Before the Subcommittee on Government Management, Information, and Technology, House Committee on Government Reform

U.S. House of Representatives

For Release on Delivery
expected at
2:00 p.m. EST
Thursday
March 18, 1999
Report Number: FE-1999-073

Financial Management at the Federal Aviation Administration

Statement of John L. Meche

Deputy Assistant Inspector General for

Financial, Economic, and Information Technology

U.S. Department of Transportation

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to testify today concerning the Federal Aviation Administration (FAA) financial systems and its financial statements.

Ten days ago, we issued our audit report on FAA's Fiscal Year (FY) 1998 Financial Statements. The report is attached to this statement. We reported that we could not determine the reliability of significant portions of FAA's Financial Statements. Consequently, we could not express an opinion on the fair and reasonable presentation of FAA's Financial Statements. This is commonly called a disclaimer of opinion.

Our testimony today will address three areas related to FAA financial systems and statements:

- Current status of financial conditions,
- Actions to develop a cost accounting system, and
- Challenges ahead for FAA.

Current Status

The Chief Financial Officers (CFO) Act of 1990 requires each Federal agency to prepare an annual financial statement that must be audited by the agency Inspector General, or an independent external auditor. In the Department of Transportation (DOT), the Office of Inspector General audits FAA's Financial Statements. During the past 7 years, we have issued 12 audit reports with over 100 recommendations to improve FAA's financial management and accounting practices.

FAA faces significant risks in funding all agency requirements since its operating costs are increasing. We recently testified that FAA is facing a funding shortfall in FY 1999, and improvements in financial management are needed to mitigate this shortfall. To control its cost, FAA will need basic financial tools, including a reliable cost accounting system and good financial data.

FAA must produce fair and accurate financial statements as a first step to establish accountability for its assets, improve financial credibility for its budget requests, collect accurate data to support sound management decisions, and establish a basis for user fees, if and when they are implemented. Until recently, FAA has been slow to implement our recommendations and initiate corrective actions. Consequently, it has never received an unqualified ("clean") audit opinion.

With the announcement by the President of the goal to have an unqualified audit opinion on the Federal Government's Financial Statements for FY 1999, we have seen a dramatic change at FAA, and it is now operating with a sense of urgency. Within the past 3 months, FAA has obtained the commitment of its Administrator, and senior DOT and FAA officials to get the job done.

The primary material weakness preventing FAA from getting a clean audit opinion relates to its property and equipment accounts, which total about $12 billion. This accounts for nearly half of FAA's assets. Much of this property was acquired years ago when the Federal Government was not overly concerned with accounting for its acquisition costs. Because of the age of some assets, the supporting records cannot be found, or involve labor-intensive processes to conduct searches for records and documents, many times only to come up short. We also have found specific instances where FAA's equipment account is significantly understated. For example, FAA's voice switching control systems, installed at 23 locations, were recorded at a total cost of $234 million, instead of the true cost of $1.1 billion.

Another material weakness pertains to the requirement that an agency's financial systems be the source of information used in preparing annual financial statements. FAA uses DOT's accounting system, but that system does not produce all the financial and budgetary information for preparing the FAA Financial Statements. Therefore, it becomes necessary for FAA to make billions of dollars of adjustments to amounts generated by the accounting system to present its financial condition. DOT and FAA recognize the accounting system does not meet today's needs. DOT is developing a replacement system that currently is planned to be fully operational by June 2001.

Cost Accounting

The FAA Reauthorization Act of 1996 required FAA to implement a cost accounting system. The Act also established the National Civil Aviation Review Commission to provide advice on aviation operations. The Commission called for strong financial controls, including a reliable cost accounting system by October 1998, so that FAA could manage its resources in a businesslike manner, and allocate its cost correctly and fairly as the basis for a cost-based user fee system. FAA set out to develop a cost accounting system by October 1, 1998, but the development project did not go as smoothly as planned.

We reviewed the FAA cost accounting system during its first phase of development. On August 10, 1998, our report identified four areas, potentially involving billions of dollars, that FAA needed to address before its cost accounting system would accurately account for FAA’s full cost of operations. FAA had not established a systematic method to identify and reflect (1) the cost of accounting adjustments, (2) cost for all development projects, (3) cost incurred by other agencies for air traffic services, and (4) the correct labor cost charged to appropriate projects. FAA had not yet decided how to allocate its costs. We also found its implementation schedule was overly aggressive, contained conflicting tasks, and omitted responsibilities and resource needs. We recommended FAA revise its milestones.

In January 1999, FAA acknowledged its existing implementation schedule was unattainable. As of today, the current plan reflects a phased implementation of the cost accounting system, with the segment of Air Traffic Services supporting overflight user fees to be implemented by June 1999, the rest of Air Traffic Services by December 1999, and a fully operational system by the end of FY 2001. The current schedule could impact FAA's ability to realize the $1.5 billion in user fees proposed in its FY 2000 budget.

Challenges Ahead

FAA agrees it has material weaknesses affecting its accounting and financial information, and is working hard to correct them. To resolve its long-standing issues with property and equipment valuations, FAA has established a "task force" under the direct leadership of the Chief Financial Officer. To be successful for FY 1999, these accounts must be cleaned up, and supporting records found by September 30, 1999. This is an enormous task at this late stage. For example, in the next 6 months, FAA must document and transfer over $1 billion of costs for 16,000 completed job orders. At the same time, FAA also must focus on long-term solutions.

The FAA cost accounting system being developed gets its source data from the Department's existing accounting system. Without a clean audit opinion on the FAA Financial Statements, the FAA cost accounting system, even if properly designed, will not produce cost-based data that are defensible. Realistic user fees cannot be established with inaccurate or unsupportable costs.

The FAA, as well as the rest of the Federal Government, is moving into a new era of measuring performance, as required by the Government Performance and Results Act. To accomplish this will require financial systems that can link cost information to performance measures, and provide information on the cost effectiveness of FAA's major programs. While this is a great idea, FAA's current financial systems do not produce the required data.

With the extraordinary effort that FAA is making, it is possible that these material weaknesses can be substantially corrected by the end of FY 1999. However, this alone is not good enough. Unless the financial systems are fixed, FAA's accounts are likely to revert back to their current inaccurate position. Not only would this result in future disclaimed opinions, it also could prevent FAA from establishing and collecting defensible user fees.

Background

The Chief Financial Officers Act of 1990 requires an annual financial report pertaining to an agency's overall financial position, results of operations, and budgetary information. Financial statements must be audited to provide an independent opinion on the fair and reasonable presentation of the financial statements. Professional accounting standards provide for four types of audit opinions:

- ♦ Unqualified "Clean" – The financial statements meet accounting standards and the material dollar amounts are supported.
- ♦ Qualified – The financial statements generally meet standards, but some dollar amounts cannot be supported.
- ♦ Disclaimer – The financial statements may or may not meet accounting standards, and material dollar amounts cannot be supported. Basically, the auditor cannot determine if the dollar amounts are correct or not.
- ♦ Adverse – The financial statements contain significant dollar amounts that are incorrect, but management refuses to make changes.

Current Status of Financial Condition

Our audit opinion on FAA's FY 1998 Financial Statements was a disclaimer. Material issues which caused that opinion are discussed in the following paragraphs. FAA's primary problem relates to its property and equipment accounts. For FY 1998, we could not substantiate the acquisition value of property and equipment reported at about $12 billion.

Property, Plant, and Equipment

This item represents nearly half of FAA assets. The major components include real property (land, buildings, and structures), personal property (equipment), and work-in-process.

Real Property - The FAA Real Property Records System includes property that is not valued correctly or whose stated value is not supported by verifiable documentation. We sampled 117 items with a recorded value of $790 million and found:

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

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

Personal Property – FAA recognizes the reported $4.1 billion acquisition value for its equipment is materially understated. This understatement is the result of years of expensing contract costs associated with bringing equipment into operational status, that should have been added (capitalized) to the asset value. We have preliminarily identified that the value for five of the most costly equipment systems, currently in operation, should be increased by over $1 billion. Our current estimate is that FAA equipment should be valued at about $10 billion. Unless FAA establishes supportable values for its substantial property investments, it will be unable to accurately compute annual operating costs associated with use of the property, and recoup its full cost through user fees.

Work-in-Process – As property is acquired and buildings are constructed for specific projects, associated costs are charged to, and accumulated in, a work-in-process account until the projects are completed and systems placed in service. When completed, the project costs should be transferred to the appropriate real or personal property accounts. Project costs are considered backlog if not removed from the work-in-process account within 6 months after project completion.

FAA has two major problems with work-in-process. FAA does not have reasonably available documentation to support the account balance, and has not transferred the costs out for completed projects.

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

FAA estimates there was $1.3 billion of completed projects in backlog as of September 30, 1998. For example, FAA completed construction of an air navigation facility in 1995 at a cost of $746,000. As of December 31, 1998, the facility remained in the work-in-process account. This backlog not only results in the improper classification of amounts in the property accounts, but also results in an understatement of annual operating costs, associated with the use of property, on the Statement of Net Cost.

New Financial Statements

The Office of Management and Budget required Federal agencies to prepare additional financial statements for the first time in FY 1998, including the Statement of Net Cost, Statement of Budgetary Resources, and Statement of Financing. The Statement of Net Cost should report the true cost to operate major government programs. FAA identified six major programs. The presentation of the Statement of Net Cost was a giant step towards development of cost accounting information that relates to operational data supporting performance measures. However, because of delays in implementation, FAA was unable to prepare the Statement of Net Cost for FY 1998 from its cost accounting system. Instead, FAA used a combination of analyses of FY 1998 expense transactions and manual distributions of administrative overhead expenses. Although operating costs were distributed among the six lines of business, the statement did not present operating costs for major programs and activities within each line of business.

The Statement of Net Cost included an accumulation of expenses for each line of business using an analysis of over one million expense transactions charged to about 9,000 cost centers by the FAA cost accounting system, which was still under development. Administrative overhead expenses were manually distributed to the six lines of business. After we questioned the basis for distribution of these costs, FAA manually re-distributed nearly $1.3 billion, increasing costs for Air Traffic Services and reducing costs for the five other lines of business by $647 million. Consequently, we did not determine if expense transactions were charged to correct cost centers, and whether total expenses charged to cost centers were accurately accumulated.

The Statement of Budgetary Resources shows the amount of resources provided and the status of those resources. We were unable to trace the amounts on the Statement of Budgetary Resources to FAA's accounting system because the accounting system does not have all general ledger accounts required by the Department of Treasury. As a result, we were not able to substantiate material items, such as Unobligated Balance of $7.2 billion. This amount represents total budget authority carried forward from prior years which had not been used. Supporting documentation for this could date back for years.

The Statement of Financing is a reconciliation of the budgetary information in the Statement of Budgetary Resources and the financial information in the Statement of Net Cost. There was an $877 million unreconciled difference between the Statement of Budgetary Resources and the Statement of Net Cost.

The problems we encountered with the new statements point out the need for better accounting practices and for developing state-of-the-art financial systems.

Cost Accounting System

The Federal Aviation Reauthorization Act of 1996 required FAA to establish a cost accounting system, and gave FAA the authority to collect user fees for flights that neither take off nor land in the United States, referred to as overflights. FAA immediately began development of its cost accounting system. Although the cost accounting system was not developed or implemented during FY 1997, FAA began collecting for overflight services. The airline industry challenged the user fee in court. On January 30, 1998, a Federal court ruled that (1) FAA's methodology for calculating overflight fees, which was developed independently from the cost accounting system, was not cost based, and (2) FAA's allocation of fixed and common costs, using a value-oriented methodology, violated the Act. The Federal court voided FAA's overflight fee schedule in its entirety. This action required FAA to accelerate the development and implementation of its cost accounting system.

We reviewed the FAA cost accounting system during its first phase of development. On August 10, 1998, our report identified four areas, potentially involving billions of dollars, that FAA needed to address before its cost accounting system would accurately account for FAA's full cost of operations. FAA had not established a systematic method to identify and reflect (1) the cost of accounting adjustments, (2) cost for all development projects, (3) cost incurred by other agencies for air traffic services, and (4) the correct labor cost charged to appropriate projects. FAA also had not decided how to allocate its costs.

FAA initially planned for its cost accounting system to be fully implemented by October 1, 1998. We found this schedule was overly aggressive, contained conflicting tasks, and omitted responsibilities and resource needs. During our audit, FAA revised its implementation plan into two stages; an initial operational cost accounting system by December 31, 1998, and a fully operational system by March 31, 1999. We reported this timeframe was very ambitious and recommended FAA revise its milestones.

In January 1999, FAA acknowledged its existing implementation schedule was unattainable. The current plan reflects a phased implementation of the cost accounting system, with the segment of Air Traffic Services supporting overflight user fees to be implemented by June 1999, the rest of Air Traffic Services by December 1999, and a fully operational cost accounting system for the entire agency by the end of FY 2001.

While many decisions need to be made regarding the future funding of FAA, user fees may be a major source. FAA has proposed in its FY 2000 budget to collect $1.5 billion in user fees, and proposes ultimately to be primarily funded by user fees. Regardless of funding sources, FAA needs an accurate and reliable cost accounting system for management information and performance measurement purposes.

Challenges Facing FAA

To correct the material weaknesses, FAA must obtain support for the acquisition value of about $12 billion of property and equipment. Since records are not centrally located, the retrieval of this information is a massive undertaking. For real property, FAA is using a model to support the value for over 700 older buildings and structures, and obtaining contracts, purchase orders, and invoices to support current costs. FAA is analyzing major system equipment costs to allocate these costs to individual assets in its personal property records. For work-in-progress, FAA is developing central files to document costs, and also is accelerating the transfer of over $1 billion for 16,000 job orders associated with completed projects that are still in the work-in-process account.

FAA needs to develop alternative means to prepare its financial statements, until DOT's new accounting system and FAA's cost accounting system are completed. Consequently, FAA must look to short-term solutions for preparing its financial statements because the Department's new accounting system will not be operational until June 2001 and FAA's cost accounting system will not be fully implemented until the end of FY 2001.

Finally, as FAA moves into the next millenium, it needs to develop accurate and reliable information to report on the efficiency and effectiveness of its operations. To comply with the Government Performance and Results Act, FAA must be able to link cost accounting information to performance measures, provide information on the cost effectiveness of its major programs, and ensure that performance measures are based on current performance and financial data.

In conclusion, we are working closely with the FAA Administrator and the Department's Chief Financial Officer to resolve these financial issues. All FAA and DOT officials have been extremely cooperative. We will continue to monitor the issues discussed in this statement, and advise the FAA Administrator and the Department's Chief Financial Officer of progress and problems.

Mr. Chairman, this concludes our statement. I would be pleased to answer any questions.