Memorandum

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

Subject: INFORMATION: Report on Fiscal Year 1998 Financial Statements, Federal Aviation Administration FE-1999-070

Date: March 8, 1999

From: Kenneth M. Mead
Inspector General

Reply To Attn Of: Meche:x61496

To: The Secretary
Thru: The Deputy Secretary

I respectfully submit the Office of Inspector General (OIG) report on the Federal Aviation Administration (FAA) Financial Statements for the Fiscal Year (FY) 1998 ended September 30, 1998. This report is required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

The audit report is the responsibility of the OIG. All other information--including the Management Discussion and Analysis, Financial Statements, Notes, and Supplemental Information--is the responsibility of FAA. Our audit was limited to the Financial Statements as of, and for the year ended, September 30, 1998.

Our efforts this year focused on actions taken on five previously reported material weaknesses that included real property (land, buildings, and structures), personal property (equipment), work-in-process, accounting for field spares, and inventory valuation. FAA also prepared, for the first time, and we audited the Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing.

During FY 1998, FAA completed significant corrective actions on its inventory. FAA revised inventory prices from standard cost to weighted average cost and performed a "wall to wall" inventory of spare parts at over 800 field units. As a result, FAA improved the accountability and overall management of its spare part inventories located throughout the country. FAA is establishing a perpetual accounting system for the field spares to correct its control weaknesses.

Real property, personal property, and work-in-process, reported at $11.9 billion, still could not be substantiated. We were unable to substantiate the acquisition cost of real property reported at $2.5 billion. For 117 real property items valued at

$790 million, we found 41 items recorded at $419 million were not properly valued; 34 items recorded at $141 million could not be supported; and 4 items valued at $50 million should be removed from property records. For example, a critical power system installed in 1992 was reported at $20 million. FAA was only able to provide contracts, purchase orders, payment records, and other support for $3.6 million. We also identified a building that was demolished over 10 years ago was still on FAA's records at $1 million.

A comparison of contracts for new equipment to personal property records showed FAA's equipment account was understated by at least $1 billion. The understatement of these assets primarily resulted from improper expensing of capital costs. For example, the voice switching control systems installed at 23 locations were recorded at $234 million, instead of the true cost of $1.1 billion. Unless FAA establishes supportable values for its substantial property investments, it will be unable to accurately compute depreciation and recoup its full cost through user fees.

FAA was unable to provide supporting cost documentation to substantiate the $2.1 billion recorded in the work-in-process account. As property is acquired and buildings are constructed for specific projects, associated costs are charged to, and accumulated in, a work-in-process account until projects are completed and systems are placed in service. FAA estimates there was $1.3 billion of completed projects in backlog as of September 30, 1998. For example, FAA completed construction of an air navigation facility in 1995 at a cost of $746,000. As of December 31, 1998, the facility remained in the work-in-process account. This backlog causes an understatement of depreciation expenses.

We also reviewed 185 projects from 7,345 active projects in the work-in-process account, and found 34 percent did not have transaction histories. Without transaction histories, recorded amounts cannot be traced to supporting documentation, such as invoices or contracts. For example, FAA spent $1.2 million on a flight service station during FY 1998. FAA could only provide transaction histories for costs of $123,000, leaving $1.1 million unsupported. As a result, we were unable to substantiate the accumulated costs for active projects.

FAA agrees property weaknesses exist, and initiated plans to correct these material weaknesses by September 30, 1999. We agree with FAA's corrective action plans, and we are closely monitoring resolution of the property issues.

We encountered problems with the new statements required for FY 1998. The presentation of the Statement of Net Cost by each FAA line of business was a giant step towards development of cost accounting information that would relate to operational data supporting performance measures. However, the Statement of Net Cost could not be substantiated because of delays in implementation of the cost

accounting system which led to the late completion of the statement. Since the system was in the development stage, we did not determine if expense transactions were charged to correct cost centers, whether total expenses charged to costs centers were accurately accumulated to the six lines of business, and whether administrative overhead expenses were accurately distributed.

We also could not substantiate material items on the Statement of Budgetary Resources and Statement of Changes in Net Position. The Statement of Financing showed an $877 million unexplained difference between the Statement of Budgetary Resources and Statement of Net Cost.

Correction of these material weaknesses will improve FAA's accountability and financial credibility, and provide accurate financial data to support budget requests, management decisions, and user fees.

FAA also is required to include excise tax revenues (revenues) in its Financial Statements. However, the Department of Treasury (Treasury) has control over collecting and reporting of revenues for the Airport and Airway Trust Fund. Last year, we asked the General Accounting Office (GAO) to review Treasury procedures for estimating and certifying revenues. GAO found errors and internal control weaknesses related to reporting and certifying total government excise tax revenues, and estimated these revenues were potentially overstated by as much as $571 million.

For FY 1998, we again asked GAO to review the Treasury's Office of Tax Analysis (OTA) estimating process and the Internal Revenue Service (IRS) quarterly certification process. GAO concluded internal control weaknesses still exist. Major weaknesses included IRS written procedures for certifying revenues and timely processing of tax returns. We again found significant variances between OTA estimates and IRS-certified revenues. For the five quarters ended June 1998, variances between estimated and actual revenues ranged from an understatement of $598 million to an overstatement of $276 million. This Treasury issue is totally outside the control of FAA and the Department of Transportation (DOT).

Because we could not determine the reliability of significant portions of the Financial Statements, we are unable to express, and we do not express, an opinion (commonly called a disclaimer of opinion) on the FAA Financial Statements as of, and for the year ended, September 30, 1998.

We identified three other significant issues. Although these issues are important, they would not necessarily prevent FAA from receiving an unqualified audit opinion.

- The National Civil Aviation Review Commission called for strong financial controls, including a reliable cost accounting system by October 1998, so that FAA could manage its resources in a businesslike manner, and allocate its cost correctly and fairly as the basis for a cost-based user fee system. FAA still lacks the detailed and reliable cost data to accurately distribute its cost. The FAA cost accounting system was scheduled to be operational by October 1, 1998, but will not be fully implemented until March 31, 2001. Consequently, FAA may not be able to realize the $1.5 billion in user fees proposed in its FY 2000 budget.

- FAA was not in compliance with the Federal Financial Management Improvement Act of 1996 because the Department's accounting system was not used to prepare the Financial Statements, and the accounting system was not the only source of financial information. FAA made 349 closing and adjusting entries, totaling $51 billion, outside the accounting system to prepare the Financial Statements.

- The performance measures presented in the Management Discussion and Analysis did not provide information about the cost effectiveness of FAA programs, and did not relate to the information presented in the Statement of Net Cost. Only two of the nine performance measures included FY 1998 performance data.

Our report on the FY 1997 FAA Financial Statements disclosed efforts were in process to complete corrective action on 21 prior recommendations. We are not making new recommendations this year because efforts are still underway on 17 recommendations. Since problems with the new statements and trust fund revenues are common to FAA and other DOT Operating Administrations, recommendations addressing these issues will be made in our report on the DOT Consolidated Financial Statements.

A draft of this report was provided to the FAA Assistant Administrator for Financial Services on February 24, 1999. We considered his comments in preparing this report. He agreed with the issues, and said FAA expects to have all corrective actions completed by September 30, 1999.

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

Attachments

TABLE OF CONTENTS

TRANSMITTAL MEMORANDUM

SECTION I: INDEPENDENT REPORT ON THE FEDERAL AVIATION ADMINISTRATION FINANCIAL STATEMENTS I-1

A. Disclaimer of Opinion on Financial Statements I-2

B. Report on Internal Control Structure I-2

C. Report on Compliance with Laws and Regulations I-10

D. Prior Audit Coverage I-12

SECTION II: FINANCIAL STATEMENTS

Consolidated Balance Sheet II-1

Consolidated Statement of Net Cost II-2

Consolidated Statement of Changes in Net Position II-3

Combined Statement of Budgetary Resources II-4

Combined Statement of Financing II-5

Notes to the Financial Statements II-6

SECTION III: SUPPLEMENTAL INFORMATION

Management Discussion and Analysis III-1

Required Supplementary Stewardship Information III-17

Supplemental Information III-21

DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT REPORT ON
FEDERAL AVIATION ADMINISTRATION
FISCAL YEAR 1998 FINANCIAL STATEMENTS

To the Federal Aviation Administrator

The Department of Transportation (DOT), Office of Inspector General (OIG), audited the Federal Aviation Administration (FAA) Financial Statements as of, and for the year ended, September 30, 1998. We were unable to express an opinion on the Financial Statements because we could not substantiate the acquisition value for property, plant, and equipment reported at $11.9 billion. The Statement of Net Cost could not be substantiated because of delays in the implementation of the cost accounting system which led to the late completion of the statement. We also could not substantiate material items on the Statement of Budgetary Resources and Statement of Changes in Net Position. The Statement of Financing showed there was an $877 million unexplained difference between the Statement of Budgetary Resources and the Statement of Net Cost.

We also are reporting on internal accounting and administrative control systems, and compliance with laws and regulations, as applicable to the FAA Financial Statements. We performed the audit in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 98-08, Audit Requirements for Federal Financial Statements, as amended on January 25, 1999.

Our audit objectives for the FY 1998 Financial Statements were to determine whether (1) the principal Financial Statements are presented fairly in accordance with OMB Bulletin 97-01 as amended on November 20, 1998; (2) FAA has an adequate internal accounting and administrative control structure; (3) FAA has complied with laws and regulations which (a) could have a direct and material effect on the Financial Statements or (b) have been specified by OMB; (4) the information and manner of presentation in the Management Discussion and Analysis is materially consistent with the information in the Financial Statements; and (5) the internal control structure ensured the existence and completeness of reported data supporting performance measures.

This report presents our disclaimer of opinion on the FAA Financial Statements as of, and for the year ended, September 30, 1998. The financial information in the Management Discussion and Analysis and Supplemental Information was materially consistent with the Financial Statements. We are including our reports on the internal control structure, and compliance with laws and regulations, in Sections B and C of this report.

A. DISCLAIMER OF OPINION ON FINANCIAL STATEMENTS

Property, plant, and equipment, reported at $11.9 billion on the Balance Sheet, could not be substantiated. We were able to determine that personal property (equipment) is significantly understated. The Statement of Net Cost could not be substantiated because of delays in the implementation of the cost accounting system which led to the late completion of the statement. Consequently, we did not determine if expense transactions were charged to correct cost centers, whether total expenses charged to costs centers were accurately accumulated, and whether administrative overhead expenses were accurately distributed. The understatement of equipment, and the backlog in the work-in-process account, cause an understatement of depreciation expense on the Statement of Net Cost.

We also could not substantiate material items on the Statement of Budgetary Resources such as Unobligated Balance ($7.2 billion), and Statement of Changes in Net Position such as Increase (Decrease) in Unexpended Appropriations ($380 million). We again found significant variances between the Department of Treasury estimated and certified excise tax revenues for the Airport and Airway Trust Fund. The Statement of Financing showed there was an $877 million unexplained difference between the Statement of Budgetary Resources and the Statement of Net Cost.

Because we could not determine the reliability of significant portions of the Financial Statements, we are unable to express, and we do not express, an opinion on the FAA Financial Statements as of, and for the year ended, September 30, 1998.

B. REPORT ON INTERNAL CONTROL STRUCTURE

While the purpose of our work was not to express, and we do not express, an opinion on internal controls, we found material internal control weaknesses that contributed to reportable conditions. Our work would not necessarily disclose all material internal control weaknesses.

MATERIAL WEAKNESSES

The following sections describe material weaknesses we identified, and their effect on the Financial Statements and management of FAA operations. The financial statement weaknesses were reported to OMB and Congress as part of the Department's reporting under the Federal Managers' Financial Integrity Act.

Accounting for Property, Plant, and Equipment

Real Property

We were unable to substantiate the acquisition cost of real property (land, buildings, and structures) reported at $2.5 billion. Improvements continue to be needed in the accuracy and reliability of real property records. The FAA Real Property Record System includes property that is not valued correctly or whose stated value is not supported. We also found unrecorded property during our site visits. As of April 30, 1998, real property records contained 11,132 property items, recorded at $25,000 or greater. We sampled 117 items with a recorded value of $790 million and found:

- 41 items, recorded at $419 million, were not properly valued,
- 34 items, recorded at $141 million, could not be supported, and
- 4 items, valued at $50 million, should be removed from property records.

For example, a critical power system installed in 1992 was reported at $20 million. FAA was only able to provide contracts, purchase orders, payment records, and other support for $3.6 million. In another example, a building demolished over 10 years ago was still on FAA's records at $1 million.

We also identified 52 items, owned by FAA, that were not recorded in the Real Property Record System. FAA could not provide documentation to support the value of these items.

Personal Property

FAA recognizes the reported $4.1 billion acquisition value for its personal property (equipment) is materially understated as disclosed in Note 9 to its Financial Statements. The understatement of equipment is the result of years of expensing contract costs, associated with bringing equipment into operational status, that should have been added (capitalized) to the asset value. We have preliminarily identified that the value for five of the most costly equipment systems, currently in operation, needs to be increased by at least $1 billion. For example, the voice switching control systems installed at 23 locations were recorded at a total cost of $234 million, instead of the true cost of $1.1 billion. Unless FAA establishes supportable values for its substantial property investments, it will be unable to accurately compute depreciation and recoup its full cost through user fees. The exact amount of the undervaluation for the five systems, and other less expensive systems, is unknown at this time. As a result,

personal property and its related accumulated depreciation are understated on the Balance Sheet, and depreciation expense is understated on the Statement of Net Cost.

Work-in-Process

FAA was unable to provide supporting cost documentation to substantiate the $2.1 billion recorded in the work-in-process account. As property is acquired and buildings are constructed for specific projects, associated costs are charged to, and accumulated in, a work-in-process account until the projects are completed and systems are placed in service. When completed, the project costs should be transferred to the appropriate real or personal property accounts. Project costs are considered backlog if not removed from the work-in-process account within 6 months after project completion. FAA estimates there was $1.3 billion in backlog as of September 30, 1998.

We statistically sampled 185 projects from 7,345 active work-in-process projects with accumulated costs estimated at $887 million. We were unable to obtain transaction histories on 34 percent of the projects. Without transaction histories, recorded amounts cannot be traced to supporting documentation, such as invoices or contracts. For example, FAA spent $1.2 million on a flight service station during FY 1998. FAA could only provide transaction histories for costs of $123,000, leaving $1.1 million unsupported. As a result, we were unable to substantiate the accumulated costs for active projects.

The remaining $1.3 billion of accumulated project costs, determined by FAA as backlog, also could materially affect the Financial Statements. Depreciation of assets begins only when completed projects are transferred to the appropriate asset account (real or personal property). For example, FAA completed construction of an air navigation facility in 1995 at a cost of $746,000. As of December 31, 1998, the facility remained in the work-in-process account. Consequently, the backlog in the work-in-process account causes an understatement of depreciation expenses on the Statement of Net Cost. For a sample of 251 backlog projects, we found unrecorded depreciation was at least $62 million.

The Departmental Accounting and Financial Information System (DAFIS) does not provide detailed information and audit trails to trace transactions to source documents to support the work-in-process balance. Instead, FAA relies on a cost report that has two major deficiencies. The report captures costs which are expensed, and therefore should not be recorded in the work-in-process account. The report also contains costs associated with completed work that should be recorded in the personal or real property accounts. In our report on the FY 1996 Financial Statements, we recommended the cost report be reconciled to summary

account records, or a new database be created to support the work-in-process balance. FAA elected to reconcile the cost report to the work-in-process balance. Over the past 2 years, FAA has been unable to demonstrate that the cost report can be reconciled to the work-in-process balance. FAA has agreed to improve the work-in-process database.

Capitalization Process

FAA does not have an effective process for accumulating costs for acquiring property, and eventually recording these costs in the appropriate real and personal property accounts. This process is commonly referred to as the capitalization process. The most recent study of the capitalization process was conducted by an independent public accounting firm under contract to FAA. The study found FAA Regional Offices were not performing timely closeout of facilities and equipment projects, leaving projects open and accumulated costs in regional work-in-process accounts. The study included 89 recommendations. FAA has implemented some recommendations, but has no comprehensive plan in place to monitor corrective actions taken, to evaluate the impact on the capitalization process, or to evaluate other recommendations to automate this labor-intensive process. FAA has agreed to form a process improvement team to streamline capitalization procedures.

Corrective Action Plans on Property

Elimination of these material weaknesses in its property accounts is essential if FAA is to obtain an unqualified opinion on its FY 1999 Financial Statements. FAA agrees the material weaknesses exist, and has initiated corrective actions. Plans are developed to correct the real property, personal property, and work-in-process weaknesses by September 30, 1999. We agree with the corrective action plans, and we are closely monitoring the work to ensure resolution of issues with property, plant, and equipment.

Cost Accounting Information

The Statement of Net Cost is one of the new Financial Statements required by OMB Bulletin 97-01 for FY 1998. According to the Managerial Cost Accounting Implementation Guide, issued by the Joint Financial Management Improvement Program, the Statement of Net Cost is pertinent to reporting performance results, and provides financial information that can be related to outputs and outcomes of an entity's programs and activities. According to OMB Bulletin 97-01, an entity should report performance measures that provide information about the cost effectiveness of programs, and should be linked to the programs featured in the Statement of Net Cost.

The Federal Aviation Reauthorization Act of 1996 required FAA to establish a cost accounting system. The FAA cost accounting system was to be fully operational by October 1, 1998. However, as of March 1, 1999, the FAA cost accounting system is not expected to be fully operational for all lines of business until March 31, 2001.

FAA decided to present the Statement of Net Cost by its six lines of business. This was a giant step towards development of cost accounting information that relates to operational data supporting performance measures. However, the Statement of Net Cost could not be substantiated because of delays in implementation of the cost accounting system which led to late completion of the statement.

DAFIS does not perform cost accounting, the Department's Financial Statements Module does not produce the Statement of Net Cost, and the FAA cost accounting system was not operational. Although operating costs were distributed among the six lines of business, the statement did not present operating cost for major programs and activities under each line of business. Therefore, the Statement of Net Cost did not relate to the performance measures presented in the Management Discussion and Analysis.

The Statement of Net Cost included an accumulation of expenses for each line of business using an analysis of over one million expense transactions charged to about 9,000 cost centers by the FAA cost accounting system, which was still under development. Consquently, we did not determine if expense transactions were charged to correct cost centers, and whether total expenses charged to cost centers were accurately accumulated to the six lines of business.

Administrative overhead expenses were manually distributed to the six lines of business. After we questioned the basis for distribution of these costs, FAA manually re-distributed nearly $1.3 billion, increasing costs for Air Traffic Services and reducing costs for the five other lines of business by $647 million. We did not determine if the administrative overhead expenses were accurately distributed to the lines of business because of the unavailability of the cost accounting system to test distribution of costs.

Using statistical sampling techniques, we estimated FAA overstated current year expenses for airport grants by $146 million. This overstatement represented prior year grant expenses that were not presented to FAA for payment until FY 1998. For example, on May 20, 1998, the City and County of Denver requested reimbursement of expenses totaling $30 million for the Denver International Airport, for January 1992 through December 1995. While these expenses were for prior periods, they were reported on the Statement of Net Cost as expenses of

FY 1998. Since the statement is to show cost components for the current reporting period, these expenses were distorting costs for the Airports line of business. FAA was aware of this problem and made the correct adjustment. Unless FAA establishes a process to estimate and report grant expenses at yearend, the Statement of Net Cost will continue to misstate current costs for Airports.

As discussed earlier, FAA continues to have property accounting weaknesses that impact the Statement of Net Cost. The understatement of equipment, and the backlog in work-in-process, cause an understatement of depreciation expense on the Statement of Net Cost.

Budgetary Accounting Information

Three of the new statements for FY 1998 are dependent on budgetary accounting information. The Statement of Budgetary Resources provides information about how budgetary resources were made available, as well as their status at yearend. The Statement of Changes in Net Position reports the beginning net position, the items which caused net position to change, ending net position, and reports on appropriations used as a financing source. The Statement of Financing is a reconciliation of the budgetary information in the Statement of Budgetary Resources and the operating expense information in the Statement of Net Cost. The reconciliation ensures there is a proper relationship between financial and budgetary accounts in the entity's financial management system.

FAA made the following disclosure in Footnote 24, Statement of Budgetary Resources Disclosures,

> In an effort to accurately reflect the status of budgetary resources, FAA compiled data from the SF-132, Apportionment, and Reapportionment Schedule, and the SF-133, Report on Budget Execution, to prepare the Statement of Budgetary Resources. Some of the budgetary account balances from the (DAFIS) general ledger were not accurate or were incomplete because the processes to record specific transactions were not available in the accounting system.

Consequently, the Department's accounting system was not the source of the budgetary accounting information reported in the Financial Statements.

We could not substantiate material items on the Statement of Budgetary Resources, such as Unobligated Balance ($7.2 billion), and Statement of Changes in Net Position, such as Increase (Decrease) in Unexpended Appropriations ($380 million). The Statement of Financing showed there was an $877 million unexplained difference between the Statement of Budgetary Resources and the

Statement of Net Cost. FAA stated this discrepancy was identified during the reconciliation of the two statements, but could not provide any other information. Therefore, FAA was unable to determine if there was a proper relationship between its financial and budgetary records.

FAA is aware of these budgetary accounting issues, and has hired an independent contractor to assist in correcting them. We support this effort and will work with FAA and the contractor to correct this weakness.

Excise Tax Revenues

FAA is required to include excise tax revenues (revenues) in its Financial Statements. However, the Department of Treasury (Treasury) has control over collecting and reporting of revenues for FAA. The Internal Revenue Service (IRS) collects revenues and makes daily deposits into the General Fund of the United States (General Fund). Upon receipt, IRS cannot differentiate between revenues for the Airport and Airway Trust Fund (AATF) and other government trust funds. IRS places these funds in a "holding" account until tax returns are filed, usually several months later. IRS then uses tax returns to certify the amount of revenues that should have been distributed to the AATF.

Congress, recognizing that trust funds cannot wait months for revenues, directed the Secretary of the Treasury to make monthly transfers, based on estimated revenues, from the General Fund to the appropriate trust funds. Within Treasury, the Office of Tax Analysis (OTA) makes these monthly estimates, and the Bureau of Public Debt transfers estimated amounts to the AATF. Estimates are adjusted later based on actual tax returns.

Last year, we asked GAO to review the Treasury procedures for estimating and certifying revenues. The GAO contractor was unable to complete the review of the estimating process, and terminated its work because information on how estimates were made was not available. GAO also found errors and internal control weaknesses related to reporting and certifying of total government excise tax revenues, and estimated these revenues were potentially overstated by as much as $571 million.

For FY 1998, we again asked GAO to review the OTA estimating process and the IRS quarterly certification process. GAO concluded internal control weaknesses still exist. Major weaknesses included IRS written procedures for certifying revenues and timely processing of tax returns.

We again found significant variances between OTA estimates and IRS-certified revenues. For the five quarters ended June 1998, variances between estimated and

actual revenues ranged from an understatement of $598 million to an overstatement of $276 million. Details follow:

Quarter Ending	OTA Estimate (Thousands)	IRS Certification (Thousands)	Difference (Thousands)
June 1997	$1,433,442	$1,533,890	$(100,448)
September 1997	1,829,463	1,722,851	106,612
December 1997	2,016,322	1,980,573	35,749
March 1998	1,778,504	1,502,650	275,854
June 1998	2,212,434	2,810,497	(598,063)

During this year's audit, GAO found internal control weaknesses. For example, the December 1997 certification was understated by $57 million because IRS omitted collections for aviation gas from its certification. IRS subsequently made adjustments and corrected the error in December 1998.

In the past, the transfer of revenues, based on estimates, to the AATF exceeded aviation tax revenues. On January 1, 1996, legislation authorizing collection of aviation taxes lapsed. The Small Business Job Protection Act of 1996 reinstated the aviation taxes from August 27 to December 31, 1996. Revenues were transferred to the AATF during this period, although airlines were not making deposits. Excess transfers totaled $1.2 billion. Legislation was needed to avoid a shortfall in the AATF, and allow the trust fund to retain the $1.2 billion.

Considering the internal control weaknesses, and the Treasury's past performance, one additional area causes concern. The AATF receives about nine percent of excise tax revenues collected by IRS. As of September 30, 1998, the IRS "holding" account has a $9.2 billion balance awaiting the receipt of tax returns. If tax returns are not filed or otherwise matched to receipts, the money remains in the General Fund. We were concerned that this "holding" account might contain revenues for the AATF. At our request, GAO asked IRS to age this account. As of February 26, 1999, IRS had not responded.

OTA also has noticed a consistent residual amount of about $1 billion annually in the "holding" account with no liability to trust funds. This "holding" account could contain revenues for the AATF.

C. REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Our objective was not to express, and we do not express, an opinion on overall compliance with laws and regulations. Our work would not necessarily disclose all material noncompliance.

Federal Financial Management Improvement Act of 1996

The Federal Financial Management Improvement Act of 1996 requires auditors to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, the government's standard general ledger at the transaction level, and Federal Financial Management Systems Requirements issued by the Joint Financial Management Improvement Program. FAA continues to be in noncompliance because (1) property, plant, and equipment amounts presented on the Balance Sheet were inaccurate and not supported by financial records, (2) DAFIS was not used for preparation of the Financial Statements, and (3) a cost accounting system had not been implemented.

Acquisition value of property and equipment could not be substantiated. For example, FAA was unable to provide supporting cost documentation to substantiate the $2.1 billion recorded in the work-in-process account. Personal property reported at $4.1 billion was materially understated. We also were unable to substantiate real property reported at $2.5 billion.

DAFIS was not the only source of financial information used to prepare the FAA Financial Statements. OMB implementation guidance states that to be in substantial compliance with the Federal Financial Management Systems Requirements, the "agency core financial system, supported by other systems containing detail data summarized in the core financial system, is the source of information used in the preparation of the annual financial statements. . . ." Because the core accounting system did not contain the most current financial information, FAA made 349 closing and adjusting entries, totaling $51 billion, outside DAFIS to prepare the Financial Statements. The 349 entries were recorded in the Financial Statement Module, a tool used to generate the Financial Statements. These adjustments, at a minimum, should be recorded in DAFIS at the summary level. However, FAA could not record these adjustments in DAFIS because FY 1998 records were closed within 5 days after yearend. DAFIS also did not account for Appropriations Used activity and was not in compliance with the Standard General Ledger. These issues will be addressed in the new Departmental accounting system currently expected to be fully operational by June 2001.

Federal Financial Accounting Standards Number 4 requires all Federal departments to have the capability in place, beginning in FY 1998, to meet requirements of the managerial cost accounting standards. Cost accounting is needed in the Federal Government to provide reliable and timely information on the full cost of Federal programs. The National Civil Aviation Review Commission called for strong financial controls, including a reliable cost

accounting system for FAA by October 1998, so that FAA could manage its resources in a businesslike manner, and allocate its cost correctly and fairly as the basis for a cost-based user fee system. FAA still lacks the detailed and reliable cost data to accurately distribute operating cost. The FAA cost accounting system was scheduled to be operational by October 1, 1998, but will not be implemented in all lines of business until March 31, 2001. Consequently, FAA may not be able to realize the $1.5 billion in user fees proposed in its FY 2000 budget.

Performance Data

Under OMB Bulletin 98-08, our responsibility was to obtain an understanding of internal controls relating to the existence and completion of performance data. The nine performance measures presented by FAA in the Management Discussion and Analysis were consistent with the measures under development by FAA as part of its implementation of the Government Performance and Results Act. The performance measures also complied with requirements of OMB Bulletin 97-01 to report performance measures consistent with goals and objectives in the agency's strategic plan.

OMB Bulletin 97-01 also requires entities to strive to develop performance measures that provide information about cost effectiveness of programs, and link to the programs presented in the Statement of Net Cost. However, as we reported in our finding on Cost Accounting Information, FAA did not accumulate or report costs by major program under each line of business, or provide information about the cost effectiveness of FAA programs. Furthermore, the performance measures did not relate to the information presented in the Statement of Net Cost. The cost accounting information, needed to link the performance measures with the Statement of Net Cost and provide information on cost effectiveness of FAA's programs, was not available because the FAA cost accounting system was still under development.

The performance measures also were not based on current performance data. While only two of the nine performance measures were based on FY 1998 operational data, five were based on 1997 data, one was based on 1996 data, and one was based on 1995 data. For example, FAA presented a performance goal of reducing the number of residents exposed to significant aircraft noise by 60 percent. However, statistics were only presented through 1995, so current performance could not be evaluated. Five of the nine measures relied on data from sources outside the Department. Consequently, we could not determine if the data were complete.

As part of our Financial Statement audit, we did not test the validity or accuracy of the performance data. This will be accomplished as part of selected program

audits during FY 1999. The Department is in process of implementing a comprehensive system to control the quality of performance data. Without timely and complete data, FAA will be unable to compare performance results with current year financial data.

D. PRIOR AUDIT COVERAGE

The OIG has issued audit reports on the FAA Financial Statements for the past 6 years. The FYs 1992 and 1993 audits were limited to the Airport and Airway Trust Fund. The subsequent audits included all FAA funding and activities, but were limited to the Statements of Financial Position (Balance Sheet). The FY 1996 audit report included 35 recommendations to strengthen internal controls and establish the correctness of financial statement balances. The FY 1997 audit report stated efforts were still in process to complete corrective action on 21 recommendations. Efforts are still underway to complete action on 17 of our prior recommendations.

Since our report on the FY 1997 Financial Statements was issued, we issued five financial-related audit reports, three of which related to FAA inventory issues. The reports on inventory were:

Replenishing Logistics Center Inventory, Report Number FE-1998-136, dated May 15, 1998.

Valuation of Logistics Center Inventory, Report Number FE-1998-202, dated September 10, 1998.

Inventory of Field Spare Parts, Report Number FE-1998-209, dated September 29, 1998.

On July 6, 1998, in Report Number FE-1998-167, we reported that while FAA established automated fund control systems to track reprogramming of appropriated funding, FAA (1) exceeded Congressionally established internal reprogramming thresholds in FY 1997 for three budget line items by $8.7 million, (2) processed reprogramming actions in FYs 1997 and 1998 that resulted in "assessments," (3) charged at least $2 million to the wrong appropriation during FYs 1997 and 1998, and (4) permitted employees to work during FY 1998 on a program that did not receive FY 1998 funding.

On August 10, 1998, in Report Number FE-1998-186, we reported FAA needed to address four system design issues, potentially involving billions of dollars of transactions, in the development of its cost accounting system. We reported that FAA had not decided how to allocate facilities and equipment costs to operating

facilities throughout FAA. We also reported that much work needed to be done to meet the very ambitious goal of having a fully operational cost accounting system by March 31, 1999.

This report is intended for the information of FAA and DOT management. However, this report is a matter of public record, and its distribution is not limited.

Kenneth M. Mead
Inspector General