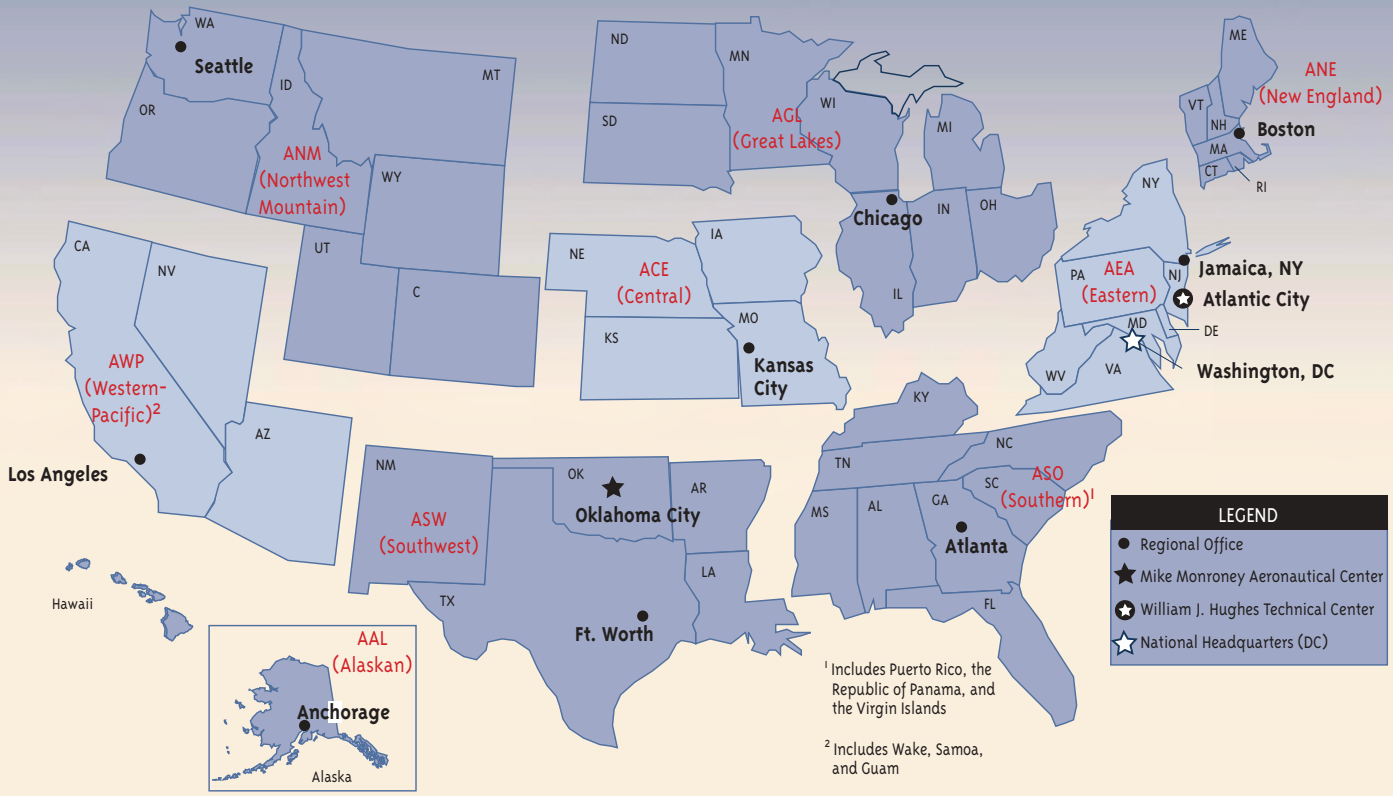
THE NEXT 100 YEARS
OF FLIGHT

FEDERAL AVIATION ADMINISTRATION

PERFORMANCE AND ACCOUNTABILITY REPORT FY 2004

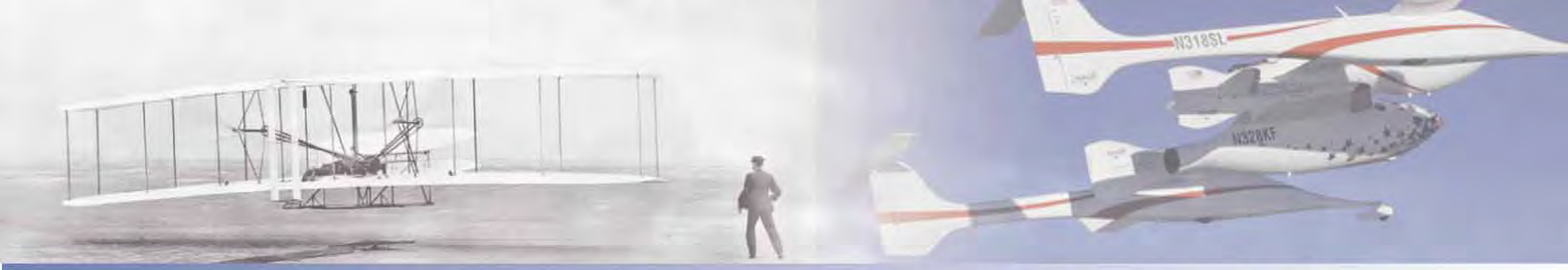
FAA REGIONS



FAA employees work at headquarters in Washington, DC, in 9 regional offices, and other facilities throughout the country and around the world. FAA fulfills its mission through four lines of business that work together to create and maintain the world's preeminent national airspace system.

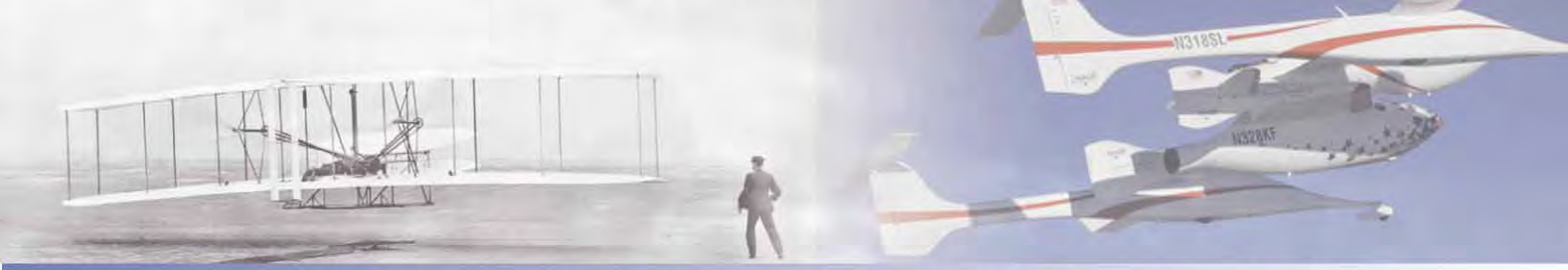
FEDERAL AVIATION ADMINISTRATION

FY 2004 PERFORMANCE AND ACCOUNTABILITY REPORT



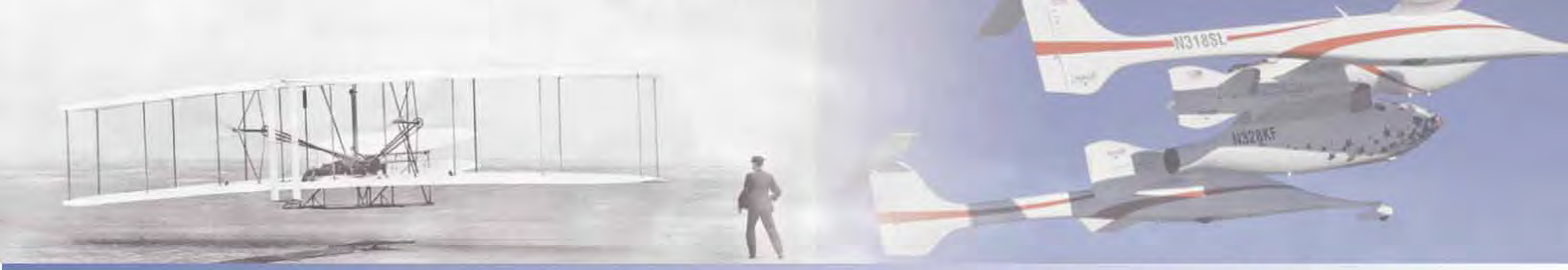
MISSION/VISION STATEMENT

To provide the safest, most efficient aerospace system in the world.



FAA AT A GLANCE

Established	1958
Headquarters	800 Independence Avenue, SW Washington, DC 20591 www.faa.gov
FY 2004 Budget	$13.871 billion
Total Employees	47,877
Headquarters	4,228 employees
Regional Offices	38,957 employees
Technical Center *Atlantic City, NJ*	1,298 employees
Aeronautical Center *Oklahoma City, OK*	3,394 employees

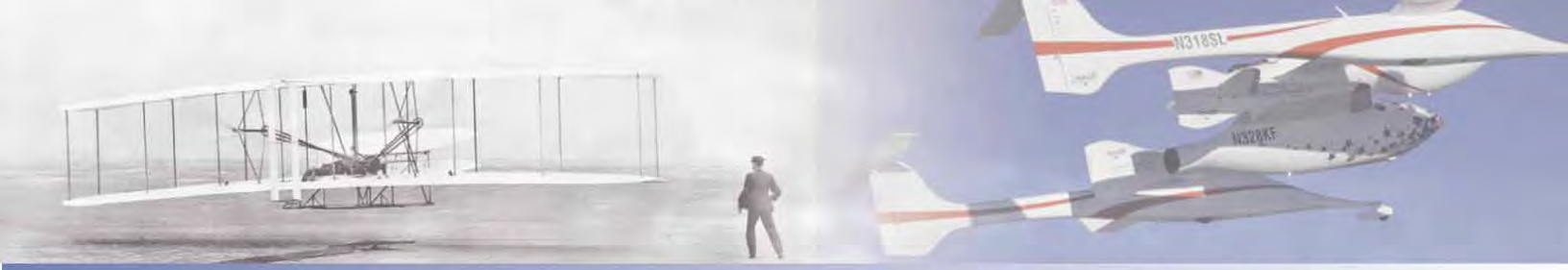


FOREWORD

The Federal Aviation Administration (FAA) is part of the U.S. Department of Transportation (DOT). The FAA is required by Office of Management and Budget (OMB) directives, which implement the Chief Financial Officers Act of 1990 (CFO Act), to prepare financial statements separate from those of the DOT. FAA is not required to prepare a separate Performance and Accountability Report (PAR). Key FAA data and information are provided to DOT and consolidated into the required DOT PAR.

We recognize, however, that to demonstrate accountability, we should present performance management and financial information using the same statutory and guidance framework. To demonstrate that accountability, we have elected to produce our own PAR for the past several years. This PAR, however, departs from the format required of CFO Act agencies. Rather than have a separate section on performance, we have included a detailed discussion of performance in the "Management's Discussion and Analysis" section. This year, we have also chosen not to report separately on our progress in achieving the goals of the President's Management Agenda (PMA). FAA does not have separate PMA targets. Our results are incorporated in the results that DOT reports.

Last year, we were proud to receive the Association of Government Accountants' prestigious Certificate of Excellence in Accountability Reporting award for the first time. This award is indicative of the progress we have made in reporting financial and program performance and in candidly assessing our results. In our effort to become a more results-oriented organization, we will continue to focus on performance and financial accountability and do our part to help DOT and the Federal government excel in providing high-quality services and products to the taxpayers we serve.



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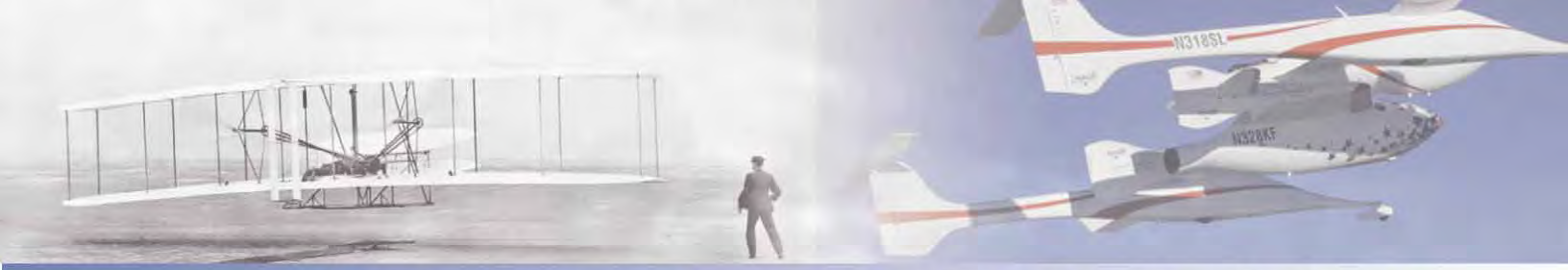

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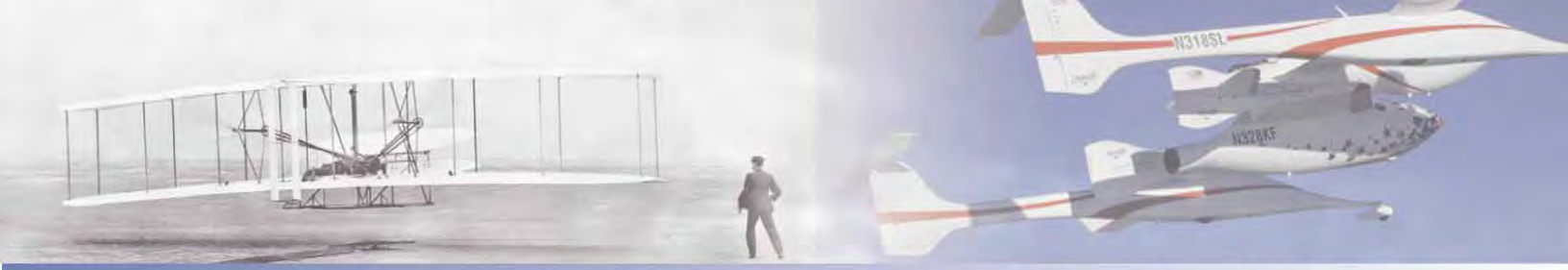
This report is also available on the FAA Website at **www.faa.gov/aba/html_fm/files_pdf/2004_PAR.pdf**
Prior year reports are available at **www.faa.gov/aba/html_fm/finst.html**



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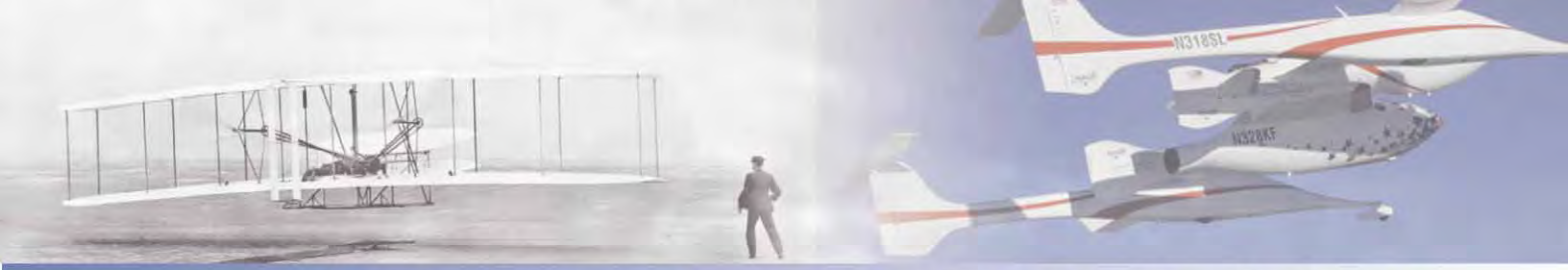


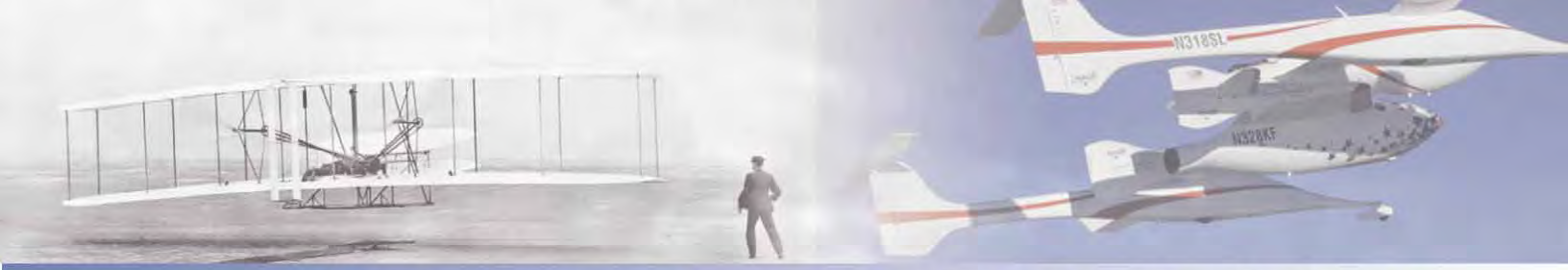
A MESSAGE FROM THE ADMINISTRATOR

FAA is making great strides in becoming a performance-based organization. This year has been one of significant accomplishments and challenges for us.

- **Safety.** Safety is our number one priority. The past three-year period has been the safest in aviation history for commercial flight, and the number of general aviation accidents continues to decline as well.
- **New Frontiers.** We launched a new era in space travel. SpaceShipOne—the first private manned space vehicle licensed by FAA—successfully completed two flights to the edge of space and won the $10 million Ansari X-Prize.
- **Reorganization.** We are implementing the most sweeping organizational change in FAA's history with the establishment of a new Air Traffic Organization. This change is going to make FAA a much more accountable, efficient, and performance-oriented organization. It is a best practice that we see paying real dividends to industry and the traveling public.
- **International Leadership.** We signed a number of bilateral agreements with foreign countries, spreading the reach of aviation safety around the globe.

Mike Melvill, SpaceShipOne pilot; Administrator Blakey; Doug Shane, SpaceShipOne Director of Flight Operations; and Burt Rutan, President of Scaled Composites, stand with SpaceShipOne to celebrate winning the Ansari X Prize.

- **Growth without Gridlock.** Achieving growth without gridlock is especially challenging in light of the financial uncertainties facing the industry. A first-ever conference was held to change air traffic control's approach to handling delays throughout the system. We instituted "express lanes in the sky" and convened daily morning conferences with the airlines to deal with weather and congestion. This partnership approach often stops delays before they occur. Separately, we reached an historic agreement with the airlines serving Chicago's O'Hare International Airport. We brokered schedule changes in Chicago, reducing congestion during peak hours by more than 30%.
- **Labor Agreements.** We are preparing for labor negotiations with FAA's two largest unions—the National Air Traffic Controllers Association and the Professional Airway System Specialists, which together represent more than 22,000 FAA employees. We are reviewing existing agreements and will enter these negotiations with the goal of reaching new contracts that are fair to our employees and fiscally responsible.
- **Competitive Sourcing.** In support of the President's Management Agenda, we initiated an A–76 review of our automated flight service stations to ensure that the government is getting the most



from the taxpayer's investment. These facilities, which are generally in need of repair, cost more than $500 million annually to operate. Whether FAA provides these services using government employees or a private sector contractor, we expect to realize more than $400 million in savings over a five-year period as a result of this process.

- **Organizational Excellence.** The Association of Government Accountants (AGA) awarded us a Certificate of Excellence in Accountability Reporting for our *FY 2003 Performance and Accountability Report.* We were honored to receive the award and are up to the challenge posed by AGA of continued improvement.

Our *FY 2004 Performance and Accountability Report* provides a detailed accounting of our service to both the flying public and the aviation industry. The financial and performance data contained in this report are reliable and complete. To reflect the increasing emphasis on accountability within the organization, we added 18 new performance goals this year. We attained 24 out of 30 goals in the areas of safety, capacity, international leadership, and organizational excellence. While I am proud of what we achieved, we hope to improve on this record.

The dedicated men and women of FAA maintain, operate, and oversee the largest and most complex aviation system in the world, with a safety record that is second to none.

We also achieved an unqualified opinion from our auditors on our financial statements and implemented a new core financial management system that supports our efforts to become a performance-based organization. Improving our overall financial management performance is an element of our organizational excellence goal.

Internally, we assess the vulnerability of our programs and systems through the Federal Managers' Financial Integrity Act (FMFIA) of 1982. I am pleased to report that taken as a whole, the management controls and financial management systems in effect from October 1, 2003, through September 30, 2004, provide reasonable assurance that the objectives of both sections 2 and 4 of FMFIA are being met. Management controls are in place and our financial systems conform to key government-wide standards. With the implementation of our new financial management system, we have made significant progress toward meeting the requirements of the Federal Financial Management Improvement Act of 1996.

As this report makes clear, our efforts to provide a safe, secure, and efficient global aerospace system, together with our commitment to the highest standards of efficiency and integrity, will ensure that FAA continues to deliver an exceptional return on investment on behalf of the American taxpayer for the next 100 years of flight.

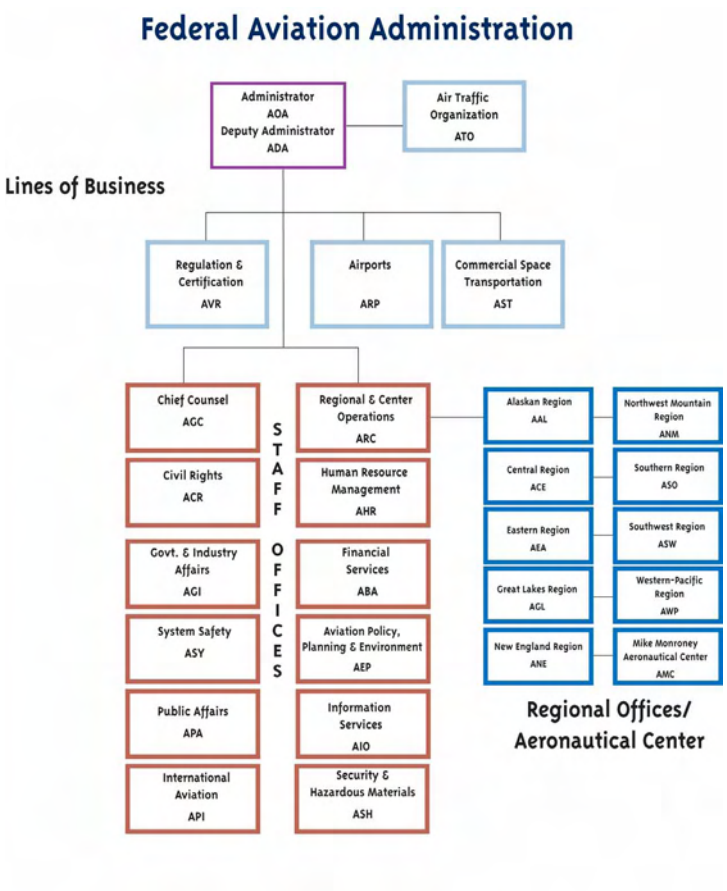
Marion C. Blakey
Administrator
November 1, 2004

MANAGEMENT'S DISCUSSION AND ANALYSIS

The Federal Aviation Administration (FAA) is responsible for overseeing the largest, most complex, and safest aviation system in the world. It not only sets the regulatory and operational standards for the United States, but also effectively sets the bar for aviation around the world—and has for almost half a century

In the first decade of the 20th century, only visionaries could imagine that air travel would be a driving force behind the phenomenal growth of the American economy. As we enter the 21st century, the future of aviation is just as hard to imagine as it was 100 years ago, as the industry finds itself facing terrorism, structural change, and a fluctuating global economy.

From 1926, when President Calvin Coolidge initiated Federal oversight of air safety in the United States by signing the Air Commerce Act, to the creation of the Federal Aviation Agency in 1958, to our modern-day incarnation, FAA and the aviation community have grown and worked together. We have shaped an industry that—like shipping and rail before it—conquered distance in a new way, lowered transportation costs, and created new opportunities that transformed the commercial landscape.



FAA's organization chart shows how the agency is structured to achieve its mission and deliver results.

Today's FAA faces the challenges of the next 100 years of flight with the help of dedicated employees at its headquarters in Washington, DC, in regional offices, and in facilities around the world. We fulfill our mission through four lines of business that work together to create and maintain the world's preeminent national airspace system. These lines of business are the following:

- **Air Traffic Organization (ATO):** Responsible for moving air traffic safely and efficiently. The customers of this performance-based organization are commercial and private aviation and the military. ATO employees are the service providers—the 38,000 controllers, technicians, engineers,

and support personnel whose daily efforts keep airplanes moving. ATO is aligned around the services delivered to its customers.

- **Regulation and Certification:** Oversees the safety of aircraft and the credentials and competency of pilots and mechanics, develops mandatory safety rules, and sets the standards that have helped make air travel one of the safest modes of transportation in history.
- **Airports:** Provides leadership in planning and developing a safe, secure, and efficient airport system; manages the Airport Improvement Program (AIP), which provides grants to state and local airport authorities; enhances environmental quality related to airport development; develops standards for the design and construction of airport facilities; and establishes regulations for the safe operation of commercial service airports and inspects airports for compliance.
- **Commercial Space Transportation:** Oversees the safety of commercial space launches and regulates the commercial space industry.

SpaceShipOne catches the sun's rays in space during its historic first flight.

FAA Helps Launch a New Era in Space Travel

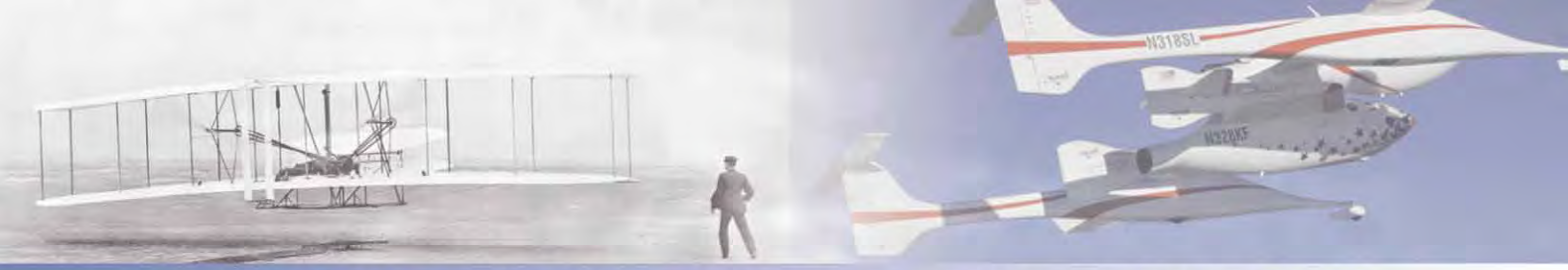
On June 21, 2004, the world witnessed the dawn of a new era in space travel, as the first private manned space vehicle licensed by FAA soared beyond Earth's atmosphere. SpaceShipOne reached a record altitude of 328,491 feet (approximately 62 miles or 100 km), making pilot Mike Melvill the first civilian to fly a spaceship out of the atmosphere and the first private pilot to earn astronaut wings. Melvill successfully reached suborbital space for a second time on September 29, 2004.

In marking SpaceShipOne's success, FAA Administrator Marion Blakey said, "The first century of flight began with 12 seconds over Kitty Hawk that would change the world. The second century begins with the advent of passenger travel into space. Our horizon will never be the same, and FAA is leading the way."

A Year in Highlights

FAA, an agency of the U.S. Department of Transportation (DOT), is charged with promoting the safety and efficiency of our national airspace system. FAA establishes and enforces regulations and oversees inspections that maintain the integrity and reliability of that system, which has fueled our economy and helped ensure our Nation's prosperity for more than 50 years.

With a workforce of 47,877 professionals and an annual budget of approximately $13.9 billion, FAA operates and maintains the complex air traffic control system and the facilities and equipment that support it. Almost 15,000 controllers manage more than half of the world's air traffic, helping to ensure ever-increasing levels of safety. The agency conducts research to improve aviation safety and efficiency



and provides grants to improve 3,344 public-use airports in the United States. FAA also regulates commercial space launch activities to ensure public safety.

FAA Administrator Marion C. Blakey led the agency to a number of significant accomplishments in 2004. Aviation safety continued to improve at an impressive pace, and the agency renewed its pledge for constant vigilance to safeguard the flying public. As a result, FAA remains on track to meet the ambitious goal of reducing commercial air carrier fatal accidents by 80% from the 1994–1996 baseline. We once again introduced new technologies to keep passengers safe both in the air and on the ground. In an effort to significantly reduce congestion and delays at airports nationwide, FAA invoked new authority granted in its reauthorization legislation.

During fiscal year (FY) 2004, FAA employees

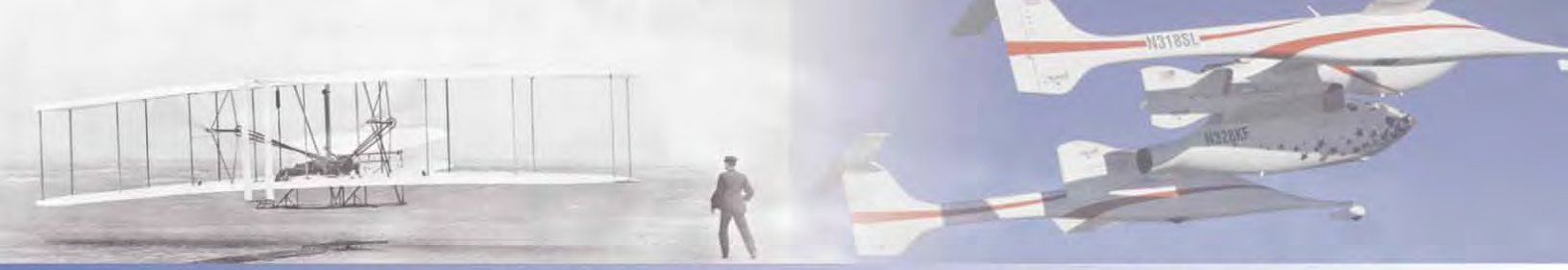
- Ushered in the first year's implementation of FAA's *Flight Plan*, a strategic plan that will guide the organization into the next century of flight. The plan sets specific performance goals in four overarching areas: safety, capacity, international leadership, and organizational excellence. It also sets the direction for the aviation community in a global transportation environment.
- Worked to win legislative support for Vision 100—the Century of Aviation Act. This four-year reauthorization bill provides $60 billion in economic power and calls for 665,000 new jobs through airport improvement projects throughout the country. Vision 100 also provides the agency with funds for important environmental and clean air initiatives, as well as expanded authority to work collaboratively with industry to reduce delays at the Nation's airports.
- Recorded the lowest commercial aviation fatal accident rate ever (based on a three-year average). We partnered with industry to achieve an unprecedented safety record and promote a culture of safety throughout commercial aviation.
- Made significant progress in reducing general aviation accidents in Alaska through initiatives such as FAA's CAPSTONE safety program.
- Issued new certification rules for light-sport aircraft that improve the safety and affordability of recreational flying. FAA created two new certificates that cover special light sport and experimental ultra-light aircraft, pilots, and mechanics. We expect these new rules to encourage the return of thousands of pilots who left aviation because of cost concerns.
- Embraced a new era in commercial space transportation, as the first privately built manned spacecraft successfully reached suborbital space on June 21, 2004.
- Engaged in an active, collaborative

America's Runways: The Safest in the World

Runway safety at the Nation's airports continued to improve in FY 2004. As runway incursions continued to decline, serious incursions, for which there is some risk of collision, dropped significantly between FY 2000 and FY 2004. For the third consecutive year, there were no serious incursions involving two large commercial jets.

FAA continues leading an industry-wide effort to improve runway safety through increased education, training, and awareness, along with new technology and improved airport runway markings and lighting. To prevent runway accidents, FAA delivered a new technology called the Airport Movement Area Safety System (AMASS) to 34 airports and is deploying the new Airport Surface Detection Equipment Model X (ASDE-X) to another 25 airports.

One of the *Flight Plan's* performance targets is to reduce the most serious type of runway incursions (Category A and B) by at least 48%, with no more than an average of 27 serious incursions per year by FY 2008.



approach to countering delays and congestion, which returned in FY 2004 as air traffic levels approached pre–September 11, 2001, levels. FAA commissioned new runways in Houston, TX, and Orlando, FL, during FY 2004. We worked with industry to develop new air traffic procedures that will allow for growth without gridlock. We also began to work with the airlines to change flight schedules to ease delays.

- Emphasized environmental stewardship. FAA worked with the Center of Excellence for Aircraft Noise and Aviation Emissions Mitigation to develop quieter, cleaner aircraft. The center conducts research into the environmental impact of aviation as it continues to grow.
- Bolstered efforts with regard to international leadership. We continue to provide assistance to other countries to improve aviation safety and efficiency throughout the world. Among our most important achievements was our success in working with the International Civil Aviation Organization (ICAO) to adopt global environmental standards and in executing three bilateral agreements, with one new agreement set to be completed in FY 2005.
- Continued to improve organizational efficiency and effectiveness by achieving six out of seven organizational excellence goals, which included controlling costs, hiring mission-critical positions, completing critical acquisitions, and strengthening information security.

FAA continues to face challenges in reducing the number of general aviation fatal accidents, boosting system capacity to handle increased traffic, and achieving new organizational excellence goals. To address these challenges, we maintained a focus on aviation as a global system and worked closely with international organizations to seek global solutions to safety, routing, procedural, technology, and environmental issues.

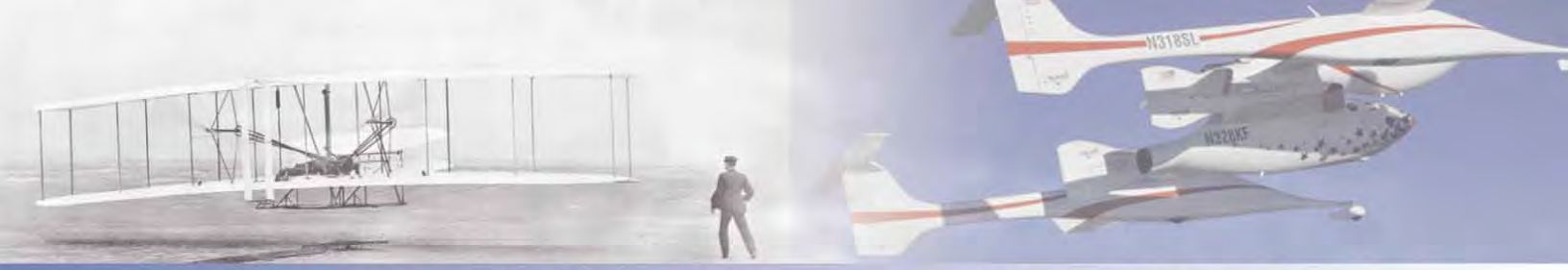
We also continued to work with airports around the country to boost system capacity by analyzing chokepoints, commissioning new runways, and taking advantage of precise satellite navigation technologies to increase efficiency. Through such improvements, we were able to increase system capacity, maintain efficiency, and minimize delays.

Achieving Results

FAA is charged with promoting the safety and efficiency of the Nation's aviation system. With broad authority to enforce safety regulations and conduct oversight of the civil aviation industry, we maintain the system's integrity and reliability. A strategic plan, annual business plans, human capital plans, and the annual Performance and Accountability Report create a recurring cycle of planning, program execution, measurement, verification, and reporting. This strong link between resources and performance shows what is being accomplished and reinforces accountability for the taxpayer money being spent**.**

In FY 2004, FAA marked the first year under its *Flight Plan*, a long-term strategic plan that charts the agency's goals through FY 2008. It provides the framework to match resources with initiatives for long-term change. It not only focuses on FAA activities, but it also sets the direction for FAA and the national air and space community in a global transportation environment. It sets forth the agency's goals and the performance measures to assess progress in meeting them. These are the goals that we must meet to address the challenges facing aviation, as well as maintain U.S. leadership in aviation. Our *Flight Plan* is tightly aligned with DOT's mission, vision, goals, and performance measures.

This year, FAA had 30 performance measures and targets that focused our efforts to achieve enhanced aviation safety, increase system capacity, provide international leadership, and ensure organizational excellence. As part of our efforts to continuously improve reporting, we redesigned the FAA Website and

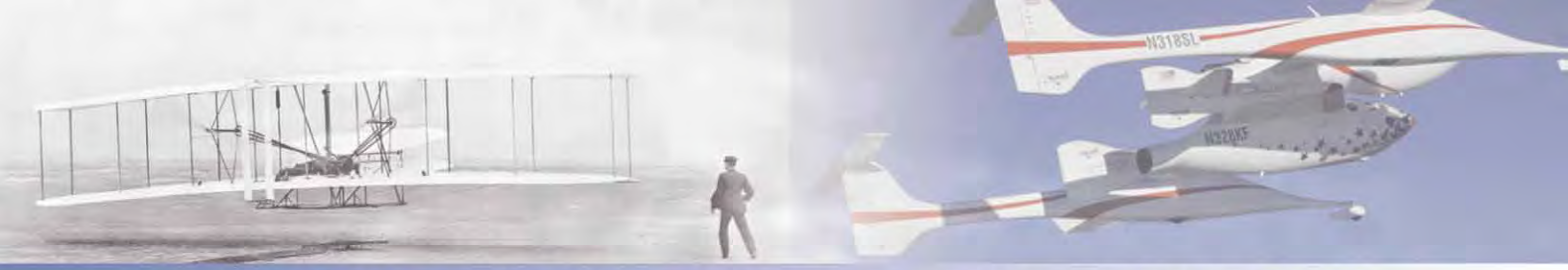


added a section that provides easy access to *Flight Plan* performance and results (www.faa.gov/aboutfaa/performance.cfm).

Our performance measures, listed in the "FY 2004 Performance At A Glance" chart on the next two pages, support FAA's mission to provide citizens with a safe, secure, and efficient global aviation system. The FAA's four strategic goals are

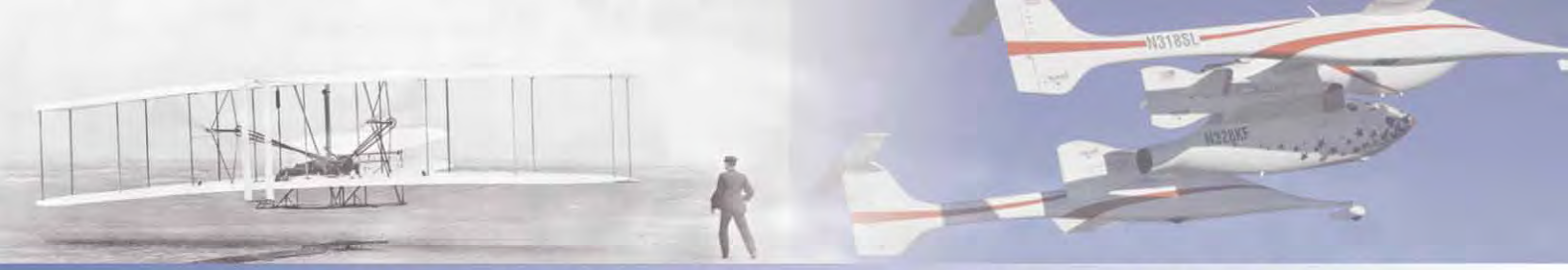
- **Safety.** Safety is not only a top priority; it is also an economic necessity. People will fly only if they feel safe. They must trust the system and that trust must be earned. Reducing the risk of aviation accidents remains a top priority. To enhance safety, we continued to focus on the challenge of reducing operational errors and runway incursions. A number of coordinated programs and safety initiatives enabled us to further reduce the commercial aviation accident rate, the number of general aviation accidents, and the number of runway incursions. In addition to these results, we were successful in ensuring that there were no commercial space launch accidents. In FY 2004, we achieved eight of nine safety goals.
- **Capacity.** Aviation capacity is the backbone of air travel. Aviation can grow only if capacity grows. We aim to achieve any increases in capacity in an environmentally sound manner. Initiatives designed to boost system efficiency were successful in improving on-time arrival and airport capacity and efficiency while reducing exposure to aircraft noise and emissions. In FY 2004, we achieved four of eight capacity goals.
- **International Leadership.** FAA's goal is to make the international aviation system as safe and efficient as the one enjoyed in the United States. This year, we provided technical assistance and training to assist more than 30 countries in improving aviation safety and efficiency. During FY 2004, we continued to promote safety by broadening the international network of partnerships with civil aviation authorities around the world. In FY 2004, we achieved all six of our international leadership goals.
- **Organizational Excellence.** To fulfill our mission, we must be a world-class organization. This requires greater fiscal responsibility, stronger leadership, more collaboration, and performance-based management. During FY 2004, we continued to address challenges identified by DOT's Office of Inspector General (OIG). We successfully enhanced acquisition management, and implemented a new accounting and acquisition system to improve financial management. Although we made great strides in improving the business processes that support efforts to improve aviation safety and system efficiency, we did not meet all of our organizational excellence goals. We did, however, succeed in meeting our goals for customer satisfaction and major acquisition projects. In FY 2004, we achieved six of seven organizational excellence goals.

Despite the challenges, FY 2004 was a year of impressive success for FAA. Although air traffic still remains 2.4% below pre–September 11, 2001, levels, passengers are regaining confidence in the system and are returning to the skies. As traffic increases, so do the challenges we face in building organizational excellence to improve safety and increase capacity. Through the combined efforts of our employees and industry partners, we were able to achieve 24 of 30 goals—an 80% success rate. The Performance at a Glance chart on the following pages provides a snapshot of the results we achieved.



FY 2004 PERFORMANCE AT A GLANCE

Performance Measure	FY 2004 Target	FY 2004 Results	FY 2004 Status	FY 2005 Target
SAFETY				
Commercial Air Carriers				
Fatal Accident Rate	0.028	0.021*	●	0.023
Single Safety Index	1	1	●	1
Injuries from Turbulence	18	9*	●	N/A**
General Aviation Accidents				
Fatal Accidents—Overall	349	340*	●	343
Accidents—Alaska	125	100*	●	120
Operational Errors	629	637#	◎	610
Runway Incursions	40	28#	●	36
Commercial Space Launch Accidents				
Fatalities/Injuries	0	0	●	0
Property Damage	0	0	●	0
CAPACITY				
On-time Arrival	82.10%	79.08%#	◎	82.20%
Aircraft Noise Exposure	2%	23%#	●	3%
Aviation Fuel Efficiency	1%	4.5%	●	2%
Airport Capacity				
Airport Daily Arrival Capacity (35 Operational Evolution Plan [OEP] airports)	51,332	51,587#	●	51,999
Airport Daily Arrival Capacity (eight metropolitan areas)	21,290	21,233#	◎	21,465
Airport Arrival Efficiency Rate (35 OEP airports)	95.67%	95.03%#	◎	95.76%
Annual Service Volume (new runways opened)	2	2	●	1
Operational Availability	99%	98.95%#	◎	99%
INTERNATIONAL LEADERSHIP				
Intellectual and Financial Assistance	20%	177%	●	40%
Bilateral Agreements	2	3	●	4



FY 2004 PERFORMANCE AT A GLANCE				
Performance Measure	**FY 2004 Target**	**FY 2004 Results**	**FY 2004 Status**	**FY 2005 Target**
Technical Assistance	**6**	**30**	●	**12**
Technology and Procedures	**75%**	**100%**	●	**N/A****
Global Environmental Standards	**2**	**3**	●	**100%**
Reduced Vertical Separation Minimum	**85%**	**90%**	●	**N/A****
ORGANIZATIONAL EXCELLENCE				
Acquisitions	**80%**	**91%**	●	**80%**
Cost Reimbursable Contracts	**180**	**135**	◎	**85%**
Customer Satisfaction—Commercial Pilots	**63**	**65**	●	**64**
Cost Control	**10%**	**10%**	●	**20%**
Information Security	**90%**	**100%**	●	**90%**
Performance Plans	**80%**	**84.56%**	●	**85%**
Mission Critical Positions	**3%**	**28%**	●	**6%**
Flight Plan *(This target itself is not included when calculating the percentage of targets achieved.)*	**90%**	**80%**	◎	**90%**

● **Green:** Goal Achieved ◎ **Red:** Goal Not Achieved

Notes:

** Numbers are preliminary. The National Transportation Safety Board (NTSB) will make final data available in May 2005.*

*** Target is not included in the* Flight Plan *for 2005.*

 # These are preliminary estimates. Final data will be available between November 2004 and January 2005.

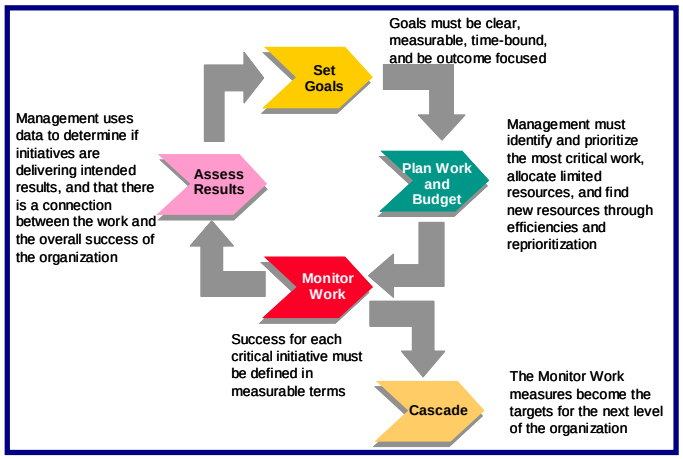
Managing Performance

In FY 2004, we launched our ambitious strategic plan to help manage and measure performance. In the first year of the *Flight Plan's* implementation, our goal was to meet at least 90% of our performance targets (27 out of 30).

As part of our efforts to deliver results—enhanced safety, increased capacity, international leadership, and organizational excellence—we continued to phase in a pay-for-performance system that is unlike traditional government compensation systems. At the end of FY 2004, 78% of FAA employees were included in this new plan, which includes pay increases for organizational success. As the agency continues to achieve its goals, employees included in the pay-for-performance system will get a pay increase.

We faced a number of challenges in implementing the *Flight Plan* and achieving results. These challenges included the following:

- The financial difficulties facing the airlines and aviation manufacturers affect their ability and willingness to equip aircraft with the new technologies that will enhance safety and capacity. Those difficulties also affect FAA, which is primarily funded by the Airport and Airway Trust Fund from taxes on airline tickets.
- Large capital investments in facility, infrastructure, and agency human capital needs will depend largely on the ability to closely link budget to performance and also in part on the ability to fund such operations and responsibilities.
- The ability to improve safety or expand capacity in the United States and in the international arena depends in part on the willingness of authorities at the state, local, and international levels to cooperate and collaborate in areas such as building new airports, expanding runways, and implementing new technologies.
- Emerging threats to national or homeland security may cause FAA priorities to shift to meet new responsibilities.



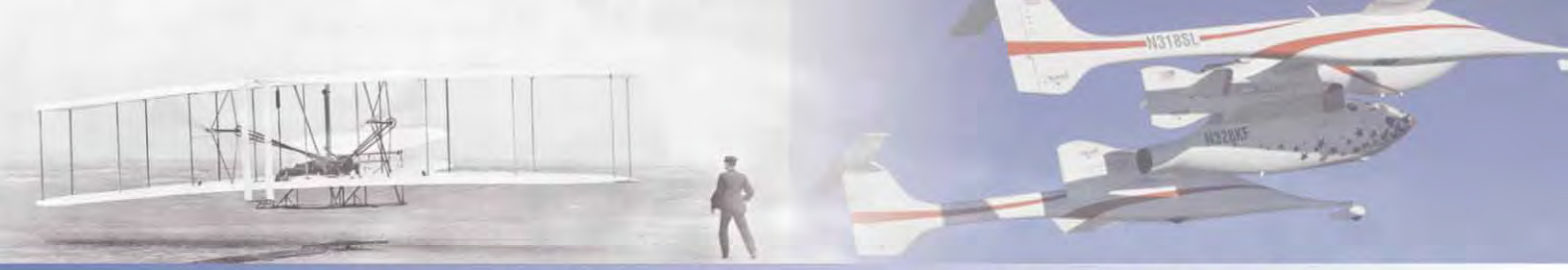
FAA manages performance by means of a four-step framework based on best practices from a number of private and public sector organizations (see chart). As we use this framework and instill management discipline into the processes, we anticipate that this will be a multiyear journey of learning and change.

The first step in the process, "Set Goals," includes consulting with management, stakeholders, and customers to determine success for the agency.

The second step, "Plan Work and Budget," focuses on the critical work and resources required to achieve the goals. Following the framework, FAA created a performance-based FY 2005 budget that linked resource requirements to our *Flight Plan.* (Our *FY 2005 Budget in Brief* is available at www.faa.gov/aba/html_budget/2005.html. Our *Flight Plan* is available at www.faa.gov/avr/flightplan.)

The third step, "Monitor Work," develops measures of the work required to achieve the goals. FAA developed organizational business plans for each line of business and staff office. These plans outlined the FY 2004 initiatives, activities, and performance targets that linked our work directly to the *Flight Plan.* (Business plans are available at www.faa.gov/aboutfaa/businessplans.cfm.)

"Assess Results" is the last and most important step in the performance management process. This year, we continued our practice of reviewing and discussing FY 2004 performance goals every month. In addition, we began to deploy a new tool and business processes that focus more on discussing performance results, root causes of performance issues, and reallocation of resources to correct performance.



Verification and Validation of Performance Information

We employ strong management controls to ensure that data used to assess performance are accurate, timely, and complete. By exercising both internal and external reviews, our verification and validation process strongly supports the confidence that the managers and Administrator have in their performance data.

We use several internal review processes to ensure accurate data. First, at the start of each year, we review every performance target for data source and validity. Where the criteria for targets have changed, we note and explain the changes in performance-related materials. DOT also independently verifies performance data. Several performance measures, such as the Commercial Air Carrier Fatal Accident Rate, require independent verification by the National Transportation Safety Board (NTSB) and the Bureau of Transportation Statistics. Data for this measure are not considered final until NTSB gives its approval.

Independent program evaluations are also an important part of the verification and validation process. Each year, we ensure that program evaluations are completed by independent outside research organizations such as MITRE.

DOT OIG, the Government Accountability Office (GAO), and the Office of Management and Budget (OMB) also regularly review FAA programs and activities. These reviews help maintain the public's trust, as well as provide opportunities for improvement. We work with each organization to address concerns and improve the way business is conducted. For example, we have focused more closely this year on tying budget to performance, as well as cascading performance measures from the agency to the lines of business and staff offices. This is a direct result of using OMB's Program Assessment Rating Tool (PART).

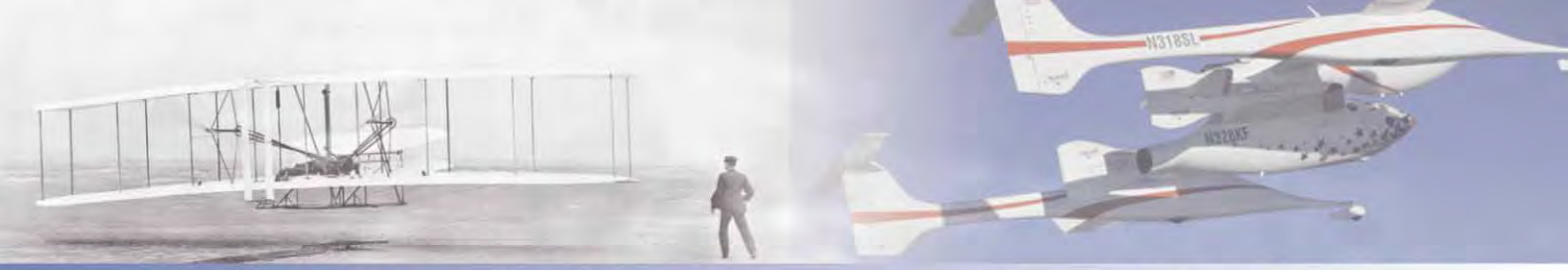
Performance Assessment Rating Tool

In FY 2002, we reviewed AIP using PART. AIP provides funding to airports for infrastructure improvements such as safety, security, and capacity projects. The OMB PART assessment indicated that the program's overall purpose is clear and that performance goals are clearly defined and achievable. The program, which was rated moderately successful, is working to improve its overall cost-effectiveness and efficiencies through greater use of automated systems and greater delegation to the regions. Dependence on Federal government assistance varies based on an airport's location, size, and financial resources. Large airports are less dependent on Federal funds because of their ability to access different revenue sources such as landing fees. The structure of the program, combined with the statute, can limit the program's ability to respond quickly to new situations and events.

OMB recommended that FAA

- Examine the grant formula to channel resources to airports most in need of Federal assistance and align the AIP budget with FAA's and DOT's performance objectives.
- Create a performance measure for efficient program delivery.
- Create a mechanism that captures full program costs in order to better support budget decisions.

In response to those recommendations, we proposed formula changes to channel more AIP funding to small and medium-sized airports in FY 2004. Vision 100 did not incorporate these formula changes. As enacted, however, the law did include other changes to AIP that benefit small airports, which will be allowed to carry over funding, share entitlements with other small airports, and use Federal funds for a greater range of projects. In addition, we have increased the Federal share of project costs from 90% to 95% at small hub and smaller airports through the end of FY 2007.



We also developed efficiency measures to track the number of labor hours spent in administering each grant and each $1 million in grant awards for the program ($3 billion total). We implemented data collection through the labor distribution reporting system and will develop baselines for the measures in FY 2005.

Evaluating Our Programs

A critical component of managing our performance is the periodic evaluation of FAA programs. In FY 2004, we asked MITRE's Center for Advanced Aviation System Development (CAASD) to evaluate our Information System Security (ISS) Program.

FAA requires all information systems listed in the information technology (IT) systems inventory provided to DOT (currently 285) to have a completed security certification and authorization package (SCAP). CAASD evaluators examined the security mitigation measures from the plans of a random sample of national airspace system SCAPs and compared them with what had been accomplished in the field. The purpose was to measure the extent to which security remediations were performed as planned. The measure of completed remediations is considered a strong indicator of ISS Program success.

FAA is now considering several findings from the evaluation. Complete and current data are critical for an agency-wide evaluation of information security. SCAPs provide a wealth of information on methods for improving the management of FAA IT system security. However, as they are now, they present challenges for data evaluation. To validate SCAP information, our ATO has started to put a subset of the mitigation data into a tracking mechanism. This best practice will be used as a model for evaluating other FAA organizations. Tracking the mitigation measures will provide a useful tool for managing FAA IT system security.

Unmanned Flight

FAA was instrumental in approving the flight plan for a test of Mariner, a remote-controlled surveillance plane operated by the U.S. Coast Guard. The test, which took place in July 2004, became a mission when this unmanned aerial vehicle (UAV), was deployed to provide video footage of wildfires burning out of control in Alaska.

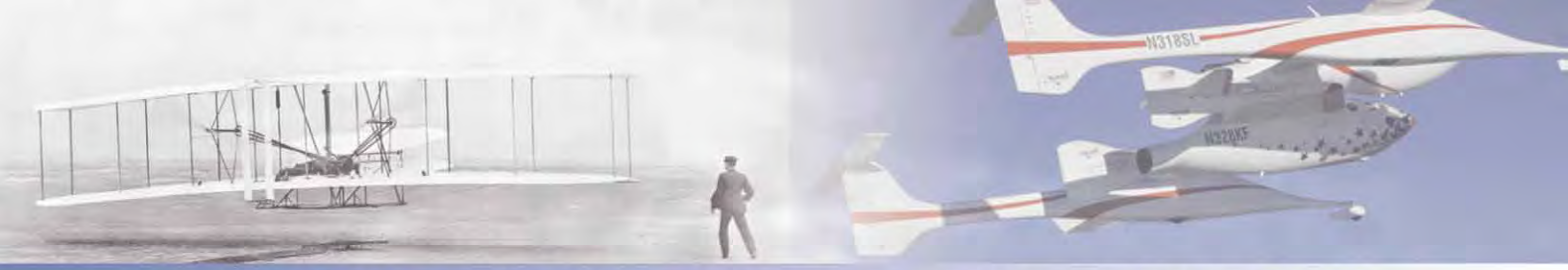
Mariner provided land management officials with valuable information about the fires. We are working with the Department of Defense, the National Aeronautics and Space Administration, and other operators to speed the process of clearing UAVs. We must balance the desire for quicker approval with the need to ensure the safety of other aircraft.

Additionally, the remediation status can be used as part of a larger effort to better allocate funding for risk mitigation based on priority, urgency, and cost. FAA's ATO is already taking action in this area and is documenting processes and procedures as a model for other lines of business.

FAA programs in the air transportation of hazardous material, physical facility security, operational errors, Safer Skies, and aircraft delay reductions are candidates for evaluations in FYs 2005 through 2008.

Improving Cost Control

In FY 2004, we introduced new cost and efficiency measures into the *Flight Plan*, focusing on the management of cost reimbursable contracts and cost control. Last fiscal year, DOT's Federal Managers' Financial Integrity Act (FMFIA) letter cited FAA with a material weakness related to our management of cost reimbursable contracts. Taking an aggressive stance on eliminating the weakness, we contracted with the Defense Contract Audit Agency to perform audits in support of the closeout of over 400 cost reimbursable contracts. As a result of our efforts, OIG no longer considers this area a material weakness.



To ensure that we continue to oversee this area, we have shifted funding for an ongoing program to review and closeout selected contracts.

Having started FY 2004 with a new *Flight Plan* that contained several new, unfunded initiatives, Administrator Blakey challenged her management team to redirect funding to support the plan. We introduced a process to help guide and track the successful reallocation of funds. Although this measure was not viewed as the kind of long-term measure that would truly drive down costs, it helped focus senior management on the need to stop certain activities and redirect funds to new strategic priorities.

One of the challenges we face with developing financial metrics is the availability of data. This fiscal year, we simultaneously implemented the new DOT financial management system, DELPHI, and the new FAA acquisition management system, PRISM. Like any major system implementation, this posed great challenges for the agency to correct problems, reduce processing backlogs, and improve business processes. These new systems, along with the existing cost accounting and labor distribution systems, provide us with a foundation of up-to-date financial tools and information to focus FAA's culture on cost control. FAA management is committed to providing more accurate and timely financial information to all lines of business beginning in FY 2005. With these data, we will explore what we can measure and seek to improve from there.

All FAA programs that were reviewed by using PART have developed efficiency measures as suggested by OMB. In the future, we will have a series of financial and other efficiency measures in place that better guide business decisions. FAA management will regularly evaluate these measures to ensure that the agency is accomplishing its mission through the best use of its resources.

Describing Results

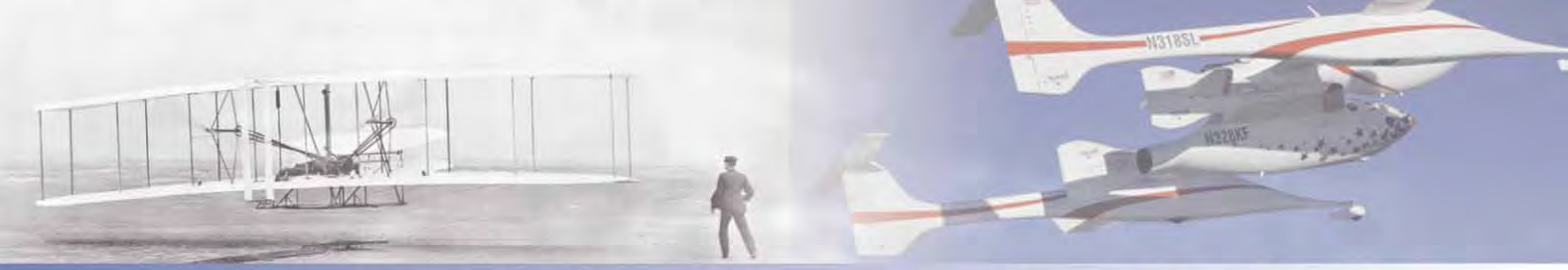
In the section that follows, we report the results for each target in our Performance at a Glance charts. The charts are followed by a detailed discussion of the most important results and initiatives in each goal area—safety, capacity, international leadership, and organizational excellence.

SAFETY

GOAL: Achieve the lowest possible accident rate and constantly improve safety.

Safety is our primary responsibility. It is central to the public's interest and the economic health of aviation. Although commercial aviation continues to be one of the safest forms of transportation, the public demands continued improvement in safety. General aviation also plays an important role in both the U.S. transportation system and the economy. We continue to focus our efforts on reducing the incidence of all types of general aviation accidents.

FAA's *Flight Plan* establishes eight specific objectives and outlines numerous initiatives to maintain the lowest aviation accident rates ever recorded. We recognize that complacency will undermine the gains in this area, and we therefore make continuous improvement in overall safety an essential task.



We assess safety through nine performance measures. The following chart describes our FY 2004 performance in improving safety through the achievement of each of these measures.

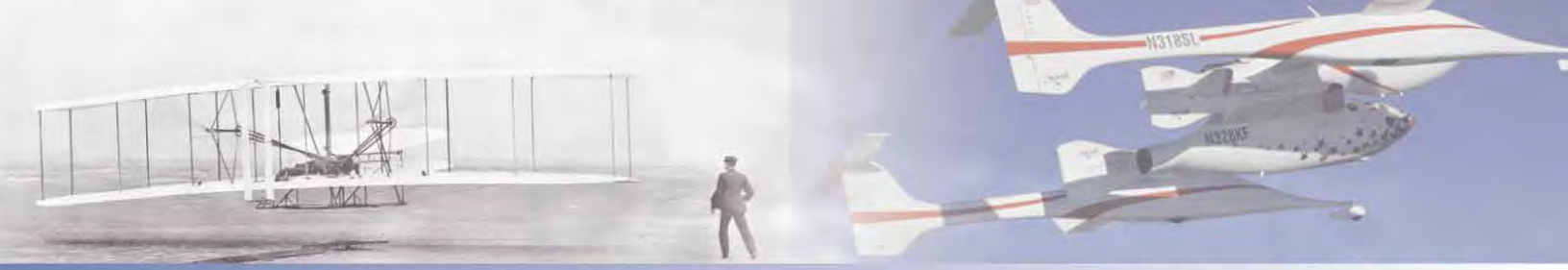
FY 2004 SAFETY PERFORMANCE MEASURES AND RESULTS

Performance Measure	Target	Results	Status
Commercial Air Carrier Fatal Accident Rate: Reduce U.S. fatal accident rates by 80% from the 1994–1996 baseline by FY 2007 and maintain the rate in FY 2008. The rate is calculated by determining the number of fatal accidents per 100,000 departures.	**0.028**	**0.021***	●
Single Safety Index: Implement a single, comprehensive index to provide a meaningful measure of the safety performance of the U.S. civil aviation system by FY 2006. The goal for FY 2004 was to plan and hold a conference to discuss the index. (The conference was held on January 21, 2004.)	**1**	**1**	●
Injuries from Turbulence: Reduce serious injuries from turbulence to no more than 12.	**18**	**9***	●
General Aviation Fatal Accidents: Reduce the number of fatal accidents to no more than 325 by FY 2008.	**349**	**340***	●
General Aviation Accidents—Alaska: Reduce accidents in Alaska to no more than 104 per year by FY 2008.	**125**	**100***	●
Operational Errors: Reduce the number of highest severity operational errors (Category A and B) to no more than 563 by FY 2008.	**629**	**637#**	◎
Runway Incursions: Reduce the number of highest severity (Category A and B) incursions to no more than 27 by FY 2008.	**40**	**28#**	●
Commercial Space Launch Accidents: Prevent fatalities or serious injuries to the uninvolved public during commercial space launch or reentry.	**0**	**0**	●
Commercial Space Launch Accidents—Property Damage: Prevent significant damage to property that is not associated with flight during commercial space launch or reentry.	**0**	**0**	●

● **Green:** Goal Achieved ◎ **Red:** Goal Not Achieved

** Numbers are preliminary. The NTSB will make final data available in May 2005.*

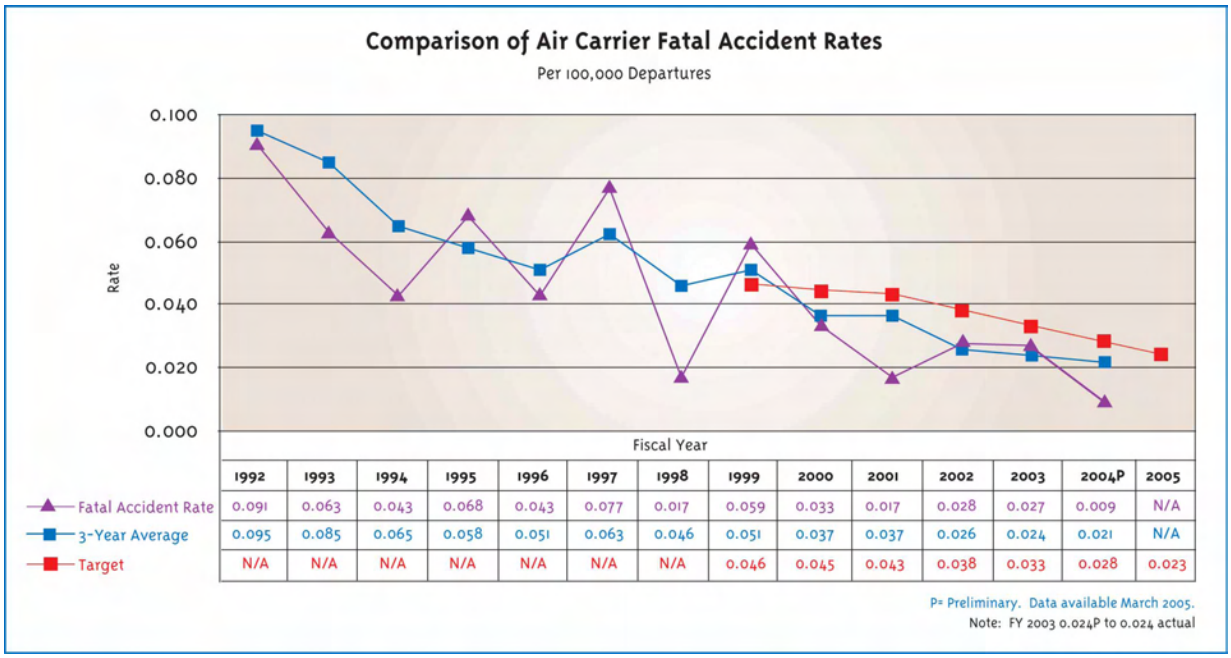
 # These are preliminary estimates. Final data will be available between November 2004 and January 2005.



Safety Results and Initiatives

Commercial Air Carrier Fatal Accident Rate

In FY 2004, FAA and the aviation industry recorded unprecedented success in preventing commercial air carrier fatal accidents, capping the lowest three-year accident rate in the history of U.S. civil aviation. Our focused safety agenda with its emphasis on using the latest technology to break the chain of events that lead to accidents, along with strong partnerships with industry, continues to keep the skies safe for commercial airspace passengers.



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004P	2005
Fatal Accident Rate	0.091	0.063	0.043	0.068	0.043	0.077	0.017	0.059	0.033	0.017	0.028	0.027	0.009	N/A
3-Year Average	0.095	0.085	0.065	0.058	0.051	0.063	0.046	0.051	0.037	0.037	0.026	0.024	0.021	N/A
Target	N/A	N/A	N/A	N/A	N/A	N/A	N/A	0.046	0.045	0.043	0.038	0.033	0.028	0.023

P= Preliminary. Data available March 2005.
Note: FY 2003 0.024P to 0.024 actual

While maintaining our regulatory and enforcement role, we continue to partner with the aviation community to improve safety. This partnership is reflected in three basic long-term strategies: (1) prevent accidents by addressing recurrent causes, (2) improve certification and surveillance, and (3) share safety data and information with aviation partners. These strategies are at the heart of our significant and long-term safety programs.

We also worked to increase aviation safety by preventing fuel tank explosions. In addition to more than 60 directives aimed at preventing ignition sources, we began working on a proposal to outfit certain large commercial jets with equipment that would virtually eliminate these accidents. The proposed systems replace oxygen in a jet's fuel tank with an inert gas, preventing the potential ignition of flammable vapors. FAA researchers have produced a lightweight system with no moving parts; the cost is relatively low compared with previous proposals.

We continued our efforts to improve the use of onboard technology that can enable pilots to navigate aircraft to any point in the world by using only geographic coordinates. Required Navigation Performance (RNP) is an important step toward moving the United States from an exclusively ground-based navigation system to one located within the aircraft itself. By providing pilots with precise guidance to all runways,

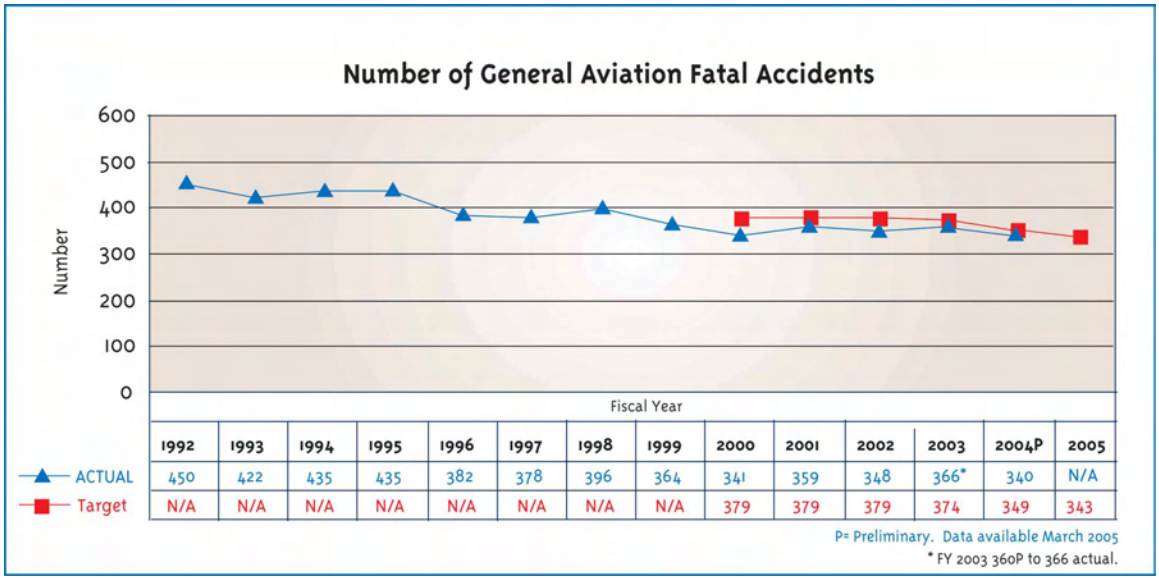
RNP can help prevent two major types of accidents—controlled flight into terrain and accidents that occur during approach and landing. In addition, RNP will enable pilots to land in weather that would ordinarily require diversion to other airports.

In addition to these safety initiatives, we also engaged in hands-on preventive measures, such as increased security screening of cargo to root out fireworks and other hazardous materials. Those efforts helped detect many undeclared hazardous materials, allowing FAA to safeguard airline passengers.

- ***Results:*** Through these initiatives and strategies, we were able to exceed our goal of reducing the rate of commercial fatal aviation accidents, achieving a rate of 0.021 fatal accidents per 100,000 departures.[1]

General Aviation Fatal Accidents

Although most people are familiar with FAA's role in commercial aviation, they may not be aware that we also oversee the safety of almost 300,000 general aviation aircraft, including single-seat home-built airplanes, rotorcraft, balloons, and highly sophisticated extended-range turbojets, in the United States. General aviation activities include student training, crop dusting, fire fighting, law enforcement, news coverage, sightseeing, industrial work, on-demand air taxi service, and corporate transportation, as well as personal and recreational flying.

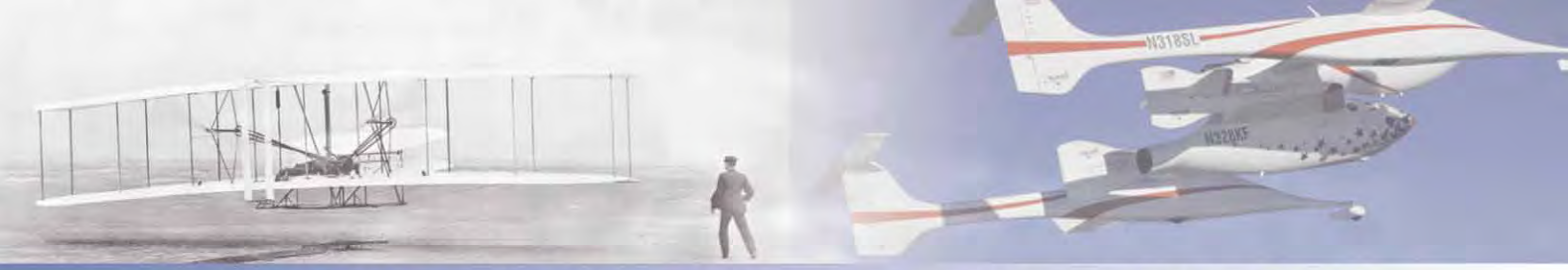


	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004P	2005
ACTUAL	450	422	435	435	382	378	396	364	341	359	348	366*	340	N/A
Target	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	379	379	379	374	349	343

P= Preliminary. Data available March 2005
* FY 2003 360P to 366 actual.

- ***Results:*** We exceeded our goal by reducing the number of general aviation fatal aviation accidents to 340 (preliminary estimate).

[1] Since the 1970s, the NTSB has not included fatal crashes caused by criminal or terrorist actions when calculating the commercial fatal accident rate. DOT follows NTSB methodology in quantifying FAA performance in commercial aviation safety. Therefore, the commercial fatal accident rate for FY 2001 did not include the four fatal crashes that occurred on September 11, 2001. If those incidents had been included, DOT would not have met the 2001 target.

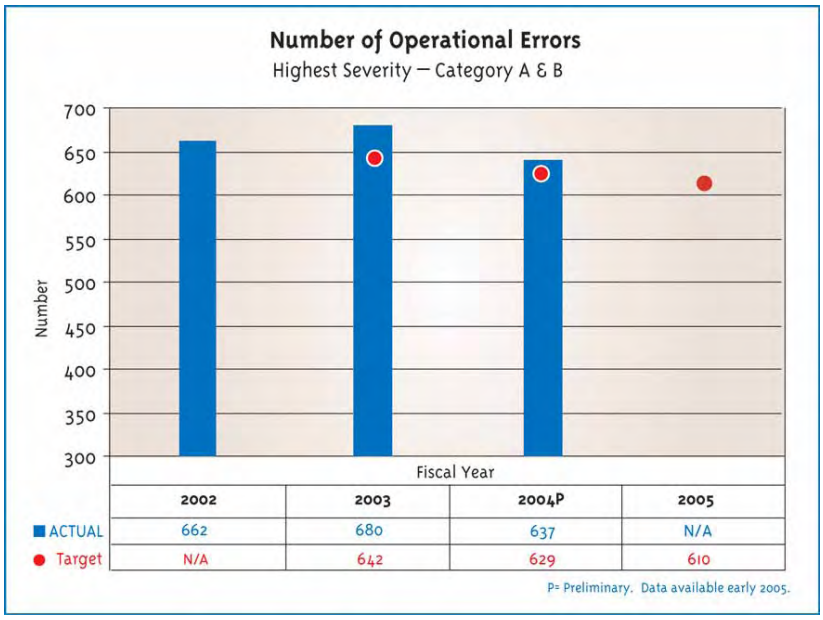


We continued to work proactively to meet our goal of reducing general aviation accidents. Because of the challenges of weather and terrain and the wide use of general aviation as a means of transportation in Alaska, our *Flight Plan* focuses specifically on reducing general aviation accidents there. Two programs in particular, Circle of Safety and CAPSTONE, appear to be making a difference. Circle of Safety is a consumer education program that works with passengers and organizations to share responsibility and take a more active role in their own flight safety. CAPSTONE helps provide pilots with information on their positions relative to terrain, as well as real-time weather information in the cockpit.

As another strategy for reducing general aviation fatal accidents, we established the Joint Steering Committee (JSC) in partnership with industry. JSC brings together key people from the general aviation community and the agency. This group met for the second time in July 2004 and established a new focus: (1) analyzing recent accidents to note emerging trends—for example, the shift in using aircraft more for transportation and less for recreational flying; (2) identifying specific new interventions that address major causes of accidents, such as formal guidance (FAA Advisory Circulars), instructional articles in magazines, and Web-based materials and interactive training aids; and (3) achieving consensus on effective new strategies and interventions, regardless of whether the effort is carried out by government or industry.

Operational Errors

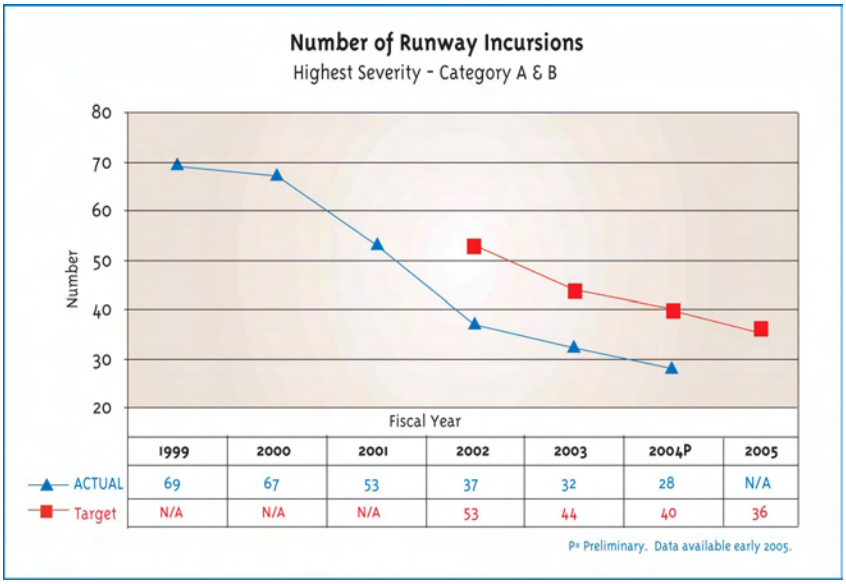
One of the fundamental principles of aviation safety is separation—the need to maintain a safe distance from other aircraft, terrain, obstructions, and restricted airspace. Air traffic controllers employ rules and procedures that define separation standards for this environment. An operational error occurs when controllers fail to apply or follow the procedures that enforce separation and allow aircraft to end up too close to each other or to an obstruction. To differentiate between technical violations and more severe operational errors, our performance measure focuses on the number of highest severity cases: Category A and B errors. These classifications are based on a point scale rating of three factors—vertical and lateral distances, closure rates, and flight paths, as well as on the level of air traffic controller oversight. Category A errors (high severity) rate 90 or higher. Category B errors (moderate severity–uncontrolled) rate between 40 and 89.



Results: We did not meet our goal of reducing Category A and B operational errors to 629 or fewer, reporting instead 637 (preliminary estimate). However, this represents a 6.3% reduction from the FY 2003 level, a significant accomplishment for our safety programs.

We are making progress toward our goal of reducing the annual number of operational errors. Last year, we exceeded our performance target of 642 Category A and B errors by 6%. This year, we missed our performance target of 629 errors by slightly more than 1%. While we did not achieve our goal, this decrease demonstrates positive improvement. To build on it, we will continue our efforts to better understand and control the human factors that cause operational errors. We also will employ a focused strategy to further reduce errors and develop an ATO quality assurance plan. In addition, we plan to implement a safety management system to anticipate emerging risks and monitor the effectiveness of our risk mitigation strategies.

Runway Incursions

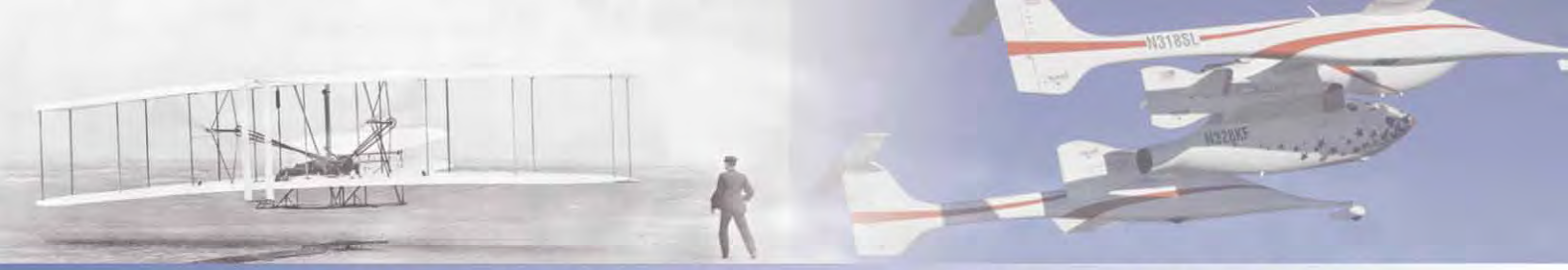


A runway incursion is any occurrence involving an aircraft, vehicle, person, or object on the ground that creates a collision hazard or results in a loss of separation with an aircraft taking off, intending to take off, landing, or intending to land at an airport. Reducing runway incursions lessens the probability of accidents that involve fatalities, injuries, and significant property damage. Our performance measure focuses on the number of Category A and B runway incursions, the highest severity events that present the most serious risk of collision. Category A incursions occur when separation is decreased and participants take extreme action to narrowly avoid a collision or the event results in a collision. With Category B incursions, a significant potential for collision exists.

- ***Results:*** FAA and industry have made progress in reducing runway incursions. There were 28 of the most serious types of runway incursions (preliminary estimate), significantly lower than our FY 2004 goal of 40. This performance continues a downward trend that began five years ago and reflects a 12.5% decrease from FY 2003.

To help reduce the number of serious runway incursions, our Office of Runway Safety developed and coordinated efforts with a variety of education and awareness materials focused on air traffic controllers, pilots, and vehicle operators. Other tools, such as air traffic control memory aids, better airport surface markers, and public service announcements, have contributed to the reduction in incursions.

A new runway technology system was prepared for deployment in FY 2004 to curb the threat of runway collisions at major U.S. airports. Airport Surface Detection Equipment, Model X (ASDE–X) was first commissioned at General Mitchell International Airport in Milwaukee, WI. It is the first phase of equipment that will eventually incorporate safety data derived from multiple airport sensors to help controllers detect potential runway collisions. Enhancing FAA's runway safety initiative, ASDE–X equipment maps moving objects on airport grounds or approaching by air. After this equipment was deployed in Milwaukee, FAA began preparing to install it at 25 other U.S. airports.



Commercial Space Launch Accidents *(new for FY 2004)*

Commercial space launches generate tremendous benefits to society by delivering payloads such as telecommunications satellites and remote-sensing devices to orbit. Since the first DOT-licensed space launch in 1989, there has not been a single accident. We strive to maintain this perfect record while safeguarding the public from the potential consequences of such an accident.

● ***Results:*** We achieved this goal in FY 2004. There were 13 licensed launches during the year, of which 4 involved reusable launch vehicles operating from an inland spaceport. No member of the public was killed or injured, and no member of the public suffered any property damage related to commercial space launches.

CAPACITY

GOAL: Work with local governments and airspace users to provide capacity that meets projected demand in the U.S. airspace system in an environmentally sound manner.

After the terrorist attacks of September 11, 2001, the demand for air travel decreased dramatically. While traffic has increased over the past three years, FAA forecasts suggest that it will not fully rebound until FY 2006.

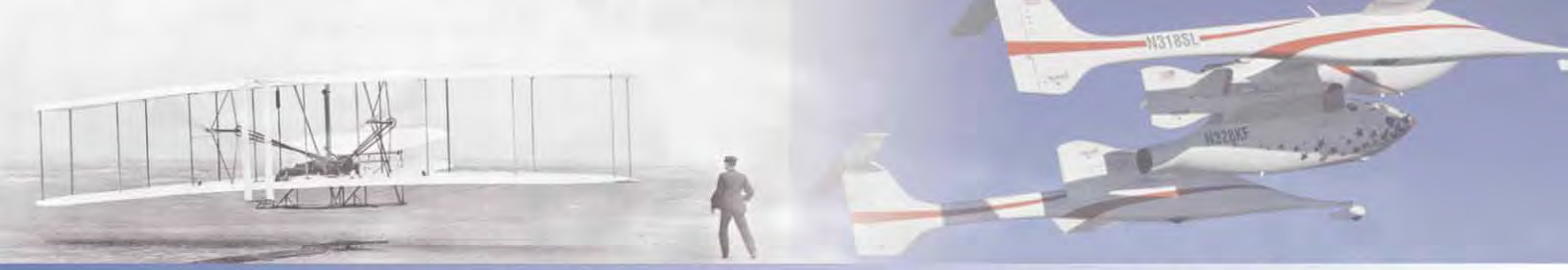
While the airlines continue to struggle with the effects of September 11 and to reinvigorate their industry, we are preparing for a return to heavy demand. During FY 2004, work continued with local governments and airspace users to improve the design and performance of both aircraft and ground systems. These improvements will accommodate more traffic while easing delays; increase safety and security while addressing noise and air quality; and foster efficient, predictable, and flexible domestic and international air travel.

As airspace systems become ever more interconnected, additional partnerships have been developed within the national and international aviation community. We continue to focus on aviation as a global system and work closely with international organizations to seek global solutions to safety, routing, procedural, equipment, and environmental issues.

We assess system capacity through eight performance measures. The following chart describes FAA's FY 2004 performance in improving efficiency through the achievement of each of these measures.

FY 2004 CAPACITY PERFORMANCE MEASURES AND RESULTS

Performance Measure	Target	Results	Status
On-Time Arrival: Through FY 2008, increase the percentage of all flights arriving within 15 minutes of schedule at the 35 OEP airports by 7%, as measured from the three-year FY 2000–2002 baseline.	**82.10%**	**79.08%** #	◎
Aircraft Noise Exposure: Reduce the number of people (in thousands) exposed to significant noise by 1% per year cumulative from FY 2003 through FY 2008, as measured by a three-year moving average, from the three-year average baseline for calendar years 2000 through 2002.	**2%**	**23%** #	●



FY 2004 CAPACITY PERFORMANCE MEASURES AND RESULTS			
Performance Measure	**Target**	**Results**	**Status**
Aviation Fuel Efficiency: Improve fuel efficiency per revenue plane-mile by 1% per year cumulative from FY 2004 through FY 2008, as measured by a three-year moving average, from the three-year average baseline for calendar years 2000 through 2002.	**1%**	**4.5%**	●
Airport Daily Arrival Capacity (35 OEP airports): Achieve an increase in capacity at the 35 OEP airports from 50,550 arrivals per day from the 2000–2002 baseline to at least 53,600 per day by FY 2008.	**51,332**	**51,587#**	●
Airport Daily Area Capacity (eight metropolitan areas): Achieve an increase in capacity for the eight major metropolitan areas from 21,290 arrivals per day from the 2000–2002 baseline to at least 22,000 per day by FY 2008.	**21,290**	**21,233#**	◎
Airport Arrival Efficiency Rate: Achieve a rate of 96% at the 35 OEP airports by FY 2008.	**95.67%**	**95.03%#**	◎
Annual Service Volume: Open as many as nine new runways and increase the volume of the 35 OEP airports by at least 1% annually through FY 2008.	**2**	**2**	●
Operational Availability: Sustain availability at 99% for the reportable facilities that support the 35 OEP airports.	**99%**	**98.95%**	◎

● **Green:** Goal Achieved ◎ **Red:** Goal Not Achieved

These are preliminary estimates. Final data will be available between November 2004 and January 2005.

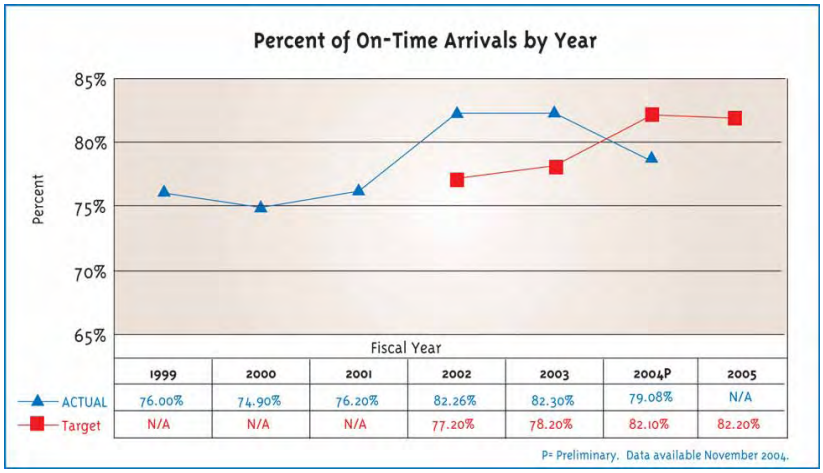
Capacity Results and Initiatives

On-Time Arrival

As air traffic volume continued to return to pre–September 11, 2001, levels, delays have increased. To respond to this increase, we continued to focus on easing congestion in eight metropolitan areas by improving overall capacity at the nation's top 35 airports, building new runways, enhancing access to reliever airports for general aviation operations, and increasing traffic coordination and communication through new technologies.

We are dedicated to improving on-time arrival rates at O'Hare International Airport in Chicago, IL, and throughout the country. As delays mounted across the system in FY 2004, FAA began negotiations in August with carriers serving O'Hare to reduce the number of scheduled flights and improve on-time arrival rates. O'Hare is a connecting point for thousands of passengers every day, and increasing delays at the already congested airport can create delays in many other airports. To resolve the problem quickly, we invoked Vision 100 authority allowing us to ask commercial airlines to meet and discuss fight reductions at severely congested airports.

As part of our efforts to implement the Roadmap for Performance-Based Navigation (2003–2020), we are working to develop criteria and guidance materials for new RNAV and RNP procedures. RNP permits greater flexibility and standardizes airspace performance requirements. By adopting the Roadmap and RNP and by leveraging existing and emerging cockpit capabilities, we will work with the aviation community to improve airspace and procedures design. The combination of new procedures and continued collaboration with industry will lead to increased capacity and improved efficiency in years to come.



Results: We did not meet our FY 2004 on-time target of 82.10%. Our failure was due primarily to a significant increase in adverse weather from May through August 2004, which caused a 72.5% increase in weather-related delays for that period compared with the previous year. Weather delays increased over 44% from last year and accounted for approximately 72% of all delays. Congestion delays at Chicago's O'Hare also played a significant role in causing systemwide delays.

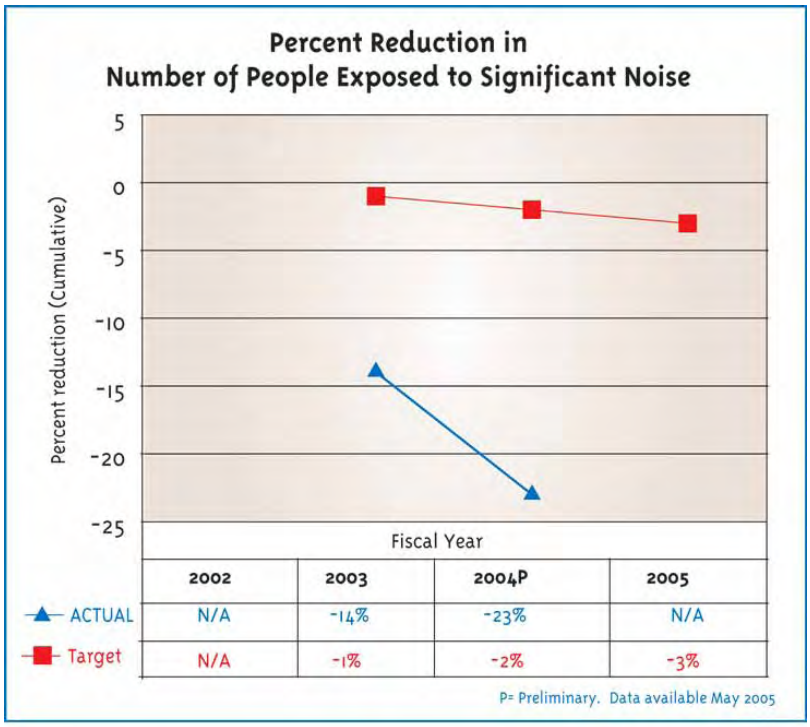
To improve on-time performance in FY 2005, we established an agreed upon ceiling with air carriers on scheduled hourly flights at O'Hare and continued efforts to improve performance during adverse weather. Physical capacity improvements at airports and collaborative efforts between FAA and the airlines to improve performance are ongoing.

Aircraft Noise Exposure

Public concern over and sensitivity to aircraft noise around airports are high. In recent years, noise complaints have increased even as quieter aircraft have been introduced. Aircraft noise is an undesired by-product of our mobility, and the government acts to reduce the public's exposure to unreasonable noise levels. In the past decade, the phase-out of noisier commercial aircraft was principally responsible for the reduction in the number of people exposed to high levels of aircraft noise, although efforts were complemented by noise compatibility projects funded under the AIP. While the new international aircraft noise standard will encourage the introduction of quieter aircraft, AIP-funded noise compatibility projects will be the principal means used by government to mitigate significant exposure to aircraft noise.

Results: We exceeded this performance target by reducing the percentage of people exposed to significant noise by 9% in FY 2004, for a cumulative reduction of 23% from the baseline.

In cooperation with the aviation community, we pursue a program involving noise reduction at the source (development and adoption of quieter aircraft), soundproofing and buyouts of buildings near airports, operational flight control measures, and land use planning. We are authorized to provide funds for soundproofing and residential relocation, but each project must be locally sponsored and be a part of a noise compatibility program prepared by the airport sponsor and approved by FAA. This noise target is based on our experience and reflects the relocation of people from the DNL (day/night sound level) 65 contour through grant funding, but is also affected by market forces that drive changes in commercial aircraft fleets and operations. [*Note:* The DNL is the 24-hour average sound level in decibels. The DNL is derived from all noise-producing events during that time period.]

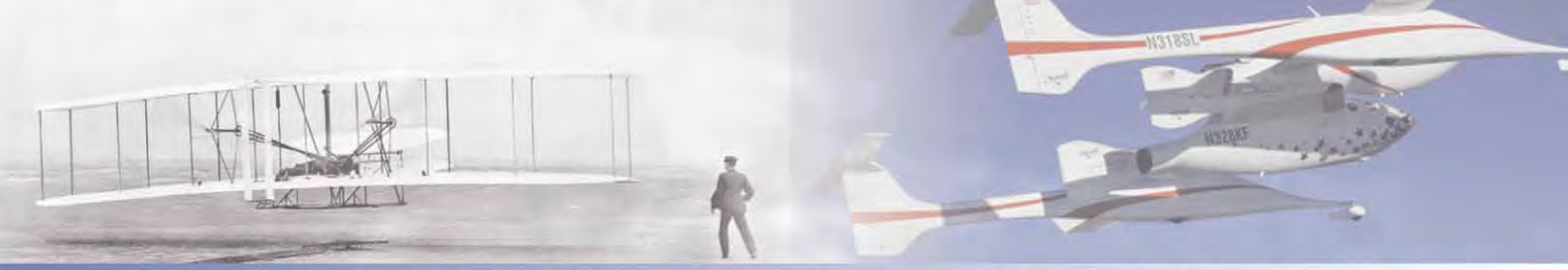


The significant improvement over targeted goals in noise reduction grew out of the confluence of a number of external factors, including the economic downturn, the impact of September 11, 2001, on the industry, and the severe acute respiratory syndrome (SARS) outbreak, which caused passengers who were afraid of contracting SARS to avoid air travel. The large-scale premature retirement of older stage 3 aircraft (Boeing 727, DC–9, and MD–80), along with these other factors, produced a dramatic downturn in operations. This combination of lower operations and the rapid reduction in the average age of operating fleets produced the dramatic improvements in noise exposure. Assuming that the industry will recover over the next few years, the level of improvements witnessed last year is unlikely to persist.

We are beginning a multiyear effort to update our noise model—MAGENTA (Model for Assessing the Global Exposure of Noise because of Transport Airplanes). These changes result from a combination of improvements in data sources and acoustic algorithms in the model. This effort will produce significant improvement in our ability to measure the number of people exposed to significant noise levels around U.S. airports. We will adopt a new performance metric report that uses percentage change in noise exposure to make it consistent with the *Flight Plan*. We will also use the projection analysis as a tool to assist us in an ongoing assessment of our noise targets.

Aviation Fuel Efficiency *(new for FY 2004)*

There is growing concern over aviation's contribution to both global climate change and local air quality. Like noise, aviation emissions are becoming a major environmental concern around airports, and local air quality is a major consideration of any assessment of potential capacity increases. Although today's aircraft are up to 70% more efficient than early jets and the science involved with emissions is still developing, aviation is viewed as a small contributor to climate change.



Our FY 2004 performance target was to improve aviation fuel efficiency per revenue plane-mile by 1% per year through FY 2008, as measured by a three-year moving average, from the three-year average for calendar years 2000 through 2002. We measure this target using SAGE—the System for Assessing Aviation Global Emissions—a computer model that estimates aircraft fuel burn and emissions for variable-year emissions inventories and for operational, policy, and technology-related scenarios. For this target, SAGE is used to generate fuel burn and total distance flown data annually for all U.S. commercial operations. We calculated the baseline for this performance target by averaging the annual SAGE-generated fuel burn for calendar years 2000 through 2002 and dividing by the average total distance flown over that period. Our FY 2004 performance was calculated for the most recent three years (2001, 2002, and 2003).

- ***Results:*** We exceeded our goal for improving aviation fuel efficiency. Relative to the baseline, the calculated fuel efficiency for FY 2004 was a 4.5% improvement.

FAA's Operational Evolution Plan: A Vision for Tomorrow

To deal with the challenges presented by growing demand for air travel, we worked with the entire aviation community to create a blueprint that will guide our efforts to enhance and modernize the airspace system. In June 2001, we released the Operational Evolution Plan (OEP)—a dynamic, comprehensive, and integrated document that uses an evolutionary, one-step-at-a-time approach to modernization. New runways, new routes, new tools, and airspace redesign are the core changes OEP addresses in this 10-year strategic plan.

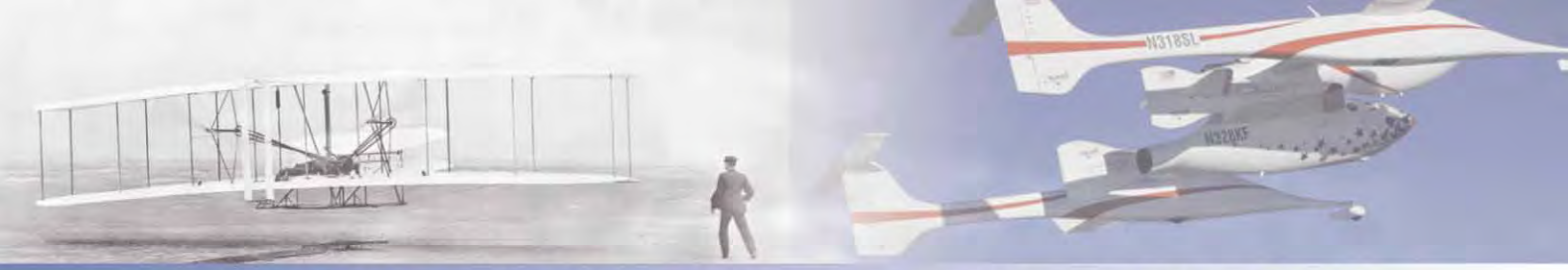
OEP specifically addresses the capacity challenges faced by the country's 31 large hub airports and 4 medium hub airports (Memphis, TN; Reagan National in Washington, DC: Cleveland, OH; and Portland, OR). These airports are referred to as the 35 OEP airports in several of FAA's FY 2004 capacity goals.

Each set of solutions outlined in OEP represents the aviation community's commitment to make investments and implement changes that will increase capacity and enhance efficiency to create an aviation system for the future. OEP is available on the FAA Website at www.faa.gov/programs/oep/.

Airport Daily Arrival Capacity

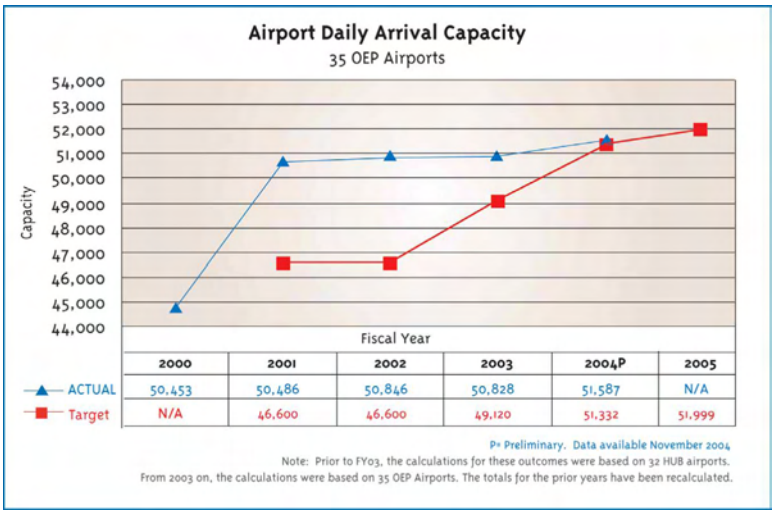
We increased long-term capacity throughout the system due, in large part, to two major new runways that were commissioned in Houston, TX, and Orlando, FL, in FY 2004. The Operational Evolution Plan (OEP), our long-range plan for expanding capacity in national air space, currently identifies seven additional air carrier runways to be commissioned through 2014, allowing these airports to accommodate an additional 889,000 operations each year. Because constructing new runways is the most effective way to add ground capacity, particularly at the Nation's larger airports, we are also improving the criteria for assessing the capacity of our larger airports and their ability to meet projected demand. This information, in turn, will be used to target efforts to use pavement, procedures, and technology to add capacity at airports with the greatest need and with the most potential to reduce delays nationwide.

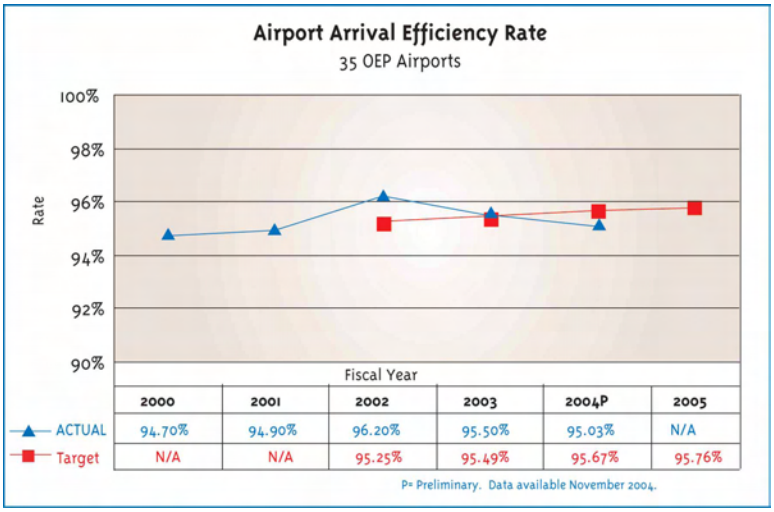
We will continue to develop and deploy technology that enables aircraft to safely take off and land in adverse weather. We will also focus on adding runways, new terminal technologies, and improved data collection to meet future capacity performance targets.



Results: We exceeded our target of 51,332 arrival positions for the 35 OEP airports. Preliminary data indicate that arrival capacity at the 35 busiest airports was 51,587 per day.

Results: We did not meet our FY 2004 target for capacity of 21,290 in the eight metropolitan areas. Runway construction at Washington Dulles and Boston's Logan International Airport markedly reduced arrival capacity in May, with lower capacity available in selected metropolitan areas because of the increased occurrence of adverse weather in the summer. Capacity was above the target levels in the closing months of the year, however. (Graph not included.)



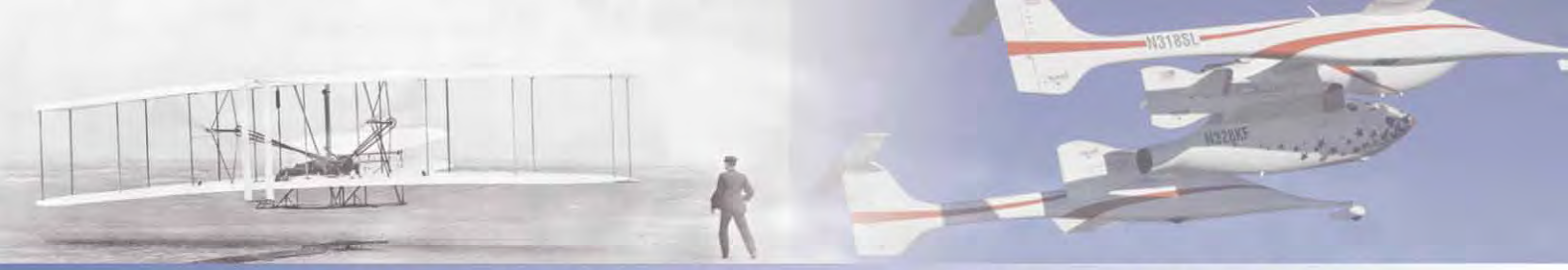


Airport Arrival Efficiency Rate

This rate measures how well the 35 OEP airports use their existing capacity. An efficient aviation system gets passengers and goods to their destinations safely and reliably. Aviation system improvements must be environmentally responsible, taking into consideration the impact of aviation development on communities near airports and on sensitive natural resources. Our focus is on the strategic expansion of system capacity and other creative solutions to address growing mobility needs and increase the reliability of the system.

Results: We did not meet our FY 2004 target of 95.67%. The arrival efficiency rate compares landed aircraft in a specific time frame with the lesser of demand or arrival capacity. The increased adverse weather experienced in 2004 reduced timely aircraft landings and increased the level of demand (aircraft not landed when originally scheduled may be "held over" successive periods), thus reducing the rate.

We are implementing procedures to standardize the compilation of airport arrival rates, which will help aircraft flow control and improve arrival rates.



Annual Service Volume *(new for FY 2004)*

The annual service volume goal is in place to prevent unreasonable delays at airports and expand the number of runways at several of the 35 OEP airports. In 2004, we commissioned two new runways (in Houston, TX, and Orlando, FL).

● ***Results:*** We met this goal by opening two new runways in the first quarter of FY 2004, thus increasing annual service volume by 1.07%, measured as a five-year moving average. These runways will accommodate an additional 370,000 annual operations.

Operational Availability *(new for FY 2004)*

Sustaining operational availability at 99.00% is another key component of FAA's *Flight Plan* goal of reducing aviation delays. FAA focuses on each OEP airport's reportable facilities, factoring in standard maintenance procedures, as well as long-term airport construction that can cause runway shutdowns. A subset of the national airspace system is analyzed to determine the ratio of total operating facility/service hours to maximum facility/service hours, expressed as a percentage.

◎ ***Results:*** We did not achieve our goal because of a 0.38% increase in scheduled downtime from improvement projects. Operational ability at all 35 OEP airports was 98.95% for FY 2004, slightly below our goal.

The goal is under review for FY 2005. We will consider an adjusted measure that excludes scheduled downtimes.

INTERNATIONAL LEADERSHIP

GOAL: Increase the safety and capacity of the global civil aerospace system in an environmentally sound manner.

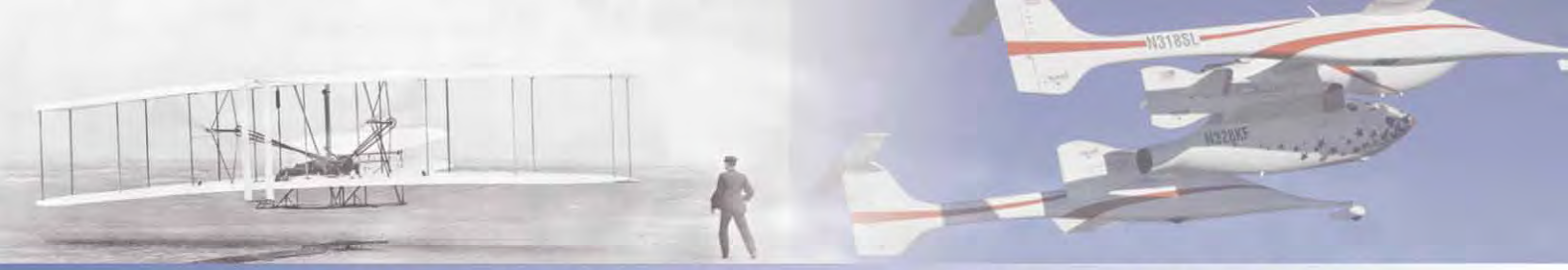
The United States has long been a leader in the global civil aviation system. In addition to controlling nearly half the world's air traffic, FAA provides direct and indirect aviation assistance to 129 countries. As a leader, we must promote safety by broadening the international network of partnerships with civil aviation authorities around the world to make air travel as safe and efficient abroad as it is at home.

We assess international performance through six performance measures. The following chart describes our FY 2004 performance in improving efficiency through the achievement of each of these measures.

FY 2004 INTERNATIONAL LEADERSHIP PERFORMANCE MEASURES AND RESULTS

Note: All International Leadership Performance Measures are new for FY 2004.

Performance Measure	Target	Results	Status
Intellectual and Financial Assistance: Secure a 100% increase by FY 2008 over FY 2003 levels in intellectual and financial assistance for international aviation activities from the United States and international government organizations, multilateral banks, and industry.	**20%**	**177%**	●
Bilateral Agreements: Conclude new bilateral agreements recognizing safety certification and approval systems with 10 key countries or regional authorities by FY 2008.	**2**	**3**	●



FY 2004 INTERNATIONAL LEADERSHIP PERFORMANCE MEASURES AND RESULTS

Note: All International Leadership Performance Measures are new for FY 2004.

Performance Measure	Target	Results	Status
Technical Assistance: Provide new or expanded technical assistance and training to 30 key countries or regional authorities by FY 2008.	**6**	**30**	●
Technology and Procedures: Ensure that the United States, ICAO, and other international partners implement new techniques and key operational procedures in a consistent and timely manner. FAA's goal was to attain 75% of the milestones planned for FY 2004.	**75%**	**100%**	●
Global Environmental Standards: Ensure that international environmental standards, recommended practices, and guidance material adopted by ICAO are globally and uniformly applied, reflect the best available technology, provide real environmental benefit, and are economically sound. This goal is considered met by the successful adoption of an internationally agreed-on approach on two of three environmental issues acceptable to the United States.	**2**	**3**	●
Required Vertical Separation Minimum (RVSM): Implement RVSM in the North American region by January 2005. Achieve all FY 2004 milestones on time.	**85%**	**90%**	●

● **Green:** Goal Achieved ◎ **Red:** Goal Not Achieved

International Leadership Results and Initiatives

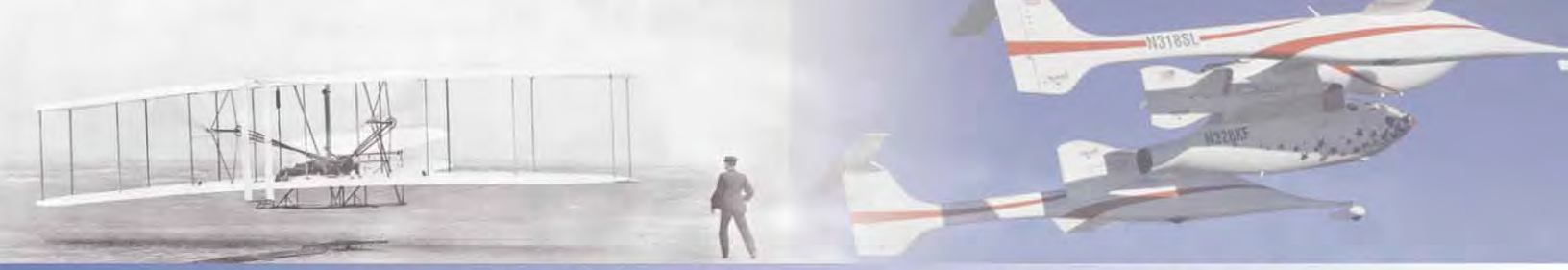
Intellectual and Financial Assistance

During FY 2004, we cooperated with several U.S. government and international development organizations to meet and exceed targets for providing intellectual and financial assistance. In FY 2004, we directed $13.8 million in funding to support 14 key aviation infrastructure and development projects in the Americas, Asia, and Africa to improve aviation safety; promote the use of new technologies, such as GNSS (Global Navigation Satellite System); enhance efficiency; and encourage regional technical cooperation. Funding sources included the U.S. Agency for International Development, the U.S. Trade and Development Agency, the World Bank, and the Japan Bank for International Cooperation.

We were instrumental in supporting the establishment of the Committee on International Aviation Safety and Security, a U.S. government interagency effort to improve coordination and tracking for funding key international aviation infrastructure projects.

Bilateral Agreements

The objective of this target is to promote improved safety and regulatory oversight through the conclusion of new Bilateral Aviation Safety Agreements (BASAs) with key countries. These BASAs recognize safety certification and approval systems, promote safety and environmental quality, and enhance cooperation and increase efficiency in matters related to civil aviation. By building a network of competent civil aviation authorities, we can increase safety around the world. Improved global understanding of U.S. safety regulations, processes, and procedures leads to better international regulatory oversight.



Our FY 2004 target was to conclude BASAs with two countries. We exceeded this goal, signing agreements with Singapore in February 2004, Brazil in March 2004, and Iceland in September 2004. BASA agreements are also pending with China and Australia.

Technical Assistance

FAA provided a range of technical assistance and training through 50 separate projects to improve aviation safety and system efficiency to 30 countries during FY 2004. Activities included supporting key presidential initiatives to improve aviation infrastructure in Iraq, Afghanistan, Africa, and the Americas. FAA focused significant resources on a range of cooperative programs with China that encompassed aviation safety, air traffic control and airport operations, and manufacturing certification activities. Under the “Safe Skies for Africa” Presidential Initiative, technical assistance and training were provided to 10 countries. We participated in ICAO regional safety programs and sponsored safety seminars in the Asia-Pacific and Americas regions.

We also supported seven FAA–George Washington University Consortium Summits on Aviation Safety and Security, with 48 countries participating. The 144 participants included 19 ministers responsible for civil aviation and 31 directors general of civil aviation. The summit program promotes global safety by creating advocacy among senior officials for implementing international standards and improving regional cooperation.

Technology and Procedures

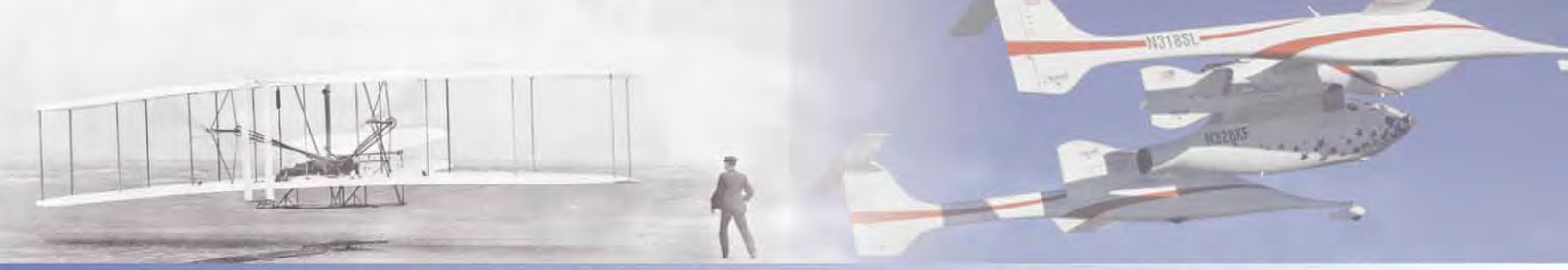
By working with international agencies, organizations and states, we can enhance the international leadership role of the United States by having a positive influence on critical technological issues. Our target for FY 2004 was to reach 75% of milestones set to ensure the implementation of new technologies and procedures in a consistent and timely manner by the U.S., ICAO, and other international partners.

The milestones set for this target were: development of a worldwide Ionospheric Mitigation Roadmap, revision of the existing FAA/EUROCONTROL Memorandum of Cooperation, exchange of information relating to RNP with two groups of ATS providers, and orchestration of a joint US/IATA/Europe Digital Air-Ground Communications Workshop. We exceeded our goal, completing 100% of these projects in FY 2004.

Global Environmental Standards

The establishment of global environmental standards promotes seamless international operations in cooperation with bilateral, regional and multilateral aviation partners. The lack of international harmonization on environmental standards and practices creates significant difficulties to the effective operation of an industry in which an aircraft takes off somewhere in the world every few seconds. It also can result in misapplication of limited regulatory and financial resources in a manner that does not achieve cost-effective solutions to deal with aviation's environmental impacts. It is important as well to ensure that internationally agreed standards and practices are acceptable to the U.S.

Our target for FY 2004 was to achieve at least two of the following three outcomes in association with ICAO: (1) agreement on new nitrogen oxide emissions standards for commercial aircraft engines, (2) adoption of guidance on the Balanced Approach to Noise Management, and (3) support for developing voluntary measures as a viable alternative to mandatory emissions trading schemes or charges. We exceeded our target, achieving all three outcomes.



Required Vertical Separation Minimum (RVSM)

Separation between aircraft is one of the fundamental principles of aviation safety. The RVSM goal is to reduce the vertical separation above 29,000 feet from the current 2,000-foot minimum to a 1,000-foot minimum. This will allow aircraft to safely fly the most efficient routes, gain fuel savings, and increase airspace capacity. RVSM was first implemented in North Atlantic airspace in 1997. It has also been implemented in other major airspaces such as Europe, the Pacific Ocean, and Australia and will be implemented in additional international airspace in 2005.

● ***Results:*** FAA met or exceeded all of its performance goals for international leadership.

ORGANIZATIONAL EXCELLENCE

GOAL: Ensure the success of FAA's mission through stronger leadership, a better trained workforce, enhanced cost-control measures, and improved decision making based on reliable data.

Organizational excellence is an ongoing challenge. Our performance measures this year continued with an external focus on improving customer satisfaction and the launch of a more concerted internal focus on improving our business processes. These internal improvements included better management of our acquisitions, faster hiring for mission-critical positions, strengthening the linkage between employee performance and agency goals, shoring up the security of our information, and reducing costs.

FY 2004 ORGANIZATIONAL EXCELLENCE PERFORMANCE MEASURES AND RESULTS

Performance Measure	Target	Results	Status
Acquisitions: Ensure that 90% of major system acquisition investments are both on schedule and within 10% of budget by FY 2008.	80%	91%	●
Cost Reimbursable Contracts: Close out 100% of 180 cost reimbursable contracts (FY 2001 baseline) by the end of FY 2004 and close out 85% of contracts that become eligible for closure in future years.	180	135	◎
Customer Satisfaction: Increase FAA's score on the American Customer Satisfaction Index.	63	65	●
Cost Control: By putting cost controls in place and having a more efficient, effective workforce, fund at least 75% of the currently unfunded portion of the *Flight Plan*.	10%	10%	●
Information Security: Achieve 90% of the annual milestones for the agency information security plan for each year through FY 2008.	90%	100%	●
Performance Plans: Directly relate all employee performance plans to FAA strategic goals and the organization's performance plans by FY 2008.	80%	84.56%	●
Mission Critical Positions: Reduce the time it takes to hire mission critical positions by 20% over the FY 2003 baseline.	3%	28%	●
***Flight Plan*:** Meet 27 of 30 performance targets for FY 2004. (This is performance goal #31.)	90%	80%	◎

● **Green:** Goal Achieved ◎ **Red:** Goal Not Achieved

Organizational Excellence Results and Initiatives

Acquisitions

In keeping with the focus on organizational excellence, FAA established a goal of achieving 80% of designated milestones and maintaining 80% of critical program costs within 10% of the budget as published in the Capital Investment Plan.

Results: FAA met the FY 2004 goal with 91% of major system acquisitions remaining within the cost and schedule performance goal. Overall, 4 out of 43 programs had schedule and/or cost variances beyond established thresholds. All cost goals remain within established thresholds. This resulted in the final 91% performance results for the acquisition goal. The use of a disciplined automated monthly reporting process allowed detailed insight into cost and schedule performance for all levels of management. Such insight enhanced decision making and ensured that critical acquisitions remained within the established 80% performance parameter. Technical issues were the primary reason four of the programs missed the FY 2004 performance goal.

Cost Reimbursable Contracts

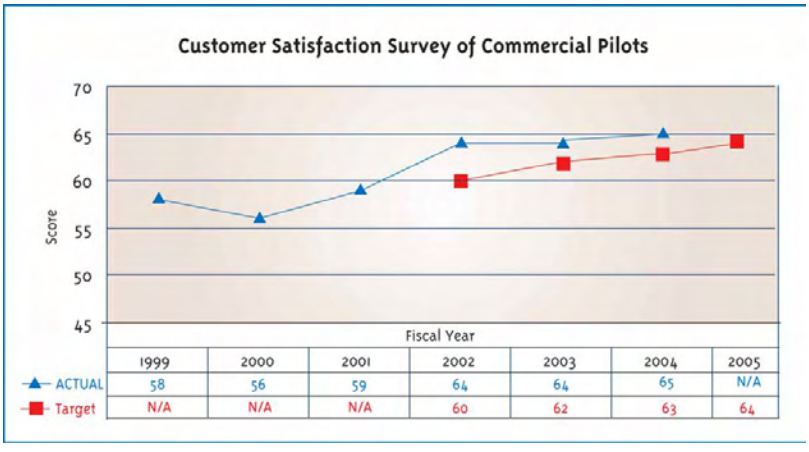
Our target for this goal required that we close out 100% of 180 cost reimbursable contracts (FY 2001 baseline) by the end of FY 2004 and close out 85% of contracts that become eligible for closeout in future years.

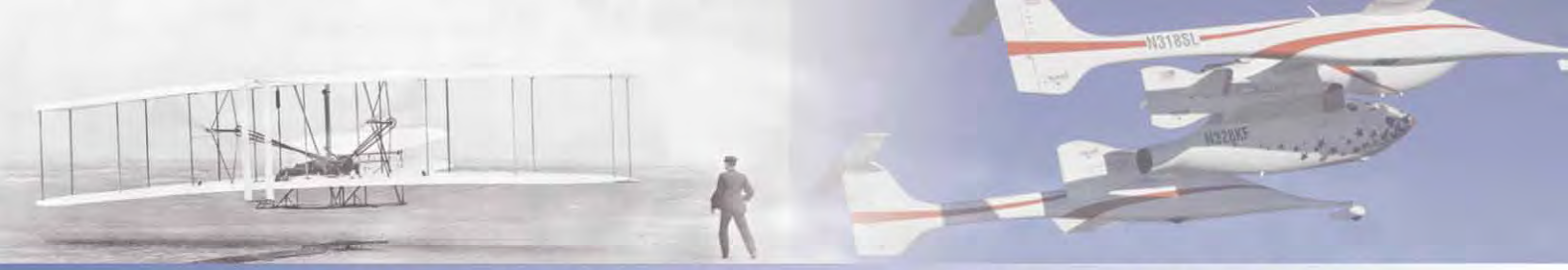
Results: There were 459 cost reimbursable contracts overdue for closeout in FY 2001. Our FY 2004 target was to close out 180 of these contracts (45 per quarter). By the end of the year, we had closed out a total of 311 cost reimbursable contracts, 135 of which were included in the FY 2001 baseline count. We also closed out 58 contracts that became overdue after the FY 2001 baseline was established. In addition, we closed out 118 contracts that were not yet overdue. While we were not able to close out 100% of the 180 targeted contracts, we demonstrated our ability to achieve timely closure of future contracts.

Key reasons for not meeting our goal for FY 2004 were that vendors were unwilling or unable to provide required information, and a lack of records for contracts that are more than 20 years old. The remaining contracts will be tracked to ensure final closeout.

Customer Satisfaction– Commercial Pilots

Over the past six years, we have used the American Customer Satisfaction Index (ACSI) to measure satisfaction with U.S. commercial pilots. The ACSI is a national indicator of the quality of goods and services available to the American public. It is a weighted average measuring overall satisfaction, customer expectations, and perceived





quality. Commercial pilots are asked about air traffic control personnel and services, pilot certification processes, the clarity of regulations, and how they contribute to aviation safety. This year's results show that the stabilized improvement in 2002 and 2003 continues into 2004. While satisfaction for commercial pilots has remained in the mid-60s for the past three years, it is significantly higher than the levels achieved in the first three years of the study.

- ***Results:*** We exceeded our FY 2004 target of 63, achieving an ACSI score of 65. Slightly higher expectations for FAA and a slightly higher rating for Air Traffic Services have led to a small increase in quality and a corresponding increase in customer satisfaction.

Cost Control *(new for FY 2004)*

We expect to fund at least 75% of the currently unfunded portion of FAA's *Flight Plan* by FY 2008 through cost control measures and a more efficient, effective workforce. Our FY 2004 target was to fund 10% of the unfunded portion through FY 2008. However, unfunded amounts for FY 2006 through FY 2008 were never calculated because of budget uncertainties. The original unfunded amount for FY 2004 was $212 million. As the year progressed, some *Flight Plan* initiatives were reprioritized, and cost estimates were reviewed and updated. Other costs were deferred to FY 2005 and later years. As a result, the unfunded amount was reduced to $4 million at the end of FY 2004.

We are now integrating an agency-wide cost control program designed to maximize savings through the *Flight Plan.* FAA is working on cross-organizational initiatives focused on controlling operational costs, starting with an emphasis on IT. As an example, we have established cross-cutting teams of IT professionals and subject matter experts to focus on several different cost-containment initiatives. These include Web and server consolidation, enterprise licensing, desktops and help desks, and IT baselining. We are retooling our FY 2005 goals in support of these FY 2004 findings. Additional efforts will focus on planning for IT infrastructure efficiencies and simplification. To support its cost containment efforts, the agency is partnering with industry leaders in such areas as asset identification, cost modeling, client technology, storage solutions, and enterprise architecture.

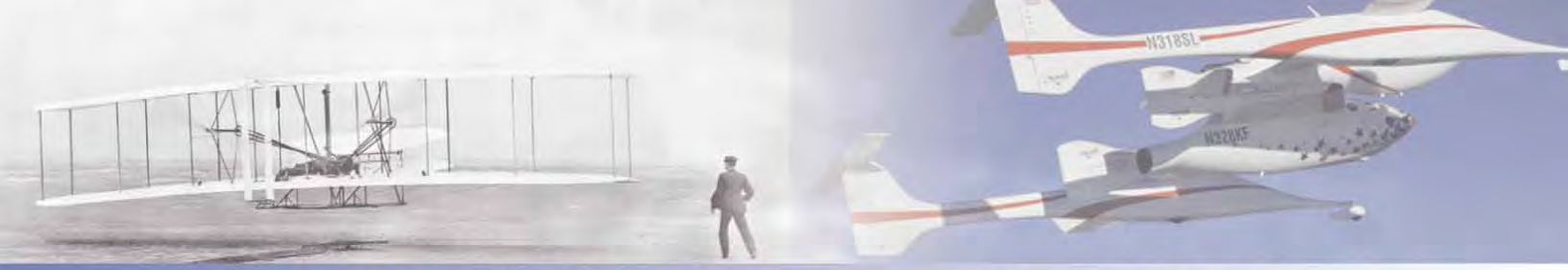
We will also focus on improving business processes related to the implementation of DELPHI (financial management system) and PRISM (acquisition system). By creating incentives for employees to better manage costs and providing them with the tools to make those decisions, the agency will continue to make progress on funding the *Flight Plan* and achieving its performance goals.

- ***Results:*** FAA met this goal.

Information Security *(new for FY 2004)*

During FY 2004, we made significant progress toward protecting our IT assets in accordance with numerous executive and congressional requirements. Noteworthy is the fact that we assisted DOT in achieving a "green" status on the President's Management Agenda's e-Gov goal, and OIG removed the material weakness condition in cyber security in its FY 2004 submission to OMB. The FY 2004 actions that contributed to the success of information security are as follows: conducting a security review of FAA's IT inventory, achieving an average of no more than 0.05 vulnerabilities per network server scanned, and expanding the intrusion detection capability for the FAA enterprise.

- ***Results:*** FAA exceeded its goal, completing 100% of the FY 2004 milestones for the information security plan.



Performance Plans *(new for FY 2004)*

This target requires 100% of employee performance plans to be directly related to FAA strategic goals and the performance plan of employees' organizations. The FY 2004 target is 80%, with a 5% increase for each succeeding fiscal year. FAA's Office of Human Resources distributed guidance to FAA line and staff offices on assessing the current level of compliance on performance plan alignment.

- ***Results:*** The final analysis of the reports from the agency's organizations show that 84.56% of FAA employees, managers, and executives had individual performance plans linked to the strategic goals in the *Flight Plan* and organizational business goals. This exceeds the 80% goal for FY 2004. Individual organizations that did not meet the 80% goal for FY 2004 have been offered assistance from FAA's Office of Human Resources in establishing FY 2005 individual performance plans.

Mission Critical Positions *(new for FY 2004)*

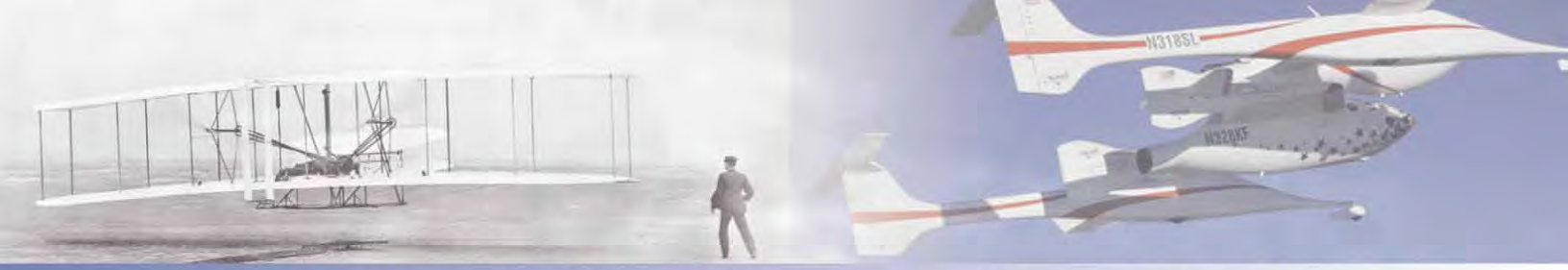
This performance target measures the time to fill all competitive FAA mission critical positions, including air traffic controllers, transportation specialists, engineers, flight inspectors, IT positions, and engineering and electrical technicians. Our FY 2004 target for filling mission critical positions was 79 days, which represents a 3% reduction from the baseline of 81 days established in FY 2003. The *Flight Plan* goal is to achieve a 20% reduction in the number of days required to fill mission critical positions by FY 2008—from 81 days to 65 days. Time is measured from vacancy notification to job offer and includes positions filled from internal and external sources.

The FY 2004 target of 79 days includes the occupational specialties described previously. However, after studying hiring patterns, we eliminated air traffic controllers from the performance measure. Our research indicated that these positions took significantly longer to fill and accounted for 37% (373 of 995) of the hiring activity for mission critical positions for FY 2004. The difference in time to fill this mission-critical position is due, in part, to internal procedures that do not allow a controller to leave a job before the position has been filled. A comprehensive internal and external study of hiring practices for air traffic controller positions is under way. We plan to use findings from the study to set a challenging, but more accurate and realistic, performance target for future years. An occupation-specific target will help ensure that we maintain an efficient and effective hiring process.

- ***Results:*** We exceeded our target of completing the hiring process for mission critical positions within 79 days. For FY 2004, it took a median of 58 days to fill these positions, excluding air traffic controller slots. Retrospectively, we recalculated the FY 2003 baseline without air traffic controllers and found it to be 62 days. We decided to retain the original targets, because the hiring process for mission critical positions is unstable and affected by changes in the relative number of positions filled, budget considerations, and internal policies and procedures. For example, if we had hired half the number of aviation safety inspectors and twice the number of engineers and transportation specialists in FY 2004, the days to fill mission critical positions would have been significantly higher. Therefore, we believe that we must continue to collect more data by occupation to determine more rational targets for mission critical positions. Further, it is also important that we balance efficiency goals with a strong focus on sustaining hiring processes that deliver high-quality candidates.

FAA Flight Plan (new for FY 2004)

This target includes the results of our 30 FY 2004 performance goals. We began operating under the *Flight Plan* in FY 2004. It was created to guide FAA into the next century of flight and to set specific



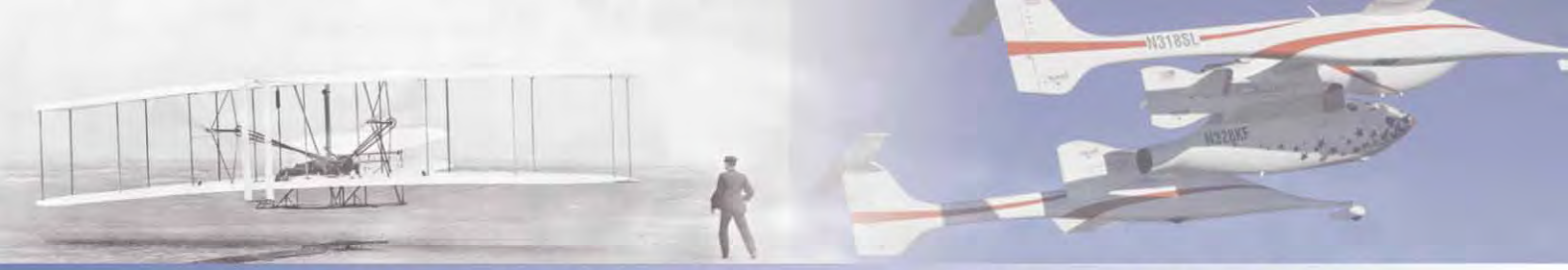
performance goals in safety, capacity, international leadership, and organizational excellence. It also established a target of achieving 27 out of 30 performance goals in FY 2004.

Results: Although we did achieve 80% (24 of 30) of our performance goals this year, we did not meet our target of 27. Our plans for meeting this target in FY 2005 are described in our discussion of each goal that we did not achieve this year.

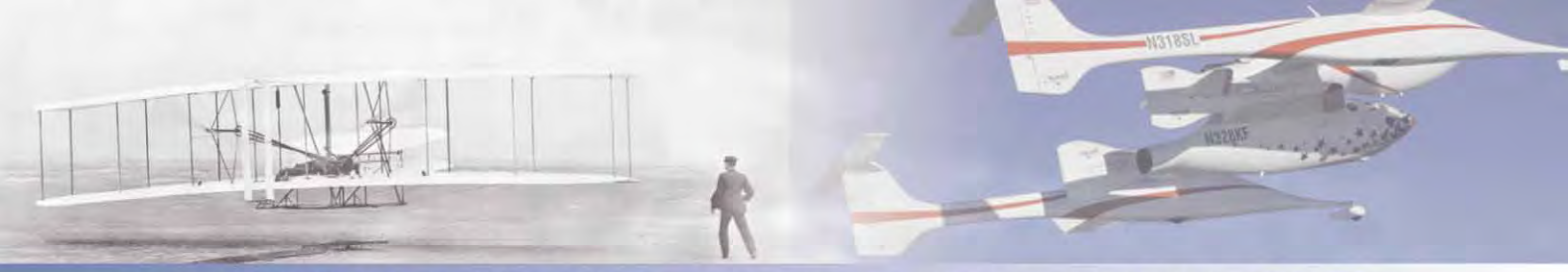
Management Challenges

FAA faced a number of management challenges in FY 2004. Some were challenges that the DOT Office of Inspector General (OIG) identified; others were DOT challenges that FAA had a role in addressing. A detailed discussion of this second group of challenges appears in DOT's *FY 2004 Performance and Accountability Report* at www.dot.gov.

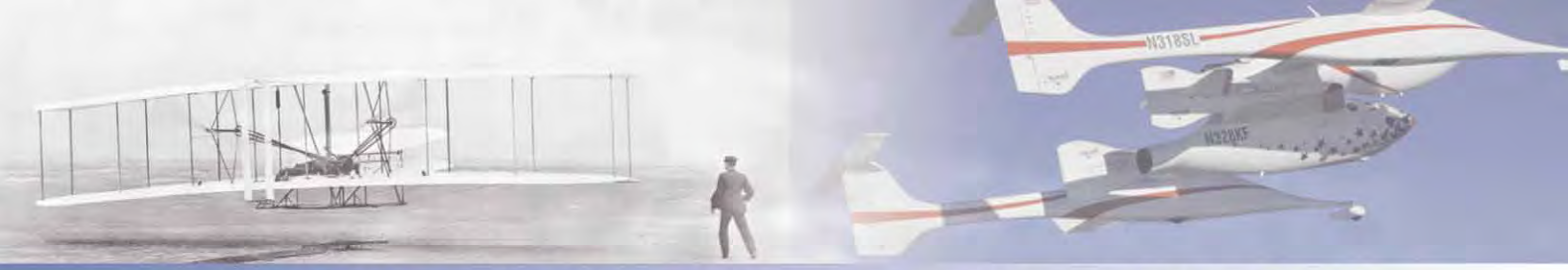
Agency	Management Challenge	Response
	SAFETY	
FAA	**Aviation Safety:** FAA must adjust its safety oversight to emerging trends in the aviation industry and changing economic conditions.	
	Inspections: FAA must adjust its safety oversight to emerging trends in the aviation industry and changing economic conditions. While air carriers have turned increasingly to outside, contracted repair stations, FAA continues to focus its inspection resources on air carriers' in-house maintenance work. Further, the FAA must strengthen its oversight procedures for foreign aviation authorities conducting inspections on FAA's behalf.	**Inspections:** We formed a risk assessment work group to develop a process that will manage risks and develop a repair station prototype program to strengthen oversight of large repair stations. We are also scheduled to conduct follow-up reviews with three foreign aviation authorities and develop a procedure to verify that these authorities place adequate emphasis on FAA regulations when conducting inspections.
	Runway Incursions/Operational Errors: While there was real progress in reducing runway incursions, operational errors continue to increase. OIG stated that corrective actions are imperative to address this ongoing safety problem. Also, the OIG has recommended that FAA improve the process for calculating operational errors.	**Runway Incursions/Operational Errors:** We educated pilots through ongoing education and awareness programs. In FY 2004, we developed a new safety brochure for pilots. In addition, we acquired or upgraded 38 additional ASDE-X and ASDE-3 systems to help ensure safety. Despite our efforts, we failed to meet our goal of reducing operational errors. We are reviewing budgetary requirements to determine additional initiatives to reduce operational errors in the future. The FAA is evaluating its process for calculating operational errors.
DOT	**Hazardous Materials:** OIG stated that the dual role of ensuring the safety and security of hazardous materials shipments is an enormous challenge for DOT.	**Hazardous Materials:** We implemented a prioritized risk-based shipper inspection plan, creating a shipper database that can be accessed by other DOT administrations. It includes shipper records related to enforcement, inspections, exemptions, and registrations. We



Agency	Management Challenge	Response
	(continued)	are also working with DOT's Research and Special Programs Administration to strengthen hazardous materials regulations to reduce the incidence of fires caused by storage batteries and flammable aerosols.
DOT/ FAA	**Aviation and Transportation Security:** Both OIG and GAO have previously noted that challenges exist in meeting national requirements for improving security in aviation and surface transportation.	**Aviation and Transportation Security:** We continue to work closely with the Transportation Security Administration (TSA) and other Department of Homeland Security divisions to ensure the security of FAA assets and operations and to support homeland and national security requirements. During FY 2004, we continued to participate in training exercises with TSA.
ORGANIZATIONAL EXCELLENCE		
FAA	**Improve Fiscal Discipline:** The growth in operating costs is a management challenge FAA must address. To slow or stop the growth in operating costs, OIG found that FAA needs to have both its cost accounting and labor distribution systems in place and operating effectively and renegotiate memorandums of understanding (MOUs) between FAA and labor that have significant cost implications. OIG and GAO recommended that FAA address fundamental problems in major acquisitions. Air traffic system modernization projects must be fielded on time and on budget for continued progress to be made in reducing congestion in the Nation's air transportation system as demand for flights grows back to and beyond pre–September 11, 2001, levels. OIG noted positive signs that the FAA Administrator and the Chief Operating Officer are committed to making changes.	**Improve Fiscal Discipline:** To address these challenges, FAA took the following steps: ▪ We are implementing a new process that places strict controls on the negotiation of union agreements, such as placing labor relations professionals in charge of the negotiations and requiring a budget analysis for each negotiation. Reform continued with the centralization of the Agency Labor Relations Management function in the Assistant Administrator for Human Resource Management and the implementation of a national Labor Relations Database to manage and monitor MOUs to ensure an effective strategic and corporate FAA Labor Management Relations Program. ▪ We did not meet the management challenge of having both cost accounting and labor distribution systems fully in place in FY 2004. This goal was dependent on the completion of the DELPHI interface to accept labor distribution data and the interface to create the data file required for the cost accounting system. Unfortunately, the cost accounting interface was delayed until the middle of the fiscal year and the labor distribution interface was delayed for the entire year. For FY 2004, cost accounting data will be available only for the fiscal year, rather than monthly. Labor distribution data were posted manually in DELPHI for proper capitalization and reimbursable charges. These problems will be eliminated in FY 2005, since the cost accounting interface is now working and the



Agency	Management Challenge	Response
	(continued)	labor distribution interface will be completed in FY 2005. ▪ We have implemented a number of initiatives to mitigate fundamental problems in major acquisitions. These include changes in organizational structures and responsibilities, process changes, reporting capabilities, and overall management discipline. Organizationally, we consolidated two major lines of business into the ATO. Flattening management layers will improve productivity, decision making, and communications. We are improving the Acquisition Management System to incorporate OMB's Capital Programming Process. We will use essential information that is part of OMB's Exhibit 300 to help FAA managers make better decisions. Programs will be segmented into smaller pieces with cost/benefits identified. This process integration will result in better investment decisions and more effective management. We are incorporating more stringent reporting, to include monthly and quarterly program variances, monthly performance goal status, and detailed cost expenditure reporting at all levels of management. These actions were effective in helping us meet our FY 2004 performance goals.
DOT/ FAA	**Financial Systems:** As indicated by OIG, GAO, and OMB, converting all DOT activities to the Department's improved financial accounting system has presented a significant management challenge, requiring DOT to develop more comprehensive cost accounting systems and, most critically, to develop improved labor distribution systems, and record keeping and valuation procedures for property, plants, and equipment. This last requirement remains a significant challenge for FAA, whose direct provision of services to the public involves significant capital assets.	**Financial Systems:** We implemented DELPHI, DOT's improved financial system, in November 2003. We also established revised business processes and record keeping, and improved valuation procedures in the property, plant, and equipment area. In the audit report for FY 2003, the material weakness in the property, plant, and equipment area was lowered to a reportable condition. This year, with the establishment of the new system and procedures, the reportable condition was eliminated as well. During FY 2004, FAA completed changing cost accounting system data structures to comply with DELPHI.
FAA	**Financial Accountability:** The OIG has stated that there has been progress in the past year, but that DOT still has a long way to go to strengthen three important financial management activities. First, DOT needs to free up millions in inactive obligations or idle funds, especially at the Federal	**Financial Accountability:** We established a national audit tracking system and, using the $3 million appropriated in the FY 2004 budget, we ordered all audits necessary to meet the specified criteria for oversight of cost reimbursable contracts. FAA also successfully



Agency	Management Challenge	Response
	Highway Administration. Second, DOT must improve oversight of cost reimbursable contracts, which have few inherent protections against cost overruns. Third, DOT and FAA must completely implement the DELPHI financial management system.	implemented DELPHI in November 2003. An ongoing process is under way to further enhance controls and the financial reporting process.
DOT/ FAA	**Computer Security:** OIG, GAO, and OMB have identified information system security as a critical government-wide management challenge and, in particular, have identified FAA air traffic control information systems as needing special attention to harden them against malicious or criminal attack.	**Computer Security:** We made significant progress toward improving security for all FAA information systems in FY 2004. We established a stable inventory of information systems; certified and authorized 274 of 285 information systems; increased monitoring of our information systems; conducted regular meetings with senior executives and mid-level managers to address strategic and tactical issues; and implemented a number of OIG and GAO recommendations from previous audits.
DOT	**IT Management:** DOT has one of the largest IT investment portfolios among civilian agencies. DOT IT systems support air traffic control and distribute billions of dollars in Federal grants for transportation improvements. Security breaches against these systems could have far-reaching effects on the Nation's transportation system and economy.	**IT Management:** Our response to this challenge is discussed in the "Information Security" section. In addition, an FAA representative participated in a DOT Investment Review Board. This board, which is chaired by the Deputy Secretary of Transportation, has the authority to approve, modify, or terminate major IT investments.

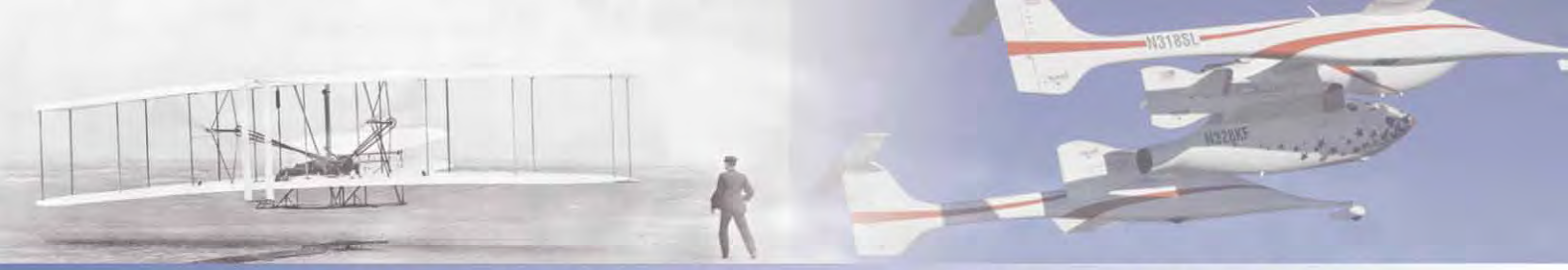
Financial Highlights

Management Integrity: Controls, Compliance, and Challenges

Every year, FAA program managers in the lines of business and staff offices assess the vulnerability of their program management controls. On the basis of these assessments, reviews are conducted to determine their compliance with sections 2 and 4 of FMFIA. The head of the line of business or staff office then identifies in writing to the Administrator any potential material internal control weakness or system nonconformance. Those deemed material are consolidated in a memorandum with a Statement of Assurance signed by the Administrator and sent to the Secretary of DOT. Our response becomes a part of the DOT Statement of Assurance sent to the President. To help resolve material weaknesses or nonconformances, we have developed a plan with specific milestones and deadlines. The plan and the status of each action are reviewed monthly, with results reported to DOT's Office of the Secretary.

As reported by the Administrator to the Secretary in a memorandum dated September 30, 2004, we identified no material weaknesses and no nonconformances in FY 2004. Last year, we had one material weakness—oversight of cost reimbursable contracts—and one material nonconformance—the lack of a fully integrated accounting system.

Cost reimbursable contracts were first reported in FY 2002 as a FMFIA material weakness. In their May 2002 audit report, the OIG reported a backlog of 1,400 over-aged cost reimbursable contracts with a



value of $6 billion. Our FY 2004 target was to close out all 180 contracts ($3.45 billion) that remained to be closed as of September 2003, and 85% of contracts that subsequently became eligible for closure.

While the oversight of cost reimbursable contracts is no longer a material internal control weakness, we did not meet our target. As of September 2004, 135 of the 180 contracts were closed, and 58 contracts that became overdue after the FY 2001 baseline were closed. We did not meet our target for several reasons. Some contracts could not be closed because there were issues to be resolved, such as final rates and instances where vendors were unwilling or unable to provide information. Other contracts were so old that there were no supporting records or documentation. The remaining contracts will be closed by September 2005, eliminating the $1.5 billion backlog.

Once a stand-alone system, our property accounting system is now integrated with our financial management system, thus eliminating last year's material system nonconformance. This was first reported in the FY 2001 FMFIA statement as a result of the temporary use of the Interim Fixed Assets System (IFAS). IFAS was established to control FAA's property accounting until the implementation of the new financial management system. DELPHI, which was implemented in November 2003, has an integrated property accounting module, bringing us into compliance with section 4 of FMFIA.

Since January 1999, FAA has been on GAO's High Risk List. GAO identified three areas of concern including (1) FAA's lack of a system to account for property, plant, and equipment; (2) the need to make hundreds of adjustments to produce audit-quality financial information for financial reporting; and (3) the fact that the cost accounting system was not fully implemented and management was not using data to make business decisions. With the implementation of our cost accounting system and DELPHI, with its integrated property system, we are optimistic that we will be removed from GAO's High Risk List.

Our Information Security Program, part of the overarching DOT program, did not report any significant deficiencies in the 2004 Federal Information Security Management Act Annual Report. We have made a concerted effort to correct weaknesses identified in previous years.

Noteworthy improvements made since the annual information security reviews began in FY 2001 include the following:

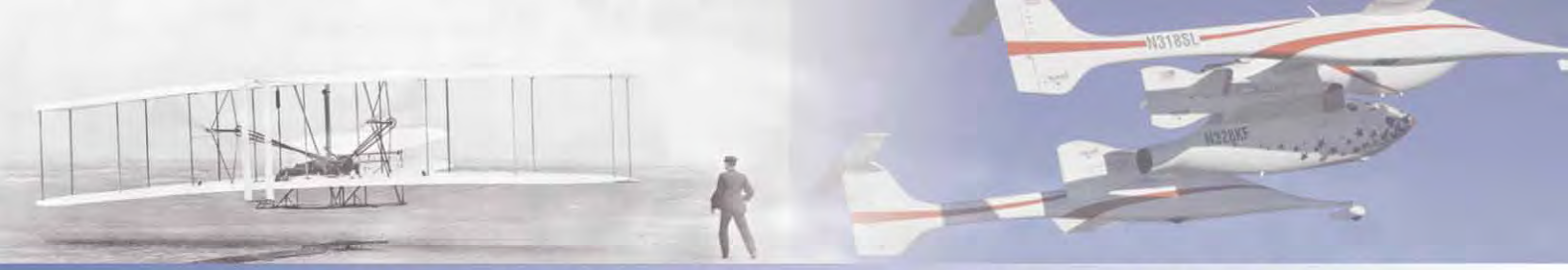
- Increased oversight of IT investment management and security controls through the DOT Investment Review Board.
- Strengthened protection of network infrastructure against internal and external attacks.
- Improved integrity, confidentiality, and availability of program operations that depend on computer systems support. This year, we increased the percentage of systems completing the security certification reviews to 96%.

In FY 2005, we will continue our efforts to coordinate IT budget requests, improve the quality of security certification reviews, and enhance air traffic control system security.

Financial Plans

We have received four successive unqualified (clean) opinions and were awarded a Certificate for Excellence in Accountability Reporting for our *FY 2003 Performance and Accountability Report*. Last year, for the first time, our auditors identified no material weaknesses. As we work toward improving our financial systems and business processes, our underlying goals are to maintain a clean opinion and to have the best possible internal and external financial reporting.

Strategically, we are replacing our legacy systems and instituting an integrated financial management system. Starting last November, we implemented a commercial, off-the-shelf system that integrates



acquisition, funds control, general ledger, property accounting, and external financial reporting, with an interface to our cost accounting and labor distribution systems. The new system fully complies with Federal financial systems standards. It follows accounting principles generally accepted in the United States of America and records transactions based on the U.S. Government Standard General Ledger. Our goal is to integrate or interface all financial and mixed financial/program systems with this core financial system to eliminate redundancy, lower maintenance and system-improvement costs, and standardize financial information. The new environment enables us to perform single-source data entry, ensuring consistency between systems and subsidiary components.

Our cost accounting system provides managers with the full cost of services, enabling them to better understand and control their costs. It includes labor charges that are allocated to services. Over the next two years, we will complete the implementation of the cost accounting system, and the entire agency will thus be well equipped to direct costs to the most critical services.

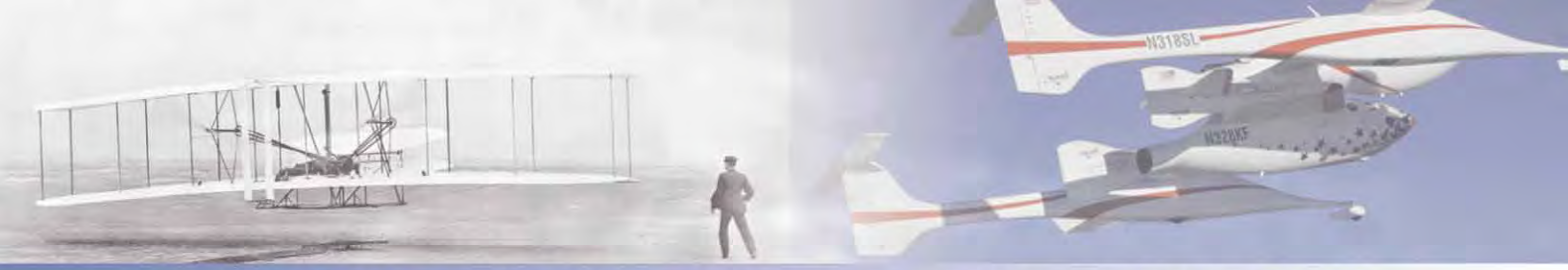
We are also implementing other initiatives that support the President's Management Agenda for financial management and e-Gov. We will work with DOT to implement a comprehensive grants management/payment system and institute E-Travel, a paperless travel reservation and reimbursement system. To further automate our processes, we plan to implement a system to image documents such as contracts and invoices. For FY 2005 and beyond, our challenge is to strengthen internal controls and to institute new business processes and improve existing ones.

Grants Management Policies and Practices

Decisions on distributing AIP funds are centralized at FAA headquarters, with significant input from regional offices. While most of the day-to-day decisions for AIP project formulation are delegated to regional offices, FAA headquarters develops the policy to ensure that grants are implemented and that grantees are treated consistently. Policies for administering the program are included in an AIP Handbook, which is regularly updated through Policy Guidance Letters issued to grant recipients. FAA also ensures the consistent implementation of AIP by participating in airport industry trade conferences and training, posting statutory and policy changes on our public Website, and requiring employees to attend annual training that focuses on improving business processes and updating personnel on policy changes.

We meet regularly with eligible airport sponsors to identify planning and development needs. Through this process, the Airport Capital Improvement Plan, a five-year plan than identifies the planning and development needs for airports nationwide, is developed, and eligible projects are prioritized. Only projects identified in this plan are awarded grants. After a project has been identified, the airport sponsor can apply to the FAA regional or district office for a grant. We have begun coordinating with Grants.gov to develop an electronic grant application process. Typically, large grants are coordinated with other Federal, state, and local government agencies, such as the Environmental Protection Agency, the Department of Defense, and state aviation agencies.

AIP administration, including the requirements for sponsor and project eligibility, is based on multiyear authorizing legislation. In FY 2003, we recommended statutory changes to AIP's authorizing legislation that were approved for FY 2004. Revisions included changes to funding levels for airports and projects, changes to the formula for determining funding levels, and revisions to the grant process to address environmental and construction issues and to give smaller airports more flexibility in qualifying for certain types of grants.



Office of the Inspector General FY 2005 Management Challenges

The OIG's memorandum finalizing the most serious management challenges facing DOT in FY 2005 will be provided in the near future. OIG has chosen to address FAA's challenges within the DOT document. Until its release, they have tentatively identified several challenges for FAA, which include:

- Delivering air traffic control services and fielding new air traffic control equipment while controlling costs in a fixed budget environment.
- Increasing aviation capacity and mitigating delays.
- Ensuring safety in a changing aviation environment.
- Strengthening financial management to protect Federal funds.
- Improving cost effectiveness of $2.7 billion in information technology investments and continuing to enhance computer security.

The OIG also identified three emerging issues that will become increasingly important in the future. They are:

- Ensuring transportation funds are adequate to meet growing needs.
- Growing interdependency among DOT and other Federal agencies to ensure safe, secure, and efficient transportation.
- Meeting human resource needs given retirements and changing skills mix.

Improper Payments Information Act of 2002: Narrative Summary of Implementation Efforts for FY 2004 and Agency Plans for FY 2005–FY 2007

Historically, FAA has not had a problem with improper payments. Since 2001, our improper payment rate has ranged from 0.01% to 0.36%, well below thresholds established by OMB (over 2.5% of program payments and $10 million). With the passage of the Improper Payments Information Act of 2002, there has been added emphasis on curtailing improper payments. This year, DOT worked with each operating administration, including FAA, to conduct a review of payments for the largest DOT programs. FAA's Operations, Facilities and Equipment (F&E), and AIP were included in this review. The results supported our past record of having improper payments well below reportable thresholds. Plans for the future call for sustaining the existing low rates.

In addition, for the past two years, DOT has contracted with a company to recover improper payments. According to this company's audit, only 0.0038% of FAA's payments were improper in FY 2004.

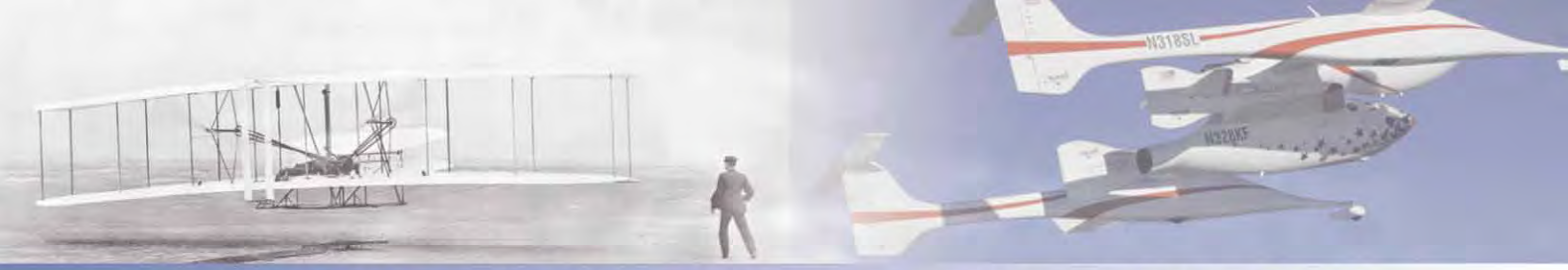
The appendix, *Improper Payments Information Act Reporting Details*, provides additional information on our improper payments review.

Discussion and Analysis of the Financial Statements

FAA prepares annual financial statements in conformity with accounting principles generally accepted in the United States. The financial statements are subject to an independent audit to ensure that they are free from material misstatement and that they can be used to assess FAA performance.

FY 2004 Financial Statement Audit

The Chief Financial Officers' Act of 1990 (Public Law 101–576), as amended by the Government Management Reform Act of 1994, requires that financial statements be prepared by certain agencies and



commercial-like activities of the Federal government and that the statements be audited in accordance with government auditing standards. FAA is required to prepare its own financial statements under OMB Bulletin 01–02, Audit Requirements for Federal Financial Statements, dated October 16, 2002. DOT OIG is statutorily responsible for the manner in which the audit of FAA's financial statements is conducted. OIG selected KPMG LLP, an independent certified public accounting firm, to audit FAA's FY 2004 financial statements. This firm also audited FAA's FY 2002 and FY 2003 financial statements.

In 2002, DOT's OIG and Chief Financial Officer, along with the FAA Chief Financial Officer, established an Audit Advisory Committee to promote and encourage open communication among the OIG, FAA management, and the independent auditors to resolve issues that arise during the audit and to monitor the implementation of audit recommendations. The committee is chaired by the Director of the Office of Financial Management and includes representatives from the OIG; DOT's Office of Financial Management; FAA's Assistant Administrator for Region and Center Operations; and the Chief Operating Officer, ATO. Last year, committee participation was expanded to include representatives from the Chief Counsel's Office, and the Assistant Administrators for Human Resources Management, Information Services, and Airports.

KPMG LLP rendered an unqualified audit opinion on FAA's FY 2004 financial statements. This means that FAA's financial statements as of, and for the year ended, September 30, 2004, were presented fairly in all material respects in conformity with accounting principles generally accepted in the United States. The audit report was presented by OIG to the FAA Administrator. KPMG identified no material weaknesses and the following five reportable conditions:

- Implementation of a new financial accounting system.
- Lack of timely cost accounting information.
- Inadequate reconciliations of fund balance with Treasury.
- IT controls over FAA and third-party systems and applications.
- Oversight of cost reimbursable contracts.

KPMG also determined that we were not in substantial compliance with FFMIA. In converting to DELPHI, we encountered a number of challenges that prevented us from recording a significant number of transactions. This affected our ability to produce accurate and complete financial and budgetary reports. In addition, KPMG found that six key subsidiary financial systems did not comply with financial management system requirements.

Management's responses to KPMG's findings are included in the Independent Auditors' Report.

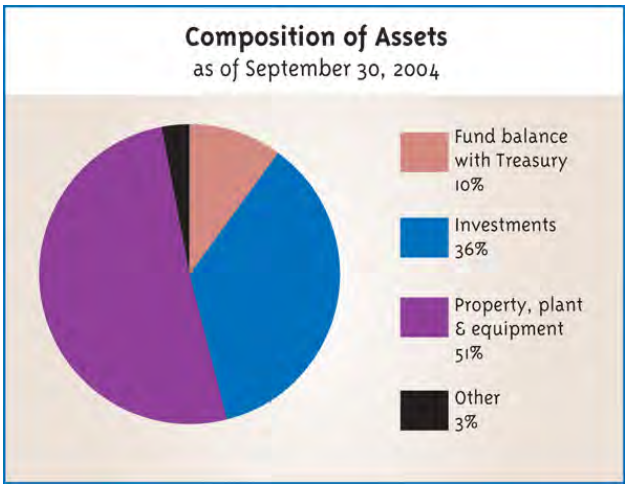
Understanding the Financial Statements

FAA's Consolidated Balance Sheets, Statements of Net Cost, Changes in Net Position and Financing, and Combined Statements of Budgetary Resources are presented in a two-year comparative format. The following section provides a brief description of (1) the nature of each financial statement and its relevance to FAA, (2) significant fluctuations from FY 2003 to FY 2004, and (3) certain significant balances where necessary to clarify their link to FAA operations.

Balance Sheet

The Balance Sheet presents the amounts available for use by the FAA (assets) against the amounts owed (liabilities) and amounts that comprise the difference (net position).

Assets

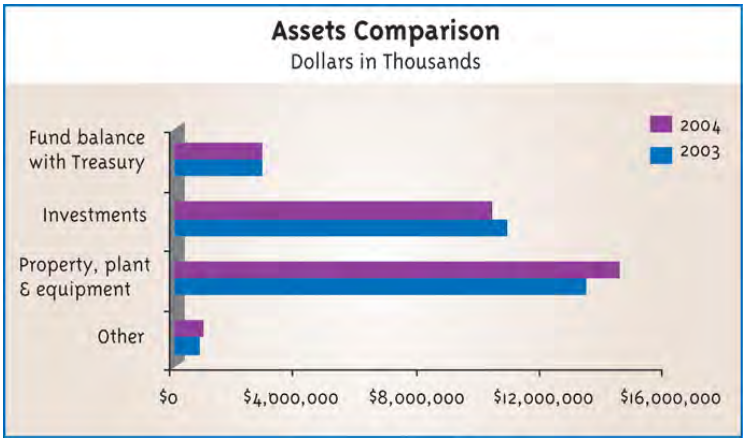


Total assets were $28.6 billion at the end of FY 2004. FAA's assets are the resources available to pay liabilities or satisfy future service needs. The *Composition of Assets* chart depicts major categories of assets as a percentage of total assets.

The *Assets Comparison* chart presents comparisons of major asset balances as of September 30, 2003 and 2004.

Fund balance with Treasury represents 10% of FAA's current year assets and consists of funding available through Department of Treasury accounts from which FAA is authorized to make expenditures to pay liabilities. It also includes passenger ticket and other excise taxes deposited to the Airport and Airway Trust Fund (AATF), but not yet invested.

At $10.3 billion, *Investments* represent 36% of current year assets and are principally derived from passenger ticket and other excise taxes deposited to the AATF. These amounts are used to finance operations to the extent authorized by Congress. Investments decreased $501 million due to a reduction in tax revenues deposited into the AATF in FY 2004.



At $14.5 billion, *Property, plant, and equipment* (*PP&E*) represents 51% of FAA's assets as of September 30, 2004, and primarily comprises construction-in-progress related to the development of national airspace system assets and capitalized real and personal property. Increases in PP&E are primarily related to purchases of equipment and additions to construction-in-progress through the normal course of business during FY 2004.

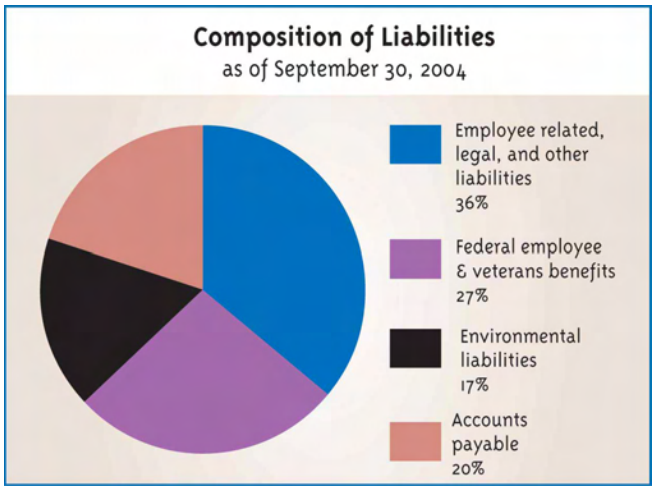
Liabilities

At the end of FY 2004, FAA reported liabilities of $3.5 billion. Liabilities are probable and measurable future outflows of resources arising from past transactions or events. The *Composition of Liabilities* chart (see next page) depicts FAA's major categories of liabilities as a percentage of total liabilities.

The *Liabilities Comparison* chart (see next page) presents comparisons of major liability balances between FY 2003 and FY 2004.

At $1.2 billion, *Employee related, legal, and other liabilities* represent 36% of total liabilities. While this overall category of liabilities was relatively constant from FY 2003 to FY 2004, several components

experienced variations that offset in the aggregate. Accrued payroll, benefits, and annual leave increased because there were a greater number of unpaid days of payroll at the end of FY 2004 and employee leave balances grew. In contrast, legal liabilities decreased due to settlements of several claims.



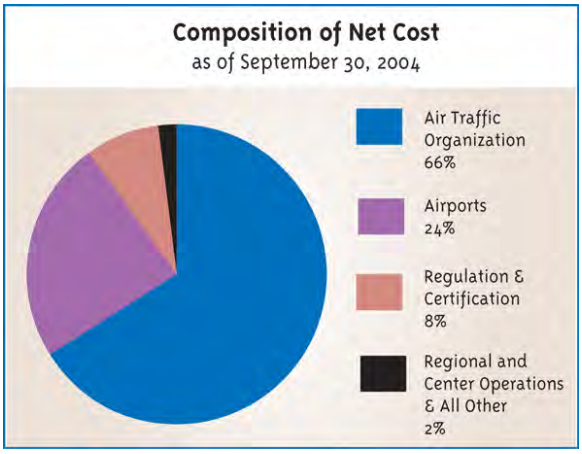
At $954.5 million, *Federal employee and veterans benefits* represent 27% of current year liabilities and consist of FAA's expected liability for death, disability, and medical costs for approved workers compensation cases, plus a component for incurred, but not reported, claims. The Department of Labor (DOL) calculates the liability for DOT, and DOT attributes a proportionate amount to FAA based upon actual workers' compensation payments to FAA employees over the preceding four years.

Environmental liabilities represent 17% of FAA's total liabilities and were relatively stable at $606.3 million as of September 30, 2004 and $621.9 million a year earlier. Environmental liabilities include a component for remediation of known contaminated sites and the estimated environmental cost to decommission assets presently in service.

Accounts payable represent 20% of liabilities. We made a concerted effort to pay down these liabilities at the end of FY 2003 in anticipation of converting to a new financial management system. Thus, at $679.0 million as of September 30, 2003, accounts payable was $31.0 million less than the same date one year later.

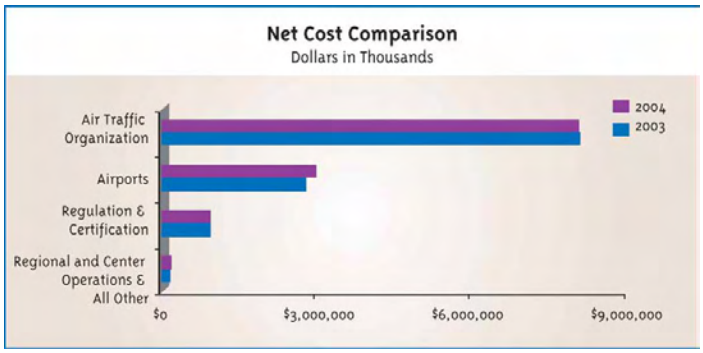
Statement of Net Cost

The Statement of Net Cost presents the annual cost of operating FAA programs. The gross cost less any offsetting revenue for each FAA program is used to arrive at the net cost of specific program operations. FAA has used its cost accounting system to prepare the Statement of Net Cost since FY 1999.



In FY 2004, FAA's net costs were $12.2 billion, compared to $12.0 billion in FY 2003. The *Composition of Net Costs* chart illustrates the distribution of net costs among FAA's lines of business. The *Net Cost*

Comparison chart compares FY 2003 and FY 2004 net costs.



With a net cost of $8.1 billion, the *Air Traffic Organization* is FAA's largest line of business, comprising 66% of total net costs. The net cost of *Regulation and Certification* represents 8% of FAA's total net costs, while *Region and Center Operations and All Other* comprise the remaining 2% of total net costs. The net costs of these three components were relatively unchanged from FY 2003 to FY 2004.

With a net cost of $3.0 billion in FY 2004, which is 24% of FAA's total net costs, *Airports* is FAA's second largest line of business. Net costs increased $190.6 million, from $2.8 billion in FY 2003. The Wendell H. Ford Aviation Investment and Reform Act for the 21st Century (P.L. 106-181) increased Airport Improvement Program funding by $725.0 million in FY 2001. Funding levels for Airports programs have continued to increase by $100 million or more each year since that time. Airport improvement projects typically take several years to complete, and FAA reports the associated expense as the grant recipient accomplishes the improvement work. Thus, FAA's net Airport costs increased in FY 2004, as the project lifecycle associated with these grants continued.

In accordance with Federal Accounting Standards Advisory Board Technical Bulletin 2003-1, FAA disclosed the net cost of civil aviation security operations, which transferred in FY 2002 to DHS. In FY 2003, we incurred $47.0 million of Civil Aviation Security costs that continued to be funded from FAA's direct appropriations. Since the transfer of the associated funding is complete, we did not incur similar costs in FY 2004.

Statement of Changes in Net Position

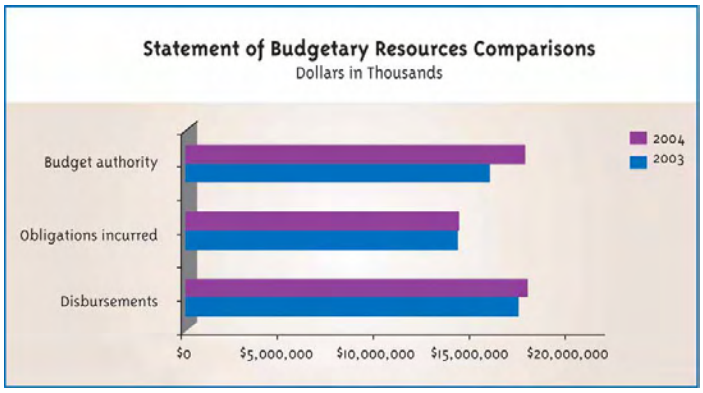
The Statement of Changes in Net Position presents those accounting items that caused the net position section of the balance sheet to change from the beginning to the end of the reporting period. Various financing sources increase net position. These financing sources include appropriations received and non-exchange revenue, such as excise taxes and imputed financing from costs absorbed on FAA's behalf by other Federal agencies. The agency's net cost of operations and net transfers to other Federal agencies serve to reduce net position.

FAA's cumulative results of operations increased slightly to $24.1 billion in FY 2004. The increase occurred because the net financing sources exceeded net cost of operations in FY 2004. Unexpended appropriations increased to $999.1 million because FY 2004 activities were funded with a greater proportion of AATF dedicated collections and less general fund appropriations.

Statement of Budgetary Resources

This statement provides information on the budgetary resources available to FAA for FY 2004 and the status of those budgetary resources at yearend. The outlays reported on this statement reflect the actual cash disbursed for the year by the Treasury for FAA obligations. The *Statement of Budgetary Resources Comparisons* chart (see next page) outlines the changes in the major categories of budgetary resources from FY 2003 to FY 2004.

Budget authority increased 5.8%, from $16.6 billion in FY 2003 to $17.6 billion in FY 2004. This increase is primarily related to the FAA Operations general and trust funds, and the Airports program. Budget authority for Operations increased $459.8 million in FY 2004. This increase was primarily attributable to pay and other inflationary increases, as well as the operational costs associated with newly deployed national airspace system equipment. Budget authority for Airports was increased $569.1 million, including $267.1 million of contract authority. This is consistent with the continued trend toward expansion of the Airports program.



Obligations incurred and *Disbursements* were both relatively stable from FY 2003 to FY 2004.

Statement of Financing

This statement reconciles the resources available to FAA to finance operations and the net cost of operating FAA programs. The c*hange in budgetary resources obligated for goods, services, and benefits ordered but not yet provided* includes the change in undelivered orders and unfilled customer orders. *Resources that finance the acquisition of assets* are additions and reductions to capital and other asset balances during the fiscal year. *Components requiring or generating resources in future periods* discloses the net increase in liabilities that are not covered by current budgetary resources. *Components not requiring or generating resources in future periods* include depreciation, the operating gains or losses recognized upon the disposition of FAA capital assets and cost of goods sold.

Budgetary Integrity: FAA Resources and How They Are Used

Approximately 78% of FAA's FY 2004 budget is provided by the Airport and Airway Trust Fund, which derives its monies from excise taxes and interest generated by the fund. Created by the Airport and Airway Revenue Act of 1970, the trust fund provides a stable source of monies to finance investments in the airport and airway system and, to the extent funds are available, covers the operating costs of the airway system. Aviation excise taxes, which include taxes on domestic passenger tickets, freight waybills, general and commercial aviation fuel/gas, and international departures and arrivals, are deposited into the fund. The Department of the Treasury maintains the fund and invests its monies in government securities.

Any interest is deposited into the fund. Monies are withdrawn as needed and transferred into each FAA appropriation to cover obligations.

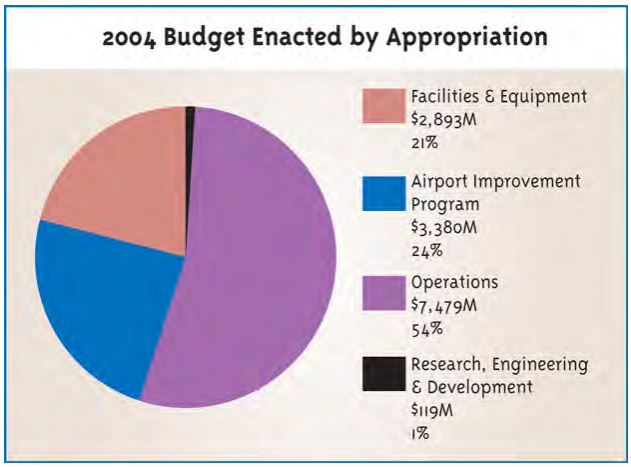
FAA is financed through annual and multiyear appropriations authorized by Congress. The FY 2004 enacted budget, $13.9 billion, is 2.7% above the FY 2003 level. The Combined Statement of Budgetary Resources reflects funding enacted by the FY 2004 Consolidated Appropriations Bill, Public law 108–199. The FY 2004 levels include an across-the-board rescission of 0.59% and $1.98 million in other budget authority for Fort Worth Alliance included in Grants-in-Aid for Airports.

FAA has four appropriations; the largest—Operations—is funded by the Treasury's General Fund and a portion from the Airport and Airway Trust Fund. The trust fund is the sole revenue source for FAA's three

capital investment appropriations: (1) Facilities and Equipment (F&E); (2) Research, Engineering and Development (R,E&D), and (3) Grants-in-Aid for Airports (AIP).

Our Operations appropriation was $7.5 billion. This account funds the operations, maintenance, communications, and logistical support of the air traffic control and air navigation systems. It also covers administrative and managerial costs for FAA's regulatory, international, medical, engineering, and development programs, as well as policy oversight and overall management functions.

For FAA's capital appropriations, F&E was funded at $2.9 billion, Grants-in-Aid for Airports at $3.4 billion, and R,E&D at $119 million. The F&E account is the principal means for modernizing and improving air traffic control and airway facilities. It also finances major capital investments required by other agency programs and other improvements to enhance the safety and capacity of the national airspace system. FAA's grants program funds airport planning and development, noise compatibility and planning, the military airport program, reliever airports, and airport program administration. R,E&D funds long-term research programs to improve the air traffic control system.

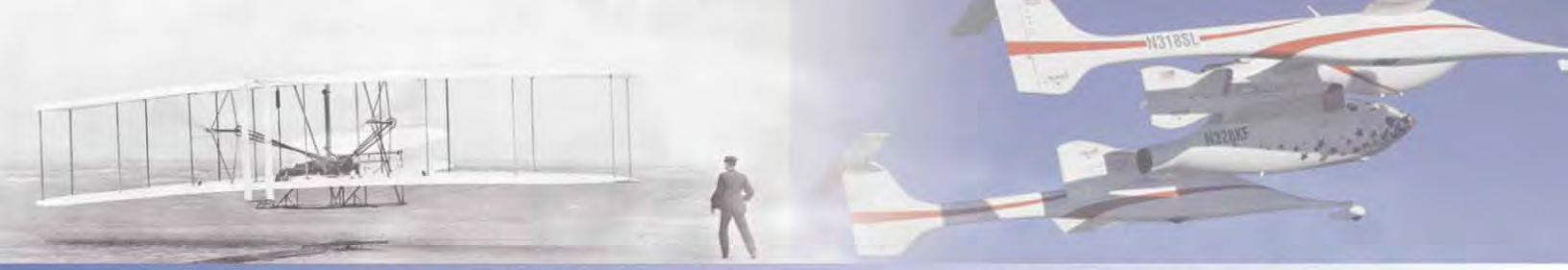


Operations. The Operations appropriation funds the salaries and costs associated with operating and maintaining the air traffic control system and carrying out our safety inspection and regulatory responsibilities. Funding in FY 2004 represents a 6.6% increase that is primarily attributable to mandatory pay increases and the operations and maintenance of newly implemented air traffic control systems.

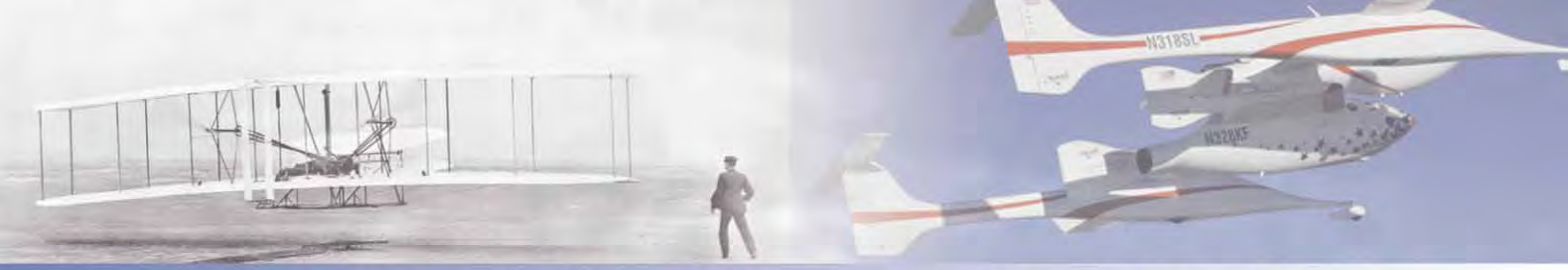
F&E. Funds from the F&E appropriation are used to modernize, expand, and replenish the air traffic control infrastructure. Funding in FY 2004 is $2.9 billion, about 2% less than the FY 2003 level. Major systems funded are En Route Automation, Terminal Automation, Oceanic Automation, Wide-Area Augmentation System, ASDE-X, Airport Surveillance Radar, and Free Flight Phase 2.

AIP. The Secretary of Transportation is authorized to award grants for airport planning and development to maintain a safe and efficient nationwide system of public airports. These grants make it possible to fund one-fourth to one-third of all capital development at the Nation's public airports. Grants are issued to maintain and enhance airport safety, preserve existing infrastructure, and expand capacity and efficiency throughout the system. AIP funding was essentially unchanged from FY 2003 and for the third consecutive year included approximately $20 million for the Small Community Air Service program.

R,E&D. Funding for R,E&D decreased $28.8 million from the previous year. The focus is on environment and energy, weather initiatives, human factors, and aircraft safety.



FINANCIAL STATEMENTS



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A Message From the Chief Financial Officer

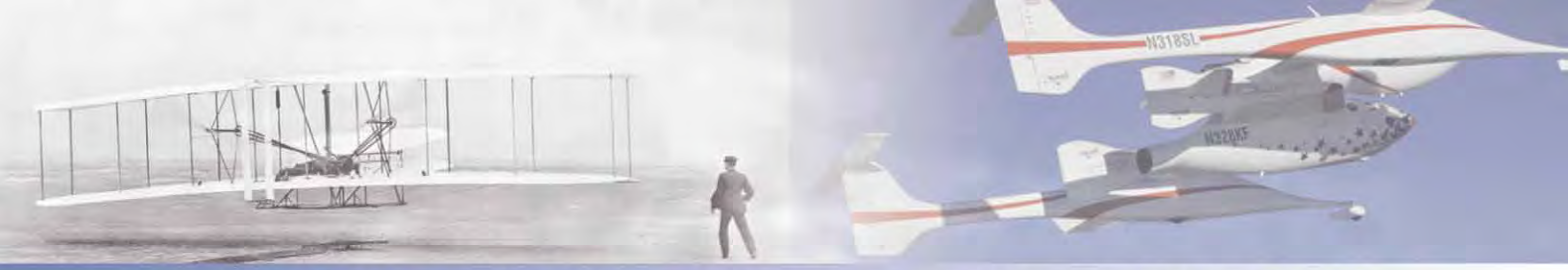
I joined FAA in April 2004 after a long career as the Chief Financial Officer for major corporations, including airlines, in the private sector. During that career, I met and managed many exceptional and dedicated people. Over the past several months, I have found my new colleagues to be among the most visionary and committed I have ever encountered, and I am impressed by FAA's already high levels of performance and accountability.

When I came to FAA, my mandate from Administrator Blakey was to improve financial discipline at the agency and to implement financial management best practices from the private sector. Over the past six months, we have made significant progress in achieving these objectives. Among our accomplishments in FY 2004, we

Chief Financial Officer Ramesh Punwani oversees FAA's $14 billion budget, as well as the development and agency-wide application of cost accounting and financial management systems. Punwani came to FAA from Cendant Corporation, where he was senior vice president for global strategy.

Punwani's background in aviation and the travel industry spans more than three decades. Before joining Cendant, he was executive vice president and CFO of Travelocity.com. He holds Masters of Business Administration and of Engineering in Management Science degrees, and a Bachelor of Technology degree in Industrial Engineering.

- Successfully implemented DELPHI, DOT's integrated financial management system. DELPHI integrates acquisition, property accounting, and cost accounting and is compliant with the U.S. Government Standard General Ledger at the transaction level, thus we have made significant progress toward meeting the requirements of the Federal Financial Management Improvement Act of 1996.
- Received an unqualified opinion on our financial statements, with no material internal control weaknesses. FY 2004 marks the fourth consecutive year in which FAA has received an unqualified audit opinion and the second year in which there has been no material weakness.
- Closed our books and prepared our year-end financial statements more quickly than ever before, completing work in October 2004.
- Worked to remove last year's FMFIA material weakness in the area of contract closeouts. While we made significant progress in this area, we did not meet our internal FY 2004 performance target of closing out 100% of cost reimbursable contracts. Many of the contracts under review are more than 20 years old and present a significant challenge. During the next year, we will concentrate on further improving our performance in closing out current contracts while we attempt to locate information on older contracts. We are confident that our increased efforts in this area will enable us to achieve our FY 2005 performance goal.
- Were honored with a Certificate of Excellence in Accountability Reporting (CEAR) from the Association of Government Accountants for our *FY 2003 Performance and Accountability Report*. FAA was 1 of only 10 Federal agencies to receive this distinction. This accomplishment, of which we are all justly proud, demonstrates that FAA's business practices are equal to or better than those found in many of today's large corporations.

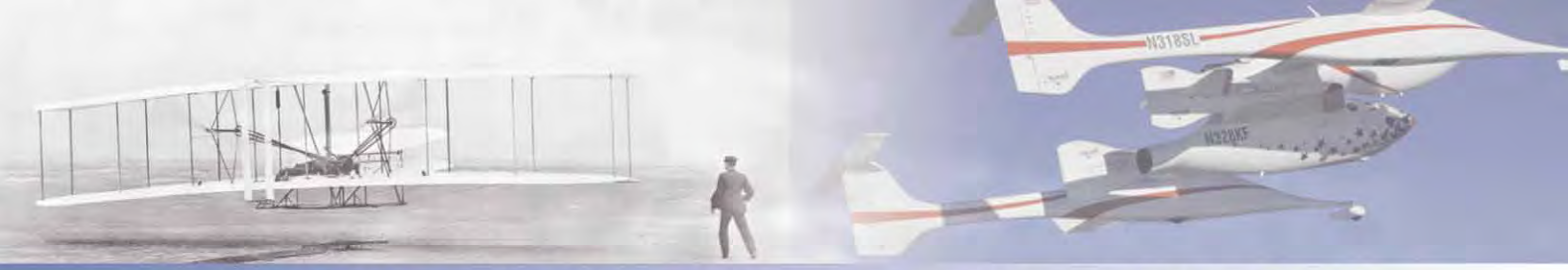


- Continued our organizational transformation by initiating the consolidation of the accounting operations of nine FAA regional locations into a single center. This consolidation will enable us to provide more timely and accurate cost and accounting data to FAA leadership while realizing cost synergies.

Because of our hard work throughout the year, FAA has a modern financial management system that fully integrates acquisition, property, and cost accounting. We can now provide our managers with better information about the real costs of our programs and initiatives. Better information leads to more effective planning, which in turn leads to improved management of our budget. The firm foundation we are building will enable us to meet one of the greatest challenges we face in the years to come—improving aviation safety in the United States and around the world, increasing capacity, and managing our business more effectively while facing a shrinking budget and ever-tighter reporting deadlines.

We made significant progress last year—not only in modernizing our technology and systems, but also in changing our culture. FAA has laid the groundwork for greater success in helping the world chart the next 100 years of flight.

Ramesh K. Punwani
Assistant Administrator for Financial Services and Chief Financial Officer
November 1, 2004

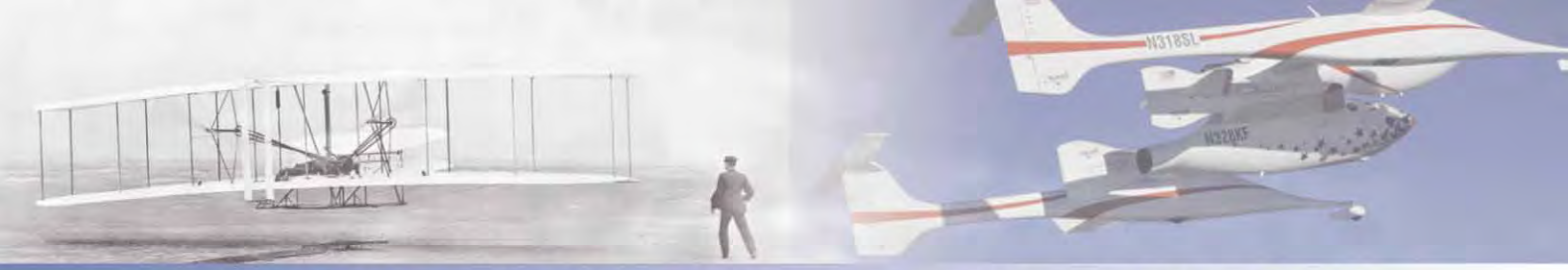


LIMITATIONS OF THE FINANCIAL STATEMENTS

FAA has prepared its financial statements to report its financial position and results of operations, pursuant to the requirements of the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994.

While the FAA statements have been prepared from its books and records in accordance with the formats prescribed by the Office of Management and Budget, the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

These statements should be read with the understanding that they are for a component of the United States Government, a sovereign entity. Liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation by Congress, and payment of all liabilities, other than for contracts, can be abrogated by the Federal Government.



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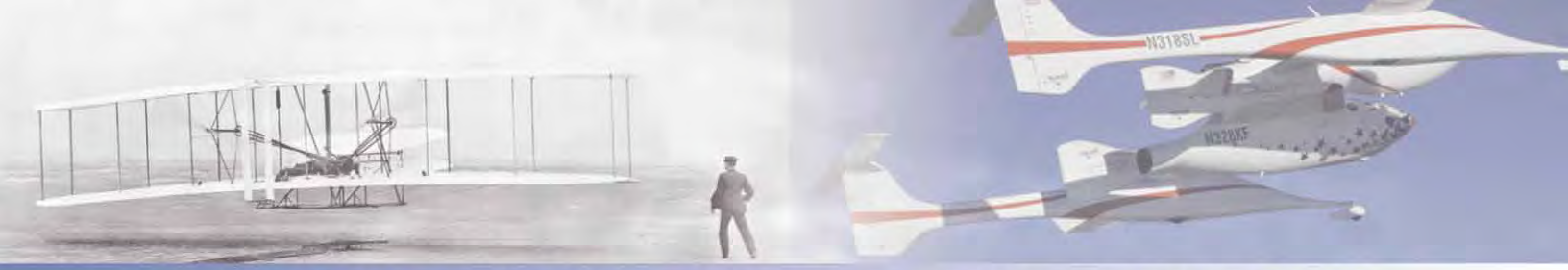


Memorandum

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

Subject: ACTION: Quality Control Review of Audited Financial Statements for FY 2004 and FY 2003, Federal Aviation Administration QC-2005-006

Date: November 10, 2004

From: Kenneth M. Mead
Inspector General

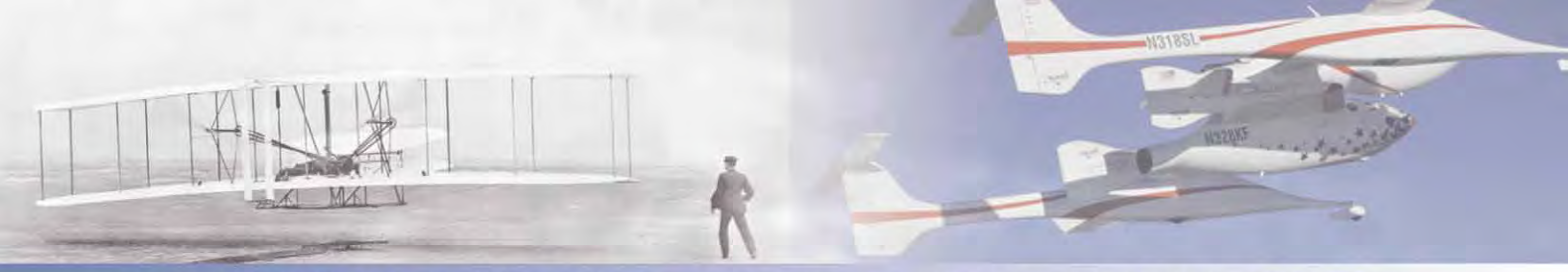
Reply to Attn. of: JA-20

To: The Secretary
Federal Aviation Administrator

The audit of the Federal Aviation Administration's (FAA) Financial Statements as of and for the years ended September 30, 2004, and September 30, 2003, was completed by KPMG LLP (KPMG) of Washington, DC (see Attachment). We performed a quality control review of the audit work to ensure that it complied with applicable standards. These standards include the Chief Financial Officers Act; Government Auditing Standards; and the Office of Management and Budget Bulletin 01-02, "Audit Requirements for Federal Financial Statements."

The KPMG audit report concluded that the financial statements presented fairly, in all material respects, the financial position of the FAA as of September 30, 2004 and September 30, 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States. We concur with this unqualified or "clean" opinion.

FAA deserves credit for addressing significant challenges this year. FAA encountered difficulties when it implemented the Department of Transportation's (DOT) Delphi accounting system and FAA's new procurement system in November 2003. Because it has implemented more disciplined financial management processes over the last 3 years, for the most part, FAA was able to identify problems, track financial activities that were not properly processed, and develop timely corrective action plans.



The report presented no material internal control weaknesses but did present the following five reportable internal control conditions:

1. Implementation of a New Financial Accounting System,
2. Cost Accounting Information,
3. Reconciliations of Fund Balance with Treasury,
4. Information Technology Controls over FAA and Third-Party Systems and Applications, and
5. Cost Reimbursable Contracts.

The report also identified instances of noncompliance with the Federal Financial Management Improvement Act of 1996. FAA's financial management system did not substantially comply with Federal financial management system requirements.

KPMG made 23 recommendations for corrective actions. We agree with the KPMG recommendations. In a November 1, 2004 response to the draft report, the FAA Chief Financial Officer concurred with the reportable conditions and non-compliance, agreed with the recommendations, and committed to implement corrective actions during FY 2005. In accordance with DOT Order 8000.1C, the corrective actions taken in response to the recommendations are subject to follow-up.

In our opinion, the audit work performed by KPMG complied with applicable standards.

We appreciate the cooperation and assistance of FAA and KPMG representatives. If we can answer any questions, please call me at (202) 366-1959 or Ted Alves, the Assistant Inspector General for Financial and Information Technology Audits, at (202) 366-1496.

Attachment

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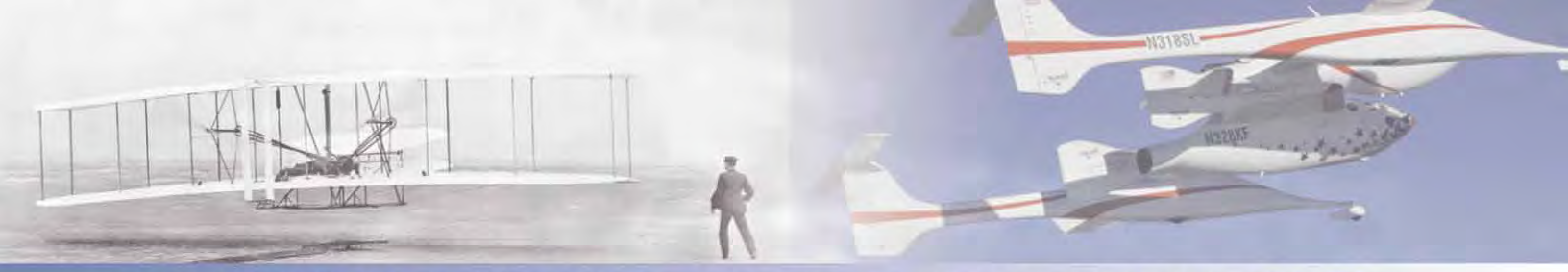


KPMG

2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

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

We have audited the accompanying balance sheets of the Federal Aviation Administration (FAA) as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the years then ended (herein referred to as "financial statements"). The objective of our audits was to express an opinion on the fair presentation of these financial statements.

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

SUMMARY

As stated in our opinion on the financial statements, we concluded that the FAA's financial statements as of and for the years ended September 30, 2004 and 2003, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16 to the financial statements, the FAA restated its fiscal year 2003 budget authority and unobligated balance reported on the Combined Statement of Budgetary Resources.

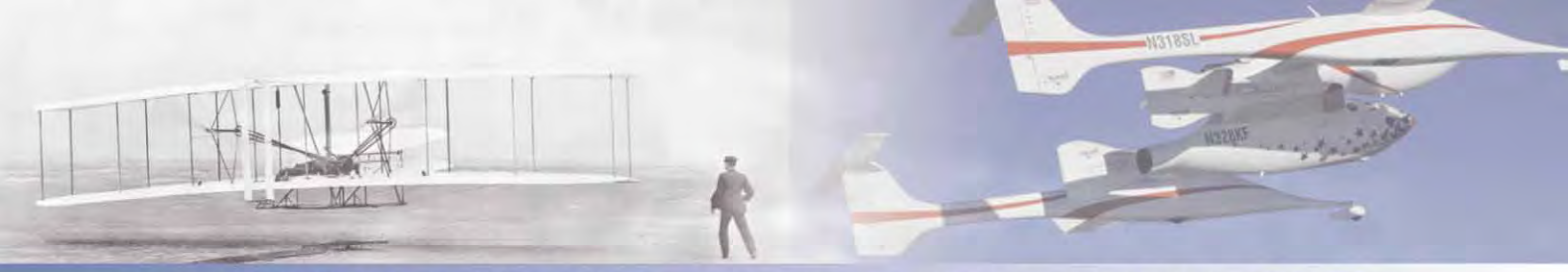
Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

1. Implementation of a New Financial Accounting System
2. Cost Accounting Information
3. Reconciliations of Fund Balance with Treasury
4. Information Technology Controls over FAA and Third-Party Systems and Applications
5. Cost Reimbursable Contracts

However, these reportable conditions are not believed to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The results of our tests of FFMIA disclosed deficiencies in financial management information systems, the application of federal accounting standards, and recording of financial transactions that are presented within the Exhibits of this report.



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

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the FAA as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources, and financing for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FAA as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations, for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 16, the FAA restated its fiscal year 2003 budget authority and unobligated balance reported on the Combined Statement of Budgetary Resources.

As discussed in Note 1, *Summary of Significant Accounting Policies*, and Note 13, *Airport and Airway Trust Fund Dedicated Collections*, the accompanying financial statements reflect actual excise tax revenues deposited in the Airport and Airway Trust Fund through March 31, 2004, and excise tax receipts estimated by the Department of Treasury's Office of Tax Analysis for the two quarters ended June 30, 2004 and September 30, 2004.

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

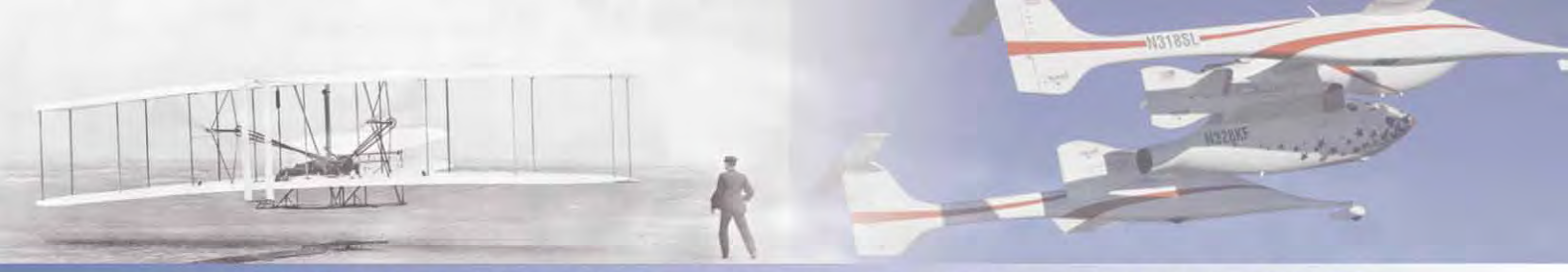
INTERNAL CONTROL OVER FINANCIAL REPORTING

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

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2004 audit, we noted certain matters, described in Exhibit 1, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that none of the reportable conditions presented in Exhibit 1 are material weaknesses.

A summary of the status of prior year reportable conditions is included as Exhibit 3.



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

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed instances, as discussed in Exhibit 2, where the FAA's financial management systems did not substantially comply with Federal financial management systems requirements, which call for a single, integrated financial system. The FAA has not fully integrated managerial cost accounting standards and was unable during fiscal year 2004 to provide timely and complete cost information to its managers.

We also noted other matters involving compliance that, under *Government Auditing Standards* and OMB Bulletin No. 01-02, were not required to be included in this report, that we will report to the management of FAA in a separate letter.

RESPONSIBILITIES

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

Management is responsible for the financial statements, including:

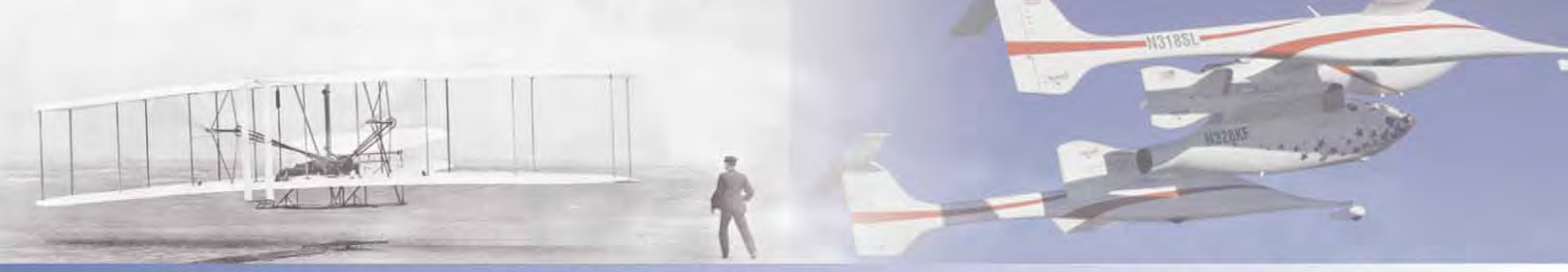
- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of the Management's Discussion and Analysis (including the performance measures), the required supplementary information, and required supplementary stewardship information; and
- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

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

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2004 and 2003 financial statements of the FAA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

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



- Evaluating the overall financial statement presentation.

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

In planning and performing our fiscal year 2004 audit, we considered the FAA's internal control over financial reporting by obtaining an understanding of the FAA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the FAA's internal control over required supplementary stewardship information by obtaining an understanding of the FAA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over required supplementary stewardship information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the FAA's fiscal year 2004 financial statements are free of material misstatement, we performed tests of the FAA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the FAA. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the FAA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

DISTRIBUTION

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

KPMG LLP

November 1, 2004

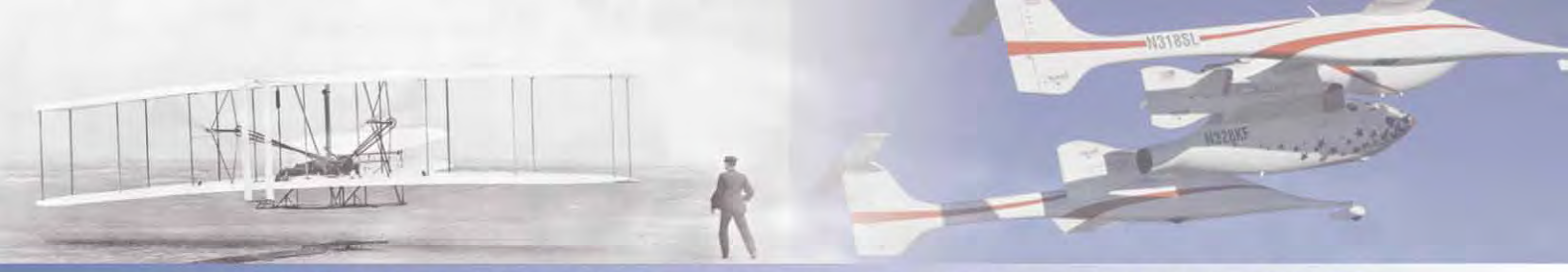


EXHIBIT 1

REPORTABLE CONDITIONS

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FAA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. We consider the following to be reportable conditions.

1. Implementation of a New Financial Accounting System

Background: In November 2003 the FAA began using the Department of Transportation's Delphi financial accounting system, retiring the use of the Departmental Accounting and Financial Information System (DAFIS) legacy system. Delphi, an Oracle-based financial system, now serves as FAA's integrated general and subsidiary ledger. Several feeder and subsidiary systems (e.g., grants, human resources, logistics, labor distribution, cost accounting, procurement, etc.) interface data with Delphi. The consolidated financial statements and important subsidiary detail are provided by Delphi. The implementation of Delphi presented management with many challenges, typically found in the first year of implementation of new systems. Several of those challenges resulted in lapses in control and other system-related deficiencies that required manual workarounds, additional personnel, and management attention during the year in order to produce accurate financial statements. The implementation of Delphi also interfered with FAA's ability to report financial information timely and accurately during the year.

Conditions: We noted the following matters related to the implementation of the new financial management system:

- *Interface errors with feeder and subsidiary systems:* Weaknesses in FAA's development of interfaces between Delphi and existing subsidiary or feeder systems used by FAA, including the cost accounting, procurement, credit card, and budget execution systems, created errors in financial information until software modifications were completed after the implementation of Delphi. For instance, there were over $55 billion in transaction errors generated due to the interface between Delphi and FAA's procurement system. These errors were not corrected at a detailed level until up to eight months after the transaction occurred. Further, interface errors between Delphi and the cost accounting system led to nine months of transactions, totaling approximately $9 billion, from being processed by the cost accounting system until eleven months into the fiscal year.
- *Transactions made outside of the accounting system:* Errors in the interface between the procurement and accounting system required certain payments, primarily those made earlier in the year immediately following the implementation of Delphi, to be processed outside the Delphi system and recorded subsequent to the transaction. The FAA recorded approximately $744 million of payments to vendors outside of Delphi via the Electronic Certification System (ECS) maintained by the Department of Treasury.
- *Failure to process financial transactions timely:* As a result of interface errors and the lack of training, a number of transactions were not recorded into Delphi in a timely manner. For example, the $744 million of ECS payments described above were not recorded into Delphi until approximately eight months into the fiscal year.

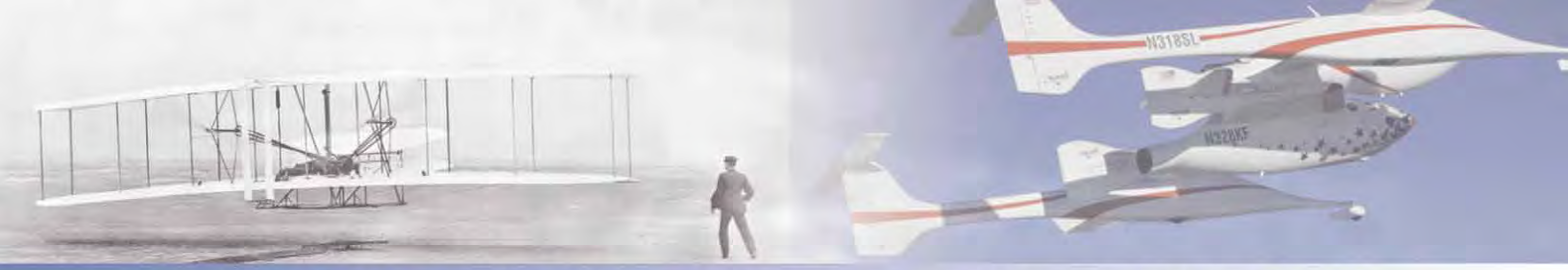


EXHIBIT 1

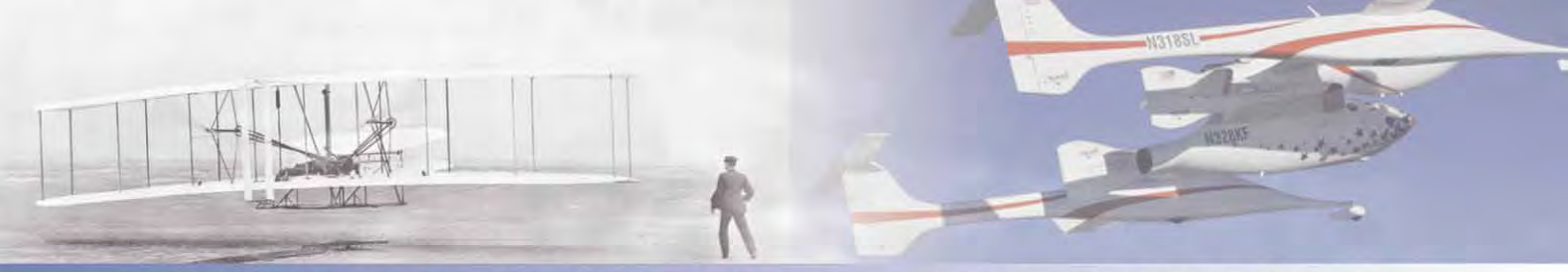
- *Lack of adequate training prior to system implementation:* Some Delphi system users were inadequately trained prior to the implementation of Delphi. Once trained, some of these individuals demonstrated a lack of understanding of the new accounting structure in Delphi, and of the new business processes put in place to support Delphi. As a result, the FAA retrained over 450 personnel on the proper use of accounting codes in Delphi, and had to reiterate the new business processes to support Delphi.
- *Lack of timely reconciliations:* The FAA did not perform timely reconciliations of subsidiary systems and supporting records to the general ledger balances in Delphi. In some cases reconciliations were not completed timely. For example, of the eight subsidiary ledger reconciliations that should be performed by FAA, we found that three reconciliations had not been completed during fiscal year 2004. Further, FAA did not have effective policies and procedures in place during fiscal year 2004 to utilize automated exception and edit reports in Delphi to identify and resolve questionable or erroneous transactions.

To address the conditions noted above, the FAA implemented extensive compensating processes and manual controls to identify and temporarily correct system deficiencies until more permanent processes could be installed. This process included frequent meetings with the Deputy Administrator and other senior FAA and DOT management officials on the status of corrective actions, the assignment of additional resources to perform analyses, the reviewing and matching of source documents to record correcting entries, putting in place multiple levels of supervisory review of transactions, and the canvassing of field and headquarters personnel on additional issues not yet resolved. FAA's actions, which were supported by management of the Department of Transportation, effectively mitigated the effects of post-conversion issues on the financial statements.

Criteria: The Government Accountability Office's (GAO) *Standards of Internal Control in the Federal Government* (GAO *Standards*) states that transactions should be recorded completely, accurately and timely. In addition, the GAO *Standards* require management to identify the knowledge and skills needed for various jobs and establish good human capital practices, to include the timely training of staff. Further, the GAO *Standards* require that information be recorded and communicated to management and others within the entity in a form and within a timeframe that enables them to carry out their internal control and other responsibilities. For example, program managers need accurate and timely financial information to determine whether they are meeting their agencies' strategic and annual performance plans, and meeting their responsibilities for the effective and efficient use of agency resources.

The Joint Financial Management Improvement Program (JFMIP) publications and OMB Circular No. A-127, *Federal Financial Systems*, outline the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities.

OMB Circular No. A-127 prescribes polices and standards for Federal agencies to follow in developing, operating, evaluating and reporting on financial management systems. In particular, OMB Circular No. A-127 specifies the need for integrated financial systems. OMB Circular No. A-127 also requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business or transaction cycles.



Recommendations: We recommend that the FAA:

- Identify and correct all significant Delphi system and subsidiary ledger interface weaknesses to develop a fully integrated financial management system as required by OMB Circular No. A-127;
- Implement procedures to record transactions in a timely manner;
- Provide appropriate follow-up training to accounting and field staff who have access to Delphi; and
- Complete the corrections to the Delphi accounting records, and ensure transactions are reconciled to the general ledger balances.

FAA Response: FAA has reviewed the reportable condition related to the implementation of Delphi and agrees with KPMG's recommendations. As is typical with any large system implementation, FAA experienced many challenges. However, as KPMG noted, FAA, through a combination of extensive senior level involvement and significant staff effort, addressed those issues aggressively to ensure that financial data was accurate and complete. During fiscal year 2005, we agree to continue our commitment to improve the processes and procedures by performing a complete analysis of our year-end closing process, by continuing our efforts to find and remedy issues that arise from the operation of the system (including the Delphi critical issues resolution process and additional training), performing monthly analysis and reconciliations, and developing new on-going review processes to locate potential problems earlier.

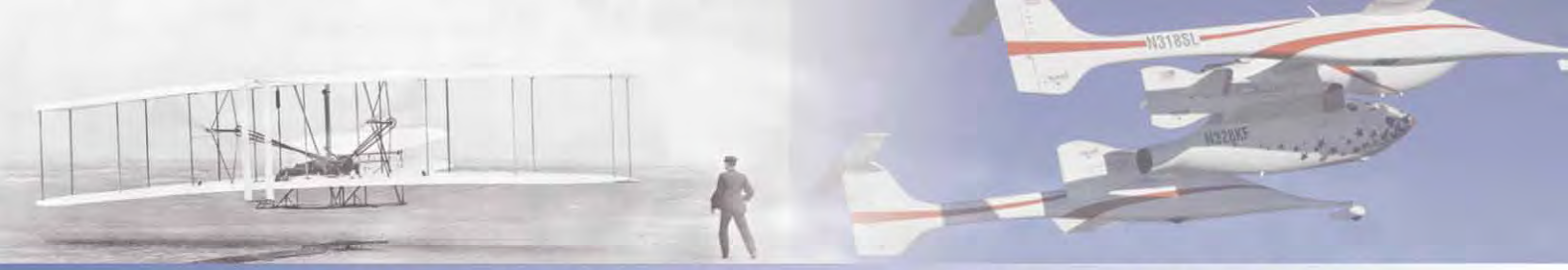
2. Cost Accounting Information

Background: The FAA has reorganized its operations in the past year to align functional and operational units with its missions and goals. One benefit of this reorganization is an ability to improve management accountability through performance and cost reporting. Essential to achieving the goal of improved performance reporting is the effective implementation of FAA's Cost Accounting System (CAS) with the new Delphi general ledger system.

Condition: During fiscal year 2004, the FAA was unable to provide comprehensive internal management cost reports from CAS due primarily to issues related to implementation of a new accounting system. Early in fiscal year 2004, the FAA was unable to extract the necessary data from Delphi in a format needed for input into CAS to allocate costs, enable comparisons of actual costs with goals, and compare costs with outputs and outcomes. Without cost data readily available, the FAA could not produce meaningful internal management cost reports, as required by Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Standards and Concepts.* Lacking this information, FAA managers did not have the required financial reports necessary to make fully informed decisions about the usage of FAA's resources during fiscal year 2004.

Further, CAS is not being used to account for costs in all lines of business within the FAA. The FAA still does not process or report costs through CAS for two lines of business (Regulation and Certification, and Airports), and has not modified CAS to reflect the cost structure of the new Air Traffic Organization (ATO). In addition, the FAA lacks a fully effective labor distribution and tracking system to provide sufficient data to allocate labor costs by program and activity.

Finally, improvements are needed in the system used by air traffic controllers and engineers to track and report time worked by project and task for allocation using CAS. According to a report issued by the Department of Transportation's Office of Inspector General (DOT OIG), the current labor distribution system lacks effective controls over the recording of start and stop times for each work day, allowing controllers and engineers to easily override the system's time stamp mechanism. Also,



based on the current labor agreement with unionized controllers and engineers, indirect activities, such as paid breaks and union activities, are not currently tracked using the existing labor distribution system.

Criteria: SFFAS No. 1, *Objectives of Federal Financial Reporting,* states that an objective of federal financial reporting is "to provide useful information to assist internal and external users in assessing operating performance." SFFAS No. 4 requires that "each reporting entity should accumulate and report the costs of its activities on a regular basis for management information purposes."

Recommendations: We recommend that FAA:

- Develop procedures to accumulate and present cost data consistent with the requirements of SFFAS No. 4 for both internal and external financial reporting;
- Use CAS to process and report costs for all lines of business in the FAA; and
- Improve the accuracy of labor distribution information reported by air traffic controllers and engineers.

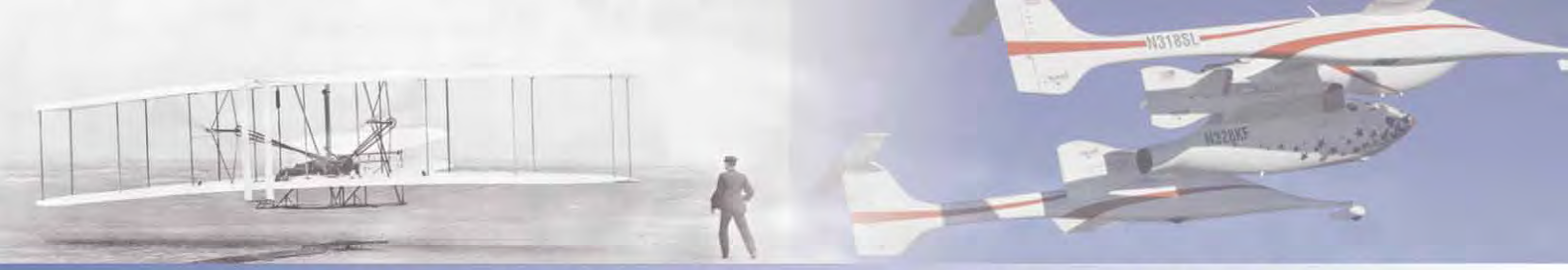
FAA Response: FAA has reviewed the reportable condition related to lack of timely cost accounting and agrees with KPMG's recommendations. FAA recognizes the importance of cost accounting information to the operation of the agency, and plans to provide cost accounting data to those organizations that currently receive data on a monthly basis, beginning in January 2005. We will continue implementation of the cost accounting system for all lines of business in fiscal year 2005 with completion scheduled in fiscal year 2006. FAA will also continue to improve the quality of the cost accounting data and to simplify the cost allocation methods used by the system.

3. Reconciliations of Fund Balance with Treasury

Background: The Fund Balance with Treasury (FBWT) account is an asset representing the future economic benefit of monies that can be spent for authorized transactions. Federal agencies use the FBWT account to reconcile with records from the Department of Treasury's Financial Management Service. This reconciliation is essential to enhancing internal controls, improving the integrity of financial information in Delphi, and providing more accurate measurement of budget results. An adequate reconciliation provides the assurance that processed transactions are properly and timely recorded in the FAA's accounting records and financial statements, which then allow management the ability to make decisions about the proper use and accountability of FAA's resources.

Conditions: We noted the following internal control weaknesses related to FBWT:

- The FAA's FBWT reconciliations were not adequately performed in a timely fashion for the first nine months of fiscal year 2004. Any differences noted between disbursements and deposits recorded in Delphi and those recorded at the U.S. Department of Treasury were recorded into a suspense account in Delphi with limited follow-up. The FAA cited resource constraints and the lack of timely recording of transactions into Delphi as the primary causes for the weaknesses in the FBWT reconciliation process;
- The FAA did not clear items carried in suspense accounts timely during the year. As of June 2004, the FAA had identified almost 11,600 disbursements, totaling approximately $439 million, which had been recorded in FAA's FBWT but not recorded in Delphi. This resulted partly from the use of ECS payments made outside of the normal process of disbursements. From June through September 2004, the FAA dedicated significant resources



to this issue, and was able to identify and substantially reconcile these unreconciled transactions prior to September 30, 2004; and

- As a separate matter, for those reconciliations that were performed during the last three months of the fiscal year, there were weaknesses in the reconciliation process. The FAA uses three groups to prepare the FBWT reconciliation. FAA personnel were unable to show a clear and consistent link between the three parts of the FBWT reconciliation. As a result, reconciling items on each part of the FBWT reconciliation have the potential to go unresolved due to the lack of communication among the three groups within the FAA that perform the FBWT reconciliation.

Criteria: The Department of Transportation's *Financial Management Policies Manual, Section 3.04.3–Reconciliations*, states that each operating administration in the DOT is responsible for reconciling all transactions posted to all clearing accounts monthly. The agency should reclassify all clearing account transactions to the correct Treasury account symbol on the next reporting cycle, but no later than two months after the accomplished date. Further, GAO *Standards* states internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. All documentation and records should be properly managed and maintained.

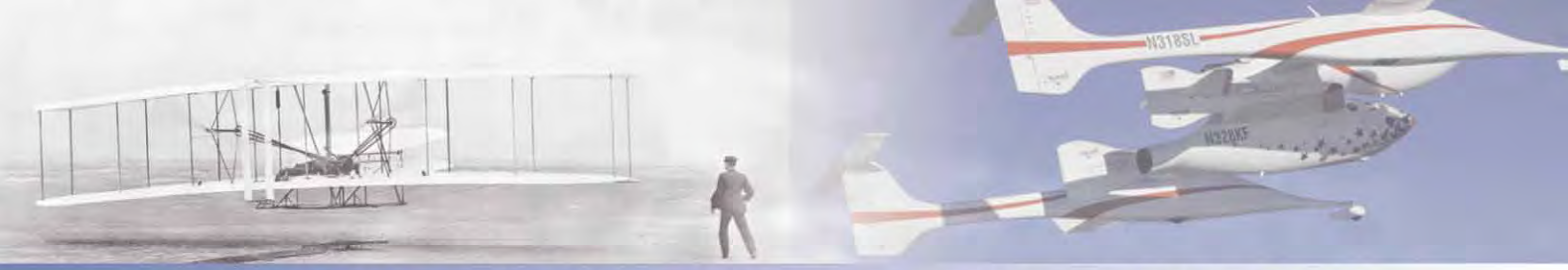
Recommendations: We recommend that FAA:

- Prepare monthly reconciliations of FBWT, including resolution of differences;
- Implement controls and procedures for clearing suspense accounts in a timely fashion;
- Provide adequate Delphi training to enable FAA personnel to produce all necessary system reports to research these transactions timely;
- Ensure compliance with policies and procedures related to monitoring suspense account activity as documented in the Department of Transportation's *Financial Management Policies Manual* and the *Treasury Financial Manual*; and
- Continue FAA's policy to curtail the use of ECS payments.

FAA Response: FAA has reviewed the reportable condition related to inadequate reconciliations of fund balance with Treasury and agrees with KPMG's recommendations. When FAA first implemented Delphi, FAA focused its resources on paying vendors (use of ECS) and then getting the ECS transactions properly recorded in Delphi after payments were made. Although these actions ensured payments were made, they drew resources from managing suspense accounts and performing regular reconciliations. Now that FAA is in its second year of Delphi use, FAA has drastically reduced its use of ECS. FAA is refocusing its resources on stable, regular processes that support managing its suspense account balance. FAA also recognizes that it needs to improve the reconciliation process for fund balances with Treasury, and consequently, plans a comprehensive review of the process by all parties to ensure that FAA has a coordinated reconciliation process. Implementation of recommendations from the review, combined with increased management review and training for technicians, will substantially strengthen our reconciliation process. This represents just a few of the many steps FAA will take during fiscal year 2005 to implement KPMG's recommendations.

4. Information Technology Controls over FAA and Third-Party Systems and Applications

Background: General controls related to the FAA's primary financial applications owned by either the FAA or the Department of Transportation, including Delphi, need to be improved. Specifically, we noted weaknesses in network information security management and application security controls, including system-level access issues, application-level operational access controls for sensitive and



critical functions, separation of duties, change management and application controls. FAA's information technology and financial management systems environment include Delphi and a number of subsidiary and feeder systems, including:

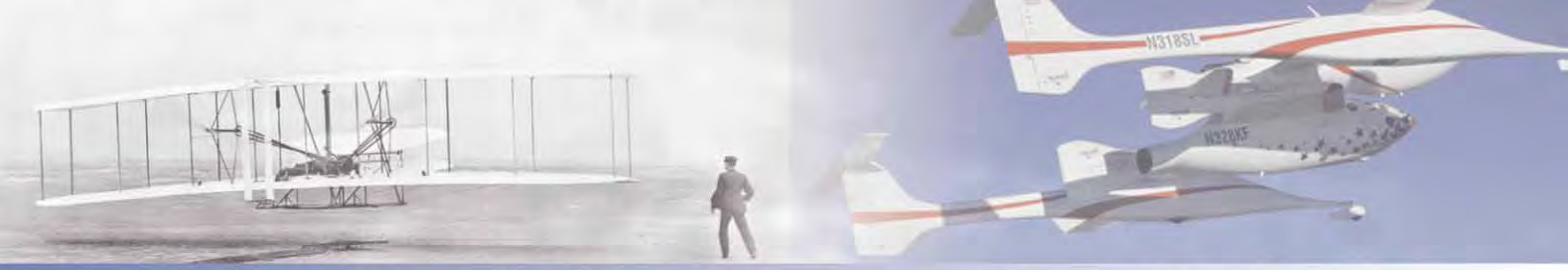
- Delphi, the DOT accounting system used by FAA;
- PRISM, the FAA's procurement system;
- Airport Improvement Program system (AIP);
- Electronic Clearing House Operations system (ECHO);
- Cost Accounting System (CAS);
- Integrated Personnel and Payroll System (IPPS);
- Consolidated Uniform Payroll System (CUPS);
- Consolidated Personnel Management Information System (CPMIS); and
- Logistics Information System (LIS).

Conditions: We noted the following information technology (IT) and financial system control and functionality weaknesses at FAA:

- Instances of security program certification and accreditation documentation not updated or in draft form only;
- Instances of weaknesses in user account management practices were noted including inactive and unused accounts highly susceptible to compromise, and system password control parameters over user accounts not set, such as passwords set to never expire and unlimited login attempts allowed. Also, we noted user accounts for most applications were not periodically reviewed for appropriate authorizations to application programs and data and to identify excessive access privileges;
- Instances of key application servers or network devices were not configured in the most secure manner including sensitive system and user account information that could be obtained without user authentication onto the system;
- Instances where the FAA did not always document changes made to applications, including change approvals and testing. Procedures for documenting, approving, and implementing application changes were not consistently in place and applied;
- Instances where individuals were able to perform incompatible functions, such as technical support staff with access to end user operational functions and end users with high risk combination of operational functions susceptible to abuse or misuse without sufficient compensating controls in place; and
- Instances of financial system integrity weaknesses requiring manual reconciliation processes to be established.

Through our substantive testing of transactions processed through these systems, we concluded that FAA management implemented effective oversight and monitoring procedures to ensure that errors were detected and corrected in a timely manner. Although we noted instances in which management did not record correcting entries in a timely fashion at a detail level, we noted that FAA had effective procedures in place to record transactions in Delphi at a summary level in the general ledger.

Criteria: Controls over IT and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control,



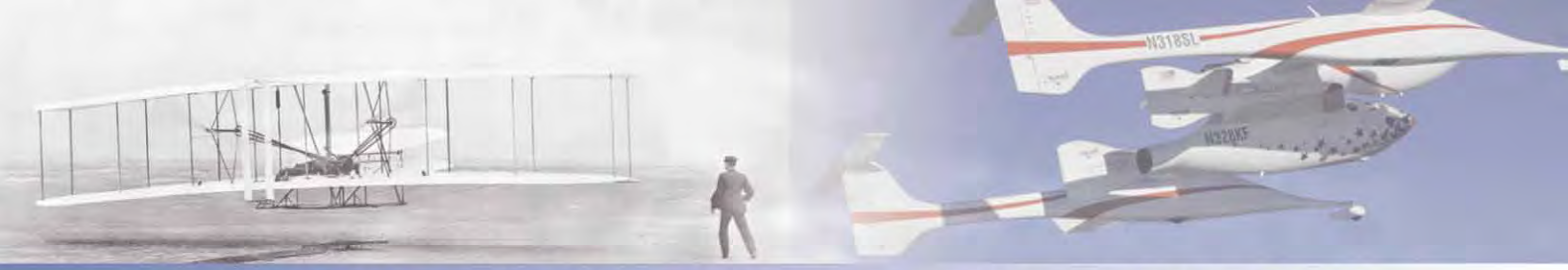
application software development and change control, system software, segregation of duties, and service continuity. In addition to reliable controls, Federal financial management system functionality is important to program monitoring, increasing accountability of financial and program managers, providing better information for decision-making, and increasing the efficiency and effectiveness of services provided by the Federal government.

OMB Circular No. A-130, *Management of Federal Information Resources*, Appendix III, requires Federal agencies to establish application security plans to assure that adequate security is provided for information collected, processed, transmitted, stored, or disseminated through the system.

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

Recommendations: We recommend that the FAA, in coordination with the DOT:

- For entity-wide security program planning and management over the applications reviewed, maintain up-to-date and complete security program documentation in accordance with the application's appropriate data classification (e.g., mission critical information system).
- For access control:
  a. Resolve system security issues noted in ECHO, AIP, PRISM, and CAS;
  b. Identify those individuals who require privileged access to Delphi accounting functions based on "least privileged, need to know" principles. Eliminate those individuals with unnecessary access to Delphi's operating system;
  c. Monitor appropriateness of user access to the Delphi operating system and Delphi operational functions via audit logging capabilities; and
  d. Improve the oversight and management of duplicate accounts in IPPS and access authorization to sensitive and incompatible functions.
- For application software development and change control of AIP, PRISM, and CAS:
  a. Maintain up-to-date and approved change management policies and procedures that requires changes to be authorized and tested prior to implementation;
  b. Adopt change management policies and procedures on a consistent basis; and
  c. Adopt policies to require analysis of change requests to ensure consistency with agency policies, user requirements, and implementation schedules.
- For segregation of duties, perform an analysis of IT and end user position responsibilities and implement policies and procedures in ECHO, IPPS, PRISM, and Delphi to improve segregation of duties for IT and accounting functions, including documentation of key security positions.
- For financial system functionality, work to resolve the financial system integrity and functionality issues noted in Delphi.



Due to the sensitive nature of these issues, we provided the detailed results of our review, along with more specific recommendations, separately to management.

FAA Response: FAA has reviewed the reportable condition related to information technology controls over FAA and third-party systems applications and agrees with KPMG's recommendations. FAA, through the leadership of our Chief Information Officer, is committed to maintaining data integrity and system security. FAA will fully implement all of KPMG's recommendations related to FAA's systems and will work with third parties that operate systems for FAA to ensure the third party complies with KPMG's recommendations. We will also work with DOT toward accomplishing these goals for DOT-sponsored systems.

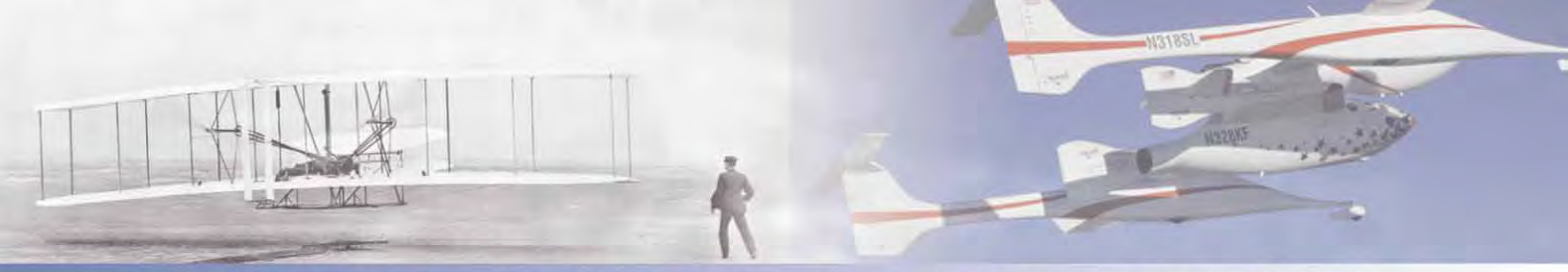
5. Cost Reimbursable Contracts

Background: The DOT OIG reported in fiscal year 2002 that the FAA was not properly administering cost reimbursable contracts. Specifically, the DOT OIG found that contracting officers exercised little effective oversight and lacked the basic information needed to properly manage, pay, and close contracts. The DOT OIG recommended that the FAA implement the necessary controls over the monitoring of cost reimbursable contracts, and that FAA perform close-out reviews of the $6 billion backlog of completed, but not yet closed, cost reimbursable contracts. In a follow-up review in June 2004, the DOT OIG found that FAA had obtained $3 million to fund contract audits, and had requested almost 200 audits of cost reimbursable contracts. FAA had also initiated significant internal control procedures, and had reduced the backlog of completed contracts awaiting audits from $6 billion to $1.5 billion.

Conditions: Although FAA has made substantial improvements from fiscal year 2001 in their oversight of cost reimbursable contracts, further improvements are needed. Specifically, we noted:

- Of the $6 billion backlog reported in fiscal year 2001, the FAA still has a backlog of $1.5 billion in completed contracts awaiting audits as of September 30, 2004;
- The results of contract audits that have been requested from the U.S. Department of Defense's Defense Contract Audit Agency (DCAA) have not been sufficiently reviewed to improve the close-out process. Once the FAA receives the results from the contract audits, we could not find evidence of any procedures to notify the contracting officers of adverse results that may impact their oversight of other cost reimbursable contracts with those vendors;
- Although FAA has a tracking system in place to monitor the contract audits, we found that FAA should improve their procedures to use the information from these contract audits to adjust their business decisions when entering into other cost reimbursable contracts. Specifically, of the 20 contract audit results that we reviewed, we noted that 3 audit reports from the DCAA reported that the vendors' accounting systems were not adequate to properly administer cost reimbursable contracts. The FAA did not modify its processes in consideration of the weaknesses noted in these vendors' systems; and
- When reviewing the invoices for the cost reimbursable contracts that we sampled, we found no evidence of a detailed review by the contracting officers to detect unallowable costs. This is an important control that FAA should have in place as an initial step in ensuring proper oversight of cost reimbursable contracts.

Criteria: FAA's *Procurement Toolbox Guidance – Contract Administration* provides guidance to management and contracting officers on the procedures that should be followed for proper oversight of cost reimbursable contracts. Further, GAO *Standards* states that monitoring of internal control should include policies and procedures for ensuring that the findings of audits and other reviews are

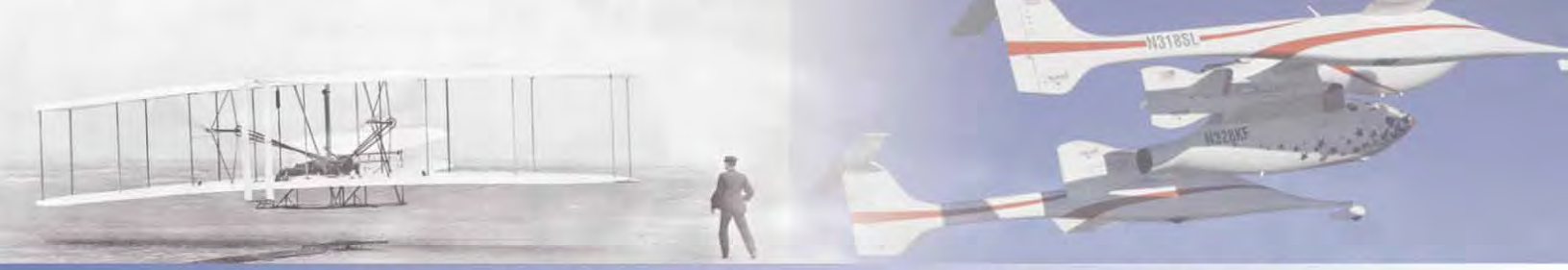


promptly resolved. Managers are to (1) promptly evaluate findings from audits and other reviews, including those showing deficiencies and recommendations reported by auditors and others who evaluate agencies' operations; (2) determine proper actions in response to findings and recommendations from audits and reviews; and (3) complete, within established time frames, all actions that correct or otherwise resolve the matters brought to management's attention. The resolution process begins when audit or other review results are reported to management, and is completed only after action has been taken that (1) corrects identified deficiencies; (2) produces improvements; or (3) demonstrates the findings and recommendations do not warrant management action.

Recommendations: We recommend that the FAA:

- Resolve the $1.5 billion backlog of completed contracts awaiting audit;
- Implement effective controls to notify contracting officers of the results of contract audits, and to utilize the information from contract audits when making decisions to award additional cost reimbursable contracts;
- Consider the assessment of vendor systems and procedures to determine the extent of FAA monitoring and follow-up that should be routinely performed; and
- Improve procedures to require a detailed review by contracting officers of invoices for unallowable costs.

FAA Response: FAA has reviewed the reportable condition related to the oversight of cost reimbursable contracts and agrees with KPMG's recommendations. FAA is committed to completing the closeout of the backlog of completed contracts in fiscal year 2005. Furthermore, FAA agrees to modify its policies and procedures to ensure that contracting officers review invoices and contract audit reports to evaluate cost reimbursable contractor performance for the purpose of future awards and to protect the public interest.



COMPLIANCE WITH LAWS AND REGULATIONS

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

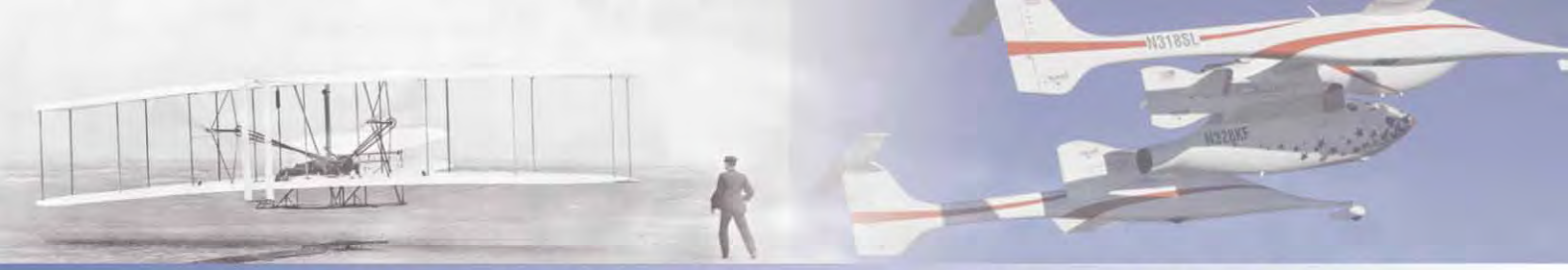
Federal Financial Management Improvement Act of 1996 (FFMIA)

Background/Criteria: FFMIA requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level.

Condition: The FAA was not in substantial compliance with FFMIA due to the following:

- The FAA uses the DOT's core accounting system, Delphi, to process and record financial transactions. After the implementation of Delphi, the FAA encountered a number of conversion-related challenges that prevented FAA from recording a significant number of transactions in Delphi. This situation then interfered with the FAA's ability to produce accurate and complete financial and budgetary reports. We also noted a deficiency with the application of accounting standards, since FAA has not been able to accurately and timely provide cost data on its programs during fiscal year 2004; and
- Six of the key financial systems used by FAA (ECHO, PRISM, CAS, IPPS, CUPS, and LIS) that feed or support financial data into Delphi do not comply substantially with the categories of FFMIA compliance listed in OMB Circular No. A-127, Section 7 – *Financial Management System Requirements*. Specifically, we noted weaknesses in the following:

Category of Non-Compliance	ECHO	PRISM	CAS	IPPS	CUPS	LIS
Lacks Agency-wide Financial Information Classification Structure				X	X	X
Is not an Integrated Financial Management System			X			X
Does not apply the U.S. Government Standard General Ledger at the Transaction Level				X	X	X
Does not conform to Federal Accounting Standards						X
Lacks Effective Financial Reporting	X					X
Lacks Effective Budget Reporting	X			X	X	X
Inadequate System and Processing Documentation	X					
Does not Adhere to Established Functional Requirements	X			X	X	X
Does not Adhere to *Computer Security Act* Requirements	X	X	X	X		
Lacks Adequate Internal Controls	X	X	X	X		



Recommendations: We recommend that the FAA:

- Continue to work aggressively toward full integration of its financial management systems and to produce accurate, timely, and reliable management cost reports using the Cost Accounting System; and
- Address and resolve the weaknesses noted in the six key financial systems that do not comply with the categories of FFMIA compliance.

FAA Response: FAA has reviewed KPMG's analysis of FAA's compliance with FFMIA and agrees with KPMG's recommendations. FAA recognizes the importance of complying with Federal financial management systems requirements, applicable Federal accounting standards, and processing transactions in accordance with the U.S. Government Standard General Ledger. FAA will fully implement all of KPMG's recommendations related to FAA's systems and will work with third parties that operate systems for FAA to ensure the third party complies with KPMG's recommendations.

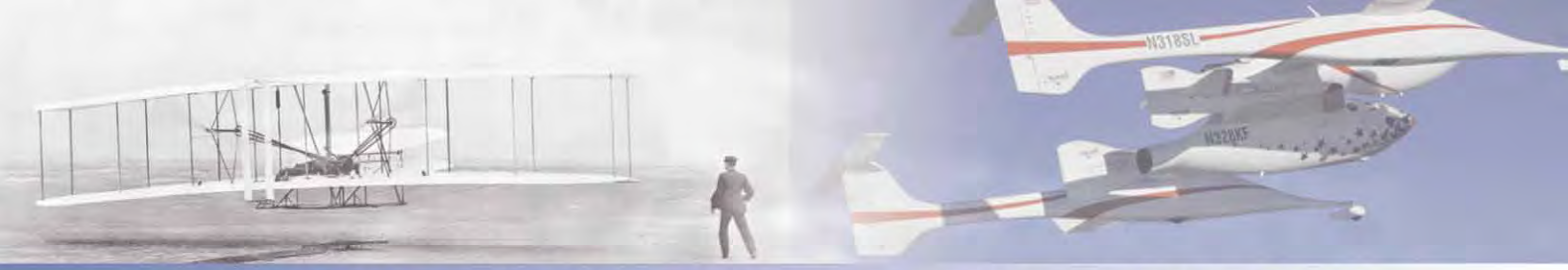


EXHIBIT 3

STATUS OF PRIOR YEAR REPORTABLE CONDITIONS, AND NON-COMPLIANCE WITH SIGNIFICANT LAWS AND REGULATIONS

Prior Year Condition	As Reported At September 30, 2003	Status As Of September 30, 2004
Controls over property, plant and equipment	**Reportable condition:** The FAA did not fully adhere to its policies and procedures designed to ensure that PP&E is stated in accordance with accounting principles generally accepted in United States of America.	**No longer deemed a reportable condition:** The FAA implemented procedures to resolve this issue.
Process for estimating environmental liabilities	**Reportable condition:** The FAA lacks adequate policies and procedures to consistently and accurately determine the estimated environmental liability for financial statement purposes.	**No longer deemed a reportable condition:** The FAA implemented procedures to resolve this issue.
Information technology controls over FAA and third-party systems and applications	**Reportable condition:** Certain general controls related to the FAA's primary financial applications owned by the FAA and the DOT need to be strengthened.	**Continue as a reportable condition:** Although improvements were made, weaknesses still remain in controls over FAA and third-party systems and applications.
Non-compliance with the *Federal Financial Management Improvement Act*	**Non-compliance with laws and regulations:** FAA was not in substantial compliance with FFMIA because: (1) DOT's core accounting system, DAFIS, cannot produce auditable financial statements and is not compliant with the U.S. Government Standard General Ledger at the transaction level; (2) security over financial information systems needed to be improved; (3) managerial cost accounting standards were not fully implemented; and (4) the financial management systems are not fully integrated.	**Continue reporting as a non-compliance with laws and regulations:** Although improvements were made (such as the implementation of Delphi to replace DAFIS), the FAA is still in material non-compliance with FFMIA due to (1) managerial cost accounting standards were not fully implemented; and (2) the financial management systems were not fully integrated.
Non-compliance with the *Anti-Deficiency Act*	**Non-compliance with laws and regulations:** The FAA's Chief Counsel's office determined that certain transactions constituted violations of the *Anti-Deficiency Act*.	**No longer deemed a non-compliance issue:** No instances of non-compliance with the *Anti-Deficiency Act* were noted during the fiscal year 2004 audit.

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
CONSOLIDATED BALANCE SHEETS
As of September 30
(Dollars in Thousands)

Assets	2004	2003
Intragovernmental		
Fund balance with Treasury (Note 2)	$ 2,840,663	$ 2,833,723
Investments (Note 3)	10,318,029	10,819,257
Accounts receivable, advances, and other (Note 4)	215,989	168,722
Total intragovernmental	13,374,681	13,821,702
Accounts receivable, advances, and other, net (Note 4)	173,283	63,411
Inventory and related property, net (Note 5)	585,709	581,766
Property, plant, and equipment, net (Notes 6 & 9)	14,469,731	13,397,607
Total assets	$ 28,603,404	$ 27,864,486
Liabilities		
Intragovernmental liabilities		
Accounts payable	$ 61,041	$ 9,324
Employee related, legal and other (Notes 8 & 9)	287,026	344,868
Total intragovernmental liabilities	348,067	354,192
Accounts payable	649,005	669,693
Environmental cleanup costs (Note 7 & 19)	606,261	621,953
Employee related, legal, and other (Notes 8 & 9)	959,527	859,124
Federal employee benefits (Note 10)	954,463	1,041,568
Total liabilities	3,517,323	3,546,530
Commitments and contingencies (Notes 9 & 19)		
Net position		
Unexpended appropriations	999,146	562,595
Cumulative results of operations	24,086,935	23,755,361
Total net position	25,086,081	24,317,956
Total liabilities and net position	$ 28,603,404	$ 27,864,486

The accompanying notes are an integral part of these financial statements.

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
CONSOLIDATED STATEMENTS OF NET COST
For the Years Ended September 30
(Dollars in Thousands)

Line of business programs (Note 12)	2004	2003
Air Traffic Organization		
Expenses	$ 8,214,526	$ 8,222,442
Less earned revenues	(135,515)	(123,746)
Net costs	8,079,011	8,098,696
Regulation & Certification		
Expenses	942,377	943,135
Less earned revenues	(2,649)	(1,126)
Net costs	939,728	942,009
Airports		
Expenses	2,977,300	2,786,717
Less earned revenues	(232)	(224)
Net costs	2,977,068	2,786,493
Commercial Space Transportation		
Expenses	12,527	11,725
Net costs	12,527	11,725
Non line of business programs		
Regional and center operations and other programs		
Expenses	389,954	342,107
Less earned revenues	(240,866)	(256,386)
Net costs	149,088	85,721
Not assigned to programs		
Expenses	36,572	61,486
Less earned revenues	-	(34,794)
Net costs	36,572	26,692
Net cost of continuing operations	**12,193,994**	**11,951,336**
Transferred operations - Civil Aviation Security (Note 15)		
Expenses	-	124,705
Less earned revenues	-	(77,455)
Net costs	-	47,250
Net cost of operations		
Total expenses	12,573,256	12,492,317
Less earned revenues	(379,262)	(493,731)
Total net cost	**$ 12,193,994**	**$ 11,998,586**

The accompanying notes are an integral part of these financial statements.

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30
(Dollars in Thousands)

	2004		2003	
	Cumulative results of operations	Unexpended appropriations	Cumulative results of operations	Unexpended appropriations
Beginning balances	$ 23,755,361	$ 562,595	$ 23,518,258	$ 481,919
Budgetary financing sources				
Appropriations received (Note 16)	-	3,032,925	-	3,273,241
Appropriations transferred-in/out	-	-	-	250
Rescissions, cancellations and other	-	(64,644)	-	(42,269)
Appropriations used	2,531,730	(2,531,730)	3,150,546	(3,150,546)
Excise taxes and associated revenue (Note 13)	9,674,509	-	9,360,469	-
Transfers-in/out without reimbursement	(101,662)	-	(123,169)	-
Other financing sources				
Donations and forfeitures of property and other	-	-	32,218	-
Transfers-in/out without reimbursement	(72,508)	-	(36,457)	-
Transferred operations (Note 15)	-	-	(643,621)	-
Imputed financing from costs absorbed by others (Note 14)	493,499	-	495,703	-
Total financing sources	12,525,568	436,551	12,235,689	80,676
Net cost of operations	12,193,994	-	11,998,586	-
Ending balances	$ 24,086,935	$ 999,146	$ 23,755,361	$ 562,595

The accompanying notes are an integral part of these financial statements.

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINED STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30
(Dollars in Thousands)

	2004	2003 AS RESTATED
Budgetary resources (Note 16)		
Budget authority	$ 17,615,716	$ 16,644,463
Unobligated balance brought forward, transfers and other	1,107,702	932,850
Spending authority from offsetting collections	675,454	726,484
Recoveries of prior year obligations	190,918	249,157
Temporarily not available pursuant to public law	(78,874)	-
Permanently not available	(3,451,054)	(3,229,132)
Total budgetary resources	$ 16,059,862	$ 15,323,822
Status of budgetary resources		
Obligations incurred	$ 14,230,011	$ 14,166,146
Unobligated balance available	1,113,378	676,205
Unobligated balance not available	716,473	481,471
Total status of budgetary resources	$ 16,059,862	$ 15,323,822
Relationship of obligations to outlays		
Obligated balance, net, beginning of period	$ 8,644,480	$ 7,998,136
Cancelled appropriations and other	(9)	15,702
Obligations incurred	14,230,011	14,166,146
Less: Spending authority from offsetting collections and receipts and recoveries of prior year obligations	(866,372)	(975,738)
Less: Obligated balance, net, end of period	(9,173,060)	(8,644,480)
Net outlays	$ 12,835,050	$ 12,559,766
Outlays		
Disbursements	$ 17,756,831	$ 17,322,760
Collections, net of offsetting receipts	(4,921,781)	(4,762,994)
Net outlays	$ 12,835,050	$ 12,559,766

The accompanying notes are an integral part of these financial statements.

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
CONSOLIDATED STATEMENTS OF FINANCING
For the Years Ended September 30
(Dollars in Thousands)

Resources used to finance activities	2004	2003
Budgetary resources obligated		
Obligations incurred	$ 14,230,011	$ 14,166,146
Less: Spending authority from offsetting collections and receipts and recoveries of prior year obligations	866,372	975,738
Obligations net of offsetting collections	13,363,639	13,190,408
Other resources		
Donations and forfeitures of property and other	-	32,218
Transfers in/(out) without reimbursement	(72,508)	(680,078)
Imputed financing from costs absorbed by others	493,499	495,703
Net other resources used to finance activities	420,991	(152,157)
Total resources used to finance activities	13,784,630	13,038,251
Resources used to finance items not part of the net cost of operations		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet received	385,476	464,695
Resources that fund expenses recognized in prior periods (decreases in unfunded liabilities) (Note 17)	171,597	158,858
Resources that finance the acquisition of assets	1,985,245	1,534,555
Other resources or adjustments to net obligated resources that do not affect net cost of operations	18,863	(71,408)
Total resources used to finance items not part of net cost of operations	2,561,181	2,086,700
Total resources used to finance net cost of operations	**11,223,449**	**10,951,551**
Components of net cost of operations that will not require or generate resources in the current period		
Components requiring or generating resources in future periods		
Increases in annual leave liablilty and other unfunded liabilities (Note 17)	108,993	103,051
Increase in exchange revenue receivable from the public	(82,812)	-
Components not requiring or generating resources in future periods		
Depreciation and amortization	952,969	911,337
Revaluation of assets or liabilities	-	(18,320)
Cost of goods sold	47,589	34,987
Other	(56,194)	15,980
Total components of net cost of operations that will not require or generate resources	944,364	943,984
Total components of net cost of operations that will not require or generate resources in the current period	**970,545**	**1,047,035**
Net cost of operations	**$ 12,193,994**	**$ 11,998,586**

The accompanying notes are an integral part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation

The financial statements have been prepared to report the financial position, net cost of operations, changes in net position, status and availability of budgetary resources, and the reconciliation between proprietary and budgetary accounts of FAA. The statements are a requirement of the Chief Financial Officers Act of 1990, Government Management Reform Act of 1994, and the OMB's Bulletin Number 01-02, *Audit Requirements for Federal Financial Statements.* They have been prepared from, and are fully supported by, the books and records of FAA in accordance with (1) the hierarchy of accounting principles generally accepted in the United States of America and standards approved by the principals of the Federal Accounting Standards Advisory Board (FASAB), (2) the OMB Bulletin Number 01-09, *Form and Content of Agency Financial Statements*, and (3) DOT and FAA accounting policies which are summarized in this note. These statements, with the exception of the Statement of Budgetary Resources, are different from financial management reports, which are also prepared pursuant to OMB directives that are used to monitor and control FAA's use of budgetary resources.

In accordance with OMB Bulletin Number 01-09, the financial statements and associated notes are presented on a comparative basis.

Unless specified otherwise, all dollar amounts are presented in thousands.

B. Reporting Entity and New Line of Business

FAA, which was created in 1958, is a component of the DOT, a cabinet-level agency of the Executive Branch of the United States Government. Our mission is to provide a safe, secure, and efficient global aerospace system that contributes to national security and the promotion of United States aerospace safety. As the leading authority in the international aerospace community, FAA is responsive to the dynamic nature of customer needs, economic conditions, and environmental concerns. FAA reporting entity is comprised of Trust Funds, Revolving Funds, Special Funds, General Funds, and General Fund Miscellaneous Receipts.

- Trust Funds are credited with receipts that are generated by the terms of a trust agreement or statute. At the point of collection, our receipts are unavailable until appropriated by the U.S. Congress. The Trust Funds included in our consolidated financial statements include the Airport and Airway Trust Fund (AATF), which is managed by the U.S. Treasury's Bureau of Public Debt, and funds the (a) Grants-in-Aid for Airports (b) Facilities and Equipment and (c) Research, Engineering and Development.
- Revolving Funds are accounts established by law to finance a continuing cycle of operations with receipts derived from such operations usually available in their entirety for use by the fund without further action by the U.S. Congress. FAA's revolving funds include the Aviation Insurance Fund and the Administrative Services Franchise Fund.
- Special Funds are accounts established for receipts earmarked by law for a specific purpose, but are not generated by a cycle of operations for which there is continuing authority to reuse such receipts. Our consolidated financial statements include Aviation User Fees, which are Special Fund receipts.
- General Funds are accounts used to record financial transactions arising under congressional appropriations or other authorizations to spend general revenues. We manage Operations and Facilities, Engineering & Development General Fund accounts.

- General Fund Miscellaneous Receipts are accounts established for receipts of non-recurring activity, such as fines, penalties, fees and other miscellaneous receipts for services and benefits.

FAA has rights and ownership of all assets reported in these financial statements. We do not possess any non-entity assets.

On February 8, 2004, FAA established the ATO. The ATO combined the FAA's Research and Acquisitions, Air Traffic Services, and Free Flight Offices into one performance based organization. The primary service of the ATO is to move air traffic safely and efficiently. The customers of the ATO are commercial and private aviation and the military.

C. Budgets and Budgetary Accounting

Congress annually enacts appropriations to permit FAA to incur obligations for specified purposes. In FYs 2004 and 2003, we were accountable for AATF appropriations, Revolving Funds, a Special Fund, and General Fund appropriations. We recognize budgetary resources as assets when cash (funds held by the U.S. Treasury) is made available through the Department of Treasury General Fund warrants and transfers from the AATF.

D. Basis of Accounting

Transactions are recorded on both an accrual accounting basis and a budgetary basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal requirements on the use of Federal funds. All material intra-agency transactions and balances have been eliminated for presentation on a consolidated basis. However, the Statement of Budgetary Resources is presented on a combined basis in accordance with OMB Bulletin 01-09.

E. Revenues and Other Financing Sources

Congress enacts annual, multi-year, and no-year appropriations to be used, within statutory limits, for operating, capital and grant expenditures. Additional amounts are obtained from service fees (e.g., landing, registry, and overflight fees), war risk insurance premiums (see note 19), and through reimbursements for products and services provided to domestic and foreign governmental entities.

The AATF is sustained by excise taxes that the Internal Revenue Service (IRS) collects from airway system users. Excise taxes collected are initially deposited to the general fund of the U.S. Treasury. The IRS does not receive sufficient information at the time the taxes are collected to determine how these payments should be distributed to specific trust funds. Therefore, the U.S. Treasury makes initial semi-monthly distributions to trust funds based on estimates prepared by its Office of Tax Analysis (OTA). These estimates are based on historical excise tax data applied to current excise tax receipts. When actual amounts are available from the IRS, generally six months after each quarter-end, adjustments are made to the estimated amounts and the difference is accrued as an intragovernmental receivable or payable. FAA's September 30, 2004 financial statements reflect excise taxes certified through March 31, 2004, and excise taxes estimated by OTA for the period April 1 to September 30, 2004 as specified by Statement of Federal Financial Accounting Standards (SFFAS) Number 7, *Accounting for Revenue and Other Financing Sources.* Actual tax collections data for the two quarters ended June 30, 2004 and September 30, 2004 will not be available from the IRS until December 2004 and March 2005, respectively. FAA management does not believe that the actual tax collections for the quarters ended June 30, 2004 and September 30, 2004 will be materially different than the OTA estimate.

The AATF also earns interest from investments in U.S. Government securities. Interest income is recognized as revenue on the accrual basis of such collections for those quarters.

Appropriations are recognized as a financing source when expended. Revenues from service fees associated with reimbursable agreements are recognized concurrently with the recognition of accrued expenditures for performing the services. War-risk insurance premiums are deferred and recognized as revenue on a straight-line basis over the period of coverage. Overflight fees are recognized as revenue in the period in which the flights took place.

We recognize as an imputed financing source the amount of accrued pension and post-retirement benefit expenses for current employees paid on our behalf by the Office of Personnel Management (OPM), as well as amounts paid from the U.S. Treasury Judgment Fund in settlement of claims or court assessments against FAA.

F. Taxes

FAA, as a Federal entity, is not subject to Federal, State, or local income taxes, and, accordingly, no provision for income taxes has been recorded in the accompanying financial statements.

G. Fund Balance with the U.S. Treasury

The U.S. Treasury processes cash receipts and disbursements. Funds held at the Treasury are available to pay agency liabilities. FAA does not maintain cash in commercial bank accounts or foreign currency balances. Foreign currency payments are made either by Treasury or the Department of State and are reported by FAA in the U.S. dollar equivalent.

H. Investment in U.S. Government Securities

Unexpended funds in the AATF and Aviation Insurance Revolving Fund are invested in U.S. Government securities at cost. A portion of the AATF investments is liquidated semi-monthly in amounts needed to provide cash for FAA appropriation accounts. The Revolving Fund investments are usually held to maturity. Investments, redemptions, and reinvestments are held and managed under the direction of FAA by the U.S. Treasury.

I. Accounts Receivable

Accounts receivable consists of amounts owed to FAA by other Federal agencies and the public. Amounts due from Federal agencies are considered fully collectible. Accounts receivable from the public include, for example, overflight fees, fines and penalties, reimbursements from employees, and services performed for foreign governments. An allowance for uncollectible accounts receivable from the public is established when either (1) based upon a review of outstanding accounts and the failure of all collection efforts, management determines that collection is unlikely to occur considering the debtor's ability to pay, or (2) an account for which no allowance has been established is submitted to the Department of the Treasury for collection, which takes place when it becomes 180 days delinquent.

J. Inventory

Within the FAA's Franchise Fund, inventory is held for sale to FAA field locations and other domestic entities and foreign governments. Inventory consists of materials and supplies used to support the national airspace system (NAS), and is predominately located at the FAA Mike Monroney Aeronautical Center in Oklahoma City. Inventory cost includes material, labor, and applicable manufacturing overhead, and is determined using the weighted moving average cost method.

FAA field locations trade non-operational repairable components with the Franchise Fund. These components are classified as "Held for Repair." An allowance is established for repairable inventory

based on the average historical cost of such repairs. The cost of repair is capitalized and these items are reclassified as "Held for Sale."

Inventory may be classified as excess, obsolete, and unserviceable if, for example, the quantity exceeds projected demand for the foreseeable future, or if the item has been technologically surpassed. An allowance is established for excess, obsolete, and unserviceable inventory based on the condition of various inventory categories as well as our historical experience disposing such inventory.

K. Operating Materials and Supplies

In contrast to inventory, which is held for sale by the Franchise Fund, operating materials and supplies are used in the operations of the agency. Operating materials and supplies primarily consist of unissued materials and supplies that will be used in the construction of NAS assets. They are valued based on the weighted moving average method or on the basis of actual prices paid. Operating materials and supplies are expensed or reclassified as equipment or work in process using the consumption method of accounting.

Operating materials and supplies "held for use" are those items that are consumed on a regular and ongoing basis.

Operating Materials and Supplies may be classified as excess, obsolete, and unserviceable if, for example, the quantity exceeds projected demand for the foreseeable future, or if the item has been technologically surpassed. An allowance is established for "held for use" and excess, obsolete, and unserviceable operating materials and supplies based on the condition of various asset categories as well as our historical experience disposing such assets.

L. Property, Plant and Equipment (PP&E)

FAA capitalizes acquisitions of PP&E when the cost equals or exceeds $25,000 and the useful life equals or exceeds two years. FAA records PP&E at original acquisition cost.

Depreciation expense is calculated using the straight-line method. Depreciation commences the first month after the asset is placed in service. FAA does not recognize residual value of its PP&E. The useful life classifications for capitalized assets are as follows:

Real Property	**Useful Life (years)**
Buildings, air traffic control towers, and enroute air traffic control centers	40
Mobile buildings	20
Roads, sidewalks, parking lots, and all other structures	15
Capital and leasehold improvements	Up to 10
Personal Property	
Aircraft, navigation, and surveillance equipment	20
Decision support systems, communications- and weather-related equipment	4-20
Office furniture, printing, projection, and office equipment, vehicles	5-13
Internal use software	3

Buildings and equipment acquired under capital leases are amortized over the lease term. If the lease agreement contains a bargain purchase option or otherwise provides for transferring title of the asset to FAA, the building is depreciated over a 40-year service life.

Construction in progress (CIP) is valued at actual direct costs, plus applied overhead and other indirect costs. FAA analyzes nationally funded capital expenditures and allocates these costs to the related in-use assets.

FAA occupies certain real property, which is leased by the Department of Transportation from the General Services Administration. Payments for these leases are from an appropriation of the Office of the Secretary of Transportation; FAA's portion is derived from the AATF.

M. Advances and Prepaid Charges

Advance payments are generally prohibited by law. There are some exceptions, such as reimbursable agreements, subscriptions and payments to contractors and employees. Payments made in advance of the receipt of goods and services are recorded as advances or prepaid charges at the time of prepayment and recognized as expenses when the related goods and services are received.

N. Liabilities

Liabilities covered by budgetary or other resources are those liabilities for which Congress has appropriated funds or funding is otherwise available to pay amounts due. Liabilities not covered by budgetary or other resources represent amounts owed in excess of available, Congressionally appropriated funds or other amounts. The liquidation of liabilities not covered by budgetary or other resources is dependent on future Congressional appropriations or other funding. Intragovernmental liabilities are claims against FAA by other Federal agencies.

O. Accounts Payable

Accounts payable are amounts FAA owes to other Federal agencies and the public. Accounts payable to Federal agencies generally consist of amounts due under inter-agency reimbursable agreements. Accounts payable to the public primarily consists of estimated amounts incurred but not yet claimed by Airport Improvement Program grant recipients and unpaid goods and services received by FAA in support of the NAS.

P. Annual, Sick, and Other Leave

Annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. For each bi-weekly pay period, the balance in the accrued annual leave account is adjusted to reflect the latest pay rates and unused hours of leave. Liabilities associated with other types of vested leave, including compensatory, credit hours, restored leave, and sick leave in certain circumstances, are accrued at year-end, based on latest pay rates and unused hours of leave. Sick leave is generally nonvested, except for sick leave balances at retirement under the terms of certain union agreements. Funding will be obtained from future financing sources to the extent that current or prior year appropriations are not available to fund annual and other types of vested leave earned but not taken. Nonvested leave is expensed when used.

Q. Accrued Workers' Compensation

A liability is recorded for actual and estimated future payments to be made for workers' compensation pursuant to the Federal Employees' Compensation Act (FECA). The actual costs incurred are reflected as a liability because FAA will reimburse the Department of Labor (DOL) two years after the actual payment of expenses. Future appropriations will be used for the reimbursement

to DOL. The liability consists of (1) the net present value of estimated future payments calculated by the DOL, and (2) the unreimbursed cost paid by DOL for compensation to recipients under the FECA.

R. Retirement Plan

FAA employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). The employees who participate in CSRS are beneficiaries of FAA's matching contribution, equal to seven percent of pay, distributed to their annuity account in the Civil Service Retirement and Disability Fund.

FERS went into effect on January 1, 1987. FERS and Social Security automatically cover most employees hired after December 31, 1983. Employees hired prior to January 1, 1984 could elect either to join FERS and Social Security, or to remain in CSRS. FERS offers a savings plan to which FAA automatically contributes 1 percent of pay and matches any employee contribution up to an additional 4 percent of pay. For FERS participants, FAA also contributes the employer's matching share for Social Security.

We recognize the imputed cost of pensions and other retirement benefits during the employees' active years of service. OPM actuaries determine pension cost factors by calculating the value of pension benefits expected to be paid in the future and communicates these factors to FAA for current period expense reporting. OPM also provides information regarding the full cost of health and life insurance benefits. We recognized the offsetting revenue as imputed financing sources to the extent these expenses will be paid by OPM.

S. Use of Estimates

Management has made certain estimates and assumptions when reporting assets, liabilities, revenue, and expenses, and in the note disclosures. Actual results could differ from these estimates. Significant estimates underlying the accompanying financial statements include (a) the allocation of AATF receipts by the OTA, (b) legal, environmental, and contingent liabilities, (c) year-end accruals of accounts and grants payable, (d) accrued workers' compensation, (e) allowance for doubtful accounts receivable, (f) allowances for repairable and obsolete inventory balances, and (g) allocations of common costs to construction in progress.

T. Environmental Liabilities

FAA recognizes two types of environmental liabilities: environmental remediation, and cleanup and decommissioning. The liability for environmental remediation is an estimate of costs necessary to bring a known contaminated site into compliance with applicable environmental standards. The increase or decrease in the annual liability is charged to current year expense.

Environmental cleanup and decommissioning is the estimated cost that will be incurred to remove, contain, and/or dispose of hazardous materials when an asset presently in service is shutdown. FAA estimates the environmental cleanup and decommissioning costs at the time an FAA-owned asset is placed in service. For assets placed in service through FY 1998, the increase or decrease in the estimated environmental cleanup liability is charged to expense over the life of the associated asset. Assets placed in service in FY 1999 and after do not have associated environmental liabilities.

U. Contingencies

Liabilities are deemed contingent when the existence or amount of the liability cannot be determined with certainty pending the outcome of future events. We recognize contingent liabilities, in the accompanying balance sheet and statement of net cost, when it is both probable and can be reasonably estimated. FAA discloses contingent liabilities in the notes to the financial statements when the conditions for liability recognition are not met or when a loss from the outcome of future

events is more than remote. In some cases, once losses are certain, payments may be made from the Judgment Fund maintained by the U.S. Treasury rather than from the amounts appropriated to FAA for agency operations. Payments from the Judgment Fund are recorded as an "Other Financing Source" when made.

V. Restatement

As discussed in note 16, FAA has restated its FY 2003 Combined Statement of Budgetary Resources to reduce the unobligated balance of budgetary resources by $7,951.7 million, which represents the amount of AATF excise tax receipts that were not available for obligation upon collection by the IRS.

W. Reclassifications

Certain FY 2003 balances have been reclassified, retitled, or combined with other financial statement line items for consistency with current year presentation.

NOTE 2. FUND BALANCE WITH TREASURY

Fund balance with Treasury account balances as of September 30, 2004 and 2003 were:

	2004	2003
Trust funds	$ 1,117,810	$ 1,250,801
Operations general fund	1,042,208	738,852
Franchise fund	208,776	170,862
Revolving funds	49,649	22,848
AATF and other funds	422,220	650,360
Total	$ 2,840,663	$ 2,833,723

Status of fund balance with Treasury

Unobligated balance		
Available	$ 1,113,378	$ 1,072,492
Restricted	716,473	700,605
Obligated balance not yet disbursed	1,010,812	1,060,626
Total	$ 2,840,663	$ 2,833,723

Restricted unobligated fund balances represent the amount of appropriations for which the period of availability for obligation has expired. These balances are available for upward adjustments of obligations incurred only during the period for which the appropriation was available for obligation or for paying claims attributable to the appropriation.

NOTE 3. INVESTMENTS

As of September 30, 2004 and 2003, respectively, FAA's investment balances were as follows:

	2004	2003
Intragovernmental securities		
Nonmarketable, par value - AATF	$ 9,891,592	$ 10,517,891
Nonmarketable, market based - Aviation Insurance Fund	351,146	196,187
Accrued interest	75,291	105,179
Investments at cost	$ 10,318,029	$ 10,819,257
Market value disclosure		
Nonmarketable, par value - AATF	$ 9,891,592	$ 10,517,891
Nonmarketable, market based - Aviation Insurance Fund	351,488	196,693
Unamortized discount - nonmarketable, market based	(342)	(506)
Nonmarketable, market based, net	351,146	196,187
Market value disclosure	$ 10,242,738	$ 10,714,078

The Secretary of the Treasury makes AATF investments on behalf of FAA. FAA investments are considered investment authority and available for unrestricted use to offset the cost of operations. As of September 30, 2004 and 2003, approximately $9.9 billion and $10.5 billion, respectively, were invested in U.S. Treasury Certificates of Indebtedness. Nonmarketable par value Treasury Certificates of Indebtedness are special series debt securities issued by the Bureau of the Public Debt to Federal accounts, and are purchased and redeemed at par (face value) exclusively through the Federal Investment Branch of the U.S. Treasury's Bureau of Public Debt. The securities are held to maturity and redeemed at face value on demand; thus, investing entities recover the full amount invested plus interest. Investments as of September 30, 2004 mature on various dates through June 30, 2005, and investments as of September 30, 2003 matured on various dates through June 30, 2004. The annual rate of return on Certificates of Indebtedness is established in the month of issuance. The average rate of return for certificates issued during FY 2004 and FY 2003 was 3.6% and 4.125%, respectively.

Nonmarketable, market-based Treasury securities are debt securities that the Treasury issues to Federal entities without statutorily fixed interest rates. Although the securities are not marketable, their terms (prices and interest rates) mirror the terms of marketable Treasury securities. FAA amortizes premiums and discounts on market-based Treasury securities over the life of the security using the interest method. As of September 30, 2004, these nonmarketable, market-based securities had an initial term of six months, have an effective market rate of approximately 1%, and mature within 98 days.

NOTE 4. ACCOUNTS RECEIVABLE, ADVANCES AND OTHER ASSETS

Accounts receivable, advances, prepayments, and other assets as of September 30, 2004 and 2003 were comprised of the following:

	2004	2003
Intragovernmental		
Accounts receivable	$ 67,146	$ 59,924
Advances, prepayments and other	148,843	108,798
Subtotal, intragovernmental	215,989	168,722
With the public		
Accounts receivable, net	124,757	42,058
Advances and prepayments	20,869	2,359
Deposits in transit and other	27,657	18,994
Subtotal, with the public	173,283	63,411
Total accounts receivable, advances, Prepayments and other	$ 389,272	$ 232,133

Intragovernmental advances and prepayments represent advance payments to other Federal Government entities for agency expenses not yet incurred, or for goods or services not yet received.

Accounts receivable from the public are shown net of allowances for uncollectible amounts of $57.0 million and $15.0 million, as of September 30, 2004 and 2003, respectively.

NOTE 5. INVENTORY AND RELATED PROPERTY

As of September 30, 2004 and 2003, operating materials and supplies and inventory were:

Operating material and supplies	2004	2003
Held for use, net	$ 166,628	$ 147,879
Excess, obsolete, and unserviceable, net	11,619	14,567
Subtotal, operating material and supplies	178,247	162,446
Inventory		
Held for sale	59,357	61,457
Held for repair, net	321,511	330,189
Raw materials, finished goods, and other	13,632	13,632
Excess, obsolete, and unserviceable, net	12,962	14,042
Subtotal, inventory	407,462	419,320
Total inventory and related property, net	$ 585,709	$ 581,766

Operating materials and supplies and inventory are shown net of the following allowances:

Operating materials and supplies	2004	2003
Held for use	$ (16,873)	$ (12,167)
Excess, obsolete, and unserviceable	(60,242)	(57,294)
Subtotal, operating materials and supplies allowances	(77,115)	(69,461)
Inventory		
Held for repair	(83,660)	(83,849)
Excess, obsolete, and unserviceable	(5,839)	(4,760)
Subtotal, inventory allowances	(89,499)	(88,609)
Total allowances	$ (166,614)	$ (158,070)

Inventory is considered held for repair based on the condition of the asset or item, and the allowance for repairable inventory is based on the average historical cost of such repairs.

FAA transfers excess items for disposal into the Government-wide automated disposal system. Disposal proceeds, recognized upon receipt, may go to the U.S. Treasury's General Fund or to an FAA appropriation, depending upon the nature of the item and the disposal method.

NOTE 6. PROPERTY, PLANT, AND EQUIPMENT, NET

Property, plant, and equipment balances at September 30, 2004 and 2003 were:

			2004		
Class of fixed asset	Deprec. method	Service life	Acquisition value	Accumulated depreciation	Net book value
Real property, including land	[1]	[2]	$ 4,086,616	$ (1,966,495)	$ 2,120,121
Personal property	SL	3-20	13,894,962	(6,622,389)	7,272,573
Assets under capital lease (Note 9)	SL	Term-40	125,923	(71,807)	54,116
Construction in progress	-	-	5,011,586	-	5,011,586
Property not in use	-	-	19,202	(7,867)	11,335
Total property, plant, and equipment			$ 23,138,289	$ (8,668,558)	$ 14,469,731

			2003		
Class of fixed asset	Deprec. method	Service life	Acquisition value	Accumulated depreciation	Net book value
Real property, including land	[1]	[2]	$ 3,874,055	$ (1,828,212)	$ 2,045,843
Personal property	SL	3-20	12,643,046	(5,881,286)	6,761,760
Assets under capital lease (Note 9)	SL	Term-40	125,923	(63,328)	62,595
Construction in progress	-	-	4,513,496	-	4,513,496
Property not in use	-	-	18,292	(4,379)	13,913
Total property, plant, and equipment			$ 21,174,812	$ (7,777,205)	$ 13,397,607

[1] Land is not depreciated; other real property as defined in Note 1 is depreciated using the straight line method.

[2] The service life disclosed pertains to real property other than land and leasehold improvements. Leasehold improvements are depreciated over the lesser of the remaining life of the "parent" asset or 10 years.

Our Construction in Progress (CIP) primarily relates to NAS assets, which are derived from centrally funded national systems development contracts, site preparation and testing, raw materials, and internal labor charges.

Assets temporarily not in use, including decommissioned assets awaiting disposal, are reflected in FAA financial records as Property Not in Use. We reported disposal losses of $11.0 million and $10.4 million in FY 2004 and FY 2003, respectively.

NOTE 7. ENVIRONMENTAL CLEANUP COSTS

FAA's environmental liabilities as of September 30, 2004 and 2003 were:

	2004	2003
Environmental remediation	$ 366,762	$ 372,125
Environmental cleanup and decommissioning	239,499	249,828
Total environmental liabilities	$ 606,261	$ 621,953

Additional information on environmental projects is disclosed in Note 19.

NOTE 8. EMPLOYEE RELATED, LEGAL, AND OTHER LIABILITIES

As of September 30, 2004 and 2003, FAA's employee related, legal and other liabilities were:

	2004		
	Non-current liabilities	Current liabilities	Total
Intragovernmental			
Advances received	$ -	$ 52,427	$ 52,427
Accrued payroll & benefits payable to other agencies	-	33,754	33,754
Liabilities covered by budgetary or other resources	-	86,181	86,181
Federal Employees' Compensation Act (FECA) payable	111,987	88,320	200,307
Other	-	538	538
Liabilities not covered by budgetary or other resources	111,987	88,858	200,845
Subtotal, intragovernmental	111,987	175,039	287,026
With the public			
Advances received and other	-	24,388	24,388
Accrued payroll & benefits payable to employees	-	174,881	174,881
Liabilities covered by budgetary or other resources	-	199,269	199,269
Accrued unfunded annual & other leave & assoc. benefits	470,995	-	470,995
Sick leave compensation benefits for air traffic controllers	68,009	1,354	69,363
Capital leases (Note 9)	46,909	13,663	60,572
Legal claims	-	19,000	19,000
Return rights	4,481	3,290	7,771
Other accrued liabilities	132,557	-	132,557
Liabilities not covered by budgetary or other resources	722,951	37,307	760,258
Subtotal, with the public	722,951	236,576	959,527
Total employee related, legal, and other liabilities	$ 834,938	$ 411,615	$ 1,246,553

	2003		
	Non-current liabilities	Current liabilities	Total
Intragovernmental			
Advances received	$ -	$ 42,448	$ 42,448
Accrued payroll & benefits payable to other agencies	-	29,101	29,101
Other	-	72,384	72,384
Liabilities covered by budgetary or other resources	-	143,933	143,933
Federal Employees' Compensation Act (FECA) payable	113,063	87,842	200,905
Debt	-	30	30
Liabilities not covered by budgetary or other resources	113,063	87,872	200,935
Subtotal, intragovernmental	113,063	231,805	344,868
With the public			
Advances received and other	-	9,089	9,089
Accrued payroll & benefits payable to employees	-	130,060	130,060
Liabilities covered by budgetary or other resources	-	139,149	139,149
Accrued unfunded annual & other leave & assoc. benefits	451,199	-	451,199
Sick leave compensation benefits for air traffic controllers	57,006	6,194	63,200
Capital leases	59,685	9,159	68,844
Legal claims	53,900	25,000	78,900
Return rights	4,400	3,150	7,550
Other accrued liabilities	50,282	-	50,282
Liabilities not covered by budgetary or other resources	676,472	43,503	719,975
Subtotal, with the public	676,472	182,652	859,124
Total employee related, legal, and other liabilities	$ 789,535	$ 414,457	$ 1,203,992

Accrued payroll and benefits to other agencies consists of FAA contributions payable to other Federal agencies for employee benefits. These include FAA's contributions payable toward life, health, retirement benefits, Social Security, and matching contributions to the Thrift Savings Plan.

An unfunded liability is recorded for the actual cost of workers' compensation benefits to be reimbursed to the DOL, pursuant to the FECA. FAA's liability accrued as of September 30, 2004 includes workers' compensation benefits paid by DOL during the periods July 1, 2002 through June 30, 2004 and accrued liabilities for the quarter July 1, 2004 through September 30, 2004. FAA's liability accrued as of September 30, 2003 included workers' compensation benefits paid by DOL during the period July 1, 2001 through June 30, 2003, and accrued liabilities for the quarter July 1, 2003 through September 30, 2003.

The estimated liability for accrued unfunded leave and associated benefits includes annual and other types of vested leave, and sick leave under the terms of certain collective bargaining agreements, including the National Air Traffic Controllers Association (NATCA) agreement, Article 25, Section 13. For example, the NATCA agreement gives air traffic controllers, who are covered under FERS, the option to receive a lump sum payment for 40 percent of their accumulated sick leave as of their

effective retirement date. Based on sick leave balances, this liability was $69.4 million and $63.2 million as of September 30, 2004 and 2003, respectively.

FAA estimated that 100 percent of its $19.0 million and $78.9 million legal claims liabilities as of September 30, 2004 and 2003, respectively, would be paid from the permanent appropriation for judgments, awards, and compromise settlements (Judgment Fund) administered by the Department of Treasury.

FAA's Return Rights Program pertains to employees who accepted transfers to overseas or certain domestic locations for a period of two to four years, and entitles them to a future return move at Government expense. As of September 30, 2004 and 2003, there were 137 and 151 employees, respectively, entitled to these return rights.

Other Accrued Liabilities with the Public is comprised primarily of accruals for utilities, leases and travel obligations. Total liabilities not covered by budgetary resources are presented in note 17.

NOTE 9. LEASES

FAA has both capital and operating leases.

Capital Leases

Following is a summary of FAA's assets under capital lease as of September 30, 2004 and 2003:

	2004	2003
Land, buildings, and machinery	$ 125,923	$ 125,923
Accumulated depreciation	(71,807)	(63,328)
Assets under capital lease, net	$ 54,116	$ 62,595

As of September 30, 2004, FAA's future payments due on assets under capital lease were:

Future payments due by fiscal year (Liabilities not covered by budgetary or other resources)	
Year 1 (FY 2005)	$ 13,663
Year 2 (FY 2006)	11,408
Year 3 (FY 2007)	11,335
Year 4 (FY 2008)	9,661
Year 5 (FY 2009)	9,468
After 5 Years	34,250
Less: Imputed interest	(29,213)
Total capital lease liability	$ 60,572

FAA's capital lease payments are funded annually. The remaining principal payments are recorded as unfunded lease liabilities. The imputed interest is funded and expensed annually.

Operating Leases

FAA has operating leases for real property, aircraft, and telecommunications equipment. Future operating lease payments due as of September 30, 2004 were:

Fiscal year	2004
Year 1 (FY 2005)	$ 55,330
Year 2 (FY 2006)	36,817
Year 3 (FY 2007)	28,899
Year 4 (FY 2008)	21,204
Year 5 (FY 2009)	13,815
After 5 Years	77,033
Total future operating lease payments	$ 233,098

Operating lease expense incurred during the years ended September 30, 2004 and 2003 was $55.3 million and $53.3 million, respectively. The operating lease amounts due after five years do not include estimated payments for leases with annual renewal options. Estimates of the lease termination dates are subjective, and any projection of future lease payments would be arbitrary.

NOTE 10. FEDERAL EMPLOYEE AND VETERANS BENEFITS PAYABLE

As of September 30, 2004 and 2003, FECA actuarial liabilities were $954.5 million and $1,041.6 million respectively. The DOL calculates the FECA liability for DOT, and DOT allocates the liability amount to FAA based upon actual workers' compensation payments to FAA employees over the preceding four years. FECA liabilities include the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The estimated liability is not covered by budgetary resources or other and thus will require future appropriated funding.

NOTE 11. TOTAL COST AND EARNED REVENUE BY BUDGET FUNCTIONAL CLASSIFICATION

In FY 2004 and FY 2003, all expenses, earned revenues, and intragovernmental transactions were related to Transportation Programs.

NOTE 12. NET COST BY PROGRAM AND OTHER STATEMENT OF NET COST DISCLOSURES

During FY 2004, the FAA formed the ATO. The ATO is largely comprised of two former lines of business, Air Traffic Services and Research & Acquisitions, as well as one other business program, Free Flight, which was previously reported under Regional and Center Operations and Other Programs. The FY 2003 net costs of these former organizations have been reclassified and reported under ATO for consistency with the current year presentation.

FAA's four lines of business represent the programs reported on the Statement of Net Cost. Cost centers assigned to each line of business permit the direct accumulation of costs. Other costs that are not directly traced to each line of business, such as agency overhead, are allocated.

The following are net costs for the years ended September 30, 2004 and 2003 by strategic goal.

For the Year Ended September 30, 2004

	Strategic Goal Areas				
Line of business programs	**Safety**	**Capacity**	**Organizational Excellence**	**International Leadership**	**Total**
Air Traffic Organization	$ 6,113,865	$ 1,513,989	$ 450,909	$ 248	$ 8,079,011
Regulation & Certification	859,372	218	71,423	8,715	939,728
Airports	1,729,468	1,213,208	33,992	400	2,977,068
Commercial Space Transportation	10,900	1,627	-	-	12,527
Non line of business programs					
Region and center operations and other	101,738	4,085	43,012	253	149,088
Not assigned to programs	20,963	2,249	13,360	-	36,572
Net cost	$ 8,836,306	$ 2,735,376	$ 612,696	$ 9,616	$ 12,193,994

For the Year Ended September 30, 2003

	Strategic Goal Areas					
Line of business programs	**Safety**	**Capacity**	**Organizational Excellence**	**Homeland Security**	**Other**	**Total**
Air Traffic Organization	$ 6,738,943	$ 800,987	$ 472,473	$ 81,557	$ 4,736	$ 8,098,696
Regulation & Certification	882,868	2,849	56,292	-	-	942,009
Airports	766,369	1,533,507	26,124	460,493	-	2,786,493
Commercial Space Transportation	11,250	-	475	-	-	11,725
Non line of business programs						
Region and center operations and other	-	-	-	-	85,721	85,721
Not assigned to programs	-	-	-	-	26,692	26,692
Net cost of continuing operations	8,399,430	2,337,343	555,364	542,050	117,149	11,951,336
Transferred Operations-Civil Aviation Security	14,553	1	-	32,696	-	47,250
Net cost of operations	$ 8,413,983	$ 2,337,344	$ 555,364	$ 574,746	$ 117,149	$ 11,998,586

The following is our distribution of FY 2004 and FY 2003 net costs by intragovernmental-related activity versus with the public.

	For the Year Ended September 30, 2004		
Line of business programs	**Intra-governmental**	**With the Public**	**Total**
Air Traffic Organization			
Expenses	$ 2,016,981	$ 6,197,545	$ 8,214,526
Less earned revenues	(65,889)	(69,626)	(135,515)
Net costs	1,951,092	6,127,919	8,079,011
Regulation & Certification			
Expenses	230,547	711,830	942,377
Less earned revenues	(432)	(2,217)	(2,649)
Net costs	230,115	709,613	939,728
Airports			
Expenses	18,336	2,958,964	2,977,300
Less earned revenues	(87)	(145)	(232)
Net costs	18,249	2,958,819	2,977,068
Commercial Space Transportation			
Expenses	336	12,191	12,527
Net costs	336	12,191	12,527
Non line of business programs			
Regional and center operations and other programs			
Expenses	180,195	209,759	389,954
Less earned revenues	(84,152)	(156,714)	(240,866)
Net costs	96,043	53,045	149,088
Not assigned to programs			
Expenses	-	36,572	36,572
Net costs	-	36,572	36,572
Net cost of operations			
Total expenses	2,446,395	10,126,861	12,573,256
Less earned revenues	(150,560)	(228,702)	(379,262)
Net costs	$ 2,295,835	$ 9,898,159	$ 12,193,994

	For the Year Ended September 30, 2003		
Line of business programs	**Intra-governmental**	**With the Public**	**Total**
Air Traffic Organization			
Expenses	$ 1,203,704	$ 7,018,738	$ 8,222,442
Less earned revenues	(36,786)	(86,960)	(123,746)
Net costs	1,166,918	6,931,778	8,098,696
Regulation & Certification			
Expenses	128,755	814,380	943,135
Less: Earned revenues	(250)	(876)	(1,126)
Net Costs	128,505	813,504	942,009
Airports			
Expenses	8,959	2,777,758	2,786,717
Less earned revenues	(50)	(174)	(224)
Net costs	8,909	2,777,584	2,786,493
Commercial Space Transportation			
Expenses	-	11,725	11,725
Net costs	-	11,725	11,725
Non line of business programs			
Regional and center operations and other programs			
Expenses	162,154	179,953	342,107
Less earned revenues	(179,475)	(76,911)	(256,386)
Net costs	(17,321)	103,042	85,721
Not assigned to programs			
Expenses	-	61,486	61,486
Less earned revenues	(7,720)	(27,074)	(34,794)
Net costs	(7,720)	34,412	26,692
Net cost of continuing operations	1,279,291	10,672,045	11,951,336
Transferred operations - Civil Aviation Security			
Expenses	94,413	30,292	124,705
Less earned revenues	(17,186)	(60,269)	(77,455)
Net costs	77,227	(29,977)	47,250
Net cost of operations			
Total expenses	1,597,985	10,894,332	12,492,317
Less total earned revenue	(241,467)	(252,264)	(493,731)
Total net cost	$ 1,356,518	$ 10,642,068	$ 11,998,586

NOTE 13. AIRPORT AND AIRWAY TRUST FUND DEDICATED COLLECTIONS

FAA's consolidated financial statements include the results of operations and financial position of the Airport and Airway Trust Fund (AATF). The AATF was created by the Airport and Airway Revenue Act of 1970 to provide a dedicated source of funding to the nation's aviation system through several aviation-related excise taxes. The IRS collects these excise taxes on behalf of FAA's AATF. These taxes can be withdrawn only as authorized by the U.S. Congress. Twice a month, Treasury estimates the amount collected, and adjusts the estimates by actual collections quarterly. Accordingly, the total taxes recognized in FY 2004 included OTA's estimate of $4.7 billion for the six months ended September 30, 2004.

The IRS has informed us that the estimated excise tax collections and the amount credited to the AATF for the benefit of the FAA, for the quarter ended June 30, 2004, may be understated by as much as $275 million. We have not recognized the potential understatement of $275 million since it is not legally enforceable until certified by the IRS. Therefore, this represents a potential gain contingency at September 30, 2004. The estimated taxes and deposits to AATF will be adjusted to equal actual tax collections in December 2004. Total taxes recognized in FY 2003 included OTA's estimate of $2.9 billion for the quarter ending September 30, 2003. Fiscal data of the AATF as of, and for the years ended, September 30, 2004 and 2003 is summarized below. Intra-agency transactions have not been eliminated in the amounts presented.

	2004	2003
Assets		
Fund balance with Treasury	$ 642,007	$ 614,503
Investments, net (Note 3)	9,891,592	10,517,891
Accounts receivable, net	129,487	105,179
Total assets	$ 10,663,086	$ 11,237,573
Liabilities and net position		
AATF amounts due to FAA	$ 3,704,148	$ 3,115,669
Cumulative results of operations	6,958,938	8,121,904
Total liabilities and net position	$ 10,663,086	$ 11,237,573
Revenue		
Passenger ticket tax	$ 6,554,599	$ 6,065,763
International departure tax	1,455,529	1,517,807
Investment income	446,956	570,873
Fuel taxes	774,150	850,950
Waybill tax	498,871	399,396
Tax refunds and credits	(55,596)	(44,320)
Total revenue	$ 9,674,509	$ 9,360,469
Expenses		
Nonexpenditure transfer out and other	$ 10,838,828	$ 9,707,949
Total expenses	$ 10,838,828	$ 9,707,949

NOTE 14. IMPUTED FINANCING SOURCES

FAA recognizes as imputed financing the amount of accrued pension and post-retirement benefit expenses for current employees. The assets and liabilities associated with such benefits are the responsibility of the administering agency, the OPM. Amounts paid from the U.S. Treasury's Judgment Fund in settlement of claims or court assessments against FAA are also recognized as imputed financing. For the fiscal years ended September 30, 2004 and 2003, respectively, imputed financing was as follows:

	2004	2003
Office of Personnel Management	$ 482,253	$ 465,868
Treasury Judgment Fund	11,246	29,835
Total imputed financing sources	$ 493,499	$ 495,703

NOTE 15. TRANSFERRED OPERATIONS

The Aviation and Transportation Security Act (Public Law 107-71) established the TSA and transferred FAA's civil aviation security functions to the TSA. The TSA assumed responsibility for these functions on February 13, 2002. Subsequently, the Homeland Security Act of 2002 (Public Law 107-296) established the Department of Homeland Security (DHS) and transferred TSA from the DOT to DHS effective March 1, 2003.

FASAB Technical Bulletin (TB) 2003-1, *Certain Questions and Answers related to the Homeland Security Act of 2002*, requires Federal agencies to segregate the net costs of continuing and transferred operations, and recognize a transfer-out for assets and liabilities transferred to the DHS. Although the guidance in TB 2003-1 applies to DHS, the guidance is relevant to the transfer of the civil aviation security function to the TSA. Accordingly, on FY 2003 the Statement of Net Cost, FAA has segregated and reported as "transferred operations," the net costs incurred related to civil aviation security functions that transferred to TSA. Net costs of internal security functions, which remained with FAA, are reported under Region and Center Operations and Other Programs. In addition, of the $643.6 million transferred operations reported on the Statement of Changes in Net Position for the year ended September 30, 2003, $623.6 million pertains to security-related PP&E that FAA transferred to the TSA. There were no transfers to TSA in FY 2004.

NOTE 16. STATEMENT OF BUDGETARY RESOURCES RESTATEMENT AND DISCLOSURES

The AATF is managed by the U.S. Department of Treasury's Bureau of Public Debt (BPD). In FY 2003 and years prior, FAA reported the AATF as having unobligated budget authority, causing an overstatement of budgetary resources presented on the Combined Statement of Budgetary Resources. In accordance with the U.S. Department of Treasury's Trust Fund Accounting Guide (updated in 2001), BPD, and consequently FAA, no longer present AATF as having budget authority. This change in classification results in a correction of an error in presentation and a restatement of the FY 2003 Budget authority and Unobligated balance brought forward, transfers and other of $.8 billion and $8.8 billion, respectively, and an offsetting reduction in Unobligated balances available of $8.0 billion. The effect of this restatement on the Combined Statement of Budgetary Resources is as follows:

	2003 Originally stated	Effect of restatement	2003 As restated
Budgetary resources			
Budget authority	$ 15,846,546	$ 797,917	$ 16,644,463
Unobligated balance brought forward, transfers and other	$ 9,682,455	$ (8,749,605)	$ 932,850
Status of budgetary resources			
Unobligated balance available	$ 8,627,893	$ (7,951,688)	$ 676,205

The amounts reported in the Statement of Budgetary Resources are in agreement with the summary totals presented in the Budget of the United States Government. Amounts reported for the Operations appropriation were adjusted to eliminate the effect of transfers between the AATF and the General Fund components of this account because they overstated budgetary resources and obligations. The Required Supplementary Information section of this report includes a schedule of budgetary resources by each of FAA's major fund types.

Budget authority as reported in the Combined Statements of Budgetary Resources includes amounts made available to FAA from general, trust and special funds. In contrast, appropriations received as reported in the Consolidated Statements of Changes in Net Position pertains only to amounts made available to FAA from general funds. The following is a reconciliation of these amounts:

	2004	2003
Combined Statement of Budgetary Resources - budget authority	$ 17,615,716	$ 16,644,463
Less amounts made available to FAA from AATF dedicated collections	(14,582,668)	(13,371,222)
Less special fund aviation user fees	(123)	-
Consolidated Statement of Changes in Net Position - appropriations received	$ 3,032,925	$ 3,273,241

In FY 2004, FAA had rescissions of budgetary resources to Grants-in-Aid to Airports of $20.1 million; Operations of $20.8 million; and the AATF of $65.0 million. In FY 2003, a rescission of budgetary resources was made to the Facilities and Equipment fund in the amount of $39.5 million, and to contract authority of the Grants-in-Aid to Airports fund in the amount of $22.1 million.

OMB Bulletin 01-09 requires the following additional Statement of Budgetary Resources disclosures:

- FAA does not have any significant differences between the information reported on the Statement of Budgetary Resources and the amounts described as FY 2004 "actual" in the Budget of the United States Government for FY 2006.
- Congress mandated permanent indefinite appropriations for the Facilities and Equipment, Grants-in-Aid, and Research, Development and Engineering to fully fund special projects that were ongoing and spanned several years.
- FAA does not have obligations classified as "exempt from apportionment." However, during FY 2004 and FY 2003, direct and reimbursable obligations incurred against amounts apportioned under categories A and B, as defined in OMB Circular No. A-11, Part 4, Instructions on Budget Execution, were as follows:

	2004		2003	
	Direct	Reimbursable	Direct	Reimbursable
Category A	$ 5,487,783	$ 509,509	$ 10,376,768	$ 264,743
Category B	8,230,998	1,721	3,524,631	4
Total	$ 13,718,781	$ 511,230	$ 13,901,399	$ 264,747

Total available contract authority at the end of FY 2004 and FY 2003 was $3.7 billion and $4.2 billion, respectively.

Public Law 108-199 authorized FAA $3.4 billion in liquidating authority, derived from the AATF, for the Grants-in-Aid program. In addition, Public Laws 108-176 and 106-181 authorized FAA with $3.7 billion of contract authority.

Unobligated balances of budgetary resources for unexpired accounts are available in subsequent years until expiration, upon receipt of an apportionment from OMB. Unobligated balances of expired accounts are not available. At the end of FY 2003, $17.6 million of obligated balances were in appropriations cancelled at year-end pursuant to 31 U.S.C. 1552, and thus have not been brought forward to FY 2004. Additionally, transfers in FY 2004 to DOT for Essential Air Services also reduced balances available for obligation.

The net obligated balance, end of period, is comprised of the following components as of September 30, 2004 and 2003:

Obligated balance, net, end of period	2004	2003
Accounts receivable and advances	$ (178,862)	$ (62,775)
Unfilled customer orders from Federal sources	(219,936)	(113,350)
Undelivered orders	8,660,222	7,926,575
Accounts payable and other liabilities	911,636	894,030
Total obligated balance, net, end of period	$ 9,173,060	$ 8,644,480

NOTE 17. FINANCING SOURCES YET TO BE PROVIDED

The following table shows liabilities not covered by budgetary or other resources as of September 30, 2004 and 2003, as well as the relationship between liabilities not covered by budgetary or other resources on the balance sheet and the change in components of net cost of operations that will require or generate resources in future periods.

	2004	2003	Change
Unfunded annual & other leave & assoc. benefits (Note 8)	$ 470,995	$ 451,199	$ 19,796
Sick leave compensation benefits and return rights (Note 8)	77,134	70,750	6,384
Other accrued liabilities (Note 8)	133,095	50,282	82,813
Increases - components of net cost of operations Requiring or generating resources in future periods			108,993
Environmental liabilities (Notes 7 and 19)	$ 606,261	$ 621,953	$ (15,692)
Legal claims (Note 8)	19,000	78,900	(59,900)
Capital leases (Notes 8 & 9)	60,572	68,844	(8,272)
Debt - intragovernmental (Note 8)	-	30	(30)
FECA payable (Note 8)	200,307	200,905	(598)
FECA actuarial liablilty (Note 10)	954,463	1,041,568	(87,105)
Decreases - resources that fund expenses Recognized in prior periods			(171,597)
Liabilities not covered by budgetary or other resources	$ 2,521,827	$ 2,584,431	$ (62,604)

NOTE 18. CUSTODIAL ACTIVITY

FAA collects certain non-exchange (custodial) revenue on behalf of the General Fund of the Treasury. During FY 2004 and FY 2003, FAA's Statement of Changes in Net Position included custodial revenue totaling $19.0 million and $21.8 million, respectively. The primary source of custodial activity is revenue from the Metropolitan Washington Airport Authority for its leases of the Ronald Reagan National Airport and the Washington Dulles International Airport. Custodial activity also includes the collection of miscellaneous fines and penalties.

NOTE 19. COMMITMENTS, CONTINGENCIES, AND OTHER DISCLOSURES

Contract Options. As of September 30, 2004 and 2003, we had contract options of $10.9 billion and $32.8 billion, respectively. These contract options give FAA the unilateral right to purchase additional equipment or services or to extend the contract terms. Exercising this right would require the obligation of funds in future years.

Letters of Intent. FAA has authority under 49 U.S.C. 47110(e) to issue letters of intent (LOIs) to enter into Airport Improvement Program grant agreements. Through September 30, 2004, FAA issued LOIs covering FY 1988 through FY 2014 totaling $4.7 billion. As of September 30, 2004, FAA had obligated $3.3 billion of this total amount, leaving $1.4 billion unobligated.

As of September 30, 2003, LOIs covering FY 1988 through FY 2014 totaled $4.5 billion. Of this amount, FAA had obligated $3.0 billion, leaving $1.5 billion unobligated as of September 30, 2003.

Airport Improvement Program Grants. FY 2004, Airport Improvement Program grant authority totaled $3.4 billion, including $2.0 billion in entitlements to specific locations. Of entitlements to specific locations, sponsors have claimed $1.6 billion, and $416.0 million remains available from unused or newly enacted contract authority to those sponsors through FY 2006, or in the case of non-hub primary airport locations, through FY 2007.

In FY 2003, Airport Improvement Program grant authority was $3.3 billion, including $2.1 billion in entitlements to specific locations. Of entitlements to specific locations, sponsors had claimed $1.8 billion, and $336.0 million remained available from unused or newly enacted contract authority to those sponsors through FY 2005, or in the case of non-hub primary airport locations, through FY 2006.

Aviation Insurance Program. FAA is authorized to issue hull and liability insurance under the Aviation Insurance Program for air carrier operations for which commercial insurance is not available on reasonable terms and when continuation of U.S. flag commercial air service is necessary in the interest of air commerce, national security, and the foreign policy of the United States. We may issue (1) non-premium insurance, and (2) premium insurance for which a risk-based premium is charged to the air carrier, to the extent practical.

FAA maintains standby non-premium war-risk insurance policies for 39 air carriers having approximately 1,228 aircraft available for Defense or State Department charter operations.

On September 22, 2001, the Air Transportation Safety and System Stabilization Act (Public Law 107-42) expanded premium insurance program authority to permit insurance of domestic operations. Under this program, we initially provided third party liability war-risk insurance to U.S. carriers whose coverage was cancelled following the terrorist attacks of September 11, 2001. Public Law 108-11 (and subsequent amendments) required us to extend policies in effect on July 19, 2002, until August 31, 2004 and gave the Secretary of Transportation discretion to further extend coverage through December 31, 2004. It also mandated provision of hull loss and passenger and third party war risk liability insurance for those policies. There are 77 FAA premium war-risk policies. Insured air carrier per occurrence limits for combined hull and liability coverage range from $100 million to $4 billion. The period of coverage in effect as of September 30, 2004 was from September 1, 2004 through December 31, 2004.

Current war risk coverage is intended as a temporary measure to provide insurance to qualifying carriers while allowing time for the commercial insurance market to stabilize. Premiums under this program are established by FAA and are based on the value of policy coverage limits and aircraft activity. However, airlines' total charge for coverage is subject to a cap mandated by Congress. During FY 2004 and FY 2003, we recognized insurance premium revenue of $145.6 million and $124.0 million, respectively. Premiums are recognized as revenue on a straight-line basis over the period of coverage. Premium revenue is reported on the Consolidated Statement of Net Cost, under "Regional and Center Operations and Other Programs."

Typically, the maximum liability for both hull loss and liability, per aircraft, is $1.75 billion. No claims for losses were pending as of September 30, 2004 or 2003. In the past, FAA has insured a small number of air carrier operations and establishes a maximum liability for losing one aircraft. Since the inception of the Aviation Insurance Program dating back to 1951, only four claims, all involving minor dollar amounts, have been paid. Because of the unpredictable nature of war risk and the absence of historical claims experience on which to base an estimate, no reserve for insurance losses has been recorded.

Overflight User Fees. FAA issued an interim final rule (IFR), effective on August 1, 2000, followed by a Final Rule, effective on August 20, 2001, that required certain aircraft operators to pay fees for air traffic control and related services provided by FAA to aircraft that operate in U.S.-controlled airspace but neither takeoff nor land in the United States. The authority to charge these fees is contained in the Federal Aviation Reauthorization Act of 1996, as amended. Several airlines and an air carrier association challenged the IFR in the U.S. Court of Appeals. FAA issued the Final Rule while the IFR litigation was still pending. The same group of plaintiffs then brought suit against the Final Rule, and the Court combined the two cases.

FAA had recognized $19.8 million in FY 2003, before it ceased billing in light of an adverse decision in the U.S. Court of Appeals on April 8, 2003. Congress has since enacted, in the FAA Reauthorization Act signed by the President on December 12, 2003, a provision on overflight fees that affects past and future fee collections. In July 2004, the FAA Administrator issued an Administrative Order determining the disposition of all fees collected under both rules. Concurrently, a settlement was reached with the plaintiff that will allow FAA to resume collection of fees in FY 2005.

Environmental. FAA is a party to two major environmental remediation projects in which the extent of liability is unknown. A study is in process to determine the magnitude and scope of the remediation required at the two sites. Of the total environmental liability reported as of September 30, 2004 and 2003, the amount related to these two sites is $49.3 million and $61.6 million, respectively. This liability includes FAA's share of the known remediation cost and the cost to complete the study.

Legal Claims. As of September 30, 2004 and 2003, FAA's contingent liabilities for asserted and pending legal claims reasonably possible of loss were estimated at $76.7 million and $325.5 million, respectively. FAA does not have material amounts of known unasserted claims.

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Required Supplementary Stewardship Information

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Stewardship Investment
Non-Federal Physical Property
Airport Improvement Program
For the Fiscal Years Ended September 30
(Dollars in Thousands)

State/Territory	2004	2003	2002	2001	2000
Alabama	$ 55,527	$ 59,760	$ 58,506	$ 27,421	$ 19,653
Alaska	153,237	158,950	121,640	83,563	51,788
Arizona	52,286	75,247	54,737	51,783	58,381
Arkansas	23,198	35,530	32,937	32,412	17,534
California	236,031	216,981	243,720	179,447	87,617
Colorado	101,792	57,872	91,495	26,340	29,860
Connecticut	8,511	7,011	10,420	3,480	1,788
Delaware	2,813	2,577	5,838	4,704	2,515
District of Columbia	555	447	71	61	83
Florida	145,690	166,066	157,878	110,428	64,694
Georgia	96,081	48,147	67,957	33,652	43,911
Hawaii	21,020	24,767	15,846	34,569	6,567
Idaho	22,677	30,721	19,925	25,477	13,106
Illinois	106,145	74,202	165,518	85,566	66,003
Indiana	49,219	47,288	43,099	30,544	24,141
Iowa	24,282	37,521	30,765	35,159	16,169
Kansas	24,118	22,694	15,655	7,587	7,378
Kentucky	51,904	67,031	48,192	46,166	26,205
Louisiana	59,438	45,394	47,915	32,841	29,200
Maine	45,987	18,143	14,456	7,496	3,828
Maryland	39,450	22,933	26,370	18,953	14,900
Massachusetts	23,495	65,930	30,348	20,709	14,560
Michigan	125,928	84,030	85,851	99,278	27,363
Minnesota	50,472	58,826	85,675	49,143	30,561
Mississippi	39,061	30,289	25,929	28,203	9,281
Missouri	89,848	59,642	71,910	62,701	35,137
Montana	36,754	34,273	24,506	19,254	13,157
Nebraska	25,280	19,423	25,181	22,983	8,534
Nevada	58,418	57,506	45,204	57,332	32,106
New Hampshire	7,996	35,082	40,351	16,173	8,582
New Jersey	55,174	29,402	26,391	18,047	10,012
New Mexico	12,756	17,336	13,106	10,882	7,671

(continued)

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Stewardship Investment
Non-Federal Physical Property
Airport Improvement Program
For the Fiscal Years Ended September 30
(Dollars in Thousands)

State/Territory	2004	2003	2002	2001	2000
New York	$ 86,382	$ 122,675	$ 109,798	$ 118,792	$ 57,671
North Carolina	44,668	75,317	73,493	60,908	26,084
North Dakota	29,007	15,458	16,562	25,221	11,490
Ohio	118,138	68,717	112,015	51,601	45,691
Oklahoma	31,272	34,351	39,238	19,780	8,678
Oregon	33,793	34,687	46,605	31,655	9,847
Pennsylvania	105,293	112,761	109,388	62,343	34,011
Rhode Island	10,861	13,736	12,409	9,547	11,705
South Carolina	23,772	22,531	39,194	18,895	11,792
South Dakota	20,915	16,841	15,440	10,466	12,301
Tennessee	47,298	62,412	46,373	58,638	39,237
Texas	174,336	159,929	192,738	127,046	111,585
Utah	26,008	24,804	21,396	39,235	14,328
Vermont	6,657	2,310	2,767	5,487	1,157
Virginia	70,688	45,240	76,647	75,555	41,109
Washington	73,153	53,351	62,798	34,023	35,498
West Virginia	20,637	24,373	18,562	18,564	7,400
Wisconsin	60,615	48,264	39,971	27,541	26,278
Wyoming	33,544	21,158	25,679	16,446	14,972
American Samoa	6,328	18,903	17,845	5,374	241
Guam	2,244	5,937	368	3,653	3,399
Northern Mariana Island	8,014	10,227	13,017	5,455	1,610
Puerto Rico	9,323	7,419	9,022	6,399	9,179
Trust Territory of Pacific	-	-	-	-	138
Virgin Islands	2,726	8,959	20,094	5,056	2,411
Administration	86,485	65,336	64,731	58,542	55,196
Totals	**$ 2,977,300**	**$2,786,717**	**$2,933,542**	**$ 2,178,576**	**$ 1,375,293**

FAA makes project grants for airport planning and development under the Airport Improvement Program (AIP) to maintain a safe and efficient nationwide system of public-use airports that meets both present and future needs of civil aeronautics. FAA works to improve the infrastructure of the nation's airports, in cooperation with airport authorities, local and state governments, and metropolitan planning authorities.

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Stewardship Investment
Research and Development
For the Fiscal Years Ended September 30
(Dollars in Thousands)

Expenditures	2004	2003	2002	2001	2000
Applied research	$ 91,743	$ 29,406	$ 59,150	$ 120,395	$ 99,777
Development	478	251	603	3,419	7,175
R&D Plant	4,230	2,903	3,020	10,130	12,800
Administration	28,643	31,669	44,480	46,988	46,219
Total	$ 125,094	$ 64,229	$ 107,253	$ 180,932	$ 165,971

FAA conducts research and provides the essential air traffic control infrastructure to meet increasing demands for higher levels of safety, efficiency, and environmental improvement.

Research priorities include aircraft structures and materials; fire and cabin safety; crash injury-protection; explosive detection systems; improved in-flight icing and ground de-icing operations; better tools to predict and warn of weather hazards, turbulence, and wake vortices; aviation medicine; and human factors. In FY 2004, our research and development program made significant contributions to achieving the agency's mission and goals, including the following achievements.

Center of Excellence for Airliner Cabin Environment Research: FAA recently established the Air Transportation Center of Excellence for Airliner Cabin Environment Research. This center, managed for FAA by the Civil Aeromedical Institute and led by Auburn University, includes Purdue University, Harvard University, Boise State University, Kansas State University, the University of California at Berkeley, and the University of Medicine and Dentistry of New Jersey. The consortium will research cabin air quality and conduct an assessment of chemical and biological threats.

Aviation Digital Data Service (ADDS) Enhancements: Accurate, timely, and user-friendly forecasts of icing, turbulence, thunderstorms, and clouds are required to support safe and efficient flight operations. The availability of weather data on the Internet has made current weather information from sophisticated numerical models readily available to users. Researchers developed several enhancements to ADDS in FY 2004. These include faster access to critical weather information, the capability to customize weather information (saving preferences), and the ability to print an entire screen display. By providing current and forecast information on key weather hazards to support the needs of users, ADDS enhances aviation safety and helps reduce delays. Access via the Internet has ensured that enhancements are available to users quickly and cost-effectively.

Aviation Environmental Design Tool: In 2004, FAA, in collaboration with the National Aeronautics and Space Administration, initiated a long-term strategic effort to develop analytical tools to address the relationship between noise and emissions and between different types of emissions. Current analytical tools focus on noise or emissions; however, noise and emissions are interdependent phenomena.

Required Supplementary Information

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Supplementary Information
Deferred Maintenance
For the Fiscal Years Ended September 30
(Dollars in Thousands)

Category	Method	Asset condition*	Costs to return to acceptable condition				
			2004	2003	2002	2001	2000
Buildings	Condition assessment survey	4 & 5	$ 53,359	$ 50,534	$ 73,741	$ 50,568	$ 30,971
Other structures and facilities	Condition assessment	4 & 5	$ 16,543	$ 29,785	$ 13,843	$ 22,928	$ 59,290

* Condition rating scale: 4--poor; 5--very poor

Information on FAA's deferred maintenance is based on condition assessment survey (annual inspection). Standards (orders) are provided for evaluating the fixed assets condition. These standards are combined with FAA technicians' knowledge, past experiences, and judgment to provide the following:

- Minimum and desirable condition descriptions
- Suggested maintenance schedules
- Standard costs for maintenance actions
- Standardized condition codes

There have not been material changes to the standards in recent years. FAA recognizes maintenance expense as incurred. However, maintenance was insufficient during the past several years and resulted in deferred maintenance on Buildings and Other Structures and Facilities. FAA reports deferred maintenance only on assets with condition ratings of 4 and 5 in compliance with the Statement of Federal Financial Accounting Standard (SFFAS) Number 6, "Accounting for Property, Plant and Equipment."

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Supplementary Information
Intragovernmental Balances
As of September 30
(Dollars in Thousands)

Intragovernmental Assets

	2004			2003		
Agency	**Accounts receivable, advances, prepayments, and other**	**Fund balance with Treasury**	**Investments**	**Accounts receivable, advances, prepayments, and other**	**Fund balance with Treasury**	**Investments**
Department of the Treasury	$ 54,045	$ 2,840,663	$ 10,318,029	$ 313	$ 2,833,723	$ 10,819,257
Department of the Air Force	12,417	-	-	25,133	-	-
Department of Agriculture	51	-	-	46	-	-
Department of the Army	6,647	-	-	6,228	-	-
Department of Commerce	78	-	-	580	-	-
Department of Defense	2,097	-	-	2,606	-	-
Department of Energy	88	-	-	16	-	-
Federal Emergency Management Agency	715	-	-	20	-	-
Federal Trade Commission	94			-	-	-
Government Accountability Office	-	-	-	1	-	-
General Services Administration	1,542	-	-	330	-	-
Independent Agencies	8	-	-	2	-	-
Department of Homeland Security	-	-	-	12,490	-	-
Department of Health and Human Services	-	-	-	2	-	-
Department of the Interior	-	-	-	3,947	-	-
Department of Justice	456	-	-	14	-	-
Department of Labor	-	-	-	4	-	-
National Aeronautics & Space Admin.	2,015	-	-	4,125	-	-
Office of Personnel Management	6	-	-	-	-	-
Department of the Navy	4,406	-	-	4,747	-	-
Social Security Administration	-	-	-	24	-	-
Department of State	4,201	-	-	46	-	-
Department of Transportation	127,103	-	-	84,098	-	-
Other Agencies	20	-	-	23,950	-	-
Total	$ 215,989	$ 2,840,663	$ 10,318,029	$ 168,722	$ 2,833,723	$ 10,819,257

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Supplementary Information
Intragovernmental Balances
As of September 30
(Dollars in Thousands)

Intragovernmental Liabilities

	2004		2003	
Agency	**Employee related and other**	**Accounts payable**	**Employee related and other**	**Accounts payable**
Department of the Treasury	$ 7,098	$ -	$ 20,868	$ -
Defense Agencies	2,413	21,833	3,362	6
Department of Agriculture	-	29	3,170	9
Department of the Air Force	700	1,228	1,690	41
Department of the Army	258	140	4	3
Department of Commerce	1,652	-	3,053	-
Corps of Engineers	-	19	-	-
Department of Education	60	-	60	-
Department of Energy	4	1	-	2
Environmental Protection Agency	300	-	100	-
Federal Emergency Management Agency	47	-	49	-
Federal Trade Commission	93	-	-	-
General Services Administration	-	6,889	7,142	-
Government Printing Office	-	83	-	-
Department of Health and Human Services	33	-	20	-
Department of Homeland Security	7,081	-	8,961	-
Department of the Interior	85	13	89	-
Department of Justice	68	54	68	-
Department of Labor	200,307	-	200,905	-
National Aeronautics & Space Administration	1,429	2,063	453	-
Department of the Navy	-	212	116	84
Office of Personnel Management	29,527	512	21,127	-
Smithsonian Institution	-	7	9	-
Department of State	115	547	120	-
Department of Transportation	11,029	26,718	11,840	9,179
United States Postal Service	-	693	-	-
Independent Agencies	5	-	4,835	-
Other Agencies	24,722	-	56,827	-
Total	$ 287,026	$ 61,041	$ 344,868	$ 9,324

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Supplementary Information
Intragovernmental Transactions
For the Fiscal Years Ended September 30
(Dollars in Thousands)

Intragovernmental Expenses and Revenues

	2004		2003	
Agency	**Expenses**	**Revenues**	**Expenses**	**Revenues**
Department of the Treasury*	$ 515,544	$ 405	$ 33,334	$ 3,115
Department of Agriculture	6,757	58	2	2
Department of the Air Force	54,492	18,781	14,511	14,511
Department of the Army	5,042	8,548	5,729	5,729
Department of Commerce	32,306	1,876	1,978	1,978
Corps of Engineers	253	-	-	-
Defense Agencies	110,084	16,602	7,929	7,929
Department of Education	-	10	5	5
Department of Energy	5,403	37	58	58
Environmental Protection Agency	40	-	-	-
Federal Emergency Management Agency	-	2,030	2,381	2,381
Department of Health and Human Services	682	19	62	62
Department of Homeland Security	145,591	50,911	53,027	53,027
Department of the Interior	2,232	903	777	777
Department of Justice	11,523	2,691	43	43
Federal Trade Commission	-	151	9	9
Department of Labor - FECA*	86,809	13	87,631	-
General Services Administration	132,991	129	119	119
Government Printing Office	8,114	-	-	-
National Aeronautics & Space Admin.	7,668	6,244	12,545	12,545
National Archives and Records Administration	84	-	-	-
National Science Foundation	49	-	-	-
Department of the Navy	-	10,386	3,178	3,178
Office of Personnel Management*	1,093,184	6	1,247,460	-
Securities and Exchange Commission	15,183	-	-	-
Social Security Administration	-	323	100	100
Smithsonian Institution	192	-	-	-
Department of State	796	274	39	39
Tennesee Valley Authority	-	-	4	4
Department of Transportation	208,819	28,964	117,561	117,561
United States Postal Service	2,382	-	-	-
Department of Veterans Affairs	5	-	-	-
Independent Agencies	-	185	154	154
Other Agencies	170	1,014	9,349	18,141
Total expenses	$ 2,446,395	$ 150,560	$ 1,597,985	$ 241,467

* *Represents imputed costs funded by other agencies on behalf of FAA and/or employee-related expenses.*

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Supplementary Information
Intragovernmental Transactions
For the Fiscal Years Ended September 30
(Dollars in Thousands)

Intragovernmental non-exchange revenue

	2004		2003	
	Transfers-out	**Transfers-in**	**Transfers-out**	**Transfers-in**
Department of Agriculture	$ -	$ -	$ 6	$ -
Department of Army	-	-	81	-
Department of Commerce	-	-	15	-
General Services Administration	-	-	14,991	15,082
Department of Homeland Security	-	-	643,621	-
National Aeronautics & Space Administration	-	-	43,904	-
Office of Personnel Management	-	-	5	5
Department of Transportation	165,755	-	103,168	-
Other Agencies	361,881	353,466	14,625	2,082
Total non-exchange revenue	$ 527,636	$ 353,466	$ 820,416	$ 17,169

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Schedule of Budgetary Resources by Major Fund Type
As of September 30, 2004
(Dollars in Thousands)

	Trust Fund Grants-in-Aid to Airports	Trust Fund Facilities & Equipment	Trust Fund Research, Eng. & Development	Aviation Insurance Revolving	Franchise Fund	Operations	Other Funds	Combined Total
Budgetary Resources								
Budget Authority	$ 7,069,128	$ 2,895,677	$ 119,863	$ -	$ -	$ 7,530,925	$ 123	$ 17,615,716
Unobligated balance brought forward and transfers	9,489	675,178	20,439	217,854	78,989	97,495	8,258	1,107,702
Spending authority from offsetting collections	578	168,413	(2,176)	1,446	362,231	144,962	-	675,454
Recoveries of prior year obligations	127,112	26,792	4,257	-	-	12,989	19,768	190,918
Temporarily not available	-	(47,169)	(706)	-	-	(30,999)	-	(78,874)
Permanently not available	(3,420,072)	-	-	-	-	(30,843)	(139)	(3,451,054)
Total Budgetary Resources	$ 3,786,235	$ 3,718,891	$ 141,677	$ 219,300	$ 441,220	$ 7,724,529	$ 28,010	$ 16,059,862
Status of Budgetary Resources								
Obligations incurred	$ 3,501,188	$ 2,654,246	$ 117,963	$ 739	$ 367,982	$ 7,561,202	$ 26,691	$ 14,230,011
Unobligated balances-available	7,884	968,754	17,956	460	73,238	43,767	1,319	1,113,378
Unobligated Balances-not available	277,163	95,891	5,758	218,101	-	119,560	-	716,473
Total Status of Budgetary Resources	$ 3,786,235	$ 3,718,891	$ 141,677	$ 219,300	$ 441,220	$ 7,724,529	$ 28,010	$ 16,059,862
Relationship of Obligations to Outlays								
Obligated balance, net, beginning of period	$ 5,681,104	$ 1,952,717	$ 198,907	$ 5,201	$ 91,873	$ 694,909	$ 19,769	$ 8,644,480
Cancelled appropriations and other	-	(9)	-	-	-	-	-	(9)
Obligations incurred	3,501,188	2,654,246	117,963	739	367,982	7,561,202	26,691	14,230,011
Less: Spending authority from offsetting collections and receipts and recoveries of prior year obligations	(127,690)	(195,205)	(2,081)	(1,446)	(362,231)	(157,951)	(19,768)	(866,372)
Less: Obligated balance, net, end of period	(6,093,262)	(1,672,086)	(173,610)	(186,254)	(135,538)	(912,310)	-	(9,173,060)
Net Outlays	$ 2,961,340	$ 2,739,663	$ 141,179	$ (181,760)	$ (37,914)	$ 7,185,850	$ 26,692	$ 12,835,050
Outlays								
Disbursements	$ 2,961,911	$ 2,773,790	$ 141,541	$ (180,314)	$ 322,323	$ 11,710,859	$ 26,721	$ 17,756,831
Collections, net of offsetting receipts	(571)	(34,127)	(362)	(1,446)	(360,237)	(4,525,009)	(29)	(4,921,781)
Net Outlays	$ 2,961,340	$ 2,739,663	$ 141,179	$ (181,760)	$ (37,914)	$ 7,185,850	$ 26,692	$ 12,835,050

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
Schedule of Budgetary Resources by Major Fund Type
As of September 30, 2003
(Dollars in Thousands)

	Airport & Airway Trust Fund Corpus	Trust Fund Grants-in-Aid	Trust Fund Facilities &	Trust Fund Research, Eng. &	Aviation Insurance	Franchise		Other	Combined Total
Budgetary Resources	AS RESTATED	to Airports	Equipment	Development	Revolving	Fund	Operations	Funds	AS RESTATED
Budget authority	$ -	$ 6,500,000	$ 2,931,899	$ 141,444	$ -	$ -	$ 7,071,120	$ -	$ 16,644,463
Unobligated balance brought forward and transfers	3	894	541,486	21,187	102,361	56,581	152,833	57,505	932,850
Spending authority from offsetting collections	-	686	104,312	(2,644)	129,426	353,862	140,810	32	726,484
Recoveries of prior year obligations	-	121,908	45,179	21,422	-	-	60,647	1	249,157
Permanently not available	-	(3,122,100)	(39,376)	(964)	-	-	(66,692)	-	(3,229,132)
Total Budgetary Resources	$ 3	$ 3,501,388	$ 3,583,500	$ 180,445	$ 231,787	$ 410,443	$ 7,358,718	$ 57,538	$ 15,323,822
Status of Budgetary Resources									
Obligations incurred	$ 3	$ 3,491,899	$ 2,908,322	$ 160,006	$ 13,933	$ 331,454	$ 7,261,223	$ (694)	$ 14,166,146
Unobligated balances available	-	8,635	612,302	17,321	6,314	-	31,633	-	676,205
Unobligated balances not available	-	854	62,876	3,118	211,540	78,989	65,862	58,232	481,471
Total Status of Budgetary Resources	$ 3	$ 3,501,388	$ 3,583,500	$ 180,445	$ 231,787	$ 410,443	$ 7,358,718	$ 57,538	$ 15,323,822
Relationship of Obligations to Outlays									
Obligated balance, net, beginning of period	$ -	$ 4,992,702	$ 1,988,809	$ 205,948	$ 5,144	$ 70,802	$ 762,286	$ (27,555)	$ 7,998,136
Cancelled appropriations and other	-	-	9	-	-	-	15,693	-	15,702
Obligations incurred	3	3,491,899	2,908,322	160,006	13,933	331,455	7,261,222	(694)	14,166,146
Less: Spending authority from offsetting collections and receipts and recoveries of prior year obligations	(97)	(122,594)	(149,491)	(18,778)	(129,426)	(353,862)	(201,457)	(33)	(975,738)
Less: Obligated balance, net, end of period	-	(5,681,104)	(1,952,717)	(198,907)	(5,201)	(91,873)	(694,909)	(19,769)	(8,644,480)
Net Outlays	$ (94)	$ 2,680,903	$ 2,794,932	$ 148,269	$ (115,550)	$ (43,478)	$ 7,142,835	$ (48,051)	$ 12,559,766
Outlays									
Disbursements	$ 3	$ 2,681,540	$ 2,884,966	$ 151,652	$ 13,876	$ 312,235	$ 11,326,505	$ (48,017)	$ 17,322,760
Collections, net of offsetting receipts	(97)	(637)	(90,034)	(3,383)	(129,426)	(355,713)	(4,183,670)	(34)	(4,762,994)
Net Outlays	$ (94)	$ 2,680,903	$ 2,794,932	$ 148,269	$ (115,550)	$ (43,478)	$ 7,142,835	$ (48,051)	$ 12,559,766

ADMINISTRATIVE SERVICES FRANCHISE FUND

Background

Public Law 104-205, "Department of Transportation and Related Agencies Appropriation Act, 1997", authorized the FAA to establish an Administrative Services Franchise Fund (Franchise Fund). The Franchise Fund is designed to create competition within the public sector in the performance of a wide variety of support services. It allows for the establishment of an environment to maximize the use of internal resources through the consolidation and joint-use of like functions and the recognition of economies of scale and efficiencies associated with the competitive offering of services to other Government agencies.

Objective

The objective of the Franchise Fund is to enhance the support provided to the core programmatic mission functions within FAA. Benefits of the Franchise Fund are derived incrementally over time through efficiencies and economies of scale associated with development of partnerships and consolidation of like functions plus the addition of new customers. Efforts in the Franchise Fund are directed toward identifying the most efficient and cost effective methods to provide support services, and this is consistent with the current President's Management Agenda initiative relating to competitive sourcing.

Services

The Franchise Fund offers a wide variety of services. These include accounting, payroll, travel, duplicating, multi-media, information technology, logistics and material management, aircraft maintenance and international and management training. The Franchise Fund's major customers are FAA Line of Business Programs as shown on the consolidated Statement of Net Cost. Other customers include DOT entities, non-DOT government agencies, and the airport authorities and militaries of other countries.

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
FRANCHISE FUND
BALANCE SHEETS
(Dollars in Thousands)

	As of September 30	
	2004	2003
Assets		
Intragovernmental		
Fund balance with Treasury	$ 208,776	$ 170,862
Accounts receivable, net	1,608	1,165
Other	1,111	13
Total intragovernmental assets	211,495	172,040
Accounts receivable, net	3,343	2,896
Inventory and related property, net	375,027	386,886
General property, plant, and equipment, net	2,130	1,080
Other assets	10	5
Total assets	$ 592,005	$ 562,907
Liabilities		
Intragovernmental liabilities:		
Accounts payable	$ 549	$ -
Other intragovernmental liabilities	137,326	97,780
Total intragovernmental liabilities	137,875	97,780
Accounts payable	15,323	7,410
Other liabilities	-	15,104
Total liabilities	153,198	120,294
Net position balances:		
Cumulative results of operations	438,807	442,613
Total net position	438,807	442,613
Total liabilities and net position	$ 592,005	$ 562,907

U. S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
FRANCHISE FUND
STATEMENTS OF NET COST
(Dollars in Thousands)

	For the years ended September 30	
	2004	2003
Programs		
Earned revenues	$ 340,077	$ 320,846
Intragovernmental costs	(339,934)	(321,159)
Profit (loss)	$ 143	$ (313)

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
FRANCHISE FUND
STATEMENTS OF CHANGES IN NET POSITION
(Dollars in Thousands)

	Cumulative results of operations	
	2004	2003
Beginning balance	$ 442,613	$ 444,399
Other financing sources		
Transfers-in/out without reimbursement	(10,906)	(8,448)
Imputed financing from costs absorbed by others	6,954	6,251
Other	3	724
Total financing sources	(3,949)	(1,473)
Profit (loss)	143	(313)
Ending balance	$ 438,807	$ 442,613

APPENDIX

Improper Payments Information Act Reporting Details

I. Describe your agency's risk assessment(s), performed subsequent to compiling your full program inventory. List the risk-susceptible programs (i.e., programs that have a significant risk of improper payments based on OMB guidance thresholds) identified through your risk assessments. Be sure to include the programs previously identified in the former Section 57 of OMB Circular A-11.

Working in coordination with DOT, we reviewed FAA programs and activities to identify those that might be susceptible to significant improper payments. This review was a two-phase process. In the first phase, the work involved (1) researching and developing an improper payment risk assessment process and methodology, (2) determining the amount of improper payments and their causes for ten DOT programs, and (3) determining an action plan for reducing improper payments for any program that was identified as having a significant problem.

For the first phase, 10 DOT programs were identified as having the highest potential risk for improper payments based on FY 2003 expenditures, including FAA's Operations, Facilities and Equipment, and Airport Improvement Program (AIP) [former Section 57 program]. In addition, one of the programs included in DOT's review was salary payments. After an initial risk assessment to determine the sample size to be analyzed, a comprehensive review, using OMB guidelines, was undertaken for each program.

For the second phase, we conducted our own self-assessment of the potential risk for improper payments in the R,E&D program using a risk-assessment tool.

For all FAA programs, it was determined that there were no significant improper payments.

II. Describe the statistical sampling process conducted to estimate the improper payment rate for each program identified.

An understanding of the programs, and the payments made under the programs, was developed through research, questionnaires, and interviews. Criteria were developed as the basis for further assessing program risk. Risk criteria included gross expended amount; complexity of payment calculations; established internal controls and oversight; type of program recipients; number of program recipients; volume of payments; probability of program growth; and changes in the program. Results of the risk assessment were used to create a sampling plan.

A stratified sampling design was used to test payments based on the FY 2003 amounts disbursed and the assessed risk of the program. This sampling plan provided a statistical confidence of 95% by measuring the actual variability of the dollar data and, through a weighted set of formulas, provided a natural measure of the relative sampling error. Use of appropriate population weights with the stratification methodology produced an unbiased estimate for the whole file. This statistical sampling design allowed us to calculate statistical projections for the amount of improper payments for each tested program and to project attributes across the selected population.

The sample selection of payments was random within each stratum. Allocations to each stratum were based on the dollar value of the payment using the Neyman Optimization formula with a design precision ranging from 1% to 10% of the estimated dollar amount, depending on the assessed risk level. For high risk, the design precision was between 1% and 3%; for moderate risk, between 5% and 7%; and for low risk, 10%. A two-sided 95% confidence limit was achieved. The stratification design relies on dollar amount ranges to generate better precision than simple random sampling for a given sample size. The

stratification ensured that all strata were mutually exclusive and collectively exhaustive, thus covering the entire population of payments.

A total sample size of 390 payments was randomly selected among a minimum of three quantitative strata based on the payment amount. The table below shows the overall sample sizes by program.

Program Name	Universe Amount	Risk for Sample Selection	Sample Size	Sample Amount
Operations	$1,397,734,502	High	146	$ 75,421,806
Airport Improvement Program	2,577,240,731	Moderate	101	169,251,812
Facilities and Equipment	1,739,830,557	High	143	180,390,902
Total Amount	$5,714,805,790		390	$425,064,520

III. Explain the corrective actions your agency plans to implement to reduce the estimated rate of improper payments. Include in this discussion what is seen as the cause(s) of errors and the corresponding steps necessary to prevent future occurrences. If efforts are already underway, and/or have been ongoing for some length of time, it is appropriate to include that information in this section.

Our improper payment rates did not exceed both 2.5% of program payments and $10 million.

IV. Improper Payment Reduction Outlook FY 2003 – FY 2007 (in millions)

Program	FY 03 Outlays	FY03 IP%	FY04 IP%	FY05 IP%	FY06 IP%	FY07 IP%
FAA AIP *[Section 57 program]*	$3,088,999	0%	0%	0%	0%	0%
Operations	$2,054,313	0%	0%	0%	0%	0%
F&E	$2,369,266	0%	0%	0%	0%	0%

V. Discuss your agency's recovery auditing effort, if applicable, including the amount of recoveries expected, the actions taken to recover them, and the business process changes and internal controls instituted and/or strengthened to prevent further occurrences.

For the past two years, DOT has used PRG-Schultz for recovery audit services. During that time PRG-Schultz reviewed payments made by the DOT agencies to their commercial vendors for fiscal years 2000, 2001, and 2002. For FAA, PRG-Schultz has recovered $34,137, an improper payment rate of 0.0038%.

VI. Describe the steps the agency has taken and plans to take (including time line) to ensure that agency managers (including the agency head) are held accountable for reducing and recovering improper payments.

The DOT CFO has required the CFOs of all operating administrations, including the FAA, to certify the results of our improper payment reviews. In addition, we are incorporating financial management training, which will include payment policies, in training provided to FAA managers. Finally, we plan to

establish a new Internal Control staff, whose responsibilities will ultimately include reviews of payment processes.

VII. Describe whether the agency has the information systems and other infrastructure it needs to reduce improper payments to the levels the agency has targeted.

Currently, we have the information systems and other infrastructures needed to measure improper payments.

VIII. A description of any statutory or regulatory barriers that may limit the agencies' corrective actions in reducing improper payments

None.

IX. Additional comments, if any, on overall agency efforts, specific programs, best practices, or common challenges identified as a result of IPIA implementation.

None.

GLOSSARY

Airport Movement Area Safety System (AMASS): AMASS, an enhancement to the Airport Surface Detection Equipment (ASDE) radar, enables controllers to observe airport surface movements, particularly at night and when visual observation is impaired by bad weather. The system works by processing surveillance data from ASDE, the airport surveillance radar, and the terminal automation system. AMASS then determines conflicts based on the position, velocity, and acceleration of airborne arrival aircraft with ground-based aircraft and vehicles.

Airport Surface Detection Equipment Model X (ASDE-X): This airport surface surveillance system radar provides air traffic controllers, pilots, airlines, and airports with highly accurate data that has many potential applications. The primary application is to provide controllers with positive identification of aircraft on the surface in all weather conditions.

American Customer Satisfaction Index (ACSI): Established in 1994, the ACSI is a uniform and independent measure of household consumption experience. A powerful economic indicator, the ACSI tracks trends in customer satisfaction and provides valuable benchmarking insights of the consumer economy for companies, industry trade associations, and government agencies. The ACSI is produced through a partnership of the University of Michigan Business School, the American Society for Quality, and the international consulting firm, CFI Group.

Automated Flight Service Stations (AFSS): These FAA facilities provide general aviation pilots with aeronautical information and services necessary to promote safe flight operations. These services include pre- and in-flight weather briefings, flight planning assistance, aeronautical notices, and emergency assistance. Unlike other air traffic facilities, such as towers and centers, automated flight service stations do not control air traffic.

Airport Improvement Program (AIP): The AIP facilitates the development of a nationwide system of public-use airports by providing funding for airport planning and development projects at airports included in the FAA's National Plan of Integrated Airport Systems. The AIP also provides funding for noise compatibility planning and noise compatibility programs established by the Aviation Safety and Noise Abatement Act of 1979.

CAPSTONE: CAPSTONE is a technology focused safety program in Alaska that seeks near term safety and efficiency gains in aviation by accelerating implementation and use of modern technology. CAPSTONE links multiple programs and initiatives under a common umbrella for planning, coordination, focus and direction and develops capabilities and requirements jointly with FAA, the Alaskan community and aviation industry. CAPSTONE focuses on improving aviation safety and efficiency through installation of government-furnished Global Positioning System (GPS)-based avionics and data link communications suites in commercial aircraft.

International Civil Aviation Organization (ICAO): ICAO is a United Nations organization that is dedicated to increasing the safety and security of international civil aviation. The organization addresses fundamental issues ranging from air navigation and capacity to emerging environmental concerns such as engine noise and emissions.

Model for Assessing the Global Exposure of Noise because of Transport Airlines (MAGENTA): MAGENTA is computerized modeling tool for evaluating the impact of aircraft noise impacts in communities around airports.

Operational Error: Occurs when controllers fail to apply or follow procedures that enforce separation and allow aircraft to end up too close to each other or to an obstruction.

Operational Evolution Plan (OEP): The OEP is a dynamic, comprehensive, and integrated document that uses an evolutionary, one-step-at-a-time approach to the modernization of the U.S. national airspace system. New runways, new routes, new tools, and airspace redesign are the core changes OEP addresses in this 10-year strategic plan.

Required Vertical Separation Minimum (RVSM): The goal of RVSM is to reduce the vertical separation between aircraft above flight level (FL) 290 (29,000 feet) from the current 2000-ft minimum to a 1000-ft minimum. This reduction will allow aircraft to safely fly more optimum profiles, gain fuel savings and increase airspace capacity.

Runway Incursion: Any occurrence at an airport involving an aircraft, vehicle, person, or object on the ground that creates a collision hazard or results in a loss of separation with an aircraft taking off, intending to take off, landing, or intending to land.

Required Navigation Performance (RNP): Required navigation performance extends the capabilities of modern airplane navigation systems by providing real-time estimates of navigation uncertainty, assurance of performance through its containment concepts, and features that ensure the repeatability and predictability of airplane navigation. This precise characterization of airplane performance is key to designing more efficient airspace routes and procedures.

System for Assessing Aviation Global Emissions (SAGE): SAGE is a computer model that estimates aircraft fuel burn and emissions.

INTERNET LINKS

Federal Aviation Administration: **www.faa.gov**

FAA Organizations: **www.faa.gov/aboutfaa/organizations.cfm**

FAA Regional Offices and Centers: **www.faa.gov/aboutfaa/regional.cfm**

FAA Operational Evolution Plan (OEP): **www.faa.gov/programs/oep**

National Transportation Library: **ntl.bts.gov**

U.S. Department of Transportation: **www.dot.gov**

ACKNOWLEDGMENTS

This *FY 2004 Performance and Accountability Report* is a collaborative endeavor on the part of many, many FAA employees and contractors. We would like to acknowledge and thank them for their hard work and commitment in successfully preparing this report and supporting the audit of the financial statements.

WE WELCOME YOUR COMMENTS!

Thank you for your interest in FAA's *FY 2004 Performance and Accountability Report*. We welcome your comments on how we can make this report more informative for our readers. Please send your comments to:

Office of Financial Management, AFM-1
Federal Aviation Administration
800 Independence Avenue, SW
Washington, DC 20591
E-mail address: susan.lee@faa.gov
Fax number: (202) 267-5271

This report is also available on the FAA Website at
www.faa.gov/aba/html_fm/files_pdf/2004_PAR.pdf

Prior year *Performance and Accountability Reports* are available at
www.faa.gov/aba/html_fm/finst.html

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U.S. DEPARTMENT OF TRANSPORTATION
Federal Aviation Administration
800 Independence Avenue, SW
Washington, DC 20591

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