
Office of Inspector General

Audit Report

Fiscal Year 1997 Financial Statements

Federal Aviation Administration

Report Number: FE-1998-098

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Memorandum

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

Subject: **INFORMATION: Report on Fiscal Year 1997**
Financial Statements, Federal Aviation Administration
Report Number: FE-1998-098

Date:

Reply To

Attn Of: **Meche:x61496**

From: **Kenneth M. Mead**
Inspector General *K.M. Mead*

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) 1997 ended September 30, 1997. 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, 1997.

During the last year, FAA worked hard to address deficiencies in its financial operations, but more needs to be accomplished. FAA must continue to aggressively work on completing corrective actions on 21 of the 35 recommendations in our prior report on the FY 1996 Financial Statements (see exhibit). Correction of these deficiencies is essential if FAA is to move to a Performance Based Organization, focused on establishing a reliable cost accounting system and eventually providing services paid directly by user fees, as recommended by the National Civil Aviation Review Commission.

The Commission called for strong financial controls, including a reliable cost accounting system by October 1998, so that FAA can manage its resources in a businesslike manner, and allocate its cost correctly and fairly as the basis for a cost-based user fee system. We are reviewing FAA's new cost accounting system, currently under development, and we will address our observations on the new cost accounting system in a separate report to be issued later. However, until the financial control issues discussed in this report are resolved and FAA receives an

unqualified (clean) opinion on its financial statements, FAA's new cost accounting system will not produce accurate, and defensible, cost data.

Noteworthy accomplishments during FY 1997 included: FAA capitalized \$2.6 billion in equipment purchase cost that previously had been erroneously expensed, tested the existence of \$1.2 billion of real property (buildings, land, and structures), completed a comprehensive physical inventory of its Logistics Center, and reconciled budget information reported to the Department of Treasury (Treasury) with account balances in the Department's accounting system.

FAA corrective actions on its inventory resulted in \$90 million of funds put to better use. FAA's physical inventory of its Logistics Center identified \$35 million of inventory that was not previously recorded on accountable records. FAA also conducted a physical inventory at 129 field locations, resulting in the identification of \$39 million of inventory that was put on accountable records. Consequently, FAA may be able to avoid placing new orders for inventory totaling \$74 million. FAA also identified \$98 million in excess and obsolete inventory, which it intends to dispose of, and will save \$16 million a year in holding cost.

Although significant progress had been made, major deficiencies still exist. The most significant issue, and the one most likely to prevent FAA from receiving a clean audit opinion, concerns its property and inventory reported at \$12.4 billion. We could not substantiate the existence and valuation of property and inventory because FAA had not:

- Conducted a comprehensive physical inventory of its property. FAA's "validation" of its property was limited to \$4 billion of the \$11.6 billion reported on the FY 1997 Financial Statements. FAA's validation process was inadequate. For example, FAA "validated" equipment totaling \$2.8 billion with a computer match of two different files. This approach only determined the equipment was recorded on both records, but did not verify its actual existence or value. Comprehensive inventories are needed to establish accountability for safeguarding the Government's assets, and establishing accurate property records.
- Addressed the value of its property recorded in the Financial Statements at \$11.6 billion. FAA's "validation" process did not include a review of recorded property values. Supporting property values is an enormous task for FAA because much of its property is old, and records supporting historical cost do not exist, or at best, are difficult to locate. We also found the recorded value of FAA property was wrong in some cases. For example, FAA records included a

partial value of \$28.5 million for an air traffic control tower. The tower should have been valued at \$43 million. Unless FAA can establish a supportable value for its substantial property investments, it will be unable to accurately compute depreciation, which is a new requirement for FY 1998. Without a proper basis to calculate depreciation, the annual depreciation expenses, which will be used to produce cost-based user fees, will not be defensible.

- Completed a comprehensive physical inventory of spare parts at field locations, or maintained up-to-date records to account for these parts. FAA conducted a physical inventory at only 129 of 871 field sites. Based on our observations and analyses, we could only rely on the inventory results supporting \$52 million of the \$325 million reported for field spares. As a result, requests for funds may not be approved since FAA cannot defend how much it has or needs, unnecessary purchases may be made, and inventory may be overstocked or inadequately safeguarded. The shortage of, or inability to locate, essential parts could result in repair delays for critical FAA equipment.

Internal control weaknesses at Treasury also could affect tax revenues and investments reported at \$4.2 billion and \$6.4 billion, respectively, for the Airport and Airway Trust Fund. Our comparison of certified revenues to quarterly estimates for eight quarters (September 1995 to June 1997) found variances ranging from an understatement of \$219 million to an overstatement of \$62 million.

In the past, the transfer of revenues, based on estimates, to the Airport and Airway Trust Fund exceeded the amount of aviation tax revenues. On January 1, 1996, legislation authorizing collection of aviation taxes lapsed, but was subsequently reinstated for the period August 27 to December 31, 1996. During this time, estimated revenues were transferred to the trust fund even though the airlines were not making deposits. Excess transfers totaled \$1.2 billion. Legislation was needed to avoid a shortfall in the Airport and Airway Trust Fund, and allow the trust fund to retain the \$1.2 billion.

This Treasury issue is outside the control of FAA and the Department of Transportation (DOT), but has a material impact on FAA's Financial Statements. Since tax revenues affect four DOT trust funds, we will address the Treasury issue and corrective actions in our report on DOT's FY 1997 Consolidated Financial Statements.

As a result of FAA's continuing problems with property and inventory, and the Treasury issue, we were unable to express, and we do not express an opinion (commonly called a disclaimer of opinion) on the fairness and reasonableness of the FAA Financial Statements.

We identified two other significant issues:

- FAA was not in compliance with the Federal Financial Management Improvement Act of 1996 because (1) the Department's accounting system was not the only source of financial information, resulting in 532 adjusting entries outside the Department's system, to prepare the financial statements, (2) property and inventory amounts were not adequately supported by financial records, and (3) Year 2000 computer issues were not timely identified and assessed during FY 1997. FAA is now proceeding with a clear sense of urgency to address and resolve Year 2000 problems.
- FAA may not be aware of the potential existence of relationships with related parties. On February 3, 1998, the Office of Government Ethics recommended immediate corrective actions concerning the FAA financial disclosure systems. FAA has initiated corrective actions, has made significant progress, and will report on actions it has taken by April 6, 1998.

This report does not contain any new recommendations for FAA. Recommendations concerning issues common to FAA and other DOT Operating Administrations will be included in our report on DOT's FY 1997 Consolidated Financial Statements.

We appreciate the cooperation and assistance of DOT and FAA representatives. If we can answer any questions or be of any further assistance, please feel free to call me on 61959, or John Meche on 61496.

Attachments

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***Status of Corrective Actions on FAA's
FY 1996 Financial Statement Audit***

	Actions Completed	Actions In Process*
Operating Materials and Supplies		
Perform a Wall-to-Wall Physical Inventory at Logistics Center	✓	
Perform Annual Physical Inventory of Field Spares		✓
Revise Process Guide 4650.19 to Comply with DOT Policy on Inventory		✓
Implement Physical Inventory Recommendations Made in FY 1993 Report		✓
Record Unit Prices at Historical Cost and Maintain Support For Price Changes		✓
Identify Excess, Obsolete, and Unserviceable Items and Initiate Disposal Action		✓
Establish Subsidiary Records to Account for Operating Materials and Supplies and Ensure Balances are Disclosed in Financial Statements		✓
Reconcile General Ledger Account Balances to Subsidiary Records and Ensure Adequate Audit Trail	✓	
Capitalization of Equipment Purchases Costs		
Implement Contractor's Recommendations on Progress Payments, Common Costs, and Contract Line Item Numbers		✓
Include Equipment Purchased Under Interagency Agreements in the Procedures		✓
Ensure all Key Personnel Receive Training on Capitalizing Equipment Costs		✓
Implement Procedures to Ensure Purchase Orders and Contracts Identify Property & Equipment, Common Costs, Materials & Supplies, Field Spares, and Expenses		✓
Review Facilities and Equipment Transactions Expensed for FYs 1995 and 1996 and Capitalize the Appropriate Amounts	✓	
Property and Equipment		
Conduct Physical Inventory of Real Property and Adjust Property Records		✓
Comply with FAA Order 2700.31 to Reconcile Real Property Accounts to Subsidiary Records		✓
Ensure Subsidiary Records are Adjusted Timely		✓
Implement Contractor's Recommendations on the Personal Property System		✓
Require Regional Managers to Furnish Support for the Value of Personal Property	✓	
Retain Documentation for the Personal Property System	✓	
Discontinue Practice of Recording Property and Equipment as Facility Equipment in the Personal Property System	✓	

*For the Actions In Process, FAA has initiated, but not completed, corrective actions on these recommendations.

***Status of Corrective Actions on FAA's
FY 1996 Financial Statement Audit***

	Actions Completed	Actions In Process
Work-In-Process		
Implement Contractor's Recommendations to Improve Work-in-Process		✓
Determine if 32-9F Report can be Reconciled with the Work-in-Process Account		✓
Budget and Financial Statement Report Reconciliation		
Revise Process Used to Record Fund Usage Transactions in DAFIS	✓	
Establish Procedures to Ensure SF-133s are Reconciled to Budgetary and Proprietary Accounts	✓	
Correct Account Balances in DAFIS for Undelivered Orders and Unobligated Authority	✓	
Submit a Revised SF-133 if Needed	✓	
Accounts Payable Liabilities		
Research Procurement Records and Progress Payments, and Adjust Open Document File Accordingly	✓	
Provide Written Instructions to Staff on Proper Recording of Accounts Payable	✓	
Establish Procedures to Monitor the Validity of Accounts Payable		✓
Year end Accrued Liabilities		
Revise Procedures to Include Estimate for Goods and Services Received	✓	
Capital Leases and Leasehold Improvements		
Revise FAA Order 2700.31 to Include Procedures for Capital Leases		✓
Determine Fair Market Value and Economic Life for Leases Included in Sample	✓	
Determine if Existing Leases are Capital Leases		✓
Develop Plan to Ensure Future Leases are Properly Classified		✓
Implement Requirement to Ensure Leasehold Improvements are Capitalized		✓
RECOMMENDATIONS COMPLETED	14	40%
RECOMMENDATIONS PENDING	21	60%
TOTAL RECOMMENDATIONS	35	100%

Sections 2 and 3 are available from:

Jeff Nelligan
Communications Officer
(202) 366-6872

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SECTION I
AUDIT REPORT

DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT REPORT ON THE
FEDERAL AVIATION ADMINISTRATION
FISCAL YEAR 1997 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, 1997. We were unable to express an opinion on the financial statements because we could not substantiate Property, Plant, and Equipment reported at \$11.6 billion, Inventory and Related Property reported at \$764 million, and verify tax revenues and investments reported at \$4.2 billion and \$6.4 billion, respectively.

We also are reporting on the internal accounting and administrative control systems, and compliance with laws and regulations, as applicable to the FAA Financial Statements. The audit was performed in accordance with Government Auditing Standards prescribed by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 93-06, Audit Requirements for Federal Financial Statements.

The objectives of our audit of the FAA Fiscal Year (FY) 1997 Financial Statements were to determine whether (1) the financial statements present fairly the financial position and results of operations of FAA in accordance with OMB Bulletins 94-01 and 97-01; (2) FAA has an adequate internal accounting and administrative control structure; (3) FAA has complied with the 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 and Supplemental Information sections are materially consistent with the information in the financial statements; and (5) supporting data for performance measures existed and were properly reported.

This report presents our disclaimer of opinion on the FAA Financial Statements as of, and for the year ended, September 30, 1997. The financial information included in the Management Discussion and Analysis and Supplemental Information was materially consistent with the financial statements, except for the Consolidating Statement of Budgetary Resources. This statement was prepared

based on budgetary accounting requirements which significantly differ from accounting policies used to prepare the financial statements as described in Note 1.

The performance measures included in the Management Discussion and Analysis were not financial-related. Therefore, we limited our work to determining if the reported performance measures met the requirements contained in OMB Bulletins and the Government Performance and Results Act, and were consistent with DOT's Strategic Plan. The information presented did not constitute performance measures as required by the OMB Form and Content Bulletins, and the Government Performance and Results Act, and were not consistent with DOT's Strategic Plan. FAA was aware of this problem, and was in process of revising its performance measures to comply.

We also 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

In accordance with the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act of 1994, the OIG audited the FAA Financial Statements (Consolidating Balance Sheet and Consolidating Statement of Operations), as of, and for the year ended, September 30, 1997. The financial statements are the responsibility of FAA. The OIG's responsibility is to express an opinion on the fairness and reasonableness of the financial statements based on our audit.

As required by OMB Bulletins 94-01 and 97-01, Note 1 to the Financial Statements describes the accounting policies used by FAA to prepare the financial statements. These policies represent generally accepted accounting principles for the Federal government.

We were unable to substantiate the existence and valuation of Property, Plant, and Equipment reported at \$11.6 billion, and Inventory and Related Property reported at \$764 million, on the Consolidating Balance Sheet because of the lack of comprehensive inventories, inaccurate general ledger balances and subsidiary records, inadequate supporting documentation, and unreconciled discrepancies between general ledger balances maintained in the Departmental Accounting and Financial Information System (DAFIS) and FAA's subsidiary records. These two accounts represent 61 percent of FAA's total assets reported on the Consolidating Balance Sheet.

The FAA also limited its property validation to about \$4 billion of the FY 1997 yearend balance of \$11.6 billion, and did not include property not already recorded on the subsidiary systems. FAA also included field spares totaling \$325 million (of the \$764 million reported as Inventory and Related Property), based on physical inventories performed at 129 (of 871) sites. However, our observations and analyses of these inventories showed we could only rely on the inventory results for \$52 million of the \$325 million of field spares because there were significant deficiencies and inconsistencies in the inventory-taking procedures, and major unexplained variances in inventory results.

FAA is required to include, in its financial statements, the financial activity for the Airport and Airway Trust Fund. FAA has no control over the collecting and reporting of tax revenues (revenues) for this trust fund. Department of Treasury (Treasury) collects and distributes the revenues into government trust funds. Revenues are received daily, while supporting information on how the revenues should be distributed (tax returns) is usually submitted quarterly. Therefore, Treasury estimates and makes the initial distribution of revenues to the various trust funds. Subsequently, the Internal Revenue Service (IRS), a component of the Treasury, uses tax returns to certify the amount that should have been transferred to the trust funds, and Treasury makes the appropriate adjustment. Typically, adjustments lag 6 to 9 months behind the distribution made from estimates.

Our comparison of certified revenues to quarterly estimates for eight quarters (September 1995 to June 1997) found variances ranged from an understatement of \$219 million to an overstatement of \$62 million. The process Treasury used to estimate and make the initial distribution of revenues, and IRS's certification process, had not been audited. However, in the past, the transfer of revenues, based on estimates, to the Airport and Airway Trust Fund 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 Airport and Airway Trust Fund during this period, even though the airlines were not making deposits. Excess transfers totaled \$1.2 billion. Legislation was needed to avoid a shortfall in the Airport and Airway Trust Fund, and allow the trust fund to retain the \$1.2 billion. Internal control weaknesses at Treasury could affect tax revenues and investments reported at \$4.2 billion and \$6.4 billion, respectively.

Concerning a disclaimer of opinion, the American Institute of Certified Public Accountants' Statements on Auditing Standards describes it this way: "A

disclaimer of opinion states that the auditor does not express an opinion on the financial statements.” A disclaimer of opinion is appropriate when the auditor has been unable to form, or has not formed, an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles, or when there are material uncertainties. Since we could not substantiate Property, Plant, and Equipment reported at \$11.6 billion, Inventory and Related Property reported at \$764 million, and verify tax revenues and investments reported at \$4.2 billion and \$6.4 billion, respectively, we were unable to express, and we do not express an opinion (disclaimer of opinion) on the FAA Financial Statements as of, and for the year ended, September 30, 1997. In our view, these limitations provide a reasonable basis for our disclaimer of opinion.

B. REPORT ON INTERNAL CONTROL STRUCTURE

OMB guidance for implementing the audit provisions of the CFO Act requires the auditors to assess the reporting entity's internal control structure. FAA management is responsible for establishing and maintaining an internal control structure. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that (1) transactions are properly recorded and accounted for, to permit preparation of reliable financial reports in accordance with applicable accounting policies; (2) funds, property, and other assets are safeguarded against unauthorized use, loss, or disposition; (3) transactions are executed in compliance with laws and regulations; and (4) data supporting reported performance measures existed and were properly recorded.

In planning our financial statement audit, we considered the internal control structure of FAA to identify appropriate auditing procedures for the purpose of expressing an opinion on the financial statements, and to determine whether the internal control structure met the FAA internal control objectives. However, the intent of our review was not to provide an opinion on FAA's overall system of internal controls.

Our internal control assessment focused on corrective actions taken by FAA on eight deficiencies presented in our prior report on the FY 1996 Financial Statements which we considered "reportable conditions" under standards established by the General Accounting Office, the American Institute of Certified Public Accountants, and OMB Bulletin 93-06. We made 35 recommendations in our report on the FY 1996 Financial Statements to strengthen internal controls and establish the correctness of financial statement balances for Operating Materials and Supplies (Inventory and Related Property), Capitalization of Equipment

Purchase Cost, Property, Plant, and Equipment, the Work-in-Process Account, Budget and Financial Statement Report Reconciliations, Accounts Payable Liabilities, Yearend Accrued Liabilities, and Capital Leases and Leasehold Improvements.

Reportable conditions are matters coming to our attention involving significant deficiencies in the design or operation of the internal control structure which, in our judgment, could adversely affect the entity's ability to ensure the objectives of the internal control structure are being achieved. Six of the eight deficiencies also were considered "material weaknesses." A material weakness is a reportable condition where the design or operation of one or more specific internal control mechanisms does not reduce, to a relatively low level, the risk of material errors or irregularities occurring and not being detected within a reasonable time by employees in the normal course of performing their assigned functions.

As a result of our internal control assessment, we concluded FAA completed corrective action to resolve one material internal control weakness (Finding E) and one reportable condition (Finding G) identified in the FY 1996 audit report. FAA successfully reconciled the budget execution information reported to Treasury with account balances maintained in DAFIS. FAA also revised procedures to estimate yearend accrued liabilities.

However, corrective actions on 21 of the 35 recommendations (60 percent) had not been completed and five material internal control weaknesses and one reportable condition continue to exist (see exhibit). Specifically, 16 of the 21 recommendations in process pertain to Property, Plant, and Equipment, and Inventory and Related Property balances representing 61 percent of FAA's total assets reported on the Consolidating Balance Sheet. Correction of these deficiencies is essential if FAA is to move to a Performance Based Organization, focused on establishing a reliable cost accounting system and eventually providing services paid directly by user fees, as recommended by the National Civil Aviation Review Commission.

The Commission called for strong financial controls, including a reliable cost accounting system by October 1998, so that FAA can manage its resources in a businesslike manner, and allocate its cost correctly and fairly as the basis for a cost-based user fee system. We are reviewing FAA's new cost accounting system, currently under development, and we will address our observations on the new cost accounting system in a separate report to be issued later. However, until the financial control issues discussed in this report are resolved and FAA receives an

unqualified opinion on its financial statements, FAA's new cost accounting system will not produce accurate, and defensible, cost data.

FAA worked hard to address deficiencies in its financial reporting for Property, Plant, and Equipment. FAA capitalized \$2.6 billion in equipment purchase cost that previously had been erroneously expensed, tested the existence (traced from records to floor) of \$1.2 of \$2.4 billion of real property reported on the Consolidating Balance Sheet, and established procedures to retain supporting documentation for personal property transactions occurring after January 1997. FAA also initiated a reconciliation of the Work-in-Process account with the job order financial information report (32-9F). However, we could not substantiate the existence and valuation for Property, Plant, and Equipment because FAA's corrective actions were not sufficient. The following represent examples of corrective actions FAA needs to complete.

(1) FAA had not, and still needs to conduct comprehensive physical inventories of its property. FAA's "validation" was limited to \$4 billion of the \$11.6 billion reported on the FY 1997 Financial Statements. FAA's validation process was inadequate. For example, FAA "validated" equipment totaling \$2.8 billion with a computer match of two different files. This approach only determined the equipment was recorded on both records, but did not verify its actual existence or value. Comprehensive inventories are needed to establish accountability for safeguarding the Government's assets, and establishing accurate property records.

(2) While FAA had implemented procedures to maintain supporting documentation for property transactions occurring after January 1997, FAA still needs to identify and retain documentation to support property transactions occurring from October 1994 to January 1997.

(3) FAA temporarily recorded \$1.3 billion in five general ledger property accounts because it did not know whether these items had already been capitalized and recorded in the appropriate general ledger accounts. This amount includes a portion of the \$2.6 billion FAA identified as prior year operating expenses that should have been capitalized. FAA had not allocated or assigned the cost to specific items of property. FAA also could not provide assurance that all or portions of the cost had not previously been recorded in other general ledger property accounts. For example, about \$672 million was in the furniture and fixtures account. FAA indicated the cost will be retained in these temporary accounts until its regional offices verify receipt documents.

(4) FAA had not addressed three of the most significant issues associated with its real property records as identified in its short-term real property validation plan. These three issues are the backlog in Work-in-Process, the lack of clarity in real property records, and the untimely and inaccurate updating of real property records. FAA stated a new real property subsidiary system would be implemented in 1997 to address these issues. However, the new system had not been implemented as of March 19, 1998.

Supporting property values is an enormous task for FAA because much of its property is old, and records supporting historical cost do not exist, or at best, are difficult to locate. We found the recorded value of FAA property was wrong in some cases. Our visits to nine locations identified eight items recorded at \$29 million that should have been recorded at \$45.9 million. For example, FAA records included a partial value of \$28.5 million for an air traffic control tower that should have been valued at \$43 million. FAA officials stated the property records were updated in March 1998. Unless FAA can establish a supportable value for its substantial property investments, it will be unable to accurately compute depreciation, which is a new Government accounting requirement for FY 1998. We recognize some of the old property will be fully depreciated. However, without a proper basis for FAA to calculate depreciation for the rest of its property, the annual depreciation expenses, which will be used to produce cost-based user fees, will not be defensible.

For Operating Materials and Supplies (Inventory and Related Property), FAA completed a comprehensive physical inventory in August 1997 of those items stored at the Logistics Center in Oklahoma City. However, FAA had not completed comprehensive physical inventories of spare parts at all field locations, or maintained up-to-date records (perpetual inventory system) to accurately account for field spares.

Instead, for the FY 1997 Financial Statements, FAA conducted a physical inventory at 129 judgmentally selected sites of 871 total field sites. FAA provided the physical inventory results for 89 sites. We accompanied FAA to 22 of the sites, observed the physical inventories being taken at 15 sites, and analyzed the results at 7 sites after FAA had conducted the physical inventories. Our observations and analyses showed we could only rely on the inventories performed at 33 sites, with spare parts totaling \$52 million, because of deficiencies and inconsistencies in the inventory-taking procedures and major unexplained variances in inventory results.

We noted FAA inventory counters had access to recorded quantities, were confused regarding what types of parts would be counted, and identified parts that could not be added to the inventory records. For example, in September 1997, at the Elgin, Illinois terminal radar approach control facility, FAA identified 17 items for new systems that could not be added because a national stock number had not been assigned. By December 1997, FAA was able to add 14 of these items valued at \$222,748. At six of the seven sites we visited after FAA had conducted the physical inventory, we found FAA had verified quantities recorded on the inventory records, but did not add parts discovered during the inventory that were not recorded on the records. Finally, we found net changes in the quantities as a result of the physical inventory varied significantly by site. At the sites we visited, the net increase in quantities was more than double those sites we did not visit. FAA could not adequately explain the variances.

During FY 1997, FAA initiated corrective actions to convert to the moving weighted average (historical cost) method of valuing inventory unit prices as required by Statement of Federal Financial Accounting Standard Number 3. FAA advised the new inventory valuation method became operational in FY 1998. However, for the FY 1997 Financial Statement, the inventory was valued at standard cost.

As a result of inaccurate Inventory and Related Property information, requests for funds may not be approved because FAA cannot defend how much it has or needs, unnecessary purchases may be made, and inventory may be overstocked and inadequately safeguarded. The shortage of, or inability to, locate essential spare parts could result in repair delays for critical FAA equipment.

FAA corrective actions on the Inventory and Related Property internal control weakness we identified resulted in \$90 million of funds put to better use. FAA's physical inventory in Oklahoma City identified \$35 million of inventory that was not previously recorded on inventory records. For example, prior to the inventory, on-hand records for directional range kits with a unit value of \$70,664 showed a quantity of 59. During the physical inventory, counters found 64 kits. As a result, the inventory was understated by \$353,320. FAA also conducted a physical inventory of items recorded at 129 field locations, resulting in the identification of \$39 million of inventory that was not on inventory records. Therefore, FAA may be able to avoid placing new orders for inventory totaling \$74 million. As part of the physical inventory performed in Oklahoma City, FAA identified \$98 million in excess and obsolete inventory. FAA intends to dispose of this unneeded inventory, and will save \$16 million a year in holding cost.

Our consideration of FAA's internal control structure would not necessarily identify all matters which should be considered reportable conditions. Accordingly, the six existing material deficiencies do not necessarily constitute all reportable conditions, including material weaknesses, associated with the FAA internal control structure.

C. REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

OMB guidance for implementing the audit provisions of the CFO Act, as amended by the Government Management Reform Act, requires auditors to assess the entity's compliance with applicable laws and regulations. Compliance with laws and regulations is the responsibility of FAA.

To obtain reasonable assurance on whether the FAA financial statements are free of material misstatements, we tested compliance with the laws and regulations directly affecting the financial statements and certain other laws and regulations designated by OMB. Our objective was not to provide an opinion on overall compliance with these provisions.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions contained in laws or regulations which cause us to conclude that the aggregation of the misstatements, resulting from those failures or violations, is material to the principal statements, or the sensitivity of the matters would cause them to be perceived as significant by others.

Except as described below, FAA complied, in all material respects, with the provisions of the laws and regulations directly affecting the financial statements as of, and for the year ended, September 30, 1997.

The Federal Financial Management Improvement Act (FFMIA) of 1996, Title 31, U.S. Code, Section 3512, established certain financial management system requirements in statute that had already been established by policies, and established requirements for auditors to report on compliance. Accordingly, under FFMIA, we are required to report whether the entity's financial management systems substantially comply with the Federal Financial Management Systems Requirements, Federal Accounting Standards, and the U. S. Standard General Ledger at the transaction level. To meet these requirements, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on September 9, 1997. The results of our tests disclosed the following instances where FAA's financial management systems did not substantially comply.

FAA was in noncompliance with FFMIA because (1) DAFIS was not used for preparation of the financial statements, (2) Property, Plant, and Equipment (\$11.6 billion) and Inventory and Related Property (\$764 million) amounts presented on the Consolidating Balance Sheet were not adequately supported by financial records, and (3) Year 2000 computer issues were not timely identified and assessed during FY 1997. FAA is now proceeding with a clear sense of urgency to address and resolve Year 2000 problems.

First, DAFIS was not the only source of financial information used to prepare the FAA Financial Statements. FAA made 532 adjusting entries outside DAFIS to prepare the financial statements. For example, Intragovernmental Accounts Receivable was reported on the Consolidating Balance Sheet at \$121.7 million, while the DAFIS general ledger accounts totaled \$64.9 million. Similarly, Intragovernmental Accounts Payable was reported at \$267.3 million, while the DAFIS general ledger accounts totaled \$215.9 million. While we agree with the adjusting entries, these entries were made because DAFIS did not accurately account for transactions occurring at, or near, the end of the accounting period. DAFIS noncompliance issues will be included in our report on DOT's Consolidated Financial Statements.

Second, as discussed in Section A of this report, Property, Plant, and Equipment, and Inventory and Related Property reported at \$12.4 billion, could not be substantiated through audit testing because of the lack of comprehensive inventories, inaccurate subsidiary records, inadequate supporting documentation, and unreconciled discrepancies between general ledger balances maintained in DAFIS and FAA's subsidiary records.

Finally, the OMB implementation guidance specifically required Year 2000 computer problems to be considered when evaluating compliance with FFMIA. The General Accounting Office and OIG have both reported concerns about FAA's Year 2000 computer problems¹. FAA was informed that its systems inventory was not complete, assessments of Year 2000 problems were behind schedule based on OMB milestones, and estimates to fix Year 2000 problems were not reliable. Because recommendations to correct these issues have already been made, we are making no additional recommendations to FAA at this time.

¹ Management Advisory on Year 2000 Computer Problems, FAA, OIG Report Number FE-1998-027, November 26, 1997; Assessing the Year 2000 Computer Problem, DOT, OIG Report Number FE-1998-053, December 18, 1997; Assessing the Year 2000 Computer Challenges, FAA, OIG Report Number FE-1998-068, February 23, 1998; and FAA Computer Systems - Limited Progress on Year 2000 Issue Increases Risk Dramatically, GAO Report AIMD 98-45, January 30, 1998.

The American Institute of Certified Public Accountants' Statements on Auditing Standards requires a test for related party transactions. Accordingly, we reviewed the financial disclosure reports on file in the FAA Office of Chief Counsel. On February 3, 1998, the U. S. Office of Government Ethics completed a review of the FAA ethics program pursuant to section 402 of the Ethics in Government Act of 1978, as amended. The review included public financial disclosure and confidential reports filed in 1996 and 1997.

The Office of Government Ethics reported (1) about 190 public financial disclosure reports filed in 1997 were not reviewed, and 3,500 confidential reports filed in 1996 and 1997 were not reviewed, (2) because accurate lists of employees required to file confidential reports were not available, ethics officials could not ensure all employees required to file in 1996 and 1997 had done so, and (3) ethics officials had not developed procedures to ensure confidential reports were filed within 30 days of employees' assignments. Consequently, FAA may not be aware of the potential existence of relationships with related parties that could affect the financial statements. FAA has initiated corrective actions, has made significant progress, and will report on actions it has taken by April 6, 1998.

D. CONSISTENCY OF INFORMATION

FAA prepared a Consolidating Balance Sheet and Consolidating Statement of Operations for its programs and activities. FAA prepared the Consolidating Statement of Operations in accordance with the requirements of OMB Bulletin 94-01. Effective for FY 1998, Federal agencies must prepare financial statements in accordance with OMB Bulletin 97-01. This bulletin makes widespread changes to the form and content of government financial statements.

To facilitate the transition and be better prepared to implement these changes, DOT required preparation of the Consolidating Balance Sheet and a Consolidating Statement of Budgetary Resources according to OMB Bulletin 97-01. The Consolidating Statement of Budgetary Resources is shown as supplemental information and is not part of the principal statements. The financial information included in the Management Discussion and Analysis and Supplemental Information was materially consistent with the financial statements, except for the Consolidating Statement of Budgetary Resources. This statement was prepared based on budgetary accounting requirements which significantly differ from accounting policies used to prepare the financial statements as described in Note 1. This issue will be addressed in our report on DOT's Consolidated Financial

Statements. We will work with FAA, DOT, and OMB to resolve these inconsistencies before the FY 1998 financial statements are prepared.

E. PRIOR AUDIT COVERAGE

The OIG issued audit reports on the FAA Financial Statements for FYs 1992, 1993, 1994, 1995, and 1996. All five reports included disclaimers of opinion. The FYs 1992 and 1993 audits were limited to the Airport and Airway Trust Fund. The FYs 1994, 1995, and 1996 audits included all FAA funding and activities, but were limited to the Statements of Financial Position. The FY 1996 audit report included 35 recommendations to strengthen internal controls and establish the correctness of financial statement balances. Efforts are still in process to complete action on 21 recommendations (see exhibit).

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
InspectorGeneral

***Status of Corrective Actions on FAA's
FY 1996 Financial Statement Audit***

	Actions Completed	Actions In Process*
Operating Materials and Supplies		
Perform a Wall-to-Wall Physical Inventory at Logistics Center	✓	
Perform Annual Physical Inventory of Field Spares		✓
Revise Process Guide 4650.19 to Comply with DOT Policy on Inventory		✓
Implement Physical Inventory Recommendations Made in FY 1993 Report		✓
Record Unit Prices at Historical Cost and Maintain Support For Price Changes		✓
Identify Excess, Obsolete, and Unserviceable Items and Initiate Disposal Action		✓
Establish Subsidiary Records to Account for Operating Materials and Supplies and Ensure Balances are Disclosed in Financial Statements		✓
Reconcile General Ledger Account Balances to Subsidiary Records and Ensure Adequate Audit Trail	✓	
Capitalization of Equipment Purchases Costs		
Implement Contractor's Recommendations on Progress Payments, Common Costs, and Contract Line Item Numbers		✓
Include Equipment Purchased Under Interagency Agreements in the Procedures		✓
Ensure all Key Personnel Receive Training on Capitalizing Equipment Costs		✓
Implement Procedures to Ensure Purchase Orders and Contracts Identify Property & Equipment, Common Costs, Materials & Supplies, Field Spares, and Expenses		✓
Review Facilities and Equipment Transactions Expensed for FYs 1995 and 1996 and Capitalize the Appropriate Amounts	✓	
Property and Equipment		
Conduct Physical Inventory of Real Property and Adjust Property Records		✓
Comply with FAA Order 2700.31 to Reconcile Real Property Accounts to Subsidiary Records		✓
Ensure Subsidiary Records are Adjusted Timely		✓
Implement Contractor's Recommendations on the Personal Property System		✓
Require Regional Managers to Furnish Support for the Value of Personal Property	✓	
Retain Documentation for the Personal Property System	✓	
Discontinue Practice of Recording Property and Equipment as Facility Equipment in the Personal Property System	✓	

*For the Actions In Process, FAA has initiated, but not completed, corrective actions on these recommendations.

***Status of Corrective Actions on FAA's
FY 1996 Financial Statement Audit***

	Actions Completed	Actions In Process
Work-In-Process		
Implement Contractor's Recommendations to Improve Work-in-Process		✓
Determine if 32-9F Report can be Reconciled with the Work-in-Process Account		✓
Budget and Financial Statement Report Reconciliation		
Revise Process Used to Record Fund Usage Transactions in DAFIS	✓	
Establish Procedures to Ensure SF-133s are Reconciled to Budgetary and Proprietary Accounts	✓	
Correct Account Balances in DAFIS for Undelivered Orders and Unobligated Authority	✓	
Submit a Revised SF-133 if Needed	✓	
Accounts Payable Liabilities		
Research Procurement Records and Progress Payments, and Adjust Open Document File Accordingly	✓	
Provide Written Instructions to Staff on Proper Recording of Accounts Payable	✓	
Establish Procedures to Monitor the Validity of Accounts Payable		✓
Year end Accrued Liabilities		
Revise Procedures to Include Estimate for Goods and Services Received	✓	
Capital Leases and Leasehold Improvements		
Revise FAA Order 2700.31 to Include Procedures for Capital Leases		✓
Determine Fair Market Value and Economic Life for Leases Included in Sample	✓	
Determine if Existing Leases are Capital Leases		✓
Develop Plan to Ensure Future Leases are Properly Classified		✓
Implement Requirement to Ensure Leasehold Improvements are Capitalized		✓
RECOMMENDATIONS COMPLETED	14	40%
RECOMMENDATIONS PENDING	21	60%
TOTAL RECOMMENDATIONS	35	100%