Federal Aviation Administration
Schedule of Property, Plant, and Equipment, Net
At September 30, 2001

And

Schedule of Real Property, Net
At September 30, 2000

KPMG

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 Schedules of Property, Plant, and Equipment (PP&E), Net, of the Federal Aviation Administration (FAA) at September 30, 2001 and Real Property, Net, at September 30, 2000 (herein after referred to as the Schedules). The objective of our audits was to express an opinion on the fair presentation of the Schedules. In connection with our audits, we also considered FAA's internal control over the financial reporting of PP&E and real property. We also tested FAA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on the Schedules.

SUMMARY

As stated in our opinions on the accompanying Schedules, we concluded that FAA's Schedules of PP&E, Net, at September 30, 2001 and Real Property, Net, at September 30, 2000, 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 condition being identified as a reportable condition:

Improve Policies and Procedures to Accurately Account for PP&E

We consider this reportable condition to be a material weakness.

The results of our tests of compliance with certain provisions of laws and regulations that could have a direct and material effect on the accompanying Schedules disclosed matters of non-compliance. Pursuant to the Federal Manager's Financial Integrity Act (FMFIA) of 1982, the Secretary of Transportation reported that the FAA property systems do not provide the data necessary for preparation of financial statements. Further, the property systems are not integrated with the accounting system, thus FAA is not in compliance with the Federal financial systems' requirements specified in the Federal Financial Management Improvement Act (FFMIA) of 1996. The foregoing material weakness in internal control is an indicator of non-compliance with the FFMIA provisions relating Federal accounting standards. Finally, FAA does not comply with the Standard General Ledger at the transaction level. We noted no other instances of noncompliance with the laws and regulations that are required to be reported under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin Number 01-02, *Audit Requirements for Federal Financial Statements*.

The following sections include our opinions on the accompanying Schedules; a discussion of our consideration of FAA's internal control over the financial reporting of PP&E and real property; the results of our tests of FAA's compliance with certain provisions of applicable laws and regulations; and a discussion of management's and our responsibilities.

OPINION ON THE SCHEDULES

We have audited the accompanying Schedules of FAA's PP&E, Net, at September 30, 2001 and Real Property, Net, at September 30, 2000. 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*, issued by the Comptroller General of the United States, 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 accompanying Schedules of PP&E and Real Property are free of material misstatement. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying Schedules presents fairly, in all material respects, the balance of FAA's PP&E, Net, at September 30, 2001 and FAA's Real Property, Net, at September 30, 2000, in conformity with accounting principles generally accepted in the United States of America.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered FAA's internal control over financial reporting of PP&E and real property by obtaining an understanding of 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 accompanying Schedules. 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* as they relate to the accompanying Schedules. 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 controls over financial reporting of PP&E and real property. Consequently, we do not provide an opinion on internal control over financial reporting of PP&E and real property.

Our consideration of internal control over the financial reporting of PP&E and real property 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 of PP&E and real property that, in our judgment, could adversely affect FAA's ability to record, process, summarize, and report PP&E and real property consistent with the assertions by management in the Schedules.

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 Schedules being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

We noted one matter involving internal control over financial reporting of PP&E and real property that we consider to be a reportable condition. We believe that this reportable condition, which is discussed below, is a material weakness.

Improve Policies and Procedures to Accurately Account for PP&E

Discussion

The FAA acquires and possesses significant amounts of both real and personal property to accomplish its mission. FAA's PP&E includes 3 major components: (1) real property, which includes land, buildings, and other structures, (2) personal property, and (3) construction-in-process.

Acquisition of FAA's PP&E ranges from a relatively simple process to an extremely complex one, in which it may take several years to develop, produce/construct, field, and place the PP&E into operation. With respect to the more complex acquisitions, generally, the responsible FAA program office awards a master or national contract for the acquisition and construction of PP&E and associated services, which may include support services from other contractors. FAA regional offices also award contracts for the acquisition and construction of PP&E and associated services. In addition, FAA also incurs in-house labor costs incidental to this activity. To capture these costs FAA establishes specific project codes, and accumulates the costs in work-in-process accounts. Each year FAA distributes costs allocable to PP&E that have been fielded and placed in service. This is referred to as the top-down process. Properly accounting for the costs of these PP&E items is a complex and challenging process.

Prior to FY 2001, FAA used legacy property management systems to record real and personal property items. These systems were not designed for financial reporting purposes and did not interface with the accounting system. To produce the information necessary for financial reporting, FAA had to electronically extract and analyze data recorded in these systems, and reconcile the data with information in the accounting system. This was a labor-intensive and error-prone process.

During FY 2001, FAA implemented a new property system, the Interim Fixed Asset System (IFAS), which was designed for financial reporting purposes. IFAS is not integrated with the accounting system. IFAS is designed with edit checks to detect errors during the data entry process. However, FAA continued to enter property transactions into the legacy systems and then electronically fed information to IFAS. FAA used the IFAS edit checks to identify potential errors before accepting the transactions from the legacy systems.

FAA intends to change the data entry process during FY 2002 so that real property transactions are entered into IFAS. However, personal property transactions will continue to be entered into the legacy system and transferred to IFAS. Direct entry of real property transactions into IFAS will result in earlier detection and correction of potential real property errors. During FY 2003, FAA plans to implement the Department of Transportation's new accounting system, Delphi, which contains an integrated property system.

The results of our audit tests disclosed that some recorded PP&E items did not exist or had not been correctly valued. Also, not all items in FAA's possession were recorded in the property system. Correcting the conditions that caused these errors is essential to ensuring that a material misstatement of the PP&E account in FAA's financial statements does not occur or is detected in a timely manner.

Condition

Our review of 1,132 real property, 406 personal property, and 303 work-in-process sample items disclosed the following:

- IFAS contained records for 82 items (56 real and 26 personal property items) that did not exist. The net book value for these items was $3.7 million.

- The acquisition date recorded in IFAS was incorrect for 56 items (40 real and 16 personal property items). Use of the correct date increased the net book value of these items by $3.0 million.

- The acquisition value recorded in IFAS for 24 items (18 real and 6 personal property items) was incorrect. Use of the correct acquisition value reduced the net book value by $10.1 million.

- The service (useful) life recorded in IFAS for 17 items (7 real and 10 personal property items) did not comply with established FAA policy. Use of the correct service life decreased net book value by $2.4 million.

- The accumulated depreciation entered into IFAS for 26 items (25 real and 1 personal property items) was incorrect. Calculating accumulated depreciation correctly increased net book value by $250,000.

- There were 28 real property items that had a combination of errors relating to the recorded acquisition value, date, and service life. Correcting these additional errors decreased net book value by $25.2 million.

- The cost of improvements made to 128 real property items was incorrectly depreciated over a 10-year service life instead of the remaining life of the item. Depreciating the cost over the remaining service life of the asset decreased net book value by $2.5 million.

- For 7 personal property items, costs allocated by the top down process was incorrect. Costs were incorrectly allocated to items that were either not in service, or were fully depreciated. Also, costs were allocated to an incorrect number of items. Correcting these errors decreased net book value by $2.7 million.

- For 5 work-in-process items, the recorded valued was understated by $37,000.

To correct these errors, FAA processed the following adjustments. FAA reduced (1) the $1.9 billion recorded net book value of FY 00 real property by $77.2 million; and (2) the $6.1 billion recorded net book value of FY 01 personal property by $60.8 million. FAA made adjustments for the 5 known errors related to the work-in-process account.

In addition to the discrepancies discussed above, we noted that the costs allocated under the top-down process to a specific type of computer system was incorrect. Several computer systems were not included in the top-down allocation, and at one location the components of the computer system were treated as separate computer systems. We also noted that approximately 800 highly specialized items were not recorded in IFAS. This occurred because the program office responsible for managing the items used a stand-alone database to account for these items instead of IFAS. FAA re-analyzed the allocation, adjusted the balances, and recorded the specialized items in IFAS.

Causes

The foregoing occurred because existing FAA policies and procedures do not address or do not correctly address the respective accounting issues. For example, existing policies do not

- require items to be promptly removed from IFAS upon disposal or retirement;
- address the type of documentation needed to support acquisition dates and value;
- describe how to account for items transferred between different organizations or those returned to the Mike Monroney Aeronautical Center (MMAC) for exchange and/or repair;
- correctly address how to account for improvements to existing PP&E items (improvements should be depreciated over the remaining service life of the item instead of the existing 10-year period);
- correctly address the date to begin depreciation; FAA policy states depreciation begins the year after the item is placed in service; and
- require the prompt processing of PP&E transactions; existing policy permits up to 6 months to process PP&E transactions.

Not all FAA personnel responsible for processing PP&E transactions that effect financial reporting fully understand the impact of the transactions they process. Also, there was insufficient oversight at the FAA headquarters and regional office levels over PP&E transactions that have a significant impact on financial reporting.

In addition, the current processes that FAA uses to budget and allocate funds, and manage and account for projects involving the acquisition of PP&E are extremely complex and contribute to problems noted above. Often, funding documents do not clearly identify the PP&E being acquired thus making the recording of items a difficult, labor-intensive, and error-prone process. Frequently there are multiple projects associated with the acquisition of a specific type of PP&E.

Further, many different FAA organizations are involved in the budgeting and fund allocation process and managing and accounting for projects involving the acquisition of PP&E. Within the regional offices and centers, there are multiple organizations (usually a finance or resource management office, a logistics office, and engineering personnel from the airway facilities office) involved in the processing of PP&E transactions.

Status of Prior-Year Recommendation

In conjunction with its audit of FAA's FY 1999 financial statements, the Office of Inspector General (OIG) issued a separate report on PP&E. In that report, the OIG recommended that FAA acquire a commercial, off-the-shelf, integrated property management system that is compatible with the Department of Transportation's new accounting system currently under development. FAA agreed with the recommendation and provided an incremental implementation plan.

In its report on the FAA's FY 2000 financial statements, the OIG reiterated its FY 1999 recommendation that FAA implement a commercial, off-the-shelf, integrated property management system. The OIG further recommended that FAA establish:

- tight controls over input data, validate the data, and maintain supporting documents for independent review and validation.
- a procedure within its property systems that financial information and acquisition dates cannot be changed without approval of the FAA Chief Financial Officer.

Although FAA implemented IFAS, the system as currently configured does not represent a fully integrated property system and consequently does not comply with Federal systems requirements Also, FAA continues to have deficiencies with its controls to ensure (1) the accuracy of input data, and (2) the sufficiency of supporting documentation. However, FAA did establish controls within IFAS to preclude changes to financial information and acquisition dates.

Recommendations

We recommend that FAA:

1. Develop a formal management oversight and evaluation process, at both the headquarters and regional office levels to:
   - review significant PP&E transactions, and
   - research and resolve discrepancies identified by exception reports.
2. Revise existing policies and procedures to:

- require that PP&E items be promptly removed from IFAS upon disposal, destruction, retirement, etc.;
- clearly identify the type of documentation that is acceptable to support the valuation and acquisition date for PP&E items;
- properly account for PP&E items that are transferred from one organization to another or sent to MMAC for exchange and/or repair;
- depreciate improvements over the remaining service life of the PP&E item;
- begin depreciation at the time the PP&E item is placed into service; and
- require that all PP&E transactions be recorded at the time they occur.

3. Evaluate the alignment and composition of financial management resources for optimizing the property management function.

4. Develop a comprehensive training program for all personnel that process PP&E transactions.

5. Determine if the current process used to budget and allocate funds and manage and account for projects involving the acquisition of PP&E can be improved by performing a comprehensive process analysis.

6. Ensure that financial and property systems are fully integrated and have adequate financial controls.

Management Response

The Assistant Administrator for Financial Services/CFO agreed with our comments and recommendations.

COMPLIANCE WITH LAWS AND REGULATIONS

As part of obtaining reasonable assurance about whether the Schedules are free of material misstatement, we performed tests of FAA's compliance with provisions of applicable laws and regulations specified in OMB Bulletin Number 01-02, including FFMIA, noncompliance with which could have a direct and material effect on the determination of amounts presented in the accompanying Schedules. We limited our tests of compliance to the foregoing provisions applicable to the Schedules, and we did not test compliance with all laws and regulations applicable to 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.

The results of our tests of compliance with provisions of the aforementioned laws and regulations disclosed instances of noncompliance that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin Number 01-02.

Under OMB Bulletin Number 01-02 and FFMIA, we are required to report whether FAA's financial management systems for PP&E and real property 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.

The results of our tests applicable to the Schedules disclosed instances, described below, where FAA does not substantially comply with FFMIA.

<u>Financial Management Systems Requirements</u>

Pursuant to FMFIA, the Secretary of Transportation reported that the FAA property systems do not provide the data necessary for preparation of financial statements. Further, the property systems are not integrated with the accounting system, thus FAA is not in compliance with the Federal financial systems' requirements specified in FFMIA.

<u>Federal Accounting Standards</u>

FAA is required to prepare its Schedules in accordance with Federal accounting standards. As discussed in the section of this report entitled "Internal Control over Financial Reporting," we identified a material weakness that affected FAA's ability to prepare its Schedules and related disclosures in accordance with Federal accounting standards. The foregoing material weakness in internal control is also an indicator of non-compliance with FFMIA provisions relating to Federal accounting standards.

<u>Standard General Ledger</u>

FAA does not comply with the Standard General Ledger at the transaction level.

The results of our tests of compliance with the provision of laws and regulations that could have a direct and material effect on the accompanying Schedules disclosed no further instances of noncompliance with the laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin Number 01-02.

RESPONSIBILITIES

Management's Responsibility

The Government Management Reform Act (GMRA) of 1994 requires federal agency's 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 meet the GMRA reporting requirements, FAA prepares annual financial statements.

With respect to the accompanying Schedules of PP&E, Net and Real Property, Net, management is responsible for:

- preparing the Schedules in conformity with accounting principles generally accepted in the United States of America;

- establishing and maintaining internal controls over financial reporting of PP&E and real property; and

- complying with laws and regulations.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibility

Our responsibility is to express an opinion on the Schedules based on our audit. An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the Schedules;

- Assessing the accounting principles used and significant estimates made by management; and

- Evaluating the overall presentation of the Schedules.

DISTRIBUTION

This report is intended for the information and use of FAA's management, the management of the Department of Transportation, the Department of Transportation's OIG, OMB 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

February 8, 2002

Federal Aviation Administration
Schedule of Property, Plant, and Equipment, Net
At September 30, 2001

	(Dollars in Thousands)
Property, Plant, and Equipment, Net	$11,726,534

The accompanying notes are an integral part of this Schedule.

Federal Aviation Administration
Schedule of Real Property, Net
At September 30, 2000

	(Dollars in Thousands)
Real Property, Net	$1,829,437

The accompanying notes are an integral part of this Schedule.

Federal Aviation Administration
Notes to the Schedules of
Property, Plant, and Equipment, Net
At September 30, 2001
and
Real Property, Net
At September 30, 2000

1. Significant Accounting Policies

A. Reporting Entity

The Federal Aviation Administration (FAA), a component of the U.S. Department of Transportation, is responsible for operating the Nation's air traffic control system and regulating aviation safety and security. FAA is responsible for providing U.S. air travelers with an efficient, safe, secure, and technically advanced airspace system. In carrying out its mission, FAA acquires both real and personal property.

B. Basis of Presentation

The Schedule of PP&E, Net, reports the amount of property and equipment owned by the FAA at September 30, 2001, net of accumulated depreciation. The Schedule of Real Property, Net, reports the amount of real property owned by the FAA at September 30, 2000, net of accumulated depreciation. FAA has prepared the Schedules in accordance with the applicable provisions of Office of Management and Budget Bulletin Number 01-09, *Form and Content of Agency Financial Statements*.

C. Basis of Accounting

The Schedules of PP&E, Net, and Real Property, Net, are presented in accordance with accounting principles generally accepted in the United States of America.

D. Capitalization Threshold and Depreciation Policy

FAA capitalizes acquisitions of real and personal property if its costs exceed $25,000 and has a useful life exceeding two years. The FAA reports general PP&E at original acquisition cost.

FAA calculates depreciation expense using the straight-line method. No depreciation expense is recognized on an asset during the fiscal year it is put in service.

FAA recognizes a full year's depreciation during the asset's final year of use. Except for aircraft, FAA does not recognize a residual value. FAA uses 25 percent of the aircraft's acquisition cost as the residual value.

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FAA adopted its current depreciation policy in FY 1998. The useful life classifications are as follows:

Asset Classification - Real Property	Useful Life (years)
Offices, buildings, warehouse buildings, residential properties, air traffic control towers, and enroute air traffic control centers	40
Mobile homes	20
Original roads, sidewalks, parking lots, and all other structures	15
Capital improvements, facility modifications, leasehold improvements (or expiration of the lease, whichever comes first)	10*
Asset Classification - Personal Property	
Aircraft	20
Navigation/landing equipment, including electronic and visual navigational aids	20
Surveillance equipment, including surveillance radars, radar transmitters, and radar receivers	20
Weather-related equipment, including general purpose weather sensors, weather radars, radar transmitters, and radar receivers	15-20
Communications-related equipment, including voice switches, air-ground radios, and microwave network	10-20
Decision support systems, including computer operating systems, FAA developed hardware, mainframe and mini computers, high-end workstations, and displays	4-20
Printing, photographic, and projection equipment	13
Portable and installed communications equipment excluding air navigation and air traffic control facilities, and avionics equipment	10
Office furniture and equipment	7
Vehicles and automatic data processing equipment	5
Software	3

*Depreciated over the remaining life of the "parent" asset; if the parent asset is fully depreciated, then the useful life of improvement or modification is considered to be 10 years.

E. Change in Accounting Principle

Effective October 1, 2000, the FAA adopted the provision of the Statement of Federal Financial Accounting Standards (SFFAS) Number 10, *Accounting for Internal Use Software*. Pursuant to this standard, the FAA capitalizes the cost of internal use software on a prospective basis. Previously, the FAA expensed

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the cost of internal use software at the time of acquisition in accordance with SFFAS Number 6, *Accounting for Property, Plant, and Equipment*.

2. PP&E, Net, At September 30, 2001

(Dollars in Thousands)

Class of Fixed Asset	Depreciation Method	Service Life	Acquisition Value	Accumulated Depreciation	Net Book Value FY 2001
Land	None	None	$ 86,294	$ 0	$ 86,294
Buildings & Structures	SL	15-40	3,192,205	<1,549,181>	1,643,024
Leasehold Improvements	SL	*	22,195	<3,807>	18,388
Aircraft	SL	20	456,253	<206,584>	249,669
ADP Software	SL	3	30,592	<7,775>	22,817
Internal Use Software in Development	None	None	54,823	0	54,823
Equipment	SL	5-20	10,687,768	<4,271,735>	6,416,033
Assets Under Capital Lease	SL	Term-40	110,432	<38,769>	71,663
Construction in Progress	None	None	3,163,823	0	3,163,823
Property Not in Use	-	-	966	<966>	0
Totals			$ 17,805,351	$<6,078,817>	$ 11,726,534

*The lesser of the remaining life of the "parent" asset or 10 years.

3. Real Property, Net, At September 30, 2000

(Dollars in Thousands)

Class of Fixed Asset	Depreciation Method	Service Life	Acquisition Value	Accumulated Depreciation	Net Book Value FY 2000
Land	None	None	$ 84,422	$ 0	$ 84,422
Buildings & Structures	SL	15-40	3,186,331	<1,468,396>	1,717,396
Leasehold Improvements	SL	*	27,619	0	27,619
Totals			$3,298,372	$<1,468,396>	$1,829,437

*The lesser of the remaining life of the "parent" asset or 10 years.