Office of Inspector General

Federal Aviation Administration
Fiscal Year 1996 Financial Statement

Report Number: R3-FA-7-004
Date Issued: March 27, 1997

Memorandum

U.S. Department of Transportation

Office of the Secretary of Transportation

Office of Inspector General

Subject: INFORMATION: Report 'on Federal Aviation Administration Fiscal Year 1996 Financial Statement Report Number R3-FA-7-004

Date: March 27, 1997

From: Joyce N. Fleischman
Acting Inspector General

Reply to Attn. of: JA-10:x605OO

To: The Secretary
Thru: The Deputy Secretary

As required by the Chief Financial Officers Act of 1990, I respectfully submit the Office of Inspector General (OIG) report on the Federal Aviation Administration (FAA) Financial Statement as of September 30, 1996. The Fiscal Year (FY) 1996 financial statement package includes the Management Overview, Principal Statements, related notes, and Supplemental Financial and Management Information.

The report on the FAA Financial Statement audit is the responsibility of the OIG. All other information in the financial statement package such as the Management Overview, Principal statements, related notes, and Supplemental Financial and Management Information are the responsibility of FAA. Our audit was limited to the Statement of Financial Position as of September 30, 1996.

If I can answer any questions or be of any further assistance, please call me on x61959 or Alexis M. Stefani on x60500.

Attachment

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U.S. Department of Transportation

Office of Inspector General

Federal Aviation Administration FY 1996 Financial Statement

Report Number R3-FA-7-004 ***March 27, 1997***

Objectives

The objectives for our audit of the Federal Aviation Administration's (FAA) Fiscal Year (FY) 1996 Financial Statement were to (1) determine whether the Statement of Financial Position presents fairly, in all material respects, the financial position of FAA in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01; (2) determine whether FAA has in place an internal accounting and administrative control structure that provides reasonable assurance of achieving established internal control objectives; (3) determine whether FAA has complied with the laws and regulations which (a) could have a direct and material effect on the financial statements or (b) have been specified by OMB; (4) assess whether the information and manner of presentation in the Overview and Supplemental Financial and Management Information sections of the financial statement package are materially consistent with the information in the Statement of Financial Position; and (5) assess control risk relative to the policies and procedures designed to provide reasonable assurance that FAA is achieving its internal accounting and administrative control objectives regarding the existence and completeness assertions for performance measures.

Conclusions

We were unable to express an opinion on the Statement of Financial Position because of six material internal control weaknesses and two reportable conditions. For Operating Materials and Supplies and Property and Equipment reported on the Statement of Financial Position at a total of $9.3 billion (representing 51 percent of FAA's total assets), there were inadequacies in supporting documentation and unreconciled discrepancies between general ledger balances maintained in the Departmental Accounting and Financial Information System and FAA's subsidiary records. In addition, equipment purchase transactions were inappropriately expensed and should have been capitalized. Furthermore, FAA did not have adequate controls in place to (a) ensure consistency between financial statements and budgetary reports in reporting budget execution results and (b) prevent recording of invalid liabilities.

SYNOPSIS

As a result of these documentation and capitalization problems, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the Statement of Financial Position as of September 30, 1996. Except for compliance issues discussed in the internal control deficiencies and the absence of performance measures, FAA complied in all material respects with laws and regulations directly affecting the Statement of Financial Position. Since we disclaimed an opinion on the Statement of Financial Position, we were unable to accomplish our fourth objective stated above.

Monetary Impact

Specific monetary savings were not identified for the material weaknesses and reportable conditions. However, correcting the internal control weaknesses will help ensure accuracy, timeliness, and reliability of FAA financial information.

Recommendations

We made recommendations to FAA to strengthen internal controls and establish the correctness of FAA financial statement balances for Operating Materials and Supplies, Capitalization of Equipment Purchase Costs, Property and Equipment, the Work-in-Process Account, Budget and Financial Statement Report Reconciliations, Accounts Payable Liabilities, Yearend Accrued Liabilities, and Capital Leases and Leasehold Improvements.

Management Position

FAA concurred with 34 of 35 recommendations and has initiated or plans corrective actions.

Office of Inspector General Comments

Corrective actions taken or planned are responsive to the 34 recommendations. We asked FAA to reconsider their position on their nonconcurrence with our recommendation to review prior transactions to identify equipment purchases that were improperly expensed.

SYNOPSIS

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To the Federal Aviation Administrator

The Department of Transportation (DOT), Office of Inspector General (OIG), has completed an audit of the Federal Aviation Administration (FAA) Statement of Financial Position as of September 30, 1996. The financial statement is the responsibility of FAA. As applicable to the FAA financial statement, we are also reporting on the associated internal control systems, compliance with applicable laws and regulations, and the existence and completeness of performance measures. The audit was performed in accordance with Government Auditing Standards as prescribed by the Comptroller General and the Office of Management and Budget (OMB) Bulletin 93-06, "Audit Requirements for Federal Financial Statements."

The audit objectives were to (1) determine whether the Statement of Financial Position presents fairly, in all material respects, the financial position of FAA in accordance with OMB Bulletin No. 94-01, (2) determine whether FAA has in place an internal accounting and administrative control structure that provides reasonable assurance of achieving established internal control objectives, (3) determine whether FAA has complied with the laws and regulations which (a) could have a direct and material effect on the financial statements or (b) have been specified by OMB, (4) assess whether the information and manner of presentation in the Overview and Supplemental Financial and Management Information sections of the financial statement package are materially consistent with the information in the Statement of Financial Position, and (5) assess control risk relative to the policies and procedures designed to provide reasonable assurance that FAA is achieving its internal accounting and administrative control objectives regarding the existence and completeness assertions for performance measures.

In March 1996, DOT requested a waiver from specific requirements of OMB Bulletin 94-01 regarding preparation of the Statement of Cash Flows and the Statement of Budgetary Resources and Actual Expenses. OMB approved the waiver and FAA did not prepare these two statements.

The financial statement audit process is intended to foster a collegial and cooperative working relationship between auditors and accounting personnel, and this was accomplished during the audit. Using the results of the audit fieldwork, FAA accounting personnel significantly enhanced the precision and comprehensiveness of the information reported in the Fiscal Year (FY) 1996 FAA Financial Statement. The resulting modifications incorporated into the final version of the financial statement include $8.2 billion in line item adjustments and $4.2 billion in line item reclassifications. We calculated the amounts for the line item adjustments and reclassifications using the value of only one side of each accounting adjustment, i.e., either debit or credit.

This report presents our disclaimer of opinion on the FAA Statement of Financial Position as of September 30, 1996. Since we disclaimed an opinion on the Statement of Financial Position, we were unable to accomplish our fourth objective stated above. In addition, we are including our reports on internal control structure and compliance with laws and regulations.

OPINION ON FINANCIAL STATEMENT

In accordance with the Chief Financial Officers (CFO) Act of 1990, as amended by the Government Management Reform Act of 1994, the OIG audited the FAA Statement of Financial Position as of September 30, 1996. The Statement of Financial Position is the responsibility of FAA. The OIG's responsibility is to express an opinion on the financial statement based on the audit.

The auditing standards under which we conducted our work require us to plan and perform the audit to obtain reasonable assurance whether the Statement of Financial Position is free of material misstatements. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. Our audit also included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit was limited to the Statement of Financial Position due to our disclaimer of opinion on the FY 1995 Statement of Financial Position.

As required by OMB Bulletin 94-01, Note 1 to the Financial Statement describes the accounting policies used by FAA to prepare the financial statement. Those policies represent a comprehensive basis of accounting other than Generally Accepted Accounting Principles.

In our view, the audit work we performed provides a reasonable basis for our disclaimer of opinion. We were unable to validate Operating Materials and Supplies and Property and Equipment reported on the Statement of Financial Position at a total of $9.3 billion (representing 51 percent of FAA's total assets) due to inadequacies in supporting documentation and unreconciled discrepancies between general ledger balances maintained in the Departmental Accounting and Financial Information System (DAFIS) and FAA's subsidiary records. In addition, equipment purchase transactions were inappropriately expensed and should have been capitalized, causing assets to be understated and expenses to be overstated by at least $325 million. Furthermore, FAA did not have adequate controls in place to (a) ensure consistency between financial statements and budgetary reports in reporting budget execution results and (b) prevent recording of invalid liabilities.

A disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to form an opinion on the financial statements. A disclaimer of opinion states the auditor does not express an opinion on the financial statements. Accordingly, as a result of the documentation and capitalization problems noted above, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the Statement of Financial Position as of September 30, 1996.

CONSISTENCY OF OTHER INFORMATION

Our disclaimer of opinion on the Statement of Financial Position as of September 30, 1996, prevented us from accomplishing our fourth audit objective. We were unable to assess whether the information in the Overview and Supplemental Financial and Management Information sections of the financial statement package was materially consistent with the Statement of Financial Position.

REPORT ON INTERNAL CONTROL STRUCTURE

OMB guidance for implementing the audit provisions of the CFO Act requires the auditors to assess the reporting entity's internal control structure. FAA management is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control mechanisms, policies, and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that (1) transactions are properly recorded and accounted for, to permit the preparation of reliable financial

reports in accordance with applicable accounting policies; (2) funds, property, and other assets are safeguarded against unauthorized use, loss, or disposition; (3) transactions are executed in compliance with laws and regulations; and (4) data supporting reported performance measures are properly recorded.

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

The work we performed included obtaining an understanding of the significant internal control policies and procedures and assessing the level of control risk relevant to all significant activity cycles, classes of transactions, and/or account balances. For those significant internal control policies and procedures found to be properly designed and placed in operation, we performed sufficient tests to assess more fully whether the controls were effective and working as designed.

Some FAA internal controls are dependent on automated information systems processing. An independent contractor evaluated the effectiveness of the general controls of the financial systems at the Transportation Administrative Service Center Computer Center in Washington, D.C., Electronic Data Systems Corporation's computer facility located in Plano, Texas, FAA Headquarters Offices in Washington, D.C., and FAA's Mike Monroney Aeronautical Center in Oklahoma City, Oklahoma. The contractor's evaluation included (a) environmental security software controls, (b) operating system integrity controls, (c) physical security controls, (d) operating system change controls and maintenance, (e) reliability-availability-stability controls, and (f) enterprise-wide security. In addition, another independent contractor conducted a penetration evaluation of the effectiveness of network security controls over access to financial systems within the Integrated Telecommunications Network Environment in the Department of Transportation. The Department's Report to the President and Congress for FY 1996 under the Federal Managers' Financial Integrity Act reported a new material weakness relating to the lack of security controls over access to the Department's Intermodal Data Network.

In addition, we reviewed application controls in DAFIS and selected feeder systems. This evaluation included obtaining an understanding of the

significant internal control policies and procedures and assessing the adequacy of preventive, detective, and corrective controls over the input, processing, and output of authorized financial data reported to, and processed by, DAFIS and selected feeder systems. The feeder systems affecting the FY 1996 FAA Financial Statement were the Consolidated Uniform Payroll System, the Electronic Clearing House Operating System, and the DAFIS Online Transaction System. The review of application controls identified a material weakness in the completion of system change requests and a material nonconformance in the use of general ledger adjustments, which will be reported to the Secretary in the report on the FY 1996 Departmentwide Financial Statement Audit.

Our internal control testing identified eight deficiencies which we concluded should be considered "reportable conditions" under standards established by the General Accounting Office (GAO), the American Institute of Certified Public Accountants, and OMB Bulletin 93-06. Reportable conditions are matters coming to our attention involving significant deficiencies in the design or operation of the internal control structure which, in our judgment, could adversely affect the entity's ability to ensure the objectives of the internal control structure are being achieved. Furthermore, we concluded six of the eight deficiencies should also be considered “material weaknesses” under the standards referenced above. A material weakness is a reportable condition where the design or operation of one or more specific internal control mechanisms does not reduce to a relatively low level the risk of material errors or irregularities occurring and not being detected within a reasonable time by employees in the normal course of performing their assigned functions. However, the deficiencies do not meet the criteria under the Federal Managers' Financial Integrity Act for reporting to the President and Congress.

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

MATERIAL WEAKNESSES

A. Operating Materials and Supplies

Operating materials and supplies reported at $432 million were not adequately supported and could not be substantiated through audit testing. This occurred because physical inventories were not performed, adequate subsidiary records were not maintained, and the general ledger was not reconciled to subsidiary records. As a result, we were unable to validate the amount of operating materials and supplies on hand as of September 30, 1996.

Discussion

The Statement of Federal Financial Accounting Standard (SFFAS) Number 3, "Accounting for Inventory and Related Property," defines operating materials and supplies as ". . . tangible personal property to be consumed in normal operations. . . ." The standard requires operating materials and supplies to be valued on the basis of historical costs. SFFAS Number 3 further requires excess, obsolete, and unserviceable operating materials and supplies to be disclosed either as part of the operating materials and supplies line item on the face of the financial statements with separate disclosure in footnotes or shown as a separate line item on the face of the financial statement.

The FAA Logistics Center in Oklahoma City, Oklahoma, is the central storage facility for operating materials and supplies. The Logistics Center uses an automated inventory management system called the Logistics and Inventory System (LIS) for operating materials and supplies. The LIS is FAA's subsidiary record to the general ledger for operating materials and supplies account balances stored at the Logistics Center. In addition to operating materials and supplies stored at the Logistics Center, FAA has operating materials and supplies (field spares) located at approximately 34,000 sites throughout the United States. Field spares are not under the control of the Logistics Center.

Until January 3, 1996, the Logistics Center followed physical inventory procedures established in FAA Order 4633.1 which generally required periodic physical counts of inventory on a cyclical basis, assuring that all items are reviewed every 3 years. On January 3, 1996, the Logistics Center implemented the physical inventory requirements in Process Guide (PG) 4650.19. The revised physical inventory guide reduced the number of physical inventory

counts by permitting the use of statistical sampling. On December 2, 1996, the Department's CFO issued policy guidance on Inventory and Related Property which stated "Periodic physical counts of inventory and related materials should be performed on a cyclical basis, assuring all items are reviewed at least every three years." FAA Order 4250.9B, "Field Material Management and Control," requires annual inventory of controlled National Airspace System (NAS) spare parts and provides the criteria for defining NAS controlled spare parts. FAA Order 4250.9B also requires a biennial review of stocked items to determine whether any items should be deleted from stock.

Physical Inventories

FAA has not performed required physical inventories of operating materials and supplies at the Logistics Center and field facilities. Also, FAA physical inventory procedures do not require that all items be inventoried within a 3-year period as provided in Departmental inventory policy guidance. Finally, FAA has not implemented recommendations to address material weaknesses in physical inventory procedures identified in a prior OIG audit report.

FAA waived the physical inventory requirements included in FAA Order 4633.1 for FYs 1991, 1992, and 1993 because of implementation of the LIS and the transition to an automated warehouse. However, in October 1993, in support of our FY 1993 financial statement audit, the Logistic Center began counting all Facilities and Equipment (F&E) items. For FYs 1994 and 1995, FAA continued to count F&E items, but excluded common line items from the physical inventory counts. For these fiscal years, FAA counted less than 5 percent of the total line items. In FY 1996, the scope of physical inventories expanded to include common line items. A total of 4,249 line items were inventoried representing 7 percent of the total line items and 36 percent of the total recorded value. As a result, for FYs 1994 through 1996, FAA failed to meet the 3-year cycle for completing a physical inventory of Logistics Center operating materials and supplies.

We performed a physical inventory of operating materials and supplies at the Logistics Center using statistical sampling techniques. The results of the statistical sample showed, at a 95 percent confidence level, that 20.2 percent of the line items in the LIS have incorrect on-hand balances. In our opinion, this error rate exceeds the level

needed to provide reasonable assurance of the accuracy of the quantities recorded in the LIS.

FAA is not performing annual physical inventories of field spares located at an estimated 34,000 sites throughout the United States. FAA Order 4250.9B requires an annual inventory of controlled NAS spare parts. We visited the William J. Hughes Technical Center in Atlantic City, New Jersey, and 17 field sites within 3 FAA regions and found only 2 sites had completed a physical inventory since the initial inventory was completed in 1993. FAA provided information showing only 26 percent of the field spares were inventoried nationwide during FY 1996, further substantiating the lack of annual physical inventories. We performed limited physical inventories at the 18 sites and concluded the LIS did not provide an accurate accounting for field spares on hand. We found a 27 percent error rate on the 394 items we inventoried.

Also, FAA physical inventory procedures described in PG 4650.19 are not consistent with DOT policy guidance. DOT policy guidance on inventory and related property issued on December 2, 1996, states "Periodic physical counts of inventory and related materials should be performed on a cyclical basis, assuring that all items are reviewed at least every three years." FAA physical inventory procedures in PG 4650.19 provide statistical sampling on an annual basis, a 2-year basis or a 3-year basis depending on the category of items (i.e. Facilities and Equipment, Exchange and Repair, and Expendable). The process guide also states inventory of expendable items (under $500 unit price) with an annual demand dollar value less than $500 are to be performed as "scheduled inventory."[1] In addition, there are an estimated 13,500 line items stocked at the Logistics Center which are not subject to physical inventory. These items are categorized as "direct ship" items.

Finally, FAA has not fully implemented recommendations made to correct weaknesses found in Logistics Center physical inventory procedures. In November 1993, we observed the physical inventory process and identified significant issues associated with inventory

[1]A scheduled inventory is defined as an inventory requested by an inventory management specialist when an expendable item under $500 unit price with an annual demand dollar value less than $500 reaches the insurance stock level, zero quantity on hand or a refusal is received. In October 1996, these items represented an estimated 35,000 line items valued at about $50 million.

procedures and reported the area as a material weakness in Report No. AD-FA-5-005, "Supplementary Report on Internal Control Systems and Compliance Related to the Airport & Airway Trust Fund Portion of FAA's FY 1993 Financial Statement." We followed up on these recommendations and found limited action had been taken on physical inventory recommendations made in this report.

In the report, we expressed concern for extensive recounts and adjustments, lack of separation of duties among counters, and unlimited "third count" updates. We continue to have concern with these issues as a result of our 1996 monitoring of physical inventories at the Logistics Center and additional followup action we took to determine the FAA's efforts on the five recommendations made in the 1995 report.

The new physical inventory procedures, implemented in January 1996, were not revised to limit the number of counts taken to three and did not require the posting of adjustments to the subsidiary record upon completion of the third count. We also determined inventories taken on three lots (a group/division of line items to be inventoried) in FY 1996 took between 2 and 6 months. The new procedures do not specify a reasonable period for making physical counts and posting adjustments nor minimize the use of transaction tapes used to account for receipts and issues during inventory counts. We also observed a continued problem with separation of duties as counters had access to recorded inventory balances. FAA has not modified the subsidiary ledger to permit no more than three counts before a final count is recorded and proper accounting adjustments are made.

Subsidiary Records

FAA did not maintain adequate subsidiary records to identify all operating materials and supplies at historical cost. We found 48.4 percent of the Logistics Center items sampled did not have any documentation (purchase order, invoice, contract) to support unit prices recorded in the LIS. Using prices recorded in the LIS we project, at a 95 percent confidence level, that $286.3 million of the $591.6 million[2] recorded in the LIS is unsupported. Our analysis of

[2]For financial statement purposes, FAA devalued the $591.6 million to $432 million primarily to account for operating materials and supplies in need of repair.

the 181 unsupported sample line items showed the last receipt date recorded in LIS for 158 line items (87 percent) was October 1988. The October 1988 date was used for all items with last receipt date prior to October 1988.

In conjunction with substantive testing for price support, we identified other internal control issues which further question the $591.6 million recorded in LIS as of September 30, 1996. These issues include:

- Price support documentation did not match LIS prices. In addition to the 48.4 percent of the line items sampled that did not have price support, we projected another 24.4 percent of the line items did not have pricing support that matched the unit prices in LIS.

- FAA inventory managers can override and set their own line item unit prices. As part of the Logistics Center quarterly price review, standard unit prices are mechanically reviewed and validated based on receipt transactions of the previous quarter. The inventory managers may, based on their review of the transactions, find the price change unjustifiable and override a price change.

- The Logistics Center used purchase orders to determine unit price instead of the invoice price. The use of purchase orders to compute unit prices does not reflect historical cost as defined in SFFAS Number 3. According to the standard, historical cost is to include all purchase and production costs incurred to bring the items to their current condition and location.

- FAA used various methods to price items which may not represent the actual cost of the item. For example, the methodology used to recompute standard costs for exchange and repair items that can no longer be purchased and are repaired by FAA for other Government agencies does not limit the standard cost to the repair cost (materials, labor, and overhead) of the item plus the cost of the core of the item. The pricing methodology in some cases increased unit prices over 400 percent. An FAA Logistics Center representative stated that the increased unit prices were used as an incentive for other Government agencies to return the cores to FAA.

- FAA did not provide documentation showing items sampled at the Logistics Center were screened for excess, obsolete, or unserviceable items. For example, 77 of 181 unsupported line

items in our sample had no demand history. FAA received 51 of the 77 line items prior to October 1988. The 51 line items totaled $3.8 million or about 15 percent of the value of our sample. We also identified during our field spares testing an exchange and repair item with a unit price of $33,705, which according to the item manager, is part of a system being decommissioned. The item manager further explained that only two of these systems remain active. However, the Logistics Center had an on-hand quantity of 106 of the exchange and repair items totaling $3.6 million as of September 30, 1996. In our opinion, some of the 106 items have the potential to be excess to FAA needs and should be devalued and placed in the disposal process. According to FAA Order 4250.9B, when a stocked recurring item fails to have sufficient usage after 4 successive years, the item is to be removed from stock and disposed and managed as a nonstocked item.

FAA could not rely on subsidiary records to report an amount for field spares on the September 30, 1996, Statement of Financial Position. Operating materials and supplies located at FAA field sites could be a material amount. The subsidiary record for field spares at September 30, 1996, showed a field spares balance of $245.3 million.[3] However, the LIS does not provide full financial disclosure of the cost of field spares. The LIS is an automated system used by the Logistics Center to manage items for which supply support responsibility has been assigned, arranged, and/or accepted by the Logistics Center. The LIS does not include the cost of field spares which are not supported by the Logistics Center nor is it used as a perpetual inventory for field spares. Field spares not supported by the Logistics Center are generally procured through FAA Headquarters, FAA regional offices, or contractors. LIS also does not include consumable items procured through the Logistics Center if the unit cost is less than $1,000 and it is not considered critical. As a result, the amount of field spares may be understated.

Unreconciled Balances

[3]In note 8 to the financial statement, FAA acknowledges that previously the OIG had contended that expensing field spares as issued by the Logistics Center may result in an understatement of operating materials and supplies. FAA also states that items shipped to regional sites may also include components of work in process or completed property and equipment.

The September 30, 1996, general ledger account balances for operating materials and supplies held at the Logistics Center were $35 million less than the balance recorded in LIS. The $35 million pertained to the difference between the general ledger account balances maintained for general operations, aircraft parts, and facility components and the balances recorded in LIS. FAA did not reconcile the general ledger and subsidiary records to account for the differences.

Recommendations

We recommend that FAA:

1. Perform a one-time wall-to-wall physical inventory of Logistics Center operating materials and supplies.

2. Perform an annual physical inventory of field spares as required by FAA Order 4250.9B. Before initiating the physical inventory, develop a plan which details the procedures to be used and provide the plans to the OIG for review and comment.

3. Revise Process Guide 4650.19 to comply with DOT policy guidance on Inventory and Related Property requiring physical counts on all items at least every 3 years.

4. Implement physical inventory recommendations made in our supplementary report (AD-FA-5-005) to FAA's FY 1993 financial statement.

5. Record line item unit prices at historical cost and maintain invoices or other documentation to support price changes.

6. Identify excess, obsolete, and unserviceable items in Logistics Center and field inventories and promptly initiate disposal action.

7. Establish subsidiary records to account for operating materials and supplies (field spares) and ensure the recorded balances are disclosed in the Statement of Financial Position in compliance with reporting requirements in SFFAS Number 3.

8. Reconcile general ledger account balances to subsidiary records and ensure an adequate audit trail is maintained supporting the reconciled balances.

Management Response

FAA concurred with the finding and recommendations. During FY 1997, FAA will perform a wall-to-wall physical inventory of Logistics Center operating materials and supplies representing 90 percent of the inventory value and 36 percent of the line items stored at the Logistics Center. The inventory will include a review for excess, obsolete, and unserviceable items. In addition, FAA is preparing a plan to perform a physical inventory of field spares, focusing primarily on high dollar value items and secondly on item count, as a means of establishing a baseline for future field spares inventories.

FAA will incorporate Departmental policy guidance in FAA Order 4633.1 to require all items be physically counted every 3 years. FAA Order 4633.1 also will be revised to include actions recommended in OIG Report No. AD-FA-5-005. The Logistics Center subsidiary records for operating materials and supplies will be modified to capture historical cost until a system is built to interface with DAFIS. FAA will rely on physical inventory results to account for operating materials and supplies stored at field locations, eliminating the need to establish subsidiary (perpetual) records for field spares. FAA will complete reconciliation of the general ledger balances to subsidiary records and adjust accounts by May 31, 1997.

Audit Comments

Actions planned by FAA meet the intent of our recommendations. However, we caution FAA on their decision not to establish perpetual records to account for field spares, but instead rely on annual physical inventories to determine yearend field spares balances. Since field spares could represent a significant portion of the total operating materials and supplies on hand, it will be crucial for the physical inventories to be completed accurately and at yearend.

B. Capitalization of Equipment Purchase Costs

FAA expensed equipment purchase costs for major system acquisitions which should have been capitalized. This occurred because procedures had not been implemented to ensure the proper classification and accounting of cost elements associated with equipment purchases. Also, key personnel involved in the acquisition and billing processes had not been trained on the proper procedures for expensing and capitalizing equipment purchase costs. As a result, Property and

Equipment on the Statement of Financial Position was understated by at least $325 million, with a corresponding overstatement of Operating Expenses on the Statement of Operations.

Discussion

SFFAS Number 6, "Accounting for Property, Plant, & Equipment," requires all costs incurred to bring property, plant, and equipment to a form and location suitable for its intended use to be capitalized rather than expensed. This standard defines property, plant, and equipment as a tangible asset with an estimated useful life of 2 years or more, not intended for sale in the ordinary course of operations, and acquired or constructed with the intention of being used.

FAA Order 2700.31, "Uniform Accounting System Operations Manual," requires all property, plant and equipment including land, structures and facilities, equipment, and related improvements that have a service life of 2 years or greater and an initial unit or item cost of $5,000 or more to be capitalized. Equipment costs not meeting this criteria should be expensed. The proper accounting of equipment purchases will become especially critical if user fees are established as an alternative source of funding for future FAA operations.

Our audit of the FY 1993 FAA Financial Statement reported $3 million in equipment purchase costs should have been capitalized but were instead expensed. In response to our audit, FAA agreed to train accounting personnel by March 1997 on the procedures for capitalizing/expensing equipment purchases. Similarly, our audits of FYs 1994 and 1995 FAA Financial Statements reported that FAA had expensed the full costs of acquiring major assets, rather than capitalizing the appropriate portions of those costs.

FAA hired a contractor to study their policy and procedures for capitalizing and expensing equipment purchases. The contractor concluded FAA improperly accounted for equipment purchase costs because (a) F&E procurement requests and contracts included contract line items with both capital and expense costs, and (b) inappropriate object class codes were included in accounting information. In September 1996, the contractor prepared draft operating procedures to address problems in capitalizing equipment purchases in FAA Headquarters. The draft procedures provide detailed guidance on structuring the procurement request and contract and processing

billing documents for payment to ensure equipment purchase costs were properly classified as either a capital asset or an expense.

FAA equipment is purchased primarily with F&E funding. During FYs 1995 and 1996, FAA charged $1.9 billion and $2.6 billion of F&E transactions to Operating Expenses on the Statement of Operations. An estimated $1.6 billion of the FY 1996 transactions represented payments to contractors under FAA contracts and reimbursements and advance payments to other Government agencies for equipment purchases.

We reviewed 137 purchases for equipment and related services totaling $473 million during FY 1996. We found that FAA expensed at least $325 million which should have been capitalized.

Equipment Purchases Under FAA Contracts

We reviewed a total of 104 contractor invoices totaling $314 million and found FAA expensed equipment costs on 96 invoices totaling $173 million which should have been capitalized**.** Eight invoices represented progress payments based on a percentage of contract completion. Progress payments should be charged to an advance payment account and reversed out when the items are delivered and services are completed. Three invoices represented common development costs under a technical support contract. Technical support costs incurred prior to completion of a project (installation of equipment) should be capitalized. We determined that the project had not been completed. The remaining 85 invoices represented contractor billings identified by contract line item. We reviewed the contract line item descriptions and concluded the costs charged to the expense account represented equipment purchase costs as well as costs incurred in bringing the equipment to a form suitable for its intended use. Therefore, these costs should have been capitalized. In addition, the accounting information for 95 of the 96 invoices cited an incorrect object class code.

Equipment Purchases Under Other Government Agency Contracts

We reviewed 33 billings totaling $159 million to reimburse or make advance payments for major system equipment costs under interagency agreements. We found FAA expensed equipment costs totaling $152 million on 31 billings which should have been capitalized. The other agencies agreed to provide FAA with project management, equipment design, equipment, site surveys, equipment

installation, training development, and spares. These costs clearly met the definition of costs to include in capitalizing equipment purchases. The accounting information for 11 of the 31 payments properly cited a capital object class code, but the 11 payments were still charged to the general ledger operating expense account. The other 20 payments were charged to the operating expense account because an expense object class code was inappropriately used in processing the payment.

Contractor's Recommendations

The contractor's recommendations included (a) posting all progress payments in an advance payment account and reversing the entry when the final payment is made, (b) creating a project cost system to accumulate common development costs, and (c) using only capital object class codes in the accounting citation for the contract line items to be capitalized. The contractor also recommended FAA revise Order 2700.31 to clearly identify which elements of F&E contract costs should be capitalized and which should be expensed. However, the contractor's recommendations did not specifically address procedures for processing payments under interagency agreements to ensure equipment costs were charged to the appropriate general ledger account. In addition, the operating procedures developed by the contractor had not been finalized, and key FAA personnel had not been trained on these new procedures.

Recommendations

We recommend that FAA:

1. Finalize and implement the contractor's recommendations on classifying and accounting for progress payments, common project costs, and contract line item numbers on FAA F&E contracts.

2. Include equipment purchased under interagency agreements in the procedures implemented under Recommendation 1.

3. Ensure that all key personnel receive training on the contractor's procedures for capitalizing equipment purchases.

4. Implement procedures to ensure purchase orders and contracts are structured to clearly identify and distinguish property and equipment, common costs, operating materials and supplies, field spares, and expenses. These procedures should also address purchases with contracts managed by other Government agencies through interagency agreements.

5. Review F&E transactions charged to Operating Expenses (about $4.5 billion) on the Statements of Operations for FYs 1995 and 1996 and capitalize the appropriate portion of the equipment purchase costs.

Management Response

FAA did not agree that at least $325 million should have been capitalized. FAA contends the amount is significantly less and states that only $14,626,885 of a total $172,637,026 in equipment purchases under FAA contracts was in fact misclassified. Therefore, FAA recommends the finding be considered a reportable condition and not a material weakness.

FAA agreed that equipment purchase costs were expensed which should have been capitalized and concurred with the first four recommendations. FAA is in the process of completing a corrective action plan to implement recommendations contained in the contractor's report. Corrective action on these recommendations are scheduled for completion by September 30, 1997.

FAA nonconcurs with Recommendation 5 to review F&E transactions charged to Operating Expenses for FYs 1995 and 1996 and capitalize

the appropriate portion of the equipment purchase costs. FAA contends the resource expenditure required to complete this recommendation cannot be justified.

Audit Comments

We reaffirm our position that equipment purchase costs totaling at least $325 million were incorrectly expensed. As previously stated, most F&E funds are used to purchase equipment and FAA charged $2.6 billion in F&E transactions to Program or Operating Expenses on the Statement of Operations for the period ended September 30, 1996. We reviewed transactions totaling $473 million and concluded at least $325 million (69 percent) should have been capitalized.

Audit materiality for the FY 1996 FAA Financial Statement is $100 million. FAA contends that approximately $158 million out of the $325 million we cite was not improperly charged to operating expenses. This leaves a balance of $167 million. This amount is in excess of the audit materiality amount. Therefore, we stand by our conclusion that FAA has a material weakness.

We recognize that Recommendation 5 is difficult to implement. Therefore, we are requesting that FAA identify alternative approaches to determine the appropriate amount of transactions initially charged to expense that need to be adjusted and properly capitalized.

C. Property and Equipment

Real and personal property reported at $5.14 billion were not adequately supported and could not be substantiated through audit testing. This occurred primarily because subsidiary records were inaccurate, record reconciliations were not done, and adequate documentation was not maintained to support the subsidiary records. As a result, we were unable to validate the amount of property and equipment reported as of September 30, 1996. In addition, this finding also impacts the amount reported by FAA for invested capital on its Statement of Financial Position.

Discussion

The CFO Act of 1990 along with OMB Circular A-127, "Financial Management Systems," require agencies to develop and maintain financial management systems that provide complete, reliable, consistent, and timely information. This requirement is further emphasized in Statement of Federal Financial Accounting Concepts Number 1, "Objectives of Federal Financial Reporting." SFFAS Number 6, "Accounting for Property, Plant, and Equipment," requires that all property, plant, and equipment be recorded at cost. Cost is defined as all expenses associated with bringing property, plant, and equipment to a form and location suitable for its intended use.

FAA Order 2700.31, Section 2, Paragraph 187 states, "Property records must agree with financial accountability records maintained by the accounting offices." Furthermore, the order requires (a) the official property report to be reconciled quarterly to the general ledger accounts, (b) systematic physical inventories be conducted by regional offices, and (c) accounting managers to certify that the dollar amount applicable to owned real property agrees with the real property account balances reflected on the post-closing general ledger trial balance as of September 30. By following these requirements, FAA can better maintain the integrity of financial reporting and increase its ability to detect and correct errors or irregularities in a timely fashion.

The majority of FAA's personal property is acquired with funds from the F&E appropriation. FAA Order 4650.7A, "Management of NAS F&E Project Materiel," prescribes policy and assigns responsibilities for the management of NAS F&E projects. Regional F&E project materiel managers are responsible for closing NAS F&E projects, normally within 150 days from the date of final completion. They determine property that should be transferred to the Personal Property In-Use Management System (PPIMS) as personal property or Real Property Record system as real property, and other materiel that should be expensed. Project materiel managers also provide responsible personnel with a copy of the project closeout package for inclusion in the facility's Facility Reference Data File, and send the capitalization package to the accounting office to initiate financial capitalization efforts.

The reported amount on the FAA financial statement for the period ended September 30, 1996, for the line item "Property and Equipment" is $8.8 billion. This line item is primarily composed of $1.98 billion for

real property, $3.16 billion for personal property, and $3.3 billion for work in process.

FAA Real Property

Real property subsidiary records contained errors and omissions which, based upon the results of our statistical sample, indicate the value of real property recorded in the subsidiary records is materially overstated. The errors and omissions included unrecorded property dispositions and improperly valued items. In addition, 4 of 11 FAA reporting units had not reconciled the DAFIS general ledger real property account balance to the subsidiary property records. We attribute these conditions to the lack of controls and adequate resources to assure that subsidiary records are complete and accurate and FAA not fully implementing previously agreed upon OIG recommendations concerning reconciliation procedures.

To determine the accuracy of the subsidiary records supporting real property general ledger account balances, we selected a statistical sample of 277 real property items recorded at $599,878,117 to perform detailed tests. These tests were designed to determine whether each of the 277 property items selected actually existed, was owned by FAA, and was properly valued. To determine the completeness of the subsidiary records, we performed additional tests at the field sites selected to determine whether real property was properly recorded and valued.

From the statistical sample, we found seven property items that should have been removed from the property records because they had been disposed, destroyed, or physically removed from the site. Also, available documentation did not support the value assigned to four items in the subsidiary records. Based on the results of our statistical sample we were able to project, with 95 percent confidence, that the value of real property recorded in the subsidiary records is overstated by about $198 million. This overstatement represents the difference between $1.891 billion from FAA's real property subsidiary records and our statistically projected best estimate of $1.693 billion.

Further, at sites visited, we identified 32 items of real property valued at $11.9 million that were not included in the subsidiary records. We also found an additional 42 property items valued at $1.2 million not included in our statistical sample that should have been removed from

the property records. At the Aeronautical Center, $6.4 million of leasehold improvements are not included in the property records or supported by adequate documentation.

To ensure the accuracy of property records, FAA procedures include performing timely physical inventories. Properly implemented, these procedures should have disclosed the types of problems we observed and permitted timely adjustment of the subsidiary real property records. However, FAA has not assigned a sufficiently high priority to real property accountability to assure a proper level of accountability.

FAA's failure to reconcile the DAFIS general ledger to the subsidiary records has been reported as a material control weakness in OIG audit reports since FY 1994. In response, FAA agreed to complete a reconciliation of the general ledger and subsidiary records. FAA advised the OIG before the start of this year's audit that the agreed upon reconciliation would be completed. At 7 of 11 property reporting units, we found that the general ledger had been reconciled to the subsidiary records. At the remaining four locations, a reconciliation had not been performed and the cumulative variance at the end of FY 1996 totaled $82.1 million. In addition, we found FAA's Southern Region had not recorded any transactions in the subsidiary property record system since FY 1994.

Although FAA has made progress towards completing the reconciliation process, all units should routinely complete this effort to ensure the integrity of the real property accounting process. FAA personnel cited resource restrictions and higher priority work assignments as the primary reasons for not completing the reconciliation between DAFIS and the subsidiary records.

FAA Personal Property

Although PPIMS generally supported the balance recorded in the general ledger account, FAA did not maintain documentation to identify and support the cost of personal property reflected in PPIMS. These problems occurred because F&E Project Materiel Managers coded a significant percentage of property and equipment as "rolled-up facility equipment," and supporting documentation to identify the equipment and support the recorded amount was not routinely obtained or retained.

PPIMS maintains two distinct personal property files. First, all itemized property and associated components considered to be "facility equipment" are rolled up to the facility level.[4] Therefore, PPIMS only maintains the cumulative value of facility equipment (including installation charges). All other property is recorded on an individual line item accountable basis. Only $535 million of the $2.87 billion reported in PPIMS as of September 30, 1996, (19 percent) represented line item accountable property. The remaining amount was rolled-up facility equipment ($1.82 billion) and installation charges ($502 million). Project closeout files, to be maintained in the Facility Reference Data File, should identify and support the value of rolled-up facility equipment and installation charges.

We performed substantive testing at one location in eight FAA regions with a recorded amount of rolled-up facility equipment and installation charges of $189.9 million. We were testing to determine existence, value, and ownership of the property. At all eight locations, property and equipment represented as rolled-up facility equipment and installation charges could not be completely identified. Documentation to support the value of the facility equipment was not available at either the site or at the regional office.

For example, at the Leesburg ARTCC there were 16 "Facility Types" reflected in PPIMS with a value of $25 million. None of the 16 Facility Reference Data Files contained documentation to identify the property and equipment. When documentation was available elsewhere, it was often incomplete or inaccurate. For example, Logistics Division personnel in Eastern Region were able to provide us with documentation to support one facility type--the Traffic Management Unit at Leesburg. While PPIMS reflected $193,204 of facility equipment, the supporting documentation identified only $192,191 with the majority involving three computer workstations valued at $162,214. When we were unable to locate the workstations, Leesburg personnel provided us with an FAA Form 4650-12 "Materiel Requisition/Issue/Receipt" showing that the workstations were replaced in 1994.

An FAA contractor hired in FY 1996 reported PPIMS records do not contain details of facility equipment and concluded "Future

[4]A facility is generally a specific location and may be further defined as an organizational component and/or system at that location. For example, at the Leesburg Air Route Traffic Control Center, the host computer was identified as a facility.

identification of specific assets and system components will be almost impossible without automated details of installed equipment. A lack of automated records will inhibit any future efforts to record depreciation expense on fixed assets." The contractor made a number of recommendations to improve FAA's property system to meet its accounting needs. For example, the contractor recommended:

- PPIMS should be modified to record individual F&E systems separately and totally at their historical costs. These detailed records should be kept on PPMIS for as long as the facility is operational.

- FAA should adopt the use of a centralized catalogue system for in-use property cataloguing throughout the FAA. A central catalogue would result in a single National Stock Number (NSN) for any one item in the FAA's in-use property records, thus consolidating the multiple NSNs currently in use for the same equipment.

We concluded regional F&E Project Materiel Managers were not providing the documentation specified in FAA Order 4650.7A. Until adequate supporting documentation is available to identify and support the value of personal property, the OIG will not be able to evaluate FAA's assertions concerning existence, valuation and ownership. We agree with the contractor's recommendations. Recording major items of facility equipment as line item accountable equipment in PPIMS would facilitate identification of the property and equipment reported as facility equipment.

The deficiencies identified relating to the accuracy and completeness of subsidiary records, the statistically projected overstatement and the reconciliation problems constitute a material internal control weakness. Therefore, we conclude the property and equipment portion of the Statement of Financial Position does not fairly present the FAA's financial condition at September 30, 1996.

Invested Capital

The deficiencies previously described in accounting for FAA's Real and Personal Property and Operating Materials and Supplies have adversely impacted the accurate accounting of the Invested Capital line of the Net Position section. OMB Bulletin 94-01 defines Invested Capital as the net investment of the Government in the reporting entity, including the acquisition costs of capitalized fixed assets. Therefore, the Invested Capital line of the Net Position section of the Statement of Financial Position should agree with the total reported for Property and Equipment and Operating Materials and Supplies. However, FAA's Statement of Financial Position as of September 30, 1996, reported Property and Equipment and Operating Materials and Supplies at a total of $9.3 billion, while the Invested Capital line of the Net Position section was reported at $11.2 billion, or a $1.9 billion difference.

Recommendations

We recommend that FAA:

1. Conduct a physical inventory of all real property and adjust the subsidiary records and DAFIS accordingly.

2. Comply with FAA Order 2700.31 for the reconciliation of DAFIS real property accounts to the subsidiary records at each reporting unit.

3. Ensure subsidiary records are adjusted timely when real property is acquired, disposed, destroyed, or physically removed from the site.

4. Implement the contractor's recommendations associated with PPIMS.

5. Require Regional F&E Project Materiel Managers to furnish documentation necessary to adequately identify and support the value of personal property.

6. Notify all organizational components of the need to retain supporting documentation associated with personal property recorded in PPIMS and include it in the Facility Reference Data File.

7. Discontinue the practice of recording readily identifiable property and equipment (e.g., items with serial numbers) as facility equipment in PPIMS.

Management Response

FAA concurred with five recommendations and partially concurred with two recommendations. For real property, the Office of Acquisitions is implementing the Real Estate Management System to replace the Real Property Record system. FAA will develop a detailed plan for conducting an inventory of real property within 60 days after the issuance of the final audit report. Regional accounting records will be adjusted as the physical inventory is completed at each site. The Office of Financial Services will develop an automated process to reconcile DAFIS real property accounts with subsidiary records. Procedures will be developed to timely adjust records when real property is acquired, disposed, or physically removed.

In regard to personal property, FAA will stress to all organizations the importance of maintaining the Facility Reference Data File as well as the need to include closeout packages in the file. FAA proposed not to modify the old system but to add a historical file to the Regional Project Materiel Management System to ensure a complete audit trail for financial management purposes. All corrective actions are scheduled to be completed by September 30, 1997.

Audit Comments

Actions planned by FAA meet the intent of our recommendations. We will work with FAA in developing a detailed action plan for conducting an inventory of real property. We stress the importance of recording readily identifiable property and equipment as line item accountable personal property.

D. Work-In-Process (WIP) Account

FAA did not have adequate documentation to support the $2.7 billion balance reflected in the WIP general ledger account. FAA used a DAFIS-generated report designed to provide financial information on job orders as the subsidiary ledger for the WIP account. The DAFIS report was not adequate documentation. Additionally, FAA has not been able to reconcile the WIP general ledger account with the DAFIS report. Therefore, we were unable to perform appropriate audit tests

or apply other auditing techniques to evaluate FAA's assertions concerning the existence, value, and ownership of property and equipment in the WIP account. We have previously reported this problem as a material internal control weakness in audits of the FAA's FYs 1993, 1994, and 1995 financial statements.

Discussion

The CFO Act of 1990 and OMB Circular A-127 require agencies to develop and maintain financial management systems that provide complete, reliable, consistent, and timely information. This requirement is further emphasized in Statement of Federal Financial Accounting Concepts Number 1, "Objectives of Federal Financial Reporting."

FAA uses a job order system featuring a five-digit job order number assigned by regional personnel to control F&E job orders funded by F&E appropriations. An F&E project can include multiple F&E job orders. As costs are incurred for each job order, DAFIS captures the costs and accumulates them by type (labor, travel, material, overhead, and other costs) and asset category (land, buildings, other construction, facility equipment, or other equipment) and expenses. FAA regional personnel rely on a DAFIS-produced report, the 32-9F, "Report of Completed Job Orders, Work-in-Process, Accrued Cost, and Related Data by Status by Job Order Number (fiscal year, sequential number and system) by Asset," for financial management of the job orders. Except for expenses, all costs for F&E job orders are posted to the WIP general ledger account. After a job order is completed, costs associated with that job order are transferred to the appropriate asset account and in some instances may be expensed.

Our report on the audit of FAA's FY 1993 financial statement disclosed that the 32-9F report reflected a balance of $3.3 billion compared to the WIP account balance of $1.9 billion reported on the Statement of Financial Position. This large discrepancy existed in part because the 32-9F report (a) captures costs which are expensed and therefore are not posted to the WIP account and (b) contains cost information associated with completed job orders which have been transferred out of the WIP account. After excluding costs associated with expenses and completed job orders, FAA personnel were able to reduce the initial discrepancy of $1.4 billion to $387 million. However, FAA personnel could not determine the reasons the 32-9F report contained $387 million more than the WIP account.

During FYs 1994 and 1995, FAA personnel were not able to reconcile the 32-9F report with the WIP account because of resource constraints and complexity of the process. The inability of DAFIS to produce adequate supporting documentation constituted a material internal control weakness and adversely affected the OIG's ability to render an opinion on FAA's FYs 1994 and 1995 financial statements.

In FY 1996, FAA initiated actions to (a) refine the procedures for reconciling the 32-9F report with the WIP account, (b) develop an automated process to assist regional personnel with the reconciliation process, and (c) have a contractor perform a comprehensive review of FAA's policies, procedures, and practices associated with the WIP account.

During FY 1996, FAA Headquarters developed an automated process to facilitate the reconciliation process. The Southwest Region took the lead in trying to complete the reconciliation of the 32-9F report with the WIP account. As of July 31, 1996, the WIP account in Southwest Region reflected a balance of $503.5 million compared to a balance of $709.6 million in the 32-9F report, a difference of $206.1 million. The automated process identified expenses and rolled-up job orders totaling $118.6 million. In addition, the reconciliation program identified costs for "capitalized" projects (i.e., costs transferred out of the WIP account), reimbursable job orders which are not posted to WIP, and labor costs not yet charged to a specific job order (a total of $121.8 million). After considering these factors, the 32-9F report reflected a revised total of $469.2 million or $34.3 million less than the WIP account. Southwest Region personnel analyzed the $34.3 million and further reduced the difference to $12.3 million. They concluded the remaining difference of $12.3 million was attributed to DAFIS conversion problems. We agreed with the analysis and conclusion reached by Southwest Region personnel.

FAA Headquarters personnel used the automated process to analyze data in the 32-9F report for all nine regional offices. For August 1996, the 32-9F report had a balance of $4.4 billion compared to a balance of $3.3 billion in the WIP account. The balance in the August 1996 32-9F report, after using the automated process, was $2.78 billion or $520 million less than the WIP account. FAA Headquarters personnel also used the automated process to do the same analysis for September, October, and November 1996. The results of the analysis showed essentially the same result, that the 32-9F report reflected a balance which was over $500 million less than the WIP account. As

reflected above, FAA's 4-month review of output from the automated process showed the fluctuation of the balances has stabilized. FAA Headquarters personnel concluded the large discrepancy occurred as a result of DAFIS yearend job order rollup and closeout processes.

FAA's contractor reviewed policies, procedures, and practices associated with the WIP account and issued a draft report on October 15, 1996. The contractor reported that regional offices were not reconciling the WIP account with the 32-9F report because it was a labor-intensive manual process hampered by a shortage of accounting personnel and compounded by a large number of active job orders. The contractor further reported the WIP account contained unsubstantiated balances which occurred from the 1983 conversion from the Uniform Accounting System to DAFIS. The contractor recommended:

- Automating the reconciliation of the cumulative total of a region's 32-9F report with the WIP account.
- Performing the reconciliation on a quarterly basis.
- Researching, identifying, and eliminating differences carried forward from the 1983 conversion to DAFIS.

The lack of adequate documentation to support FAA's WIP account has been a long-standing problem. This occurred because the 32-9F report was designed to provide financial information on total costs associated with all F&E projects. The 32-9F report was not designed to serve as a subsidiary ledger for the WIP account. Since we first reported this problem in our audit of the FY 1993 financial statement, FAA has not demonstrated that the 32-9F report can provide adequate support for the WIP account. Until FAA can reconcile the 32-9F report with the WIP account, the OIG's ability to render an opinion on FAA's financial statement will be hampered. Due to the complexity and the labor intensive process of reconciling, FAA may need to explore alternatives for providing adequate support for the WIP account.

Recommendations

We recommend that FAA:

1. Implement the recommendations to improve the WIP process contained in the contractor's draft report.

2. Determine if the 32-9F report can be reconciled with the WIP account. If not, FAA should seek an alternative, such as, using DAFIS transactions posted to the WIP account to create a separate subsidiary ledger database.

Management Response

FAA concurred with the finding and recommendations. FAA is completing a corrective action plan to implement the recommendations in the contractor's report. The corrective action plan will include establishing a baseline, developing policies and procedures, enhancing the automated reconciliation process implemented in August 1996, capitalizing and closing job order numbers with expiring appropriations, and establishing oversight and performance metrics. By the end of FY 1997, to correct the WIP deficiencies, FAA will either create a separate subsidiary ledger database, prepare a DAFIS system change request to create a separate subsidiary ledger database, or develop a 32-9F subsidiary ledger database external to DAFIS.

Audit Comments

Actions planned by FAA meet the intent of our recommendations. However, we would appreciate being advised on the status of FAA's implementation of the contractor's recommendations and the alternative chosen as the subsidiary ledger database.

E. Budget and Financial Statement Report Reconciliation

FAA did not have adequate controls in place to (a) ensure consistency of Unexpended Appropriations reported on financial statements and related budgetary reports and (b) resolve discrepancies in key budgetary accounts. These discrepancies occurred because of the lack of a requirement to reconcile the budget execution results between budgetary and financial reports. As a result, the Unexpended Appropriation reported on the financial statement as of September 30, 1996, was $1.874 billion less than the unobligated authority and undelivered orders reported to OMB on the "Report on Budget Execution (SF-133)."

Discussion

The goal stated in both the CFO Act and OMB Circular A-127 is for agencies to develop and maintain financial management systems which provide complete, reliable, consistent, and timely information for management decisionmaking. OMB Bulletin 94-01 and its replacement 97-01, "Form and Content of Agency Financial Statements," require Unexpended Appropriations to represent undelivered orders and unobligated authority for the reporting entity's appropriation accounts. The OMB also requires agencies to report these balances on the SF-133 report based on general ledger accounts. As shown below, we found the "gross"[5] Unexpended Appropriation reported on the draft financial statement was $1.874 billion less than the unobligated authority and undelivered orders reported to OMB on the SF-133 for September 30, 1996.

	(Dollars in Thousands)		
	SF-133 Balance	F/S Balance	Discrepancy Amount
Unobligated Authority	$859,386	($3,173,125)	$4,032,511
Undelivered Orders	$4,712,056	*$6,870,613	($2,158,557)
Gross Unexpended Appropriation	$5,571,442	$3,697,488	$1,873,954

* Adjusted to include $1.8 billion of Future Funding Requirement for Grants obligation in excess of liquidating authority.

According to FAA management, balances reported on the SF-133 were closely monitored by accounting, budget, and program staff throughout the year. Therefore, FAA proposed to replace the Unexpended Appropriation balances on the draft financial statement with SF-133

[5]In compliance with Departmental guidance, FAA did not include the unobligated authority and all undelivered orders for the Airport Improvement Program in the Unexpended Appropriations line item for financial statement reporting. The portion of the obligations in excess of liquidating authority was reported as "Liabilities Not Covered by Budgetary Resources." The unobligated authority was included in note disclosure only. Therefore, all these balances had to be combined to form the "gross" Unexpended Appropriations which was then compared to the balances reported on SF-133 for unobligated authority and undelivered orders.

balances. While this adjustment would eliminate reporting a negative amount for unobligated authority in the financial statement, there is no assurance the adjusted balances would be accurate until the discrepancies are fully resolved.

We further verified whether both reported balances were supported by corresponding general ledger account balances--i.e., draft financial statement balances supported by proprietary accounts and SF-133 balances supported by budgetary accounts. Management made a significant amount of manual adjustments to the proprietary accounts for financial statement reporting. We concluded these adjustments were valid. The adjustments were primarily made to remove previous years' unfunded grant authority. In the budgetary accounts, however, we found abnormal balances (e.g., negative amount of unobligated authority for unexpired appropriations) and material discrepancies from what was reported to OMB on the SF-133 (see below).

	(Dollars in Thousands)		
	SF-133 Balance	G/L Balance	Discrepancy Amount
Unexpired Authority	N/A	($1,108,205)	N/A
Expired Authority	N/A	$9,952,553	N/A
Unobligated Authority	$859,386	$8,844,348	($7,984,962)
Undelivered Orders	$4,712,056	$5,228,354	($516,298)
Gross Unexpended Appropriation	$5,571,442	$14,072,702	($8,501,260)

These discrepancies occurred because of the lack of a requirement to reconcile the budget execution results between budgetary reports and financial reports. FAA management advised us that they are aware of the existence of incorrect balances in the budgetary accounts (e.g., the $9.9 billion unobligated authority recorded in expired appropriations) and the need to examine the processing used to record fund authority and usage transactions in DAFIS. However, they have not been able to allocate the resources needed to resolve the discrepancies.

Until these material discrepancies are resolved and corrective actions taken, management does not have adequate controls in place to ensure accurate accounting for budget execution results to OMB. Correcting this control deficiency is critical to the success of future financial statement audits because OMB is placing more emphasis on

Unexpended Appropriation. Currently, Federal agencies are required to report Unexpended Appropriation and four other net position line items on the financial statement. Under OMB Bulletin No. 97-01, effective FY 1998, the other four line items will be combined into one. Meanwhile, Unexpended Appropriation stays intact and will have to be reconciled to unobligated authority and undelivered orders.

Recommendations

We recommend that FAA:

1. Revise the processing used to record fund authority and usage transactions in DAFIS.

2. Establish procedures to ensure budget execution results reported on the monthly SF-133 are reconciled to both budgetary and proprietary account balances recorded in DAFIS.

3. Correct general ledger account balances in DAFIS for unobligated authority and undelivered orders.

4. Submit a revised SF-133 report, if needed, as a result of the reconciliation.

Management Response

FAA concurred with the finding and recommendations. The internal coordination processes for the SF-133 reports were reviewed and informal procedures were developed on March 10, 1997, to improve the preparation and submission of the reports. The general ledger balances for the proprietary and budgetary accounts for all FAA appropriations are currently being analyzed to determine amounts and causes of any imbalances. All adjustments will be completed to ensure the proper presentation of the FY 1997 financial statements. Not later than July 1, 1997, new procedures will be issued for the monthly reconciliation of unexpended appropriations with the SF-133 budgetary accounts, changes to the SF-133 process, and reconciliation of yearend reports. The regional accounting offices were instructed on March 6, 1997, to reconcile obligations with airports offices to ensure the budgetary data in DAFIS are accurate. All adjustments identified will be entered in DAFIS prior to preparation of the monthly SF-133s. Revised SF-133s will be submitted if necessary.

Audit Comments

Actions taken and planned by FAA meet the intent of our recommendations. However, we would appreciate being apprised of the results of the analysis of general ledger balances for the proprietary and budgetary accounts, including the amounts and causes of any imbalances, and any adjustments entered in DAFIS.

F. Accounts Payable Liabilities

About 50 percent of FAA's accounts payable liabilities included in the DAFIS subsidiary ledger file were not valid. This occurred because FAA (a) did not reduce the accounts payable liabilities when progress payments were made and (b) prematurely recorded accounts payable liabilities before goods and services were received. As a result, FAA overstated accounts payable and understated unexpended appropriation balances on the draft Statement of Financial Position by approximately $293 million. FAA subsequently adjusted the financial statement to correct the account balances.

Discussion

SFFAS Number 1, "Accounting for Selected Assets and Liabilities," requires agencies to recognize accounts payable liabilities only for ". . .goods and services received from, progress in contract performance made by, and rents due to other entities." Appendix A of this standard clearly distinguishes between recording obligations for budget purposes and recognizing a liability for financial accounting purposes. Under the standard, accounts payable liabilities are to be reduced by the amount of progress payments.

As of September 30, 1996, FAA had 83,755 accounts payable totaling $543 million in one of the key DAFIS subsidiary ledger files--the Open Document File (ODF). We selected a statistical sample of 217 valued at $243 million or 45 percent of the accounts payable recorded in ODF for testing and found $107.5 million were not properly recorded. However, we did not find any instances where this improper recording of accounts payable resulted in improper payments to vendors or other entities. Based on our sample results, we project with 95 percent confidence that FAA overstated its account payable liability by $293 million (plus or minus $43 million) on the draft Statement of Financial Position.

These accounts payable liabilities were improperly recorded for two reasons. First, FAA was not reducing the accounts payable balance by the amount of its progress payments. Of the $107.5 million of improperly recorded accounts payables included in our sample, $100 million resulted from the processing of progress payments made by FAA. According to FAA accounting personnel, they were using the transaction codes provided in the DAFIS User Guide to process progress payments. These transaction codes effectively recorded the accounts payable liability but did not reduce it when FAA made progress payments. Therefore, the full liability remained on the accounting records. When FAA accounting personnel discovered this processing error in 1996, they informed Oklahoma City DAFIS personnel. However, DAFIS personnel were not able to implement a new procedure using different transaction codes to properly process progress payments until after yearend.

Second, contrary to SFFAS Number 1, FAA was recording an accounts payable liability when only an obligation should have been recorded for budgetary purposes because goods and services had not been received. Of the $107.5 million of improperly recorded accounts payable included in our sample, $7.5 million resulted from this practice. The $7.5 million consists of $7 million in miscellaneous procurements and $.5 million in Permanent Change of Station (PCS) moves. This practice has been used for years because of the emphasis placed on budgetary accounting versus proprietary accounting in the Federal Government. FAA's accounting staff had not been adequately trained to differentiate between the recording of an obligation for budget purposes and recording a liability for financial accounting purposes. FAA's Headquarters staff was responsible for about $4.7 of the $7.5 million of improperly recorded accounts payable and the regional staffs were responsible for the remaining amount. Based on FAA's review of Headquarters records, FAA agreed the $4.5 million related to miscellaneous procurements were invalid and also requested the regions to conduct a similar review.

During the audit, FAA officials initiated aggressive corrective action to resolve these two areas. FAA accelerated its examination of procurement records and progress payments to purify the accounts payable liabilities included in the ODF. FAA reduced the accounts payable by $293 million and increased unexpended appropriations by $293 million on the financial statement.

We commend FAA on these aggressive corrective actions. However, problems of this nature would have been detected and corrected more timely if FAA had procedures and controls to better monitor its accounts payables. This monitoring can best be achieved through the production of management exception reports. For example, FAA does not currently require the periodic preparation and review of an aging accounts payable report. If such a report were prepared and reviewed, many of the problems associated with the recording of accounts payable would have been identified by FAA.

Recommendations

We recommend that FAA:

1. Continue its research of procurement records and progress payments and adjust the ODF records accordingly.

2. Provide detailed written instructions to accounting staff concerning the proper recording of accounts payable liabilities with emphasis on the receipt of goods and services.

3. Establish procedures and controls to better monitor the validity of accounts payables recorded in DAFIS such as the development and use of an aging report.

Management Response

FAA concurred with one recommendation and partially concurred with two recommendations. FAA personnel researched the 147 invalid items identified during the audit and concluded 56 items totaling $96.5 million have been deobligated or otherwise resolved subsequent to September 30, 1996, and 5 additional items totaling $5.3 million will be reversed. With respect to the progress payments totaling $96.3 million, FAA Headquarters identified the problems associated with the DAFIS transaction code early in 1996 and initiated a change in the transaction and financial activity codes associated with progress payments. Unfortunately, the changes were not effected until after the close of FY 1996. FAA considers PCS transactions as liabilities because the occurrence of a liability is eminent and is a material amount. By April 30, 1997, FAA will seek a DOT-wide policy on the proper accounting treatment of PCS transactions. By May 15, 1997, FAA will submit a DAFIS change request for the development of an on-line exception file on aged accounts payable documents.

Audit Comments

The actions taken and planned by FAA meet the intent of our recommendations.

REPORTABLE CONDITIONS

G. Yearend Accrued Liabilities

FAA has not established adequate procedures to accrue total liabilities for goods and services received at yearend. This occurred because FAA's new accrual procedure disregarded goods and services that had not been invoiced. As a result, FAA understated the Accounts Payable and overstated Unexpended Appropriation line items in the draft Statement of Financial Position by approximately $163 million. FAA subsequently adjusted the financial statement to include the $163 million.

Discussion

SFFAS Number 1 requires agencies to recognize a liability for the unpaid amount of the goods to which agencies have accepted title. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.

During the audit of the FY 1996 Financial Statements, FAA Headquarters accounting office implemented a new procedure to recognize a liability for the unpaid amount of goods and services recorded in Headquarters Invoice Tracking System. By using this procedure, FAA recorded $133 million of yearend accrued liabilities in the DAFIS Open Document File before yearend closing. This significantly improved the accuracy of FAA's financial statement reporting. However, our test for unrecorded liabilities indicated this process should be expanded to include an estimate for "uninvoiced" deliveries, as required by SFFAS Number 1.

Our test for unrecorded liabilities included disbursements of $937 million made in October and November 1996. We selected a statistical sample of $280 million of payments made during this time by FAA regions, two centers, and Headquarters Offices. We found $70 million of sampled payments were for uninvoiced goods/services delivered in FY 1996 but were not included in the $133 million accrual recorded by Headquarters. Based on these results, we project with

95 percent confidence that $296 million (plus or minus $63 million) of estimated liabilities and expenses should have been accrued by FAA for financial statement reporting. As a result, FAA understated the Accounts Payable and overstated Unexpended Appropriations line items by about $163 million ($296 million projected less $133 million already accrued by FAA) on the draft financial statements. FAA subsequently adjusted the financial statement to include the $163 million.

This occurred because FAA's new procedure was limited to using only unpaid invoices recorded in the Invoice Tracking System at yearend to develop the estimated accrual. This procedure failed to consider goods and services received but had not yet been invoiced. By not estimating for the uninvoiced services received, only part of the liability is being accrued.

Recommendation

We recommend FAA revise its procedures to include in the accrued liabilities amount an estimate for goods and services received but not invoiced by yearend.

Management Response

FAA concurred with the finding and recommendation. FAA will revise procedures to estimate the value of goods and services received for which no invoices have been rendered at fiscal yearend. Accounting offices will review October and November transactions to make a prior year projection of uninvoiced goods and services received. This will be implemented for FY 1997.

Audit Comments

Actions planned by FAA satisfy our recommendation and the recommendation is consider resolved.

H. Capital Leases and Leasehold Improvements

FAA did not adequately identify and account for capital leases and leasehold improvements and alterations. This occurred because FAA did not (a) issue procedures for identifying and accounting for capital leases or (b) implement the existing requirement for capitalizing leasehold improvements and alterations. As a result, assets under capital lease reported at $103.9 million may have been understated

and expenses may have been overstated by an unknown amount on the FY 1996 FAA Financial Statement.

Discussion

OMB Bulletin Number 94-01 and SFFAS Number 6 define capital leases as leases that transfer substantially all the benefits and risks of ownership to the lessee. A lease should be classified as a capital lease if, at its inception, one or more of the following four criteria is met.

- The lease transfers ownership of the property to the lessee by the end of the lease term.

- The lease contains an option to purchase the leased property at a bargain price.

- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.

- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

FAA Order 2700.31, Paragraph 103, requires the costs of improvements to be capitalized as leasehold improvements when (a) the estimated useful life is longer than a year and (b) the improvements are made to leased properties, or to properties occupied by FAA and owned by another Government agency.

In our Supplementary Report of Internal Control Systems and Compliance Related to the Airport & Airway Trust Fund Portion of FAA's FY 1993 Financial Statement (Report No. AD-FA-5-005), we found capital leases may have been inappropriately expensed. We recommended FAA (a) promptly advise all FAA accounting personnel of the criteria and procedures for capitalizing leases and (b) revise FAA Order 2700.31 to properly distinguish between capital and operating leases. FAA management agreed to advise accounting offices of the distinction between capital and operating leases and issue guidance on capitalizing leases by May 1995. In addition, FAA agreed to revise FAA Order 2700.31 by September 1995.

Capital Leases

We reviewed a total of 65 operating leases at FAA's Eastern Region, Central Region, and the Mike Monroney Aeronautical Center. We found 22 of 65 operating leases potentially met the criteria to be reported as capital leases. The 22 potential capital leases represented annual payments totaling $4,111,886. We were unable to determine whether the 22 leases were capital leases because the files did not include the estimated economic life or the fair value of the properties at the inception of the lease as required by SFFAS Number 6. If any of the 22 operating leases are capital leases, then assets and liabilities reported on the FY 1996 FAA Financial Statement will be understated and will not accurately reflect FAA's capital lease commitments.

In June 1995, FAA Headquarters issued a guidance memorandum to its field offices in response to our prior audit recommendations. In the memorandum, FAA identified the criteria for distinguishing capital leases from operating leases and stipulated that FAA Order 2700.31 would be updated to include this criteria. However, we found a revised order was never issued. Instead, we were informed by FAA officials that a contractor had been hired to complete the revision by September 1997. The contractor will include the criteria to distinguish between capital and operating leases and will also develop new procedures for reporting and accounting for capital leases.

Leasehold Improvements and Alterations

We found 7 of the 65 operating leases reviewed had a total of $597,969 in leasehold improvements and alterations that were not capitalized. We interviewed personnel in the Eastern and Central Regions and found FAA Order 2700.31 was not being followed. According to the regional officials, they were not aware of the capitalization requirement in the order. As a result, the proper capitalization of leasehold improvements and alterations was not possible, and FAA's operating expenses in their FY 1996 Financial Statement were overstated.

Actions Needed

Although FAA had promised to issue procedures on capitalizing leases by May 1995, we found procedures had not been issued and the identification of capital leases continued to be a problem. We also found leasehold improvements and alterations were not being capitalized properly. FAA should improve its identification, accounting for, and reporting of, capital leases as well as the capitalization of leasehold improvements and alterations. This will

ensure future financial statements more accurately reflect FAA's assets, liabilities, and expenses.

Recommendations

We recommend that FAA:

1. Promptly revise FAA Order 2700.31 to include procedures for identifying, accounting for, and reporting capital leases.

2. Determine fair value and economic life (at the time of inception) for the 22 potential capital leases included in our sample.

3. Determine if any existing leases should be classified as capital leases.

4. Develop a plan to ensure all future leases are properly evaluated and classified as either a capital lease or an operating lease at their inception.

5. Implement the existing requirement to ensure leasehold improvements and alterations are properly capitalized.

Management Response

FAA concurred with the finding and recommendations. FAA will revise FAA Order 2700.31. The regions will be instructed to document fair value and economic life for the 22 potential capital leases identified by the audit. Guidance will be provided to all regional real estate offices to ensure the proper identification of capital leases. The requirements of OMB Circulars A-11 and A-94 will be reinforced and any additional guidance needed will be provided. Additional guidance will be issued to reinforce the requirements for the capitalization of leasehold improvements. All corrective actions are scheduled to be completed by September 30, 1997.

Audit Comments

The actions taken and planned by FAA meet the intent of our recommendations. However, we are clarifying the scope of Recommendation 3 to determine if any leases, in addition to the 22 we identified, should be classified as capital leases.

REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

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

In order to obtain reasonable assurance on whether the FAA Statement of Financial Position is free of material misstatements, we tested compliance with the laws and regulations directly affecting the financial statement and certain other laws and regulations designated by OMB. Our objective was not to provide an opinion on overall compliance with these provisions.

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

We evaluated the existence and completeness assertions for the information presented in the Draft 1996 FAA Annual Report, and the consistency of this information with FAA's implementation efforts under the Government Performance and Results Act (GPRA). We concluded the information in Chapters 1 (Overview), 2 (Mission Performance Indicators), and 3 (FY 1996 Financial Highlights) of the Draft 1996 FAA Annual Report was not presented as performance measures, as described by the OMB Form and Content Bulletins, and was not consistent with FAA's GPRA implementation efforts.

FAA recognizes the need to integrate the GPRA performance measures into their annual report and will do so once the measures are refined and supported by auditable and verifiable data. We will work with FAA to ensure their performance measures accomplish the objectives of the GPRA. Therefore, we are not making any recommendations regarding the information presented as performance measures in the FY 1996 FAA Financial Statement at this time.

In addition, except for the noncompliances discussed in the Report on Internal Control Structure section of this report, FAA complied, in all material respects, with the provisions of the laws and regulations directly affecting the Statement of Financial Position as of September 30, 1996.

PRIOR AUDIT COVERAGE

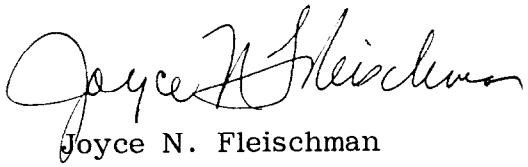
The OIG issued audit reports on the FAA Financial Statements for FYs 1992, 1993, 1994, and 1995. The FYs 1992 and 1993 audits were limited to the Airport and Airway Trust Fund portion of the FAA Financial Statements. The FYs 1994 and 1995 audits included all FAA funding and activities, but were limited to the Statements of Financial Position.

The FY 1992 audit report included 25 recommendations, all of which are considered resolved. However, efforts still are in process to complete actions on 12 recommendations. These recommendations concern processing fund usage transactions for commercial payments and reimbursable agreements, reconciliation of the Purchases-in-Transit account at yearend, and posting of prior year fund usage in the current year. Three of the recommendations involve changes to the DAFIS system.

The FY 1993 audit report included 44 recommendations, all of which are considered resolved. However, efforts are still in process to complete actions on 23 recommendations. These recommendations include capitalization of assets, posting F&E transactions to the Purchases-in-Transit account, physical inventory procedures, and reconciliations of the Work-in-Process account. Additional information regarding the open recommendations is included in the Report on Internal Control Structure section of this report.

The FYs 1994 and 1995 audit reports did not include any recommendations.

This report is intended to inform Congress, OMB, and those with FAA management responsibility. This restriction is not intended to limit the distribution of this report, which is a matter of public record.



Joyce N. Fleischman
Acting Inspector General

U.S. Department
of Transportation
**Federal Aviation
Administration**

Memorandum

Subject: **INFORMATION**: Discussion Draft Report on FAA FY 1996 Financial Statement

Date: MAR 21 1997

From: Acting Chief Financial Officer

Reply to Attn. of: AWilliams: 267-9000

To: Director, Office of Transportation Program Audits

Attached are the FAA comments to the discussion draft findings in response to your memorandum, subject as above, dated March 17. Please incorporate these comments into your final report.

Please let me know if you would like to discuss our comments or if you need any additional information.

Joel C. Taub

Attachment

Federal Aviation Administration (FAA)
Comments on the Office of Inspector General (OIG)
Discussion Draft Report on FAA FY 1996 Financial Statement

MATERIAL WEAKNESSES

A. Operating Materials and Supplies

Finding: Operating materials and supplies reported at $432 million were not adequately supported and could not be substantiated through audit testing.

Recommendations:

1. Perform a one-time wall-to-wall physical inventory of the FAA Logistics Center (FAALC) operating materials and supplies.

FAA Response: Concur. The FAA will perform a wall-to-wall physical inventory of the FAALC operating materials and supplies in FY 1997 to establish a baseline. We are in the process of finalizing a proposed statement of work for the Volpe/Coopers Team to prepare a detailed plan within 30 days for conducting the physical inventory. We will coordinate this plan with the OIG. One hundred percent of the Facilities and Equipment (F&E) project materiel, aircraft parts, and ground exchange and repair (E&R) items will be inventoried in FY 1997. This represents 90 percent of the inventory dollar value and 36 percent of the line items stored at FAALC. Since 92 percent of the expendable items have an annual demand of less than $500, the relative dollar value will influence how to take a cost-effective inventory.

2. Perform an annual physical inventory of field spares as required by FAA Order 4250.9B. Before initiating the physical inventory, develop a plan which details the procedures to be used and provide the plans to the OIG for review and comment.

FAA Response: Concur. As mentioned in response 1, FAA is in the process of finalizing a proposed statement of work for the Volpe/Coopers Team to prepare a detailed plan for conducting the physical inventory of field spares. Considering that there are 34,000 sites and the degree of dispersion of concentration of these items, the physical inventory will cover a high percentage of the regions' field spares measured primarily by dollar value (and secondarily by item count). FAA will coordinate this plan with the OIG.

3. Revise Process Guide 4650.19 to comply with DOT policy guidance on Inventory and Related Property requiring physical counts on all items at least every 3 years.

FAA Response: Concur. FAA has an agency directive, 4633.1 which is in the process of being updated to incorporate both recommendations 3 and 4. The Process Guide 4650.19 is an internal FAALC document. However, the local process guide will be updated to reflect the changes to 4633.1

4. Implement physical inventory recommendations made in our supplementary report (AD-FA-5-005) to FAA's FY 1993 financial statement.

FAA Response: Concur. FAA will complete implementation of the following recommendations that are contained in AD-FA-5-005.

o Change FAA Order 4633.1 to: (a) clarify the meaning of the completion of the inventory count by reducing the total number of physical counts permitted to no more than three.; (b) require posting the adjustments to the Logistics Information System (LIS) inventory balances immediately upon completing the third count; and (c) provide the follow-up detailed reset after adjustments are posted to determine reasons for discrepancies.

o Change FAA Order 4633.1 to specify a reasonable period for making physical inventory counts (three counts) and posting adjustments (e.g., 2-4 weeks).

o Minimize the use of freeze tapes during the period the counts are being made and limit physical inventory movements to emergency issuance only at locations being counted.

o Enforce proper segregation of duties by eliminating counters access to recorded balances in LIS.

o Modify LIS to permit entry of no more than three counts before the LIS "Third Count Comparison Report" is compiled. Adjustments made to the final count should be processed as error corrections subject to management review and approval.

5. Record line item unit prices at historical cost and maintain invoices or other documentation to support price changes.

FAA Response: Concur. FAA will modify LIS in FY 1997 to add a dollar amount field to capture the historical cost for centrally (Washington headquarters) procured items and purchase order/contract price for items procured by the Mike Monroney Aeronautical Center(MMAC)/FAALC. This is a temporary fix until we can build an interface between the Departmental Accounting and Financial Information System (DAFIS) and LIS. Key data elements to the systems/files together have been identified by Washington headquarters and estimates for the number of man-hours have been provided by MMAC/FAALC. The system will be modified to accommodate both

standard cost for pricing issues such as the Integrated Materiel Management (IMM) agreement items and historical cost.

6. Identify excess, obsolete and unserviceable items in Logistics Center and field inventories and promptly initiate disposal action.

FAA Response: Concur. Identification and disposition plan of actions for excess, unserviceable, and unrequired items will be included in the wall-to-wall inventory. Many old FAA systems, which are obsolete by today's standards, are still in operation and must be supported by FAALC. Therefore, we cannot dispose of such obsolete items.

7. Establish subsidiary records to account for operating materials and supplies (field spares) and ensure the recorded balances are disclosed in the Statement of Financial Position in compliance with reporting requirements in SFFAS No. 3.

FAA Response: Partially concur. FAA will determine whether any system modifications would be necessary to enable the LIS/Field Spares Inventory (FSI) to serve as the regions' operating materials and supplies counting, and possible tracking system, as part of the inventory-taking plan. In 1992, a 100 percent inventory was conducted to establish a baseline for the field spares inventory. As indicated in the response to recommendation 2, in FY 1997 we will conduct another inventory which will serve as the baseline. We plan to utilize a periodic method for future operating materials and supplies/field spares inventories. This is an acceptable accounting method and would eliminate the need to establish a subsidiary record.

8. Reconcile general ledger account balances to subsidiary records and ensure an adequate audit trail is maintained supporting the reconciled balances.

FAA Response: Concur. A reconciliation was performed from 1992 to 1996 on a monthly basis and adjustments to the DAFIS general ledger were made regularly. During FY 1996, personnel changes in the accounting area resulted in a discontinuance of the DAFIS adjustment. As part of the yearend close-out during the grace period, two fiscal years are maintained simultaneously. An adjustment to bring the accounts into agreement will be made by May 31, 1997.

Unfortunately, the FY 1996 adjustment was not recorded to the proper fiscal year. MMAC has reinstituted the monthly reconciliation process. In addition, an analysis to determine needed improvements in the processing of data between DAFIS and LIS will be initiated by September 30, 1997.

B. Capitalization of Equipment Purchase Costs

FINDING: FAA expensed equipment purchase costs for major system acquisitions which should have been capitalized.

FAA Comments on Finding: We determined after reviewing equipment purchases under FAA contract that only $14,626,884 of the total $172,637,026 cited as being improperly charged to operating expense was in fact misclassified. Therefore, we recommend this finding be considered a reportable condition. The following is a breakdown of our review:

$60,366,756 represented part of the yearend accruals. This amount was reversed in FY 1997.

$43,042,247 represented settlement payments on the Advanced Automation System contract termination.

$4,252,964 represented payments for support services provided to various FAA lines of business. The applicable contract line item numbers clearly indicated the procurement of support services and not equipment.

$1,270,946 represented a progress payment improperly recorded as operating expense. However, the payment was reclassified as a progress payment in May 1996.

$49,077,230 represents six progress payments which were intentionally recorded as operating expense at the time of payment pending the establishment of a new DAFIS transaction code to accurately record progress payments. The transaction code was not established until October 1996. However, these payments were presented on the financial statements as progress payments, not operating expense. The payments have subsequently been moved to the progress payment account.

Disposition of the $14,626,884 that were improperly classified is as follows:

$3,982,330 was corrected in March 1997.

$10,644,554 has been reviewed by the Accounting Operations Division (ABA-200). Assistance is being sought from the business and program managers to obtain the necessary detailed information to effect proper classification of these items.

We also reviewed equipment purchases under other Government agency contracts in the amount of $152,716,455. The following is an analysis of our review:

$68,112,904 represents expenditures on an agreement with the U.S. Air Force. ABA-200 began a review of this agreement in August 1996 and requested assistance from the program office to identify total capital expenditures and capitalizable cost by site. A contractor employed by the program office recently provided ABA-200 an extensive report reflecting the detailed information necessary to correctly record these transactions in DAFIS. This will be accomplished by April 15, 1997.

$63,849,050 represents FAA expenditures on an interagency agreement with the Department of Commerce (DOC) on the Next Generation Weather System (NEXRAD). These assets are owned by the DOC and nearly all of the equipment acquired to date has been recorded by DOC. FAA program management has not yet determined what percentage represents capital assets of the FAA. ABA-200 will continue to work with the program managers until such determination is made.

The remaining $20,754,501 are being reviewed. This action will be completed by May 1, 1997.

Recommendations:

1. Finalize and implement the consultant's recommendations on classifying and accounting for progress payments, common project costs, and contract line item numbers on FAA F&E contracts.

FAA Response: Concur. FAA is in the process of completing an Integrated OIG Corrective Actions Plan to implement the recommendations contained in the contractor's report. These recommendations are scheduled for completion by September 30, 1997.

2. Include equipment purchased under interagency agreements in the procedures implemented under Recommendation 1.

FAA Response: Same as response to recommendation 1.

3. Ensure that all key personnel receive training on the consultant's procedures for capitalizing equipment purchases.

FAA Response: Same as response to recommendation 1.

4. Implement procedures to ensure purchase orders and contracts are structured to clearly identify and distinguish property and equipment, common costs, operating materials and supplies, field spares, and expenses. These procedures should also address purchases with contracts managed by other Government agencies through interagency agreements.

FAA Response: Same as response to recommendation 1.

5. Review F&E transactions charged to Operating Expenses (about $4.5 billion) on the Statements of Operations for FYs 1995 and 1996 and capitalize the appropriate portion of the equipment purchase costs.

FAA Response: Nonconcur. We do not believe the resource expenditure required to complete this recommendation can be justified. FAA has disclosed in notes to the financial statements that operating expenses may be overstated and capital assets may be understated. We believe that adequate tools to assist accounting, financial, and program management personnel in the identification and recording of capital assets are now available. In addition, the consultant has developed a matrix which is being used by accounting personnel as a guide in determining capitalizable cost. New guidance has also been prepared for program personnel who prepare the original procurement documents . When used together, we believe the problem of misclassified costs will be eliminated.

The consultant also held group discussion sessions for all regional accounting and logistics personnel in June 1996 and for key accounting personnel in January 1997.

C. Property and Equipment

Finding: Real and personal property reported at $5.14 billion were not adequately supported and could not be substantiated through audit testing.

Recommendations:

1. Conduct a physical inventory of all real property and adjust the subsidiary records and DAFIS accordingly.

FAA Response: Concur. Conducting a complete physical inventory of real property located at approximately 15,000 sites at this time is not cost effective. The Office of Acquisitions (ASU) is implementing the Real Estate Management System (REMS) during FY 1997 to replace the current Real Property Record (RPR) system. Any inventory done prior to full implementation of the REMS would require a duplication of work because data would have to be loaded into both the RPR system and the REMS.

ASU will develop a detailed plan for conducting an inventory of real property. This plan will be coordinated with the OIG. The scheduled completion date for this action will be 60 days from the date of the final audit report.

The regional accounting records will be adjusted as the physical inventory is completed at each site.

2. Comply with FAA Order 2700.31 for the reconciliation of DAFIS real property accounts to the subsidiary records at each reporting unit.

FAA Response: Concur. The Office of Financial Services (ABA) will develop an automated process for reconciliation of the records. The scheduled completion date for this action is September 30, 1997.

3. Ensure subsidiary records are adjusted timely when real property is acquired, disposed, destroyed, or physically removed from the site.

FAA Response: Concur. ABA, ASU, and Airway Facilities will jointly develop capitalization procedures that will include appropriate time-frames for timely adjustment of records when real property is acquired, disposed, or physically removed from the site. The scheduled completion date for this action is September 30, 1997.

4. Implement the contractor's recommendations associated with PPIMS.

FAA Response: Partially Concur. (a) The Regional Project Materiel Management System (RPMMS) is capable of maintaining a historical file. This file would be added to the application to ensure a complete audit trail for financial management purposes. This file would link to the PPIMS application through the use of the job order number (JON). The JON is maintained within both applications. This would accomplish the overriding purposes of ensuring an audit trail for F&E projects. In addition, if the recommendation in recommendation 6 is followed, we will also be able to provide the auditors auditable records (albeit, manual ones). The scheduled completion date for this action is July 31, 1997.

(b) We already have a centralized catalog system.

5. Require regional F&E project materiel managers to furnish documentation necessary to adequately identify and support the value of personal property.

FAA Response: Concur. We will stress to all organizations the requirement to have and maintain the Facility Reference Data File (FRDF), as well s the need to include closeout packages in the file. The scheduled completion date for this action is July 1, 1997.

6. Notify all organizational components of the need to retain supporting documentation associated with personal property recorded in PPIMS and include it in the Facility Reference Data File.

FAA Response: Same as response to recommendation 5.

7. Discontinue the practice of recording readily identifiable property and equipment (e.g., items with serial numbers) as facility equipment in PPIMS.

FAA Response: Partially concur. This requires a major modification to an old system which will soon be replaced. In addition, the return on our investment is questionable, especially if the systems modification to RPMMS is made. The requirement is to ensure the detail of the facility is available for auditing and decommissioning purposes. By developing a historical file within RPMMS, and including the closeout packages in the FRDF, these requirements would be met.

D. Work-in-Process (WIP) Account

FINDING: FAA did not have adequate documentation to support the $2.8 billion balance reflected in the WIP general ledger account.

Recommendations:

1. Implement the recommendations to improve the WIP process contained in the contractor's draft report.

FAA Response: Concur. FAA is in the process of completing an Integrated OIG Corrective Actions Plan to implement the recommendations contained in the contractor's report. For example, FAA plans to implement the following by the end of FY 1997.

- o Establish a WIP baseline.
- o Develop WIP policy and procedures that address contractor labor cost, capitalization/close-out, and reconciliation between the 32-9 report and DAFIS.
- o Enhance the automated reconciliation process that was developed and implemented in August 1996.
- o Capitalize and close-out JONs with expiring appropriations.
- o Establish and implement oversight and performance metrics for WIP.

2. Determine if the 32-9F report can be reconciled with the WIP account. If not, FAA should seek an alternative, such as using DAFIS transactions posted to the WIP account to create a separate subsidiary ledger database.

FAA Response: Concur. FAA will use one of the following alternatives to correct the WIP material internal control weakness by the end of FY 1997. The alternatives are as follows:

o Alternative Number 1: Direct request to MMAC to create a separate subsidiary ledger database and populate the database with detail transactions that support each dollar amount field that is on the current 32-9F report.

o Alternative Number 2: prepare a DAFIS system change request (SCR) to the Office of Financial Management (B-30) to create a separate subsidiary ledger database.

o Alternative Number 3: Develop a 32-9F subsidiary ledger database external to DAFIS.

E. Budget and Financial Statement Report Reconciliation

FINDING: FAA did not have adequate controls in place to (a) ensure consistency of Unexpended Appropriations reported on financial statement and related budgetary reports, and (b) resolve discrepancies in key budgetary accounts.

Recommendations:

1. Revise the processing used to record fund authority and usage transaction in DAFIS.

FAA Response: Concur: The Financial Statements, Control, and Analysis Branch ABA-310 ; the Review and Coordination Branch, ABA-120; and the Operations and Capital Budget Divisions, ABA-400/500 reviewed the current internal coordination process for the Report on Budget Execution, SF-133 and the Apportionment and Reapportionment Schedule, SF-132. Informal procedures were developed on March 10, 1997 to ensure ABA-120 submits advance copies of sequentially numbered SF-132's to ABA-310, followed by an official copy annotated with the appropriate public law. ABA-310 now maintains a copy of the ABA-120 log for SF-132's and will verify on at least on a quarterly basis with ABA-120 that all SF-132's are on file. Additionally, the monthly review of the SF-133, Report on Budget Execution, now in place by our budget office prior to submission will provide an additional check that the most recent SF-132 is recorded.

ABA-310 is currently performing an analysis of the current balances of general ledger account (GLA) 31AX, Unexpended Appropriations (a proprietary account) and the corresponding budgetary accounts for the SF-133, including lines 9 (unobligated allotment), line 10 (unobligated balances not available), line 14B (unfilled customer orders) and line 14C (undelivered orders) for all FAA appropriations to ascertain amounts of imbalance. Further analyses will be made to determine the cause of such

imbalances such as improper yearend closing of DAFIS accounts or the use of improper transaction codes. ABA-310 will adjust GLAs for known discrepancies, if appropriate DAFIS transaction codes are available. ABA-310 will request, through B-30, adjustments to DAFIS if appropriate transaction codes to affect the changes are not available. Any final reconciliation of GLAs that cannot be identified and corrected in DAFIS by fiscal yearend, will be adjusted on the financial statement module to ensure proper balances are presented on the FY 1997 financial statements.

2. Establish procedures to ensure budget execution results reported on the monthly SF-133 are reconciled to both budgetary and proprietary account balances recorded in DAFIS.

FAA Response: Concur: We have implemented, effective with February month-end reporting, new procedures requested by the Office of Budget and Program Performance for preparation of the SF-133 including: (1) use of a standardized format for the Department, (2) review of the report before submission by our budget office, and (3) submission of the reports by the 20th of each month. Additionally we will issue written procedures to begin not later than July 1, 1997, for: (1) monthly reconciliation of unexpended appropriations with the SF-133 budgetary accounts prior to preparation of the monthly SF-133's; (2) the previously mentioned changes to the SF-133 process; and (3) yearend procedures to insures reconciliation of yearend reports including the FMS 2108, Yearend Closing Statement, SF-133, and the financial statements.

In addition, a study is currently underway to determine the feasibility of recording transactions, including obligations, commitments and plans, for the Airport Improvement Program (AIP) through an interface with an existing system operated by the Office of Airport Planning and Programming. In the interim, a reconciliation of AIP obligation transactions is nearly completed. Revised yearend SF-133 and FMS-2108 reports will be produced when the reconciliation is completed. Additionally, a memo was issued on March 6, 1997,. to regional accounting offices requiring a monthly reconciliation of obligations with their airports offices effective with the March monthly closeout to ensure that budgetary data contained in DAFIS is accurate. A similar memo will be issued by the Associate Administrator for Airports to the regional airports offices stating the same requirement.

3. Correct general ledger account balances in DAFIS for unobligated authority and undelivered orders.

FAA Response: Concur. This will be a follow-on action to the three steps mentioned in our response to recommendation 2. After the reconciliation is complete and ABA-400/500 concurs with the SF-133s, adjustments, when required, will be entered into DAFIS prior to preparation of the subsequent month's SF-133.

4. Submit a revised SF-133 report, if needed, as a result of the reconciliation.

FAA Response: Concur. Revised SF-133's will be submitted based on the results of the review mentioned in our response to recommendation 2

F. Accounts Payable Liabilities

Finding: About 50 percent of FAA's accounts payable liabilities included in the DAFIS subsidiary ledger filed were not valid.

FAA Comments on Finding: The audit report states that FAA recorded progress payments without reducing the accounts payable balance by the amount of the payment. ABA-recognized this deficiency and began work to correct it in early 1996. However, DAFIS was not modified until October 1996.

DAFIS provides the transaction codes applicable to the recordation of progress payments. DAFIS required the establishment of an accrued liability equal to the amount of the progress payment being paid. Further, DAFIS required that the liability remain on the books until the contract was complete and a final invoice was received. At that time, the accrued liability would be liquidated.

This procedure has been documented in DAFIS since its implementation in 1982. The audit report makes no mention of this DAFIS deficiency.

Further, the audit report states that FAA was recording an accounts payable liability and an obligation at the same time, regardless of whether goods and services had been received. The recording of an accrued liability does not result in a simultaneous recording of an undelivered order or any other obligation.

The report mentions that FAA accounting staff had not been trained to differentiate between the recording of obligations for budget purposes and the recording of a liability for financial accounting purposes. The Office of Financial Services is arranging for accounting offices to receive training on the new Statements on Federal Financial Accounting Standards. It is important to point out that nearly all obligations recorded in DAFIS are through the automated interface with the System for Acquisition Management. Only a small percentage are recorded manually.

Recommendations:

1. Continue its research of procurement records and progress payments and adjust the Open Document File records accordingly.

FAA Response: Partially concur. FAA personnel have researched the items in the sample listings that were identified as invalid and have taken the following actions.

Of the 147 invalid items totaling $107.6 million, 56 items totaling $96.5 million (89.7 percent of the total) have been deobligated or otherwise resolved subsequent to September 30, 1996. These totals include 7 progress payment transactions totaling $96.3 million. In addition, 5 items totaling $5.3 million (4.9 percent) will be reversed. The combined total of items resolved or reversed is almost 95 percent.

With respect to the progress payments for $96.3 million, ABA-200 identified the problems associated with the use of DAFIS transaction code 060 early in calendar year 1996 and initiated steps to resolve them. These steps culminated in a request for a change in the transaction and accompanying financial activity codes associated with progress payments. Unfortunately, the necessary changes were not effected until after the close of FY 1996. Since that time, ABA-200 has reversed nearly all of the transactions established as accrued liabilities and placed them in the progress payment account using the new transaction codes. This includes the $96.3 million identified by the OIG which was reversed on March 6, 1997.

2. Provide detailed written instructions to accounting staff concerning the proper recording of accounts payable liabilities with emphasis on the receipt of goods and services.

FAA Response: Partially concur. Sixteen sample items amounting to $5.3 million (4.9 percent) are deemed to be valid non-permanent change-of-station (PCS) related items. Another 69 items amounting to $0.5 million were PCS related items.

FAA considers PCS transactions as agency liabilities because the occurrence of a liability to the agency is eminent and is a material amount. A significant number of FAA's air traffic and airway facilities personnel are required to relocate periodically. The FAA will seek by April 30, 1997, a DOT-wide policy on the proper accounting treatment of such transactions from B-30. Appropriate action will be taken after the policy has been issued.

3. Establish procedures and controls to better monitor the validity of accounts payables recorded in DAFIS such as the development and use of an aging report.

FAA Response: Concur. FAA will submit a DAFIS SCR to B-30 requesting the development of an on-line DAFIS exception file to "point and click" on aged accounts payable documents and to generate reversal entries. The scheduled completion for this action is May 15, 1997.

REPORTABLE CONDITIONS

G. Yearend Accrued Liabilities

Finding: FAA has not established adequate procedures to accrue total liabilities for goods and services received at yearend.

FAA Comments on Finding: ABA-200 has performed an in-depth review of all invoice activity during FY 1996 yearend and the first 2 months of FY 1997 and determined the following.

o The estimated value of invoices on hand, unpaid as of September 30, 1996, at $133 million. This inventory should have been as of October 4, 1996.

o $61,483,157 of the $133 million was paid during the grace period October 1 through 4, 1996.

o $61,517,421 is the value of FY 1996 invoices unpaid and on hand at yearend.

o $10,000,000 was the value of invoices not paid nor included in the inventory.

o $111,169,847 is the value of the FY 1996 invoices received in FY 1997 for which ABA-200 had no prior knowledge.

o $172,687,268 is the total invoice dollars to be accounted for.

o $133,000,000 is the total estimatef accrual.

o $39,687,268 is the net value of unknown and unaccrued invoices.

Recommendation:

FAA should revise its procedures to include in the accrued liabilities amount an estimate for goods and services received but not invoiced by yearend.

FAA Response: Concur. We will revise procedures which will allow for estimating the value of goods and services received for which no invoices have been rendered at fiscal yearend. Each accounting office will be instructed to annually review October and November transactions for computation of a prior year projection of uninvoiced goods and services received. This amount of uninvoiced goods and services will then be entered into the financial statement module. This will be implemented for FY 1997.

H. Capital Leases and Leasehold Improvements

Finding: FAA did not adequately identify and account for capital leases, and leasehold improvements and alterations.

Recommendations:

1. Promptly revise FAA Order 2700.31 to include procedures for identifying, accounting for, and reporting capital leases.

FAA Response: Concur. ABA will revise FAA Order 2700.31. The scheduled completion date for this action is September 30, 1997.

2. Determine fair value and economic life (at the time of inception for the 22 potential capital leases included in our sample.

FAA Response: Concur. The regions will be instructed to document fair value and economic life for all 22 sites. The scheduled completion date for this action is May 1, 1997.

3. Determine if any existing leases should be classified as capital leases.

FAA Response: Concur. Guidance to ensure proper identification of capital leases will be provided to all regional real estate offices. The scheduled completion date for this action is September 30, 1997.

4. Develop a plan to ensure all future leases are properly evaluated and classified as either a capital lease or an operating lease at their inception.

FAA Response: Concur. ASU will reinforce the requirements of Office of Management and Budget (OMB) Circulars A-11 and A-94. These circulars provide guidance on determining capital and operating leases. Any additional guidance that may be needed will be provided. The scheduled completion date for this action is September 30, 1997.

5. Implement the existing requirement to ensure leasehold improvements and alternations are properly capitalized.

FAA Response: Concur. On November 22, 1993, ASU issued guidance to ensure the requirements for leasehold improvements and alterations were properly capitalized. This guidance was in response to OIG Report No. AS-FA-3-011 dated April 15, 1993. ASU will issue additional guidance to reinforce the requirements for capitalization of leasehold improvements. This guidance will be accomplished in conjunction with

recommendation 4 above. The scheduled completion date for this action is September 30, 1997.

FAA General Comments: Page II-21, first paragraph, last sentence states "At the Aeronautical Center, $6.4 million of leasehold improvements are not included in the property records or supported by adequate documentation."

Currently, the leasehold improvements are not recorded in the Real Property System. The MMAC Financial Services and Acquisitions Offices have reconciled the DAFIS general ledger account to the subsidiary records for 1990 through the present. These offices are researching the leasehold improvements documentation and DAFIS general ledger accounting entries prior to 1990. When a final determination is made, adjustments will be processed.

Page II-36, Capital Leases, two leases were identified as needing clarification. Extensive research is being conducted to make the requested determination. Additional information is required before these decisions can be finalized.

I. Additional FAA General Comments: The audit report, in the section addressed to the FAA Administrator, states that "We reviewed the information presented in Chapters 1, 2, and 3 of the Draft 1996 FAA Annual Report, and concluded the information in these sections was not presented as performances measures, so we were unable to accomplish our fifth audit objective." This is particularly perplexing since the performance measures were audited in prior fiscal years. The FY 1993 audit disclosed as other reportable conditions that FAA needs to develop performance measures for Trust Fund programs. In the FY 1994 and subsequent annual reports FAA has included performance measures for AIP. In the FY 1996 report major facility commissionings were added for the F&E program. The FY 1994 audit report disclosed as other reportable conditions that FAA had not developed and issued formal written policies and procedures to ensure the data reported were verifiable. A draft directive was completed in 1995 by ABA and is currently under review by the Office of Business Information and Consultation.

As stated in the opening section of the performance indicator chapter of the annual report, FAA recognized the need to integrate the Government Performance and Results Act (GPRA) performance measures into the annual report and will do so once the measures are refined and are supported by auditable and verifiable data. The safety and efficiency performance measures in the FY 1996 annual report, including accidents, runway incursions, near mid-air collisions, runway incursions, and system induced delays, are the same measures identified in the GPRA annual performance plan.

Instructions for the Overview section in OMB Bulletin 97-01, applicable to FY 1996, states that agency performance measures "should relate to the programs' purposes and goals, be consistent with measures previously included in budget documents and other materials related to implementation of the GPRA, and linked to the programs presented in the Statement of Net Cost. The measures in the overview should be limited to the entity's most significant program and financial measures."

FAA's 1998 Performance Plan, as submitted to the Office of the Secretary and to OMB November 21, 1996, is written to the agency's mission performance. FAA's current safety and efficiency performance measures are the agency's two major missions. While some FAA programs can be linked exclusively to a specific agency mission (e.g., AIP) the air traffic program contributes to both the safety mission and the efficiency mission. Therefore, it is inappropriate to attribute air traffic measures to only one of these missions. As stated in the annual report, the agency performance measures are still evolving. Linkages to cross reference FAA's specific mission performance to its programs are being developed.

SECTION II
FINANCIAL STATEMENTS

MANAGEMENT REPORT OF THE CHIEF FINANCIAL OFFICER

FY 1996 was a year of numerous financial challenges for the FAA. Most notably was the December 31, 1995, expiration of FAA's authority to collect aviation excise taxes. This lapse of taxing authority significantly impacted the viability of the Airport and Airway Trust Fund, causing a reduction in the Trust Fund principal of approximately $3 billion.

Financial reform initiatives are currently underway to enable the FAA to become more business like and self sufficient. FAA was authorized to collect $75 million in user fees in FY 1997. Such fees will be assessed on foreign overflights through U.S. airspace. Authority to assess additional user fees is anticipated in FY 1998.

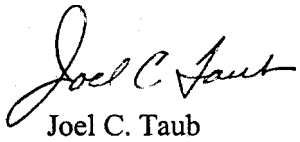
The Office of Financial Services is developing and implementing a new national project/job order cost accounting system (CAS) using commercial off-the-shelf (COTS) software. This system will enable the agency to capture the cost of providing various services to airspace system users. In addition, the system will provide managers with a wide range of cost information. CAS will receive and process financial and statistical data from the existing core departmental accounting and financial, information system and other operational core feeder systems. The baseline system will be commissioned by September 1997.

FAA travel policy reform was initiated in FY 1996 in light of reform legislation that removed the agency from the requirements of some parts of Title 5. The task force established to review such reform developed 22 recommendations which, when fully implemented, will reduce travel costs for the FAA by almost $6 million annually. One recommendation, to fully automate the travel voucher process using COTS software, will generate $1,8 million in cost avoidance by reducing the voucher preparation time and the number of travel voucher examiners. FAA's Management Board has concurred with the 22 recommendations, which must go through the formal union bargaining process before final approval.

FAA has contracted with an independent accounting firm to review, recommend, and assist with improving the agency's accounting processes for the entire capital asset acquisition cycle. The results of this review will enable FAA to establish standardized accounting policies and practices for capital asset acquisitions. The contract also includes the development of improved procedures for conducting physical inventories at the FAA Logistics Center and field facilities.

The agency's future challenge is to seek alternative methods of funding. The aviation excise taxes will expire on September 30, 1997. This impacts FAA's ability to rely on the Airport and Airway Trust Fund as a source of funding and may impact spending in FY 1998. FAA will work with the National Civil Aviation Review Commission to develop a long-term strategy for financing the agency.

Questions regarding this annual report may be directed to the Financial Statements, Analysis, and Control Branch, ABA-310, 800 Independence Avenues, S.W., Washington, DC 20591.



Joel C. Taub
Acting Chief Financial Officer

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

	AIRPORT AND AIRWAY TRUST FUND (CORPUS)	TRUST FUND GRANTS-IN-AID TO AIRPORTS	TRUST FUND FACILITIES & EQUIPMENT	TRUST FUND RESEARCH, ENGR & DEVEL
ssets				
ntity Assets:				
Intragovernmental Assets:				
Fund Balance With Treasury (Note 2)	$ 1	$ 106,711	$ 58,587	$ 12,700
Investments (Note 4)	4,013,087	282,170	3,162,779	223,932
Accounts Receivable, Net (Note 5)			128,230	847
Interest Receivable	120,995			
Advance and Prepayments			21,010	7,189
Other Intragovernmental (Note 6)			7,021	2
Governmental Assets:				
Accounts Receivable, Net (Note 5)		2	13,217	317
Credit Program Receivables and Related Foreclosed Property, Net (Note 7)				
Advances and Prepayments			73	(1)
Other Governmental				
Cash and Other Monetary Assets (Note 3)				
Inventory, Net				
Operating Materials and Supplies, Net (Note 8)			108,848	
Property and Equipment, Net (Note 9)			8,602,585	
Total Entity Assets	$ 4,134,083	$ 388,883	$ 12,102,348	$ 244,986
otal Assets	$ 4,134,083	$ 388,883	$ 12,102,348	$ 244,986

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

	AVIATION INSURANCE REVOLVING	AIRCRAFT PURCHASE LOAN GUAR	OPERATIONS	OTHER FUNDS	Consolidated Total
	$ 304	$ 2	$ 652,715	$ 3,706	$ 834,726
	62,273				7,744,241
			30,374	8,556	168,007
					120,995
			35,077		63,276
			4,569	(7)	11,585
			7,438	3,583	24,557
				548	548
			2,533		2,605
			26		26
			323,145		431,993
			196,491		8,799,076
	$ 62,577	$ 2	$ 1,252,368	$ 16,383	$ 18,201,630
	$ 62,577	$ 2	$ 1,252,368	$ 16,383	$ 18,201,630

UNAUDITED

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

	AIRPORT AND AIRWAY TRUST FUND (CORPUS)	TRUST FUND GRANTS-IN-AID TO AIRPORTS	TRUST FUND FACILITIES & EQUIPMENT	TRUST FUND RESEARCH, ENGR & DEVEL
abilities				
.iabilities Covered by Budgetary Resources:				
Intragovernmental Liabilities:				
Accounts Payable	$	$	$ 60,718	$ 2,369
Other Intragovernmental Liabilities (Note 11)			24,675	2,828
Governmental Liabilities:				
Accounts Payable		19,970	309,451	8,331
Other Governmental Liabilities (Note 11)			6,859	4,355
Total Liabilities Covered by Budgetary Resources	$	$ 19,970	$ 401,703	$ 17,883
.iabilities not Covered by Budgetary Resources:				
Intragovernmental Liabilities:				
Debt (Note 10)	$	$	$	$
Other Intragovernmental Liabilities (Note 11)				
Governmental Liabilities:				
Lease Liabilities (Note 12)			110,989	
Pensions and Other Actuarial Liabilities (Note 13)				
Other Governmental Liabilities (Note 11)		1,710,070	404,013	
Total Liabilities not Covered by Budgetary Resources	$	$ 1,710,070	$ 515,002	$
otal Liabilities	$	$ 1,730,041	$ 916,705	$ 17,883

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U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

	AVIATION INSURANCE REVOLVING	AIRCRAFT PURCHASE LOAN GUAR	OPERATIONS	OTHER FUNDS	Consolidated Total
	$ 54	$	$ 83,964	$ 181	$ 147,286
			8,599	5,214	41,316
	5		95,232	6,631	439,620
	12		147,642	5,885	164,753
	$ 71	$	$ 335,438	$ 17,912	$ 792,977
	$	$ 21	$	$	$ 21
			184,238		184,238
					110,989
			821,258		821,258
	16		671,532		2,785,631
	$ 16	$ 21	$ 1,677,028	$	$ 3,902,137
	$ 87	$ 21	$ 2,012,466	$ 17,912	$ 4,695,115

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U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

	AIRPORT AND AIRWAY TRUST FUND (CORPUS)	TRUST FUND GRANTS-IN-AID TO AIRPORTS	TRUST FUND FACILITIES & EQUIPMENT	TRUST FUND RESEARCH, ENGR & DEVEL
let Position				
Balances:				
Unexpended Appropriations (Note 14)	$	$ 483,865	$ 1,319,240	$ 93,703
Invested Capital (Note 14)		2,754	10,549,377	127,093
Cumulative Results of Operations (Note 14)	4,134,083		(180,199)	6,306
Other (Note 14)		(117,706)	12,226	
Future Funding Requirements (Note 14)		(1,710,070)	(515,002)	
Total Net Position (Note 14)	$ 4,134,083	$ (1,341,158)	$ 11,185,642	$ 227,103
otal Liabilities and Net Position	$ 4,134,083	$ 388,883	$ 12,102,348	$ 244,986

The accompanying notes are an integral part of these statements

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF FINANCIAL POSITION
AS OF SEPTEMBER 30, 1996
(Dollars in Thousands)

AVIATION INSURANCE REVOLVING	AIRCRAFT PURCHASE LOAN GUAR	OPERATIONS	OTHER FUNDS	Consolidated Total
$	$	$ 103,073	$ (672)	$ 1,999,209
	5	497,164	(888)	11,175,505
62,506	(3)	316,693	30	4,339,416
				(105,480)
(16)	(21)	(1,677,028)		(3,902,137)
$ 62,490	$ (19)	$ (760,098)	$ (1,530)	$ 13,506,513
$ 62,577	$ 2	$ 1,252,368	$ 16,383	$ 18,201,630

The accompanying notes are an integral part of these statements

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF OPERATIONS
FOR THE PERIOD ENDED SEPTEMBER 30, 1996
(Dollars in Thousands)

	AIRPORT AND AIRWAY TRUST FUND (CORPUS)	TRUST FUND GRANTS-IN-AID TO AIRPORTS	TRUST FUND FACILITIES & EQUIPMENT	TRUST FUND RESEARCH, ENGR & DEVEL
evenues and Financing Sources				
ppropriated Capital Used	$	$ 1,664,931	$ 1,776,566	$ 233,561
evenues from Sales of Goods and Services:				
To the Public			10,287	288
Intragovernmental			103,925	1,498
nterest and Penalties, Non-Federal				
nterest, Federal	694,617			
axes (Note 15)	2,404,970			
ther Revenues and Financing Sources (Note 16)			275,613	
ess: Taxes and Receipts Transferred to the Treasury or Other Agencies (Note 16)	(6,627,152)			
Total Revenues and Financing Sources	$ (3,527,564)	$ 1,664,931	$ 2,166,393	$ 235,347
xpenses				
rogram or Operating Expenses (Note 17)	$	$ 1,664,931	$ 2,508,902	$ 233,495
Cost of Goods Sold				
Intragovernmental			111,662	1,770
Depreciation and Amortization			7,908	
Bad Debts and Writeoffs			117	(5)
nterest				
Federal Financing Bank/Treasury Borrowing				
Other			7,212	71
Other Expenses (Note 18)			262,522	
Total Expenses	$	$ 1,664,931	$ 2,898,323	$ 235,331
Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items	(3,527,564)		(731,930)	17
Plus (Minus) Extraordinary Items (Note 19)			(222,584)	
Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	$ (3,527,564)	$	$ (954,514)	$ 17

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U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF OPERATIONS
FOR THE PERIOD ENDED SEPTEMBER 30, 1996
(Dollars in Thousands)

AVIATION INSURANCE REVOLVING	AIRCRAFT PURCHASE LOAN GUAR	OPERATIONS	OTHER FUNDS	Consolidated Total
$	$	$ 4,806,803	$ 50	$ 8,481,911
		8,716		19,291
		45,636		151,059
4,852				4,852
				694,617
				2,404,970
27		5,023		280,663
				(6,627,152)
$ 4,879	$	$ 4,866,179	$ 50	$ 5,410,215
$ 337	$	$ 4,739,877	$ 50	$ 9,147,592
		24,074		137,506
		6,337		14,245
		1,917		2,029
	(1)			(1)
	3	280		7,566
		555,085		817,607
$ 337	$ 2	$ 5,327,569	$ 50	$ 10,126,543
4,542	(2)	(461,392)		(4,716,329)
				(222,584)
$ 4,542	$ (2)	$ (461,392)	$	$ (4,938,913)

UNAUDITED

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF OPERATIONS
FOR THE PERIOD ENDED SEPTEMBER 30, 1996
(Dollars in Thousands)

	AIRPORT AND AIRWAY TRUST FUND (CORPUS)	TRUST FUND GRANTS-IN-AID TO AIRPORTS	TRUST FUND FACILITIES & EQUIPMENT	TRUST FUND RESEARCH, ENGR & DEVEL
hange in Net Position				
Net Position, Beginning Balance, as Previously Stated	$ 6,951,413	$ 533,838	$ 12,392,183	$ 276,982
Adjustments (Note 19)	710,234		(71,925)	
Net Position, Beginning Balance, as Restated	7,661,647	533,838	12,320,258	276,982
Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	(3,527,564)		(954,514)	17
Plus (Minus) Non Operating Changes (Note 20)		(1,874,996)	(180,102)	(49,896)
Net Position, Ending Balance	$ 4,134,083	$ (1,341,158)	$ 11,185,642	$ 227,103

The accompanying notes are an integral part of these statements

U.S. Department of Transportation
FEDERAL AVIATION ADMINISTRATION
COMBINING STATEMENT OF OPERATIONS
FOR THE PERIOD ENDED SEPTEMBER 30, 1996
(Dollars in Thousands)

	AVIATION INSURANCE REVOLVING	AIRCRAFT PURCHASE LOAN GUAR	OPERATIONS	OTHER FUNDS	Consolidated Total
	$ 57,948	$ (17)	$ (1,460,517)	$ (1,608)	$ 18,750,222
			(21,141)		617,168
	57,948	(17)	(1,481,658)	(1,608)	19,367,390
	4,542	(2)	(461,392)		(4,938,913)
			1,182,952	77	(921,965)
	$ 62,490	$ (19)	$ (760,098)	$ (1,530)	$ 13,506,513

The accompanying notes are an integral part of these statements

UNAUDITED

Note 1. Significant Accounting Policies:

The consolidated financial statement is presented in accordance with the accounting principles and reporting standards contained in Department of Transportation (DOT) and Federal Government financial policies, procedures, and reporting requirements, including those of the principal fiscal agencies: the Department of Treasury (Treasury); the General Accounting Office; and the Office of Management and Budget (OMB). Those reporting standards include OMB's Statements of Federal Financial Accounting Standards (SFFAS) Nos. 1 through 3. In addition, Federal Aviation Administration (FAA) Order No. 2700.31, Uniform Accounting Systems Operations Manual, and related documentation contain FAA-specific accounting policy.

A. Basis of Presentation

The financial statement has been prepared to report the financial position and results of operations of the FAA, as required by 31 U.S.C. 3515, as added by the Chief Financial Officers Act of 1990 and as amended by the Federal Financial Management Act of 1994, which is title IV of the Government Management Reform Act of 1994. The statement has been prepared from the books and records of FAA in accordance with the requirements for form and content of entity financial statements, as specified by OMB Bulletin 94-01, and in accordance with FAA's accounting policies summarized in this note. Consequently, this statement is different from the financial management reports, also prepared by FAA pursuant to OMB directives, that are used to monitor and control FAA's use of budgetary resources.

B. Reporting Entity

The Treasury designates the reporting entities that Federal agencies are to use in submitting financial statements to the Treasury. The OMB budget account listing also specifies reporting entities. In preparing this financial statement, FAA followed the Treasury designations (listed below) and not the OMB designations. The combining statement presents the financial condition and activities of FAA as a whole, as well as the component data for each of the four entities. This statement also reflects relevant transfers between funds and fund entities, where appropriate.

Entity	Title
1. Trust Fund	Airport and Airway Trust Fund Cash and Investments Grants-in-Aid Facilities and Equipment Research and Development Programs Administered by Other Agencies
2. Revolving Fund	Aviation Insurance Program
3. Loan Guarantee	Aircraft Purchase Loan Guarantee Program Borrowing Authority for Program Expenses Appropriation to Liquidate Borrowed Funds and Accrued Interest
4. All Others (Unsegmented)	Operations Facility and Equipment Development General Fund Miscellaneous Receipts Budget Clearing Accounts Suspense Accounts Items Not Classified by Financing Source

The Airport and Airway Trust Fund (Trust Fund) financed approximately 75 percent of the fiscal year (FY) 1996 total budget. A brief description of each appropriation is presented in chapter 3, FY 1996 Financial Highlights. The only appropriations receiving General Fund financing are the Operations appropriation and, if enacted, the appropriation to liquidate debts to the Treasury incurred for the Aircraft Purchase Loan Guarantee Program. (No such liquidating appropriation was enacted in FY 1996.) Approximately 50 percent of the FY 1996 funding of the Operations appropriation was financed by the General Fund, and the remainder was funded by the Trust Fund. Infusing funds from the Trust Fund to the Operations appropriation is accomplished by periodic transfers. Once a transfer is made, the corresponding portion of the Operations account derived from the Trust Fund is accounted for under the General Fund Operations appropriation symbol, thus losing the identity of the source.

Section 3515 of title 31, U.S. Code, requires submitting to the OMB Director an audited financial statement covering all agency activities. This statement shows each activity's component data. Further details within an entity are provided as notes where appropriate.

C. Budgets and Budgetary Accounting

Congress annually enacts appropriations to permit FAA to incur obligations for specified purposes. For FY 1996, FAA was accountable for Trust Fund appropriations, General Fund appropriations, a Revolving Fund, and borrowing authority. FAA recognizes budgetary resources as assets when cash (funds held by Treasury) is made available through Treasury General Fund warrants and Trust Fund transfers. See paragraph B above.

D. Basis of Accounting

Transactions are recorded on 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. Trust Fund revenues derived from excise taxes are treated differently. They are recorded on the basis of cash transferred from the Treasury General Fund to the Trust Fund. Transactions are also classified by fund account. This is accomplished by assigning to each transaction a unique attribute (Treasury symbol) identifying the corresponding appropriation and its period of availability. Note 1.E, Revenues and Other Financing Sources, contains further information.

Budgetary accounting facilitates complying with legal controls on the use of Federal funds.

E. Revenues and Other Financing Sources

Congress enacts annual, multi-year, and no-year appropriations to be used, within statutory limits, for operating and capital expenditures. Additional amounts are obtained from service fees (e.g., registry fees) and through reimbursements for services performed for other domestic and foreign governmental entities.

The Trust Fund is sustained by excise taxes collected by the Internal Revenue Service (IRS) from airway system users. The IRS records excise tax revenues deposited in the General Fund on a cash basis; Treasury transfers an equivalent amount from the General Fund to the Trust Fund. The Trust Fund also earns interest from investments in Treasury securities. Interest income is recognized as revenue on the accrual basis.

Appropriations are recognized as a financing source when expended. Revenues from service fees and reimbursements are recognized concurrently with the recognition of accrued expenditures for performing the services.

F. Fund Balances with Treasury and Cash

FAA does not maintain cash in commercial bank accounts. Treasury processes cash receipts and disbursements. Funds at the Treasury are available to pay agency liabilities. FAA maintains petty cash (imprest funds) outside the Treasury to facilitate small purchases.

FAA does not maintain any foreign currency balances. Foreign currency payments are made either by the Treasury or the Department of State, and are reported by FAA in the U.S. dollar equivalent.

G. Accounts and Loans Receivable

FAA's financial statement includes the activities and balances of relevant Treasury General Fund Miscellaneous Receipt accounts. This is done to establish an audit trail. It also maintains accountability for defaulted loans under the Aircraft Purchase Loan Guarantee Program. Upon default, FAA established accounts receivable in the General Fund Miscellaneous Receipts account to reflect the amount due from the borrower for principal and interest. FAA also established an intragovernmental liability to offset the accounts receivable which represents an asset of the Treasury, not FAA.

H. Operating Materials and Supplies

Operating materials and supplies consist primarily of unissued materials and supplies that will be consumed in normal operations. The value of operating materials and supplies on hand at yearend is stated using standard costs. Standard costs are adjusted quarterly to reflect current prices and are applied to materials and supplies on hand. The resulting write-up or write-down is recognized as a materials and

supplies valuation gain or loss. Other classifications of materials and supplies are valued on the basis of actual prices paid.

SFFAS No. 3, Accounting for Inventory and Related Property, allows the recording of valuation gains and losses when items are determined to be excess, obsolete, or unserviceable. SFFAS No. 3 does not address gains and losses for valuation variances due to using standard cost. FAA will begin valuing materials and supplies using a moving weighted average not later than FY 1998. This will eliminate the variances caused by the use of standard cost. Adjustments for the proper valuation of reparable, excess, obsolete, and unserviceable items are made to the appropriate allowance accounts at fiscal yearend.

Operating materials and supplies are reclassified as expenses or work in progress when consumed or issued. See Note 8, Operating Materials and Supplies, Net, for additional information.

I. Investment in U.S. Government Securities

Unexpended funds in the Trust Fund and Aviation Insurance Revolving Fund are invested in U.S. Government securities. A portion of the Trust Fund 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 controlled and processed by the Treasury. See Note 4, Investments, for additional information.

J. Property and Equipment

Depreciation and amortization of fixed assets were not recognized before FY 1996. A provision of SFFAS No. 6, Accounting for Property, Plant, and Equipment, which becomes effective in FY 1998, requires the depreciation of fixed assets classified as general property, plant, and equipment. Early implementation of the standard is encouraged, and individual provisions of the standard may be implemented before other provisions. Beginning in FY 1996, the depreciation of aircraft and the amortization of depreciable assets acquired under capital leases are recognized.

Depreciation and amortization are based on the straight-line method, generally over an asset's estimated service life. Aircraft are depreciated to a 25 percent salvage value over a service life of 20 years. Buildings 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 30-year service life.

Expenditures for all other categories of capital assets are recognized as expenses (loss) upon disposal of the asset. Additional categories of assets will be depreciated in FY 1997, leading to full compliance with the depreciation provision of SFFAS No. 6 in FY 1998.

Construction in progress is valued at direct (actual) costs, plus applied overhead and other indirect costs as accumulated by the regional project materiel system. The system accumulates costs by the project number assigned to each facility being constructed.

The General Services Administration (GSA) receives payment for real property that is under its control and is used by FAA. Payments are made from an appropriation to the Office of the Secretary of Transportation (OST), part of which (corresponding to FAA costs) is derived from the Trust Fund. See Note 17, Program Expenses, for further discussion of GSA rental payments.

Personal property is capitalized when the acquisition cost of one unit exceeds $5,000. Equipment with a unit acquisition cost of less than $5,000 is expensed. Software is capitalized when the acquisition cost of one unit exceeds $25,000. Capitalization thresholds differ from the thresholds for classifying property as accountable or sensitive.

K. Prepaid and Deferred Charges

Advance payments are generally prohibited by law; there are some exceptions, such as subscriptions. When permitted, payments made in advance of the receipt of goods and services are recorded as prepaid charges at the time of prepayment and recognized as expenses when the related goods and services are received.

L. Liabilities

A liability represents the amount to be paid by FAA as the result of a transaction or event that has already

occurred. However, no liability can be liquidated by FAA absent an appropriation. Liabilities for which an appropriation has not yet been enacted are therefore classified as unfunded liabilities, and there is no certainty that such appropriation will be enacted.

M. Borrowing Payable to the Treasury

Borrowing involves loans from the Treasury to fund expenses in the Aircraft Purchase Loan Guarantee Program. Treasury renews the debt obligation until FAA receives an appropriation to liquidate the principal and interest. No such appropriation was enacted for FY 1996.

N. Interest Payable to the Treasury

FAA owes interest to the Treasury based on its debt to the Treasury as a result of borrowing for the Aircraft Purchase Loan Guarantee Program.

O. Contingencies

FAA recognizes losses for contingent liabilities when such losses are probable and reasonably estimable. For example, FAA recognizes material contingent liabilities in the form of claims that have been brought to the attention of the Office of Chief Counsel (OCC) and: (1) have been asserted, or, if not yet asserted, in the opinion of the OCC are more likely to be asserted than not; (2) in the opinion of the OCC are more likely to be paid than not; and (3) for which the OCC can estimate the probable payment.

P. Annual, Sick, and Other Leave

Annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. At 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. Funding will be obtained from future financing sources to the extent that current or prior year appropriations are not available to fund annual leave earned but not taken. Sick leave and other types of nonvested leave are expensed when taken. See Note 11, Other Liabilities, for further discussion of other liabilities for compensated absences.

Q. Retirement Plan

FAA employees who participate in the Civil Service Retirement System (CSRS) receive from FAA a matching contribution to their annuity equal to 7 percent of pay. FAA does not report CSRS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to employees. Reporting such amounts is the responsibility of the administering agency, the Office of Personnel Management (OPM), not of the employing agency.

On January 1, 1987, the Federal Employees Retirement System (FERS) went into effect pursuant to Public Law 99-335. Most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. 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 most employees hired since December 31, 1983, FAA also contributes the employer's matching share for Social Security.

R. Comparative Data

Although comparative data for FY 1995 have not been presented in the financial statement, some comparative data are included in the following notes.

Note 2. Fund Balance with Treasury:

(Dollars in Thousands)

	Obligated	Unobligated & Available	Unobligated & Restricted	Total
Trust Fund	$ 2,462,145	$ (1,877,986) (1)	$ (406,159) (1)	$ 178,000
Revolving Fund	(66,951)	67,255	-	304
Operations General Fund	602,244 (2)	2 (3)	50,470 (4)	652,716
Other Funds	3,133 (5)	573	-	3,706
Total	$ 3,000,571	$ (1,810,156)	$ (355,689)	$ 834,726

The period of time during which FAA has authority to incur obligations is determined by the type of appropriation (i.e., single-, multi-, or no-year). Obligated fund balances represent appropriations that are available to liquidate (i.e., pay) obligations that existed as of September 30, 1996, having been properly incurred before obligating authority expired. Unobligated and available fund balances represent amounts that are available for incurring new obligations (i.e., obligational authority has not yet expired). Unobligated and restricted fund balances represent balances of appropriations for which the period of availability for (voluntary) obligation has expired. These balances are only available for upward adjustments of obligations incurred during the period for which the appropriation was available for obligation, or for paying claims attributable to the appropriation.

(1) The amount withdrawn biweekly from the Trust Fund is based on cash outlays, not obligational authority, to minimize interest costs. In addition, the Airport Improvement Program (AIP) has obligational authority, but has not yet received a liquidating cash appropriation.

(2) This amount includes $490.7 million from the FY 1996 appropriation, available as of September 30, 1996, to pay obligations that had been incurred during FY 1996. The amount also includes $2,142 appropriated in prior years to liquidate debts to Treasury for cash lent to FAA for the Aircraft Purchase Loan Guarantee Program. Additionally, the amount includes $107.6 million of balances of single-year appropriations that remain available to pay obligations incurred prior to FY 1996. The remaining $3.9 million represents the balance available to pay the obligations of a no-year appropriation.

(3) Represents the unobligated balance of a no-year appropriation.

(4) This amount includes $6.9 million from the FY 1996 appropriation, for which the availability for obligation expired on September 30, 1996. The remaining $43.6 million represents single-year appropriations that expired prior to FY 1996.

(5) Includes a $0.59 million transfer appropriation balance from GSA for the relocation costs involved in moving FAA facilities to more economical facilities from under-utilized valuable property targeted for public sale.

Note 3. Cash, Foreign Currency, and Other Monetary Assets:

(Dollars in Thousands)

Imprest Fund Cash	$ 26
Total Cash, Foreign Currency, and Other Monetary Assets	$ 26

FAA closed all but essential imprest funds and reduced the fund balances from $1.5 million in FY 1995 to $26,000 in FY 1996. A further and final reduction to $16,000 will occur in FY 1997.

Note 4. Investments:

(Dollars in Thousands)

	Cost	Amortization Method	Unamortized (Premium) Discount	Market Value	Investments Net	Required Market Value Disclosure
Intragovernmental Securities:						
Non-Marketable, Par Value						
Airport and Airway Trust Fund (1)	$ 7,681,968		$ -	$ -	$ 7,681,968	$ -
Non-Marketable, Market Based						
Aviation Insurance Revolving Fund (2)	64,460	Straight Line	(2,187)	-	62,273	-
Total	$ 7,746,428		$ (2,187)	$ -	$ 7,744,241	$ -

(1) Nonmarketable par value Treasury securities are special series debt securities that the Treasury issues to Federal entities at face value (par value). The securities are redeemed at face value on demand; thus, investing entities recover the full amount invested, plus interest. Trust Fund investments are made by the Fund's trustee, the Secretary of the Treasury.

A total of $7.68 billion was invested in U.S. Treasury Certificates of Indebtedness as of September 30, 1996, at a rate of 6.63 percent, maturing June 30, 1997. This represents a $3.46 billion decrease in the amount invested as of September 30, 1995. Although an annual decrease has been the norm in recent years, the lapse of excise taxes in FY 1996 caused a significant change. See chapter 3 of the Annual Report for additional information on the expired taxes. A total of $3.67 billion of the Trust Fund balance corresponds to Trust Fund appropriations of cash to liquidate pending obligations.

(2) Market-based Treasury securities are debt securities that the Treasury issues to Federal entities without statutorily determined 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, in accordance with SFFAS No. 1. The following amounts are invested in market-based Treasury securities:

(Dollars in Thousands)

	Maturity Date	Effective Interest Rate	Amount
1	12/12/96	5.04%	$ 12,335
2	4/03/97	5.16%	21,265
3	6/26/97	5.49%	14,395
4	9/18/97	5.52%	16,465
			$ 64,460

Note 5. Accounts Receivable :

(Dollars in Thousands)

	Other Accounts Receivable	Gross Amount Due		Allowance for Uncollectable Amounts	Net Amount Due	
Intragovernmental:						
Airport and Airway Trust Fund	$ 129,077	$ 129,077		$ -	$ 129,077	(1)
Appropriated Funds	30,374	30,374		-	30,374	
Other Funds	8,556	8,556		-	8,556	
Total	$ 168,007	$ 168,007		$ -	$ 168,007	
Governmental:						
Airport and Airway Trust Fund	$ 13,718	$ 13,718		$ (182)	$ 13,536	
Appropriated Funds	9,480	9,480		(2,042)	7,438	
Other Funds	5,693	5,693	(2)	(2,110)	3,583	
Total	$ 28,891	$ 28,891		$ (4,334)	$ 24,557	

Delinquency notices are sent to debtors when billings remain uncollected for 30 days. Followup notices are sent if the debtor does not respond. Additional actions, such as salary or retirement offset (when the debtor is a current or former Federal employee), as well as tax refund offset, consumer reporting, and referral to collection agencies may be taken, depending on the circumstances of each case. An allowance for uncollectible accounts receivable is established when, based upon a monthly review of outstanding accounts and the failure of all collection efforts, management determines that collection is unlikely to occur.

(1) In fiscal years 1994 and 1995, appropriated amounts not yet transferred from the Treasury to FAA appropriation accounts were reported as intragovernmental accounts receivable. As of September 30, 1996, $3.67 billion in funds appropriated to FAA had not yet been transferred from the Trust Fund. This amount is more properly reported in FY 1996 as Trust Fund investments. See Note 4, Investments.

(2) A total amount of $3.94 million represents an accounts receivable balance of Treasury General Fund Miscellaneous Receipt accounts. FAA established a $3.94 million intragovernmental liability to offset the accounts receivable balance which represents an asset of the Treasury, not FAA. See Note 11. Other Liabilities.

Note 6. Other Assets:}

(Dollars in Thousands)

Other Entity Assets - Intragovernmental

Undistributed Foreign Costs	$ 403
Undistributed Costs - Treasury Clearing	4,901
Other Assets - Undistributed	6,281
Total	$ 11,585

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers:

(Dollars in Thousands)

Defaults on Pre-1992 Guaranteed Loans:

Aircraft Purchase Loan Guarantee Program	Defaulted Guaranteed Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Defaulted Guaranteed Loans Receivable, Net
	$ 644	$ 241	$ (337)	$ -	$ 548

FAA has no direct loan programs, but FAA administered the Aircraft Purchase Loan Guarantee Program. Authorization for issuing new loan guarantees expired before 1992. The only remaining program function is to maximize recoveries from defaulted loans. While this authority was in effect, FAA could guarantee up to 90 percent of the principal and 100 percent of the interest of an aircraft purchase loan. Upon default, FAA would establish accounts receivable in the General Fund Miscellaneous Receipts account to reflect the amount due from the borrower for principal and interest. This amount was considered to be a direct loan. FAA would also establish an intragovernmental liability to offset the accounts receivable that represented assets of the Treasury, not FAA. See Note 5, Accounts Receivable, footnote 2, and Note 11, Other Liabilities, footnote 1.

Accounts receivable from debtors on account of defaulted guaranteed loans are reported net of an allowance for estimated uncollectible amounts. The Federal Credit Reform Act was enacted after the authority to issue new guarantees expired, and therefore does not apply to FAA's loan guarantees.

Administrative expenses to maintain residual values in this program are minimal. FAA has no full-time employees administering the program.

Note 8. Operating Materials and Supplies, Net:

(Dollars in Thousands)

	Value	Allowance	Net Value	Valuation Method
Items Held For Use:				
General Operations	$ 409,317	$ (113,737)	$ 295,580	Standard Cost
Aircraft Parts	35,784	(8,219)	27,565	Standard Cost
Facility Components	86,214	-	86,214	Standard Cost
Other Unclassified	22,634	-	22,634	
Total	$ 553,949	$ (121,956)	$ 431,993	

General operating materials and supplies, including aircraft spare parts, are reported as operational assets. Applying standard costs results in gains and losses which are recognized as current period expenses. This may cause operating materials and supplies, as well as operating expenses to be under or overstated. FAA will, not later than FY 1998, use the moving weighted average method to value operating materials and supplies. This will eliminate valuation gains and losses attributable to using standard costs. See Note 16, Other Revenues and Financing Sources, and Note 18, Other Expenses.

FAA currently expenses items as issued. The DOT Office of Inspector (OIG) determined during the FY 1996 audit that expensing items as issued may result in understating the value of operating materials and supplies, because the items shipped from the William J. Hughes Technical Center (WJHTC) and the Mike Monroney Aeronautical Center (MMAC) to regional facilities may not have been consumed by fiscal yearend. During FY 1997, FAA will establish a baseline of such items by conducting a nationwide inventory of regional items not yet consumed. Subsequently, at each fiscal yearend, regional stock items will be counted and their value will be included in the operating materials and supplies balance. Operating expense will be adjusted accordingly. Items shipped to regional facilities may also include components of work in process or completed property and equipment. During FY 1997, FAA will review the operating materials and supplies transfers and shipments to ensure proper classification as operating expense, work in process, or property and equipment. See Note 9, Property and Equipment, Net, and Note 17, Program Expenses.

The allowance method is used to account for operating materials and supplies held for repair, reducing the net carrying value of such items to 35 percent of their original cost. An allowance for reparable items of $113.7 million for general operations and $8.2 million for aircraft parts was established in FY 1996. Items are considered for repair if the maximum repair cost does not exceed 65 percent of the original cost.

A $16.5 million loss on excess operating materials and supplies was recognized in FY 1996. These items were written down in value from an original cost of $62.6 million to a net realizable value of $46.1 million. The write-down is generally based on condition levels and on the ratio of repair cost to original cost. Scrap and salvage items are written down to zero value and may be sold for nominal amounts. FAA transfers excess items for disposal into the governmentwide automated disposal system. Disposal proceeds may go to the General Fund or to an FAA appropriation, depending on the nature of the item and the disposal method. FAA may not donate items.

The purchases-in-transit account generally represents property and equipment in transit from suppliers to FAA. Purchases in transit were improperly classified as operating materials and supplies in prior fiscal years. They are correctly classified in FY 1996 as property and equipment. See Note 9, Property and Equipment, Net.

Note 9. Property and Equipment, Net:

(Dollars in Thousands)

Classes of Fixed Assets	Deprec. Method	Service Life (yrs)	Acquis. Value	Accum. Deprec.	Net Book Value FY 1996	Net Book Value FY 1995
Land	None	None	$ 63,020	None	$ 63,020	$ 57,340
Structures, Facilities and Lease Improvements	*	*	1,915,752	$ -	1,915,752	1,680,648
Aircraft	SL	20	243,452	(51,038)	192,414 (1)	211,462
Aircraft Engines	*	*	3,961	-	3,961	5,576
ADP Software	*	*	2,760	-	2,760 (2)	224,600
Equipment	*	*	3,125,441	-	3,125,441 (3)	2,723,522
Assets Under Capital Lease	SL	25-30	179,848	(75,899)	103,949 (1)	130,599
Construction in Progress	None	None	3,303,235	-	3,303,235 (4)	2,780,856
Equip. Furnished to Others	*	*	69,874	-	69,874	69,874
Property Not in Use	*	*	18,610	-	18,610 (5)	68,645
Equip. Loaned to Agency	*	*	60	-	60	4,163
Total			$ 8,926,013	$ (126,937)	$ 8,799,076	$ 7,957,285

(1) FAA has begun depreciating aircraft and amortizing buildings acquired under capital leases. Additional categories of assets will be depreciated or amortized in FY 1997 to ensure full compliance with the depreciation provision of SFFAS No. 6, which becomes effective in FY 1998.

(2) As a result of the FY 1993 financial statement audit, the DOT OIG disclosed that approximately $772 million in Advanced Automation System (AAS) software development costs were not properly capitalized because FAA management had viewed software development as basic research and development. The portion of AAS software retained by the agency was capitalized in FY 1995 at $224.6 million. After further analysis during FY 1996, it was determined that much of the software retained by FAA was not fully operational. Consequently, the software account has been adjusted to include only the value of the operational portion ($2.3 million). The $222.3 million balance was transferred to the work-in-process account under the property and equipment category of construction in progress. The remaining software is scheduled to be completed in December 1998.

(3) All purchases in transit from suppliers to FAA are classified as equipment, even though some of these purchases may be other types of items. Before FY 1996, all purchases in transit were improperly classified as operating materials and supplies. See Note 8, Operating Materials and Supplies, Net. Therefore, before FY 1996 operating materials and supplies were overstated and equipment was understated.

The final FY 1995 purchases-in-transit account balance of $897 million erroneously included $561 million for progress payments to contractors and for prior period operating expenses. The latter amount was removed from that balance in FY 1996, leaving $336 million. Of that remaining $336 million, $113 million was found to have been correctly classified as equipment, and therefore allowed to remain in the purchases-in-transit account. The remaining balance of $223 million could not be reconciled and was written off as an extraordinary item. See Note 19, Extraordinary Items/Prior Period Adjustments.

(4) Construction in progress represents incomplete work on all classes of fixed assets identified in this table. The DOT OIG determined during the FY 1995 audit that, when an asset has been substantially completed for its intended use, the asset's cost should be transferred from the construction-in-progress account to the proper fixed asset account.

The construction-in-progress account contains costs that should have been charged to current and prior period operating expenses. See Note 8, Operating Materials and Supplies, Net, and Note 17, Program Expenses. FAA is correcting these

deficiencies in FY 1997. Further, the construction-in-progress balance may have been understated if items shipped from the WJHTC and the MMAC were improperly classified as operating expenses. This possibility is being reviewed in FY 1997.

(5) FAA recognized a $19.4 million loss on excess property in FY 1996, by writing down the value of property not in use from an original cost of $43.6 million to a net realizable value of $24.2 million. The write-down is generally based on condition levels and on the ratio of repair cost to original cost. Scrap and salvage items are written down to zero value. FAA transfers excess property for disposal into the governmentwide automated disposal system. Disposal proceeds may go to the General Fund or to an FAA appropriation, depending on the nature of the item and the disposal method. FAA may not donate items.

Note 10. Debt:

(Dollars in Thousands)

	Beginning Balance	Net Borrowing	Ending Balance
Other Debt:			
Aircraft Purchase Loan Guarantee Program Debt to the Treasury	$ 21	$ -	$ 21
Total Debt	$ 21	$ -	$ 21

Note 11. Other Liabilities:

(Dollars in Thousands)

A. Other Liabilities Covered by Budgetary Resources

1. Intragovernmental:	Noncurrent Liability	Current Liability	Total	
Advances from Others	$ 20,018	$ 20,778	$ 40,796	(1)
Employee Savings Bond Deductions		508	508	
Proceeds From Replacement of Property	12	-	12	
Total	$ 20,030	$ 21,286	$ 41,316	
2. Governmental:				
Accrued Payroll & Benefits, Federal	$ -	$ 128,019	$ 128,019	(2)
Accrued Payroll & Benefits, Employee Contributions	90	27,480	27,570	
Advances from Others, Unclassified	94	3,226	3,320	
Tax Deductions - State and Local	145		145	
Liability for Unapplied Collections	145	5,554	5,699	
Total	$ 474	$ 164,279	$ 164,753	

(Dollars in Thousands)

B. Other Liabilities Not Covered by Budgetary Resources

1. Intragovernmental:	Noncurrent Liability	Current Liability	Total	
Voluntary Separations	$ -	$ 9,566	$ 9,566	(3)
Workers' Compensation Benefits	78,378	96,294	174,672	(4)
Total	$ 78,378	$ 105,860	$ 184,238	
2. Governmental:				
Environmental Remediation	$ -	$ 382,224	$ 382,224	(5)
Air Traffic Control at Closed DOD Bases	-	21,789	$ 21,789	(6)
Senior Executive Service Awards	-	124	$ 124	(7)
Accrued Unfunded Leave and Associated Benefits	-	318,919	$ 318,919	(8)
Contingent Liabilities for Legal Claims	-	320,505	$ 320,505	(9)
Contingent Liabilities for Return Rights Program	-	32,000	$ 32,000	(10)
Airport Improvement Program Grant Agreements	-	1,710,070	$ 1,710,070	(11)
Total	$ -	$ 2,785,631	$ 2,785,631	

(1) An amount of $4.49 million represents an intragovernmental liability established to offset Treasury General Fund Miscellaneous Receipt account balances ($3.94 million in accounts receivable, net, and $.55 million in loan guarantees, net). See Note 5, Accounts Receivable, and Note 7, Loans and Loan Guarantees, Non-Federal Borrowers.

(2) Accrued liabilities for Federal payroll and benefits and related employee contributions represent the unpaid pay period September 15 through September 30, 1996.

(3) During FY 1996, FAA offered voluntary separation incentive payments to employees, under section 3 of the Federal Workforce Restructuring Act of 1994. Agencies offering such payments must make additional CSRS and FERS retirement contributions to the OPM through FY 1998. The amount of the liability is $80 per employee estimated to be employed on March 31, 1997, and per employee estimated to be employed on March 31, 1998. In addition, for FY 1997 agencies must make additional CSRS and FERS retirement contributions to OPM, equal to 9 percent of the salary of employees receiving incentive payments in FY 1997.

(4) The U.S. Department of Labor (DOL) administers the Federal Employees' Compensation Fund. DOL provides FAA with a quarterly statement of workers' compensation benefits paid for its employees during each DOL accounting period (July 1 through June 30), under 5 U.S.C. 8147. Funding for the amount charged to FAA is normally appropriated for the fiscal year ending 2 years after the FAA accounting period in which the expense was incurred. Therefore, FAA's FY 1996 accrued liability includes workers' compensation benefits paid by DOL for the periods July 1, 1994 through June 30, 1995; July 1, 1995 through June 30, 1996; and July 1, 1996 through September 30, 1996.

(5) Environmental remediation includes: environmental cleanup; the fuel storage tank program; environmental, occupational safety and health compliance; and energy conservation. Such remediation will bring FAA into compliance with Federal, state, and local environmental and occupational safety and health regulations. Environmental remediation costs are currently being reviewed. This review may disclose that such costs have been understated by $310 million.

(6) Providing ATC services where needed is FAA's responsibility under 49 U.S.C. 44502(a)(1)(B). FAA will continue providing ATC functions for civilian users of the National Airspace System near certain DOD bases that are scheduled for closure. FAA's costs include those for equipment, real property, and personnel relocation.

(7) These accrued liabilities, amounting to $.124 million, are for FY 1996 performance awards to senior executive service employees that will not be paid until the first quarter of FY 1997.

(8) The estimated liability for accrued wages includes employee annual, home, and military leave and compensatory and credit hours, plus the agency's cost of employee benefits associated with such compensated absences for the period ended September 30, 1996.

(9) In FY 1996, FAA recognized contingent liabilities of $320.5 million associated with claims that had been brought to the attention of the OCC and that: (a) had been asserted, or, if not yet asserted, in the opinion of the OCC were more likely to be asserted than not; (b) in the opinion of the OCC were more likely to be paid than not; and (c) for which the OCC could estimate probable payment. Such claims represented a variety of administrative proceedings and legal actions against which the OCC was then defending or then expected to defend. Prior to FY 1996, FAA disclosed such liabilities in notes to the financial statement.

Of the contingent liabilities recognized, approximately $16.8 million could be payable from agency appropriations and approximately $303.7 million could be payable from the permanent appropriation for judgments, awards, and compromise settlements (Judgment Fund) administered by the Department of Justice. An OMB interpretation of SFFAS No. 5, Accounting for Liabilities of the Federal Government, proposes requiring agencies to recognize an expense and a liability for the full amount of an expected loss, whether payable from agency appropriations or from the Judgment Fund. The estimated maximum exposure to the agency for claims payable from agency appropriations or from the Judgment Fund is approximately $30.9 billion. See Note 22, Contingencies.

Recognized contingent liabilities may have been understated, because the stated amount does not include contract, personnel, or other claims processed without OCC involvement. It is unknown whether such claims represent a material amount. Action will be taken during FY 1997 to estimate the amount of claims being processed by organizations other than OCC.

(10) A contingent liability in the amount of $32 million for the Re-employment, Restoration, and Return Rights Program was recognized in FY 1996. The program covers temporary assignments for 2 to 4 years. At the beginning of FY 1996, approximately 827 employees who previously had accepted transfers to overseas or certain domestic locations were contractually entitled to a future return move at Government expense. The typical cost per move is $50,000. During FY 1996, approximately 187 cases of potential return right claims were closed, because employees elected not to exercise their rights. At the end FY 1996, approximately 640 employees remained in the program. The liability may be overstated because not every employee remaining in the program will exercise his or her return rights.

(11) Represents AIP grant agreements for which FAA has obligational authority, but has not yet received a liquidating cash appropriation. This amount includes only the portion of available authority that has been obligated. It does not include the unobligated balance. See Note 21, Other Disclosures.

Note 12. Leases:

A. FAA as Lessee:

Capital Leases:

(Dollars in Thousands)

Summary of Assets Under Capital Lease:	
Land and Buildings:	
Aeronautical Center	$ 130,599
Technical Center	49,250
	$ 179,849 (1)
Accumulated Amortization	(75,899) (2)
Net Assets Under Capital Lease	$ 103,950

Future Payments Due: Fiscal Year	Land and Buildings
Year 1 (FY 1997)	$ 16,757
Year 2 (FY 1998)	16,703
Year 3 (FY 1999)	16,160
Year 4 (FY 2000)	12,422
Year 5 (FY 2001)	11,218
After 5 Years (FY 2002 to Contract End)	98,386
Less: Imputed Interest	(60,523)
Total Capital Lease Liability	$ 111,123
Funded	$ -
Unfunded	$ 111,123
Less: Physical Assets Held for Others	(134)
Total Unfunded Capital Lease Liability	$ 110,989 (3)

Capital leases cover land and buildings at the MMAC in Oklahoma City, Oklahoma, and at the WJHTC in Pomona, New Jersey. (Operating leases presented in the following section cover other real property.) FAA leases the MMAC land and buildings from the Oklahoma City Airport Trust at $12 million per year. FAA leases various real property, including the WJHTC technical building, from the Atlantic County Improvement Authority at $4.8 million per year.

FAA's capital lease payments are funded annually. The following represents capital lease accounting treatment under generally accepted accounting principles;

(1) Capital lease assets are recorded at the net present value of the minimum lease payments at the inception of the lease.

(2) In FY 1996, FAA implemented the depreciation/amortization provision of SFFAS No. 6, which is applicable to assets acquired under capital leases.

(3) Amounts due within the current fiscal year corresponding to the principal portion of the lease payments are recorded as current year obligations. The remaining principal payments are recorded as unfunded lease liabilities. The imputed interest is funded and expensed annually. Interest amounts imputed to subsequent years ($60.5 million) are not recorded as unfunded liabilities in the Departmental Accounting and Financial Information System (DAFIS).

Operating Leases:

(Dollars in Thousands)

Future Payments Due:

Fiscal Year	Land & Buildings	Mach. & Equipment	Other	Total	
Year 1 (1997)	$ 44,295	$ 360	$ 430	$ 45,085	
Year 2 (1998)	40,971	367	431	41,769	
Year 3 (1999)	36,400	377	432	37,209	
Year 4 (2000)	31,814	242	436	32,492	
Year 5 (2001)	27,758	250	281	28,289	
After 5 Years (2002 to Contract End)	64,947	4,403	119	69,469	(1)
Total Future Operating Lease Payments	$ 246,185	$ 5,999	$ 2,129	$ 254,313	

FAA leases property, aircraft, equipment, and telecommunications under operating leases. Such leases are funded annually and expensed as recurring charges in DAFIS. Unfunded liabilities and future funding requirements for operating lease payments due in future years are not recorded in DAFIS.

(1) The cumulative amount due on operating leases after 5 years does not include estimates for leases with annual renewal options. Estimates of the lease termination dates are subjective, and any projection of future lease payments would be arbitrary.

B. FAA as Lessor:

Operating Leases:

(Dollars in Thousands)

Future Projected Receipts:

Fiscal Year	Land & Buildings	Mach. & Equipment	Other	Total
Year 1 (1997)	$ 3,933	$ 276	$ -	$ 4,209
Year 2 (1998)	4,123	276	-	4,399
Year 3 (1999)	4,320	275	-	4,595
Year 4 (2000)	4,530	275	-	4,805
Year 5 (2001)	4,759	275	-	5,034
After 5 Years (2002 to Contract End)	200,034	-	-	200,034
Total Future Operating Lease Receivables	$ 221,699	$ 1,377	$ -	$ 223,076

FAA leases Washington National Airport and Washington Dulles International Airport to the Metropolitan Washington Airports Authority, the airports' operator. The lease took effect in March 1987 at $3 million per year for a 50-year term. Upon lease expiration, the airports and facilities, originally valued at $244 million, together with any improvements thereto, will revert to the Federal Government. In addition, FAA leases equipment to foreign governments and leases parcels of Government-owned land, generally for agriculture. The original value of these assets is approximately $2.8 million.

Note 13. Pensions and Other Actuarial Liabilities:

(Dollars in Thousands)

	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%) *	Assets Available to Pay Benefits	Actuarial Liability Not Covered by Budgetary Resources
Workers' Compensation Benefits	$ 821,258		$ -	$ 821,258
Total	$ 821,258		$ -	$ 821,258

OMB has directed that Federal agencies establish an unfunded actuarial liability under the Federal Employees Compensation Act for workers' compensation benefits. Liability estimates include death, disability, medical, and miscellaneous costs for approved compensation cases. Estimates are based on the paid losses extrapolation method, calculated over the ensuing 23-year period. This method uses historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. Using the DOL's actuarial projection, OST initially established FAA's liability at $725.3 million as of June 30, 1994. DOL adjusts this liability annually by applying actuarial procedures.

* Annual benefit payments have been discounted to present value, assuming the following interest rates:

for 1996, 7.00 percent in year 1 and thereafter;

for 1995, 7.10 percent in year 1, 6.60 percent in year 2, and 7.00 percent thereafter; and

for 1994, 7.00 percent in year 1 and thereafter.

Note 14. Net Position:

(Dollars in Thousands)

	Trust Fund	Operations General Fund	Aviation Insurance Revolving Fund	Aircraft Purchase Loan Guarantee	Other Funds	Total
A. Unexpended Appropriations						
(1) Unobligated						
a. Available	$ (2,796,275)	$ (263,818)	$ -	$ -	$ (798)	$ (3,060,891) (1)
b. Unavailable	-	-	-	-	-	-
(2) Undelivered Orders	4,582,094	366,891	-	-	126	4,949,111
(3) Other:						
Not Yet Appropriated	110,989 (2)	-	-	-	-	110,989
Total	$ 1,896,808	$ 103,073	$ -	$ -	$ (672)	$ 1,999,209
B. Invested Capital	10,679,224	497,164	-	5	(888)	11,175,505
C. Cumulative Results of Operations	3,960,190 (3)	316,693	62,506	(3)	30	4,339,416
D. Other	(105,480)	-	-	-	-	(105,480)
E. Future Funding Requirements	(2,225,072) (4)	(1,677,028) (5)	(16) (5)	(21)	-	(3,902,137)
Total	$ 14,205,670	$ (760,098)	$ 62,490	$ (19)	$ (1,530)	$ 13,506,513

(1) The amount withdrawn biweekly from the Trust Fund is based on cash outlays, not obligational authority, to minimize interest costs. In addition, the AIP has obligational authority, but has not yet received a liquidating cash appropriation.

(2) Represents appropriations not yet enacted for capital lease principal payments.

(3) Includes $4.13 billion of excise tax revenues transferred from the General Fund to the Trust Fund and invested in Treasury securities. In prior years, the corresponding amount was reported as invested capital.

(4) Includes future funding requirements for capital lease principal payments, environmental remediation, providing ATC functions to civilian users of the NAS system in the vicinity of closed DOD bases, and AIP grant obligations above liquidating cash appropriations already enacted.

(5) Includes future funding requirements for accrued compensated absences and other employee benefit programs and recognized contingent liabilities for claims. (A portion of these contingent liabilities may be attributable to the Judgment Fund or to FAA appropriations other than the Operations appropriation.)

Note 15. Taxes:

(Dollars in Thousands)

Excise Taxes:

	1996	1995
Passenger Ticket Tax	$ 2,122,879	$ 4,767,634
Waybill Tax	150,905	361,315
International Departure Tax	128,380	232,952
Fuel Taxes	2,806	210,740
Total Tax Revenues	$ 2,404,970	$ 5,572,641

Total FY 1996 tax revenues were $3.17 billion less than in FY 1995. This significant change was caused by the lapse of excise taxes. See chapter 3 of the Annual Report for additional information on the expired taxes.

Note 16. Other Revenues and Financing Sources:

(Dollars in Thousands)

A. Other Revenues and Financing Sources

	1996	1995
Gain on Materials and Supplies Valuations	$ 240,357 (1)	$ 258,161
Gain on Fixed Assets	35,256	32,367
Other Gains	-	(206)
Revenue Credited to Operations Appropriation	4,262	3,150
Revenue Credited to Miscellaneous Receipts	761	-
Aviation Insurance Premiums Credited to the Aviation Insurance Revolving Fund	27	36
Total	$ 280,663	$ 293,508

(1) Gains result from various functions performed at the MMAC, such as making repairs and improvements, receiving items returned from field facilities, fabricating specialty items, transferring parts, making transfers between accounts, inspecting bins, and recognizing differences between actual costs and standard costs used in valuing materials and supplies. Other valuation gains for operating materials and supplies result from regional adjustments. See Note 8, Operating Materials and Supplies, Net. The OIG determined during the FY 1996 audit that FAA is not compliant with the SFFAS No. 3 requirement that valuation gains be treated as unrealized gains. Therefore, other revenues and financing sources are overstated by $240 million. This revenue overstatement is partially offset by the recognition of realized losses from such valuations. See Note 18, Other Expenses.

SFFAS No. 3 allows using standard cost only if that cost approximates historical cost. By FY 1998, FAA will value operating materials and supplies by the moving weighted average method. This method will value operating materials and supplies more accurately and will comply with SFFAS No. 3.

(Dollars in Thousands)

B. Other Information

	1996	1995
Amount of Tax Refunds and Estimated Tax Credits	$ (36,032)	$ (38,862)
Total Transferred to General Fund	$ (36,032)	$ (38,862)
Transfers to FAA Appropriation Accounts	(6,591,120)	(7,352,382)
Total	$ (6,627,152)	$ (7,391,244)

OMB Circular A-34, Instructions on Budget Execution, dated December 26, 1995, requires payments between fund groups to be recorded as obligations and an expenditure from the transferring account. In DOT, this involves expenditure transfers from Trust Funds to General Funds. The amount of $6.6 billion includes $2.2 billion that represents expenditure transfers from the Airport and Airway Trust Fund to the General Fund. The General Fund reflects the actual revenues and expenses resulting from the expenditure transfers.

Note 17. Program Expenses:

(Dollars in Thousands)

Operating Expenses by Appropriation	1996	1995
Operations	$ 4,739,877	$ 4,501,261
Facilities and Equipment	2,508,902 (1)	1,896,689
Research, Engineering and Development	233,495	243,637
Grants-in-Aid for Airports	1,664,931	1,833,809
Aviation Insurance Revolving Program	337	502
Aircraft Purchase Loan Guarantee Program	-	1
Other Funds	50 (2)	70
Total	$ 9,147,592	$ 8,475,969

Operating expenses are the actual costs incurred in conducting each program for the reporting period. Operating expenses exclude capital expenditures, interest expenses, and direct and indirect costs associated with the cost of goods sold and the services rendered. Operating expenses are not necessarily the same as outlays (expenditures of cash), a term which is used in many budget presentation documents. Obligations by major object class are discussed in chapter 3, Financial Highlights. DAFIS cannot now disclose program expenses by object class.

OMB Circular A-34, Instructions on Budget Execution, dated December 26, 1995, requires payments between fund groups to be recorded as obligations and an expenditure from the transferring account. In DOT, this involves expenditure transfers from Trust Funds to General Funds. The General Fund reflects the actual revenues and expenses resulting from the expenditure transfers.

Funds were appropriated to OST for paying to GSA the cost of space that is under GSA control and is occupied by all DOT organizations. OST recognizes an operating expense for that portion of the cost that is derived from the General Fund. The remaining $41.4 million is derived from the Trust Fund and is recognized as FAA's operating expense.

Items shipped from the WJHTC and the MMAC to regional facilities have been charged to operating expense when shipped. This may have understated operating materials and supplies for the reporting period, if some items were not consumed in that period. The FY 1996 DOT OIG audit disclosed this deficiency. During FY 1997, a baseline of regional items not yet consumed will be established by conducting a nationwide inventory. Subsequently, at each fiscal yearend, FAA will physically count all such items, and the dollar value will be included in the operating materials and supplies account. Operating expense will be adjusted accordingly. In addition, some items that were shipped by regional facilities and that should have been classified as work in process or completed property and equipment have been classified improperly as operating materials and supplies. During FY 1997, FAA will review operating materials and supplies transfers and shipments to ensure that items are properly classified. See Note 8, Operating Materials and Supplies, Net, and Note 9, Property and Equipment, Net.

(1) Includes environmental remediation expenses which include: environmental cleanup; the fuel storage tank program; environmental, occupational safety and health compliance; and energy conservation. Such remediation will bring FAA into compliance with Federal, state, and local environmental and occupational safety and health regulations. Environmental remediation costs are currently being reviewed. This review may disclose that such costs have been understated by $310 million.

(2) Includes Facilities, Engineering, and Development; Other Ledger; expired Operations appropriations; suspense funds; and deposit funds.

Note 18. Other Expenses:

(Dollars in Thousands)

Other Expenses	1996	1995
Loss of Fixed Assets	$ 98,360	$ 170,978
Loss on Materials & Supplies Valuation	174,591 (1)	221,595
Allowance for Reparable Materials & Supplies	122,826 (2)	-
Discounts Lost	3	2
Increase/(Decrease) FECA Actuarial Liability	101,322	10,886
Contingent Liabilities for Claims	320,505 (3)	-
Aviation Insurance - Annual Leave Expense	- (4)	3
Total	$ 817,607	$ 403,464

(1) Losses result from various functions performed at the MMAC, such as making repairs and improvements, receiving items returned from field facilities, fabricating specialty items, transferring parts, making transfers between accounts, inspecting bins, recognizing differences between actual costs and standard costs used in valuing materials and supplies, and adjusting for damage to materials and supplies. Other valuation losses for operating materials and supplies result from regional adjustments. See Note 8, Operating Materials and Supplies, Net. The OIG determined during the FY 1996 audit that FAA is not compliant with the SFFAS No. 3 requirement that valuation losses be treated as unrealized losses. Therefore, other expenses are overstated by $175 million. This overstatement of expenses is partially offset by the recognition of realized gains from such valuations. See Note 16, Other Revenues and Financing Sources.

(2) SFFAS No. 3 allows using standard cost only if that cost approximates historical cost. By FY 1998, FAA will value operating materials and supplies by the moving weighted average method. This method will value operating materials and supplies more accurately and will comply with SFFAS No. 3.

An item is considered to be reparable if the repair cost does not exceed 65 percent of its acquisition cost. Reparable items are written down to 35 percent of their acquisition cost.

(3) An OMB interpretation of SFFAS No. 5 proposes requiring agencies to recognize an expense and a liability for the full amount of an expected loss, whether payable from agency appropriations or from the Judgment Fund. Before FY 1996, FAA did not recognize expenses arising from contingent liabilities associated with claims against FAA. Of such liabilities recognized in FY 1996, approximately $16.8 million could be payable from agency appropriations and approximately $303.7 million could be payable from the Judgment Fund.

(4) Annual leave for FY 1996 is appropriately classified as an operating expense and is recognized in Note 17, Program Expenses.

Note 19. Extraordinary Items/Prior Period Adjustments:

(Dollars in Thousands)

A. Extraordinary Items:

Trust Fund Appropriations	$ (222,584)	
Total	$ (222,584)	(1)

B. Prior Period Adjustments:

Trust Fund Appropriations	$ 638,309	(2) (3)
Operations Appropriations	(21,141)	(2)
Total	$ 617,168	

(1) Reconciling the purchases-in-transit account balance to contract documentation (see Note 9, Property and Equipment, Net) resulted in writing off $222.6 million. The material amount of this unusual and infrequent asset write-off warrants separate disclosure.

(2) Efforts during FY 1996 to reduce the work-in-process account for completed capital projects and to properly reclassify costs in the proper asset account disclosed that capital costs had been improperly charged to operating expenses in prior periods. Prior period adjustments also include corrections of FY 1996 payments of prior year accrued expenses that were improperly charged to FY 1996 operating expense. The FY 1996 beginning Net Position balances of the Trust Fund (facilities and equipment) and the Operations appropriations were credited $71.9 million and $21.1 million respectively. See Note 9, Property and Equipment, Net

(3) The FY 1996 beginning Net Position of the Trust Fund Corpus was adjusted by $710 million to reconcile with the Treasury custodial accounts as of September 30, 1996.

Note 20. Nonoperating Changes:

(Dollars in Thousands)

A. Increases:	1996	1995
(1) Transfers In	$ 32,120	$ 351,806
(2) Donations & Other Capital	1,873	817
(3) Other	3,736,889	6,195,647
(4) Total Increases	$ 3,770,882	$ 6,548,270
B. Decreases:		
(1) Transfers Out	$ (32,145)	$ 351,806
(2) Donations & Other Capital	(780)	-
(3) Other	(4,659,922)	3,418,453
(4) Total Decreases	$ (4,692,847)	$ 3,770,259
C. Net Nonoperating Changes	$ (921,965)	$ 2,778,011

Note 21. Other Disclosures:

Contract Negotiations. FAA has a total of $165.3 million in commitments (funds reserved for possible future obligations) under unexpired Facilities and Equipment, and Research, Engineering, and Development appropriations, for purchases of goods and services for which contract negotiations have not been completed (i.e., agency obligations had not been incurred) at the end of FY 1996.

Contract Options. As of September 30, 1996, FAA had $1.59 billion in contract options that, if exercised, 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 (LOI) to enter into AIP grant obligations; but LOIs do not create obligations. FAA has issued LOIs covering FY 1988 through FY 2008 in the aggregate amount of $2,112 million. FAA had obligated $1,294 million of this total from FY 1988 through FY 1996, leaving $818 million unobligated as of September 30, 1996. FAA anticipates obligating $198 million in FY 1997.

AIP Grants. In prior fiscal years, FAA disclosed the amount of outstanding AIP grant obligations for which liquidating cash appropriations had not been enacted. Of the AIP grant authority that FAA apportioned in FY 1996, $61.9 million remained unobligated as of September 30, 1996. This amount remains available for obligation through September 30, 1998.

Sunday Premium Pay. The U. S. Court of Appeals for the Federal Circuit ruled that Federal employees who were regularly scheduled to work on a Sunday but instead took paid leave (annual, sick, or other excused absence) were entitled to Sunday premium pay for leave hours, under 5 U.S.C. 5546(a) (*Armitage v. United States*, 991 F.2d 746 (Fed. Cir. 1993)). This decision made FAA liable for retroactive payments for the 25 percent Sunday premium, including accrued interest, to those who took leave on Sunday when they had been scheduled to work. There is a 6-year statute of limitation for back-pay claims. As of September 30, 1996, a total of $33.3 million had been paid through negotiated settlements to or on behalf of 30,000 current and former FAA employees. No FY 1996 appropriations were used to pay any portion of the back pay liability because the FY 1996 DOT Appropriations Act prohibited using FY 1996 funds to pay Sunday premiums unless work was actually performed. As of September 30, 1996, unpaid claims attributable to years for which appropriation accounts have been closed amounted to $287,590. These would have been payable from FY 1996 funds under 31 U.S.C. 1553(b)(1), but for the limitation on the FY 1996 DOT Appropriations Act that prohibited that payment.

Note 22. Contingencies:

Legal Proceedings. FAA recognized contingent liabilities of $320.5 million for certain claims. Such claims are those that have been brought to the attention of the OCC and that: (a) have been asserted, or, if not yet asserted, in the opinion of the OCC are more likely to be asserted than not; (b) in the opinion of the OCC are more likely to be paid than not; and (c) for which OCC can estimate the probable payment. The maximum exposure associated with such claims is $30.9 billion. Therefore, FAA's exposure to loss for such contingent liabilities in excess of the amount recognized is $30.6 billion. Total exposure may have been understated because the stated amount does not include contract, personnel, or other claims processed without OCC involvement. It is unknown whether such claims represent a material amount. Action will be taken during FY 1997 to estimate the amount of claims being processed by organizations other than OCC.

Aviation Insurance Program. FAA may issue aircraft hull and liability insurance under the Aviation Insurance Program for certain air carrier operations. FAA's authority to issue insurance is limited to situations where commercial insurance is not available on fair and reasonable terms and where the operation to be insured is necessary to carry out the U.S. Government's foreign policy. No claims for losses were pending as of September 30, 1996.

The categories of insurance issued by FAA are: (1) premium insurance, for which a risk-based premium is charged to the air carrier; and (2) non-premium insurance. Non-premium insurance, which represented all of the insurance issued by FAA in FY 1996, is issued for air carrier operations under contract to or on behalf of a U.S. Government agency, provided that the agency has an agreement with FAA to indemnify FAA against all losses covered by the insurance. FAA maintains standby non-premium war-risk insurance policies for 48 air carriers having approximately 936 aircraft available for Defense or State Department charter operations.

FAA normally insures only a small number of air carrier operations at any time. Airspace and airport capacity in areas where FAA insurance coverage would apply is usually very limited, so that FAA expects to be able to terminate insurance coverage and/or insured air carrier operations in high-risk areas after the loss of no more than two aircraft. Thus, probably no more than two FAA-insured aircraft could be lost before the FAA exercises its regulatory authority to stop flights to the area of loss. FAA establishes maximum liability for losing one insured aircraft at the limit of commercial insurance that applied to that aircraft before FAA issued its insurance. This liability covers third party losses. In many cases FAA's maximum liability is $1 billion; usually it is less. Assuming a loss of not more than two aircraft per year, the maximum expected insurance liability for any year would be $2 billion. Therefore, the range of possible liability to FAA is between zero and $2 billion. Since inception of the program (including the predecessor Aviation War Risk Insurance Program, dating back to 1951), only four claims, ranging from $626 to $122,469, have been paid.

The Aviation Insurance Revolving Fund is available for paying claims to the extent of its available balance. This balance was $62.6 million as of September 30, 1996. Additional appropriations from the General Fund to the Revolving Fund are authorized. No claims for losses of FAA-insured operations were pending as of September 30, 1996.

Canceled Appropriations. Under 31 U.S.C. 1552(a), an appropriation account which was available for obligation for a definite period is closed for all purposes at the end of the fifth fiscal year after its period of availability for obligation has expired. All obligated and unobligated balances in the account are then canceled. On September 30, 1996, FAA canceled undelivered orders (i.e., obligations) for the following closed appropriations: $5.3 million for Operations and $2.3 million for Facilities and Equipment. Under 31 U.S.C. 1553(b)(1), as implemented by OMB Circular No. A-34, after an appropriation is closed, any obligations or adjustments to obligations that would have been properly chargeable to that appropriation may be paid from an unexpired appropriation that is available for the same purpose. A single cumulative limit of no more than 1 percent of an unexpired appropriation may be used to pay any combination of obligations relating to closed accounts.

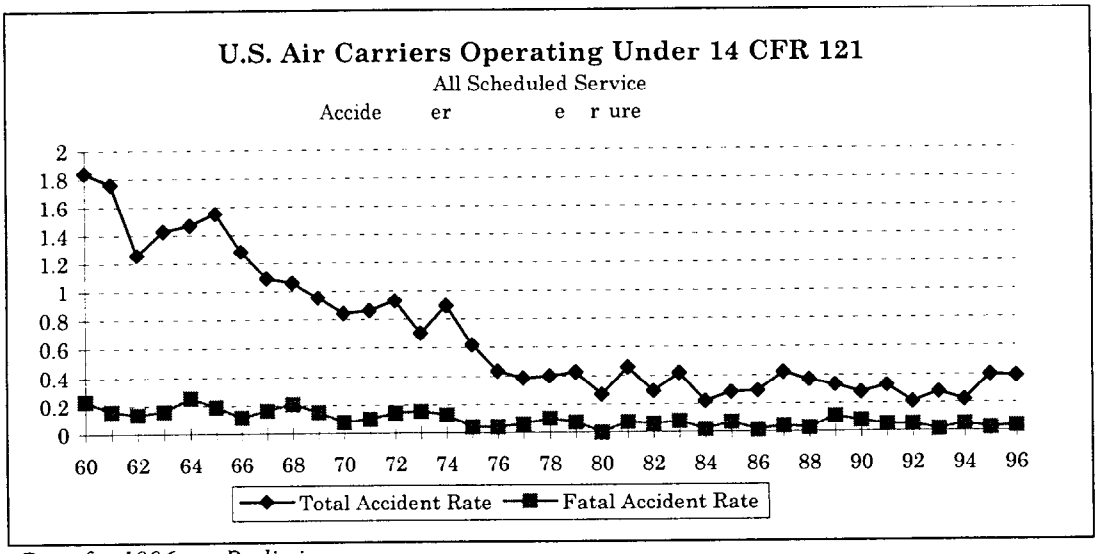
SECTION III
SUPPLEMENTAL INFORMATION

OVERVIEW

Mission. For nearly three-quarters of a century, the United States government has provided for the safe and orderly growth of civil aviation and the management of the Nation's airways. In 1958, to the meet the demands of the emerging jet age, Congress created the FAA, and charged the new agency with a two-fold mission: to promote air safety and to foster air commerce. With the passage of the Federal Aviation Reauthorization Act of 1996 (Public Law 104-264), the Congress formally recognized the FAA's long-standing emphasis on its safety mission by eliminating the promotion of air commerce from its legislative mandate.

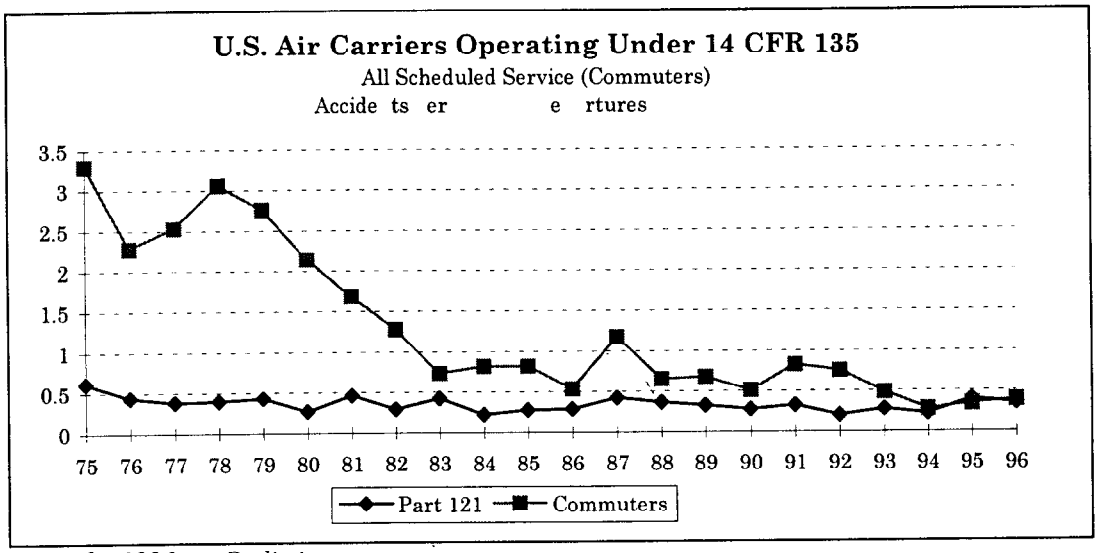
Since 1960, the accident rate for U.S. air carriers operating scheduled passenger service under 14 CFR Part 121 (the regulations governing operation of aircraft with 30 or more seats) has dropped from 1.84 accidents for every 100,000 departures to 0.39 accidents. Yet, over the same period, total scheduled airline departures have increased from 3.9 million a year to 11.7 million, and the number of passengers has grown from 62 million to 605 million. These dramatic gains in safety are not due to the efforts of any one part of the FAA, but to the coordinated and dedicated activities of the entire agency and the aviation industry.

In 1996, two devastating accidents involving large carriers drove the fatal accident rate up from 0.25 accidents per 100,000 departures to 0.37. The total accident rate among these carriers declined, however, from 0.42 to 0.39.



Data for 1996 are Preliminary

Safety is never a static concept. It evolves in response to new technology and the changing structure of the industry. One such change has been the rapid expansion of commuter air travel. In December 1995, the FAA published a final rule which requires small carriers to adhere to the same rigorous safety standards as the large airlines. The rule applies to operators providing scheduled passenger service using aircraft with 10 or more seats. Transition to the new rule began on March 19, 1996. This regulatory action should reduce even further an accident rate for commuter airlines that has fallen sharply since 1978. In 1996, the total accident rate among scheduled commuter airlines fell below that of the large scheduled carriers for the second year.



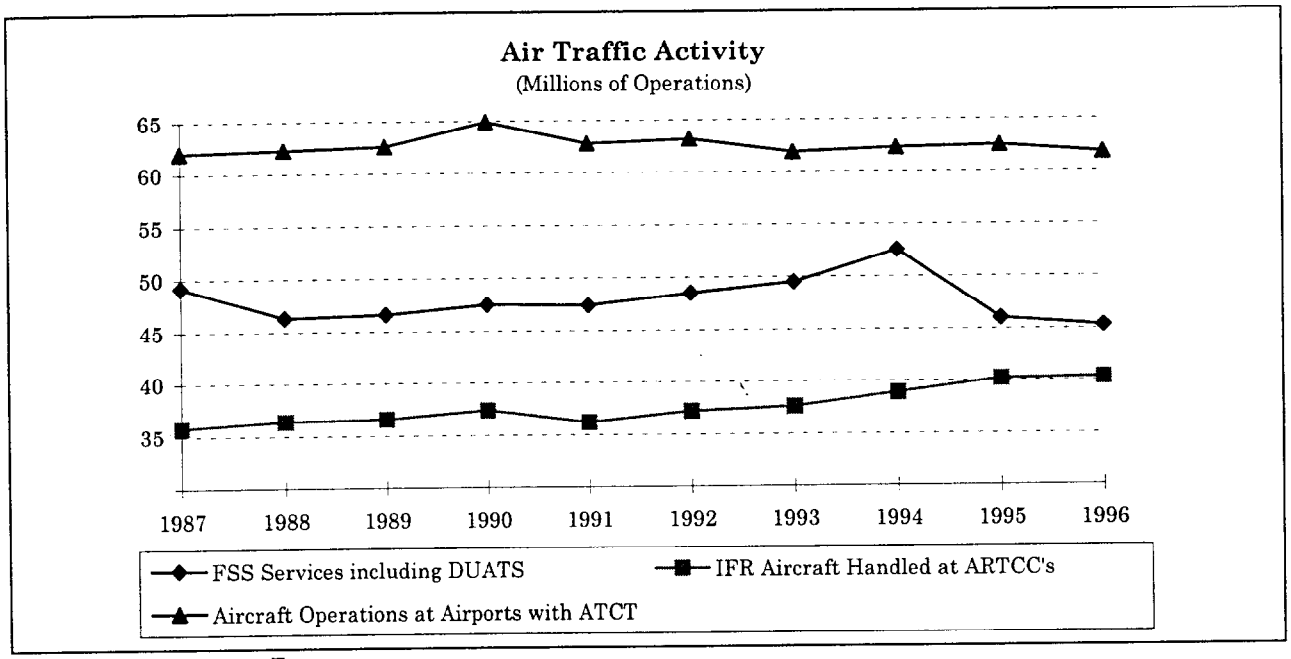
Data for 1996 are Preliminary

To fulfill its safety mission, the FAA maintains a well-trained, multi-disciplined work force of over 48,000 employees organized along seven principal lines of responsibility:

- Air Traffic Services
- Regulation and Certification
- Research and Acquisition
- Airports
- Civil Aviation Security
- Administration
- Commercial Space Transportation

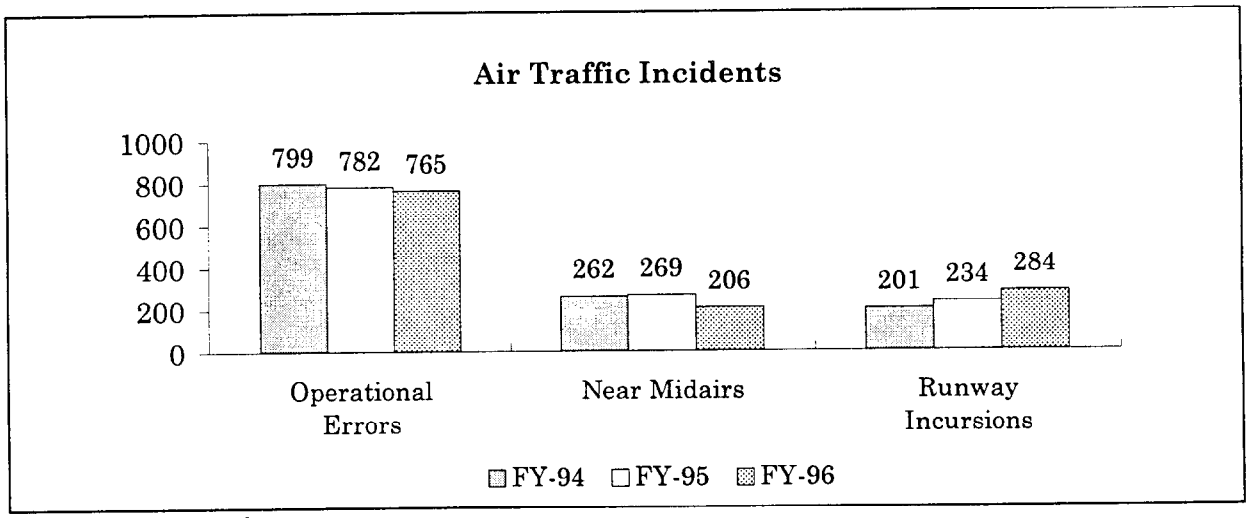
Air Traffic Services. The FAA provides the aviation community with three types of air traffic services: controllers at airport traffic control towers (ATCT) and terminal approach control (TRACON) facilities direct the safe and orderly movement of aircraft arriving at or departing the airport; controllers at air route traffic control centers (ARTCC) oversee aircraft flying between airports under instrument flight rules (IFR); and flight service station (FSS) specialists provide flight planning, weather briefings and other pilot assistance. Services are available to both civil and military users 24-hours a day, 365 days a year.

On a typical day in FY 1996, air traffic controllers handled, on average, three aircraft operations *per second,* moving over 1.6 million air travelers safely to their destination. The United States also has the largest and most active population of general aviation pilots in the world. This past fiscal year, FAA flight service specialists processed an estimated 12 million flight plans, supplied close to 17 million pilot briefings, and contacted 3.8 million aircraft.



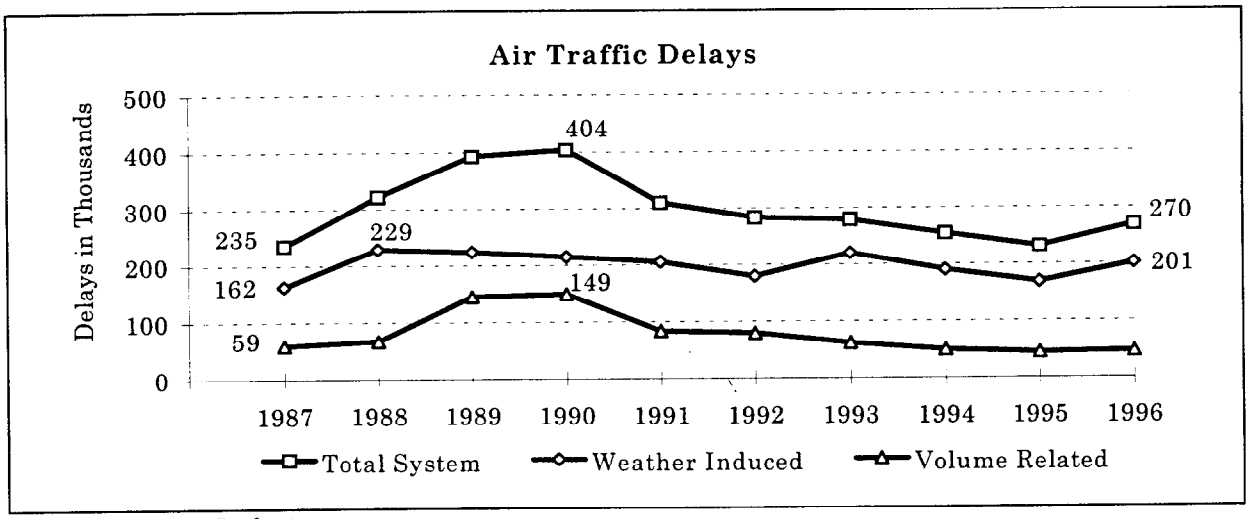
Source: FAA Aviation Forecast

In FY 1996, general aviation activity declined slightly, offset, in large measure, by rising demand for commercial air traffic services. Despite this growing demand, consistent progress



Data for 1996 are Preliminary

has been made in reducing the number of potentially hazardous incidents -- including near midair collisions and operational errors. New equipment is being deployed now that is expected to significantly reduce the number of runway incursion incidents at the nation's airports. Delays, excluding those attributed to weather, were only slightly above the record low level reported in 1995.



Data for 1996 are Preliminary

The FAA also maintains the National Airspace System (NAS) infrastructure to support air operations in the United States. At the end of FY 1996, there were over 34,000 pieces of equipment in the NAS -- maintained at peak efficiency and 99.84 percent availability by FAA technicians and engineers. During FY 1996, the FAA installed over 2,400 new facilities, including the nation's first Airport Movement Area Safety System (AMASS) at San Francisco International Airport. AMASS is being deployed at 34 high activity airports, commencing in the Spring of 1997, to provide tower controllers with active audio and visual alerts on potential runway incursions.

Facility Performance

Fiscal Year	Number of Facilities	Equipment and Service Availability
1994	30,378	99.82%
1995	31,648	99.85%
1996 (Est.)	34,120	99.84%
1997 (Est.)	35,501	99.85%
1998 (Est.)	37,187	99.85%

Regulation and Certification. The FAA's safety regulatory mission encompasses three primary elements: (1) defining the rules and policies governing the design, manufacture, and operation of U.S. aircraft; (2) certificating and overseeing commercial and cargo aircraft operators, aircraft and avionics manufacturers, maintenance organizations, pilot schools, and general aviation; and (3) monitoring compliance throughout the industry.

The aviation safety regulatory framework, established in cooperation with the aviation community, has helped the United States achieve global preeminence not only in safety, but in virtually all aspects of aviation technology. The FAA serves as model for civil aviation authorities throughout the world, and has fostered the international adoption of a regulatory system based on uniform standards and compatible practices.

Inspection Policies Tightened. The FAA moved quickly following the ValuJet crash in the Florida Everglades to tighten its policies governing the oversight of air carriers, particularly those that rely on contract maintenance and training. Among the new policies announced on June 18, 1996, carriers must list all contractors performing substantial maintenance or training activities in their operating specifications, demonstrate the regulatory compliance of each contractor-supported program, and obtain FAA approval before employing any new contractors. Airlines must show that they have the organizational and managerial capacity to oversee these programs and that they are integrated into a effective, comprehensive safety assurance program.

The new policies followed earlier action taken by the FAA and the DOT to accelerate the hiring of additional inspectors, expand its hazardous materials work force, and ban the transporting of certain hazardous materials on passenger and cargo aircraft. These steps followed a previous ruling by DOT which prohibited the transportation of chemical oxygen generators on passenger aircraft.

Research and Acquisitions. The FAA's research and acquisition initiatives are aimed at accelerating the pace of air traffic control (ATC) system modernization, while advancing the frontiers of technology to achieve ever higher levels of safety, increase the capacity and efficiency of the system, protect the environment, and serve national aviation needs, both now and in coming decades. Critical areas of research and development include aircraft and airport safety, security, hazardous weather, and aviation human factors. For air traffic control, the agency is introducing new technologies such as satellite navigation based on the global positioning system (GPS), data link communications, and a portfolio of automated decision-support tools.

In a clear demonstration that the air traffic control system modernization program is back on track, the first of five display channel complex rehost (DCCR) computers arrived at the Chicago Air Route Traffic Control Center (ARTCC) in June 1996 -- 10 months ahead of schedule. The DCCR began operating at Chicago Center in December 1996 and has been delivered to Dallas-Fort Worth, Washington, Cleveland, and New York Centers.

Airports. The FAA works in partnership with airports, local units of government, metropolitan planning organizations and states to plan infrastructure improvements for the national airport system. In FY 1996, the FAA's airport personnel approved over 941 applications, resulting in the obligation of $1.45 billion for new grants and increases in prior grants for airport planning and development. Of this amount, $279.3 million was invested in capacity enhancement, $187.2 million was directed to noise compatibility planning and implementation projects, and $25.7 million was granted to assist in the civil aviation development of joint-use and former military airfields. In addition, over 100 passenger facility charge (PFC) applications were processed, approving over $1.7 billion in PFC collections to fund almost 700 projects. Airport safety and certification inspectors conducted inspections at 380 airports to ensure that they complied with established safety standards.

Civil Aviation Security. The responsibility for aviation security is, by law, a shared one. The FAA, in concert with the nation's security, intelligence, and law enforcement agencies, continuously assesses threats against civil aviation and vulnerabilities at U.S. and international airports, develops countermeasures for dealing with existing threats and anticipates future ones. Air carriers are responsible for putting these safeguards into practice to protect passengers and personnel. Airports are responsible for maintaining a secure ground environment and providing law enforcement support. The overall effectiveness of the security effort also depends on the continued cooperation and vigilance of passengers and shippers.

In late July 1996, the FAA increased security levels at U.S. airports, with a special focus on international flights. The heightened level included more intensive screening of passengers and carry-on baggage, and additional controls on air transport cargo. Following the explosion of TWA Flight 800, the White House Commission on Aviation Security, Safety, and ATC Modernization, led by Vice President Gore, examined all the FAA's aviation security practices and recommended additional measures to further protect air travelers against terrorists or criminal attacks. The FY 1997 Omnibus Continuing Appropriations Act signed by the President on September 30, adopted many of the Commission's recommendations. The act provides funding to install a significant number of advanced bomb detection devices, trace detectors, and upgraded x-ray systems; expand the use of canine teams to sniff out concealed explosives; increase security research programs; conduct additional airport vulnerability assessments; and hire 300 more security agents to work with airports, law enforcement, and intelligence agencies. As a direct consequence of this legislation, on December 26, 1996, the FAA awarded a $52.2 million contract to InVision Technologies of Foster City, California, for the purchase of 54 CTX 5000 SP explosive detection systems, with options for additional units. The first systems began arriving in January 1997.

Administration. The FAA strives continually to make its operations more efficient and responsive by employing best business practices, introducing computer-age tools, maintaining a highly-skilled work force, and operating as a model workplace.

- ***FAA Reform.*** On April 1, 1996, the FAA began operating under new acquisition management and personnel policies. The reforms are the result of legislation successfully sought by President Clinton to free the FAA from overly restrictive federal regulations. The new acquisition management is expected to cut acquisition time in half and reduce costs by 20 percent. The new personnel policies allow the FAA the flexibility to put the right people in the right jobs more quickly, and has reduced the average time for outside hiring from seven months to about six weeks.

- ***Meeting National Performance Review Objectives.*** At the end of August 1996, the FAA had reduced its full-time equivalent employment (FTE) by 11.7 percent from the 1992 baseline -- just under the 12 percent target recommended bring the National Performance Review and mandated by Executive Order 12839. These reductions were achieved, without adverse impact on safety, through buyouts, retirements, and attrition. The National Performance Review initiative to reduce unnecessary directives and other internal regulations by 50 percent ended September 30, 1996. During this effort, FAA canceled more than 49 percent of its internal directives--eliminating over 50,000 pages.

Commercial Space Transportation. In FY 1996, the FAA acquired a seventh line of responsibility when the Office of Commercial Space Transportation was transferred from DOT. As part of this activity, the FAA last year granted licenses for 13 commercial space launches and continued a program to promote the development of voluntary industry and international standards for launch safety. The agency also released a Notice of Proposed Rulemaking to set up a process for determining financial responsibility for the increasing number of commercial space launch operators.

Looking Ahead to 1997. Continued reductions in the accident rate, during a period of rapid growth in air travel, remains the primary task of the FAA in the coming year. Acquisition and personnel reforms give the agency a much stronger hand as it works to introduce improvements in safety and efficiency. Future success may be jeopardized, however, by the absence of an adequate and stable source of funding. This critical issue is yet to be resolved.

In October, the President signed the Federal Aviation Reauthorization Act which established a commission to study the FAA's long-term funding needs and recommend the best financing mechanism. Concurrently, The White House Commission on Aviation Security, Safety, and ATC Modernization is also considering the funding question as part of its broad review of the governance issues confronting the agency. Both of these commissions are considering problems of long-standing concern to the FAA and of great importance to the future of aviation in the United States.

The FAA's Strategic Goals. The development of strategic, mission-oriented goals is a continuing process within the FAA, involving intensive internal and external consultations. Representatives of the industry have participated from the start: first in helping to formulate goals and objectives, and in evaluating the agency's performance in carrying them out. The supplemental section of this report contains a description of these goals and examples of the steps taken to achieve them.

SUPPLEMENTAL PROGRAM INFORMATION

FAA STRATEGIC PLAN

During 1996, the FAA fine-tuned its Strategic Plan for the five-year period which spans the millennial transition. The revision accommodates added responsibilities and an expanded set of objectives.

The FAA's role was enlarged by the addition of commercial space transportation -- an activity which can be expected to grow in significance during the coming years.

In FY 1996 the number of Strategic Plan goals was increased as the agency responded to the past year's significant events, both externally and internally. These goals provide the framework for summarizing the agency's accomplishments in its annual report.

The rapid expansion of aviation, the globalizing trends within the industry, and the rapid advances in technology all have had an impact on the agency's strategic thinking -- especially during a period of tight budgets and government reform.

These developments underscore the importance of the each goal as the FAA continues, on course, in fulfilling its long-range plan.

The FAA's Strategic Goals

System Safety	Eliminate accidents and incidents in aviation and protect public safety and property
Security	Eliminate security incidents in the aviation system
Human Factors in Safety	Eliminate human factors as a causal factor in accidents and incidents
System Capacity	Meet the system capacity needs for air and space transportation safely and efficiently
Industry Vitality	Support an active, vital, and efficient aviation and space transportation industry in a manner that best promotes safety
Global Leadership	Achieve a safe, secure, and efficient global air and space transportation system
Environmental Responsibility	Provide strong leadership regarding the environmental impact of aviation and commercial space transportation
FAA Business Practices	Manage resources and investments to control costs and increase productivity, efficiency, and effectiveness while promoting safety and customer service
Transforming the FAA into the Model Federal Workplace	Support and encourage innovation and diversity, and encourage FAA employees to perform at their fullest potential

1. SYSTEM SAFETY

Promoting Aviation Safety Through Assessments, Inspections, and Accident Investigations

Regulation and Certification Practices: FAA 90-Day Review. This past summer, Deputy Administrator Linda Hall Daschle headed a 90-day assessment of the "lessons learned" from FAA's experience with ValuJet. The review examined the FAA's oversight of rapidly growing airlines, particularly those that outsourced maintenance and training functions, as well as the flexibility with which FAA inspection resources can be deployed effectively in response to an air carrier's varied fleet mix and rapid growth. Recommendations included the establishment of a national certification team, stepping up the surveillance of newly certificated air carriers, and increasing the number of aviation inspectors.

Assessing Air Safety of Foreign Governments. As part of an effort to provide the public with more information about aviation safety in international travel, the FAA assesses the safety oversight of countries whose carriers serve the United States. These countries must adhere to the safety guidelines of the International Civil Aviation Organization (ICAO). The FAA will continue to release the results of safety assessments to the public as they are completed. First announced in September 1994, the ratings are part of an ongoing FAA program to complete initial assessments, by the end of 1996, of all countries with air carriers that operate to the United States. Travelers may call 1-800 FAA-SURE (1-800-322-7873) to obtain a summary statement about whether a foreign country has been assessed and the results, if available.

Promoting Safety Through Rulemaking

New Rules on Aircraft Icing. New rules issued in May instruct pilots how to recognize specific hazardous icing conditions and require them to quickly and safely exit these conditions when encountered. The 18 new directives affect 29 different aircraft models with unpowered controls and pneumatic deicing boots. In all, a total of 4,430 aircraft will be affected by the new regulations.

Flight Crewmember Duty Period Limitations, Flight Time Limitations and Rest Requirements. On December 11, 1995, the FAA issued a notice of proposed rulemaking (NPRM) to establish one set of requirements for all operators engaged in air transportation. The NPRM was published December 20, 1995. The comment period, which originally closed on March 19, 1996, was extended to June 19, 1996, and comments are being reviewed and considered.

Wake Vortex Separation Standards. Wake vortices are tornado-like disturbances created as an aircraft passes through the atmosphere. Currently, all aircraft are separated for wake vortex using three categories: small, large, and heavy. In August, the FAA implemented new aircraft separation standards for all aircraft operating in the United States. Separation of small aircraft traveling behind a Boeing 757 will increase from four to five nautical miles. Some 57 types of aircraft, including several business jets and some smaller commercial aircraft, were moved from the large to small aircraft category.

Revisions to Digital Flight Data Recorders (DFDR). In July 1996, the FAA proposed to revise and update the Federal Aviation Regulations to require certain operators to record additional digital flight data recorder parameters. The revisions followed a series of safety recommendations issued NTSB and the FAA decision that the DFDR rules should be revised to upgrade recorder capabilities in most transport airplanes. These revisions would allow additional information to be collected to ensure more thorough accident or incident investigation and to enable industry to predict certain trends and make necessary modifications before an accident or incident occurs.

The Boeing 737 Flight Control System. The FAA has proposed changes in various components of the 737's flight control system, following a Critical Design Review involving representatives from the FAA, the National Transportation Safety Board, other government agencies, and foreign civil aviation authorities. The nine Airworthiness Directives which are proposed would modify certain design characteristics which could possibly reduce the pilot's ability to control the aircraft.

Medical Standards and Certification Procedures, Title 14, CFR, Part 67. The FAA issued a rule that became effective in September 1996, revising airman medical standards and medical certification procedures. The amendments implemented a number of recommendations resulting from a comprehensive review of the medical standards announced in previous notices. The revision of the standards for airman medical certification and associated administrative procedures was necessary for aviation safety and reflects current medical knowledge, practice, and terminology. The rule also revised procedures for the special issuance of medical certificates ("waivers") for those airmen who are otherwise not entitled to a medical certificate. In addition, the rule changed the duration of third class airman medical certificates, based on the age of the airman, for operations requiring a private, recreational, or student pilot certificate.

FAA/NHTSA Ban on Use of Certain Child Restraints Aboard Aircraft. A final rule became effective on September 3, 1996, banning the use of booster seats, as well as harness and vest-type child restraint systems (CRS) aboard all U.S. air carriers. Tests conducted by the FAA's Civil Aeromedical Institute (CAMI) in Oklahoma City have shown that these types of restraints do not provide adequate protection for infants and toddlers during aircraft takeoff, landing and while aircraft move on the ground.

A companion rule was announced by the National Highway Traffic Safety Administration (NHTSA), which is responsible for developing design standards used by CRS manufacturers and for approving them for both automobile and aviation use. NHTSA's rule complements the FAA rule by requiring manufacturers to label booster seats, and harness and vest restraints as "not certified" for use in aircraft. The FAA strongly recommended that all children who fly, regardless of their age, be protected by an approved CRS that is appropriate to the child's size and weight. An "approved" CRS will have a label that reads "This restraint is certified for use in motor vehicles and aircraft." The FAA has tested several types of child restraints at CAMI. A complete list of FAA safety recommendations for air travel with children is available by calling the agency's consumer information hotline at 1-800-FAA-SURE.

Promoting Safety Through Data Sharing

Global Analysis and Information Network (GAIN). Studies show that unless steps are taken now to further reduce the already low rate of accidents, the number of accidents will escalate along with the growth of air traffic. In May 1996, the FAA published a proposal and solicited comments from the world-wide aviation community for the development of a global analysis and information concept to help reduce airline accidents. The proposal is an effort to develop an early warning capability designed to both detect and alert users to existing and emerging safety problems. The network would collect aviation safety data, analyze that data for potential safety-related trends, and share that analysis with the aviation community worldwide to improve aviation safety. The first GAIN conference, held in Boston in October, provided an opportunity for participants to exchange ideas and discuss organizational issues. The FAA is proposing, for example, that GAIN be owned and operated by an international consortium.

The Royal Aeronautical Society will host a two-day conference this spring on ways to make safety data instantly available on-line to aviation professionals worldwide. The objectives would be to move toward resolution of institutional questions, such as a GAIN charter, membership requirements, and sharing agreements between the various GAIN participants. The workshop also would focus on reviewing development of a prototype and considering other possibilities.

Aviation Safety Conference. In January 1995, Secretary Peña hosted an industry-wide aviation safety conference in Washington, D.C., which brought together more than 1,000 industry, government and union aviation officials. The initiatives developed as a result of this conference were compiled and released as an *"Aviation Safety Action Plan"*. A follow-up meeting was held in New Orleans, Louisiana, on December 6 and 7, 1995, to evaluate the first year's accomplishments, and set the agenda for 1996. An updated Aviation Safety Plan was released on February 8, 1996.

Flight Operations Quality Assurance (FOQA). Working groups at the January 1995 Safety Conference identified the sharing of FOQA information as a major partnership initiative to reduce aviation accidents. In July 1995, the FAA began a demonstration study in cooperation with industry to access in-flight recorded data collected by the airlines. A contract amendment was awarded in FY 1996 to expand the study to regional airlines. Study participants at present are United, USAir, Continental, UPS, TWA, Alaska, and Southwest Airlines. Other participants are pending completion of union agreements.

Transportation Partnership for Safety. In July, 1996, the FAA requested comments on a proposed Advisory Circular (AC) that offers guidance for establishing air transportation partnership for safety programs. These programs are intended to generate safety information that may not otherwise be obtainable, and are entered into voluntarily by the FAA, a certificate holder, and other parties as appropriate. Partnership for safety programs are intended for air carriers that operate under Part 121 and major domestic repair stations certificated under Part 145 of the Federal Aviation Regulations. The FAA plans to implement a two-year demonstration program under which information can be collected and analyzed to measure the program's effect on safety.

Promoting Safety Through Improved ATC Technology

Terminal Doppler Weather Radar (TDWR). This radar detects hazardous wind shear in and near airports terminal approach and departure corridors and reports that information to pilots and controllers. The FAA has purchased 47 TDWR systems (including two support systems) from Raytheon Corporation. Twenty systems have been commissioned, including twelve in FY 1996. At the close of FY 1996, TDWR had been delivered to 42 sites.

Airport Surface Detection Equipment (ASDE-3). ASDE-3 is a high-resolution ground radar that aids in the movement of aircraft and vehicles on the airport surface, especially during periods of low visibility, such as rain, fog, and night operations. The FAA is purchasing 40 ASDE's for installation at 34 high-activity airports. At the close of FY 1996, 32 systems had been delivered and 26 commissioned, including 9 since October 1995.

Airport Movement Area Safety System (AMASS). The nation's first AMASS system was installed at San Francisco International (SFO) Airport on May 30, 1996, for a one-year operational evaluation. AMASS was developed to prevent runway incursions and accidents. Using radar data from the airport surface detection equipment (ASDE) and flight information from the automated radar terminal system (ARTS), the AMASS provides tower controllers with active audio and visual alerts on potential runway incursions. System-wide application should begin during the Spring of 1997.

Promoting Safety Through Improved Airport Technology

Soft Ground Arresting System for Airports. The FAA, its industry partner Engineered Systems Company of Aston, Pennsylvania, and the Port Authority of New York and New Jersey successfully tested a new technology that will better protect both passengers and aircraft in the unlikely event of a runway overrun. During the May 21 test at the FAA's William J. Hughes Technical Center in Atlantic City, New Jersey, a cellular cement "soft arrestor" bed stopped an FAA Boeing 727-100 within approximately 300 feet. The test aircraft was traveling at 55 knots when it entered the bed, which was 332 feet long, 40 feet wide, 24 inches deep at its highest point and 9 inches deep at the lowest. Neither the aircraft nor the personnel on board felt more deceleration than on a normal landing.

The Port Authority of New York and New Jersey plans to install several arrestor beds at New York Airports. Construction of the first soft ground arrestor is nearing completion at John F. Kennedy (JFK) International Airport, runway 4R. The agency will use the knowledge gained from studying this bed to prepare guidance for airports across the nation.

2. SECURITY

Meeting New Challenges in Aviation Security

Explosive Detection System Research. The FAA recertified the Invision CTX 5000SP explosive detection system after major system hardware and software changes were made to improve performance of the system. In addition, the airport demonstration program on the CTX 5000SP continued on track during the fiscal year. The agency installed two units each at Manila International Airport and Atlanta International Airport, and tests continue at the San Francisco International Airport.

Aircraft Hardening. The FAA and its research partners are acquiring blast containers for evaluation on airlines. In the first of two phases, the agency selected two suppliers to provide 16 units. For the second phase, the agency anticipates selecting up to fifteen potential suppliers to provide approximately 60 units, with delivery beginning in February 1997. All units will be closely monitored for their operational utility, durability, and inspection and repair considerations. Airline cooperation has been achieved through the Air Transport Association.

Transportation of Hazardous Materials. In July 1996, the FAA announced a series of steps to further protect against the potential dangers of transporting hazardous materials aboard aircraft. New initiatives include a seven-fold increase of previous resources devoted to inspection, outreach, and public education regarding hazardous materials in air transportation, as well as a ban of transporting on passenger aircraft specific oxygen-yielding hazardous materials that can fuel fires. In addition the FAA asked the Research and Special Programs Administration (RSPA) to ban the transportation of "oxidizers" and "oxidizing materials" in specific compartments on passenger and cargo aircraft. Oxidizers, such as hydrogen peroxide, are materials that may, generally by yielding oxygen, cause or enhance the combustion of other materials. This effort is in addition to RSPA's temporary ban on the transportation of chemical oxygen generators which went into effect in May.

Fire Detection and Suppression. As part of a continuing comprehensive safety initiative, the FAA announced in November 1996 that it intended to propose new rules to require fire detection and suppression systems in the cargo compartments of all commercial passenger aircraft and to ban the transportation of oxidizing materials. One rulemaking, to be issued shortly, would propose banning oxidizing materials from commercial passenger air cargo compartments. Another rulemaking would propose requiring the retrofit of fire detection and suppression equipment on about 2,800 older commercial aircraft. A public notice and comment process will be required for both rulemakings.

3. HUMAN FACTORS IN SAFETY

Promoting Safety Through Human Factors Studies and Research

Shift Work and Fatigue. The US Coast Guard and the FAA began a joint investigation in FY 1996 of the human factors issues of fatigue in flight operations. This cooperative effort involved personnel from the headquarters of Coast Guard and the FAA, along with the Coast Guard Research and Development Center, the FAA Civil Aeromedical Institute (CAMI), and the US Army Aeromedical Research Laboratory. The study will evaluate new approaches to assessing fatigue and performance demands in an operational environment. Data collection from the first group of personnel at the Cape May station was completed this summer. Research with National Aeronautics and Space Administration - Ames on shift work and fatigue is also ongoing, and collaboration continues with Walter Reed Army Institute for Research to evaluate a drowsiness detection system.

Cabin Air Quality Research. The FAA and the National Institute for Occupational Health (NIOSH) are examining cabin air quality and cosmic radiation exposures aboard commercial aircraft. This research will address broad disease transmission issues. The focus of the first examination will be on flight attendant health. During the next five years, the FAA-NIOSH research will collect data on the likelihood that

passengers and crew contract diseases from air borne infectious agents. The incidence of respiratory ailments among flight attendants will be compared with data collected in national health surveys to detect abnormal patterns.

Advanced Qualification Program (AQP) Model. The advanced qualification program is a comprehensive crew training plan designed to ensure the seamless integration of crew resource management and technical skills with all other flight procedures required by specific flight situations. It not only provides systematic training, but also evaluates that training and addresses weaknesses. During FY 1996, United, Delta, Northwest, and Piedmont completed implementation of AQP in one type of aircraft. Additionally, the FAA designed a model AQP for use by regional carriers that allows operators to create individualized programs by plugging data pertinent to its aircraft and procedures into the data base to generate an AQP program.

4. SYSTEM CAPACITY

Keeping Pace with Today's Capacity Needs

Dallas/Fort Worth Metroplex Air Traffic System Plan. On October 10, 1996, the FAA formally activated the Air Traffic Metroplex Plan. This $166 million program, begun in 1987 and developed in concert with the airport, carriers, and the aviation community, included 68 projects and the largest airspace modification ever undertaken by the FAA as a single event. The air traffic Metroplex system is expected to increase capacity by 75 percent in the D/FW area and by 15 percent in the National Airspace System, saving the aviation industry and the general public $10 billion over the next 20 years. The Metroplex system improves the efficiency of all D/FW-area radar controlled airports, including Dallas Love Field, Fort Worth Alliance, and Fort Worth Meacham, by doubling the number of arrival routes. The navigational aids enable pilots to fly parallel arrival routes into the area over each airspace quadrant, and then on to more efficient routes t the airport. With activation of the Metroplex Plan, all existing airspace and procedures within a 150-mile radius were change changed to take advantage of the new capacity.

With the opening of its new 8,500-foot east runway, Dallas/Fort Worth International Airport now has the capability to conduct simultaneous triple arrivals during instrument meteorological conditions. Only one other airport, the recently completed Denver International Airport, has this capability. DFW's investment in this additional airfield capacity included a comprehensive noise abatement plan and compatible land use initiative. The FAA issued $158 Million in grants for this project from Airport Improvement Program proceeds. DFW also collected $127 million in passenger facility charges to assist in financing this development program.

Voice Switching and Control System (VSCS). The last of 21 VSCS installations -- all delivered on schedule -- arrived at the FAA's Jacksonville ARTCC in Hilliard, Florida, on June 28, 1996. VSCS is a state of the art communications system that provides clear, fast communications between pilots of en route aircraft and controllers, and other users of the NAS. It is the largest automation system ever introduced by the agency and a key element of the FAA's plan to modernize the ATC system. In FY 1996, systems at eleven ARTCC's became fully operational, bringing the total to fifteen sites. The remaining six sites are scheduled to achieve full operation by February 1997.

Meeting Future Capacity Needs With New Technology

Expediting the Use of the U.S. Global Positioning System (GPS). The wide area augmentation system (WAAS) is the first planned augmentation to GPS for aviation purposes. When operational, WAAS will allow aircraft to use GPS for all phases of flight from en route down to Category I precision approaches. It is the key program in the FAA's plan to transition from a ground-based to a satellite-based navigation system. On May 1, 1996, the FAA signed a letter contract with Hughes Aircraft Corporation for development of the WAAS, replacing the initial contract that the agency canceled last April. Hughes was awarded a formal long-term contract in October 1996.

In March 1996, President Clinton issued a policy that confirms to the world that the United States will provide GPS for peaceful civil, commercial, and scientific use on a continuous basis, free of direct user fees. The directive announced the intention to terminate the practice of degrading GPS civil signals within the next decade. As a result of these efforts, the GPS system has gained international acceptance for use in civil aviation.

DSR Moves Toward System Acceptance. The Display System Replacement (DSR) program to modernize air traffic control computers used at ARTCC's continues to proceed on schedule and within budget. The DSR provides an automation platform for future en route air traffic control enhancements that will be needed as the complexity and volume of air traffic continues to grow. During FY 1996, the DSR program completed hardware and software design and development. The system is currently in the formal test phase of acquisition, with system acceptance at the FAA's William J. Hughes Technical Center scheduled for March 1997. The DSR is scheduled to be operational at the first site, Seattle, in October 1998.

Standard Terminal Automation Replacement System (STARS). A joint program being undertaken by the FAA and DOD, STARS is designed to replace automated radar terminal systems (ARTS) with a modern, commercially-based, fully digital system. STARS will provide the platform and open architecture necessary to meet increasing air traffic demands, as well as enhance the safety and efficiency of the NAS. With the new system, maintenance costs will be reduced and future upgrades will be more affordable. The FAA awarded a contract for the STARS procurement in September 1996 to a team led by Raytheon Company's Equipment Division. The first system is scheduled to be operational in Boston in December 1998.

Center-TRACON Automation System (CTAS) Prototypes Become Operational. The FAA is developing CTAS to assist traffic management specialists and controllers in the management of terminal area traffic. The CTAS is comprised of a set of automated tools including the Traffic Management Advisor (TMA) and Final Approach Spacing Tool (FAST), which are implemented as prototypes at the Denver and Fort Worth en route centers and the Dallas-Fort Worth TRACON, respectively. The CTAS TMA/FAST prototype provides controllers with aircraft advisories directly on their displays, assisting them in delivering aircraft to the TRACON's at efficient and accurate intervals. Assessment of the prototype indicates initial aircraft delay reductions of up to three minutes during peak periods. The CTAS-TMA prototype at the Miami ARTCC began operating in late September. Installations at the Los Angeles and Atlanta ARTCC's were also completed.

5. INDUSTRY VITALITY

Promoting the Harmonization of Regulations and Procedures

Final Harmonization of FAR Parts 27 and 29. The FAA Aircraft Certification Service Rotorcraft Directorate and the European Joint Aviation Authorities (JAA) have worked for over a decade to harmonize (standardize) the regulations relating to rotorcraft. This initiative culminated with the issuance by the JAA in March 1993 of Joint Aviation Requirements (JAR) 29 for transport rotorcraft and JAR 27 for normal category rotorcraft. The FAA published amendments in May 1996 to FAR 27 and 29. The combined efforts have produced harmonization of the United States and European Rotorcraft Regulations.

Common Certification Standards Established for US and European Small Airplanes. Effective March 11, 1996, a common set of standards to increase safety and simplify certification of newly designed US and European small airplanes (less than 12,500 pounds) was established by the FAA and the JAA. Through nearly uniform design safety standards between the FAA and the 23-member nation JAA, the new rules require any new-type models of small airplanes seeking certification to have such additional safety equipment as: a takeoff warning system to ensure the airplane's wing flap settings are in the proper position before takeoff; fire-proof materials and better fire protection in the cargo and baggage compartments; and, stronger windshields to protect against bird strikes. The rules also relieve US airplane

manufacturers of the need to comply with one design standard for the US and a different standard for each JAA-member country.

The new standards represent the first comprehensive regulatory harmonization package accomplished by a subcommittee of the Aviation Advisory Rulemaking Committee (ARAC), made up of European authorities, European and US industry representatives, and FAA personnel. ARAC is comprised of 64 aviation organizations representing the entire aviation community, including air carriers, airports, manufacturers, general aviation groups, labor groups, environmental groups, universities, corporations, associations, public interest groups, and FAA representatives.

Reducing the Regulatory Burden While Maintaining the Highest Levels of Safety

Regulatory Reviews. Beginning in January 1997, and every three years thereafter, the FAA will publish an announcement in the *Federal Register* inviting the public to identify those regulations, issues, or subject areas that should be reviewed by the FAA. In order to focus on those areas of greatest interest, respondents will be expected to limit their comments to the three issues they consider most urgent. The FAA will review and analyze the issues submitted, compare them with its regulatory agenda and rulemaking program efforts, and adjust its regulatory priorities consistent with its statutory authority and responsibilities. Each review will conclude with a published summary and general disposition of the comments and, where appropriate, indicate how regulatory priorities will be adjusted.

Re-engineering the Rulemaking Process. Last July, the FAA instituted a wide-ranging review of its rulemaking process. A team was organized to devise a procedure that is more efficient than the current one, and is proactive in its early identification of issues with significant policy, technical, economic, and legal implications. The effort complies with a legislative directive and fulfills one of the objectives of Vice President Gore's National Performance Review -- to streamline regulatory processes and make government rulemaking more responsive to public needs.

Meeting new Aviation and Space Requirements

National Route Program. In 1995, the FAA began offering users a choice of routing options while in the en route phase of flight. The National Route Program is now available at flight level 31,000 (FL310) across the conterminous United States. Participation in the program has risen steadily and currently includes about 900 flights a day out of 12,000 eligible flights.

"Free Flight" Concept Adopted. The FAA and the aviation industry have adopted a new operational concept which will allow pilots, under certain circumstances, to choose their own routes, speed, and altitudes in real time -- taking advantage of favorable winds and avoiding rough weather. Restrictions would be imposed only to ensure safe separation, avoid overloading airports, and prevent intrusion into airspace reserved for special use. The FAA and the aviation community have developed an action plan and are working together to phase in Free Flight by the year 2010. An industry-wide panel, formed in April 1996, is overseeing its implementation. Air Traffic operations personnel were involved from the start and will be key participants in making the concept work as envisioned.

Technologies that will play a central role in the transition to the new concept include satellite navigation by means of GPS, data link capability, airborne collision avoidance systems, and more advanced decision support systems, including automated en route air traffic control (AERA) and center/TRACON automation system (CTAS).

Free Flight will benefit airspace users and passengers by reducing the need for aircraft to operate along prescribed routes, saving fuel and time. Clear-cut lines of authority and responsibility between pilots and air traffic controllers, along with the use of protected and alert zones around aircraft, will ensure the safety of the nation's airspace system.

Spaceport at Vandenberg AFB. In September 1996, the FAA issued the country's first commercial spaceport license to California Spaceport. The company, headquartered in Lompoc, California, is developing a 108 acre site on Vandenberg Air Force Base (VAFB). Commercial space launches are expected to begin as early as next fall. The licensing is a critical link in the long regulatory process that will eventually lead to commercial launches at VAFB. Essentially, it is the FAA's recognition that a private company has met all government standards to ensure a competent, safe and reliable commercial space operation.

Commercial Space Launches. U.S. launch operators conducted thirteen licensed commercial launches during the fiscal year, one more than during the previous year, and more than any year since commercial launching began in this country in 1989. The FAA, which now has responsibility for overseeing this industry, particularly with regard to safety, licensed all of these launches. This brought to 65 the number of U.S. commercial launches conducted since 1989. Also during FY 1996, the FAA issued 4 new launch licenses and 4 amendments to existing licenses. In support of these and other active licenses, the agency conducted 11 maximum probable loss (MPL) analyses in support of financial responsibility determinations required by statute.

6. GLOBAL LEADERSHIP

Achieving a safe, secure, and efficient global air and space transportation system

Trade Agreements. The Associate Administrator for Commercial Space Transportation provided representation and in-depth analytical and policy support to negotiations led by the U.S. Trade Representative (USTR) to establish a commercial space launch trade agreement between the U.S. and Ukraine. The negotiations were completed in December 1995, and the agreement was signed into force on February 21, 1996. The FAA provided similar representation and industry expertise in USTR-led negotiations with Russia to modify the U.S.-Russia commercial space launch trade agreement (making its terms and provisions more compatible with those in the agreements with China and Ukraine). These negotiations were completed in mid-January and the amendments were signed into force on January 30, 1996. The Department of Commerce's (DoC) Office of Aerospace in the International Trade Administration also participated in these efforts.

In July 1996, the FAA supported the USTR-led annual consultations with the People's Republic of China (PRC) concerning the functioning of the 1995 U.S.-PRC commercial space launch trade agreement. In addition, the agency continued to serve as chair of the interagency Working Group on Information responsible for monitoring foreign compliance with the U.S.-PRC, U.S.-Russia, and U.S.-Ukraine launch trade agreements. The DoC's Office of Aerospace participated in these working groups and assisted in the efforts concerning all three agreements.

Aviation Activities with China. This past year marked the tenth year of formal cooperation between FAA and its counterpart organization in China, the General Administration of Civil Aviation in China (CAAC). Accomplishments included technical exchanges in the areas of airport safety and development, flight standards, aviation medicine, and air traffic control. The objectives of these efforts is to enhance safe civil air operations in China by promoting and gaining support for U.S. standards, policies, and procedures for safety and security in air transportation.

Aviation Activities with Russia. The Federal Aviation Authority of Russia and Russia's Ministry of Defense are working toward agreement on a modernized Unified Air Traffic Control System with strong support from the FAA and the Department of Defense (DOD). This step and the planned formation of a state corporation to operate Russia's ATC system will speed worldwide implementation of a satellite-based communication navigation and surveillance/air traffic management (CNS/ATM) system using civil signals from the U.S. GPS and Russian Global Orbiting Navigation Satellite System (GLONASS).

Central and Eastern European Airspace Initiative. The FAA continued to work with the countries of the region to assist them in restructuring their airspace and ATC systems along the lines used in the West, especially with regard to civil and military cooperation. Begun in 1995 with the Czech Republic, Slovakia, Poland, and Hungary, then subsequently extended to Romania, Albania, and Slovenia, the initiative now includes the three Baltic states. The study and recommendations for the ATC and airspace architecture of Latvia, Lithuania, and Estonia were presented at a multinational conference co-sponsored by the FAA in Bled, Slovenia, in September 1996.

7. ENVIRONMENTAL RESPONSIBILITY

Providing strong leadership regarding the environment impacts of aviation and commercial space transportation

Continued Drop in Airline Noise Levels.. The level of noise at the Nation's airports and surrounding areas continues to decline as airlines take older, noisier airplanes out of service and replace them with newer, quieter ones or retrofit the older aircraft with "hush kits" or new engines. In the Report to Congress released in September 1996, the FAA documented that the number of noisier aircraft had declined from 2,250 in 1994 to 2,048 by the end of 1995.

During 1995, the proportion of quieter airplanes used by U.S. airlines increased from 66.3 percent of the fleet to 70.7 percent. The number of airplanes with reduced noise levels rose from 4,427 to 4,935 during the year. The improvement reflects compliance by the airlines with legislation passed in 1990 requiring that older, noisier (Stage 2) airplanes be replaced by quieter (Stage 3) airplanes by the year 2000.

8. BUSINESS PRACTICES

Managing resources and investments to control costs and increase productivity, efficiency, and effectiveness while promoting safety and customer service

Introducing Best Business Practices. The FAA is in the process of phasing in its new streamlined acquisition management system, focusing on a nucleus of "lead-the-fleet" programs. At the same time, the agency is developing a new human resource management program that will make the FAA more competitive in attracting world-class talent, better able to meet staffing needs at all its facilities, and better able to manage its workforce while ensuring fairness and equal opportunity. Implementation teams are at work, overseeing and tracking progress on the various tasks associated with putting the reforms in practice.

Challenge 2000. In 1995, the FAA launched Challenge 2000, a comprehensive review of the FAA's regulation and certification process. This initiative is intended to ensure that the agency is prepared to meet the increasing challenges of regulating the aviation industry and certifying rapidly changing technologies in the 21st century. In May 1996, the FAA announced the results of this independent review. The report provided recommendations on:

- Restructuring FAA's safety regulation function.
- Creating "centers of excellence" which would serve as repositories of expertise and become the recognized authorities on specific subject areas, thus increasing the efficiency and consistency of information provided to other FAA offices and to industry.
- Streamlining and expediting FAA's rulemaking process.
- Identifying and disseminating aviation industry "best practices" as a strategy for increasing aviation safety.

A team from FAA's Regulation and Certification organization is reviewing these recommendations to determine which of them should be adopted and develop aggressive strategies and schedules for their implementation.

Customer Service Standards. In accordance with Executive Order 12862, Setting Customer Service Standards, the FAA developed new customer service standards for nine distinct agency products and services in FY 1996. Brochures reflecting these new standards were distributed this fall. In addition, the FAA evaluated existing agency customer service standards for products/services developed in previous years and submitted evaluation reports as required.

External Communications. The FAA continued an aggressive outreach campaign to inform the public about agency policies and programs, including safety actions and the modernization of the NAS. During FY 1996, the agency expanded its "home page" on the World Wide Web to include "sites" for individual agency offices which provide information on organizational missions and goals as well as descriptions of the ATC products and services provided. The home page also provides the public with news releases, speeches by FAA managers, biographical sketches of key officials, and a listing of telephone numbers. The main FAA web site also contains electronic links to a broad spectrum of acquisition and rulemaking documents. To reach the home page, enter http://www.faa.gov.

9. TRANSFORM THE FAA INTO THE MODEL FEDERAL WORK PLACE

Supporting innovation and diversity, and encouraging employees to perform at their fullest potential

Workplace Diversity. Administrator Hinson approved and authorized the distribution of the *FAA Model Work Environment* brochure for all employees and *FAA Model Work Environment Managers and Supervisors Action Plan*. The Model Work Environment documents were developed by a senior management work group and serve to present:

- Clear definitions of terms.
- The business case for maintaining a productive and hospitable work environment.
- Roles and responsibilities of all employees and of all supervisors and managers.
- The FAA pledge to create the best place where anyone would want to work.

This effort is the first ever collaboratively developed, management-endorsed agency plan that sets a foundation for diversity, Equal Employment Opportunity (EEO), and Affirmative Action for the FAA. It unites all efforts into one direction and it clearly articulates the agency's commitment to have the best work environment possible and what it takes to achieve that objective.

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