Memorandum

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

Subject: INFORMATION: Report on Financial Statements for Fiscal Years 2001 and 2000, FAA FI-2002-082

Date: February 27, 2002

From: Kenneth M. Mead
Inspector General

Reply To Attn. of: Meche:x61496

To: The Secretary

I respectfully submit the Office of Inspector General (OIG) report on the Federal Aviation Administration (FAA) Financial Statements for Fiscal Years (FY) 2001 and 2000. For the first time starting with FY 2001, the Office of Management and Budget requires comparative financial statements to be presented covering 2 years. This report is required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

This report presents our unqualified opinion on the FY 2001 FAA Consolidated Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position, and Combined Statement of Budgetary Resources and Statement of Financing as of, and for the year ended, September 30, 2001; and our qualified opinion on the FY 2000 FAA Consolidated Balance Sheet and Statement of Net Cost as of, and for the year ended, September 30, 2000.

Since the tragic events of September 11, the aviation community has seen a dramatic reduction in air travel. This has resulted in steep declines in revenues available to fund FAA and its programs. Since September 11, expected revenues to the Airport and Airway Trust Fund have dropped by about $2.4 billion, or about 20 percent below original projections. Congress also authorized supplemental appropriations of about $600 million from the trust fund to increase security. These events and actions will result in a substantial draw down of the trust fund's uncommitted balance. We estimate that the uncommitted balance could drop from $7.3 billion at the beginning of FY 2002 to about $4.3 billion by the end of FY 2002.

To assist us, the Department of the Treasury (Treasury) Office of Inspector General audited the schedule of assets and liabilities, and the related schedule of activity for the Airport and Airway Trust Fund accounts (referred to as the Corpus account) administered by the Treasury Bureau of Public Debt. The Treasury OIG issued an unqualified opinion on these schedules. The General Accounting Office (GAO) performed agreed-upon procedures on tax revenue receipts at the Internal Revenue Service and distributions to the FAA Corpus account, and identified no material discrepancies.

FAA engaged KPMG LLP to audit the property, plant, and equipment accounts on the FAA Financial Statements. KPMG recommended that the net book value of FAA property be reduced by $138 million. FAA made the adjustments and KPMG issued an unqualified opinion on FAA property, plant, and equipment as of September 30, 2001. KPMG also cited FAA property accounting as a material weakness and made six recommendations. FAA agreed with the recommendations. As part of our work, we also recommended adjustments of about $184 million to the reported net book value of FAA property. FAA made these adjustments prior to the KPMG audit.

In addition to the material weakness for FAA property accounting, we identified three FY 2001 issues involving internal control weaknesses and compliance with laws and regulations. While they are important, they did not affect our audit opinion.

- FAA needs to do more to determine whether funds obligated on inactive transactions are needed. We identified $45 million of obligations that were no longer needed. FAA adjusted its financial records accordingly.

- FAA was not in compliance with the Federal Financial Management Improvement Act of 1996 because the Department of Transportation (DOT) accounting system did not provide the data for preparing the FAA Financial Statements, did not comply with the U.S. Government standard general ledger, and did not comply with the requirements for implementing managerial cost accounting standards. FAA also needs to enhance security over financial information systems. DOT plans to have a compliant accounting system by January 2003 and FAA plans to secure its financial systems by May 2003.

  FAA is making good progress and has implemented a cost accounting system in its largest line of business, Air Traffic Services. FAA still needs to implement the cost accounting system in its other four lines of business. FAA is developing its Cru-X labor distribution system, but this system has a serious flaw that must be corrected so that air traffic controllers cannot override the system's internal clock to record any start or stop time. FAA plans to have its cost accounting system fully operational early in calendar year 2003.

- The performance measures presented in the Management Discussion and Analysis did not provide information about the cost-effectiveness of programs nor relate to the Statement of Net Cost. The FY 2001 performance measures were based on FY 2000 rather than FY 2001 performance data. None of the measures was linked to the cost of achieving targeted results.

We are making three recommendations in this report. Issues that are common to FAA and other DOT agencies will be addressed in our report on the DOT Consolidated Financial Statements for FYs 2001 and 2000.

A draft of this report was provided to the FAA and DOT Chief Financial Officers on February 22, 2002. They agreed with the report.

We appreciate the cooperation and assistance of FAA and DOT representatives. If we can answer questions or be of any other assistance, please call me at (202) 366-1959, or John Meche at (202) 366-1496.

Attachments

#

DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT
ON THE FEDERAL AVIATION ADMINISTRATION
FINANCIAL STATEMENTS FOR FISCAL YEARS 2001 AND 2000

To the Federal Aviation Administrator

The Department of Transportation (DOT), Office of Inspector General (OIG), audited the Federal Aviation Administration (FAA) Financial Statements and accompanying notes as of, and for the years ended, September 30, 2001, and September 30, 2000. In our audit of the FAA Financial Statements for Fiscal Years (FY) 2001 and 2000, we found:

- the FY 2001 financial statements are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;

- except for depreciation expense and the net book value of property, plant, and equipment, the FY 2000 financial statements are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;

- a material weakness in internal controls over accounting for property, plant, and equipment; and reportable conditions concerning recorded obligations, personal property acquisitions, and performance measures;

- noncompliance with the Federal Financial Management Improvement Act of 1996 (FFMIA) regarding (1) DOT's accounting system, (2) security over financial information systems, and (3) managerial cost accounting standards;

- financial information in the Management Discussion and Analysis was materially consistent with the FAA Financial Statements, except performance measures were based on FY 2000 rather than FY 2001 performance data; and

- supplementary and stewardship information was consistent with management representations and the FAA Financial Statements.

We performed our work in accordance with U.S. generally accepted government auditing standards and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*. The following sections discuss these conclusions. Our audit objectives, scope, and methodology are discussed in the Exhibit. We believe that our audit provides a reasonable basis for our opinion.

A. OPINION ON FINANCIAL STATEMENTS

In our opinion, the Consolidated Balance Sheet, Statement of Net Cost, and Statement of Changes in Net Position, and Combined Statement of Budgetary Resources and Statement of Financing, including accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the FAA assets, liabilities, and net position; net costs; changes in net position; budgetary resources; and reconciliation of net costs to budgetary obligations as of September 30, 2001, and for the year then ended.

We expressed a qualified opinion on the FY 2000 Financial Statements because FAA was unsuccessful in implementing an integrated property accounting system, calculated depreciation expense and the net book value of its property, plant, and equipment using electronic spreadsheets outside the existing property system, and these amounts could not be substantiated. Except for depreciation expense and the reported net book value, in our opinion, the Consolidated Balance Sheet and Statement of Net Cost, including accompanying notes, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles as of September 30, 2000, and for the year then ended. During FY 2001, FAA reduced the net book value of property, plant, and equipment by $322 million, but did not restate the FY 2000 Consolidated Balance Sheet and Statement of Net Cost.

B. CONSIDERATION OF INTERNAL CONTROLS

In planning and performing our audit, we considered FAA's internal controls over financial reporting and compliance with laws and regulations. We do not express an opinion on internal controls and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 01-02 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found a material weakness in the accounting for property, plant, and equipment. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce, to a relatively low level, the risk that errors, fraud, or noncompliance that would be material to the financial statements, may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses or reportable conditions.

Our work also identified the need to improve internal controls over financial reporting and compliance in two other areas. These reportable weaknesses in internal controls, although not considered material weaknesses, represent significant deficiencies in the design and operation of internal controls, which could adversely affect the FAA Financial Statements.

Material Weakness

Accounting for Property, Plant, and Equipment

Our report on the FY 2000 FAA Financial Statements expressed a qualified opinion because FAA was unsuccessful in implementing an integrated property accounting system; calculated depreciation expense and the net book value of its property, plant, and equipment using electronic spreadsheets outside the existing property system, and these amounts could not be substantiated.

After issuing our FY 2000 report, we initiated a review of FAA personal property (equipment) balances as of September 30, 2000. We found the net book value was overstated. FAA immediately developed a plan to correct these accounts. As a result, FAA reduced the net book value of its personal property by $184 million.

After these adjustments, FAA engaged KPMG LLP to audit the property, plant, and equipment accounts. KPMG recommended that the net book value of FAA property be reduced by $138 million. FAA made the adjustments, and KPMG issued an unqualified opinion on property, plant, and equipment as of September 30, 2001. KPMG cited a material weakness in accounting for property, plant, and equipment and made six recommendations. FAA agreed with the recommendations.

On January 11, 2002, as required by the Federal Managers' Financial Integrity Act of 1982, the Secretary of Transportation reported this material weakness to the President and Congress. To address this material weakness, FAA is developing an integrated property accounting system that will be an integral part of DOT's new Delphi accounting system. FAA plans to have this completed by November 2002.

Recommendation 1. We recommend that the FAA Chief Financial Officer implement the KPMG recommendations and establish central oversight and control over all property functions to ensure property acquisitions are capitalized, supporting documentation is maintained, and depreciation expense and net book value of FAA property, plant, and equipment are properly reported at yearend.

Reportable Conditions

Internal control weaknesses existed because of insufficient reviews to identify inactive obligations that were no longer needed, and yearend review procedures for personal property acquisitions did not include FAA regional offices.

Inactive Obligations

In December 1999, in response to our Departmentwide review of inactive obligations, DOT issued its *Policy for Active Validation of Obligations* requiring that DOT agencies annually review obligations and expenditures to determine whether unexpended obligations exceeded needs. In February 2000, FAA expanded the policy by requiring quarterly reviews of obligations to deobligate unneeded funds prior to yearend.

During our testing, we reviewed unexpended obligations totaling $160 million that individually exceeded $100,000 with no expenditures for 18 months. We identified about $45 million of obligations that were no longer needed. FAA agreed and reduced the reported obligations accordingly in the FY 2001 Financial Statements.

Recommendation 2. We recommend that the FAA Chief Financial Officer revise existing procedures to require reviews of inactive obligations exceeding $100,000 before yearend.

Personal Property Acquisitions

To prepare yearend financial statements, FAA reviews its Headquarters expense transactions within the Facilities and Equipment appropriation, and transfers property acquisitions to the property accounts to be capitalized as assets. For FY 2001, FAA transferred $614 million. During our testing of FY 2001 expenses, we found personal property acquisitions in FAA Headquarters and three regions (Western Pacific, Alaskan, and Southern), totaling about $14 million, that were initially recorded as expenses but needed to be capitalized. This was not identified by FAA because the yearend review of expense transactions in FAA Headquarters does not include transactions posted by FAA regional offices.

Recommendation 3. We recommend that the FAA Chief Financial Officer revise the yearend review procedures of personal property transactions to include transactions by FAA regional offices.

C. COMPLIANCE WITH LAWS AND REGULATIONS

Our objective was not to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to selected provisions of laws and regulations that would be reportable under U.S. generally accepted government auditing standards or under OMB audit guidance. Our work disclosed instances in which FAA did not comply with FFMIA. We also found noncompliance with laws and regulations for reporting obligations and performance measures.

Federal Financial Management Improvement Act of 1996

Under FFMIA, we are required to report whether or not FAA financial management systems substantially comply with: (1) Federal financial management system requirements, (2) applicable Federal accounting standards, and (3) the U.S. Government standard general ledger at the transaction level. On January 4, 2001, OMB issued *Revised Implementation Guidance for the Federal Financial Management Improvement Act*, including factors for determining compliance and auditor reporting responsibilities. To meet the FFMIA audit requirement, we performed tests of compliance with the three FFMIA section 803(a) requirements and the revised OMB guidance, including financial management systems; the standard general ledger; and accounting standards.

FAA did not meet FFMIA requirements for financial management systems because: (1) DOT's accounting system, DAFIS, cannot produce auditable financial statements; (2) FAA needs to enhance security over financial information systems; (3) DAFIS does not use the U.S. Government standard general ledger; (4) FAA has not fully implemented managerial cost accounting standards; and (5) a material weakness exists in accounting for property, plant, and equipment.

Financial Management System Requirements

FAA uses DAFIS, which cannot produce financial statements based on the information included within the system. For example, FAA made 468 adjustments, totaling about $25 billion, outside DAFIS to prepare the financial statements. These adjustments were recorded in a financial statement module, a tool used to process the adjustments. However, the adjustments were not recorded in DAFIS. DOT plans to have its new Delphi accounting system fully operational and compliant with accounting standards by January 2003. Delphi compliance with FFMIA will be discussed in our report on the DOT Consolidated Financial Statements for FYs 2001 and 2000.

FAA also needs to enhance security over financial information systems. FAA has to complete a security plan for its five major financial management systems and perform required certification and accreditation reviews as required by OMB Circular A-130. FAA also needs to enhance security over network connections with industry associations and contractors. FAA stated that the corrective actions would be completed by May 2003. This is a Departmentwide issue that will be addressed in our report on the DOT Consolidated Financial Statements for FYs 2001 and 2000.

U.S. Government Standard General Ledger

DAFIS does not comply with the U.S. Government standard general ledger (SGL) at the transaction level because it does not use all of the SGL accounts. As a result, 468 adjustments, totaling $25 billion, were made outside DAFIS to prepare the financial statements. Delphi is compliant with the SGL, and DOT plans to have Delphi fully operational by January 2003.

Federal Cost Accounting Standards

FAA has made good progress implementing a cost accounting system, but still faces significant challenges to complete and operate a credible cost accounting system. Statement of Federal Financial Accounting Standards (SFFAS) Number 4, *Managerial Cost Accounting Standards,* require that beginning in FY 1998, each reporting entity should accumulate and report the costs of its activities on a regular basis. Costs may be accumulated either through the use of cost accounting systems or cost finding techniques. FAA began implementing a cost accounting system in 1997 and has implemented the cost accounting system for its first and largest line of business, Air Traffic Services. FAA also needs to complete the cost accounting system for its other four lines of business. FAA plans to have a fully functioning cost accounting system early in calendar year 2003.

FAA also is developing its Cru-X labor distribution system, but this system has a serious flaw that must be corrected so that air traffic controllers cannot override the system's internal clock to record any start or stop time. Because we made recommendations on the Cru-X system in a separate report, no recommendations are being made in this report.

Property, Plant, and Equipment

To be compliant with FFMIA, integrated financial management systems must maintain data accuracy between the core financial systems and feeder systems. As discussed in Section B, FAA has a material weakness concerning property accounting. FAA is taking action to resolve this issue.

On January 11, 2002, as required by the Federal Managers' Financial Integrity Act of 1982, the Secretary of Transportation reported FAA property accounting as a material weakness in DOT's FY 2001 annual report, and also reported that DOT was taking remedial and progressive actions in these areas that will bring DOT into substantial compliance with FFMIA when its actions are successfully implemented.

Inactive Obligations

Title 31, United States Code, Section 1501 and Treasury Financial Management Bulletin 2001-06 state that obligations must be supported and that agencies only report valid obligations. As discussed in Section B, about $45 million of unneeded obligations were recorded in financial records. FAA adjusted its FY 2001 Financial Statements accordingly and is taking action to resolve this issue.

Performance Data

Under OMB Bulletin 01-02, our responsibility is to obtain an understanding of internal controls relating to the existence and completeness of performance data. FAA is responsible for establishing and maintaining adequate internal controls. The FY 2001 DOT Performance Plan contained 71 performance measures, of which 10 were in the FY 2001 FAA Financial Statements. The overall presentation complied with the requirements of OMB Bulletin 01-09, *Form and Content of Agency Financial Statements,* to report performance measures consistent with goals and objectives from agencies' strategic and performance plans.

Linking to Statement of Net Cost and Measuring Cost-Effectiveness

According to OMB Bulletin 01-09:

> Entities should strive to develop and report objective measures that . . . provide information about the efficiency and cost effectiveness of programs. The discussion of performance . . . should be clearly linked to cost categories . . . featured in the Statement of Net Cost. . . . To further enhance the usefulness of the information, agencies should include an explanation of what needs to be done and what is planned . . . to improve financial or program performance.

As we reported last year, FAA still does not have the systems in place to allocate costs by major program. Consequently, the performance measures could not be linked to the Statement of Net Cost. For example, one FAA measure is to reduce U.S. commercial air carrier fatal accidents. FAA did not report the FY 2001 cost data for this measure.

The performance measures presented in the FAA Financial Statements also did not provide information about cost-effectiveness. None of the measures was linked to the cost of achieving targeted results, or to the Statement of Net Cost. For example, one FAA goal is to reduce commercial aviation delays. FAA did not report the FY 2001 cost data for reducing these delays.

DAFIS does not have the capability to accurately identify program costs. DOT is in the process of replacing DAFIS, and plans to have its Delphi accounting system in full operation by January 2003. FAA also is developing a separate cost accounting system, which is expected to be fully operational early in calendar year 2003.

Assessing Internal Controls

We performed various procedures to assess internal controls relating to performance data. While our work disclosed no material internal control weaknesses, we were not required to, and we did not, test the validity or accuracy of performance data as part of the FAA Financial Statement audit. However, FAA is facing a significant challenge to ensure the incoming data are accurate and complete.

FAA is relying on third-party organizations outside the Federal Government for some of its performance data, which are coming from external sources such as commercial airlines and airports. Although FAA has some FY 2001 data, DOT instructed the agencies to present 2000 data, for consistency across DOT.

Although not part of the financial statement audits, the OIG performed audits in FY 2001 addressing selected performance measures and data. OIG will continue to address performance measures as part of program and financial audits. For example, OIG conducted a performance audit and found that FAA should measure whether initiatives are effective in addressing the causes of runway incursions, and periodically assess regional efforts to ensure that progress is being made to reduce runway incursions at specific airports. FAA agreed to measure performance regarding runway incursions.

Reporting of Planned Actions

To enhance the usefulness of performance information, OMB Bulletin 01-09 encourages entities to include an explanation of what is planned to improve financial or program performance. As we reported last year, the Management Discussion and Analysis overview of the FAA Financial Statements includes general comments on how to improve performance; however, specific plans to improve financial performance through performance measures were not included. For example, planned action to increase the number of aircraft arrivals and departures during peak periods at nine major airports was not addressed.

D. CONSISTENCY OF OTHER INFORMATION

Management's Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements.

We are not required to, and we do not, express an opinion on this information. We compared this information for consistency with the FAA Financial Statements and discussed the methods of measurement and presentation with FAA officials. Based on this work, except for FY 2001 performance measures that were based on 2000 performance data (Part C of this report), we found no material inconsistencies with the FAA Financial Statements or nonconformance with OMB guidance.

E. PRIOR AUDIT COVERAGE

Our report on the FY 2000 Financial Statements expressed a qualified opinion because FAA was unsuccessful in implementing an integrated property accounting system, calculated depreciation expense and the net book value of its property, plant, and equipment using electronic spreadsheets outside the existing property system, and these amounts could not be substantiated. We made one recommendation that FAA implement a commercial, off-the-shelf, integrated property accounting system and maintain tight controls over input data. FAA plans to have its integrated property accounting system, to include interfacing with Delphi, completed in November 2002.

This report is intended for information and use by FAA, DOT, OMB, GAO, and Congress. This report is a matter of public record, and its distribution is not limited.

Kenneth M. Mead
Inspector General

Exhibit. Objectives, Scope, and Methodology

Our audit objectives for the FAA Financial Statements for FYs 2001 and 2000 were to determine whether: (1) principal FAA Financial Statements and accompanying notes are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; (2) FAA has adequate internal controls over financial reporting, including safeguarding assets; (3) FAA has complied with laws and regulations that could have a direct and material effect on the FAA Financial Statements or that have been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis is materially consistent with the information in the principal FAA Financial Statements; (5) internal controls ensured the existence and completeness of reported data supporting performance measures; and (6) supplementary and stewardship information is consistent with management representations and the FAA Financial Statements.

FAA is responsible for (1) preparing the FAA Financial Statements for FYs 2001 and 2000 in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of the Federal Managers' Financial Integrity Act are met; (3) ensuring that FAA's financial management systems substantially comply with FFMIA requirements; and (4) complying with applicable laws and regulations.

OIG is responsible for obtaining reasonable assurance about whether (1) the FAA Financial Statements for FYs 2001 and 2000 are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles and (2) management maintained effective internal controls. The objectives of these controls are:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and Governmentwide policies identified by OMB audit guidance.

OIG also is responsible for (1) obtaining sufficient understanding of internal controls over financial reporting and compliance to plan the audit, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and

(3) performing limited procedures with respect to certain other information appearing in the FAA Financial Statements for FYs 2001 and 2000.

To fulfill these responsibilities, we examined the amounts and disclosures in the financial statements; assessed accounting principles and estimates; evaluated internal controls; observed physical inventories; and evaluated the presentation of the financial statements. We reviewed the work performed by KPMG LLP on FAA property to determine whether the work was performed in accordance with U.S. generally accepted government auditing standards. We also examined the validity of financial transactions and interviewed financial management officials.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to FAA. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the FAA Financial Statements for FY 2001 ended September 30, 2001, and FY 2000 ended September 30, 2000. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. We also caution that our internal control testing may not be sufficient for other purposes.

We performed our work in accordance with U.S. generally accepted government auditing standards and OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.