *"...setting the trivial amount at this level is not required by AICPA standards or the FAM."* Even though the OIG agrees that CLA followed professional standards in determining a Trivial Amount for the DFAS audit, it nonetheless reports it as a Finding in its Report. In addition, the OIG continues to comment in other sections of the Report that CLA should have accumulated audit differences identified during the audit that were less than the Trivial Amount.

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CliftonLarsonAllen, LLP (CLA) Response to DoD OIG Report Dated October 10, 2014 October 24, 2014

Accordingly, the OIG has included conflicting findings in its Report. CLA believes this matter should be removed from the OIG Report.

Additional Background on This Matter

In accordance with FAM 0540.04 (which references AU 312.42), *"the auditor may designate an amount below which misstatements are not accumulated. The auditor should set this trivial or de minimis amount so that any such misstatements, either individually or when aggregated with all other misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered."* Auditors refer to this amount as "Trivial Amount."

In an initial draft of its Report (provided to CLA on September 5, 2014), the OIG indicated that *"Industry practices suggest that the Trivial Amount should be set between one to five percent of planning materiality, or no more than five percent of design materiality.....based on oversight the DoD OIG recently provided over other independent public accounting firms performing financial statement audits."* Even though the revised OIG draft Report (dated October 10, 2014) has stated this point a bit differently, the concept is the same as that noted in the initial OIG draft Report. Audits of other entities (that had not been completed when the FY 2012 DFAS audit was commenced) should not have served as a basis for CLA's development of its plan for DFAS' audit. Accordingly, the OIG's suggestions on this matter are not warranted. Service auditors are supposed to follow published professional standards, not unwritten best or industry practices that the OIG believes are better. If service auditors do not follow published professional standards, they would also be in default of its contracts to perform such services.

Furthermore, CLA does not believe that the OIG's suggestion of the Trivial Amount for the DFAS audit needing to be 1 to 5 % of Planning Materiality (for DFAS it would be \$310 Thousand to \$1.5 million), based on audits of unrelated DoD divisions, is consistent with FAM guidance. The FAM clearly states that the auditor should use professional judgment in determining Trivial Amount, and such auditor judgment should be specific and unique to the audit being performed, utilizing its knowledge of the entity and audit risks evaluated throughout the audit, in the context of providing an opinion on the entity's financial statements as a whole. The Trivial Amount used by CLA on the DFAS audit was \$2.3 million, which is based on the audit history at DFAS, is clearly appropriate for a \$1.5 billion federal entity.

CLA requested that the OIG provide CLA with the reports it used as the basis of its best or industry practices Report finding. Such other audits (obtained from the OIG website) were as follows, including a summary of the audit results:

1. DoDIG-2014-023 – Army Corp of Engineers – Unqualified Opinion with 3 Significant Deficiencies, including Financial Oversight and Reporting and General PP&E.
2. DoDIG-2014-022 – Contract Resource Management – Could not be viewed on DoD OIG Website, for apparent confidentiality concerns.

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3. DoDIG-2014-021 – DoD Medicare Eligible Retiree Health Care Fund – Qualified Opinion with 2 Material Weaknesses in Internal Control, and reports of non-conformance with FMFIA & FFMIA.
4. DoDIG-2014-018 – Military Retirement Fund (FY 2013 financial statements) – Unqualified Opinion with 1 Significant Deficiency.

These audits were commenced after the FY 2012 DFAS audit was complete. In addition, such OIG oversight audits are not similar to the DFAS audit, either as to complexity or apparent accounting system or auditee personnel competency. Prior to FY 2012, DFAS participated in full scope financial statements audits for nine years, with the four audits performed prior to 2012 (2008-2011) having few and immaterial proposed audit adjustments. In contrast to the above OIG oversight audits, CLA's DFAS financial statements opinions prior to 2012 had been unqualified, with no significant deficiencies in internal control, and no instances of reportable non-compliance with relevant laws and regulations.

Given the condition of the accounting records for each of the above OIG oversight audits, it is understandable why certain of the above service auditor's materiality levels would be lower than that used by CLA for the DFAS audit. The FAM is very clear on this matter. Audit risk must be considered when designing an audit approach and setting materiality guidelines, including with respect to the Trivial Amount threshold (where an exact calculation is not provided for in the FAM). CLA documented these matters in the ASM and carried out that audit strategy in the formulation and implementation of the Audit Program steps. Therefore, since DFAS' audit risk is much lower than that which would likely be achieved for the above referenced OIG oversight audits, CLA believes it is not warranted for the OIG to suggest that CLA use the audit approach or materiality levels\calculations similar to those used by the auditors of the other aforementioned DoD components.

Specifically, CLA utilized the concepts in FAM 540.04 (which references AU 312.42). Given the overall risk of error in the financial statements, CLA made appropriate professional auditor judgments in setting the FAM suggested Trivial Amount at \$2.3 million at September 30, 2012. Accordingly, CLA believes it to be unrealistic to suggest a Trivial Amount for the DFAS audit at \$300,000 on a \$1.5 billion federal entity. As CLA has stated previously, the concept of Trivial Amount is clearly described in the FAM as requiring significant professional judgment, which CLA applied based on its experience auditing DFAS for many years.

In summary, it appears that the OIG is holding CLA to an audit standard\preference that may be applicable to other differently complicated and high risk audits it has overseen, but that is not relevant to factors CLA has professionally determined to apply in performing the FY 2012 financial statement audit of the DFAS WCF.

The OIG's apparent requirement to use what CLA considers excessively low materiality levels appears to permeate many of the findings in the OIG Report.

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5. OIG Report Excerpt – Page 2, 2nd Bulleted Paragraph

"CLA used the most likely error as opposed to the upper-error limit for sample results based on monetary unit sampling (MUS) methodology. The IDEA⁽¹⁾ manual, "Sampling with IDEA—Beyond the Mechanics," encourages the use of larger sample sizes and specifically states the larger the sample, the more likely the projection is closer to the true misstatement in the population. The manual states: A robust sample that has a small precision (for example, a precision of 1-2 percent) is best to use as an estimator of the true value. A small sample with a wide upper limit may not provide the best support for recording a financial statement amount. Unless the sample size is very large, when the projected misstatement is close to the tolerable misstatement, the upper limit of such an estimate would likely be well above the tolerable misstatement. Without further evidence that the populations are free of material misstatement or a correction of some of the known and projected amount of misstatement, the auditor cannot conclude at a low risk that the financial statements are free of material misstatements. When statistical techniques are used, the auditor can conclude through the upper limit which is associated with a confidence level, whether the evidence supports acceptance of test results, adjustments are required, and whether the auditor achieved their assurance level when designing the test."

⁽¹⁾IDEA is data analysis software that CLA used to select samples using the monetary unit sampling methodology.

CLA Response

- a) **With respect to Use of IDEA** - IDEA is not an audit standard, and the IDEA manual is meant to be used by a variety of parties in the context of the work in which they use IDEA pursuant to the objectives of their work. CLA's objective is an audit of DFAS financial statements to be performed pursuant to professional audit standards. IDEA sampling was just one means CLA used to audit a DFAS account. This multi-faceted audit approach is in direct contrast to other uses of IDEA where IDEA could be the only method of quantification/validation used to meet other user's objectives.
- b) **With Respect to Sampling** - The OIG's evaluation of sampling applications classified as "imprecise audit procedures" (MUS and judgmental sampling) were related to Property Plant and Equipment (PPE). CLA performed these tests in accordance with FAM 0480.06 regarding "non-representative selection (non-sampling selection)." The results of these non-sampling applications were evaluated in accordance with the concepts and requirements in FAM 0480.06 and FAM 0540.04 to 0540.14 regarding accumulation and evaluation of misstatements, considering both quantitative and qualitative elements of the testing completed. In addition to FAM 0540.11, specific concepts from the FAM that CLA considered include the following:
- **FAM 0480.06, 3rd paragraph specifies:** *"The auditor should evaluate the effects of any misstatements found in the non-representative selection. However, unlike sampling, the results of procedures applied to items selected under non-sampling selection apply only to the selected items. It is incorrect for the auditor to project the results to the portion of the population that was not tested. Accordingly, the auditor should apply appropriate substantive analytical and/or other substantive*

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procedures to the remaining items, unless those items are immaterial in total or the auditor has already obtained enough assurance that there is a low risk of material misstatement in the untested population."

- **FAM 0540.01 specifies:** *"The auditor may detect misstatement during substantive tests or other procedures. The Auditor should evaluate misstatement individually and in the aggregate in both quantitative and qualitative terms. Based on the evaluation of all the misstatements the auditor should determine the type of report to issue on the financial statements."*
- **FAM 0540.03 specifies:** *"FAM 475 (substantive analytical procedure) and FAM 480 (substantive detail tests) discuss the evaluation of individual misstatements from a quantitative standpoint. Following that guidance, the auditor should quantify the effects of the misstatements and classify them as either:*
 - *Known Misstatement: the amount of misstatement actually found, or*
 - *Likely Misstatement: the auditor's best estimate of the amount of the misstatement in the population (likely misstatement includes the known misstatement). For sampling applications, this amount is the projected misstatement (Also see FAM 0540.11).*

Additional Note - In CLA's judgment, the most likely error was the best estimate available at the time of CLA's audit. Such judgment had not been found to be inappropriate over the years, as evidenced by the current year's audit not identifying any correction of error amounts in testing the AP & UDO audit areas.

- **FAM 0540.04 specifies:** *"To evaluate the aggregate effects of misstatements on the financial statements, the auditor should accumulate known and likely misstatements; this should be done on the Schedule of Uncorrected Misstatements."*
- **FAM 0540.04 further states:** *"Per AU 312.42, the auditor may designate an amount below which misstatements are not accumulated. The auditor should set this trivial or de minimus amount so that any such misstatements, either individually or when aggregated with all other misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered."*

The OIG appears to have overlooked the breadth of all CLA's audit procedures, both financial and information technology related, in assessing the adequacy of CLA's work as a whole. For example, CLA performed cash disbursement test of control procedures prior to the commencement of June 30th substantive procedures in PP&E accounts. CLA concluded that such controls were functioning properly and could be relied upon to reduce the nature and extent of detailed substantive audit procedures in a variety of audit areas affected by cash disbursement transactions (Cash Disbursement Internal Summary Memo at WP 0506.51c).

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With that internal control conclusion, substantive procedures were performed and included detailed testing of PP&E activity at June 30, 2012. Such procedures included IDEA sampling techniques for material activity areas (three activity areas with activity balances greater than Design Materiality) and other sampling methods for two activity areas less than Design Materiality. The results of the June 30th testing resulted in errors that would have decreased PP&E at June 30, 2012 by only \$2,014,836. In addition, CLA performed analytical procedures on total activity balances through June 30, 2012 (WP 1321.00), along with PP&E depreciation analysis (WP 1314.04), and repairs and maintenance analysis (WP 1314.03). These June 30th substantive test procedures and conclusions were summarized in CLA's PP&E Summary Memorandum (WP 1313.00), which included references to several relevant supporting workpapers. On various occasions, CLA requested that the OIG thoroughly review the PP&E June 30th Audit Program at WP 1310 and referenced workpapers to obtain a full understanding of the breadth of CLA's audit procedures. Given the finding in the OIG Report, it does not appear that such a review was performed or adequately considered by the OIG in preparing its Report.

Using the internal control and substantive tests through June 30, 2012, CLA then implemented its year end substantive testing sampling plan. Due to the success of testing through June 30th and the low level of activity in the last quarter for FY 2012, CLA used less sophisticated sampling methods of PP&E account activity for the quarter ended September 30, 2012. CLA's detailed testing of transactions continued to show a very low error rate. Those results, coupled with various analytical procedures on property accounts (WP 1354.03, 1354.04, 1356.03 and 1360.00), provided CLA with enough audit evidence to conclude that no proposed specific adjustments to PP&E were needed to be included in the FY 2012 Schedule of Uncorrected Misstatements. In addition, based on all testing through September 30, 2012, CLA concluded that an allowance for sampling risk (referred to in the FAM) for PP&E was not material and therefore not necessary to bring forward to the FY 2012 Schedule of Uncorrected Misstatements.

These September 30th substantive test procedures and conclusions were summarized in CLA's PP&E Summary Memoranda at WP 1353.00, which included references to several relevant supporting workpapers. On various occasions over the last eighteen months of its review, CLA recommended that the OIG review the PP&E September 30th Audit Program at WP 1350 to obtain a full understanding of the breadth of all PP&E audit procedures performed.

- **Additional Note** – During a meeting with the OIG on September 23, 2014, CLA provided the OIG with a duplicate package of various PP&E workpaper copies (re: 6/30 & 9/30 work) in support of the narrative response above (i.e. Audit Program, Summary Memoranda, Internal Control Test, and Analytical procedures, etc.). Based on the findings in the most recent OIG Report, it does not appear that such review has been completed, or information adequately considered.

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6. OIG Report Excerpt – Page 3, Paragraph Under Table 1

"CLA carried forward proposed adjustments of \$7.7 million for undelivered orders and \$516,000 for accounts payable to the Schedule of Uncorrected Misstatements. CLA proposed a \$7.7 million adjustment to DFAS for undelivered orders. CLA did not require DFAS to adjust its financial statements because this amount was below both the design materiality of \$10 million and the reporting materiality of \$23 million. DFAS personnel chose not to make the recommended adjustment because they were not material to the financial statements as a whole, and the correction window for making adjustments had passed. If DFAS made the proposed adjustment, CLA would have had greater assurance that the DFAS FY 2012 Financial Statements were free of material misstatements. CLA did not propose the adjustment of \$516,000 for accounts payable because it was below CLA's trivial amount threshold of \$2.3 million.

CLA Response

CLA does not believe the OIG's reference to needing to obtain "greater assurance" is correct. CLA's opinion on DFAS' FY 2012 financial statements indicated that "the WCF financial statements referred to above present fairly, in all material respects, the financial position of DFAS' WCF as of September 30, 2012 and 2011 and its net costs; changes in net position; and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the U.S." Even in hindsight, CLA believes that obtaining the greater assurance suggested by the OIG, would not have changed that "present fairly" opinion issued for the FY 2012 financial statement audit. However, obtaining the "greater assurance" suggested by the OIG would have resulted in CLA over-auditing (forcing the use of excessively low materiality levels) in other audit areas as well. It also would likely have resulted in an increase in the cost to perform the DFAS audit in future years.

7. a) OIG Report Excerpt – Page 3, Bulleted Paragraph Under Table 1

"CLA did not consider the aggregate value of non-sampled items when they performed judgmental sampling for property, plant, and equipment. CLA used a combination of MUS and judgmental sampling techniques to conduct its testing. The totals of the unaudited and untested balances where CLA used judgmental sampling are \$13.7 million, which was above the design materiality threshold of \$10.2 million. Table 2 details the results of CLA's judgmental samples."

AND

b) OIG Report Excerpt – Page 4, 2nd Paragraph Under Table 2

"However, FAM 540.11 states: In addition to the total likely uncorrected misstatements, the auditor should evaluate the risk of further misstatement, which is due to the imprecision of audit procedures as discussed in FAM 230.12. This risk includes the allowance for sampling risk (the combined precision of all sampling applications), an allowance for imprecision of analytical and other substantive audit procedures, and an allowance for unaudited immaterial account balances. The statistician should compute the combined precision for all sampling applications."

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CLA Response

- a) CLA agrees with the factual content of Table 2 in the OIG's Report. However, the OIG fails to acknowledge other important audit procedures (internal control – financial and IT, and substantive testing performed by CLA in those audit areas) that supplement the detailed testing procedures summarized in Table 2, which was used to fully assess the potential error in the accounts. Accordingly, CLA does not agree with the OIG's assessment of the accumulation of potential uncorrected misstatements.

b) Discussion of Allowance for Sampling Risk

- Property Plant & Equipment (PP&E) – Based on the composition of the PP&E accounts and prior years audit testing results, PP&E was not considered a high risk audit area in FY 2012.

On several occasions during the OIG's eighteen month review of CLA's audit of the DFAS WCF, CLA pointed out that CLA's audits are performed holistically. This means that CLA's audit conclusions are based on all testing done in the PP&E area (both internal control tests – IT and Financial -- and substantive at June 30th and September 30th – both detailed testing and analytical procedures), using professional judgment and other tests contemplated in FAM 480.06 (3rd paragraph). CLA's June and September PP&E Summary Memoranda (WP 1313.00 & 1353.00) evaluated the PP&E errors (quantitatively and qualitatively) noted in its testing in the context of the PP&E populations and the financial statements as a whole.

CLA concluded that an allowance for sampling risk was not material for the PP&E accounts not tested. Therefore it was not necessary to bring forward any amount to the Schedule of Uncorrected Misstatements. CLA's overall conclusions are documented in the PP&E and overall Year End Substantive Phase Summary Memoranda at WPs 1313.00, 1353.00, and 0303.28a. CLA has previously provided the OIG (on September 23, 2014) with a summary of the sampling tests performed in the PP&E audit area along with an evaluation of the Upper Error Limits noted in Table 1 of the OIG Report. Due the confidential audit scope information in the summary document previously provided to the OIG, it is not provided again in this Response document. However, such information in that separate confidential document was derived from various PP&E WPs, including WPs 1311 and 1351.

- Account Payable (AP) and Undelivered Orders (UDO) – As noted in Table 1 of the OIG Report, CLA included the midpoint of the Point Estimate and Upper Bound amounts in the Likely Misstatements section of the Schedule of Uncorrected Misstatements (\$516 thousand and \$7.7 million, respectively). These amounts were in excess of the typically required and statistically calculated Point Estimate, often referred to as Most Likely Error. Therefore the excess was effectively an allowance for sampling risk. This was determined to be CLA's "best estimate" of the likely misstatement as per

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FAM 0540.03 guidance. Respectfully, to suggest that CLA should propose the Upper Bound (\$896,285 and \$12,092,186) to DFAS to adjust their financial statements is unsupported by professional standards. Such a suggestion does not take into consideration the very low likelihood of the error actually being the Upper Bound amount, the overall account risk factors of the account, or the assessment of other work completed throughout the audit (i.e. internal control, substantive and analytical) that reduces the likelihood of error even further. CLA believes the use of the midpoints noted above is more than adequate to quantify the potential error in the AP & UDO balances at September 30, 2012.

- Other Audit Areas – As allowed by professional audit standards and guidance provided in the GAO FAM, statistical sampling is not required to be performed in all areas of an audit. Statistical sampling was performed in the PP&E, AP & UDO areas of the audit. However, in all other areas of the audit, internal control tests and non-statistical substantive tests were performed, and conclusions were reached on material account balances based on the collective results of the work performed. This audit approach was designed based on the composition of accounts and the assessment of the likelihood of error in the accounts. In each audit area, a Summary Memorandum was prepared detailing the procedures performed, and conclusions reached thereon. Such conclusions included an assessment of the likelihood and amount of errors (actual or by allowance), by which CLA concluded that there no error amounts above the Trivial Amount threshold for any of the other audit area accounts.

8. a) OIG Report Excerpt – Page 4, Last Bulleted Paragraph

"CLA did not maintain evidence to support that it reviewed and tested the detailed transactions in the DFAS-Columbus Cash Accountability System as part of the audit procedures for Fund Balance with Treasury (FBWT). While CLA personnel performed detail testing of cash collections and cash disbursement transactions, CLA's audit documentation indicated it only tested transactions from DFAS' internal accounting system. AICPA AU Section 350, "Audit Sampling," states: Sample items should be selected in a way that the sample can be expected to be representative of the population; therefore, all items in the population should have an opportunity to be selected. The auditor should determine that the population from which he draws the sample is appropriate for the specific audit objective."

AND

8b) OIG Report Excerpt – Page 4, Last Paragraph

"Additionally, FAM Section 350 states that the auditor should use a combination of audit procedures to obtain sufficient, appropriate audit evidence regarding the operating effectiveness of controls. According to CLA's audit documentation, CLA compared summary collection and disbursement amounts from the DFAS accounting

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system to summary amounts from the DFAS Cash Management Report (CMR)³ and noted that those summary amounts agreed with immaterial differences. Although it is not explicitly required by audit standards or the FAM, re-performing the DFAS FBWT reconciliations is a key audit step that helps obtain assurance that the account balance is correct and the processes are effectively capturing all receipts and disbursements. To re-perform the DFAS FBWT reconciliations, CLA would have to retrieve the disbursement and collections transactions supporting the summary amounts on the CMR and reconcile those transactions to the detail disbursements and collections reported in the accounting system. By performing this key audit step, CLA would reduce their audit risk; however, without re-performing these procedures, CLA would not have assurance that the population they sampled included unauthorized and unrecorded transactions. An appropriate sampling plan would involve sampling from an entire population of transactions."

AND

8c) OIG Report Excerpt – Page 7, 1st portion of Last Bulleted Paragraph

"CLA did not consider the effect that the absolute value of the undistributed account would have on the financial statements. CLA personnel did not have assurance that the population they sampled included unauthorized and unrecorded transactions that a proper FBWT reconciliation would detect. FAM 921 states that auditors should determine the magnitude of the entity's gross unreconciled differences at year end by analyzing their aggregate absolute values and resulting impact on the financial statements. Undistributed transactions represent potential misstatements, and CLA personnel relied on the summary undistributed amount without aggregating each of these potential misstatements in the absolute form."

AND

8d) OIG Report Excerpt – Page 5, 2nd Part of Last Bulleted Paragraph

"The OIG obtained a file of DFAS undistributed transactions as of September 30, 2012, and calculated an absolute value of \$8.9 million of these undistributed transactions. Although these DFAS-provided transactions did not exceed CLA's \$10.2 million design materiality threshold, CLA did not perform the work to identify the absolute value of those transactions as required by FAM 921. While the total of the undistributed transactions were immaterial, additional testing performed by CLA would have reduced the audit risk associated with this approach."

CLA Response

CLA disagrees with the OIG's assessment that audit procedures in the FBWT area were insufficient, especially given that, by design, FBWT balance of DFAS' working capital fund should be zero at September 30, 2012. Accordingly, tests of and reliance on receipt and disbursement controls were critical to CLA's conclusion that the zero FBWT balance at September 30, 2012 was reasonable in the context of DFAS' FY 2012 financial

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statements as whole. Specifically, the following paragraphs explain this position in more detail.

- a) Upon receipt of the Collection and Disbursement detail listings at April 30, 2012, CLA reconciled these listings to DFAS' eBiz trial balance amount to ensure completeness of the populations. Collections and disbursements were reconciled within immaterial amounts (\$1.5 million and \$1.0 million, respectively) as documented on WP 0503.53a and WP 506.53a, respectively. CLA also performed analytical procedures on these collection and disbursement totals, as documented at WP 0503.53b and 0506.53b, respectively. CLA's sample selections were then made randomly, ensuring that all items in these populations had an opportunity to be selected as required by AU350. The unreconciled differences at June 30, 2012 (WP 0503.53c and 0506.53c, respectively) were equal to or less than those amounts identified at April 30, 2012. CLA believes that the workpapers noted provide appropriate audit evidence to support conclusions reached and explained in the FBWT Summary Memorandum at WP 1115.00.
- b & c) All AU sections, including section 350, assume such principles are applied to material balances. The absolute value of undistributed transactions in question was \$8.9 million. Since the amount was less than Design Materiality (\$10 million), professional standards do not require detailed testing of such balance. Accordingly, CLA analytically reviewed this component balance of FBWT and found it to be reasonable. This analytical review process is provided for in the FBWT audit program (WP 1100) section D3, and most steps in that audit program are referenced to WP 1151.01. CLA agrees that it could have documented the amount of the undistributed amount (\$8.9 million) in CLA's workpapers, but the FBWT Audit Program is clear that CLA considered it.
- d) As noted in the OIG Report, the absolute value of undistributed transactions of \$8.9 million did not exceed the Design Materiality threshold. Coupled with the fact that the net amount of such transactions was \$2.1 million, which was less than the trivial amount of \$2.3 million, detailed testing of such transactions is not required (see AU 9350 for more information to support this conclusion). In CLA's professional judgment, based on ALL work in the Fund Balance with Treasury (FBWT) audit area as detailed in the FBWT Audit Program and Summary Memorandum at September 30, 2012, CLA concluded that detailed testing of this \$8.9 million absolute value was not necessary.

In its Report, the OIG noted that testing was not required for this \$8.9 million item, and, therefore, it is unclear why this matter is in the OIG Report. As noted in CLA Response # 6 above, CLA does not believe the OIG's reference to needing to "reduce audit risk" or obtaining "greater assurance" is valid. CLA's opinion on DFAS' FY 2012 financial statements indicated that *"the WCF financial statements referred to above present fairly, in all material respects, the financial position of DFAS' WCF as of September 30, 2012 and 2011 and its net costs; changes in net position; and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the*

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U.S.” Even in hindsight, CLA believes that obtaining the greater assurance suggested by the OIG would not have changed that “present fairly” opinion issued for the FY 2012 financial statement audit. However, obtaining the “greater assurance” suggested and apparently preferred by the OIG would have resulted in CLA over-auditing (forcing the use of consistently excessively low materiality levels) in other audit areas as well, and likely increase the cost of the DFAS audit in future years.

Summary Conclusion

CLA believes the OIG Report (dated October 10, 2014) findings and conclusions to be substantially factually inaccurate and not reflective of the quality of CLA’s audit of the fiscal year (FY) 2012 financial statements of the Defense Finance and Accounting Service (DFAS) Working Capital Fund (WCF).

CLA specifically disagrees with the OIG’s conclusions in its Report that CLA’s audit documentation in certain areas of its audit, and certain materiality levels used in the audit, were not in compliance with professional standards. CLA also disagrees with the OIG’s conclusion that CLA did not adequately summarize potential errors in accounts tested at June 30, 2012 and September 30, 2012.

Acronyms and Abbreviations

AICPA	American Institute of Certified Public Accountants
CLA	CliftonLarsonAllen LLP
CMR	Cash Management Report
DFAS	Defense Finance and Accounting Service
FAM	Financial Audit Manual
FBWT	Fund Balance with Treasury
GAGAS	Generally Accepted Government Auditing Standards
MUS	Monetary Unit Sampling
PP&E	Property, Plant, and Equipment
WCF	Working Capital Fund

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