Department of Veterans Affairs
Office of Inspector General

REPORT OF THE AUDIT OF THE DEPARTMENT OF VETERANS AFFAIRS CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2007 AND 2006

Report No. 07-01016-21 November 15, 2007
VA Office of Inspector General
Washington, DC 20420

DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

Memorandum to the Acting Secretary

Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2007 and 2006

1. Attached is the Report of Audit of the Department of Veterans Affairs (VA) Consolidated Financial Statements (CFS) for Fiscal Years (FY) 2007 and 2006, as required by the Chief Financial Officers Act of 1990. The Office of Inspector General contracted with the independent public accounting firm, Deloitte & Touche LLP, to perform the audit of VA's FY 2007 CFS.

2. The independent auditors' report by Deloitte & Touche LLP provides an unqualified opinion on VA's FYs 2007 and 2006 CFS. The report on internal control identifies four material weaknesses. Three of the four material weaknesses are repeat conditions from the prior year audit and identified as (i) financial management system functionality (modified), (ii) information technology security controls and (iii) financial management oversight (modified). The fourth material weakness, retention of computer generated detail records in Benefit Delivery Network (BDN) system was identified in FY 2007.

3. The report on compliance with laws and regulations continues to show that VA is not in substantial compliance with the financial management system requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. The material weaknesses in internal control over financial reporting indicate that VA's financial management systems did not substantially comply with the Federal financial management systems requirements as required by FFMIA section 803(a).

4. Deloitte & Touche LLP is responsible for the attached auditor's report dated November 15, 2007, and the conclusions expressed in the report. We do not express opinions on VA's financial statements or internal control or on whether VA's financial management systems substantially complied with FFMIA; or conclusions on compliance with laws and regulations.

5. The independent auditors will follow up on these internal control findings and evaluate the adequacy of corrective actions taken during the audit of the VA's FY 2008 CFS.

Belinda J. Finn

BELINDA J. FINN
Assistant Inspector General
For Auditing

Attachment

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INDEPENDENT AUDITORS' REPORT

To the Inspector General and the Acting Secretary
of Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs ("VA") as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources for the years then ended which collectively comprise VA's basic financial statements. These financial statements are the responsibility of VA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and the requirements of Office of Management and Budget ("OMB") Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of VA's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of VA as of September 30, 2007 and 2006, and the respective net costs, changes in net position, and budgetary resources thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 15, 2007, on our consideration of VA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte & Touche LLP

November 15, 2007

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INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Inspector General and the Acting Secretary of
Department of Veterans Affairs

We have audited the basic financial statements of the Department of Veterans Affairs (VA) as of and for the year ended September 30, 2007, and have issued our report thereon dated November 15, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the requirements of the Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered VA's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion in the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the VA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the VA's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies and material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses.

We identified the following matters involving the internal control over financial reporting and its operation that we consider to be significant deficiencies. The significant deficiencies that we identified in our prior year report dated November 14, 2006 are identified in this report as "Repeat Condition".

Deficiencies described in Section I include significant departures from certain requirements of OMB Circular A–127, *Financial Management Systems*; Circular A–123, *Management's Responsibility for Internal Control*; and Circular A–130, *Management of Federal Information Resources*. We consider each of the four significant deficiencies identified as "Financial Management System Functionality," "Information Technology (IT) Security Controls," "Financial Management Oversight" and "Retention of Computer Generated Detail Records in Benefit Delivery Network (BDN) System" to be material weaknesses.

Distribution

This report is intended solely for the information and use of the VA Office of Inspector General, the management of VA, the Office of Management and Budget, the U.S. Government Accountability Office, Office of the President, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

November 15, 2007

SECTION I — MATERIAL WEAKNESSES

We consider each of the following deficiencies in VA's internal control over financial reporting to be a material weakness:

A. Financial Management System Functionality – Material Weakness (Repeat Condition)

VA management implemented a reporting system to automate the preparation of the consolidated financial statements in fiscal year 2006 which has improved the financial reporting process for fiscal year 2007. Although we noted some improvement, we identified continuing difficulties with the legacy systems related to the reliable, timely and consistent preparation, processing, and analysis of financial information for VA's consolidated financial statements. Key examples of significant deficiencies are described below.

Conditions:

- A significant number of manual adjusting entries are required at year-end to prepare the financial statements. This is indicative of systems which do not effectively and efficiently support reliable, timely and consistent preparation, processing and analysis of financial information. In addition, management has chosen to manually "rollover" entries from prior year adjustments in its reporting system, MinX.

- The legacy payroll and property systems do not readily provide information to support activity in the related general ledger accounts. The Personnel and Accounting Integrated Data (PAID) system cannot produce reports to support all accrued annual leave activity, including payroll adjustments, such as timesheet adjustments and expired leave balances. The Fixed Asset Package (FAP) cannot readily identify all current year property, plant and equipment additions and reclassifications of work in process due to system limitations.

Criteria:

OMB Circular A–127, *Financial Management Systems* states:

"A financial system supports the financial functions required to track financial events, provide financial information significant to the financial management of the agency, and/or required for the preparation of financial statements. A financial system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions. A financial system may include multiple applications and controls that are integrated through a common database or are electronically interfaced, as necessary, to meet defined data and processing requirements."

"The term "financial management systems" means the financial systems and the financial portions of mixed systems necessary to support financial management."

"Financial management systems shall be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems."

"An agency's financial management system should generate reliable, timely, and consistent information necessary for meeting management's responsibilities, including the preparation of financial statements."

"Transaction detail supporting SGL accounts shall be available in the financial management systems and directly traceable to specific SGL account codes."

OMB Circular A–123, *Management's Responsibility for Internal Control* states:

"The management control processes necessary to ensure that 'reliable and timely information is obtained, maintained, reported and used for decision making' are set forth, including prompt and appropriate recording and classification."

Cause:

There are inherent system weaknesses to assemble, compile, and review the necessary financial information for annual financial reporting requirements and to perform needed analyses.

Effect:

Significant manual workarounds and the posting of a large number of general ledger adjustments increase the risk of processing errors and, in turn, the risk of misstatements in the financial statements.

Recommendation:

The VA Chief Information Officer (CIO) and Chief Financial Officer (CFO) should work to improve system functionality in order to better support preparation of the financial statements and reduce the number of adjusting entries required.

VA management should inventory all non-systematic or manual workaround processes performed during the year-end closing period and continue to make improvements through adjustment of timing, refinement and consolidation of these processes.

B. Information Technology (IT) Security Controls – Material Weakness (Repeat Condition)

During fiscal year 2007, the Office of CIO (OCIO) issued Directive 6500, *Information Security Program*, and began to reorganize information technology (IT) resources and reporting structures. In September 2007, the OCIO also issued Handbook 6500 that is designed to assist the organization in implementing its information security programs as described in Directive 6500. In addition, management of major data centers and selected program offices have taken actions to remediate elements of IT security control weaknesses reported in our prior year reports.

However, legacy IT infrastructure and longstanding security control weaknesses due to the lack of effective implementation and enforcement of an agency-wide information security program continue to place VA's program and financial data at risk. Our assessment of the general and application controls of VA's key financial systems identified the following conditions.

Conditions:

Agency-wide Security Program

- Many key information security control procedures have not been updated and/or implemented to enforce security control over program and financial management systems throughout the organization in a uniform manner.
- The risk assessments for critical financial management systems were not consistently conducted in conformity with standards of the National Institute of Standards and Technology (NIST) Special Publication 800-30, *Risk Management Guide for Information Technology Systems*, to reflect VA's information security challenges and to facilitate effective mitigation of such challenges.

Access Control

- Strong system access authentication mechanisms and administration of user access have not been consistently implemented and enforced.
- Information systems were not patched in a consistent and timely manner.
- Access privileges were not restricted by proper system access profiles for users and IT personnel. nor were the access activities monitored on a routine basis.
- Intrusion detection mechanisms were not always operating consistently.

Segregation of Duties

- Legacy financial management systems and procedures have not been structured to enforce proper segregation of duties among IT personnel and end users within key financial management systems.

Service Continuity

- A service continuity plan at the departmental level has not been fully implemented to provide overall guidance, direction, and coordination for entity-wide IT service continuity.
- Testing of the service continuity plan "Continuity of Operations Plan" for financial management systems at selected program offices and certain data centers has not been routinely scheduled and adequately performed.

Change Control

- Standard change control policy and procedures have not been implemented to enforce financial application development and change management controls.

Criteria:

E-Government Act 2002, Title III, *Federal Information Security Management Act of 2002* states:

"Each agency shall develop, document, and implement an agency-wide information security program to provide information security for the information and information systems that support the operations and assets of the agency, including those provided or managed by another agency, contractor, or other source."

OMB A-130, Appendix III, *Security of Federal Automated Information Resources* states:

"Agencies shall implement and maintain a program to assure that adequate security is provided for all agency information collected, processed, transmitted, stored, or disseminated in general support systems and major applications."

Cause:

VA operated under a decentralized IT management structure until fiscal year 2006. One legacy of this structure was the lack of current and cohesive policies and procedures in major information security areas. Development, implementation and enforcement of these policies and procedures play an important role in the effective management of agency-wide information security programs and the success of the resulting security controls employed to protect financial information systems.

Effect:

Information security control weaknesses place sensitive information, including financial information and veterans' medical and benefit information, at risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, theft, or destruction, possibly occurring without detection.

Recommendations:

VA senior leadership should continue to pursue a more centralized approach to facilitate the effective implementation and enforcement of information security controls. VA should continue its effort to prioritize its resources in accomplishing its management agenda. Key tasks should include, but are not limited to, the following:

- Take an agency-wide approach to implement information security programs to guide information security control operations in accordance with standards established by NIST and OMB. Establish and communicate chain of command and accountability to enforce and monitor compliance with information security control policies and procedures.
- Provide actionable steps for ensuring that user access to VA financial management systems, including general support systems and major applications, is authorized based on need; that system logical security settings and updates are properly implemented for all interconnected networks, systems, and applications; and that proper oversight of system activities is performed.
- Configure systems to support proper system segregation of duties and provide adequate human resources and management oversight to complement system controls.

- Complete and implement a service continuity plan that will provide effective guidance, communication and coordination of service continuity planning. Perform routine testing to validate the effectiveness of the service continuity planning throughout the agency.
- Develop and implement a standard change control framework that guides the development and implementation of change management procedures for VA financial applications.

C. Financial Management Oversight – Material Weakness (Repeat Condition)

Conditions:

We have identified eight significant deficiencies that support the need for enhanced management oversight. Most of these deficiencies relate to observations also identified in prior years that remain uncorrected. When aggregated, the series of deficiencies has a recurring theme of inadequate or ineffective management oversight, thus resulting in an overall material weakness.

In the past management has attempted a number of approaches to remediate the recurring deficiencies. Management has provided training and become more involved in the process overall. Since these approaches have not proven effective, management should review the root cause of each issue and the reason that attempts to remediate the issue have been met with limited success.

The following eight significant deficiencies support the overall material weakness and are also described in greater detail in Section II of this report:

- ***Accrued Services Payable and Undelivered Orders***
  Veterans Health Administration (VHA) financial management did not perform adequate reviews in each of these areas.

- ***Accounts Receivable***
  VHA financial management did not perform sufficient follow-up of accounts receivable collections, and review of write-offs and allowances.

- ***Property, Plant and Equipment***
  VHA financial management demonstrated little evidence of improvement over monitoring internal controls and accounting for property, plant and equipment, including capitalization and disposals.

- ***Environmental and Disposal Liabilities***
  VHA financial management did not effectively monitor proper accounting and reporting of environmental liabilities.

- ***Payroll Agreed-Upon Procedures Report***
  The Central Office could not produce reports to support payroll data submissions to the Office of Personnel Management. Its review process did not detect the inaccuracies on reports generated from the PAID system until identified by our procedures.

- ***Accrual for Unbilled Receivables and Allowance for Contractual Adjustments***
  VHA financial management has not initiated adequate processes to review the allowance for contractual adjustments and information used in the calculation of accrual for unbilled receivables to assure these amounts are recorded in accordance with generally accepted accounting principles.

- ***Adjusting Entries and Reconciliation Review***
  There are deficiencies in Veterans Benefits Administration's (VBA) management review of journal entries and reconciliations that resulted in financial adjustments as a result of our audit process.

- ***Compensation and Pension Actuarial Liability***
  VBA management has not provided the external actuary with all relevant data nor has VBA management considered the impact of this relevant data to the liability.

Criteria:

Management must maintain a system of internal controls in accordance with *Standards for Internal Control in the Federal Government* issued by the Government Accountability Office (GAO). These five standards for internal control include:

- Control Environment – It provides the discipline and structure as well as the climate which influences the quality of internal control.
- Risk Assessment – It is the identification and analysis of relevant risks associated with achieving control objectives.
- Control Activities – They are the policies, procedures, techniques, and mechanisms that enforce management's directives.
- Information and Communications – Information should be recorded and communicated to management and others within the entity who need it and in a form and within a time frame that enables them to carry out their internal control and other responsibilities.
- Monitoring – Internal control monitoring should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved.

Cause:

The operational causes for the deficiencies highlighted above vary. Common issues include a lack of resources with the appropriate skills and a significant volume of transactions. In addition, as in the case of environmental liabilities and property, plant and equipment, the solution requires routine communication with non-financial functions such as facilities management. If the essential financial accounting work has not been performed or performed inadequately, various levels of financial management should be in place to properly monitor, identify and detect these issues. VA's decentralized structure makes management of control processes more difficult.

Effect:

Recording financial data without sufficient review and monitoring increases the likelihood that an error in the financial statements will occur and that it will go undetected.

Recommendation:

Management should review its financial management organizational structure to determine if the financial management organization has sufficient authority and resources to solicit support to improve financial management at all levels of the organization. Any initiative should have support from the Secretary to promote strong financial management and coordination amongst all operational levels to ensure financial management can promote change within the overall organization. This may require additional funding and resources but it also requires a fundamental commitment from all operational levels. VA should also assess the resource and control challenges associated with operating in a highly decentralized accounting function. While the assessment is being performed, management should develop an immediate interim review and monitoring plan to detect and resolve issues in each of the eight deficiencies discussed above.

D. Retention of Computer Generated Detail Records in BDN System – Material Weakness

Conditions:
We noted that VBA retains certain computer generated transaction details from the BDN system for approximately 60 to 90 days; as such, management was unable to provide supporting detail to substantiate certain amounts recorded in the financial statements.
Also large differences for Compensation and Pension and Education programs existed between BDN, a subsidiary ledger, and FMS, the general ledger and management was unable to provide support for these differences.

Criteria:
Benefit Systems Requirements, formerly published by the Joint Financial Management Improvement Program and now under the responsibility of the Financial Systems Integration Office, states:
"Audit Trails Process

Adequate audit trails are critical to provide support for transactions and balances maintained by the benefits system. While audit trails are essential to auditors and system evaluators, they are also necessary for day-to-day operation of the system. For example, they allow for the detection and systematic correction of errors that arise.

Mandatory Requirements

To support the Audit Trails process, the benefits system must:

- Provide audit trails to trace transactions from source documents, original input, other systems, system-generated transactions, and internal assignment transactions through the system.
- Provide transaction details to support account balances.
- Provide audit trails to trace source documents and transactions through successive levels of summarization to the financial statements and the reverse.
- Provide audit trails to identify changes made to system parameters and tables that would affect the processing or reprocessing of any financial transactions.
- For all types of transactions, provide capability to select items for review based on user-defined criteria. Examples of selection criteria are accounting period, amount, and payee.
- Provide audit trails that identify document input, change, approval, and deletions by originator.

- Provide the capability to record the user ID, date, and time updated for each transaction affecting the general and subsidiary ledger accounts."

Cause:

Management has informed us that this deficiency is due to system limitations in BDN and the high volume of transactions processed on a daily basis.

Effect:

Management cannot provide support for certain balances in the general ledger after 60 to 90 days from the transaction date.

Recommendation:
Policies and procedures should be implemented to ensure that computer generated transaction detail is maintained for an appropriate number of years in order to provide adequate support and audit trail for balances recorded in the financial statements.

SECTION II — SIGNIFICANT DEFICIENCIES

We consider the following deficiencies in VA's internal control over financial reporting to be significant deficiencies. Items with an asterisk (*) are repeat conditions included in a letter we issued to management last year.

1. Accrued Services Payable, and Undelivered Orders —VHA*

Condition- During our medical center site visits, we noted instances where accrued services payable and undelivered orders were not properly monitored and reviewed to ensure they were valid transactions.

Criteria- OMB Circular A-123, *Management's Responsibility for Internal Control,* requires that management be responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations.

Cause- Inadequate financial management oversight at the medical centers.

Effect- Accrued services payable and undelivered orders balances could be misstated during the year, and in some cases, unauthorized transactions may not be detected.

Recommendation- We recommend that the VHA CFO, in coordination with the Veterans Integrated Service Network (VISN) CFOs, take action to review and monitor accrued services payable and undelivered orders on a monthly basis. Large or old payables or undelivered order balances should be reviewed to ensure validity.

2. Accounts Receivable —VHA*

Condition- We noted the following with respect to accounts receivable (both medical care and non-medical care).

- Incorrect non-medical care allowance for bad debts and no central office analytical reviews of station balances.
- Receivable was booked before earned.
- Lack of timely follow-up of accounts receivable.
- Incorrect calculation of interest expense.

Criteria- OMB Circular A-123, *Management's Responsibility for Internal Control,* requires that management be responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations.

Cause- Inadequate financial management oversight at the medical centers.

Effect- The accounts receivable balance and its related allowance have a higher risk for misstatement.

Recommendation- We recommend that the VHA CFO, in coordination with the VISN CFOs, take action to implement proper follow-up procedures of accounts receivable and to ensure calculating and recording of allowance estimates and transactions correctly. In addition, VHA CFO should review the allowance estimates for reasonableness on a regular basis.

3. Property, Plant and Equipment (PP&E) – Estimated Useful Life and Recording of Transactions —VHA*

Condition- During our medical center site visits, we noted the following:

- Work in process projects were not capitalized on a timely basis.
- Assets that are no longer property of VA remained capitalized.
- Transactions that should have been expensed were capitalized due to unclear operating procedures.
- The estimated useful lives were not consistent with VA policy.

Criteria- OMB Circular A-123, *Management's Responsibility for Internal Control,* requires that management be responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations.

Cause- Inadequate financial management oversight at the medical centers and inadequate communication with facilities management.

Effect- PP&E and related expense accounts may be misstated.

Recommendation- We recommend that VHA CFO, in coordination with the VISN CFOs, take action to ensure better coordination between financial and facilities management, that work-in-process projects are reviewed for completion dates and timely capitalization, and that estimated useful lives are consistent with VA policy. In addition, management should put procedures in place to ensure that projects no longer in use are removed from the general ledger.

4. Environmental and Disposal Liabilities—VHA*

Condition- We noted that many stations were not updating the estimate for, or documentation of, environmental and disposal liabilities on a timely basis. In addition, inconsistent methodologies for calculating environmental and disposal liabilities were noted throughout the medical centers. Furthermore, we noted that the Austin Financial Services Center reverses the estimate on an annual basis to force the stations to review and re-book an updated estimate. In certain instances, medical centers were not aware that balances had been reversed.

Criteria- In accordance with the Federal Financial Accounting and Auditing Technical Release Number 2, an agency is required to recognize a liability for environmental cleanup costs resulting from past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable.

Cause- Inadequate communication and review with facilities management and no review of station balances by central office.

Effect- As a result of our audit, numerous stations were required to post significant adjustments during the fourth quarter to correctly state environmental and disposal liabilities.

Recommendation- We recommend that the VHA CFO, in coordination with the VISN CFOs, take action to ensure that these estimates are updated and recorded timely and that appropriate documentation is maintained to support these estimates. To ensure consistency in reporting and reasonable estimates, management should develop standard procedures that address the requirements and methodologies for the estimating and recording of environmental liabilities, improve communication with facilities management, and ensure central office reviews are conducted.

5. Payroll Agreed-Upon Procedures Report

Condition- On an annual basis, VA is required to submit a Report of Withholdings and Contributions for Health Benefits, Life Insurance, and Retirement to the U.S. Office of Personnel Management (OPM) on which we issue an agreed-upon procedures report. As in past years, significant effort was expended by both Deloitte & Touche LLP and VA in performing the agreed-upon procedures due to inaccurate reports generated from the PAID system. As a result, significant differences were noted by our agreed-upon procedures report.

Criteria- In accordance with OMB Circular A-127, *Financial Management Systems*,

"A financial system supports the financial functions required to track financial events, provide financial information significant to the financial management of the agency, and/or required for the preparation of financial statements."

"An agency's financial management system should generate reliable, timely, and consistent information necessary for meeting management's responsibilities, including the preparation of financial statements."

"The agency financial management system shall be able to provide financial information in a timely and useful fashion to …comply with internal and external reporting requirements…,"

Cause- Limitations with the PAID legacy system.

Effect- Inaccurate reports could impact the calculation of imputed pension costs.

Recommendation- We recommend that the VA CFO review reports generated from the PAID system for accuracy and make programming adjustments as necessary to support standard reports that allow VA to meet this reporting requirement more efficiently, accurately, and timely.

6. Accrual for Unbilled Receivables and Allowance for Contractual Adjustments—VHA

Condition- The following conditions were noted during the review of accounts receivable:

- Accrual for unbilled receivables is calculated using a three-month moving average of change in accounts receivable, write-offs and collections multiplied by the number of days it takes to bill a receivable after services are provided. However, management has not validated the reasonableness of the accrual methodology by analyzing actual billings subsequent to the accounting period. In addition, we noted that the days to bill information is calculated by a separate division within VHA which was not aware that the information was to be used for financial statements.

- The allowance for contractual adjustments for medical care accounts receivables is a system calculated percentage. During our review, we noted that management had not reviewed the reasonableness of the allowance based on prior year actuals.

Criteria- GAO's *Standards for Internal Control in the Federal Government* state that managers need to compare actual performance to planned or expected results and analyze significant differences.

Cause- Inadequate financial management review at VHA central office.

Effect- Accounts receivable balances could be misstated as a result of an inadequate accrual.

Recommendation- We recommend that VHA CFO validate the methodology for the accrual for unbilled receivables and the allowance for contractual adjustments by comparing actual activity to prior estimates.

7. Adjusting Entries and Reconciliation Review*

Condition- As part of our audit of adjusting entries for compensation, pension and education, specifically relating to the statement of budgetary resources, we noted instances where the entry was either not posted or posted with an incorrect amount. These errors were not identified during the VBA review process.

During our audit of property management, we noted that the reconciliation between Centralized Property Tracking System and FMS was not prepared correctly. We also noted that accrual errors were identified on the reconciliation however they were not investigated by VBA in a timely manner.

Criteria- Appropriate review and reconciliation is the basis of a sound internal control environment. The *Standards for Internal Control in the Federal Government* includes reconciliation and review of financial data.

Cause- These deficiencies are due to inadequate management review of financial information. We noted that in most instances, controls to detect these deficiencies are designed, but they are not implemented and operating effectively.

Effect- Relying on financial data without sufficient review and monitoring processes may increase the likelihood that an error in the financial statements will go undetected.

Recommendations- Management reviews should be performed as part of the accounting process. In addition, VA should consider reconciliations as a control and work to resolve any significant differences noted therein to ensure that balances reported in the financial statements are accurate.

8. Accrued Annual Leave*

Condition- A tremendous amount of effort was expended to prepare the support for the year-end accrued annual leave balances and associated activities during the year by using the PAID system. The reports used to support leave activity did not capture payroll adjustments such as timesheet adjustments and expired leave balances, causing differences between the report and the general ledger.

Criteria- In accordance with OMB Circular A-127, *Financial Management Systems*, "A financial system supports the financial functions required to track financial events, provide financial information significant to the financial management of the agency, and/or required for the preparation of financial statements."

Cause- Lack of effective system functionality and inadequate financial management oversight.

Effect- Inaccurate financial information may not be detected timely.

Recommendation- We recommend that the VA CIO and CFO develop reports to support the annual leave balances in the PAID system to ensure timely, reliable, and consistent accrued annual leave information is available and reconciled when used to prepare the financial statements.

9. Operating Lease Commitments*

Condition- VA does not have an effective process to accumulate information on their future lease commitments for equipment. This information is needed to complete footnote disclosures.

Criteria- OMB Circular A-136, *Financial Reporting Requirements,* requires the disclosure of future lease commitments for each of the next five years and total remaining lease commitment thereafter.

Cause- Decentralization of records.

Effect- Footnote disclosure may not reflect all future commitments.

Recommendation- We recommend that the CFOs for each administration and officials from Veterans Affairs Central Office develop a process to gather operating lease information for year-end disclosure requirements.

10. Intra-Governmental Reconciliations and Related Controls

Condition- VA has drafted policies and procedures to address the requirements of Intra-governmental Business Rules issued by OMB Memorandum M-07-03, but these draft policies and procedures have not been issued in final form. In addition, unreconciled differences exist primarily with the VA's trading partner, the Department of Defense.

Criteria- The Financial Manual, Bulletin No. 2007-03, outlines business rules for intra-governmental transactions. These rules apply to all intra-governmental business, specifically transactions that entail the exchange of goods and services, investments, borrowings and transfers between Federal entities.

Cause- VA does not have sufficient data from their trading partners to properly reconcile all the accounts. In addition, during our audit, we found the draft intra-governmental internal control procedures had not yet been issued in final form.

Effect- Significant unreconciled differences may result with trading partners and inaccurately reflect the related intercompany accounts on both the VA's and individual trading partner's stand-alone financial statements.

Recommendation- We recommend the draft policy and procedures be reviewed to ensure compliance with all the Intra-governmental Business Rules outlined in the Treasury Financial Manual Bulletin No 2007-03. All significant differences should be resolved with trading partners as outlined in Section VII, Resolving Intra-governmental Disputes and Major Differences. VA should also consider the impact of these differences and assess the need for adjustments or write-offs as part of their year-end financial reporting cycle.

11. Property, Plant and Equipment

Condition- The Fixed Asset Package (FAP) provides the capability to retroactively enter acquisitions. While this practice may correctly reflect the actual acquisition dates of specific assets, it may cause difficulty for FAP to identify current year only additions based on acquisition dates. In addition, the system cannot identify reclassifications of work-in-process projects to various capitalized or expense accounts.

Criteria- In accordance with OMB Circular A-127, *Financial Management Systems*,
"A financial system supports the financial functions required to track financial events, provide financial information significant to the financial management of the agency, and/or required for the preparation of financial statements."

Cause- System limitation.

Effect- Inaccurate financial information may not be detected.

Recommendation- We recommend that the VA CIO and CFO develop reports to support actual property, plant and equipment activities occurred during the year and to ensure balances on the reports reconcile back to the financial statements.

12. Compensation and Pension Actuarial Liability

Condition- The model provided to an external actuary to calculate the C&P actuarial liability does not consider hold back and offsets for incarcerated veterans and severance pay provided by the Department of Defense.

Criteria- In order for an external actuary to accurately estimate the C&P actuary liability, they must be provided with all relevant data.

Cause- VBA management has not provided the external actuary with all relevant data nor has VBA management considered the impact of this relevant data to the liability.

Effect- The external actuary does not have all the relevant information to calculate the actuarial liability.

Recommendation- We recommend that VBA management prepare a reconciliation between the BDN payment file and the gross summary file each time a file is provided to an external actuary. Reconciling items identifying data relevant to the calculation of the estimated liability should be provided to an external actuary.

13. Statement of Net Cost

Condition- VA does not have an effective process of collecting, documenting and validating the cost drivers, allocations, and factors used in MinX to prepare the statement of net cost.

Criteria- OMB Circular A–123, *Management's Responsibility for Internal Control*, states:

"The management control processes necessary to ensure that 'reliable and timely information is obtained, maintained, reported and used for decision making' are set forth, including prompt and appropriate recording and classification."

The Chief Financial Officers (CFO) Act of 1990 contains several provisions related to managerial cost accounting, one of which states that an agency's CFO should develop and maintain an integrated accounting and financial management system that provides for the development and reporting of cost information and the systematic measurement of performance.

Cause- VA does not have an automatic cost allocation system that can identify and accumulate the information needed to prepare the statement of net cost.

Effect- The current process, which uses Excel spreadsheets is inefficient and error prone due to the numerous manual inputs that could cause a potential error in the financial statements and statement of net cost footnote disclosures.

Recommendation- VA should develop an entity-wide system to ensure that costs are accurately and consistently tracked throughout all business lines and provides information needed to prepare the statement of net cost. This will reduce the need for manual inputs thereby reducing the risk of potential errors in the financial statements and footnote disclosures.

Follow-Up on Previous Report

In our *Independent Auditors' Report On Internal Control Over Financial Reporting And On Compliance Based Upon the Audit Performed in Accordance with Government Auditing Standards* dated November 14, 2006, we reported three material weaknesses in the areas of (1) Lack of an Integrated Financial Management System, (2) Information Technology (IT) Security Controls, and (3) Operational Oversight. These conditions continue to be reported as material weaknesses this year. The Integrated Financial Management System weakness is referred to as Financial Management System Functionality, and the Operational Oversight material weakness is referred to as Financial Management Oversight in the current year.

SECTION III - COMPLIANCE AND OTHER MATTERS

With respect to the internal controls related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions and determined whether they have been placed in operation, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on internal control over reported performance measures and accordingly, we do not provide an opinion on such controls.

In addition, we considered VA's internal control over Supplementary Information by obtaining an understanding of VA's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on these internal controls and accordingly, we do not provide an opinion on such controls.

As part of obtaining reasonable assurance about whether VA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, non-compliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards* and are described below.

1. Non-compliance with FFMIA

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U. S. Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance and evaluative criteria issued by OMB in Circular A-127.

The material weaknesses in internal control over financial reporting discussed above and identified as "Financial Management System Functionality," "Information Technology (IT) Security Controls," and "Retention of Computer Generated Detail Records in BDN System" indicate that VA's financial management systems did not substantially comply with the Federal financial management systems requirements as required by FFMIA section 803(a).

2. Non-compliance with Debt Collection Improvement Act*

Condition- Several instances of non-compliance with the Debt Collection Improvement Act of 1996 (DCIA) were noted.

- A few medical centers selected for review had incorrect interest calculations due to manual errors, incorrect percentage rates and other unexplained errors.

- Interest and administrative costs should be charged to VA's delinquent debtors. The rates are determined by the Treasury on a yearly basis. However, VBA did not charge interest on Life Insurance delinquent debts nor Compensation and Pension ("C&P") Chapter 30 or Chapter 1606 Education receivables.

Criteria- Public Law 96-466, 38 U.S.C. 501(a) and 5315, and 38 CFR 1.919 gave VA specific authority to charge interest on any amount owed the United States.

Cause- The condition is a combination of the inability of the Hines system to calculate interest on VBA debts, inadequate financial management oversight at the medical centers, and the former VA Deputy Secretary's decision in July 1992 to not charge interest on compensation and pension debts.

Effect- Accounts receivable could be misstated.

Recommendation- We recommend the VBA CFO and VHA CFO, in coordination with the VISN CFOs, should take action to:

- Ensure accurate calculation of interest.

- Implement policies and procedures to administer the requirements of Public Law 96-466 and Title 38 with respect to interest and administrative charges or propose a legislative remedy to request a waiver of these requirements for the Veterans C&P programs.

3. Non-compliance with USC Title 5, 552A –VBA*

Condition- There were several files that could not be located for testing during VBA testing as well as instances where the appropriate documents were not available to substantiate the amounts recorded. Some of these were comprised of instances where key forms were missing from the veteran's file.

Criteria- USC Title 5, 552A subsection D5 states:

"An agency should maintain all records which are used by the agency in making any determination about any individual with such accuracy, relevance, timeliness, and completeness as is reasonably necessary to assure fairness to the individual in the determination."

Cause- Inadequate control of the retention of the veteran file records due to the fact that the files were manually stored and some of those files were subsequently transferred to off site locations and not adequately tracked.

Effect- VA is not in compliance with USC Title 5, 552A, subsection D5, as it relates to several veteran files. Also the balances recorded in FMS cannot be substantiated due to the lack of supporting documentation.

Recommendation - We recommend that the VA implement procedures to ensure that veteran file records are properly retained and can be located.

In addition, we noted other matters involving the internal control and compliance over financial reporting that will be reported to VA in a separate letter.

Department of Veterans Affairs

Memorandum

Date: November 15, 2007

From: Assistant Secretary for Management (004)

Subj: Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2007 and 2006

To: Assistant Inspector General for Auditing (52)

1. We have reviewed the Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2007 and 2006, and are pleased with the receipt of an unqualified opinion. We are also proud that we were able to meet the FY 2007 reporting timeline established by the Office of Management and Budget. Please extend to your staff and the staff of Deloitte & Touche, LLP our appreciation for their detailed planning, hard work, and cooperation during this year's audit.

2. The Department's senior officials and I, as well as program managers in VHA, VBA, NCA, and affected staff offices, are aware of the results of the audit. We will continue to focus on completing corrective actions as detailed in the remediation plans for the three material weaknesses, Financial Management System Functionality (previously identified as Lack of an Integrated Financial Management System), Financial Management Oversight (previously identified as Operational Oversight), and Information Technology Security Controls. These existing remediation plans will be revised and expanded, as needed, to address the findings and recommendations in your audit report. A remediation plan will be developed for the new audit material weakness, Retention of Computer Generated Detail Records in Benefits Delivery Network (BDN) System - VBA. We will forward copies of each of these plans to you during the second quarter of FY 2008, and will keep you apprised of our progress in remediating these weaknesses throughout FY 2008.

3. Thank you again for your efforts in bringing us to another successful conclusion of the audit cycle.

Robert J. Henke