# Should We Care about Secrecy in Financial Reporting?


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Published February 8, 2019

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**Introduction**

On October 7, 2016 Reuters published an article by Scot Paltrow (2016), which reported that in fiscal year 2015 the Army made $6.5 trillion in unsupported accounting adjustments "to create an illusion that its books were balanced." Given that the Army general fund budget in that year was $122 billion, this was an astounding revelation. Though the article highlighted ongoing accounting problems within the Department of Defense (DOD), Paltrow tried to alleviate public concerns about the enormous unsupported adjustments with the following statement:

> *At first glance the adjustments totaling trillions may seem impossible. The amounts dwarf the Defense Department's entire budget. Making changes to one account also requires making changes to multiple levels of sub-accounts, however. That created a domino effect where, essentially, falsifications kept falling down the line. In many instances this daisy chain was repeated multiple times for the same accounting item.*

Though the massive $6.5 trillion figure raised eyebrows, the story quickly faded from public view. The original government report upon which Paltrow based his article comes from the Office of the Inspector General (OIG). The document "**Army General Fund Adjustments Not Adequately Documented or Supported**" (2016) concluded that the problems were attributed to "control deficiencies." While the report did not receive much additional attention from the media, it did catch the eye of former Assistant Secretary of Housing and Urban Development, Catherine Austin Fitts. Ms. Fitts had been tracking similar unsupported adjustments in the Departments of Housing and Urban Development (HUD) and the Department of Defense (DOD) for nearly twenty years. Fitts became interested in the issue because she had become aware of financial impropriety within HUD many years prior.

The DOD made major media headlines many years earlier for its accounting problems on September 10, 2001 when Secretary of Defense Donald Rumsfeld stated in a Congressional hearing (**C-SPAN, 2014**) that the DOD had lost track of $2.3 trillion in transactions. At the time, Mr. Rumsfeld said:

> *According to some estimates, we cannot track $2.3 trillion in transactions. We cannot share Information from floor to floor in this building because it's stored on dozens of technological systems that are inaccessible or incompatible.*
>
> *-Remarks as Delivered by Secretary of Defense Donald H. Rumsfeld, The Pentagon, Monday, September 10, 2001*

This acknowledgement made news headlines on that day, but was forgotten a day later when the tragedy of 9/11 captured the attention of the entire world. DOD accounting problems also found their way into the media during the Iraq War, but have largely remained out of public view for more than a decade.

When Professor Mark Skidmore learned of the $6.5 trillion in unverifiable Army transactions, he contacted Ms. Fitts and they agreed in the spring of 2017 to work together to identify other similar government reports that indicated unusually large unverifiable transactions within HUD and DOD. Over the course of the next six months, Skidmore, Fitts and a small team of graduate students collected official government documents wherein a total of $21 trillion in undocumentable transactions were identified during the 1998-2016 period.[1]

The remainder of this report provides an assessment of the nature of the huge unsupported transactions, placing the issue within the context of changing financial reporting rules that enable ever-growing secrecy within both the public and private sectors. In the next section, we provide a formal definition of an "unsupported journal voucher adjustment", discussing examples with some interpretation. This section is followed by an evaluation of an important change in federal financial reporting rules, which is known as Standard 56. Adopted by the federal government in October 2018, Standard 56 effectively enables a small group of high level government authorities with security clearances to create financial reports for the public, which have been altered in order to hide expenditures that may be related to issues of national security. From this point forward, the United States will produce two sets of financial reports, one altered set for the public and another real set of undisclosed financial reports. The discussion of Standard 56 is followed by a brief section describing two major changes in private sector financial reporting rules that create greater opacity. Here, we discuss a little known law that enables the National Security Agency (NSA) to exempt some corporations from Securities and Exchange Commission (SEC) financial reporting requirements as well as the suspension of "mark to market" valuation of assets for financial institutions that was implemented in 2009 during the financial crisis. The report concludes by discussing implications of ever growing secrecy for economists, investors and all U.S. citizens.

**What is an Unsupported Journal Voucher Adjustment?**

The Office of the Undersecretary of Defense (2016) defines an unsupported journal voucher adjustment as:

> *Journal vouchers are summary-level accounting adjustments made when balances between systems cannot be reconciled. Often these journal vouchers are unsupported, meaning they lack supporting documentation to justify the adjustment or are not tied to specific accounting transactions. While many adjustments are valid, having too many journal vouchers may be an indicator of underlying problems, such as weak internal controls. For an auditor, journal vouchers are a red-flag for transactions not being captured, reported, or summarized correctly. Auditors must judge whether the errors that triggered the journal voucher are isolated or systemic, leading them to select more transactions to test. If the auditors cannot estimate the magnitude of the errors, they may not be able to complete the audit or issue an opinion on the financial statements.*

A journal voucher or journal entry requires appropriate accompanying documentation such as receipts with accompanying explanations. Journal voucher entries without such documentation are referred to as "unsupported journal voucher entries", or "unsupported journal voucher adjustments" and are sometimes used to reconcile accounts.[2] According to DeVries and Kiger (2004), unsubstantiated journal entries and other adjustments represent significant exposure to potential fraud. Thus, unsupported journal voucher entries are considered red flags for potential fraud.

In the case of Army in fiscal year 2015, the OIG report (2016) identified $6.5 trillion in unsupported journal voucher entries. The report indicates that unsupported transactions are the result of the agency's failure to correct system deficiencies. According to the report, the data used to prepare the year-end financial statements were unreliable and did not have an adequate audit trail. For context, keep in mind that the entire budget of the DOD in 2015 was $565 billion. Therefore, the Army unsupported journal voucher entries were more than 10 times the entire DOD budget.

The anomalous size of the unsupported adjustments for the Army in fiscal year 2015 coupled with Rumsfeld's $2.3 trillion figure prompted us to conduct a search at the websites of the OIG, Government Accountability Office (GAO), and to the Office of the Under Secretary of Defense to compile documents between the years 1998 and 2016 for DOD and HUD that indicate the amounts of unsupported journal voucher entries. To make these original federal government source documents more easily accessible to the public, they have been made available at https://missingmoney.solari.com/dod-and-hud-missing-money-supporting-documentation/. While we were unable to find reports for many years, we were able to identify more than $20 trillion in unsupported adjustments for DOD and nearly $600 billion for HUD. For reference, the entire sum of authorized DOD and HUD spending for years 1998-2016 in nominal terms was $9.2 trillion and $806 billion, respectively.[3] Thus, the unsupported journal voucher adjustments we identified for DOD, which are incomplete, were more than twice the size of authorized spending over the period. In the case of HUD, we were only able to identify five years for which the amounts of unsupported adjustments and/or errors were reported. Notable is the fact that in fiscal years 2015 and 2016 HUD "errors" in reporting were $516 billion, roughly 10 times the size of the sum of authorized spending in those two years.

The OIG reports that are available to the public only provide summary information, and thus it is impossible for us to conduct a full assessment of the nature of these unsupported adjustments/errors. However, the report for fiscal year 2015 "Army General Fund Adjustments Not Adequately Documented or Supported" (2016) offers some additional information in the appendices. We discuss some of the unsupported adjustment in Skidmore and Fitts (2016), and we highlight them again here. Appendix C Table 4 on page 27 of the report provides a summary of net changes in the Army General Fund balance sheet that are due to unsupported journal voucher adjustments. On the asset side, there is an increase of $794 billion in Fund Balance with Treasury. In addition, liabilities increased by $929 for accounts payable. On page 6 Table 2, there are 170 unsupported adjustments tallying to $2.3 trillion.
While the report does not provide a detailed accounting of the $6.5 trillion in unsupported adjustments, the information provided in the appendix offers guidance in terms of questions to ask:

1. On the asset side of the ledger, from where did the additional $794 billion in Fund Balance with Treasury come? Do these unsupported adjustments represent a flow of funds to the Army through Treasury beyond the known resources authorized by Congress? If the undocumented transactions merely represent a "domino" effect of falsification as described by Paltrow (2016), why is it that the Army fund balance with Treasury must be increased by nearly $1 trillion? If these represent funds flowing to the Army, were they authorized and if so when and by whom? From where did the funds come?
2. With regard to liabilities, it appears that the $929 billion in Accounts Payable represents the amount owed for items or services purchased on credit. If this is the case, what entities are expected to receive payment, noting that amounts are in excess of authorized spending? While the report does not provide enough information to answer this question, it may be possible to learn more about such transactions via other means. For example, numerous DOD contractors are publically traded companies that regularly produce SEC filings and audited financial statements. Would not prudent fiscal management compel one to inquire further? Similarly, given that Federal Reserve Bank is the fiscal agent of the federal government, it has a record of all transactions.
3. With regard to the 170 adjustments that amount to $2.1 trillion, Skidmore has repeatedly asked the OIG to provide an addendum which would list these transactions so that the public can see what the Army says they were presumably for. To date, the OIG has not provided any information, even with a FOIA request.

The report also offers a footnote in Appendix C Table 4 to indicate that: "DFAS Indianapolis personnel stated that the majority of the increase is related to budget execution adjustments from prior years that must be applied to establish the correct beginning balances for the general ledger accounts reported on this line." If the OIG were willing to provide additional information, it would be possible to learn more about the nature of these adjustments and when the original transactions occurred. While it could be that these adjustments represent a one-time event to reconcile the budget in advance of the first ever DOD independent audit that was conducted in 2018, as shown in the compiled reports available at **https://missingmoney.solari.com/dod-and-hud-missing-money-supporting-documentation/**, these types of substantial unsupported adjustments occur regularly.

To date, the OIG is no longer responding to our inquiries. Further, evidence suggests that authorities are hiding important information from lawmakers. For example, a recent C-Span video recording came to our attention in which David Norquist, Comptroller of the DOD, offered an explanation to Congressman Walter Jones regarding the nature of the Army's $6.5 trillion in unsupported adjustments. Norquist's testimony is available on YouTube (**West**, 2018), and the following assessment was originally provided by **Kotlikoff and Skidmore** (2018).

In his testimony, Norquist claimed that the unsupported journal voucher entries are the result of changes in the "property book" that amount to hundreds of billions of dollars. According to Norquist, the system that tracks the property book is not integrated with the system that tracks the general fund ledger, and thus large unsupported adjustments are required for reconciliation. From his testimony, Mr. Norquist says that changes in the valuation of property and equipment due to depreciation, base closures, equipment becoming obsolete, etc. are leading to large undocumentable adjustments.

Let us examine his statement. The original Army **OIG report** (2016) highlighting unsupported adjustments of $6.5 trillion indicates that $164 billion in undocumentable adjustments were related to property (see page 27 of the report). First, the $164 billion in unsupported adjustments is substantial and yet there is no indication regarding what properties, equipment, etc. required changes in valuation. However, what is more important is that while $164 billion is a substantial figure, it accounts for only two percent of the $6.5 trillion. Why were an additional $6.3 trillion in unsupported adjustments needed? Because the publicly available reports do not offer detailed explanations and additional data are not forthcoming, we are left to "trust" that the authorities are offering an accurate assessment, and yet it is clear that Norquist withheld vital information, thus making his testimony deceptive.

Further evaluation is in order. Consider the Army for which we found $11.5 trillion in unsupported adjustments over the 1998-2016 period. During this period, authorized general fund Army spending was just over $2 trillion. We know from other sources that about 40 percent of the Army's general fund budget is allocated to personnel costs, and therefore was not used for purchasing property and equipment. For simplicity, assume that the remaining amount (60 percent of the $2 trillion, or $1.2 trillion) was used to purchase property and equipment, and assume all of this spending is fully written off at 100 percent. For how many years could the Army write off all non-personnel spending and then call it an unsupported adjustment? Between 1998 and 2016, the Army's average annual budget was about $118 billion, of which roughly $71 billion annually was for non-personnel spending. Dividing $11.5 trillion by $71 billion shows that the Army could have fully written off all non-personnel spending for the past 163 years (assuming a stable budget allocation in real terms), and then called it an unsupported adjustment. From this evaluation, it seems that Mr. Norquist's explanation does not hold up to a modest level of scrutiny.

As the questions we posed regarding the $21 trillion in unverifiable transactions gained traction in the media, the issue received even more attention in late 2018 when incoming representative Alexandria Ocasio-Cortez referred to the $21 trillion in a Tweet:

> *$21 TRILLION of Pentagon financial transactions "could not be traced, documented, or explained." $21T in Pentagon accounting errors. Medicare for All costs ~$32T. That means 66% of Medicare for All could have been funded already by the Pentagon. And that's before premiums.*

Numerous media outlets including the *New York Times* (**Qiu**, 2018) and the *Washington Post* (**Blake**, 2019) "fact" checked Ocasio-Cortez's statement. The near universal assessment was that Ocasio-Cortez's Tweet was misleading—the $21 trillion in undocumentable transactions do not reflect actual unauthorized spending. However, as noted by Kotlikoff (2019) there is a very important point that was missed by nearly all media outlets.

Despite our efforts, the federal government has not shared any of the underlying data or information regarding the nature of the undocumentable transactions. To illustrate, Mark Skidmore has repeatedly asked the OIG to provide an addendum to the **report** published by the OIG (2016), which indicated that the Army had $6.5 trillion in undocumentable transactions. For example, Skidmore requested that the OIG provide more information about the nature of 170 transactions that generated $2.1 trillion in undocumentable adjustments (see page 6 of the report). Why would the Army make up such enormous phony numbers, as asserted in a recent article by **Lindorff** (2018) and his sources? On the other hand, it is difficult to imagine how huge unauthorized sums could flow in and/or out of the Army. We argue that it is impossible to verify without greater transparency.

We have tried to make the case that in order to determine what these unsupported adjustments were presumably for, one would need access to the underlying information. And yet the OIG has to date refused to provide any data, even with a FOIA request. Without additional supporting documents, we must decide whether or not we have faith that our government officials are sharing accurate information. Unfortunately, as discussed above Norquist is clearly omitting important information in his testimony to Congressman Walter Jones. Greater transparency is needed to re-establish some level of public trust. Instead, we have been fully blocked from accessing additional information. Further, note that through 2017 all of the government reports we collected were unredacted and thus deemed not to be an issue of national security. Then in early 2018 we identified the latest **OIG report** (2017), which was fully redacted. That is, nearly all the numbers in the report had been blocked out; suddenly these reports had become a threat to national security.

**Standard 56**

Shortly after we made information about the $21 trillion in unsupported adjustments more accessible to the public, the DOD announced that it would conduct its first ever external independent audit, which it failed. Concerned that the audit process would reveal sensitive information, Pentagon officials turned to the Federal Accounting Standards Advisory Board (FASAB) for advice. Several months into the audit FASAB posted a new document (**FASAB report**, 2018), which recommended that the government be allowed to misstate and move funds in order to conceal expenditures if it is deemed necessary to protect national security interests. The statement is known as Standard 56. A summary of the recommendation is available on page 3 of the document:

> *This Statement permits modifications that do not affect net results of operations or net position. In addition, this Statement allows a component reporting entity to be excluded from one reporting entity and consolidated into another reporting entity, and the effect of the modification may change the net results of operations and/or net position.*

The federal government accepted the FASAB recommendation on October 4, 2018, which was just in time for it to be applied to the financial statements generated by the DOD audit. It is important to note that Standard 56 was adopted with the full support of both the GAO and the OMB, making it a bipartisan effort on the parts of the executive branch and Congress. See **Ferri and Lurie, Solari Report** (2019) and **Federation of American Scientists** (2018) for a more detailed assessment of Standard 56. Importantly, Standard 56 applies to all federal entities that issue unclassified general purpose reports (GPFFR), including entities that are: 1) budgeted for by elected federal officials, 2) owned by the federal government, 3) or controlled by the federal government. Standard 56 applies to at least 154 entities including entities ranging from the Department of Agriculture, Department of Housing and Urban Development, to the Farm Credit System Insurance Corporation, and government entities that are unrelated to issues of national security. It is also alarming that Standard 56 can include publicly traded corporations with significant funding and/or federal government control.

With these new accounting rules, which is a full departure from Generally Accepted Accounting Principles (GAAP), a few people with high level security clearances have the authority to determine what is deemed to be a national security issue and this same group has the authority to restate financial reports in order to conceal actual revenue and expenditure flows. Further, the federal government will not disclose whether or not financial reports have been restated. The new social contract appears to be that the federal government will pretend to publish real financial statements, and the public will pretend that they are meaningful. No one outside this circle of national security advisors will know the degree to which modifications were made, thus making evaluation of government financial statements impossible for anyone outside this circle. From this point forward, the federal government will keep two sets of financial reports, one modified (and useless) set for the public and one true set that will remain undisclosed. D. Scott Showalter, Chair of FASAB, has written a forthcoming article about the ruling (Showalter, 2019) in which he states:

> *Ultimately the board (FASAB) concluded that finding a way to include most financial information correctly in public financial statements was better than not providing financial statements publicly.*

In other words, the assessment of the board is that if they had not adopted this ruling, the federal government would no longer be able to provide financial statements to the public. Further, though he suggests the new approach will “include most financial information correctly,” he neglects to say that the ruling applies to all 154 federal entities and that authority is fully transferred to a small invisible group of people who determine when an issue is a matter of national security and can then make adjustments to public financial statements in any way they please without any indication that the financial statements had been altered.

The FASAB recommendation institutionalizes non-transparency in federal financial reporting. Up to now, many aspects of federal finances have been opaque because government has failed to comply with existing financial reporting laws, but at least the laws worked in favor of citizen interests. With Standard 56 in place, citizens have no recourse; non-transparency is a matter of executive branch authority and policy. This change has important implications for the integrity of the republic and it greatly expands the opportunity for fraud or the financing of illegal operations, as accountability and transparency are eliminated. Unfortunately, this is just one of several accounting rule changes that has reduced transparency. Below, we discuss two other important changes.

**Changes to Financial Reporting in the Private Sector**

According to an article published by *BusinessWeek* (**Kopecki**, 2006), President Bush bestowed the Director of National Intelligence with the power to exempt publicly traded companies from standard financial reporting laws set forth by the Securities and Exchange Commission. According to the article, at least since the Carter administration, the Office of the President has had the authority to exempt companies working on top secret projects from financial reporting if it was deemed by the President to be in the interest of national security. However, in 2006 President Bush delegated that authority to the Director of National Intelligence. To our knowledge, nothing is known about the degree to which the intelligence branch of the federal government has granted exemptions to private corporations. The ability of the intelligence branch of government to exempt companies from financial reporting laws is very important, but few realize it exists.

In the aftermath of the financial crisis, the Financial Accounting Standards Board (FASB) suspended "mark-to-market" rules on bank assets (**Foley**, 2009). In the midst of the financial crisis and collapsing real estate values, FASB allowed financial institutions to ignore market valuations in determining their asset valuations. The concern was that bank liabilities (bad loans) would not be fully offset by declining asset valuations (the foreclosed properties). Under pressure from Congress, the FASB decided to allow financial institutions to book smaller losses on foreclosed properties by allowing these companies to value their assets at what they think they may be worth in the future. The move enabled financial institutions with trillions of dollars of mortgage-related assets to avoid insolvency. FASB changed the rules to prevent the insolvency of the financial institutions. While the U.S. is now well beyond the last crisis, the suspension of "mark-to-market" is still in place. Thus, it is difficult to assess the true financial condition of these companies. Importantly, many of the financial institutions affected by the suspension of "mark-to-market" provide depository functions for the U.S. government through the New York Federal Reserve and also serve as primary dealers in the U.S. Treasury securities market. The potential for conflicts of interest are significant.

**Implications and Conclusions**

Here is the current state of financial reporting in the U.S. First, we have a federal government with the authority to create fake books for the public, and not indicate where or how the financial statements have been altered. Second, the national intelligence branch of government has the authority to exempt companies from standard reporting requirements. Again, investors and the general public have no way of knowing which companies have altered financial statements. Third, financial institutions are free to value their assets in ways that improve the appearance of their financial condition. The potential negative consequences of these changes for U.S. citizens are profound.

At a fundamental level, we must all ask ourselves whether this arrangement is compatible with a functioning representative democracy and U.S. constitutional financial reporting requirements. Is it possible for citizens to assess how their tax dollars (and future tax dollars via debt issuance) are being used when publicly available financial reports are altered with no way of knowing the degree to which they have been changed? In our assessment, Standard 56 formally severs the flow of information between the governing body and the governed, thus eliminating accountability and transparency necessary for the United States to be called a representative democracy. While the structure or skeleton of representative democracy is still in place, the essential prerequisite of transparency has been stripped away. If we are not a representative democracy, what form of government do we have?

Economists and policymakers depend greatly on publicly available financial information to assess the effectiveness of government programs. Is it possible for researchers to conduct policy evaluation or financial analysis under Standard 56? With the implementation of Standard 56, how will researchers and policy analysts evaluate government spending and programs? How can researchers be sure the data available to them offer an accurate reflection of actual government activities? Recall that under the new standard there is no obligation on the part of government authorities to reveal where or to what degree financial reports have been altered.

On the private sector side, how do investors and financial advisors assess companies and allocate resources to the most productive entities when they cannot know which companies receive exemptions from standard financial reporting rules, and cannot know the true value of the assets for financial institutions? Is this arrangement compatible with an efficient market-oriented economy? What misallocation of resources occurs because of cloaked financial information?

Even more troubling is that with the two-way reporting exemptions (public and private), it is now possible for government authorities to funnel public resources (funds and assets) to corporations without public disclosure. Recall that a limited number of government officials who are invisible to the public now have the authority to alter publicly available financial statements and exempt companies from standard reporting requirements. This combination fully opens the door for large scale fraud.

In past years, the OIG provided periodic reviews of government agency financial reporting. We have shown that these reports reveal enormous problems within HUD and DOD, the scale of which is almost unfathomable. The most recent similar OIG report for the DOD was fully redacted; apparently the revelation of huge accounting discrepancies is now a national security issue. Shortly after the redacted report was made available, the government altered its accounting practices and policies to allow fake financial reports to be distributed to the public while concealing the true financial statements. In the words of Fitts (2019), "The time has come to invoke the rule of 'Caveat Emptor'—Buyer Beware." As a matter of executive branch policy, the U.S. government will not provide adequate financial disclosure. Thus, the responsibility of collecting the needed information for assessing and pricing the quality of credit and promises made is now fully transferred to citizens and investors. One should no longer rely on the government to provide accurate government financial information or assurances of private sector financial reporting accuracy.

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1 All original federal government source documents can be found at **https://missingmoney.solari.com/dod-and-hud-missing-money-supporting-documentation/**.

2 In this report we use these two terms as well as "unverified transactions," "undocumentable transactions," and "undocumentable adjustments" interchangeably.

3 These data were obtained from historical tables available at **https://www.whitehouse.gov/omb/budget/Historicals**.