

GAO

## Testimony

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

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For Release on Delivery  
Expected at  
2 p.m.  
Thursday,  
March 18, 1999

# FEDERAL AVIATION ADMINISTRATION

## Financial Management Issues

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss financial management issues at the Federal Aviation Administration (FAA). In January 1999, we designated FAA financial management as a high-risk area because of serious and long-standing accounting and financial reporting weaknesses. These weaknesses render FAA vulnerable to waste, fraud, and abuse; undermine its ability to manage operations; and limit the reliability of financial information provided to the Congress. Beginning with fiscal year 1994, the Department of Transportation's Office of the Inspector General (OIG) has audited FAA's financial statements and has consistently been unable to determine whether the financial information is reliable. This pattern of negative financial audit results continues today with the OIG's recent financial audit report--a disclaimer of opinion<sup>1</sup>--on FAA's fiscal year 1998 financial statements.<sup>2</sup> The OIG was unable to substantiate billions of dollars in major assets, or determine the accuracy of the reported \$9 billion of costs for FAA's programs.

My testimony today will

- provide a brief history of FAA's financial management weaknesses,
- discuss the identified fundamental problems which FAA must resolve in order to achieve financial accountability, and
- highlight corrective measures the agency has under way.

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## History of Financial Management Weaknesses

Beginning with fiscal year 1994, the first year that the OIG performed an audit of FAA's financial statements, significant problems with FAA's accounting for billions of dollars of inventory and property, plant, and equipment (PP&E) were disclosed, including the agency's failure to properly capitalize the costs of major assets. Because of the pervasive uncertainties surrounding these major assets, the OIG could not determine the reliability of the fiscal year 1994 financial statements and issued a

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<sup>1</sup>A disclaimer of opinion means that the auditor is unable to form an opinion on the financial statements. A disclaimer results when a pervasive material uncertainty exists, or there is a significant restriction on the scope of the audit.

<sup>2</sup>Report on Fiscal Year 1998 Financial Statements, Federal Aviation Administration, Department of Transportation Office of Inspector General, (FE-1999-070) dated March 8, 1999.

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disclaimer of opinion on those statements.<sup>3</sup> Similar results occurred for fiscal years 1995 through 1997.

Again in fiscal year 1998, the IG was unable to express an opinion on the reliability of FAA's financial statements, citing as a primary reason the inability to verify PP&E reported at a cost of \$11.9 billion. The OIG reported, as it had for fiscal year 1994, that PP&E was significantly understated due to FAA's improper expensing of capital assets. Additionally, the OIG reported other significant accounting and reporting issues related to the reliability of FAA's financial statements and the records that support those statements.

We have previously reported that problems in accounting for PP&E and inventory affect FAA's ability to efficiently and effectively manage programs that use these assets and expose the agency to waste, fraud, and abuse.<sup>4</sup> Recently, we reported that FAA needs to improve its accountability over its field spares inventory.<sup>5</sup>

Many problems in the PP&E and inventory accounts result from the lack of a reliable system for accumulating project cost accounting information. The lack of cost accounting information limits FAA's ability to make effective decisions about resource needs and adequately control major projects, such as its multibillion-dollar air traffic control (ATC) modernization program. This mission-critical capital investment program, aimed at modernizing FAA's aging ATC infrastructure, was begun in 1981 to combat the strain on the current ATC system, which has experienced sustained growth and aging equipment.

The modernization program currently consists of over 200 separate projects estimated to cost over \$42 billion through fiscal year 2004. It includes acquisition of new radar and automated data processing, navigation, and communications equipment, as well as new computer software, facilities, and support equipment. As these items are placed in

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<sup>3</sup>The OIG report specifically disclaimed on the Statement of Financial Position and stated that its audit work was limited to that statement because the balances for inventory and PP&E could not be validated, and those balances materially affected the other statements presented.

<sup>4</sup>Financial Management: Federal Aviation Administration Lacked Accountability for Major Assets (GAO/AIMD-98-62, February 18, 1998).

<sup>5</sup>Financial Management: Briefing on the Federal Aviation Administration's Inventory Accountability (GAO/AIMD-99-98R, March 3, 1999).

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service, FAA is required to capitalize them and report them as property and equipment assets in its financial statements. However, as the OIG reports have shown, FAA for years has erroneously expensed many of these investments to current operations, thereby losing track of the specific cost of individual assets and the accumulated cost of major projects.

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## Fundamental Problems Need Resolution

Four fundamental problems must be resolved before FAA can achieve the most basic level of financial accountability.

- First, FAA must resolve the basic problems related to accounting for property, plant, and equipment, and institute systems, procedures, and controls to ensure that accountability is maintained on an ongoing basis.
- Second, FAA must complete its improvements to its inventory accounting system, particularly those related to field spares.
- Third, FAA must implement a cost accounting system capable of reliably accumulating full project cost information.
- And, finally, FAA must address its other financial reporting issues that preclude it from preparing meaningful financial statements.

I will now discuss each of these issues in a little more detail.

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## Property, Plant, and Equipment Accountability Is Deficient

During fiscal years 1982 through 1998, FAA spent approximately \$26 billion on capital improvement programs; however, as of September 30, 1998, the agency had reported less than \$12 billion in gross property, plant, and equipment asset costs—a difference of \$14 billion. Although some portion of the \$14 billion was undoubtedly properly charged to expense accounts, a significant portion was improperly expensed. Since fiscal year 1994, the IG has consistently reported that assets are being inappropriately expensed or otherwise unaccounted for.<sup>6</sup> During the audit of the fiscal year 1998 financial statements, the OIG specifically identified \$1 billion in assets that were not recorded on the balance sheet. More recently the IG testified that

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<sup>6</sup>Some of these capital improvement program costs relate to terminated or cancelled programs that should not currently be reported as assets. However, because the costs related to these programs were never fully captured, it is impossible to tell how much of the \$14 billion relates to terminated projects. Other costs relate to the acquisition of spare parts, which are reported in a different asset category—inventory—which totaled less than \$1 billion as of September 30, 1998. Further, some costs may be appropriate expenses because they are for services unrelated to property acquisition.

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the total understatement for all equipment “could be as much as \$10 billion.”<sup>7</sup>

The OIG’s audit report on the fiscal year 1998 financial statements identified numerous errors and weaknesses in FAA’s process for keeping track of amounts related to PP&E. Specifically, the OIG found that:

- The reported \$2.1 billion in the “work- in- process” account, which is supposed to be used to accumulate the costs of projects under development, could not be substantiated because FAA did not have an effective process to accumulate and document these costs, nor to eventually record them in the appropriate PP&E accounts. For example, FAA was unable to provide supporting documentation for 34 percent of the \$887 million in work-in-process items selected for testing, including a flight service station with recorded costs of \$1.2 million, of which FAA could only provide information for costs of \$123,000.
- The work-in-process account included an estimated \$1.3 billion that related to projects that had been completed for at least 6 months. These completed project costs should have been moved to the appropriate property and equipment accounts, with related depreciation expense being charged to operations. Unrecorded depreciation expense related to these projects amounted to at least \$62 million.
- Real property (land, buildings, and structures), reported at \$2.5 billion, included significant amounts of items that were not properly valued, or had no support for the values assigned. Additionally, a number of real property items were identified that were not recorded at all, while others that were recorded did not currently exist. For example, FAA was only able to provide supporting records for \$3.6 million of the \$20 million recorded for a power supply system installed in 1992. In another example, FAA’s records included \$1 million for a building that had been demolished over 10 years ago.
- Personal property (equipment), reported at \$4.1 billion, was understated by at least \$1 billion due to FAA’s long-standing practice of expensing rather than capitalizing material portions of major equipment systems. For example, voice switching control systems with an estimated cost of \$1.1 billion were recorded on the books at a total cost of \$234 million.

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<sup>7</sup>This statement was made by the Honorable Kenneth M. Mead, Inspector General of the U.S. Department of Transportation before the Subcommittee on Transportation and Related Agencies, House Committee on Appropriations, on March 9, 1999, in his testimony [Federal Aviation Administration: Financing and Cost Control](#).

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These deficiencies affect FAA's ability to properly manage these assets, thus giving rise to potential operational inefficiencies. For example, mission-critical equipment, such as radar and other air-traffic-control equipment, may be difficult to locate when needed, which could exacerbate an emergency situation. Also, asset theft could go undetected, and funds could be spent unnecessarily to acquire equipment that is already on hand. Problems in accounting for property and equipment also affect FAA's ability to properly maintain these assets, including estimating maintenance and deferred maintenance funding needs, and impair long-range planning for future facilities and equipment needs.

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## Inventory Accountability Has Improved But Uncertainties Remain

Problems similar to those just discussed for PP&E have also plagued FAA's inventory accounting, although the amounts involved have not been as significant. FAA inventory, reported at almost \$820 million as of September 30, 1998, primarily consists of spare parts located at the FAA Logistics Center in Oklahoma City and at about 34,000 field locations (referred to as field spares).

The Logistics Center is the central warehouse for operating materials and supplies and uses an automated inventory system, which continuously updates the reported quantities on hand as parts are received and issued to the field.<sup>8</sup> Although some ongoing minor issues remain, the accounting for inventory quantities on hand at the Logistics Center has improved significantly over the last year, and as of September 30, 1998, inventory quantities were reasonably stated in the accounting records.<sup>9</sup>

However, the accuracy of FAA's accounting for field spares quantities remains uncertain. Field spares are mission-critical parts that support the National Airspace System and are maintained at locations near the facilities they support. As of September 30, 1998, the reported value of field spares inventory was \$338 million. Based on our analysis of the OIG's field spares inventory workpapers, we were unable to satisfy ourselves about the accuracy of reported field spares inventory quantities. In addition, FAA did not have a reliable system in place to track and control field spares on a continuous basis. In its review of fiscal year 1998 field spares inventory,

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<sup>8</sup>This system, commonly referred to as a perpetual inventory system, updates inventory quantities at various points in time, depending on the situation at hand. Updates may be performed immediately, daily, or on some other periodic basis.

<sup>9</sup>Neither the OIG nor we validated the reported inventory values as of September 30, 1998.

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the OIG tested data for 14 sites with a recorded value of \$14 million, and found numerous errors in inventory recordkeeping. For example:

- At one site, FAA had not recorded \$106,000 of communication equipment spares for newly commissioned systems.
- At another site, 11 items valued at over \$39,000 that support new systems were not included in the records, while 21 items valued at about \$67,000 could not be located.
- At a third site, numerous errors resulting from inaccurate or incomplete recordkeeping totaled \$380,000.

The lack of physical controls over field spares increases the risk that theft or loss could go undetected. Additionally, inaccurate information about field spares could result in shortages of critical parts or unnecessary ordering of parts already on hand. The latter situation may lead to excess or obsolete stock requiring storage, control, and other activities that consume operating resources.

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## Cost Accounting Implementation Delays Have Pervasive Effects

The inadequacy of FAA's cost accounting system has been identified by GAO,<sup>10</sup> the OIG, and others as a weakness that prevents the agency from having reliable and timely information about the full cost of program activities. The objective of a cost accounting system is to provide this information by accumulating basic financial cost data, such as contractor invoices and agency labor and overhead costs, and allocating these costs, by category, to the applicable program activities. Although FAA originally expected that a cost accounting system would be fully implemented by October 1, 1998, this objective was not met. It subsequently revised this goal to implementation of a partially operational system by December 31, 1998, and a fully operational system by March 31, 1999. FAA now projects partial implementation in June 1999 and full systems implementation by March 31, 2001.<sup>11</sup>

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<sup>10</sup>Air Traffic Control: Improved Cost Information Needed to Make Billion Dollar Modernization Investment Decisions (GAO/AIMD-97-20, January 22, 1997).

<sup>11</sup>Statement of Federal Financial Accounting Standards No. 4, Managerial Cost Accounting Standards, (SFFAS No. 4), effective in fiscal year 1998, requires agencies to accumulate and report the full costs of their activities. FAA officials told us that the cost accounting system they are implementing goes well beyond the requirements of SFFAS No. 4 and that they believe they will be in compliance with SFFAS No. 4 for fiscal year 1999.



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The lack of reliable and timely information about the costs of program activities limits the ability of FAA management and other decisionmakers to use past costs to help estimate future costs in preparing and reviewing budgets, to control and reduce costs, and to identify and avoid waste. For example, without reliable cost information, FAA and other decisionmakers may not be able to effectively

- compare, during the budgeting process, expected costs with expected benefits, identify activities that add value, and make fully informed decisions about whether to expend resources for activities that are not cost effective;
- compare and identify the causes of cost changes over time;
- identify and reduce excess capacity costs (the cost to maintain a level of service that may not be needed), if any;
- choose among alternative actions such as whether to perform a project in-house or contract it out, to accept or reject a proposal, or to continue or eliminate a product or service; and
- compare costs of similar activities and find causes for cost differences, if any.

The lack of reliable cost information also limits the ability of FAA management and other decisionmakers to establish fees for services based on the cost of the services provided. The Federal Aviation Reauthorization Act of 1996 (Public Law 104-264) directed FAA to establish user fees not to exceed \$100 million for selected services, including aircraft overflight, and to directly relate these fees to the costs of providing the service rendered. A recent federal court decision, which resulted in FAA refunding \$12 million in fees already collected, reemphasized that these fees must be based on cost.<sup>12</sup>

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## Reporting Weaknesses Undermine the Usefulness of Financial Statements

Audited financial statements are designed to provide a public report of how taxpayer money provided to a given agency was spent. This information can then be linked with performance measures such that taxpayers can be apprised of what they received for their money. Further linkage of this information to budgetary accounts could also provide some level of assurance over the amounts reported in the budget as actual expenditures, which are considered in determining budgeted amounts for future years.

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<sup>12</sup>*Asiana Airlines, et al., Petitioners v. Federal Aviation Administration and Barry Valentine, Acting Administrator*, 134 F. 3d 393 (D.C. Cir. January 30, 1998).

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However, until basic accountability over the amounts reported in the financial statements is achieved, none of these benefits can be realized. FAA lacks this basic accountability.

In addition to the accounting and reporting weaknesses already discussed, the OIG's audit disclosed the following deficiencies in the fiscal year 1998 financial statements.

- The Statement of Net Cost<sup>13</sup> could not be substantiated because it could not be determined if expenses were charged to appropriate accounts, whether total expenses charged to the accounts were accurately accumulated, and whether administrative overhead expenses were accurately included.
- Material items included in the Statement of Budgetary Resources,<sup>14</sup> including the \$7.2 billion reported unobligated balance, could not be substantiated.
- A difference of \$877 million between the Statement of Budgetary Resources and the Statement of Net Cost could not be explained.
- FAA's accounting system was not able to generate the required financial statements, and the agency made 349 adjustments to its accounting records, totaling \$51 billion, in the process of manually preparing the statements.

These conditions, which are indicative of the inability of FAA's systems to support financial management and to efficiently prepare reliable, auditable financial statements, along with the other significant recordkeeping deficiencies discussed above, mean that FAA faces significant challenges in order to meet its goal of a clean audit opinion for fiscal year 1999.

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## Corrective Measures Are Under Way

FAA senior management has indicated that they recognize the urgency of correcting their financial management deficiencies and have recently taken steps to address them, including the following.

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<sup>13</sup>The Statement of Net Cost presents the cost of major lines of business, which are intended to relate to FAA's performance measures.

<sup>14</sup>The Statement of Budgetary Resources shows what budgetary resources were available to spend during the year, how much was spent, and how much remained obligated and unobligated at year-end.

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- A comprehensive effort is being undertaken to identify all major PP&E assets and to develop accurate, supportable historical cost information for those assets.
  - The agency is in the process of establishing a perpetual inventory system for its field spares and plans to conduct a 100 percent field spares physical inventory for fiscal year 1999.
  - Efforts continue to develop a cost accounting system that is capable of accumulating the full cost of program activities on a timely basis. As previously discussed, FAA expects to have this system partially in place in June 1999 with a fully operational system expected to be in place in 2001.

While these actions are a step in the right direction, FAA is still far from achieving financial accountability. Until the agency is able to correct its basic accounting deficiencies and produce a complete set of auditable financial statements, it will not fulfill its responsibility to the taxpaying public to be a responsible steward for the billions of dollars it is provided annually to carry out its mission.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions that you or the Members of the Subcommittee may have.

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