



U.S. DEPARTMENT OF TRANSPORTATION  
**OFFICE OF INSPECTOR GENERAL**

**FAA Needs To Improve Oversight  
and Enhance Transparency in  
Its Franchise Fund**

**FAA**

Report No. F12020012

December 11, 2019





## FAA Needs To Improve Oversight and Enhance Transparency in Its Franchise Fund

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*Mandated by the FAA Reauthorization Act of 2018*

Federal Aviation Administration | FI2020012 | December 11, 2019

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### What We Looked At

The Federal Aviation Administration (FAA) Administrative Services Franchise Fund is a Government-run, fee-for-service organization that aims to foster competition, increase efficiency, and reduce costs across the Federal Government. The Fund has six service organizations and reported \$480 million in annual revenues in 2018. As required by the FAA Reauthorization Act of 2018, our office initiated an audit to assess FAA's management and oversight of the Fund's operations and activities. Specifically, we looked at the Fund's history, intended purpose, and objectives; conformance to generally accepted accounting principles; and conformance to Federal policies and other guidelines.

### What We Found

The Fund's six service organizations serve multiple types of customers; by law, they are required to receive payment in advance. While the Fund's annual revenues reflect increases in its services and customers, we found weaknesses in its internal controls. For example, the Fund does not track inventory age; as such, we could not determine if the inventory value, reported to be \$656 million in 2018, had been overstated. Fund officials also do not conduct adequate oversight of the financial operations. For example, we found \$2.6 million in unexpended funds that should have been returned to customers; we project the total unreturned amount to be \$26 million of \$338 million in unexpended funds. In addition, if they are not paid in advance, some service organizations use operating reserves to pay for the costs of providing services, contrary to law. Most of them do not fully comply with requirements for capital reserve plans—increasing the risk that funds could be mismanaged. Still, FAA is changing the Fund's governance structure, which might allow it to measure whether the Fund is receiving adequate oversight and stability. However, FAA could do more to address customer concerns regarding transparency and to avoid the risk of improperly obligating funds. Enhancing financial-related internal controls is key to ensuring the Franchise Fund functions as Congress intended.

### Our Recommendations

We made 13 recommendations to help FAA strengthen its management and oversight of the Franchise Fund. FAA fully concurred with recommendations 3 through 13, but did not concur with recommendations 1 and 2. We have asked the Agency to reconsider its position.

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For inquiries about this report, please contact our Office of Government and Public Affairs at (202) 366-8751.

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## Memorandum

Date: December 11, 2019

Subject: ACTION: FAA Needs To Improve Oversight and Enhance Transparency in Its Franchise Fund | Report No. FI2020012

From: Louis C. King   
Assistant Inspector General for Financial and Information Technology Audits

To: Federal Aviation Administrator

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The Federal Aviation Administration (FAA) Administrative Services Franchise Fund (Franchise Fund or Fund) was authorized under the Department of Transportation (DOT) and Related Agencies Appropriations Act of 1997<sup>1</sup> to foster competition, increase efficiency, and reduce costs across the Federal Government. The Government Accountability Office (GAO) defines franchise funds as Government-run, fee-for-service organizations that provide a portfolio of services, including contracting services, to other Federal agencies. FAA's Franchise Fund is composed of six service organizations,<sup>2</sup> through which it provides products and services to customers on a fee-for-service basis. In 2018, the Franchise Fund reported annual revenues of approximately \$480 million and \$1.1 billion in total assets.

The FAA Reauthorization Act of 2018<sup>3</sup> required our office to initiate an audit of FAA's Franchise Fund. In accordance with that mandate, our audit objectives were to assess FAA's management and oversight of the Franchise Fund's operations and activities. Specifically, we:

1. Reviewed the history, intended purpose, and objectives of the Fund; for details, see the Background section of this report.
2. Assessed, to a limited extent, the Fund's conformance to generally accepted accounting principles and certain financial matters related to inventory records, profits and losses, and unexpended balances. However,

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<sup>1</sup> Pub. L. 104-205, 110 Stat. 2958 (September 30, 1996).

<sup>2</sup> Enterprise Services Center, International Training, Federal Leadership Training, Logistics Center, Flight Program Operations, and Acquisition Services. A Corporation Services component also supports the Franchise Fund.

<sup>3</sup> Pub. L. 115-254, signed by the President on October 5, 2018.

we did not perform a financial statement audit in conformance with generally accepted Government auditing standards, and, accordingly, are not expressing an opinion on the Fund's financial statements.

3. Assessed FAA's governance and oversight of the Franchise Fund, including the use of performance metrics, and the Fund's conformance to Federal policies, best practices, and other guidance related to revolving funds.<sup>4</sup>

Our audit was not the first examination of the FAA Franchise Fund. In a May 2016 report,<sup>5</sup> GAO reviewed the franchise fund operations at FAA and the Department of the Treasury (Treasury)—based on their roles as Federal shared service organizations and their use of unexpended balances. GAO found that FAA gave pricing and performance information to existing customers but not potential ones and lacked processes for managing the Fund's operating reserves. GAO recommended that FAA make the Franchise Fund's pricing information, strategic goals, and performance metrics publicly available, and develop an operating reserve policy. FAA addressed all of the recommendations and GAO closed them in March 2018.

We conducted our work in accordance with generally accepted Government auditing standards for program audits. Our methodology included reviewing applicable guidance; the Fund's customer history; its internal, unaudited financial statements; and FAA's performance and accountability reports. We also met with key officials such as the members of the Franchise Fund Management Council. To verify self-reported profits, losses, revenues, and expenses for fiscal years 2014 to 2018, we used Delphi, DOT's official accounting system. To evaluate unobligated balances for the same period, we performed a 5-year trend analysis of the Franchise Fund's balance with Treasury,<sup>6</sup> and tested a statistical sample from fiscal year 2018—specifically, 82 unfilled customer orders valued at \$177 million from a universe of 1,161 orders valued at \$338 million. Details of our scope and methodology, and locations visited or contacted are included in exhibits A and B, respectively.

We appreciate the courtesies and cooperation of Department of Transportation representatives during this audit. If you have any questions concerning this report, please call me at (202) 366-1407 or Kevin Dorsey, Program Director, at (202) 366-1518.

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<sup>4</sup> A revolving fund uses revenue earned from its business operations to finance those same operations. Government Accountability Office (GAO), *Principles of Federal Appropriations Law, volume 3* (GAO-08-978SP), September 2008.

<sup>5</sup> GAO, *Revolving Funds: Additional Pricing and Performance Information for FAA and Treasury Funds Could Enhance Agency Decisions on Shared Services* (GAO-16-477), May 2016.

<sup>6</sup> The Treasury Department maintains the Franchise Fund's unexpended funds—the obligated funds plus the unobligated balance.

cc: The Secretary  
DOT Audit Liaison, M-1  
FAA Audit Liaison, AAE-100

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## Background

The DOT Appropriations Act of 1997<sup>7</sup> established the FAA Franchise Fund to ensure that funds for capitalizing and operating administrative services would be available without fiscal year limitation. In addition, Congress intended the Fund to provide support services and entrepreneurial assistance that could be offered more advantageously on a shared basis. In general, franchise funds do not receive an annual appropriation from Congress. Instead they may receive any of the following: reimbursements and advances from Federal accounts, as well as fees collected for the sales of Governmental products and services.

We reviewed all six of the FAA service organizations, which provide Franchise Fund services to multiple customers (see table 1 on page 6).

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## Purpose, History, and Objectives of the Franchise Fund

The law allows the FAA Administrator to determine which administrative services the Fund can perform more advantageously for its customers on a centralized or shared basis. Customers include programs managed by FAA's own lines of business, other DOT components, non-DOT agencies, and international government entities. Designed to be revolving and self-sustaining,<sup>8</sup> the Fund reduces and recovers costs by:

- Providing support services—including accounting, travel, information technology, logistics and material management, aircraft maintenance, international and management training, etc.—to other entities on a fee-for-service basis;
- Establishing entrepreneurial, self-sustaining, and cost-reimbursable business activities and reducing the redundancy of multiple offices performing similar functions;
- Giving managers more flexibility through the use of revolving funds that operate on a no-year basis.

The act states that FAA's service organizations cannot provide products or services to Franchise Fund customers unless they receive payment in advance.

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<sup>7</sup> Pub. L. 104-205, 110 Stat. 2958 (September 30, 1996).

<sup>8</sup> Pub. L. 104-205 requires the Franchise Fund to recover all of its costs.

At its launch in 1997, the Franchise Fund comprised two service organizations, and by 1998 it had three service organizations<sup>9</sup> and two primary customers—FAA and the rest of DOT’s components. By 1998, its annual revenues totaled approximately \$21 million. In the years that followed, the Franchise Fund grew in size, customer base, and budget. By 2018, the Franchise Fund had expanded to its current six service organizations,<sup>10</sup> and its annual revenues of approximately \$480 million reflected significant increases in both services and customers.

According to the FAA Franchise Fund Program Manager, the Franchise Fund operates under the same objectives listed in guidance drafted by the U.S. Chief Financial Officers Council:<sup>11</sup> to offer better services at lower costs and drive less effective activities out of business, with the goal of making the Federal Government efficient and fiscally responsible. FAA’s Franchise Fund Management Council provides governance and oversight of the fund.

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## Six FAA Organizations Provide Franchise Fund Services to Internal and External Customers

FAA relies on six service organizations to provide Franchise Fund services to customers on a fee-for-service basis (see table 1).

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<sup>9</sup> In 1998, the FAA Franchise Fund included the Enterprise Services Center, International Training, and FAA Learning & Leadership Institute.

<sup>10</sup> Between fiscal years 2001 and 2011, the FAA Franchise Fund added three more service organizations: the Logistics Center, Aircraft Maintenance and Engineering (now Flight Program Operations), and Acquisition Services.

<sup>11</sup> U.S. Chief Financial Officers Council, “Draft implementation guidance for a Federal Franchise Fund pilot program,” June 1996. The council’s members are chief financial officers and other financial officials in the largest Federal agencies.



Table 1. FAA Organizations That Provide Services for the Franchise Fund

Service Organization	Joined in FY	Services Provided	Primary Customers
Enterprise Services Center (ESC)	1997	Financial and information services: travel, accounting, printing, multimedia, information technology.	Internal: DOT components, including FAA External: non-DOT agencies (e.g.; Departments of Agriculture, Commerce, Education)
International Training Division—FAA Academy (ITD)	1997	Aerospace training to the international community: technical training for international aviation officials; training assessments and consultations.	Internal: FAA External: international entities (e.g.; Canada, South Korea, Mexico, Nigeria, and Thailand)
FAA Learning & Leadership Institute (FLLI)	1998	FAA management-focused training in leadership skills and workforce development.	Internal: FAA
FAA Logistics Center (AML)	2001	National Airspace System (NAS) maintenance, supplies, and repairs; supply chain management; logistics support services.	Internal: FAA External: non-DOT agencies (e.g.; U.S. Customs and Border Protection, Department of Defense)
Flight Program Operations / Aircraft Maintenance & Engineering (FPO)	2001	Maintenance services and avionics support for FAA Flight Program aircraft.	Internal: FAA External: non-DOT agencies (e.g.; Department of Justice)
Acquisition Services (AAQ)	2010	Provides administrative support to Franchise Fund service organizations for contract awards.	Internal: FAA

Source: OIG analysis based on FAA data

In addition, FAA’s Mike Monroney Aeronautical Center’s (MMAC) Office of Financial Services (referred to as Corporate Services) monitors the Fund’s organizational performance and financial position; provides monthly performance reviews; and issues quarterly reports to the Fund’s Director and Management Council.

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## Results in Brief

### **The Franchise Fund lacks audited financial statements and has internal control weaknesses.**

While the Franchise Fund is not required to have audited financial statements, independent reviews of FAA's financial statements for fiscal years 2018 and 2017 identified weaknesses in the Fund's inventory controls at FAA's Logistics Center (AML). We found that AML does not have a detailed aging report for tracking the age of its inventory, which might include items that are 30 or more years old. Without a detailed aging report, we cannot determine if FAA is overstating the Fund's inventory value, reported to be \$656 million in 2018. Moreover, the Franchise Fund has operated at a loss in recent years—approximately \$7.9 million in fiscal year 2018 and \$9.4 million in fiscal year 2017 (although these amounts are much smaller than the \$71 million and \$69 million reported by the Franchise Fund). In part, this is because two of its biggest service organizations reported losses during this period, and they have not been able to recover all their costs, as the DOT Appropriations Act of 1997 requires. In addition, FAA does not enforce DOT's financial completion requirements. Specifically, Fund officials do not conduct adequate oversight of unexpended balances or unfilled customer orders. For example, we found 26 items representing \$2.6 million in unexpended funds that had not been returned to customer. Based on this, we project that \$26 million of \$338 million have not been returned.<sup>12</sup> We also identified eight agreements, totaling \$16.3 million, that were invalid; as a result, we project that \$39 million in customer agreements were invalid or incomplete.<sup>13</sup> Furthermore, when some service organizations do not receive advance payment from customers, they use operating reserves to pay for the costs of providing services. In addition, most service organizations do not fully comply with FAA and Franchise Fund requirements for capital reserve plans—increasing the risk that funds could be mismanaged.

### **FAA is changing its governance of the Franchise Fund but can do more to address customer concerns.**

The Fund is governed by a Management Council, whose voting members were reduced in number from 11 to 5 in June 2019 when the Agency approved a new Franchise Fund Charter and reorganized the Council's oversight role. The revised charter states that one of the primary purposes of the Council is to give the Fund a strategic vision and list the expected outcomes for the portfolio of services it

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<sup>12</sup> Our \$26 million projection has a precision of +/- \$16.6 million or 4.9 percent of the universe amount at the 90-percent confidence level, which means our 90-percent confidence limits ranged from \$9.4 million to \$42.6 million.

<sup>13</sup> Our \$39 million projection has a precision of +/- \$19.8 million or 5.8 percent of the universe amount at the 90-percent confidence level, which means our 90-percent confidence limits ranged from \$18.9 million to \$58.5 million.

provides to customers. It is too soon to assess the overall impact of the reorganization; however, these changes may provide FAA with an opportunity to enhance its governance and oversight. Until the Council develops a plan that defines its vision and expected outcomes for services provided to customers, it may not be able to measure whether it is providing adequate oversight and stability for the large and complex Franchise Fund. We also found that while the Fund's service organizations track performance metrics, not all are publicly available. In addition, one service organization accepted expiring year-end funds from an internal organization, its customer, without sufficient documentation that there was a legitimate, *bona fide* need. Thus, the service organizations run the risk of improperly obligating funds. As FAA expands its oversight of the Franchise Fund, enhancing financial-related internal controls will be key to ensuring the Fund continues to function in the way that Congress intended.

We are making recommendations to help FAA improve its oversight of the Franchise Fund.

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## FAA's Franchise Fund Lacks Audited Financial Statements and Has Internal Control Weaknesses

While the Franchise Fund is not required to have audited financial statements, recent audits of FAA's financial statements identified a significant deficiency in the Fund's inventory controls, which we reviewed during our audit. The FAA Reauthorization Act of 2018 required us to assess the degree to which FAA's policies and controls for the Franchise Fund conform to generally accepted accounting principles (GAAP). The act also required us to provide (1) an assessment of the Fund's revenue, expenses, and profits or losses; (2) a breakdown of the revenue collected from services provided to FAA, DOT, other Federal entities, and non-Federal entities; (3) the number of employees, including full-time equivalents (FTE), and contractors, the associated personnel costs, and the extent to which such costs are covered by Federal appropriations or Franchise Fund revenues; and (4) overhead rates. In addition, we evaluated the status of the Fund's unexpended balances—past and present. While we did not reach overall conclusions on the Fund's financial state, we did note multiple instances where it did not conform to Federal policies or have appropriate control practices.

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## The Franchise Fund Is Not Required To Have Audited Financial Statements

The Fund is not required to have, and we did not perform, an audit of its financial statements. Consequently, we cannot express an opinion about whether its statements are fairly presented in accordance with GAAP. Until the Fund can regularly present audited financial statements, it will be unable to report to Congress and the public about its progress in establishing transparency, internal controls, and compliance with laws and regulations.

KPMG LLP, an independent public accountant, audited FAA's financial statements for fiscal years 2018 and 2017 under OIG's oversight.<sup>14</sup> However, KPMG's audit was not designed to express, and it did not express, an opinion on the Fund's financial statements for those fiscal years or to report on the Fund's internal controls over financial reporting or compliance with laws and regulations. Consequently, KPMG's work cannot be used to draw conclusions about the Fund's financial statements.

### **KPMG Found Inventory Control Weaknesses**

The Fund owns 99 percent of FAA's total inventory, representing a total value of \$656 million—approximately 2 percent of FAA's \$34.6 billion in assets and 59 percent of the Franchise Fund's \$1.1 billion in assets. Consequently, weaknesses in inventory controls are likely to have a significant impact on the Franchise Fund.

In the independent review of FAA's financial statements for fiscal years 2018 and 2017, KPMG identified a significant deficiency<sup>15</sup> in the Agency's controls for reviewing inventory. Specifically, KPMG found that FAA's controls were not properly designed and implemented to ensure the accuracy of the inventory data (including labor hours, routing, and final condition codes). As a result, KPMG stated, FAA's inventory items and related expenses may be inaccurate, increasing the risk that misstatements will be recorded in the general ledger.<sup>16</sup> In September 2019, FAA informed OIG that KPMG is currently evaluating the effectiveness of their corrective actions.

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<sup>14</sup> See *Quality Control Review of the Independent Auditor's Report on the Federal Aviation Administration's Audited Consolidated Financial Statements for Fiscal Years 2018 and 2017* (OIG Report Number QC2019009), November 14, 2018. OIG reports are available on our website: <https://www.oig.dot.gov/>.

<sup>15</sup> A deficiency in internal controls exists when management or employees are unable to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency that likely will not be mitigated in a timely manner. A significant deficiency is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

<sup>16</sup> Of KPMG's five recommendations, two addressed the issues with inventory. All of the KPMG recommendations remain open.

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## The Franchise Fund Does Not Assess Inventory Age or Maintain Complete Inventory Records

During our audit, we found that AML did not maintain detailed reports that tracked inventory age while items are in the Logistics Center. While AML officials acknowledged the inventory items could be 30 years old or older, they stated that an aged inventory report would not add significant value to their current processes or be worth the cost required to implement it. FAA officials added that availability rather than age was the primary criteria for AML inventory stock levels, and that they currently have four processes for handling excess inventory.<sup>17</sup> They also stated that producing the information would be extremely difficult because AML's systems were not designed to respond to such requests.

However, lack of knowledge about inventory age can cause an organization to store excess, obsolete, and unserviceable items. Such unnecessary storage might have contributed to a \$485,000 increase in AML's operation and maintenance costs—from \$1.13 million in fiscal year 2017 to \$1.61 million in fiscal year 2018. Moreover, FAA's Inventory Management Guide states that proper inventory accountability requires the Agency's components to maintain detailed records, whether the items are produced or acquired. Without a detailed report, Franchise Fund warehouse managers, inventory supervisors, and auditors cannot determine if the age of the items is causing an overstatement of the inventory value, reported as \$656 million as of September 30, 2018, or an increase in operation and maintenance costs due to storage fees.

In its financial statements, FAA reported it had inventory excess<sup>18</sup> of \$27 million in fiscal year 2017 and \$6.9 million in fiscal year 2018. To verify the existence or proper disposition of these items, we visited an FAA warehouse that stores and disposes excess items from MMAC in Oklahoma City. There, we learned that items transferred to excess inventory no longer belong to the Franchise Fund. Still, we confirmed that the tracking system used by this warehouse was inaccurate, and many items listed as "onsite" either had been sold or could not

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<sup>17</sup> The four processes are: (1) Inspection of Assets by a Quality Assurance Specialist, (2) Customer Service Action to return assets that did not meet expectations, (3) Unused Material, which is visually inspected or tested by technical personnel, and (4) Decommission Plans from Program Offices.

<sup>18</sup> The "excess" process refers to the removal of assets from the AML inventory that are no longer required to meet FAA's mission to support the National Aviation System.

be found on the warehouse floor. Thus, this issue warrants the attention of those charged with governance.<sup>19</sup>

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## FAA's Franchise Fund Financial Presentation Is Misleading

The law<sup>20</sup> requires the Fund to recover all of its costs from the revenue it earns for its goods and services. We determined that the Fund's reported losses of \$71 million and \$69 million for fiscal years 2018 and 2017, respectively, were grossly overstated. This is due to the Franchise Fund's accounting practices for recording the overhead related to the use of FAA's resources (e.g., MMAC facility support, FAA support, and Office of Personnel Management [OPM] costs). The Fund treats overhead expenses as imputed costs,<sup>21</sup> which are reflected on the Statement of Net Cost,<sup>22</sup> but offsets this amount with an imputed financing source,<sup>23</sup> which is reported on a separate statement. Because the Statement of Net Cost includes only overhead costs and not the financing source, it reflects an excessive net cost of operations. For example, in 2018, the \$71 million loss the Fund reported in the PAR appears to have been overstated by at least \$60 million (85 percent). Such overstatements can cause confusion about the Fund's ability to recover its costs and reach its goal: to break even. According to the Federal Accounting Standards Advisory Board (FASAB), Federal financial reports should help users evaluate (1) the costs of the reporting entity and the manner in which the entity's efforts and accomplishments have been financed, and (2) the costs of providing the specific programs and activities and the composition of, and changes in, these costs.<sup>24</sup>

Based on our review of the Franchise Fund's unaudited financial statements, the Fund operated with a loss of approximately \$7.9 million in fiscal year 2018 and \$9.4 million in fiscal year 2017. Five service organizations and Corporate Services reported losses in 2018, while four reported losses in 2017 (see exhibit D). These losses occurred primarily in two service organizations: AML had a net loss of \$8.1 million in fiscal year 2017, and the Enterprise Services Center (ESC) had a net

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<sup>19</sup> GAO's *Government Auditing Standards* 9.31 requires auditors to communicate any deficiencies in internal controls that are not significant to the audit objectives but warrant the attention of those charged with governance. See GAO, *Government Auditing Standards 2018 Revision*, (GAO-18-568G), July 17, 2018.

<sup>20</sup> Pub. L. 104-205 (September 1996).

<sup>21</sup> Imputed costs are incurred by one Federal agency on behalf of another. For example, FAA pays the Franchise Fund's facility and security costs, and OPM pays pensions and other retirement benefits.

<sup>22</sup> This statement presents the net cost of the Government's operations, including those related to funds from dedicated collections. Costs and earned revenues are categorized on this statement.

<sup>23</sup> Imputed financing sources are amounts equal to costs that are incurred by the reporting entity but financed by another entity. In this case, the Franchise Fund incurred the cost, but considers FAA to have financed it.

<sup>24</sup> Federal Accounting Standards Advisory Board, *Statement of Federal Financial Accounting Concepts 1: Objectives of Federal Financial Reporting*, September 1993.

loss of \$6.1 million in fiscal year 2018. While revolving funds are not created to generate profits, they are expected to break even over the long term. Consequently, the Fund cannot continue this loss trend indefinitely.

We reviewed the Franchise Fund's financial statements for the 2 years in question to determine the reason for the losses. AML's \$8.1 million deficit was due mainly to losses in inventory equipment. ESC's \$6.1 million loss was largely because of costs to operate and maintain equipment, and non-labor service costs.

We also examined each service organization's revenues, expenses, profits, and losses between fiscal year 2014 and fiscal year 2018 as documented in the Franchise Fund's unaudited internal financial statements. For all 5 years, we compared revenue data provided by Franchise Fund officials, which totaled approximately \$2.2 billion, to Delphi and the internal financial statements. This limited testing did not reveal any additional anomalies in the data we reviewed.

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## **Costs Recorded as Imputed Costs in Franchise Fund Financial Statements Are Paid by Multiple Direct Appropriations**

In fiscal year 2017, the Franchise Fund reported about \$60 million in imputed costs.<sup>25</sup> Imputed costs paid by FAA were for overhead costs such as managerial services, facilities, and security services. These overhead costs totaled about \$62 million in 2017, approximately \$52 million from FAA's imputed costs and about \$10 million collected in overhead fees from non-DOT and non-Department of Defense (DoD) customers. While the Fund bills external customers for these costs (based on an allocation) and passes the payments it collects to FAA, it does not directly pay FAA for the remaining costs (see figure 1). FAA officials stated that it would be inefficient, unnecessarily complicated, and potentially expensive for the Franchise Fund to recover these costs through user fees and then reimburse FAA for the same amounts. Furthermore, the officials said, the Franchise Fund does not charge FAA the user fees it charges non-DOT and non-DoD customers because the Agency pays the imputed costs. Otherwise, the Fund would likely start charging FAA user fees to offset its expenses and increase its annual revenue. The Fund does not bill for these costs, so it appears that they are paid by FAA's appropriations.

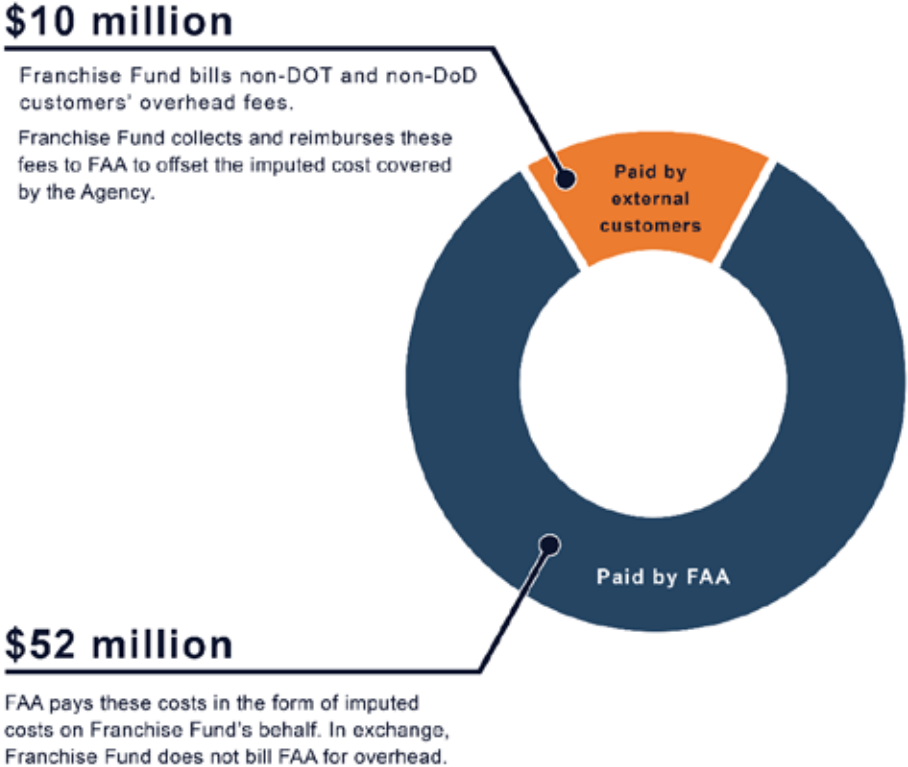
Indeed, we confirmed that FAA pays for building space and other overhead expenses via appropriations. However, we do not agree that the Agency's allocation of these costs represents an imputed cost to the Fund. FAA's argument

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<sup>25</sup> Approximately \$52 million of this was imputed costs paid by FAA and about \$8 million was paid by OPM for accrued pension and post-retirement benefit expenses for current employees, on FAA's behalf.

that billing it for user fees is inefficient assumes the Agency would have to significantly change its practices to better account for overhead. While the two entities—FAA and the Franchise Fund—do not exchange funds for overhead, in substance, FAA is clearly reimbursed. Specifically, the Franchise Fund does not charge FAA user fees, and in return, FAA pays for the Fund’s space and security, etc. In this way, the Fund meets its cost-recovery requirements, but this is not reflected on the Statement of Net Costs. Until the FAA and the Franchise Fund revise their accounting practices, the Statement of Net Cost will continue to mislead users into believing the Fund’s losses are up to 10 times greater than they are (based on unaudited numbers).

Figure 1. Allocation of Overhead Costs in FY 2017



Source: OIG analysis

## FAA Service Organizations Have a Variety of Methodologies for Determining Overhead Rates

The Franchise Fund charges multiple types of overhead fees, which vary from customer to customer, as needed. Non-DOT and non-DoD customers are



charged a fee to cover FAA Headquarters overhead, and individual service organizations charge an overhead cost for each service a customer purchases. Customers outside FAA are also charged an MMAC overhead fee. Overhead fees do not directly lead to the generation of profits; instead these fees are added to ensure services are performed at rates that will fully return all operational expenses, as required by law.<sup>26</sup>

FAA's Financial Manual includes steps that all FAA service organizations can consider when recovering overhead costs. We reviewed the fiscal year 2018 internal overhead rates for the six Franchise Fund service organizations and the FAA Headquarters overhead rate, which is 7 percent for non-DOT customers. We reviewed the manual and documentation identifying the methodology and calculations the Agency used to determine the rates. We did not assess the adequacy of overhead cost models for FAA and the service organizations included in the manual.

We also reviewed MMAC overhead rates, which are charged to non-FAA customers to cover the Fund's general and administrative costs. We did not assess the adequacy of overhead cost models the manual provides for MMAC.

According to the manual,<sup>27</sup> FAA's Office of Financial Management reviews overhead or indirect cost<sup>28</sup> rates annually, using financial data from FAA's cost accounting system. When necessary, rates are updated and applied to new agreements produced for the rest of that calendar year.

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## FAA Is the Primary Source of Franchise Fund Revenue

According to Agency officials, between fiscal years 2013 and 2018, FAA was the source of most of the Franchise Fund's revenue, which averaged about \$290 million annually. Non-DOT entities provided the second-highest amount of revenue, approximately \$140 million in fiscal year 2018. DOT components provided the smallest amount, expending about \$51 million in fiscal year 2018 (see figure 2).

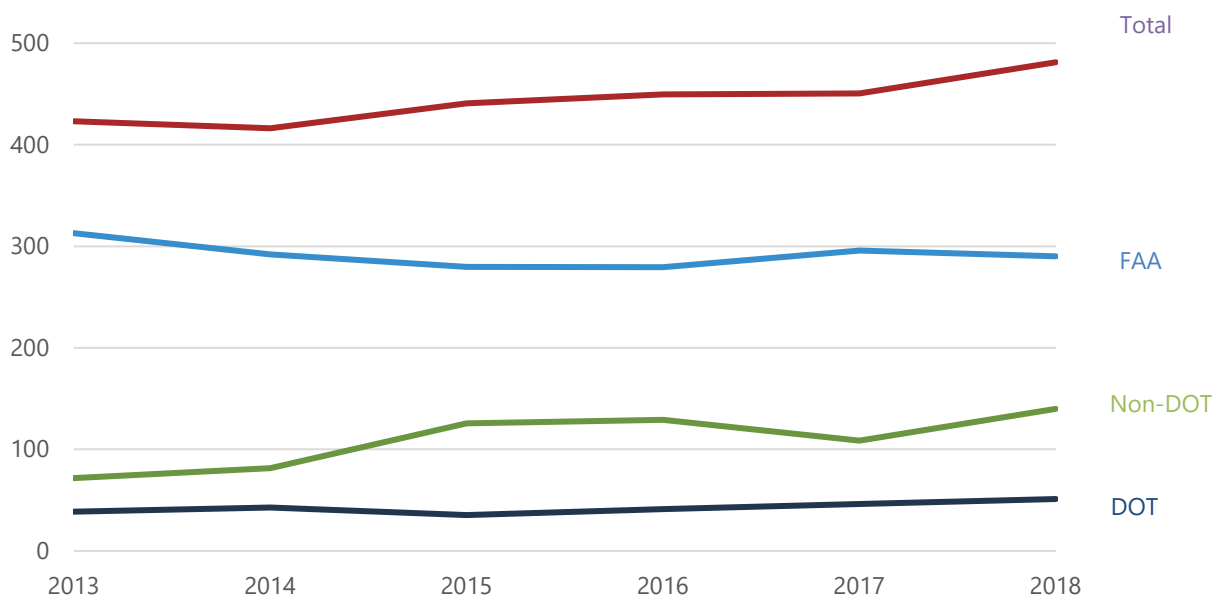
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<sup>26</sup> Pub. L. 104-205 requires the Franchise Fund to recover all of its costs.

<sup>27</sup> FAA Financial Manual, vol. 4, chapter 6 (January 2017).

<sup>28</sup> Indirect costs are incurred in the course of business operations but are not attributable to a specific product or service (e.g., utilities, administrative salaries, etc.).

Figure 2. Franchise Fund Revenues, FY 2013–FY 2018 (Dollars in Millions)



Note: Roughly 1 percent of the Fund’s non-DOT customers are non-Federal entities.

Source: OIG analysis based on FAA and Franchise Fund data

## According to FAA, the Franchise Fund’s Direct Personnel Costs Are Covered by Its Revenues

According to FAA officials, Franchise Fund personnel are compensated with money earned by the Fund and not with Federal appropriations. Each service organization tracks its own employees and contractors, assigning them a unique number that identifies their funding source during payroll execution. We performed limited testing to corroborate the Agency’s statement by comparing the labor costs FAA reported on its internal financial statements to the revenue accounting strings and other supporting documentation in the Delphi database. We found no exceptions.

The Franchise Fund included approximately 1,618 FTEs and 676 contractors in fiscal year 2017, and approximately 1,516 FTEs and 650 contractors in fiscal year 2018 (see table 2). The Franchise Fund Management Council instructs service organizations to fill resource needs with contractors rather than FTEs when appropriate, which allows them to make adjustments as needed in response to

customer demand. On the Franchise Fund’s fiscal year 2018 financial statements, FAA reported labor costs of approximately \$192 million: employee compensation was about \$147 million, and contract labor cost about \$45 million.

Table 2. Number of Franchise Fund FTEs and Contractors by Service Organization

Service Organization	Personnel (end of FY 2017)	Personnel (end of FY 2018)
ESC	711 FTEs 427 contractors	687 FTEs 406 contractors
ITD	12 FTEs 3 contractors	10 FTEs 4 contractors
FLLI	11 FTEs 32 contractors	11 FTEs 31 contractors
AML	573 FTEs 197 contractors	571 FTEs 178 contractors
FPO	273 FTEs 0 contractors	205 FTEs 9 contractors
AAQ	29 FTEs 17 contractors	24 FTEs 22 contractors
<b>Total</b>	<b>1,618 FTEs*</b> <b>676 contractors</b>	<b>1,516 FTEs**</b> <b>650 contractors</b>

Note: All counts are approximate. \* FTE totals in fiscal year 2017 include nine employees from Corporate Services. \*\* FTE totals in fiscal year 2018 include eight employees from Corporate Services.

Source: FAA Franchise Fund Brief

## FAA’s Oversight of the Franchise Fund’s Unexpended Balances Is Insufficient

The Treasury Department maintains the Franchise Fund’s unexpended funds—the obligated funds plus the unobligated balance. Federal law gives FAA the authority to use unexpended funds to cover its costs and liabilities. While this amount fluctuates from year to year, in general it has increased since 2014. We found that Franchise Fund officials did not adequately oversee the unexpended balance for fiscal year 2018. Specifically, they did not return unused funds in a timely manner or identify invalid interagency agreements associated with unfilled customer orders.<sup>29</sup> In addition, the Fund provided services without receiving

<sup>29</sup> FAA records advance payments from customers as unfilled customer orders in the financial system.

payment in advance, and did not verify whether capital reserve plans at service organizations were in compliance with FAA and Federal requirements.

### The Franchise Fund’s Unexpended Balances Rose and Fell Between FY 2014 and FY 2018

Over a 5-year period, beginning in fiscal year 2014, the amount of the Fund’s unexpended balance increased steadily until fiscal year 2017, when it peaked at approximately \$457 million. By fiscal year 2018, the balance had decreased to approximately \$411 million (see table 3).

Table 3. Unexpended Balances, FY 2014–FY 2018

Type of Balance	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Obligated Balance	\$177,610,000	\$173,212,000	\$155,970,008	\$196,197,650	\$191,270,289
Unobligated Balance	\$185,649,000	\$184,268,000	\$260,375,992	\$260,687,350	\$220,225,711
<b>Unexpended Balance</b>	<b>\$363,259,000</b>	<b>\$357,480,000</b>	<b>\$416,346,000</b>	<b>\$456,885,000</b>	<b>\$411,496,000</b>

Source: OMB and FAA

### FAA Officials Did Not Adequately Oversee the Franchise Fund’s Unexpended Balances

To assess the Franchise Fund’s oversight of its fiscal year 2018 unexpended balances, we examined a statistical sample of 82 unfilled customer orders (UFCO) valued at \$177 million from a universe of 1,161 UFCOs valued at \$338 million. We found that FAA could not always determine which service organizations were associated with the UFCOs. Furthermore, the service organizations themselves did not return unused funds to their customers in a timely manner, identify invalid interagency agreements, or require advance payments before providing goods or services.

#### **FAA does not always know which service organizations are responsible for unfilled customer orders.**

Specifically, Franchise Fund officials have not determined to which service organization(s) they should apply approximately \$6.9 million in unassigned UFCOs. “Unassigned” is the organizational code the Fund uses to capture unknown amounts in the UFCO account or discrepancies with the Delphi database. The officials stated they can accurately monitor the multimillion-dollar discrepancy between the UFCO account and the balances recorded in Delphi. However, for the last 8 years, FAA has not identified which Franchise Fund service organization(s) generated the discrepancies or officially reconciled the

unassigned \$6.9 million with specific service organizations. The Treasury<sup>30</sup> has established that failure to implement timely and effective reconciliation processes could increase the risk of fraud, waste, and mismanagement of funds. In addition, GAO<sup>31</sup> defines effective internal controls as those that ensure all transactions are recorded completely and accurately.

FAA agreed that it should assign the unassigned \$6.9 million in unfilled customer orders to the appropriate service organization(s).

**The Franchise Fund does not always return unused unexpended funds to its customers in a timely manner.**

DOT Order 1200.9, *DOT Inter and Intra Agency Agreements Order* (July 2018), states that an agreement must go through a financial completion process no more than 90 days after the performance is completed; the period of performance or underlying contract has expired, whichever is later; or the agreement has been terminated. At that point, DOT components must return unexpended funds to the buyer and send final bills.

However, our analysis found that the service organizations do not adequately oversee their UFCO balances and do not always enforce the financial completion agreement process requirements in DOT Order 1200.9. For example, during our review of the statistical sample of 82 UFCOs, we found 26 items representing \$2.6 million in unexpended funds, although the periods of performance had ended or the projects were completed. Based on these findings, we project that the FAA Franchise Fund has not returned \$26 million in unexpended funds to its customers, or 7.7 percent of the \$338 million in the universe.<sup>32</sup>

**The Franchise Fund service organizations do not consistently identify invalid or delinquent agreements.**

Our review of the statistical sample of 82 UFCOs found 8 items, totaling \$16.3 million, with invalid<sup>33</sup> or delinquent agreements. The Franchise Fund's Delinquent Agreement Process<sup>34</sup> states that agreements are considered delinquent if they are not signed before the start date, expire before the work is completed, or have expenses that exceed the advance funding level. According to this guidance, an organization that discovers an agreement is delinquent should

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<sup>30</sup> *Treasury Financial Manual*, section 5145.

<sup>31</sup> GAO, *Standards for Internal Control in the Federal Government* (GAO-14-704G), September 10, 2014.

<sup>32</sup> Our \$26 million projection has a precision of +/- \$16.6 million or 4.9 percent of the universe amount at the 90-percent confidence level, which means our 90-percent confidence limits ranged from \$9.4 million to \$42.6 million.

<sup>33</sup> Invalid agreements occur because they did not have all approvals or do not have timely approvals before the agreement start dates.

<sup>34</sup> FAA Franchise Fund, *Delinquent Agreement Process*, August 25, 2011.

take immediate corrective action and convert it to a binding agreement, signed by the Franchise Fund Director.<sup>35</sup>

While DOT and FAA have established policies<sup>36</sup> on developing and monitoring agreements, they do not have sufficient processes to enforce them. As a result, Franchise Fund service organizations lack clarity and do not always comply with those policies. We identified several instances in which agreements were not signed before the start date and expired before all the work was performed. Based on these findings, we project that the Franchise Fund's invalid or delinquent agreements represent \$39 million or 11.4 percent of the \$338 million in the universe.<sup>37</sup>

**The Franchise Fund provided services to its customers without being paid in advance.**

Among the sample of 82 UFCOs, we found two instances, representing a total of \$2.1 million, in which a service organization provided goods or services before it had received payment from the customer. The 1997 DOT Appropriations Act requires FAA service organizations to obtain advance payments from Franchise Fund customers before they provide the products or services.

Our survey results<sup>38</sup> indicate that timely communication can affect the receipt of advance payments. For example, many ESC customers told us that waiting for responses to their questions about interagency agreements or price changes caused payment delays. Franchise Fund officials told us continuing resolutions are another reason. Based on our statistical sample of 82 UFCOs, we project that the Franchise Fund did not collect advances totaling approximately \$4.5 million or 1.3 percent of the \$338 million in the universe.<sup>39</sup> As a result, even though work was completed, the Fund did not earn any revenue and had to use operating reserves to cover the costs of providing the services. According to an official from the Franchise Fund Management Council, operating reserves are not meant to cover the costs of customers who do not pay their bills.

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<sup>35</sup> At FAA, the Director of the Aeronautical Center serves as the Franchise Fund Director.

<sup>36</sup> *Franchise Fund Policy Statement FY 2017–02 Agreements for Products/Services* (November 2017); *DOT Financial Management Policies Governing Funded Inter and Intra Agency Agreements*, section 9 (October 2006–July 2018); DOT Order 1200.9, *DOT Inter and Intra Agency Agreements Order* (July 2018).

<sup>37</sup> Our \$39 million projection has a precision of +/- \$19.8 million or 5.8 percent of the universe amount at the 90-percent confidence level, which means our 90-percent confidence limits ranged from \$18.9 million to \$58.5 million.

<sup>38</sup> We surveyed all Franchise Fund customers with unpaid (outstanding) advances as of November 26, 2018. The outstanding advances, totaling about \$2.1 million, were attributable to 16 customer agreements—all with ESC.

<sup>39</sup> Our \$4.5 million projection has a precision of +\$4.0 million or 1.2 percent of the universe amount at the 90-percent confidence level and -\$2.4 million or 0.7 percent of the universe amount at the 100-percent confidence level. This means the lower 100-percent and upper 90-percent confidence limits ranged from \$2.1 million to \$8.5 million.

## Capital Reserve Plans at Some Service Organizations Do Not Fully Comply with FAA and Franchise Fund Requirements

The DOT Appropriations Act of 1997 established operating and capital reserves for the Franchise Fund. Specifically, the law authorized the FAA Administrator to determine a reasonable operating reserve, which was set at 4 percent of the highest annual revenue. The law also established the capital reserve at 4 percent of the total annual revenue. The Franchise Fund uses customer revenues to accumulate funds in the reserves and can retain these funds until they are expended, without fiscal year limitation. At the end of fiscal year 2018, the Franchise Fund reported that it held \$21.6 million in its operating reserves and \$29.6 million in its capital reserves.

The Franchise Fund has a policy in place to guide its oversight of the operating reserve, which covers cash-flow deficiencies caused by nonpaying customers, Government shutdowns, downturns in the market, and other unexpected events. Capital reserve funds are used for acquisition, improvement, installation of assets, support systems, facilities, or infrastructure. FAA policy requires service organizations to submit project plans that forecast the amount the Fund must collect from customers to pay for these capital projects.

We randomly selected and reviewed the plans for six capital projects (one per service organization). Only two service organizations, AAQ and AML, properly documented their plans and expenditures. Four of them—ESC, FLLI, FPO, and ITD—were noncompliant with FAA policy and Federal requirements. Specifically:

- ESC and FLLI did not provide a cost-estimate analysis or plan; in ESC's case, that was due to a recent staff turnover. ESC's summary of expenditures also was not sufficient to verify the accuracy of the costs.
- FPO and ITD did not document formal approvals from their directors.

The Franchise Fund's Major Business Investment and Expenditures Policy establishes a three-tiered approval process. Depending on the estimated project cost, approvals may be made by the Service Organization Director, Franchise Fund Director, or Franchise Fund Management Council. In addition, FAA's Acquisition Management Policy requires appropriate documentation for all market analyses, formal or informal. Service organizations that do not document project approvals increase the risk that they will mismanage capital reserve funds or select a product or service that does not represent the best value.

Agency officials agreed on the need to implement a requirement for documented approvals and business cases for larger capital investment projects that require the Council's approval.

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# FAA Is Changing Its Governance of the Franchise Fund but Can Do More To Address Customer Concerns

FAA is changing the mechanisms it uses to govern and oversee the Franchise Fund but can do more to address ongoing customer concerns about its two largest services providers. In addition, the Fund tracks performance metrics, but does not make them all publicly available. We also found areas, other than those discussed above, in which the Fund can improve its compliance with Federal policy and guidelines.

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## FAA Recently Reorganized the Franchise Fund Management Council

The Franchise Fund is governed by a Management Council, whose voting members were reduced in number from 11 to 5 when the new charter was approved. The revamped Council comprises the Assistant Administrator for FAA's Office of Finance and Management, FAA's Chief Financial Officer (CFO), DOT's Deputy CFO, the Franchise Fund Director, and the Chief Operating Officer for FAA's Air Traffic Organization (ATO). In December 2018, FAA updated the Franchise Fund charter, and the new version was approved in June 2019.<sup>40</sup> Based on the charter in place at the time of our audit, the Council is responsible for monitoring the performance and status of each service organization, reviewing and approving business plans, and developing procedures. According to Agency officials, since 2018, FAA has been implementing changes to give the Management Council the authority to make strategic decisions for the entire Franchise Fund rather than each specific service organization. According to Council members, FAA also created a Finance Working Group to provide oversight of Franchise Fund's financial data and review, analyze, and communicate the financial results. This will allow the Council to focus on the strategy and performance of the Fund as a whole.

FAA had two reasons for expanding the Management Council's oversight role. First, Council members had reported that customers were not sending payments in advance, as required by law. This was a key concern as service organizations used operating reserves instead, putting themselves at risk of having negative account balances and spending more money than they had in the reserves.

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<sup>40</sup> DOT/FAA Franchise Fund Charter, revision dated April 24, 2019 (signed June 5, 2019).



According to Council members, FAA also needed to address a lack of transparency issue raised by a couple of the Franchise Fund's biggest customers. We were told that customers had questions about the fees charged by ESC and AML. During the audit, we encountered other customers that expressed concerns about the lack of transparent pricing. We conducted a survey that focused primarily on customer satisfaction with service provider communication and performance. While the survey did not specifically ask customers if they understood or were satisfied with the transparency of service provider's pricing, it did ask them if they participated in cost negotiations and to rate their satisfaction with the value of the product(s)/service(s) received for the price paid.

Only 37 of 173 ESC customers responded<sup>41</sup> to the survey. Half of those that responded rated ESC as "above average" for value of the product(s)/service(s) received for the price paid. Of the remaining respondents, 3 said it was "below average," and 15 said "average."<sup>42</sup> Two respondents commented<sup>43</sup> about ESC's lack of transparent pricing, specifically:

- "We have been unsuccessful in obtaining backup documentation to support the cost estimate from ESC...ESC provides a cost without much backup and is unable to adequately explain its cost model."
- "Never seemed to get a clear accounting of how the funds were applied to different line items. Quotes for services were adjusted according to funding levels without documentation as to how services were adjusted. Funds went into a pot and services came out."

Thirteen of 44 AML customers responded<sup>44</sup> to the survey. They rated the value of the product(s)/service(s) received for the price paid as follows: 2 respondents said it was "below average," 1 said "far below average," 4 said "average," 4 said "above average," and 2 said "far above average." Three respondents expressed concern about AML's lack of transparent pricing, specifically:

- "The Logistics Center does not provide enough information in their Service Order Report to do EVM [earned value management; EVM helps project managers measure project performance]...The description for the service provided by each labor category for the hours they charged was very vague."

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<sup>41</sup> The Survey of ESC Communication and Performance was emailed to 173 ESC customer points-of-contact with active fiscal year 2018 agreements; 37 responded to the survey, and 10 addresses bounced back as undeliverable.

<sup>42</sup> The response rate to the survey was very low. We did not assess non-response bias, and survey results only apply to the customers that responded to the survey and not to all Franchise Fund customers.

<sup>43</sup> The survey offered multiple choice answers; any narrative comments received were optional.

<sup>44</sup> The Survey of AML Communication and Performance was emailed to 44 AML customer points-of-contact with active fiscal year 2018 agreements; 13 responded to the survey, and 2 addresses bounced back as undeliverable.

- “Data systems to provide correct counts and consumption are still not fixed. Old system was bad; new system...is still not providing reliable data.”
- “The FAALC [Logistics Center] needs to have a team that evaluates the checks and balances of costs that are billed to the customer, instead of the customer having to question all the costs.”

The Franchise Fund faces a number of challenges, including inadequate administration and a lack of transparency. FAA has not developed or implemented an actionable plan for identifying and prioritizing its expected outcomes to those challenges. Until the Agency does so, the Council may not be able to provide adequate oversight for the large and complex Franchise Fund.

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## FAA Service Organizations Track Performance Metrics But Do Not Make Them All Publicly Available

In a May 2016 audit,<sup>45</sup> GAO stated that, franchise funds should add competition to the market for administrative services and that a well-functioning market requires transparent information about a fund’s performance. As a result, GAO recommended that FAA make the Fund’s performance metrics publicly available. Our review of the Fund found that five of the six FAA Franchise Fund service organizations have developed performance metrics, but only ESC provides these metrics on the General Services Administration (GSA) website (see table 4). Because the Fund at large does not publicly report its metrics, potential customers might be unable to fully understand how it is performing.

According to FAA officials, the website for GSA’s shared services forum provides a venue to publish metrics for services in high demand—such as the financial services provided by ESC. However, publishing metrics for the other service organizations would have minimal impact, the officials say, because demand for them outside FAA is limited. GAO accepted FAA’s rationale for publishing metrics only for ESC and in March 2018 closed the recommendation from its May 2016 report.

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<sup>45</sup> GAO, *Revolving Funds: Additional Pricing and Performance Information for FAA and Treasury Funds Could Enhance Agency Decisions on Shared Services* (GAO-16-477), May 2016.

Table 4: Selected Performance Metrics for Each Franchise Fund Service Organization

Service Organization	Performance Metric	Internally Available	Publicly Available
ESC	Travel payments made in 6 days >95%	Yes	Yes
AML	On-time delivery = 81% effectiveness	Yes	No
FPO	Developing new metrics	No	No
AAQ	Cost to procure =1.24%	Yes	No
FLLI	Course satisfaction >90%	Yes	No
ITD	Provide schedule class offerings->90%	Yes	No

Source: OIG analysis of Franchise Fund data and GSA and FAA websites

## Other Instances of Noncompliance with Federal Policies and Guidelines

We reviewed select policies and procedures to assess conformance with Federal policies and guidance. We noted areas of noncompliance, in addition to the financial-related control weaknesses discussed previously.

For example, FPO accepted expiring year-end funds from an internal organization, its customer, with minimal supporting documentation establishing scope, schedule and cost of the project. As a result, it was difficult to determine from the procurement documentation that there was a legitimate, *bona fide*, need identified during the fiscal year the appropriation was made. The *bona fide* needs rule<sup>46</sup> requires Federal agencies to enter into an obligation only if it bears a sufficient relationship to the legitimate need during the time period the appropriation is available. As FAA's appropriations law training materials describe, the *bona fide* needs rule guides officials to use this year's funds for this year's needs.<sup>47</sup>

The interagency agreement we reviewed was modified on September 14, 2018, to obligate \$3 million in funds expiring on September 30, 2018, to a project that was still in the planning phase. As of May 2019, the project was still in the planning phase, a statement of work (SOW) was not yet available, and the service

<sup>46</sup> The *bona fide* needs rule is rooted in Title 31, U.S. Code (U.S.C.), section 1502(a), which states that a fixed-term appropriation is available only for payment of expenses properly incurred during the appropriation's period of availability and to complete contracts properly made during that period. If an agency does not act to fill an identified *bona fide* need before the end of the period of availability, the appropriation will no longer be available.

<sup>47</sup> Federal Aviation Administration, *FAA Appropriations Law Procurement Restrictions: Bona Fide Needs & 12-Month Rules*, May 30, 2019.

organization had not begun any work. We do not dispute that there may be a legitimate need for the project in question; however, the procurement documentation did not demonstrate that the need was sufficiently defined in fiscal year 2018, when the expiring funds were obligated. Without a SOW or documentation that clearly described the work to be performed, it appeared from the documentation that the service provider was unable to start the project in fiscal year 2018.

In addition, the Office of Management and Budget (OMB)<sup>48</sup> has established a checklist of responsibilities to help both the requesting and the servicing agencies navigate the acquisition process. The checklist includes such items as preparing detailed scope of work, financial documents, defining deliverables, milestones, performance standards, acquisition strategies, etc.

Developing documentation standards, particularly for end-of-year obligations, can help agencies ensure there is a genuine need for goods or services and eliminate the perception that funds have been obligated so that they will not lapse. The FAA Franchise Fund lacks a policy that requires customers to document the *bona fide* need for projects, and thus the Fund runs the risk of improperly obligating funds. This could potentially cause a service organization to mismanage its obligations and violate the Antideficiency Act, which prohibits Federal employees from expending or obligating monies in excess of the amount available in the appropriation or fund unless authorized by law.<sup>49</sup> As FAA moves to expand its governance over Franchise Fund service organizations, the Agency will need to establish proper controls to ensure interagency agreements are not modified unless there is a *bona fide* need.

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## Conclusion

Congress established FAA's Franchise Fund to help foster competition, increase efficiency, and reduce costs across the Federal Government. As it makes changes to its oversight practices, the Fund faces financial and governance challenges that reduce its ability to meet Federal mandates and policy. Until it addresses these challenges, the Fund cannot fully account for and optimize its resources or provide transparency to its customers.

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<sup>48</sup> OMB Memo, *Improving the Management and Use of Interagency Acquisitions*, June 6, 2008.

<sup>49</sup> 31 U.S.C. § 1341(a)(1)(A).

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## Recommendations

To help FAA strengthen its management and oversight of the Franchise Fund, we recommend that the Federal Aviation Administrator:

1. Engage an auditor to perform an independent audit of the Franchise Fund's financial statements in accordance with generally accepted Government auditing standards and the Government Accountability Office's Financial Audit Manual and that includes an opinion on the Fund's internal controls.
2. Develop and implement a process directing the Logistics Center to maintain detailed records of the age and costs of inventory items as a way to identify obsolete items and prevent unnecessary storage and maintenance costs or purchase of assets already on hand.
3. Revise the accounting treatment for imputed costs to avoid the appearance of overstating losses.
4. Assign the unassigned balance of \$6.9 million in unfilled customer orders identified in this report to the appropriate Franchise Fund service organization(s).
5. Review the \$2.6 million in unused unfilled customer orders identified in this report, and return the unexpended balances as appropriate.
6. Develop and implement a plan to improve oversight of the Franchise Fund's unfilled customer orders balance, such as tracking performance to ensure unexpended funds are returned timely as required. Implementing this recommendation could potentially put \$26 million in funds to better use.
7. Revise the Franchise Fund's policies on agreements to include dealing with delinquent agreements, and require service organizations to adhere to applicable DOT and FAA policies. Implementing this recommendation could potentially put \$39 million in funds to better use.
8. Implement the requirement that service organizations collect advance payments before they provide products or services, in accordance with Public Law 104-205.
9. Develop and implement a process that requires Franchise Fund service organizations to respond promptly to customer questions about agreements and price changes before the period of performance begins.

10. Develop and implement formal, documented procedures that require service organizations to include a business case when they submit a capital reserve project to the Franchise Fund Management Council for approval to ensure the project represents the best value.
11. Implement the Major Business Investment and Expenditures Policy requirement to document formal approval of capital reserve projects.
12. Develop a plan that clearly describes the Franchise Fund Management Council's vision, goals and expected outcomes for the services provided to its customers. The plan should include what initiatives or specific actions the Council will take to provide the additional oversight and transparency needed.
13. Develop Franchise Fund process and procedures that require
  - (a) customers to document *bona fide* needs for new projects before agreements are written and funds obligated and advanced and
  - (b) service organizations to accept year-end funding only for projects that clearly represent a *bona fide* need.

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## Agency Comments and OIG Response

We provided FAA with our draft report on October 15, 2019, and received its response on November 25, 2019, which is included as an appendix to this report. FAA fully concurred with recommendations 3 through 13 as written and provided appropriate completion dates. Accordingly, we consider these recommendations resolved but open pending completion of the planned actions. FAA did not concur with recommendations 1 and 2, and we are requesting that the Agency reconsider its responses.

For recommendation 1, we asked FAA to engage an auditor to perform an independent audit of the Franchise Fund's financial statements—in accordance with generally accepted Government auditing standards and GAO's Financial Audit Manual—that includes an opinion on the Fund's internal controls. However, FAA did not concur with this recommendation, stating that "...the Franchise Fund is already included in independent financial audits for the FAA" and "the transactions and balances of the Franchise Fund roll up into the FAA Financial Statements; therefore, they are included in the auditors' tests to determine that the FAA's Financial Statements are fairly presented in all material respects." We do not agree with FAA's rationale. As we discussed with Agency officials, FAA's financial statement audit results cannot be used to draw conclusions about the Franchise Fund's financial statements due to the significant difference between the materiality thresholds of the two entities. For example, a financial statement audit of the Franchise Fund would have likely revealed that the Fund's fiscal year 2018 reported loss of \$71 million was grossly overstated by approximately \$60 million. However, FAA's fiscal year 2018 performance and accountability report makes no mention of this overstatement. Instead, it clearly labels the Franchise Fund statements as "unaudited." Since the Fund's statements have not been audited in years, users have no basis to assess if they are fairly presented. An independent audit of the Fund's finances, even if not done on an annual basis, would allow the Fund to report to Congress and the public on its progress in establishing transparency, internal controls, and compliance with laws and regulations, as well as the fair presentation of its financial statements. We therefore consider recommendation 1 to be open and unresolved and ask FAA to reconsider its position.

For recommendation 2, we asked FAA to develop and implement a process directing the Logistics Center to maintain detailed records of the age and costs of inventory items. Such a process could identify obsolete items and prevent unnecessary storage and maintenance costs or the purchase of assets already on hand. However, FAA did not concur, stating that "...obsolescence is not determined by the age of an asset; rather, it is determined based on the

decommissioning of NAS systems that the asset is used to support. Therefore, AML does not produce an aged asset report; AML tracks issue and receipt of inventory in accordance with generally accepted accounting principles.” Further, according to FAA, our report incorrectly states that “the FAALC [AML] does not track inventory or have a system in place to track inventory.” We disagree. Our audit report states accurately that the Logistics Center has an inventory system, although we note that independent audits have repeatedly identified issues with Franchise Fund’s inventory accuracy. Moreover, the inventory system cannot produce a report that shows the age of the item. According to the Joint Financial Management Improvement Program (JFMIP) Inventory System Requirements,<sup>50</sup> an inventory system must record the date of receipt to be used for the purposes of making prompt payments and monitoring the timeliness of placing items into inventory and the age of inventory items. To ensure the Fund can demonstrate compliance with laws and regulations, we ask FAA to reconsider its position on recommendation 2, which we consider open and unresolved.

Finally, FAA states that this report should not have discussed the oversight of excess inventory since the Franchise Fund does not manage excess. We disagree with this assumed limitation on reporting requirements. GAO’s *Government Auditing Standards* 9.31 requires auditors to communicate any deficiencies in internal controls that are not significant to the audit objectives but warrant the attention of those charged with governance.<sup>51</sup> If we did not disclose such issues, OIG would not be in compliance with GAO audit requirements.

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## Actions Required

We consider recommendations 3 through 13 resolved but open pending completion of the planned actions. We request that FAA reconsider its position regarding recommendations 1 and 2 and provide specific actions that meet the intent of the recommendations along with the target dates for completion. In accordance with DOT Order 8000.1C, we ask that the additional information requested for each recommendation be provided within 30 days of this final report.

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<sup>50</sup> JFMIP, Federal Financial Management System Requirements, FFMSR-7, June 1995

<sup>51</sup> GAO, *Government Auditing Standards 2018 Revision* (GAO-18-568G), July 17, 2018.



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## Exhibit A. Scope and Methodology

We conducted this performance audit between November 2018 and October 2019 in accordance with generally accepted Government auditing standards as prescribed by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit objectives were to assess FAA's management and oversight of the Franchise Fund's operations and activities.

To assess FAA's management and oversight of the Fund, we followed the requirements in the FAA Reauthorization Act of 2018. The law required our office to conduct an audit of FAA's Franchise Fund to (1) review the history, purpose, and objectives of the Fund; (2) describe and assess each program, service, or activity that uses the Fund; (3) assess FAA's governance and oversight of the Fund, including the use of internal and publicly available performance metrics; (4) evaluate the current and historical unobligated and unexpended balances; and (5) assess the degree to which policies and controls conform with generally accepted accounting principles, Federal policies, best practices, or other guidance relating to revolving funds.

To review the history, purpose, and objectives of the Fund, we researched laws, Federal policies, and prior audits and financial statements. We also interviewed FAA and Franchise Fund personnel to determine their roles in the service organizations, Corporate Services, and the Franchise Fund Management Council. We met with each of the six service organizations for an overview of its financial history, the products and services offered, and how performance is measured. In addition, we met with the Franchise Fund Manager and the Council Chair to understand their oversight functions for the Fund.

To assess each service organization, we reviewed financial and budgetary documentation extracted from Delphi, and the organizations internal systems. To verify the number of FTEs the Franchise Fund reported<sup>52</sup> to us, OIG's Statistician reconciled those data with information in the Federal Personnel and Payroll System. We did not verify the number of Franchise Fund contractors. Instead, we looked at potential trends to explain the fluctuation in the number of contractors at each service provider.<sup>53</sup> The Franchise Fund provided reasonable explanations for significant fluctuations that we could not explain. We used information from

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<sup>52</sup> All personnel counts (FTEs and contractors) are reported as of the end of the fiscal year, September 30.

<sup>53</sup> Examples of trends we observed include, contractor numbers in relation to annual revenue and increases in the contractor-to-FTE ratio, which was reflective of a Franchise Council initiative.

Delphi to verify the costs associated with Franchise Fund FTEs and contractors. We reviewed the procedures the Franchise Fund uses to track the cost of non-Fund employees who perform Fund-related tasks. It appears that these costs are minimal and are covered by Franchise Fund revenues. We used information from Delphi to verify the Franchise Fund's annual revenue. We reviewed Trading Partner codes<sup>54</sup> for fiscal year 2018 revenue transactions to verify the sources: FAA, DOT, non-DOT Federal entity, or non-Federal entity. To assess expenses, we reviewed each service provider's annual labor and non-labor costs, which are reported on the Franchise Fund's financial statements. Service providers explained the causes of all cost irregularities, high and low. To assess overhead fees charged to Franchise Fund customers, we reviewed applicable Federal and FAA policy and methodologies for the three types of overhead charges likely to be billed to customers: FAA Headquarters corporate, MMAC, and service provider specific overhead rates. We determined that the methodologies were reasonable and in compliance with applicable policies. We did not assess the adequacy of overhead cost models for FAA and the service organizations.

To evaluate FAA's governance and oversight we visited MMAC in Oklahoma City where most of the service organizations are located. There, we met with the Franchise Fund Director and the leaders of the service organizations. We toured the AML, ESC, and FPO facilities, guided by their respective personnel. We reviewed the charters and meeting minutes of the Franchise Management Council and the Finance Working Group. In addition, we confirmed that performance metrics existed for the service organizations and the Fund itself and checked to see whether they were publicly available on different Government websites. We found that, with the exception of ESC, the metrics are only available internally.

We performed two surveys during the course of the audit: one for customers with outstanding advances (customers that received goods and/or services before making a payment), and the other to gauge customer satisfaction with service provider performance and communication. We sent the first survey to 13 unique customers associated with 16 agreements with ESC and whose outstanding advances totaled about \$2.1 million, as of November 26, 2018. We requested that each customer complete a separate survey for each agreement. Our goal was to obtain customer perspectives on the causes for the outstanding advances. We developed and tested the survey, in consultation with OIG's Statistician, Certified in Survey Statistics, through brainstorming and survey testing between December 2018 and February 2019, and distributed it to customers via Survey Monkey in March 2019. We received 13 responses to the survey for a response rate of 81 percent.

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<sup>54</sup> A Trading Partner is a Federal entity that conducts intragovernmental transactions with another Federal entity. The Treasury assigns each entity an attribute to identify the trading partner.

We developed a survey to evaluate service provider communication and performance in the same manner. This survey asked about the frequency, methods, and topics of provider-to-customer communication, and about customer satisfaction with the quality, timeliness, and price of products and services. We sent it out in April 2019, to customers<sup>55</sup> of all six service providers. The Franchise Fund provided points of contact for the active fiscal year 2018 agreements. The response rate to this survey was very low.<sup>56</sup> We did not assess non-response bias, and survey results only apply to the customers that responded to the survey and not to all Franchise Fund customers.

We reviewed the amount of unexpended balances from fiscal year 2014 through fiscal year 2018. We verified the unassigned amount as \$6.9 million and asked Fund officials about the reason for this unreconciled item. In addition, Corporate Services sent us a file with 15,429 UFCO balances as of September 30, 2018. From that list, we deleted 14,268 UFCOs, as they had \$0 balances. We stratified the remaining 1,161 UFCOs with a total balance of \$337,978,657.05—into 4 strata and selected a stratified sample as follows: stratum 1 was a census of all 15 high-risk UFCOs that were older than 5 years; stratum 2 was a census of all 6 UFCOs that were closed but had remaining balances; stratum 3 was a census of all 4 UFCOs with balances greater than \$10 million; and stratum 4 was a sample of 63 of the remaining 1,136 UFCOs, selected with probability proportional to size with replacement where size was the UFCO balance. Six UFCOs in stratum 4 were selected twice due to our “with replacement” sampling methodology, which reduced our actual sample size for stratum 4 from 63 to 57, and our total sample size from 88 to 82, or 7.1 percent of the 1,161 UFCOs in the universe. Our sample had a UFCO balance of \$177,359,382.13 or 52.5 percent of the \$337,978,657.05 in the universe. We computed sample size based on desired estimates with 90 percent confidence and a precision no greater than +/-10 percent. We used this sampling methodology because it is widely used and accepted in the accounting industry.

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<sup>55</sup> The survey was sent to customer program managers for all active fiscal year 2018 agreements.

<sup>56</sup> Survey populations and response rates: the ESC survey was emailed to 173 ESC customer points-of-contact with active fiscal year 2018 agreements; 37 responded to the survey, and 10 addresses bounced back as undeliverable for a response rate of 23 percent; the AML survey was emailed to 44 customer points-of-contact; 13 responded to the survey, and 2 addresses bounced back as undeliverable for a response rate of 31 percent; the ITD survey was emailed to 109 customer points-of-contact; 19 responded to the survey, and 8 addresses bounced back as undeliverable for a response rate of 19 percent; the FLLI survey was emailed to 30 customer points-of-contact; 10 responded to the survey, and 2 addresses bounced back as undeliverable for a response rate of 36 percent; the AAQ survey was emailed to 6 customer points-of-contact; 2 responded to the survey, and 0 addresses bounced back as undeliverable for a response rate of 33 percent; and the FPO survey was emailed to 8 customer points-of-contact; 1 responded to the survey, and 0 addresses bounced back as undeliverable for a response rate of 12 percent.







Fiscal Year	Description	Corp Services	ESC	FPO	FLLI	ITD	AML	AAQ	Unassigned	Total Franchise
2017	Net Income (Loss) from Operations	1,751	(3,668)	1,779	(756)	(485)	915	102	(07)	(368)
	Net Gains or (Losses)	00	00	00	00	00	(9,052)	00	00	(9,052)
	Imputed OPM Costs	(37)	(3,359)	(1,357)	(36)	(119)	(2,796)	(220)	00	(7,924)
	Imputed Overhead Charge from FAA	00	(17,904)	(7,721)	(807)	(605)	(23,288)	(1,492)	00	(51,817)
	Imputed Financing absorbed by others	37	21,263	9,078	843	725	26,084	1,712	00	59,742
	<b>Total Consolidated Income (Loss)</b>	<b>1,751</b>	<b>(3,668)</b>	<b>1,779</b>	<b>(756)</b>	<b>(485)</b>	<b>(8,136)</b>	<b>102</b>	<b>(07)</b>	<b>(9,420)</b>
2018	Net Income (Loss) from Operations	(24)	(6,105)	(1,963)	(248)	(626)	6,796	(332)	00	(2,502)
	Net Gains or (Losses)	00	00	00	00	00	(5,363)	00	00	(5,363)
	Imputed OPM Costs	(66)	(5,027)	(1,714)	(72)	(122)	(4,304)	(247)	00	(11,552)
	Imputed Overhead Charge from FAA	00	(14,201)	(6,920)	(906)	(538)	(27,485)	(1,260)	00	(51,311)
	Imputed Financing absorbed by others	66	19,228	8,634	978	660	31,789	1,507	00	62,863
	<b>Total Consolidated Income (Loss)</b>	<b>(24)</b>	<b>(6,105)</b>	<b>(1,963)</b>	<b>(248)</b>	<b>(626)</b>	<b>1,433</b>	<b>(332)</b>	<b>00</b>	<b>(7,866)</b>

Source: OIG analysis of unaudited Franchise Fund internal financial statements

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## Exhibit E. Major Contributors to This Report

KEVIN DORSEY	PROGRAM DIRECTOR
DORY DILLARD-CHRISTIAN	PROJECT MANAGER
LAKARLA LINDSAY	SENIOR AUDITOR
FRANCISCO RAMOS-HILERIO	SENIOR AUDITOR
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AMY BERKS	DEPUTY CHIEF COUNSEL
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SHAWN SALES	VISUAL COMMUNICATIONS SPECIALIST
ERIC WEEMS	CONGRESSIONAL AND PUBLIC AFFAIRS OFFICER



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## Appendix. Agency Comments



### Federal Aviation Administration

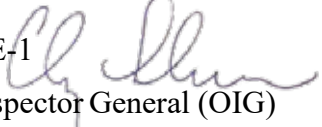
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## Memorandum

Date: November 25, 2019

To: Louis C. King, Assistant Inspector General for Financial and Information Technology Audits

From: H. Clayton Foushee, Director, Office of Audit and Evaluation, AAE-1 

Subject: Federal Aviation Administration's (FAA) Response to Office of Inspector General (OIG) Draft Report: FAA Needs To Improve Oversight and Enhance Transparency in Its Franchise Fund

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The FAA Franchise Fund<sup>1</sup> was established through the Department of Transportation and Related Agencies Appropriations Act of 1997, Public Law 104-205, to promote competition, increase efficiency, and reduce costs across the Federal Government. Since its inception in 1997, the FAA's Franchise Fund has successfully grown from providing consolidated services only to FAA to servicing over 23 agencies in 2019. During this period, Franchise revenue has grown from \$18 million to \$500 million. This growth occurred by consistently offering and delivering products and services that met the customer needs and were of value, while driving cost reduction for the customers of the Franchise Fund. Through sharing of services, fixed costs have been spread across the customer base, saving millions of dollars annually for the FAA and other federal customers. Examples of recent Franchise Fund outcomes include the following:

- In Fiscal Year (FY) 2018, Acting Chief of the US Border Patrol (USBP) recognized the FAA Logistics Center (FAALC) for saving USBP more than \$76M by capitalizing on the Logistics Center's infrastructure, proven processes, and technical expertise. The Department of Homeland Security also recognized the Enterprise Services Center (ESC) for saving \$12.9M.
- In FY 2019, a large customer base allowed for the distribution of fixed costs across external customers that reduced FAA's portion by \$12.5M. Further, ESC realized \$7.7 million in annual cost savings through contract services restructuring, contract re-negotiations, and automation efforts.
- In October 2019, ESC received the Office of Management and Budget's approval to on-board the Office of Personnel Management (OPM) onto the Delphi system,<sup>2</sup> with projected benefits and savings of over \$3 million across OPM and the remaining Delphi customer base.

The FAA has reviewed the OIG draft report and offers the following comments:

- The report incorrectly states the FAALC does not track inventory or have a system in place to track inventory. The issue raised was specifically that the FAA does not have a report to track the age of its inventory. The FAALC maintains detailed records of all inventory

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<sup>1</sup> The Franchise Fund is composed of six service organizations; Enterprise Services Center (ESC), International Training, Federal Leadership Training, Logistics Center, Flight Program Operations, and Acquisition Services.

<sup>2</sup> A web-based financial management system.

issued and receipted through the current Logistics Center Support System and the predecessor Logistics Inventory System. These systems track inventory from the date FAALC receives the asset until they are shipped. However, the age of the inventory item is not the criteria for stocking or excessing a part needed for maintenance, repair, or overhaul functions. Inventory support for the National Air Space (NAS) is atypical in that parts must be available, regardless of the NAS asset age. The mission is to support the NAS regardless of its age.

- The report includes item oversight issues related to Utilization, Screening, & Disposal inventory at the Thomas Road warehouse. This inventory is not managed by the Franchise Fund and therefore should not be cited as issues in this report.

Upon review of the recommendations, we concur with recommendations 3 through 13 as written. We plan to complete actions for recommendations 4 and 8 by March 31, 2020 and complete actions for recommendations 3, 5–7 and 9–13 by September 30, 2020.

The FAA does not concur with recommendation 1 to engage an auditor to perform an independent audit of the Franchise Fund's financial statements since the Franchise Fund is already included in independent financial audits for the FAA. The transactions and balances of the Franchise Fund roll up into the FAA Financial Statements; therefore, they are included in the auditors' tests to determine that the FAA's Financial Statements are fairly presented in all material respects.

We do not concur with recommendation 2 to develop and implement a process directing the Logistics Center (AML) to maintain detailed records of the age and costs of inventory. Obsolescence is not determined by the age of an asset; rather, it is determined based on the decommissioning of NAS systems that the asset is used to support. Therefore, AML does not produce an aged asset report; AML tracks issue and receipt of inventory in accordance with generally accepted accounting principles.

We appreciate this opportunity to offer additional perspective on the OIG draft report. Please contact H. Clayton Foushee at (202) 267-9000 if you have any questions or require additional information about these comments.

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