Memorandum

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

Subject: INFORMATION: Report on Fiscal Year 1999 Financial Statements, FAA FE-2000-060

Date: February 29, 2000

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) 1999 ended September 30, 1999. 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.

This report presents our unqualified opinion on the FAA Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing as of, and for the year ended, September 30, 1999.

To assist us, the Department of the Treasury (Treasury) OIG audited the schedule of assets and liabilities, and the related schedule of activity for the FAA accounts (referred to as the Corpus account) administered by the Treasury Bureau of Public Debt. The Treasury OIG issued an unqualified opinion on these FY 1999 schedules. The General Accounting Office performed agreed-upon procedures on the tax revenue receipts at the Internal Revenue Service and distributions to the Airport and Airway Trust Fund, and identified no material discrepancies.

During FY 1999, FAA overcame major problems with its financial records by hiring additional contractors, detailing employees, and using extensive overtime and compensatory time. As a result, FAA was able to provide sufficient evidence supporting all material lines on the FY 1999 FAA Financial Statements.

FAA needs to make financial management system improvements. If such improvements are not made, FAA will have to continue the same type of extraordinary, expensive, and labor-intensive efforts in the future. Such efforts are not sustainable for the long term and unnecessarily expend significant amounts of resources to maintain accurate records, which should routinely be produced by the accounting systems.

We identified five areas involving weaknesses in internal controls and compliance with laws and regulations. While these issues are important, they did not affect our audit opinion.

- FAA was able to support the cost in its property, plant, and equipment accounts by using alternative procedures and labor-intensive methods. These procedures and methods included preparing an electronic spreadsheet from multiple sources to compute depreciation for about 30,000 property items, manually researching and creating documentation files supporting $1.5 billion in cost for about 20,000 backlogged job orders in work-in-process, and performing detailed manual searches of expense transactions back to 1982 to identify personal property costs. In a separate report, we recommended that FAA acquire a commercial, off-the-shelf, integrated property management system. FAA agreed.

- FAA had not established procedures to fully estimate and accrue liabilities, thereby underestimating goods and services received by grantees at yearend. As a result, both liabilities and expenses would have been understated by about $103 million. FAA made appropriate adjustments on its FY 1999 Financial Statements. This issue is common to FAA and other Department of Transportation (DOT) Operating Administrations. Therefore, we will address this departmentwide issue in our report on the FY 1999 DOT Consolidated Financial Statements.

- During FY 1999, FAA revised its estimate of environmental and disposal liabilities from $3.2 to $1.3 billion. The $1.9 billion reduction was necessary because FAA used unsupported budget information and occupational safety and health environmental compliance costs that had nothing to do with cleanup or disposal liabilities. FAA also decided to retain certain facilities that previously had been identified for decommissioning, so no liability needed to be reported. We will address this departmentwide issue in our report on the FY 1999 DOT Consolidated Financial Statements.

- The performance measures presented in the Management Discussion and Analysis did not provide information about the cost effectiveness of programs, and did not relate to the Statement of Net Cost. The nine performance measures were based on 1998 rather than 1999 performance data. None of the measures was linked to the cost of achieving targeted results. This departmentwide issue will be addressed in our report on the FY 1999 DOT Consolidated Financial Statements.

- FAA was not in compliance with the Federal Financial Management Improvement Act of 1996 because liabilities were not fully accrued at yearend, the Department's accounting system and FAA's property systems did not provide all data for the FAA Financial Statements, and a managerial cost accounting system was not implemented. The Department plans to have a compliant system operational by June 30, 2001. FAA plans to have its cost accounting system ready in FY 2002. Because corrective actions are ongoing, we are making no recommendations.

A draft of this report was provided to the FAA Chief Financial Officer on February 25, 2000. She agreed with the report.

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

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DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT
ON THE FEDERAL AVIATION ADMINISTRATION
FISCAL YEAR 1999 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, 1999. In our opinion, the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing were fairly presented, in all material respects, in conformance with Generally Accepted Accounting Principles.

We also are reporting on internal controls and compliance with laws and regulations applicable to the Fiscal Year (FY) 1999 FAA Financial Statements. We performed audit work in the FAA Headquarters offices; its nine regional offices; the Mike Monroney Aeronautical Center; and the William J. Hughes Technical Center. We examined the validity of financial transactions and interviewed financial management officials. We examined, on a test basis, evidence supporting the amounts and disclosures in the FAA Financial Statements. We assessed the accounting principles and estimates used by management. We evaluated the overall presentation of 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.

Our audit objectives for the FY 1999 FAA Financial Statements were to determine whether (1) the principal FAA Financial Statements are presented fairly, in all material respects, in conformance with Generally Accepted Accounting Principles; (2) FAA has adequate internal controls over financial reporting, including the safeguarding of assets; (3) FAA has complied with laws and regulations that could have a direct and material effect on the FAA Financial Statements or have been specified by OMB; (4) the financial information in the Management Discussion and Analysis is materially consistent with the information in the principal FAA Financial Statements; (5) the internal control structure ensured the existence and completeness of reported data supporting performance measures; and (6) FAA stewardship information is consistent with management representations and the FAA Financial Statements.

Except for performance measures, which were based on 1998 performance data (Part C of this report), the financial information in the Management Discussion and Analysis

was materially consistent with the FY 1999 FAA Financial Statements. The FAA stewardship information was consistent with management representations and the FAA Financial Statements.

We are including our reports on the internal control structure, and compliance with laws and regulations, in Parts B and C of this report.

A. OPINION ON FINANCIAL STATEMENTS

In our opinion, the Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, Statement of Budgetary Resources, and Statement of Financing as of, and for the year ended, September 30, 1999, were fairly presented, in all material respects, in conformance with Generally Accepted Accounting Principles.

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 internal control weaknesses that contributed to reportable conditions. Our work was limited to applicable internal controls designed to ensure reliable financial reporting, including the safeguarding of assets against loss from unauthorized use. We obtained an understanding of the design of the internal controls, determined whether the controls have been placed in operation, assessed control risk relevant to the assertions embodied in the Financial Statements, and performed tests of the internal controls. Because of inherent limitations in any internal control structure, misstatements and losses may occur and not be detected.

MATERIAL WEAKNESS

The following section describes a material weakness we identified and its impact on the FAA Financial Statements and management of FAA operations. The financial statement weaknesses were reported to The President and Congress on December 29, 1999, as part of the Department's report required by the Federal Managers' Financial Integrity Act of 1982.

Property Systems

FAA was able to provide sufficient evidence supporting the cost in its property, plant, and equipment accounts as of September 30, 1999, by using alternative procedures and labor-intensive methods. However, these manual and labor-intensive methods are expensive, are prone to errors, mistakes, and inaccuracies, and cannot be sustained. The existing FAA property systems were not designed as an integrated system to accurately account for property costs and to compute depreciation. The lack of sufficient controls over a $10.8 billion account represents a material internal control weakness. We recommended in Report FE-2000-058 that FAA acquire a commercial,

off-the-shelf, integrated property management system. FAA agreed with our recommendation.

REPORTABLE CONDITIONS

The following sections describe reportable conditions we identified and discuss their effect on the FAA Financial Statements and management of FAA operations.

Accrual of Liabilities to Grantees

Statement of Federal Financial Accounting Standard Number 1 requires agencies to recognize a liability for unpaid goods and services that have been accepted at yearend. Goods and services are accepted and paid by grantees, and subsequently reimbursed by FAA. Invoices for goods and services that are not available when financial statements are prepared should be estimated for financial statement purposes. The intent of accruing liabilities at yearend is to properly report liabilities and expenses in the appropriate accounting period.

FAA had not established procedures to fully accrue liabilities at yearend. During FY 1999, FAA estimated and accrued liabilities of $53 million for goods and services received by grantees at yearend. We tested the estimate and found it did not include all goods and services that had been accepted but not yet billed to FAA. As a result, both liabilities and expenses would have been understated on the Balance Sheet and Statement of Net Cost by about $103 million. FAA revised the estimate and appropriately reported liabilities on the Balance Sheet and expenses on the Statement of Net Cost as of September 30, 1999. FAA also adjusted liabilities that were underestimated prior to FY 1999.

Environmental and Disposal Liabilities

DOT guidelines, implementing Statement of Federal Financial Accounting Standards 5 and 6, state that for any known or identified environmental liability, the Operating Administrations will include on the Financial Statements the estimated cleanup cost if the liability is probable and can be reasonably estimated. When management decides to dispose of, or decommission, existing assets, it should identify the associated environmental cleanup and/or disposal costs. In its FY 1998 Financial Statements, FAA reported environmental and disposal liabilities at $3.2 billion.

We examined the $3.2 billion estimate and found it was based on unsupported budget information, and included occupational safety and health environmental compliance costs that had nothing to do with cleanup or disposal liabilities. FAA agreed its estimate needed to be revised.

During FY 1999, FAA reviewed the environmental liability account and its estimating procedures. As a result of this work, FAA reduced its environmental and disposal liabilities from $3.2 billion to $1.3 billion as of September 30, 1999.

We examined the validity of FAA's actions. We found the $1.9 billion reduction included $723 million for environmental remediation because FAA changed its estimating procedures to use actual costs associated with known cleanup sites rather than unsupported budget estimates. A total of $515 million of cost was eliminated for occupational safety and health environmental compliance because these costs had nothing to do with cleanup or disposal liabilities. The remaining $690 million reduction in liability occurred because FAA decided it would have to retain certain facilities that previously had been identified for decommissioning, so no liability needed to be reported.

Based on our detailed testing work, in our opinion the $1.3 billion reported by FAA for environmental and disposal liabilities is fair and reasonable as of September 30, 1999.

C. REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Our objective was not to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to selected provisions of laws and regulations that would have a direct and material effect on the FAA Financial Statements or have been specified by OMB, and would not necessarily disclose all material noncompliances.

Performance Data

Under OMB Bulletin 98-08, our responsibility is to obtain an understanding of internal controls relating to the existence and completeness of performance data. FAA is responsible for establishing and maintaining adequate internal controls. The FY 1999 DOT Performance Plan contained 70 performance measures, of which 9 were in the FY 1999 FAA Financial Statements. The presentation complied with requirements of OMB Bulletin 97-01 to report performance measures consistent with goals and objectives from agencies' strategic plans.

Linking to the Statement of Net Cost and Measuring Cost-Effectiveness

OMB Bulletin 97-01 states:

> Entities should strive to develop and report objective measures that . . . provide information about the cost effectiveness of programs. The reported measures . . . should be linked to the programs featured in the Statement of Net Cost.

FAA did not have systems in place to allocate costs by major program. Consequently, the performance measures could not be linked to the Statement of Net Cost. For

example, one FAA measure is to maintain at least 93 percent of runways in good or fair condition. FAA did not report the FY 1999 cost data for this measure.

The performance measures presented in the FAA Financial Statements did not provide information about cost-effectiveness. None of the measures was linked to the cost of achieving targeted results, or to the Statement of Net Cost. For example, one FAA measure is to decrease the number of people exposed to significant aircraft noise in the United States. FAA did not report the FY 1999 cost data for decreasing aircraft noise.

The Departmental Accounting and Financial Information System (DAFIS) does not have the capability to track program costs. However, DOT is in the process of replacing DAFIS, and plans to have the new accounting system in full operation by June 30, 2001. FAA also is developing a separate cost accounting system. FAA plans to have its cost accounting system fully operational by FY 2002.

Internal Control Environment

We performed various procedures to assess the internal control environment relating to performance data. While our review disclosed no material internal control weaknesses, we were not required to, and we did not, test the validity or accuracy of performance data as part of the FAA Financial Statement audit. FAA is facing a significant management challenge to ensure its data are complete. FAA is relying on third party organizations outside the Federal Government for some of its performance data, which are coming from external sources such as commercial airlines and airports.

Although not part of the Financial Statement audits, the OIG began performing audits during FY 1999 addressing performance measures and data. More of these audits will be accomplished as part of selected program audits. For example, one of our FY 1999 performance audits found FAA had not implemented controls to ensure the accuracy and completeness of runway incursion data. The runway incursion performance measure is one of the nine performance measures in the FY 1999 FAA Financial Statements. FAA has a goal to reduce runway incursions from 325 in calendar year 1998 to 241 in calendar year 2001. We found investigative reports of runway incursions were not being prepared and forwarded by field offices within the required timeframe to enable FAA Headquarters to validate the incident as a runway incursion.

The Department is in the process of implementing a system to further enhance the quality of all performance data.

Federal Financial Management Improvement Act of 1996

The Federal Financial Management Improvement Act (FFMIA) of 1996 requires auditors to report whether agencies' financial management systems comply substantially with Federal financial management system requirements, Federal

accounting standards, and the Government's standard general ledger at the transaction level. FAA was not in compliance because liabilities were not fully accrued at yearend, DAFIS and the FAA property systems did not provide the data necessary for preparation of the FAA Financial Statements, and a managerial cost accounting system had not been implemented. FAA made 324 adjustments totaling $29 billion outside DAFIS to prepare the Financial Statements. These adjustments were recorded in the financial statements module, a tool used to prepare the annual financial statements, but were not recorded or retained in DAFIS.

On December 29, 1999, the Secretary of Transportation reported that the Department was not in substantial compliance with FFMIA because the existing core accounting system was not the primary source of information used for preparation of Financial Statements. The Secretary also reported the Department had not fully implemented the requirements of Managerial Cost Accounting Standards, because the Department's accounting system did not have the capability to capture cost by program. The Department is working to correct these conditions by June 30, 2001, when a new, commercial off-the-shelf, FFMIA compliant, accounting system is planned to be fully implemented. FAA also is developing its own cost accounting system which is scheduled to be fully operational by FY 2002.

D. PRIOR AUDIT COVERAGE

OIG has been auditing FAA Financial Statements since FY 1992. Our FY 1996 audit report included 35 recommendations to strengthen internal controls and improve accounting procedures. Our FY 1998 audit report stated corrective actions were still underway on 17 recommendations. During FY 1999, FAA completed action on all of our prior recommendations.

Since our report on the FY 1998 FAA Financial Statements, we issued six financial-related reports. The reports were:

- On May 5, 1999, in Report FE-1999-096, we found DOT accurately reported its non-tax delinquent debt of $148 million for FY 1997.

- On May 20, 1999, in Report FE-1999-103, we identified computer security weaknesses in FAA's administration of systems used to support DOT financial applications. We recommended that FAA identify and cancel user accounts for contractors and DOT employees who no longer work for DOT, certify all database users, restrict access to a certain program only to security representatives, and determine whether four vulnerable programs should be disabled or modified. FAA agreed and took corrective actions.

- On August 4, 1999, in Report FE-1999-119, we reported the FAA labor system for facilities and equipment projects provided adequate support for accumulating estimates of labor costs for financial statement reporting purposes.

- On September 27, 1999, in Report FE-1999-131, we identified $672 million of recorded obligations departmentwide that no longer represented valid financial liabilities. We recommended a departmentwide policy requiring at least annual reviews of inactive obligations. On December 28, 1999, the Department issued a policy for annual reviews of obligations. FAA either deobligated or reprogrammed a total of $255 million to other active projects.

- On December 17, 1999, in Report FE-2000-024, we found improvements were needed in the FAA cost accounting system and procedures used to estimate overflight costs. We recommended that FAA use FY 1999 cost data, update its labor standards as a short-term improvement, and establish a labor distribution system. FAA agreed and is taking corrective actions.

- On February 28, 2000, in Report FE-2000-058, we reported that FAA made an extraordinary and labor-intensive effort to overcome accounting and financial system weaknesses with its property accounts during FY 1999. Although FAA was able to provide sufficient evidence supporting the cost of its property, plant, and equipment as of September 30, 1999, FAA's existing property systems were not producing the data for the financial statement, representing a material internal control weakness. We recommended that FAA acquire a commercial, off-the-shelf, integrated property management system. FAA agreed with the recommendation.

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

Kenneth M. Mead
Inspector General