2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Administrator, Federal Aviation Administration
Inspector General, U.S. Department of Transportation

We have audited the accompanying balance sheets of the Federal Aviation Administration (FAA) as of September 30, 2003 and 2002, and the related statements of net cost, changes in net position, financing, and budgetary resources for the years then ended (herein referred to as "financial statements"). The objectives of our audits were to express an opinion on the fair presentation of these financial statements.

In connection with our audits, we also considered the FAA's internal control over financial reporting and tested the FAA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the financial statements, we concluded that the FAA's financial statements as of, and for the years ended, September 30, 2003 and 2002, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

1. Controls over property, plant, and equipment
2. Process for estimating environmental liabilities
3. Information technology controls over FAA and third-party systems and applications

However, none of the reportable conditions are believed to be material weaknesses.

The results of our tests of compliance with certain provisions of laws and regulations disclosed instances of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin number 01-02, *Audit Requirements for Federal Financial Statements*.

1. *Federal Financial Management Improvement Act of 1996 (FFMIA)*
2. *Anti-Deficiency Act, as amended (ADA)*

The following sections discuss our opinion on the FAA's financial statements, our consideration of the FAA's internal control over financial reporting, our tests of the FAA's compliance with certain provisions of applicable laws and regulations, and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the FAA as of September 30, 2003 and 2002, and the related statements of net cost, changes in net position, financing, and budgetary resources for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FAA as of September 30, 2003 and 2002, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin number 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The Other Accompanying Information is presented for purposes of additional analysis, and also is not a required part of the fiscal year 2003 and 2002 financial statements. Such information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions 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 misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2003 audit, we noted certain matters, described in Exhibit 1, involving internal control over financial reporting and its operation that we consider to be reportable conditions. However, none of the reportable conditions are believed to be material weaknesses.

A summary of the status of prior year reportable conditions is included in Exhibit 2.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of the FAA in a separate letter.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report disclosed two instances of noncompliance with the laws and regulations that are

are required to be reported under *Government Auditing Standards* and OMB Bulletin number 01-02, and are described below.

1. *Federal Financial Management Improvement Act of 1996* (FFMIA)
2. *Anti-Deficiency Act*

The results of our tests of FFMIA disclosed instances, described in Exhibit 3, where the FAA's accounting system does not comply with the United States Standard General Ledger at the transaction level and Federal financial management system requirements, which call for a single, integrated financial system. The FAA has not fully implemented managerial cost accounting and its Statement of Net Cost does not present costs by strategic goal.

In addition, as discussed in Exhibit 3, we noted that certain transactions associated with the Aviation Insurance Revolving and Emergency Response Funds constituted violations of the Anti-Deficiency Act.

RESPONSIBILITIES

Management's Responsibilities

The *Government Management Reform Act of 1994* (GMRA) requires each federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the Department of Transportation in meeting GMRA reporting requirements, the FAA prepares annual financial statements.

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of the Management Discussion and Analysis (including the performance measures), the Required Supplementary Information, and Required Supplementary Stewardship Information, and
- Complying with laws and regulations, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal year 2003 and 2002 financial statements of the FAA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin Number 01-02. Those standards and OMB Bulletin Number 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and

- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2003 audit, we considered the FAA's internal control over financial reporting by obtaining an understanding of the FAA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin Number 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin Number 01-02, we considered the FAA's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the FAA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin Number 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the FAA's fiscal year 2003 financial statements are free of material misstatement, we performed tests of the FAA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin Number 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to the FAA. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin Number 01-02 and FFMIA, we are required to report whether the FAA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

DISTRIBUTION

This report is intended for the information and use of FAA's management, the Department of Transportation's Office of the Inspector General, OMB, the General Accounting Office, and the U.S. Congress, and is not intended to be, and should not be used by, anyone other than these specified parties.

KPMG LLP

December 5, 2003

REPORTABLE CONDITIONS

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

We consider the following to be reportable conditions.

1. Controls over Property, Plant, and Equipment

Condition

The FAA did not fully adhere to its policies and procedures designed to ensure that property, plant, and equipment (PP&E) is stated in accordance with accounting principles generally accepted in United States of America. We noted deficiencies in the following areas:

- *Non-Integrated Systems* – During FY 2003, the FAA's PP&E subsidiary ledger (Interim Fixed Asset System, or IFAS) was not integrated with the general ledger system (the Departmental Accounting and Financial Information System or DAFIS). As a result, property transactions must be entered separately from those entered into the general ledger accounting system. Transactions related to real property are entered directly into IFAS, but personal property (i.e., equipment) transactions are first entered into a legacy property management system and then transferred to IFAS. The lack of electronic interface between IFAS and the general ledger greatly increases the likelihood that the two systems will, from time-to-time, not agree due to a backlog of input to either system or errors that occur in entering the data. The initial transaction (disbursement or receipt related to a property transaction) is recorded in the general ledger system, however depreciation is computed from data in IFAS. If IFAS is not updated timely, the financial statements will not accurately reflect depreciation expense.

- *Additions and disposals* – The FAA does not have effective controls to prevent or detect errors when costs associated with Construction-in-Progress (CIP) assets are capitalized. Specifically, the FAA failed to detect a $49.6 million overstatement in the transfer of assets from DAFIS into IFAS by regional personnel. Further, regional personnel did not record property disposals in a timely manner. This situation affected the FAA's ability to produce accurate interim financial statements and management reports. It also resulted in a substantial effort to research property transactions to prepare an accurate trial balance at year-end. Also, several Office of Inspector General (OIG) reports have indicated that the FAA has inadequate management and oversight controls over cost-reimbursable contracts, which is one method that the FAA uses to acquire PP&E.

- *CIP transfers* – The FAA did not record all of its transfers of completed construction projects in a timely manner after the assets were placed in service. We noted that the primary reason for the delay is that responsible personnel in the regional offices are often focused on clearing older, completed CIP projects as there was little incentive to transfer costs for newly completed projects. This situation could result in an understatement of depreciation expense, which is not recognized until assets are capitalized in IFAS and an in-service date has been established. This situation has been a longstanding, recurring problem for the FAA that impacts financial management. However, the FAA implemented changes in its policies, which have significantly reduced the number of older, completed projects that had not been transferred to in-use assets.

- *Leases* – The FAA's controls were not fully effective in ensuring appropriate documentation is maintained to support the FAA real estate office's determination whether the lease is capital or operating. Also, the FAA does not have a central database or location for maintaining detailed lease information.

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- *Purchases of Non-CIP Assets* – The FAA does not have adequate controls to ensure purchases of non-CIP assets are recorded at the correct amount in IFAS. The FAA initially records the cost for the purchase of non-CIP assets in DAFIS and then subsequently enters the cost into IFAS. In one instance, FAA personnel recorded costs associated with a non-CIP asset at $2.2 million in IFAS although the actual recorded in DAFIS was only $22,000. This data entry error was not detected as the FAA did not have effective reviews over these transactions.

These discrepancies occurred principally because the FAA's property subsidiary system is not integrated with the general ledger system. In November 2003, the FAA implemented the Department of Transportation's new core accounting system, DELPHI, which has an integrated property subsidiary system.

Criteria

The Joint Financial Management Improvement Program's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and support managerial cost accounting. It further states that costs should be captured at the lowest level to reflect actual costs incurred by the agency in providing goods and services. The detail transactions should be timely recorded in subsidiary ledgers and interfaced or timely reconciled with the general ledger. Cost tracking should be sufficiently detailed to explain the change in account balances during any period of time.

OMB Circular Number A-123, *Management Accountability and Control*, states that transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

Statement of Federal Financial Accounting Standards (SFFAS) Number 6, *Accounting for Property, Plant and Equipment*, requires that constructed PP&E be recorded as construction work in progress until the asset is placed in service, at which time it is to be transferred to general PP&E, and depreciation expense should be taken over the estimated useful life of the asset.

Recommendations

We recommend that the FAA:

- Perform a FY 2003 yearend reconciliation of capitalized costs reported in the accounting system to those costs capitalized in IFAS.

- Reemphasize the need for regional accounting offices to follow procedures related to recording leases consistent with the determination made by the real estate office; and maintain appropriate supporting documentation.

- Give appropriate consideration to the effects on the timeliness, completeness, and accuracy of financial reporting as it takes corrective actions in response to the OIG's cited deficiencies related to management and oversight controls for cost-reimbursable contracts.

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2. Process for Estimating Environmental Liabilities

Condition

The FAA's estimate for environmental liabilities is comprised of two components – the costs to remediate known contaminated sites and the costs to cleanup and decommission active facilities at some future date. Within the FAA, there are different offices involved with developing and documenting the costs associated with these two components. The Environmental, Energy, and Safety Division (AFZ-800) is the primary office responsible for environmental remediation, and the Investment Analysis and Operations Research Division (ASD-400) is the primary office responsible for environmental cleanup and decommissioning. Together they compile a summary listing of estimated environmental cleanup liabilities, which is needed to produce timely, reliable financial statements.

Although the FAA made significant improvements in this area during the current year, the Investment Analysis and Operations Research Division does not have adequate policies and procedures to consistently and accurately determine the estimated liability for cleanup and decommissioning. Specifically, FAA personnel:

- Do not use actual cost information to help ensure the accuracy of the environmental clean-up and decommissioning cost model; and

- Do not have an effective process in place to ensure all facilities are included in the estimate for environmental clean-up and decommissioning. Specifically, 29 different types of facilities (a total of 1,480 facilities) were not included in the initial cost estimate.

Criteria

SFFAS Number 5, *Accounting for Liabilities of the Federal Government,* defines a liability as a probable future outflow or other sacrifice of resources as a result of past transactions or events. SFFAS Number 6 defines cleanup costs as the costs of removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated property, plant and equipment. Cleanup may include, but is not limited to, decontamination, decommissioning, site restoration, site monitoring, closure, and post closure costs. Federal Financial Accounting and Auditing Technical Release Number 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government,* states that an agency is responsible for recognizing a liability for government-related environmental cleanup costs resulting from past transactions or events when a future outflow or other sacrifice of resources is probable and can be reasonably estimated.

Recommendations

To improve the reliability of the environmental clean-up and decommissioning estimates, we recommend that the FAA:

- Establish a routine and systematic process for capturing actual cost data and incorporate this information into the cost models supporting the Environmental Cleanup and Decommissioning (EC&D) liability. Actual cost information should also be used to improve cost models by incorporating area cost factors and similar factors based upon site-specific considerations.

- Develop and implement a policy to ensure that all facility quantities and types are submitted as part of the EC&D liability and that submissions are reviewed by management for completeness.

(Continued)

3. Information Technology Controls over FAA and Third-party Systems and Applications

Condition

Certain general controls related to the FAA's primary financial applications owned by the FAA and the Department of Transportation need to be strengthened. Specifically, there were weaknesses in network information security management and host-based application security controls, including system level access issues, application level operational access controls for sensitive and critical functions, separation of duties, and change management. In addition, there were weaknesses in network and application controls.

As part of our audit, we tested general information technology controls over the following key systems that support FAA's financial transactions and reporting:

- Departmental Accounting and Financial Information System (DAFIS)
- Integrated Personnel and Payroll System (IPPS)
- Consolidated Uniform Payroll System (CUPS)
- Consolidated Personnel Management Information System (CPMIS)
- Interim Fixed Asset System (IFAS)
- Acquire
- Logistics Information System (LIS)

At the general support level, certain controls needed improvement related to system access and integrity issues for IFAS, and Acquire host based systems. Additionally, there were weaknesses in the areas of application operational access control for appropriate segregation of duties issues and application software development and change control for DAFIS, Acquire, IPPS, and IFAS. Due to the sensitive nature of these issues, we provided the detailed results of our review, along with specific recommendations, separately to management.

Criteria

Appendix III, OMB Circular Number A-130, *Management of Federal Information Resources*, requires Federal agencies to establish application security plans to assure that adequate security is provided for information collected, processed, transmitted, stored, or disseminated through the system.

National Institute of Standards and Technology (NIST) Special Publication Number 800-18, *Guide for Developing Security Plans for Information Technology Systems*, states the purpose of security plans are to provide an overview of the security requirements of the system and describe the controls in place or planned for meeting those requirements; and delineate responsibilities and expected behavior of all individuals who access the system.

Recommendation

We recommend that the FAA improve its information technology by implementing the specific recommendations previously provided.

Exhibit 2

STATUS OF PRIOR YEAR REPORTABLE CONDITIONS AND COMPLIANCE WITH LAWS AND REGULATIONS

Condition	As Reported at September 30, 2002	Status as of September 30, 2003
Process for Estimating Liabilities for Legal Matters	**Material Weakness:** The FAA did not have adequate controls to ensure that the basis for the estimated liability for legal matters pending against the FAA, both those recorded as liabilities and disclosed in the notes to the financial statements, were accurate.	**No longer deemed a reportable condition:** The FAA implemented procedures to resolve this issue.
Controls and Processes over Financial Reporting and Account Reconciliations	**Reportable Condition:** The FAA's financial statements initially produced by its financial reporting processes and systems required substantial review and adjustment in the post-closing process to produce materially correct financial statements.	**No longer deemed a reportable condition:** The FAA implemented procedures to resolve this issue.
Process for Estimating Environmental Liabilities	**Reportable Condition:** The FAA lacks adequate policies and procedures to consistently and accurately determine the estimated liability for financial statement purposes.	**Continue as a Reportable Condition:** Although improvements were made, weaknesses still remain over FAA's ability to produce accurate environmental liability estimates.
Accounting Methods and Controls over Field Spares	**Reportable Condition:** The FAA did not have adequate controls to ensure all recorded field spares existed and that all items on hand were recorded.	**No longer deemed a reportable condition:** The FAA implemented procedures to resolve this issue.
Controls over Property, Plant and Equipment	**Reportable Condition:** The FAA did not fully adhere to its policies and procedures designed to ensure that PP&E is stated in accordance with accounting principles generally accepted in United States of America.	**Continue as a Reportable Condition:** Although improvements were made, weaknesses still remain in FAA's controls over property, plant and equipment.
Technology Controls over Third-Party Systems and Applications	**Reportable Condition:** Certain general controls related to the FAA's primary financial applications owned by Department of Transportation (DOT) need to be strengthened.	**Continue as a Reportable Condition:** Although improvements were made, weaknesses still remain in FAA's information technology controls. Combined with Technology Controls over FAA Systems.
Technology Controls over FAA Systems	**Reportable Condition:** Certain general controls associated with key FAA-owned financial systems needed improvement.	**Continue as a Reportable Condition:** Although improvements were made, weaknesses still remain in FAA's information technology controls. Combined with Controls over Third-Party Systems and Applications.

COMPLIANCE WITH LAWS AND REGULATIONS

This section discusses instances of non-compliance with significant laws and regulations.

1. Federal Financial Management Improvement Act of 1996 (FFMIA)

Condition

The FAA was not in substantial compliance with FFMIA.

Discussion

During FY 2003, the FAA used the DOT's core accounting system, DAFIS, to process and record financial transactions. DAFIS does not comply with the United States Standard General Ledger (USSGL) at the transaction level and Federal financial management system requirements, which call for a single, integrated financial system. As reported last year, the FAA still has not fully implemented managerial cost accounting, however, progress was made during FY 2003. Also, the FAA's Statement of Net Cost does not breakout costs by strategic goal. The FAA converted to DOT's new core accounting system, DELPHI, during November 2003. DOT believes the new system processes transactions at the USSGL level, and meets Federal systems requirements.

Criteria

FFMIA requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the USSGL at the transaction level.

Recommendation

We recommend that the FAA work aggressively to implement the new DOT accounting system.

2. Anti-Deficiency Act

Condition

During FY 2003 the Chief Counsel's office determined that certain transactions associated with the Aviation Insurance Revolving and the Emergency Response Funds constituted violations of the Anti-Deficiency Act.

Discussion

For the Aviation Insurance Revolving Fund, the Chief Counsel's office noted that the following transactions constituted violations:

- Valid allotments were not established for FY 2003, thus all expenditures, which totaled approximately \$10.9 million, violated DOT and FAA regulations and therefore the Anti Deficiency Act (31 USC 1517).
- Payments of approximately \$10.0 million, made during FY 2003, exceeded the amount apportioned.
- An allotment made in late FY 2003 exceeded the amount apportioned.

(Continued)

In addition, the Chief Counsel determined that several payments made during the second half of FY 2002 may have been made after the authority to make such payments had expired. The Chief Counsel is continuing its review of these transactions.

For the Emergency Response Fund, the FAA obligated $1.3 million in September 2003, which was in excess of the FY 2003 allotment and the annual apportionment.

Both the Aviation Insurance Revolving and Emergency Response Funds involve a relatively small number of transactions. Also, the Emergency Response Fund is a special account related to the recovery from and response to terrorist attacks on the United States. FAA determined that the violations occurred due to a lack of communication and a lack of knowledge related to obtaining apportionments from the Office of Management and Budget and DOT and FAA regulations related to making allotments.

FAA reported the violations to the DOT and was in the process of reporting the violations to the President and the Congress as required by 31 USC 1517.

Criteria

31 USC 1517 states that an officer or an employee of the United States Government may not make or authorize an expenditure or obligation exceeding an apportionment or an amount permitted by regulations as specified by 31 USC 1514.

Recommendation

We recommend that the FAA provide training to personnel responsible for requesting apportionments and making allotments and strengthen controls to prevent further violations.