# A Letter from the Acting Chief Financial Officer

*I am pleased to report that the Department of Veterans Affairs continued its tradition of financial excellence in FY 2004. For the sixth straight year, VA received an unqualified audit opinion on its financial statements from the external auditors, Deloitte & Touche.*

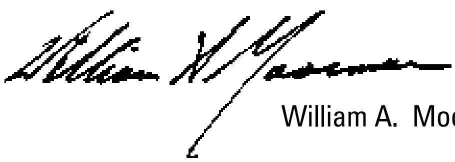
We continue to strengthen our fiscal management and accountability by enhancing internal controls, complying with financial management laws and regulations, and taking timely corrective actions on the auditors' recommendations concerning reportable conditions, material weaknesses, and non-conformances.

In FY 2004, we continued our efforts to assess and correct the two outstanding audit material weaknesses reported by Deloitte & Touche — *Information Technology Security Controls* and *Lack of Integrated Financial Management System*. We have implemented an information technology security training and awareness program and established a VA centralized clearinghouse for computer-related security incidents, as well as made substantial progress in completing corrective actions within our application systems. In FY 2004, the Department deployed the CoreFLS pilot program at the Bay Pines VA Medical Center and two additional pilot sites. This pilot program was designed to test a new computerized financial management and logistics system and to demonstrate the ability of commercial off-the-shelf finance/logistics software to operate effectively in a complex VA environment. However, due to technology and other issues, management decided to discontinue the pilot and return the pilot sites to VA's existing financial management system by the beginning of FY 2005. An executive project committee, chaired by VA's Assistant Secretary for Information and Technology (VA CIO) and comprised of other senior leaders, is examining the results of the CoreFLS pilot program at the Bay Pines VA Medical Center, as well as the other two pilot sites, and will make recommendations to the VA Secretary concerning the future of the program.

Under FMFIA, VA corrected one material weakness, *Compensation and Pension System — Lack of Adaptability and Documentation*. We are currently working on the closure of the remaining two material weaknesses, *Personnel Accounting Integrated Data (PAID) System — Mission Performance* and *Internal Control Weaknesses in the Compensation and Pension Payment Process*, which are expected to be closed in early FY 2005 and FY 2006, respectively. We continued efforts to implement the requirements of the Improper Payments Information Act (IPIA). VA successfully completed a statistical sampling of 17 of the 19 programs in VA's IPIA inventory. The remaining two programs will be sampled in FY 2005.

The Department also continues to make progress in implementing the Government Performance and Results Act. We are continuously assessing and refining our performance measures, the quality of data used to compute those measures, and procedures for compiling performance data. Procedures are being developed to enhance data validation to ensure that our stakeholders have useful and accurate performance data.

While we are proud of our accomplishments in FY 2004, we will continue to strengthen and improve all aspects of our performance. Our goal is to maintain and/or exceed VA's high financial management standards in FY 2005. We will continue to promote effective management controls and focus on further actions associated with the President's Management Agenda initiatives.



William A. Moorman

# Consolidated Financial Statements

**DEPARTMENT OF VETERANS AFFAIRS**
**CONSOLIDATED BALANCE SHEETS** (DOLLARS IN MILLIONS)
AS OF SEPTEMBER 30,

| | 2004 | 2003 |
|---|---|---|
| **ASSETS** | | |
| **INTRAGOVERNMENTAL** | | |
| Fund Balance with Treasury (Note 3) | $ 16,741 | $ 17,795 |
| Investments (Note 5) | 13,643 | 13,941 |
| Accounts Receivable, Net (Note 6) | 132 | 196 |
| Other Assets | 122 | 96 |
| **TOTAL INTRAGOVERNMENTAL ASSETS** | **30,638** | **32,028** |
| **PUBLIC** | | |
| Investments (Note 5) | 184 | 201 |
| Accounts Receivable, Net (Note 6) | 887 | 859 |
| Loans Receivable, Net (Note 7) | 2,954 | 4,655 |
| Cash (Note 4) | 68 | 41 |
| Inventories (Note 8) | 69 | 73 |
| General Property, Plant and Equipment, Net (Note 9) | 11,215 | 10,949 |
| Other Assets | 56 | 29 |
| **TOTAL PUBLIC ASSETS** | **15,433** | **16,807** |
| **TOTAL ASSETS** | **$ 46,071** | **$ 48,835** |
| **LIABILITIES** | | |
| **INTRAGOVERNMENTAL** | | |
| Accounts Payable | $ 72 | $ 61 |
| Debt | 2,618 | 2,854 |
| Other Liabilities (Note 13) | 2,134 | 3,506 |
| **TOTAL INTRAGOVERNMENTAL LIABILITIES** | **4,824** | **6,421** |
| **PUBLIC** | | |
| Accounts Payable | 3,003 | 2,907 |
| Liabilities for Loan Guarantees (Note 7) | 4,740 | 4,756 |
| Federal Employee and Veterans Benefits Liability (Note 11) | 926,553 | 956,688 |
| Environmental and Disposal Liabilities (Note 12) | 339 | 375 |
| Insurance Liabilities (Note 15) | 12,291 | 12,640 |
| Other Liabilities (Note 13) | 7,047 | 6,309 |
| **TOTAL PUBLIC LIABILITIES** | **953,973** | **983,675** |
| **TOTAL LIABILITIES** | **958,797** | **990,096** |
| **NET POSITION** | | |
| Unexpended Appropriations | 2,642 | 4,233 |
| Cumulative Results of Operations | (915,368) | (945,494) |
| **TOTAL NET POSITION** | **(912,726)** | **(941,261)** |
| **TOTAL LIABILITIES AND NET POSITION** | **$ 46,071** | **$ 48,835** |

*The accompanying Notes are an integral part of these financial statements.*

**DEPARTMENT OF VETERANS AFFAIRS**
**CONSOLIDATED STATEMENTS OF NET COST** (DOLLARS IN MILLIONS)
FOR THE YEARS ENDED SEPTEMBER 30,

| | | 2004 | | 2003 |
|---|---|---|---|---|
| **NET PROGRAM COSTS (NOTE 18)** | | | | |
| Medical Care | $ | 25,396 | $ | 23,576 |
| Medical Education | | 1,111 | | 1,036 |
| Medical Research | | 898 | | 826 |
| Compensation | | 27,306 | | 25,546 |
| Pension | | 3,526 | | 3,491 |
| Education | | 2,037 | | 1,740 |
| Vocational Rehabilitation and Employment | | 676 | | 649 |
| Loan Guaranty | | 1,141 | | (988) |
| Insurance | | 63 | | 91 |
| Burial | | 332 | | 325 |
| **NET PROGRAM COSTS BEFORE CHANGES IN VETERANS BENEFITS ACTUARIAL LIABILITIES** | | **62,486** | | **56,292** |
| Compensation | | (30,100) | | 105,800 |
| Burial | | 100 | | (200) |
| **SUBTOTAL** | | (30,000) | | 105,600 |
| **NET NON-PROGRAM COSTS** | | 781 | | 582 |
| **NET COST OF OPERATIONS (NOTE 18)** | **$** | **33,267** | **$** | **162,474** |

*The accompanying Notes are an integral part of these financial statements.*

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
FOR THE YEAR ENDED SEPTEMBER 30, 2004
(DOLLARS IN MILLIONS)

| | Cumulative Results of Operations | Unexpended Appropriations |
|---|---|---|
| **Beginning Balances** | $ (945,494) | $ 4,233 |
| **Budgetary Financing Sources** | | |
| Appropriations Received | - | 62,179 |
| Other Adjustments | - | (460) |
| Appropriations Used | 63,325 | (63,325) |
| Transfers-in | - | 15 |
| Nonexchange Revenue | 5 | - |
| Donations | 28 | - |
| **Other Financing Sources** | | |
| Donations of Property | 14 | - |
| Transfers-out | (880) | - |
| Imputed Financing | 1,252 | - |
| Other | (351) | - |
| **Total Financing Sources** | **63,393** | **(1,591)** |
| Net Cost of Operations | (33,267) | - |
| **Ending Balances** | **$ (915,368)** | **$ 2,642** |

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
FOR THE YEAR ENDED SEPTEMBER 30, 2003
(DOLLARS IN MILLIONS)

| | Cumulative Results of Operations | Unexpended Appropriations |
|---|---|---|
| **Beginning Balances** | $ (840,350) | $ 3,366 |
| **Budgetary Financing Sources** | | |
| Appropriations Received | - | 59,060 |
| Other Adjustments | (1,113) | 1,092 |
| Appropriations Used | 59,285 | (59,285) |
| Nonexchange Revenue | 1 | - |
| Donations | 27 | - |
| **Other Financing Sources** | | |
| Donations of Property | 15 | - |
| Transfers-out | (1,925) | - |
| Imputed Financing | 1,082 | - |
| Other | (42) | - |
| **Total Financing Sources** | **57,330** | **867** |
| Net Cost of Operations | (162,474) | - |
| **Ending Balances** | **$ (945,494)** | **$ 4,233** |

*The accompanying Notes are an integral part of these financial statements.*

**DEPARTMENT OF VETERANS AFFAIRS**
**COMBINED STATEMENT OF BUDGETARY RESOURCES (NOTE 19)** (DOLLARS IN MILLIONS)
FOR THE YEAR ENDED SEPTEMBER 30, 2004

| | Budgetary | Credit Financing |
|---|---|---|
| **Budgetary Resources** | | |
| Budget Authority | $ 64,987 | $ 1,169 |
| Unobligated Balance at the Beginning of the Period | 16,208 | 6,150 |
| Net Transfers-Prior Year Balance | (116) | - |
| Spending Authority from Offsetting Collections | 4,955 | 2,944 |
| Adjustments | (386) | (1,347) |
| **Total Budgetary Resources** | **$ 85,648** | **$ 8,916** |
| **Status of Budgetary Resources** | | |
| Obligations Incurred | $ 69,981 | $ 4,440 |
| Unobligated Balance Available | 13,232 | 1 |
| Unobligated Balance Not Yet Available | 2,435 | 4,475 |
| **Total Status of Budgetary Resources** | **$ 85,648** | **$ 8,916** |
| **Outlays** | | |
| Obligations Incurred | $ 69,981 | $ 4,440 |
| Less Spending Authority from Offsetting Collections and Adjustments | (4,955) | (2,944) |
| Obligated Balance, Net Beginning of Period | 8,945 | 76 |
| Less Obligated Balance, Net End of Period | (10,034) | (93) |
| **Outlays** | 63,937 | 1,479 |
| Less Offsetting Receipts | (2,668) | - |
| **Net Outlays** | **$ 61,269** | **$ 1,479** |

**DEPARTMENT OF VETERANS AFFAIRS**
**COMBINED STATEMENT OF BUDGETARY RESOURCES (NOTE 19)** (DOLLARS IN MILLIONS)
FOR THE YEAR ENDED SEPTEMBER 30, 2003

| | Budgetary | Credit Financing |
|---|---|---|
| **Budgetary Resources** | | |
| Budget Authority | $ 61,723 | $ 1,334 |
| Unobligated Balance at the Beginning of the Period | 15,579 | 5,316 |
| Net Transfers-Prior Year Balance | (105) | - |
| Spending Authority from Offsetting Collections | 4,906 | 4,666 |
| Adjustments | (206) | (1,506) |
| **Total Budgetary Resources** | **$ 81,897** | **$ 9,810** |
| **Status of Budgetary Resources** | | |
| Obligations Incurred | $ 65,689 | $ 3,660 |
| Unobligated Balance Available | 13,708 | 218 |
| Unobligated Balance Not Yet Available | 2,500 | 5,932 |
| **Total Status of Budgetary Resources** | **$ 81,897** | **$ 9,810** |
| **Outlays** | | |
| Obligations Incurred | $ 65,689 | $ 3,660 |
| Less Spending Authority from Offsetting Collections and Adjustments | (4,906) | (4,666) |
| Obligated Balance, Net Beginning of Period | 7,819 | 103 |
| Less Obligated Balance, Net End of Period | (8,945) | (76) |
| **Outlays** | 59,657 | (979) |
| Less Offsetting Receipts | (2,174) | - |
| **Net Outlays** | **$ 57,483** | **$ (979)** |

*The accompanying Notes are an integral part of these financial statements.*

**DEPARTMENT OF VETERANS AFFAIRS**
**CONSOLIDATED STATEMENTS OF FINANCING (NOTE 20)**
**FOR THE YEARS ENDED SEPTEMBER 30,**
**(DOLLARS IN MILLIONS)**

| | 2004 | 2003 |
|---|---|---|
| **Resources Used to Finance Activities** | | |
| Obligations Incurred | $ 74,421 | $ 69,349 |
| Less Spending Authority from Offsetting Collections and Adjustments | (7,899) | (9,572) |
| Obligations Net of Offsetting Collections and Adjustments | 66,522 | 59,777 |
| Less Offsetting Receipts | (2,668) | (2,174) |
| Net Obligations | 63,854 | 57,603 |
| Donations of Property | 14 | 15 |
| Transfers-out | (1,227) | (1,925) |
| Imputed Financing | 1,252 | 1,082 |
| Other Financing Sources | 3 | (42) |
| **Total Resources Used to Finance Activities** | **63,896** | **56,733** |
| | | |
| **Resources That Do Not Fund Net Cost of Operations** | | |
| Change in Amount of Goods, Services and Benefits Ordered But Not Yet Provided | (452) | (357) |
| Resources that Finance the Acquisition of Assets | (5,398) | (4,428) |
| Resources that Fund Expenses Recognized in Prior Periods | (441) | (1,105) |
| Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations | 3,065 | 4,812 |
| Other | (3) | 2 |
| Total Resources That Do Not Fund Net Costs of Operations | (3,229) | (1,076) |
| **Total Resources Used to Finance the Net Cost of Operations** | **60,667** | **55,657** |
| | | |
| **Costs That Do Not Require Resources in the Current Period** | | |
| Increase in Annual Leave Liability | 75 | 55 |
| Increase in Environmental and Disposal Liability | (37) | 104 |
| Reestimates of Credit Subsidy Expense | 2,148 | (565) |
| Increase in Exchange Revenue Receivable from the Public | 952 | 157 |
| Increase in Veterans Benefits Actuarial Liability | (30,000) | 105,600 |
| Depreciation and Amortization | 465 | 1,345 |
| Bad Debts Related to Uncollectible Non-Credit Reform Receivables | 328 | 194 |
| Loss on Disposition of Assets | 99 | 109 |
| Other | (1,430) | (182) |
| **Total Costs That Do Not Require Resources in the Current Period** | **(27,400)** | **106,817** |
| | | |
| **Net Cost of Operations** | **$ 33,267** | **$ 162,474** |

*The accompanying Notes are an integral part of these financial statements.*

# Notes to Consolidated Financial Statements

*For the Years Ended September 30, 2004 and 2003 (dollars in millions, unless otherwise noted).*

## 1. Summary of Significant Accounting Policies

### Basis of Presentation

The Department of Veterans Affairs' (VA) consolidated financial statements report all activities of VA components, including the Veterans Health Administration (VHA), Veterans Benefits Administration (VBA), National Cemetery Administration (NCA), and staff organizations. The consolidated financial statements meet the requirements of the Chief Financial Officers (CFO) Act of 1990 and the Government Management Reform Act (GMRA) of 1994. The consolidated financial statements differ from the financial reports used to monitor and control budgetary resources, but are prepared from the same books and records. The statements should be read with the understanding that VA is a component unit of the U.S. Government. VA fiscal year (FY) 2004 and (FY) 2003 financial statements are presented in conformity with the Office of Management and Budget's (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements," as amended.

### Reporting Entity

The mission of VA is to provide medical care, benefits, social support, and lasting memorials to veterans, their dependents, and beneficiaries [(38 U.S.C. Section 301(b) 1997)].

The Department is organized under the Secretary of VA. The Secretary's office includes a Deputy Secretary and has direct lines of authority over the Under Secretary for Health, the Under Secretary for Benefits, and the Under Secretary for Memorial Affairs. Additionally, six Assistant Secretaries, an Inspector General, a General Counsel, and the chairmen of the Board of Contract Appeals and the Board of Veterans' Appeals support the Secretary.

### Budgets and Budgetary Accounting

Budgetary accounting measures appropriation and consumption of budget/spending authority or other budgetary resources, and facilitates compliance with legal constraints and controls over the use of Federal funds. Under budgetary reporting principles, budgetary resources are consumed at the time of the purchase. Assets and liabilities that do not consume budgetary resources are not reported, and only those liabilities for which valid obligations have been established are considered to consume budgetary resources.

### Basis of Accounting

The accompanying consolidated financial statements have been prepared in accordance with Federal Accounting Standards Advisory Board (FASAB) standards. The Comptroller General, the Secretary of the Treasury, and the Director of the OMB sponsor FASAB, which determines Federal accounting concepts and standards.

### Revenues and Other Financing Sources

Exchange revenues are recognized when earned to the extent the revenue is payable to VA from other Federal agencies or the public as a result of costs incurred or services performed on its behalf. Revenue is recognized at the point the service is rendered. Imputed financing sources consist of imputed revenue for expenses relating to legal claims paid by Treasury's Judgment Fund and post-retirement benefits for VA employees. Non-exchange revenue, e.g., donations, is recognized when received, and related receivables are recognized when measurable and legally collectible, as are refunds and related offsets.

## Accounting for Intragovernmental Activities

VA, as a department of the Federal Government, interacts with and is dependent upon the financial activities of the Federal Government as a whole. Therefore, these consolidated financial statements do not reflect the results of all financial decisions applicable to VA as though the department were a stand-alone entity.

In order to prepare reliable financial statements, transactions occurring among VA components must be eliminated. All significant intra-entity transactions were eliminated from VA's consolidated financial statements.

## Fund Balance with Treasury

The Department of the Treasury (Treasury) performs cash management activities for all Federal Government agencies. The Fund Balance with Treasury represents the right of VA to draw on the Treasury for allowable expenditures. Trust fund balances consist primarily of amounts related to the Post-Vietnam Educational Assistance Trust Fund, the National Service Life Insurance (NSLI) Fund, the United States Government Life Insurance (USGLI) Fund, the Veterans Special Life Insurance (VSLI) Fund, General Post Fund, and the National Cemetery Gift Fund. The use of these funds is restricted.

## Cash

Cash consists of Canteen Service and Loan Guaranty Program amounts held in commercial banks, cash held by non-federal trusts, as well as Agent Cashier advances at VA field stations. Treasury processes all other cash receipts and disbursements. Amounts relating to the Loan Guaranty Program represent deposits with trustees for offsets against loan loss claims related to sold loan portfolios.

## Investments

Investments are reported at cost and are redeemable at any time for their original purchase price. Insurance program investments, which comprise most of VA's investments, are in non-marketable Treasury special bonds and certificates. Interest rates for Treasury special securities are based on average market yields for comparable Treasury issues. Special bonds, which mature during various years through the year 2019, are generally held to maturity unless needed to finance insurance claims and dividends. Other program investments are in securities issued by Treasury, with the exception of Insurance Program holdings in stock received from Prudential as a result of its demutualization and the Loan Guaranty Program investments in trust certificates issued by the American Housing Trusts.

Allowances are recorded to reflect estimated losses of principal as a result of the subordinated position in American Housing Trust certificates I through V. The estimated allowance computations are based upon discounted cash flow analysis. Although VA continues to use the income from these subordinated certificates to cover the immediate cash requirements of the Federal guarantee on loans sold under American Housing Trust certificates VI through XI and the Veterans Mortgage Trust program, the income is reimbursed to VA and is not used to pay the amount of the realized losses on guaranteed loan sales.

## Accounts Receivable

Intragovernmental accounts receivable consists of amounts due from other Federal Government agencies. No allowances for losses are required.

Public accounts receivable consists mainly of amounts due for veterans' health care and amounts due for compensation, pension, and readjustment benefit overpayments. Allowances are based on prior experience. For FY 2004, contractual adjustments were 52 percent and bad debt allowances for medical-related receivables were 9 percent. For FY 2003, contractual adjustments were 52 percent and bad debt allowances for medical-related receivables were 9 percent. Educational-related receivables bad debt allowances were 44 percent for FY 2004 and 37 percent for FY 2003. Compensation and pension benefits overpayment-related bad debt receivables were 72 percent for FY 2004 and 74 percent for FY 2003.

VA is required by Public Law 96-466 to charge interest and administrative costs on benefits debts similar to charges levied on other debts owed the Federal Government. In a July 1992 decision, the former VA Deputy Secretary decided that VA would not charge interest on compensation and pension debts. This decision continues to be VA policy.

## Loans Receivable

Loans Receivable are recorded as funds are disbursed. For loans obligated prior to October 1, 1991, loan principal and interest receivable amounts are reduced by an allowance for estimated uncollectible amounts. The allowance is estimated based on past experience and an analysis of outstanding balances. For loans obligated after September 30, 1991, an allowance equal to the subsidy costs associated with these loans reduces the loans receivable. This reduction is due to the interest rate differential between the loans and borrowing from Treasury, the estimated delinquencies and defaults, net of recoveries, offsets from fees, and other estimated cash flows.

## Inventories

Inventories consist of items such as precious metals held for sale and Canteen Service retail store stock and are valued at cost. VA follows the purchase method of accounting for operating supplies, medical supplies, and pharmaceutical supplies in the hands of end users. The purchase method provides that these items be expensed when purchased. VA defines an end user as a VA medical center, regional office, or cemetery.

## Property, Plant, and Equipment

The majority of the general property, plant, and equipment is used to provide medical care to veterans and is valued at cost, including transfers from other Federal agencies. Major additions, replacements, and alterations are capitalized, whereas routine maintenance is expensed when incurred. Construction costs are capitalized as Construction in Progress until completion, and then transferred to the appropriate property account. Individual items are capitalized if the useful life is 2 years or more and the unit price is $100,000 or greater. Buildings are depreciated on a straight-line basis over estimated useful lives of 25 to 40 years. Equipment is also depreciated on a straight-line basis over its useful life, usually 5 to 20 years. There are no restrictions on the use or convertibility of general property, plant, and equipment. All VA heritage assets are multi-use facilities and are classified as general property, plant, and equipment.

## Other Assets

Other assets consist of advance payments. Public advance payments are primarily to hospitals and medical schools under house staff contracts, grantees, beneficiaries, and employees on official travel. Intragovernmental advance payments are primarily to the General Services Administration (GSA) for rent and Government Printing Office (GPO) for supplies, printing, and equipment.

## Accounts Payable

Intragovernmental accounts payable consists of amounts owed to other Federal Government agencies. The remaining accounts payable consist of amounts due to the public.

## Loan Guarantees

For direct loan obligations and loan guaranty commitments made after 1991, the resulting direct loans are reported net of an allowance for subsidy costs at present value, and loan guarantee liabilities are reported at present value. The present value of the subsidy costs associated with direct loans and loan guarantees is recognized as a cost in the year the direct or guaranteed loan is disbursed. Pre-1992 direct loans and loan guarantees are reported under the allowance for loss method. The nominal amount of the direct loan is reduced by an allowance for uncollectible amounts, and the liability for loan guarantees is the amount VA estimated will most likely require a future cash outflow to pay defaulted claims. Interest is accrued on VA-owned loans by computing interest on a loan-by-loan basis at the end of the month and recording the amount owed as an accrual.

The guaranteed loan sales liability represents the present value of the estimated cash flows to be paid by VA as a result of the guarantee. VA guarantees that the principal and interest payment due on a loan will be paid by the 15th of each month. If the payment is not made, VA allows the loan servicer to receive funds from a cash reserve account for the amount of the deficiency. VA guarantees the loans against losses at foreclosure. Although VA will not buy back the loan, VA will pay the loan loss and foreclosure expenses.

## Debt

All intragovernmental debt is due to Treasury and is primarily related to borrowing by the Loan Guaranty Program. The interest rates ranged from 1.29 to 5.24 percent in FY 2004 and from 1.20 to 5.03 percent in FY 2003. VA's financial activities interact with and are dependent upon those of the Federal Government as a whole.

## Insurance Liabilities

Actuarial reserve liabilities for VA's insurance programs are based on mortality and interest rate assumptions at the time of issue. These assumptions vary by fund, type of policy, and type of benefit. The interest rate assumptions range from 2.25 to 5.0 percent for both the FY 2004 and FY 2003 calculations.

## Annual Leave

The accrued annual leave balance is adjusted at the end of the fiscal year to reflect current pay rates for leave that has been earned but not taken. Sick and other types of non-vested leave are expensed as taken. To the extent appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources.

## Workers' Compensation Liability

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. Claims incurred for benefits for VA employees under FECA are administered by the Department of Labor (DOL) and are ultimately paid by VA.

Workers' compensation is comprised of two components: (1) the accrued liability which represents money owed by VA to DOL for claims paid by DOL on behalf of VA through the current fiscal year, and (2) the actuarial liability for compensation cases to be paid beyond the current year.

Future workers' compensation estimates are generated from an application of actuarial procedures developed by DOL to estimate the liability for FECA benefits. The liability for future workers' compensation benefits includes the expected liability for death, disability, medical, and miscellaneous costs for approved compensation cases and for potential cases related to injuries incurred but not reported. The liability is determined by utilizing historical benefit payment patterns related to a particular period to estimate the ultimate payments related to that period.

## Pension, Other Retirement Benefits, and Other Post-Employment Benefits

Each employing Federal agency is required to recognize its share of the cost and imputed financing of providing pension and post-retirement health benefits and life insurance to its employees. Factors used in the calculation of these pensions and post-retirement health and life insurance benefit expenses are provided by the Office of Personnel Management (OPM) to each agency.

VA's employees are covered under the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS) to which VA makes contributions according to plan requirements. CSRS and FERS are multi-employer plans. VA does not maintain or report information about the assets of the plans, nor does it report actuarial data for the accumulated plan benefits. That reporting is the responsibility of OPM.

### Veterans Benefits Liability

VA provides compensation benefits to veterans who are disabled by military service-related causes. Benefits are also provided to deceased veterans' beneficiaries. These benefits are provided in recognition of a veteran's military service. The liability for future compensation payments is reported on VA's balance sheet at the present value of expected future payments, and is developed on an actuarial basis. Various assumptions in the actuarial model, such as the number of veterans and dependents receiving payments, discount rates, cost of living adjustments and life expectancy, impact the amount of the liability.

### Litigation

VA is a party in various administrative proceedings, legal actions, and claims brought against it. In the opinion of VA management and legal counsel, the ultimate resolutions of these proceedings, actions, and claims will not materially affect the financial position or results of VA operations.

### Non-Federal Trusts

VA has entered into enhanced-use leases to maximize use of underutilized VA property. In seven of these enhanced-use leases, the assets and liabilities were transferred to a non-Federal trust. In FY 2004, the assets, liabilities, and results of operations of these seven trusts are consolidated in VA's consolidated financial statements.

### Estimates

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein. In FY 2004, VA changed its estimate of medical malpractice and other tort liabilities to discount the liability and changed the method used to estimate credit subsidy amounts to the balances approach method. See Notes 16 and 7, respectively.

## 2. Non-Entity Assets

Entity and Non-Entity assets have been combined on the face of the balance sheet. Non-Entity assets relate primarily to patient funds.

| **Non-Entity Assets as of September 30,** | **2004** | **2003** |
|---|---|---|
| Fund Balance with Treasury | $ 47 | $ 56 |
| Intragovernmental Accounts Receivable | 1 | 1 |
| Public Accounts Receivable | 11 | 14 |
| **Total Non-Entity Assets** | $ 59 | $ 71 |

## 3. Fund Balance With Treasury

| Fund Balance with Treasury as of September 30, | 2004 | 2003 |
|---|---|---|
| **Entity Assets** | | |
| Trust Funds | $ 86 | $ 89 |
| Revolving Funds | 5,661 | 7,190 |
| Appropriated Funds | 10,917 | 10,427 |
| Special Funds | 156 | 116 |
| Other Fund Types | (126) | (83) |
| Total Entity Assets | $ 16,694 | $ 17,739 |
| **Non-Entity Assets** | | |
| Other Fund Types | 47 | 56 |
| Total Non-Entity Assets | 47 | 56 |
| **Total Entity and Non-Entity Assets** | $ 16,741 | $ 17,795 |
| **Reconciliation of VA General Ledger Balances with Treasury** | | |
| Entity VA General Ledger | $ 17,159 | $ 17,867 |
| Reconciled Differences | (433) | (75) |
| Unreconciled Differences | 15 | 3 |
| Fund Balance with Treasury | $ 16,741 | $ 17,795 |
| **Status of Fund Balance with Treasury** | | |
| Unobligated Balance | | |
| Available | $ 3,558 | $ 2,153 |
| Unavailable | 4,943 | 6,554 |
| Obligated Balance not yet Disbursed | 8,319 | 9,114 |
| Deposit/Clearing Account Balances | (79) | (26) |
| Fund Balance with Treasury | $ 16,741 | $ 17,795 |

## 4. Cash

| Cash as of September 30, | 2004 | 2003 |
|---|---|---|
| Canteen Service | $ 3 | $ 1 |
| Agent Cashier Advance | 19 | 4 |
| Loan Guaranty Program | 4 | 36 |
| Funds held by non-federal trusts | 42 | - |
| **Total Cash** | $ 68 | $ 41 |

## 5. Investments

| Investment Securities as of September 30, | | 2004 | 2003 |
|---|---|---|---|
| **Intragovernmental Securities** | Interest Range | | |
| Special Bonds | 3.25-9.5% | $ 13,329 | $ 13,618 |
| Treasury Notes * | 1.62-4.25% | 67 | 92 |
| Treasury Bills | 0.91-1.95% | 30 | 2 |
| Subtotal | | 13,426 | 13,712 |
| Accrued Interest | | 217 | 229 |
| **Total Intragovernmental Securities** | | $ 13,643 | $ 13,941 |
| **Other Securities** | | | |
| Prudential Stock (Insurance) | | $ 6 | $ 9 |
| Trust Certificates (Loan Guaranty) | | 178 | 192 |
| **Total Other Securities** | | $ 184 | $ 201 |

*The investment in Treasury Notes includes unamortized premiums of $0.1 million as of September 30, 2004 and $0.7 million as of September 30, 2003. Premiums and discounts are amortized on a straight-line basis over the life of the investments.

| Offset for Losses on Investments as of September 30, | 2004 | 2003 |
|---|---|---|
| Investment in Subordinate Certificates at Time of Sale | $ 424 | $ 425 |
| Cumulative Reductions | (238) | (224) |
| **Subtotal** | 186 | 201 |
| Allocation of Loss Provision | (8) | (9) |
| **Trust Certificates (Loan Guaranty)** | $ 178 | $ 192 |

## 6. Accounts Receivable, Net

| Accounts Receivable, Net as of September 30, | 2004 | 2003 |
|---|---|---|
| **Intragovernmental Accounts Receivable** | $ 132 | $ 196 |
| Public Accounts Receivable, Gross | $ 2,088 | $ 2,029 |
| Allowance for Loss Provision | (1,201) | (1,170) |
| **Net Public Accounts Receivable** | $ 887 | $ 859 |

# 7. Direct Loans and Loan Guarantees

Direct loan obligations and loan guarantee commitments made after 1991, and the resulting direct loans or loan guarantees, are governed by the Federal Credit Reform Act of 1990. The Act provides that the present value of the subsidy costs associated with direct loans and loan guarantees be recognized as a cost in the year the direct or guaranteed loan is disbursed. Direct loans are reported net of an allowance for subsidy costs at present value, and loan guarantee liabilities are reported at present value. Pre-1992 direct loans and loan guarantees are reported under the allowance for loss method. The nominal amount of the direct loan is reduced by an allowance for uncollectible amounts, and the liability for loan guarantees is the amount VA estimates will most likely require a future cash outflow to pay defaulted claims.

Interest is accrued on VA-owned loans by computing interest on a loan-by-loan basis at the end of the month and recording the amount owed as an accrual.

The recorded value of loans receivable, net, and the value of assets related to direct loans are not the same as the proceeds that VA would expect to receive from selling its loans. VA operates the following direct loan and loan guaranty programs:

- Vocational Rehabilitation and Employment.
- Education.
- Insurance.
- Loan Guaranty.

Under the Loan Guaranty Program, a loan may be made to an eligible veteran by an approved private sector mortgage lender. VA guarantees payment of a fixed percentage of the loan indebtedness to the holder of such a loan, up to a maximum dollar amount, in the event of default by the veteran borrower. Occasionally, a delinquency is reported to VA and neither a realistic alternative to foreclosure is offered by the loan holder nor is VA in a position to supplementally service the loan. In such cases, VA determines, through an economic analysis, whether VA will authorize the holder to convey the property securing the loan (foreclosure) or pay the loan guarantee amount to the holder.

## Direct Loans

Loans receivable related to direct loans represent the net value of assets related to acquired pre-1992 and post-1991 direct loans. For pre-1992 loans, VA employs the allowance for loss method in which the assets are offset by an allowance for loan losses (estimated uncollectible loans). For post-1991 loans, the assets are offset by an allowance for subsidy costs. An analysis of loans receivable and the nature and amounts of the subsidy costs associated with the direct loans are provided in the tables that follow:

**Loans Receivable and Related Foreclosed Property From Direct Loans**

| as of September 30, 2004 | Loans Receivable Gross | Interest Receivable | Allowance for Loan Losses | Foreclosed Property | Value of Assets Related to Loans |
|---|---|---|---|---|---|
| Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method) | $ 82 | $ 7 | $ - | $ - | $ 89 |
| Direct Loans Obligated after 1991 | 1,051 | 29 | (166) | 93 | 1,007 |
| Insurance Policy Loans | 716 | 17 | - | - | 733 |
| **Total Loans Receivable and Related Foreclosed Property from Direct Loans, Net** | | | | | $ 1,829 |

**Loans Receivable and Related Foreclosed Property From Direct Loans**

| as of September 30, 2003 | Loans Receivable Gross | Interest Receivable | Allowance for Loan Losses | Foreclosed Property | Value of Assets Related to Loans |
|---|---|---|---|---|---|
| Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method) | $ 114 | $ 15 | $ - | $ - | $ 129 |
| Direct Loans Obligated after 1991 | 1,585 | 29 | 1,136 | 87 | 2,837 |
| Insurance Policy Loans | 770 | 19 | - | - | 789 |
| **Total Loans Receivable and Related Foreclosed Property from Direct Loans, Net** | | | | | $ 3,755 |

## Direct Loans Disbursed

The total amount of direct loans disbursed for the years ended September 30, 2004 and 2003, was $123 and $563 million, respectively.

## Provision for Losses on Pre-1992 Loans

The present value of the cost VA will bear as loans already guaranteed default is an element of the mortgage loan benefit that VA provides to veterans. This cost is reflected in the financial statements as an offset to the value of certain related assets.

The provision for losses on vendee loans is based upon historical loan foreclosure results applied to the average loss on defaulted loans. The calculation is also based on the use of the average interest rate of U.S. interest-bearing debt as a discount rate on the assumption that VA's outstanding guaranteed loans will default over a 12-year period. For FY 2004, VA determined that these vendee loans have sufficient equity due to real estate appreciation and buy-down of principal, to minimize or eliminate any potential loss to VA. The components of the provision are as follows:

| Provision for Loss<br>as of September 30, | 2004 | 2003 |
|---|---|---|
| Offsets Against Foreclosed Property Held for Sale | 10 | 8 |
| **Total Provision for Loss** | $ 10 | $ 8 |

## Subsidy Expense for Post-1991 Direct Loans

Pursuant to the Credit Reform Act, all direct loans established after September 30, 1991, will be subsidized. The subsidy expense for direct loans is as shown:

| Direct Loan Subsidy Expense<br>for the years ended September 30, | 2004 | 2003 |
|---|---|---|
| Interest Differential | $ (6) | $ (55) |
| Defaults* | 3 | 12 |
| Fees** | 0 | (9) |
| Other*** | 4 | 44 |
| **Subtotal** | 1 | (8) |
| Interest Rate Reestimates | 473 | (178) |
| Technical Reestimates | 922 | (44) |
| **Total Direct Loans** | $ 1,396 | $ (230) |

* Includes approximately $50,000 and $42,000 in defaults and other expenses for the Vocational Rehabilitation Program for FY 2004 and 2003, respectively.
** "Fees" expense for direct loans includes estimated down payments and other fees collected when homes are sold with vendee financing.
*** The "Other" expense for direct loans includes the estimated loss of scheduled principal and interest when vendee loans are sold.

## Subsidy Rates for Direct Loans by Component

The subsidy rates disclosed below pertain only to the current year cohorts. These rates cannot be applied to the direct loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loans reported in the current year could result from disbursements of loans from both current year cohorts and prior year(s) cohorts. The subsidy expense reported in the current year also includes reestimates.

| Subsidy rates for direct loans | |
|---|---|
| Interest Differential | (17.19%) |
| Defaults | 12.8% |
| Fees | (0.44%) |
| Other | 7.28% |

## Allowance for Subsidy for Direct Loans (Post-1991)

VA reports the allowance for subsidy for direct loans, subject to Credit Reform requirements. For these loans, the allowance for subsidy represents the present value of the estimated net cash flows to be paid by VA as a result of a disbursed direct loan. VA disburses a direct loan and receives an allowance for subsidy along with borrowing from Treasury. For FY 2004, the subsidy rate for October through December is (11.16) and the subsidy rate for January through September is (2.48). In FY 2003 the rate was 0.86 percent. The allowance for subsidy as of September 30, 2004 and 2003 is $166 and ($974) million, respectively.

Schedule for Reconciling Subsidy Cost Allowance Balances

| **Beginning Balance, Changes and Ending Balance** | **FY 2004** | **FY 2003** |
|---|---|---|
| Beginning balance of the allowance | $ (1,136) | $ (853) |
| Subsidy expense for direct loans disbursed during the reporting years by component: | | |
| Interest subsidy costs | (6) | (55) |
| Default costs (net of recoveries) | 3 | 12 |
| Fees and other collections | 0 | (9) |
| Other subsidy costs | 4 | 44 |
| Total of the above subsidy expense components | 1 | (8) |
| Adjustments: | | |
| Loan modification | 0 | 0 |
| Fees received | 1 | 11 |
| Foreclosed property acquired | (21) | (5) |
| Loans written off | (9) | (6) |
| Subsidy allowance amortization | (65) | (53) |
| Other | 0 | 0 |
| Ending balance of the allowance before reestimates | (1,229) | (914) |
| Subsidy reestimates by component | | |
| Interest rate reestimate | 473 | (44) |
| Technical/default reestimate | 922 | (178) |
| Total of the above reestimate components | 1,395 | (222) |
| Ending balance of the allowance | $ 166 | $ (1,136) |

## Loan Guarantees

Loans receivable related to loan guarantees represent the net value of assets related to pre-1992 and post-1991 defaulted guaranteed loans and non-defaulted guaranteed loans. For pre-1992 loans, VA employs the allowance for loss method in which the assets are offset by an allowance for loan losses (estimated uncollectible loans). An analysis of loans receivable, loan guarantees, the liability for loan guarantees, and the nature and amounts of the subsidy costs associated with loan guarantees are provided in the tables that follow:

Loans Receivable and Related Foreclosed Property from Loan Guarantees
**as of September 30,**

| **2004** | **Loans Receivable Gross** | **Interest Receivable** | **Allowance for Loan Losses** | **Foreclosed Property** | **Value of Assets Related to Loans** |
|---|---|---|---|---|---|
| Defaulted Guaranteed Loans Pre-1992 Guarantees | 129 | 1 | (121) | 45 | 54 |
| Defaulted Guaranteed Loans Post-1991 | - | - | - | 1,071 | 1,071 |
| **Total Loans Receivable and Related Foreclosed Property from Loan Guarantees** | | | | | $ 1,125 |

Loans Receivable and Related Foreclosed Property from Loan Guarantees
**as of September 30,**

| **2003** | **Loans Receivable Gross** | **Interest Receivable** | **Allowance for Loan Losses** | **Foreclosed Property** | **Value of Assets Related to Loans** |
|---|---|---|---|---|---|
| Defaulted Guaranteed Loans Pre-1992 Guarantees | 147 | 4 | (138) | 46 | 59 |
| Defaulted Guaranteed Loans Post-1991 | - | - | - | 841 | 841 |
| **Total Loans Receivable and Related Foreclosed Property from Loan Guarantees** | | | | | $ 900 |

| Total Loans Receivable and Related Foreclosed Property, Net for the years ended September 30, | **2004** | **2003** |
|---|---|---|
| Total Direct Loans | $ 1,829 | $ 3,755 |
| Total Guaranteed Loans | 1,125 | 900 |
| **Total Loans Receivable and Related Foreclosed Property, Net** | $ 2,954 | $ 4,655 |

## Foreclosed Property

Prior to the foreclosure of property secured by a VA loan, VA obtains an independent appraisal of the property. This appraisal is reviewed by VA staff who make a determination of the fair market value. To determine the net value of the property, VA expenses such as costs for acquisition, management, and disposition of the property, as well as estimated losses on property resale, are subtracted from the estimated fair market value. As of September 30, 2004 and 2003, the estimated number of residential properties in VA's inventory was 15,539 and 11,872, respectively. For FY 2004 and FY 2003, the average holding period from the date properties were conveyed to VA until the properties were sold was estimated to be 10.1 months and 8.9 months, respectively. The number of properties for which foreclosure proceedings are in process is estimated to be 10,355 and 10,513 as of September 30, 2004 and 2003, respectively.

| Guaranteed Loans as of September 30, | | **2004** | | **2003** |
|---|---|---|---|---|
| Guaranteed Loans Outstanding: | | | | |
| Outstanding Principal Guaranteed Loans, Face Value | $ | 207,374 | $ | 213,248 |
| Amount of Outstanding Guarantee | | 64,683 | | 67,654 |
| New Guaranteed Loans Disbursed: | | | | |
| Outstanding Principal Guaranteed Loans, Face Value | $ | 44,130 | $ | 63,255 |
| Amount of Outstanding Guarantee | | 12,643 | | 18,245 |
| **Liabilities for Loan Guarantees Post 1991 (Present Value)** | $ | 4,740 | $ | 4,756 |

## Guaranty Commitments

As of September 30, 2004, VA had outstanding commitments to guarantee loans that will originate in FY 2005. The number and amount of commitments could not be determined, as VA has granted authority to various lenders to originate VA loans that meet established criteria without prior VA approval. Nearly 90 percent of VA's guaranteed loans originate under this authority.

## Subsidy Expense for Post-1991 Loan Guarantees

Pursuant to the Credit Reform Act, guaranteed loans closed after September 30, 1991, will be subsidized. The subsidy expense for loan guarantees related to the Loan Guaranty Program is as shown:

| Guaranteed Loan Subsidy Expenses for the years ended September 30, | | **2004** | | **2003** |
|---|---|---|---|---|
| Defaults | $ | 652 | $ | 1,678 |
| Fees* | | (470) | | (1,145) |
| Other** | | 0 | | 0 |
| Subtotal | | 182 | | 533 |
| Interest Rate Reestimates | | (241) | | (471) |
| Technical Reestimates | | (542) | | (1,407) |
| **Total Guaranteed Loan Subsidy Expense** | $ | (601) | $ | (1,345) |

* The "Fees" expense includes estimated up-front fees collected when the loans are guaranteed and the present value of estimated annual fees from loan assumptions.

** The "Other" expense for guaranteed loans includes estimated recoveries on defaults through the sales of foreclosed properties.

| Loan Sale-Guaranteed Loan Subsidy Expense for the years ended September 30, | 2004 | 2003 |
|---|---|---|
| Defaults | $ 19 | $ 14 |
| Other | (2) | 0 |
| Subtotal | 17 | 14 |
| Interest Rate Reestimates | 102 | (50) |
| Technical Reestimates | 80 | (109) |
| **Total Loan Sale-Guaranteed Subsidy Expense** | $ 199 | $ (145) |

| Total Subsidy Expense for the years ended September 30, | 2004 | 2003 |
|---|---|---|
| Total Direct Loans | $ 1,396 | $ (230) |
| Total Guaranteed Loans | (601) | (1,345) |
| Total Sale Loans | 199 | (145) |
| **Total Subsidy Expense** | $ 994 | $ (1,720) |

## Subsidy Rates for Loan Guarantees by Component

The subsidy rates disclosed below pertain only to the current year cohorts. These rates cannot be applied to the guarantees of loans disbursed during the current reporting year to yield the subsidy expense. The subsidy expense for new loan guarantees reported in the current year could result from disbursements of loans from both current year cohorts and prior year(s) cohorts. The subsidy expense reported in the current year also includes reestimates.

| Subsidy Rates for Loan Guarantees | |
|---|---|
| Defaults | 1.85% |
| Fees | (1.33%) |
| Other | 0 |

## Loan Sales

VA continues to have vendee loan sales to reduce the administrative burden of servicing vendee loans. During the period FY 1992 through FY 2004, the total loans sold amounted to $13.8 billion. Under the sale of vendee loans, certificates are issued pursuant to the Pooling and Servicing Agreement (the Agreement) among VA, the Master Servicer, and the Trustee. On the closing date of the certificates, VA transfers its entire interest in the related loans to the Trustee for the benefit of the related certificate holders pursuant to the Agreement. Under the Agreement, the Trust will issue certificates backed by mortgage loans and installment contracts. The Trust owns the mortgage loans and other property described in the offering and the Trust makes elections to treat certain of its assets as one or more Real Estate Mortgage Investment Conduits (REMIC) for U.S. Federal income tax purposes. The certificates represent interests in the assets of the Trust and are paid from the Trust's assets. The certificates are issued as part of a designated series that may include one or more classes. VA guarantees that the investor will receive full and timely distributions of the principal and interest on the certificates and that guaranty is backed by the full faith and credit of the Federal Government.

VA may terminate the Trust, causing the early retirement of certificates, by purchasing all of the Trust's assets on any distribution date on or after the distribution date on which the current aggregate principal balance of all principal certificates is less than 1 percent of the original aggregate principal balance, or if VA determines that the Trust's REMIC status has been lost or a substantial risk exists that such status will be lost. In the event of termination, the certificate holder will be entitled to receive payment for the full principal balance of the certificates plus any accrued interest and unpaid interest through the related distribution date.

The Agreement requires the mortgage loans to be serviced generally in compliance with Fannie Mae and Freddie Mac standards and consistent with prudent residential mortgage loan servicing standards generally accepted in the servicing industry. For mortgage loans sold during FY 2004, servicing was performed by Countrywide Home Loans, Inc. (Master Servicer). The Master Servicer is responsible for the performance of all of the servicing functions under the Agreement. The Master Servicer is entitled to be compensated by receiving (1) a service fee of 0.2075 percent per annum payable monthly and calculated by multiplying the interest payment received by a fraction, the numerator of which is 0.2075 percent and the denominator of which is the mortgage interest rate on such loan; (2) earnings on investment of funds in the certificate account; and (3) all incidental fees and other charges paid by the borrowers and a portion of the liquidation proceeds in connection with the liquidated loans.

VA completed one sale during FY 2004 and one sale during FY 2003 totaling approximately $298 million and $283 million of vendee loans, respectively. The components of the vendee sales are summarized in the tables below:

| Loan Sales<br>Years ended September 30, | 2004 | 2003 |
|---|---|---|
| Loans Receivable Sold | $ 298 | $ 283 |
| Net Proceeds From Sale | 308 | 299 |
| **Loss (Gain) on Receivables Sold** | **$ (10)** | **$ (16)** |

## Outstanding Balance of Loan Sale Guarantees

All loans sold under the American Housing Trust (AHT VI through AHT XI) and the Vendee Mortgage (VMT 92-1 through 03-1) programs carry a full government guarantee. The outstanding balance for guaranteed loans sold is summarized in the table below:

| Guaranteed Loans Sold<br>as of September 30, | 2004 | 2003 |
|---|---|---|
| Outstanding Balance Guaranteed Loans Sold, Start of Year | $ 5,569 | $ 7,406 |
| Sold to the Public | 298 | 283 |
| Payments, Repayments, and Terminations | (1,679) | (2,120) |
| **Outstanding Balance Guaranteed Loans Sold, End of Year** | **$ 4,188** | **$ 5,569** |

## Liability for Loan Sale Guarantees (Post-1991)

VA reports the liability on the guarantee of loans sold under the Vendee Mortgage Trust and American Housing Trust programs, subject to Credit Reform requirements. For these loans, the guaranteed loan sale liability represents the present value of the estimated net cash flows to be paid by VA as a result of the guarantee. These sales contain two types of guarantees for which VA pays net cash flow. VA guarantees that the principal and interest payment due on a sold loan will be paid by the 15th of each month. If not paid by the borrower, VA allows the loan servicer to take funds from cash reserve accounts for the deficient amount. VA also guarantees the loan against loss at foreclosure. VA will not buy back the loans but will pay off the loan loss and foreclosure expenses. The subsidy rate for FY 2004 is 5.65 percent. For FY 2003 the subsidy rate was 5.06 percent. The liability for loan sale guarantees as of September 30, 2004 and 2003 is $255 and $77 million, respectively.

Schedule for Reconciling Loan Sale Guarantee Liability Balances

| **Beginning Balance, Changes and Ending Balance** | **FY 2004** | **FY 2003** |
|---|---|---|
| Beginning balance of the liability | $ 77 | $ 210 |
| Subsidy expense for guaranteed loans disbursed during the reporting years by component: | | |
| Interest subsidy costs | - | - |
| Default costs (net of recoveries) | 19 | 14 |
| Fees and other collections | - | - |
| Other subsidy costs | (2) | - |
| Total of the above subsidy expense components | 17 | 14 |
| Adjustments: | | |
| Loan guarantee modifications | - | - |
| Fees received | - | - |
| Interest supplements paid | - | - |
| Foreclosed property and loans acquired | - | - |
| Claim payments to lenders | (36) | (19) |
| Interest accumulation on the liability balance | 6 | 15 |
| Other | 9 | 16 |
| Ending balance of the liability before reestimates | 73 | 236 |
| Subsidy reestimates by component | | |
| Interest rate reestimate | 102 | (50) |
| Technical/default reestimate | 80 | (109) |
| Total of the above reestimate components | 182 | (159) |
| Ending balance of the liability | $ 255 | $ 77 |

## Liability for Loan Guarantees (Post-1991)

VA reports the liability on the guarantee of loans, subject to Credit Reform requirements. For these loans, the guaranteed loan liability represents the present value of the estimated net cash flows to be paid by VA as a result of a defaulted loan guarantee. VA guarantees the loan against loss at foreclosure for which VA pays net cash flow up to a legally specified maximum based on the value of individual loans. VA will pay the lender the guarantee and foreclosure expenses. If an agreement can be made with the veteran, VA may acquire the loan by refunding the lender for the loan. The FY 2004 and FY 2003 subsidy rate is 0.52 and 0.81 percent, respectively. The liability for loan guarantees as of September 30, 2004 and 2003 is $4,485 and $4,679 million, respectively.

Schedule for Reconciling Loan Guarantee Liability Balances

| **Beginning Balance, Changes and Ending Balance** | **FY 2004** | **FY 2003** |
|---|---|---|
| Beginning balance of the liability | $ 4,679 | $ 5,452 |
| Subsidy expense for guaranteed loans disbursed during the reporting years by component: | | |
| Interest subsidy costs | - | - |
| Default costs (net of recoveries) | 652 | 1,677 |
| Fees and other collections | (469) | (1,145) |
| Other subsidy costs | - | - |
| Total of the above subsidy expense components | 183 | 532 |
| Adjustments: | | |
| Loan guarantee modifications | - | - |
| Fees received | 482 | 549 |
| Interest supplements paid | - | - |
| Foreclosed property and loans acquired | 67 | 189 |
| Claim payments to lenders | (406) | (449) |
| Interest accumulation on the liability balance | 263 | 284 |
| Other | - | - |
| Ending balance of the liability before reestimates | 5,268 | 6,557 |
| Subsidy reestimates by component | | |
| Interest rate reestimate | (241) | (471) |
| Technical/default reestimate | (542) | (1,407) |
| Total of the above reestimate components | (783) | (1,878) |
| Ending balance of the liability | $ 4,485 | $ 4,679 |

## Estimation Technique Change

VA used the balances approach method for the 2004 financial statement reestimates to replace the traditional approach method used in FY 2003 to more accurately project the remaining financial requirements for cohorts being reestimated in the Direct Loan Financing Account (DLFA, 36X4127) and the Loan Sales Securities Account (LSSA, 36X4124). By comparing with the traditional method, the use of the balances approach results in a net difference of $343.6 million less for all reestimated cohorts for the DLFA. The net difference for the LSSA is $100.1 million more for all reestimated cohorts. As a result of the change of the calculator, future reestimates will be significantly less.

## Administrative Expense

Administrative expense on direct and guaranteed loans for the years ended September 30, 2004 and 2003, was $154 and $168 million, respectively.

# 8. Inventories

| Inventories as of September 30, | **2004** | **2003** |
|---|---|---|
| Held for Current Sale | $ 65 | $ 62 |
| Other | 4 | 11 |
| **Total Inventories** | $ 69 | $ 73 |

# 9. General Property, Plant and Equipment

Depreciation and amortization expense totaled $805 and $779 million in FY 2004 and FY 2003, respectively.

General Property, Plant and Equipment
as of September 30, 2004

| | Cost | Accumulated Depreciation | Net Book Value |
|---|---|---|---|
| Land and Improvements | $ 303 | $ (13) | $ 290 |
| Buildings | 14,915 | (7,045) | 7,870 |
| Equipment | 3,128 | (1,884) | 1,244 |
| Other | 1,974 | (1,101) | 873 |
| Work in Progress | 938 | 0 | 938 |
| **Total Property, Plant, and Equipment** | $ 21,258 | $ (10,043) | $ 11,215 |

General Property, Plant and Equipment
as of September 30, 2003

| | Cost | Accumulated Depreciation | Net Book Value |
|---|---|---|---|
| Land and Improvements | $ 285 | $ (10) | $ 275 |
| Buildings | 14,507 | (6,599) | 7,908 |
| Equipment | 3,017 | (1,789) | 1,228 |
| Other | 1,797 | (1,021) | 776 |
| Work in Progress | 762 | - | 762 |
| **Total Property, Plant, and Equipment** | $ 20,368 | $ (9,419) | $ 10,949 |

## 10. Liabilities Not Covered By Budgetary Resources

The total amount of VA liabilities not covered by budgetary resources was $929.5 billion and $959.6 billion as of September 30, 2004 and 2003, respectively, as shown in the following table.

Components of Unfunded Liabilities
as of September 30,

| | 2004 | 2003 |
|---|---|---|
| Workers' Compensation* | $ 2,112 | $ 2,239 |
| Annual Leave | 1,173 | 1,097 |
| Judgment Fund | 501 | 528 |
| Environmental and Disposal | 339 | 375 |
| Accounts Payable – Canceled Appropriations | 6 | 6 |
| Veterans Compensation and Burial | 924,800 | 954,800 |
| Insurance | 568 | 581 |
| **Total** | $ 929,499 | $ 959,626 |

* The actuarial estimate for workers' compensation provided by DOL was computed using interest rates of 4.88 percent for FY 2004 and 3.84 percent for FY 2003.

## 11. Federal Employee and Veterans Benefits

Federal Employee Benefits

| **Imputed Expenses-Employee Benefits years ended September 30,** | **2004** | **2003** |
|---|---|---|
| Civil Service Retirement System | $ 366 | $ 351 |
| Federal Employees Health Benefits | 788 | 641 |
| Federal Employees Group Life Insurance | 2 | 2 |
| **Total Imputed Expenses-Employee Benefits** | $ 1,156 | $ 994 |

### Veterans Benefits

Certain veterans who die or are disabled from military service-related causes, as well as their dependents, receive compensation benefits. Also, veterans are provided with burial flags, headstones/markers, and grave liners for burial in a VA national cemetery or are provided a plot allowance for burial in a private cemetery. These benefits are provided in recognition of a veteran's military service and are recorded as a liability on the balance sheet.

Federal Employee and Veterans Benefits Liabilities
as of September 30,

| | **2004** | **2003** |
|---|---|---|
| FECA | $ 1,753 | $ 1,888 |
| Compensation | 921,500 | 951,600 |
| Burial | 3,300 | 3,200 |
| **Total Federal Employee and Veterans Benefits Liabilities** | $ 926,553 | $ 956,688 |

VA provides certain veterans and/or their dependents with pension benefits, based on annual eligibility reviews, if the veteran died or was disabled from nonservice-related causes.  The actuarial present value of the future liability for pension benefits is a non-exchange transaction and is not required to be recorded on the balance sheet.  The projected amount of future payments for pension benefits (presented for informational purposes only) as of September 30, 2004 and 2003 was $102.2 and $102.7 billion, respectively.

## Assumptions Used to Calculate the Veterans Benefits Liability

Several significant actuarial assumptions were used in the valuation of compensation, pension, and burial benefits to calculate the present value of the liability.  A liability was recognized for the projected benefit payments to: (1) those beneficiaries, including veterans and survivors, currently receiving benefit payments; (2) current veterans who will in the future become beneficiaries of the compensation and pension programs; and (3) a proportional share of those in active military service as of the valuation date who will become veterans in the future.  Future benefits payments to survivors of those veterans in classes (1), (2), and (3) are also incorporated into the projection.

All future benefits were discounted. Discount rates were based on rates for securities issued by Treasury on September 30, 2004, ranging from 2 to 5.23 percent, and on September 30, 2003, ranging from 1.15 to 4.91 percent. Beginning in FY 2004, the discount rates used were based on U.S. Treasury's spot rates rather than corresponding constant maturity rates, which were used in previous years.  Benefit payments were assumed to occur at the midpoint of the fiscal year.

All calculations were performed separately by attained age for the Compensation and Pension programs, while the Burial liability was calculated on an aggregate basis.

Life expectancies of beneficiaries collecting benefits from the Compensation and Pension programs were based upon studies of mortality experience of those beneficiaries between 1995 and 2003.  Life expectancies of veterans not yet collecting these benefits used in the calculation of the liability for future beneficiaries are based on mortality derived from the 1990 U.S.  decennial census and beneficiary mortality experience.  Applying mortality improvements at a rate of 1 percent per annum brought both sets of mortality rates forward.  In addition, rates of benefit termination of beneficiaries due to reasons other than mortality are also reflected.

The amount of benefits by category and age were based on current amounts being paid and future cost of living adjustments (COLAs) to determine the average benefits per veteran for each future time period.  A COLA of 2.7 percent was assumed for FY 2005.  For fiscal years after 2005, COLAs have been determined from OMB's estimates prepared in conjunction with the Administration's annual budget.  Expected changes in benefits due to other reasons were also reflected.

Expected benefit payments have been explicitly modeled for the next 75 years.  This period is the same as that used by the Office of the Actuary of the Social Security Administration.  However, unlike Social Security, (1) estimates of expected benefit payments after this 75-year period were incorporated in the liability based on extrapolations reflecting expected aggregate experience by beneficiary category between the years 70 and 75 and (2) SSA uses an open population model, while the C&P projections only reflect benefits associated with military service through September 30, 2003.

## 12. Environmental and Disposal

VA had unfunded environmental and disposal liabilities in the amount of $339 million and $375 million as of September 30, 2004 and 2003, respectively. The majority of the unfunded liabilities involve asbestos removal, lead abatement, replacement of underground oil and gasoline tanks, decommissioning of waste incinerators, and decontamination of equipment prior to disposal.

While some facilities have applied prevailing state regulations that are more stringent than Federal guidelines, the Occupational Safety and Health Administration and Environmental Protection Agency regulations provide the legal base behind the majority of VA's environmental and disposal liabilities. Estimated liabilities for these projects are based on known contamination that exists today and have been computed by the facility engineering staff based on similar projects already completed, or by independent contractors providing work estimates.

## 13. Other Liabilities

Funded liabilities are generally considered to be current liabilities. Unfunded liabilities are generally considered to be non-current liabilities.

| Other Intragovernmental Funded Liabilities as of September 30, | 2004 | 2003 |
|---|---|---|
| Deposit and Clearing Account Liabilities | $ (61) | $ (73) |
| Accrued Expenses - Federal | 149 | 99 |
| Deferred Revenue | 283 | 446 |
| Resources Payable to Treasury | 350 | 404 |
| Custodial Liabilities* | 1,022 | 2,260 |
| General Fund Receipts Liability | 29 | 12 |
| Accrued VA Contributions for Employee Benefits | 3 | 2 |
| **Total Other Intragovernmental Funded Liabilities** | $ 1,775 | $ 3,150 |

* The Custodial Liabilities Accounts include subsidy reestimates for loans made after September 30, 1991, which are subject to the provisions of the Credit Reform Act of 1990. The liability provision for future losses on credit reform guaranteed loans is comprised of a funded subsidy for each loan guaranteed at the rate equal to the amount of the present value of estimated loss to the Government for the cohorts of loans. The subsidy amount for each cohort is reestimated annually to ensure amounts reflect the actual losses on guaranteed loans. Based on the reestimated amounts, additional subsidy funds are provided for or excess funds are returned.

Other Intragovernmental Unfunded Liabilities
as of September 30,

| | 2004 | 2003 |
|---|---|---|
| Accrued FECA Liability | $ 359 | $ 356 |
| **Total Other Intragovernmental Unfunded Liabilities** | $ 359 | $ 356 |

Other Public Funded Liabilities
as of September 30,

| | 2004 | 2003 |
|---|---|---|
| Accrued Funded Annual Leave | $ 11 | $ 10 |
| Accrued Expenses | 2,482 | 2,135 |
| Accrued Salaries and Benefits | 583 | 420 |
| Contract Holdbacks | 12 | 16 |
| Deferred Revenue | 1 | 1 |
| Unredeemed Coupons | 1 | 1 |
| Deposit and Clearing Account Liability | 46 | 17 |
| Unearned Premiums | 111 | 118 |
| Insurance Dividends Left on Deposit and Related Interest Payable* | 1,677 | 1,673 |
| Dividend Payable to Policyholders | 225 | 254 |
| Amounts due to non-federal trusts | 1 | 0 |
| Capital Lease Liability | 30 | 33 |
| **Total Other Public Funded Liabilities** | $ 5,180 | $ 4,678 |

* Interest earned on dividends left on deposit is paid annually to insurance policyholders on the policy anniversary dates.

Other Public Unfunded Liabilities
as of September 30,

| | 2004 | 2003 |
|---|---|---|
| Annual Leave* | $ 1,172 | $ 1,097 |
| Accounts Payable from Cancelled Appropriation | 6 | 6 |
| Amounts due to non-federal trust | 188 | 0 |
| Judgment Fund-Unfunded** | 501 | 528 |
| **Total Other Public Unfunded Liabilities** | $ 1,867 | $ 1,631 |

* Annual leave is accrued when earned and is adjusted at the end of the fiscal year to reflect current pay rates of cumulative leave earned but not taken. Sick and other types of leave are expensed as taken.
** The Judgment Fund liability amount represents the estimate for future payments on legal cases that will be paid by the Treasury Judgment Fund on behalf of VA.

## 14. Leases

VA has both capital and operating leases. The capital lease liability is $30 and $33 million as of September 30, 2004 and 2003, respectively. Real property leases reflect those that VA has committed to as of September 30, 2004. Due to the number of equipment operating leases and the decentralization of records, the future commitment for equipment operating leases is not known. VA's FY 2004 operating lease costs were $243 million for real property rentals and $79 million for equipment rentals. The FY 2003 operating lease costs consisted of $236 million for real property rentals and $67 million for equipment rental. The following chart represents VA's operating lease commitments or costs for the next 5 years. Equipment amounts assume a range of 3.1 to 3.5 percent yearly increase in cost.

Leases:

| YEAR | REAL PROPERTY | PERCENTAGE | EQUIPMENT |
|---|---|---|---|
| 2005 | $ 237 | 3.1 | $ 82 |
| 2006 | 227 | 3.5 | 85 |
| 2007 | 212 | 3.4 | 88 |
| 2008 | 205 | 3.4 | 91 |
| 2009 | 188 | 3.4 | 94 |

## 15. Insurance Programs

Through VA, the United States Government administers five life insurance programs and the Veterans' Mortgage Life Insurance program for certain totally disabled veterans. VA supervises the Servicemembers' Group Life Insurance (SGLI) and the Veterans' Group Life Insurance (VGLI) programs, which provide life insurance coverage to members of the uniformed armed services, reservists, and post-Vietnam veterans. United States Code, Title 38, requires that the Life Insurance programs invest in Treasury securities.

### Administered Programs

The United States Government Life Insurance (USGLI) program was the Government's first venture into life insurance. During World War I, the U.S. provided Marine Insurance to protect the interests of ship owners and merchants who were providing supplies to the allies in Europe. USGLI was the natural outgrowth of this Marine Insurance. The program was established to meet the needs of World War I veterans, but remained open to servicemembers and veterans with service before October 8, 1940. The Government became a self-insurer because private insurance companies were unwilling to assume the unpredictable risks associated with war. By establishing this program, Congress intended to avoid the financial burden imposed on the Government by the pension programs that were established after previous wars. The Government became the largest life insurer in the United States with the coverage provided by this program.

The National Service Life Insurance (NSLI) program covers policyholders who served during World War II. The program opened October 8, 1940, when it became clear that large-scale military inductions were imminent. Over 22 million policies were issued under the NSLI program. The majority of policies VA administers directly are NSLI policies. This program remained open until April 25, 1951, when two new programs were established for Korean War servicemembers and veterans.

The Veterans' Special Life Insurance (VSLI) program was established in 1951 to meet the insurance needs of veterans who served during the Korean Conflict, and the post-Korean period through January 1, 1957. During this period, all servicemembers on active duty were covered for $10,000, at no cost, under a program known as Servicemen's Indemnity. They remained covered for 120 days after their discharge. The VSLI program allowed these newly discharged servicemembers to apply for $10,000 of contract term insurance. Application had to be made during the 120-day period during which they remained covered by Servicemen's Indemnity. It was during this period that representatives of the commercial insurance industry began a major lobbying effort to get the Government out of the insurance business because the programs were viewed as competition. As a result, the VSLI program was closed to new issues at the end of 1956, and coverage for individuals in the uniformed services was terminated. Approximately 800,000 VSLI policies were issued between 1951 and 1957.

In addition to VSLI coverage, which was provided to healthy veterans, the Insurance Act of 1951 also established the Service-Disabled Veterans Insurance (S-DVI) program for veterans with service-connected disabilities. S-DVI is open to veterans separated from the service on or after April 25, 1951, who receive a service-connected disability rating. New policies are still being issued under this program.

In 1964, Congress enacted legislation providing for a limited reopening of NSLI and VSLI, and the Veterans' Reopened Insurance (VRI) program was established. Beginning May 1, 1965, veterans who had been eligible to obtain insurance between October 8, 1940, and January 1, 1957, could once again apply for government life insurance. They had one year to apply for this "reopened" insurance, which was available only to disabled veterans. Approximately 228,000 VRI policies were issued. No term insurance policies were issued in this program.

The Veterans' Mortgage Life Insurance (VMLI) program began in 1971, and is designed to provide financial protection to cover eligible veterans' home mortgages in the event of death. VMLI is issued to those severely disabled veterans who have received grants for specially adapted housing from VA. These grants are issued to veterans whose movement is substantially impaired because of their disability. The maximum amount of VMLI allowed an eligible veteran is $90,000. The insurance is payable if the veteran dies before the mortgage is paid off and is payable only to the mortgage lender.

## Supervised Insurance Programs

The Servicemembers' Group Life Insurance (SGLI) program was established in 1965 for Vietnam-era servicemembers. SGLI is supervised by VA and is administered by the Office of Servicemembers' Group Life Insurance (OSGLI) under terms of a group insurance contract. This program provides low-cost term insurance protection to servicemembers.

In 1974, the Veterans' Group Life Insurance (VGLI) program became available. VGLI, like SGLI, is supervised by VA, but is administered by the OSGLI. VGLI provides for the conversion of SGLI coverage to lifetime term insurance protection after a servicemember's separation from service.

## Public Insurance Carriers

VA supervises the administration of the SGLI and VGLI programs. Prudential Insurance Company of America (Prudential) provides insurance coverage directly for the SGLI and VGLI programs. VA has entered into a group policy with Prudential whereby Prudential and its reinsurers provide servicemembers and veterans coverage in multiples of $10,000 up to a maximum of $250,000. The basic SGLI coverage is provided to those members on active duty in the Army, Navy, Air Force, Marine Corps, Coast Guard, commissioned members of the Public Health Service and the National Oceanic and Atmospheric Administration. The Ready Reserve is also insured by SGLI, and includes reservists and members of the National Guard who are assigned to a unit or position in which they may be required to perform active duty or active duty for training. The VGLI coverage is comprised of separated and retired active duty members and reservists covered under Basic SGLI.

The Veterans' Opportunities Act of 2001 extended life insurance coverage to spouses and children of members insured under the SGLI program, effective November 1, 2001. For a spouse, up to $100,000 of coverage can be purchased in increments of $10,000, not to exceed the amount of the servicemember's coverage. Each dependent child of every active duty servicemember or reservist insured under SGLI is automatically insured for $10,000 free of charge.

Premiums for the SGLI and VGLI programs are set by mutual agreement between VA and Prudential. SGLI premiums for active duty personnel and their spouses are deducted from the servicemember's pay by the Armed Services components through the Department of Defense (DoD). DoD, through the Defense Finance and Accounting Service (DFAS), remits collected premiums to VA, which are then transmitted to Prudential. Prudential records the premiums and maintains investments in their accounting records separate and independent from the VA reporting entity. VA monitors Prudential's insurance reserve balances to determine their adequacy and may increase or decrease the amounts retained by Prudential for contingency purposes. The reserves for the contingent liabilities are recorded in Prudential's accounting records and are not reflected in the VA reporting entity, because the risk of loss on these programs is assumed by Prudential and its reinsurers through the terms and conditions of the group policy.

Effective January 1, 1970, the Secretary of Veterans Affairs determined the costs that are traceable to the extra hazards of duty in the uniformed services, on the basis of the excess mortality incurred by members and former members of the uniformed armed services insured under SGLI, above what their mortality would have been under peacetime conditions. The Secretary is authorized to make adjustments regarding contributions from pay appropriations as may be indicated from actual experience.

## Reserve Liabilities

The insurance reserves for administered programs are reported as liabilities covered by budgetary resources, while part of the S-DVI and Veterans Insurance and Indemnities (VI&I) reserves are reported as liabilities not covered by budgetary resources. Reserves for SGLI and VGLI are maintained in Prudential's financial records since the risk of loss is assumed by Prudential. Actuarial reserve liabilities for the administered life insurance programs are based on the mortality and interest assumptions at time of issue. These assumptions vary by fund, type of policy, and type of benefit. The interest assumptions range from 2.25 to 5.0 percent. The mortality assumptions include the American Experience Table, the 1941 Commissioners Standard Ordinary (CSO) Table, the 1958 CSO Basic Table, and the 1980 CSO Basic Table.

Insurance Liability (Reserve) Balances

Insurance Liability (Reserve) Balances As of September 30, 2004

| Program | Insurance Death Benefits | Death Benefit Annuities | Disability Income & Waiver | Reserve Totals |
|---|---|---|---|---|
| NSLI | $9,372 | $170 | $145 | $9,687 |
| USGLI | 30 | 5 | - | 35 |
| VSLI | 1,512 | 11 | 31 | 1,554 |
| S-DVI | 305 | 2 | 237 | 544 |
| VRI | 379 | 2 | 5 | 386 |
| VI&I | 85 | - | - | 85 |
| Subtotal | $11,683 | $190 | $418 | $12,291 |
| Less Liability not Covered by Budgetary Resources | | | | (568) |
| Liability Covered by Budgetary Resources | | | | $11,723 |

Insurance Liability (Reserve) Balances As of September 30, 2003

| Program | Insurance Death Benefits | Death Benefit Annuities | Disability Income & Waiver | Reserve Totals |
|---|---|---|---|---|
| NSLI | $9,660 | $185 | $167 | $10,012 |
| USGLI | 34 | 5 | - | 39 |
| VSLI | 1,493 | 11 | 33 | 1,537 |
| S-DVI | 404 | 2 | 156 | 562 |
| VRI | 396 | 2 | 6 | 404 |
| VI&I | 86 | - | - | 86 |
| Subtotal | $12,073 | $205 | $362 | $12,640 |
| Less Liability not Covered by Budgetary Resources | | | | (581) |
| Liability Covered by Budgetary Resources | | | | $12,059 |

## Insurance In-Force

The amount of insurance in-force is the total face amount of life insurance coverage provided by each administered and supervised program as of the end of the fiscal year. It includes any paid-up additional coverage provided under these policies. Prudential and its reinsurers provided coverage to 5,946,231 and 5,901,345 insured for a face value of $737.9 billion and $725.8 billion as of September 30, 2004 and 2003, respectively. The face value of the insurance provided by Prudential and its reinsurers represents 97.5 and 97.4 percent of the total insurance in-force as of September 30, 2004 and 2003, respectively. The number of policies represents the number of active policies remaining in the program as of the end of each fiscal year.

| | 2004 Policies | 2003 Policies | 2004 Face Value | 2003 Face Value |
|---|---|---|---|---|
| Supervised Programs | | | | |
| SGLI Active Duty | 1,545,000 | 1,548,000 | $371,135 | $372,659 |
| SGLI Ready Reservists | 783,500 | 775,500 | 176,493 | 174,171 |
| SGLI Post Separation | 120,000 | 87,000 | 28,351 | 20,512 |
| SGLI Family - Spouse | 990,000 | 990,000 | 97,198 | 96,215 |
| SGLI Family - Children | 2,100,000 | 2,100,000 | 21,000 | 21,000 |
| VGLI | 407,731 | 400,845 | 43,767 | 41,275 |
| **Total Supervised** | 5,946,231 | 5,901,345 | $737,944 | $725,832 |
| Administered Programs | | | | |
| NSLI | 1,300,404 | 1,401,357 | $14,013 | $14,802 |
| VSLI | 213,545 | 220,719 | 2,525 | 2,566 |
| S-DVI | 165,651 | 154,537 | 1,614 | 1,484 |
| VRI | 57,757 | 62,696 | 523 | 556 |
| USGLI | 10,390 | 11,770 | 33 | 37 |
| VMLI | 2,625 | 2,793 | 170 | 176 |
| **Total Administered** | 1,750,372 | 1,853,872 | $18,878 | $19,621 |
| **Total Supervised and Administered Programs** | 7,696,603 | 7,755,217 | $756,822 | $745,453 |

## Policy Dividends

The Secretary of VA determines annually the excess funds available for dividend payment. Dividends are based on an actuarial analysis of the individual programs at the end of the preceding calendar year. Dividends are declared on a calendar year basis and paid on policy anniversary dates. Policyholders can elect to: (1) receive a cash payment; (2) prepay premiums; (3) repay loans; (4) purchase paid-up insurance; or (5) deposit the amount in an interest-bearing account. A provision for dividends is charged to operations, and an insurance dividend is established when gains to operations are realized in excess of those essential to maintain solvency of the insurance programs. Policy dividends for fiscal years 2004 and 2003 were $497 and $551 million, respectively.

## Sale of Prudential Stock

On December 18, 2001, Prudential completed its conversion from a mutual company to a stock company. As policyholder of the SGLI and VGLI programs, VA received 369,177 shares of Prudential stock. VA is liquidating these shares in six sales over a three-year period, which started in 2003. As of fiscal year end, VA has liquidated 246,000 shares of stock in four sales. Proceeds of $9,824,505 from the sales have been deposited into the SGLI Contingency Reserve, which is held for VA by Prudential in an interest-bearing account. This guarantees that the monies will be used for the benefit of the servicemembers and veterans who are the intended recipients of these life insurance programs.

# 16. Contingencies

VA is a party in various administrative proceedings, legal actions, and tort claims arising from various sources including: disputes with contractors, challenges to compensation and education award decisions, loan guaranty indemnity debt cases, and allegations of medical malpractice. Certain legal matters to which VA may be a named party are administered and, in some instances, litigated by the Department of Justice. Generally, amounts (more than $2,500 for Federal Tort Claims Act cases) to be paid under any decision, settlement, or award are funded from the Judgment Fund, which is maintained by Treasury. Of the amounts paid from the Judgment Fund, malpractice cases claimed 85 percent in FY 2004 and 84 percent in FY 2003. Contract dispute payments for FY 2004 and FY 2003 were $9.4 and $5.9 million, respectively.

VA uses accepted actuarial methods to estimate the liability resulting from medical malpractice and other tort claim exposure. In FY 2004, VA discounted future estimated payments using U.S. Treasury spot rates as of September 30, 2004. Had these payments not been discounted, the associated liability would have been $41 million more.

VA has recorded a liability for pending legal claims that are estimated to be paid by the Judgment Fund. This liability is established for all pending claims whether reimbursement is required or not. This liability was $501 million for FY 2004 and $528 million for FY 2003. There were 16 contract and personnel law cases with claimed amounts totaling $117.8 million where there was at least a reasonable possibility that a loss may occur. VA is also required to record an operating expense and imputed financing source for the Judgment Fund's pending claims and settlements. Judgment Fund accounting is shown on the following page:

| Judgment Fund<br>For the Years Ended September 30, | 2004 | 2003 |
|---|---|---|
| Fiscal Year Settlement Payments | $ 108 | $ 92 |
| Less Contract Dispute Payments | (11) | (6) |
| Imputed Financing-Paid by Other Entities | 97 | 86 |
| Increase (Decrease) in Liability for Claims | 27 | (97) |
| **Operating Expense (Revenue)** | $ 70 | $ (11) |

It is the opinion of VA's management that resolution of pending legal actions as of September 30, 2004 will not materially affect VA's operations or financial position when consideration is given to the availability of the Judgment Fund appropriation to pay some court-settled legal cases. Fiscal year 2004 settlement payments were $97 million.

The amount of unobligated and obligated authority relating to appropriations cancelled on September 30, 2004 and 2003 was $16.9 million and $20.5 million, respectively. Any payments due that may arise relating to cancelled appropriations will be paid out of the current year's appropriations in accordance with the provisions of the Expired Funds Control Act of 1990.

VA provides medical care to veterans on an "as available" basis, subject to the limits of the annual appropriations. In accordance with 38 CFR 17.36 (c), VA's Secretary makes an annual enrollment decision that defines the veterans, by priority, who will be treated for that fiscal year subject to change based on funds appropriated, estimated collections, usage, the severity index of enrolled veterans, and changes in cost. While VA expects to continue to provide medical care to veterans in future years, an estimate of this amount cannot be reasonably made. Accordingly, VA recognizes the medical care expenses in the period the medical care services are provided. For the fiscal years 2000-2004, the average medical care cost per year was $22 billion.

# 17. Exchange Transactions

## Exchange Revenues

Although VA recognizes full cost per SFFAS No. 4, VHA has legislated exceptions to the requirement to recover the full cost to the Federal Government of providing services, resources, or goods for sale. Under "enhanced sharing authority," VHA facilities may enter into arrangements that are in the best interest of the Federal Government. In FY 2004, randomly selected VA medical centers were reviewed by the Financial and Systems Quality Assurance Service to determine the facility's compliance with Statement of Federal Financial Accounting Standards No. 7 and the Chief Financial Officers Act of 1990.

VA's Loan Guaranty Program collects rental fees on a small number of properties during the period when the property is titled to VA.

NCA leases lodges at 11 cemeteries to not-for-profit groups for no fee. The not-for-profit groups are required to provide the upkeep on the lodges and pay the costs for utilities, insurance, minor repairs, and maintenance and any other costs associated with the lodges, and NCA pays for major repairs at these facilities. NCA also has four agricultural leases with private companies/individuals.

NCA leases land for growing crops and, on certain leases, receives various services in exchange from the lessee, such as brush cutting and removal services, backfilling and grading of roads, and welding services. In addition, NCA received fees for motion picture filming performed at three cemeteries.

## Exchange Transactions with Public

Exchange transactions with the public occur when prices are set by law or executive order and are not based on full cost or on market price. VA's Medical Care Collections Fund, "Conforming Amendments," changed the language of specific sections of 38 USC Chapter 17 to substitute "reasonable charges" for "reasonable cost." The VHA Chief Financial Officer (CFO) is responsible for implementing and maintaining these reasonable charges for billing third-party payers for services provided to insured veterans for treatment of nonservice-connected conditions.

Reasonable charges are used to bill for reimbursable health insurance, non-Federal workers' compensation, and no-fault or uninsured motorists insurance cases. Reasonable charges are based on provider charges in the market area of each VA facility. The lesser of VA-billed charges or their usual customary and reasonable payment to other providers will be paid.

Cost-based per diems are calculated annually to produce tort rates used to bill for tort fees or workers' compensation (other than Federal), humanitarian emergency, ineligible patient, VA employee, family member, allied beneficiary, no fault or uninsured motorist's insurance, or reimbursable insurance cases. These per diem costs are derived primarily from cost and workload data from a national cost allocation report (Cost Distribution Report).

VA is required to collect a co-payment of $7 from veterans for treatment of a nonservice-related condition for each 30-day supply of medication furnished on an outpatient basis. This fee does not cover the cost of the medications in the vast majority of cases.

VA's Loan Guaranty Program collects certain fees that are set by law. The loan guarantee funding fees collected for FY 2004 were $478.9 million and for FY 2003 were $634 million. The loan guarantee lender participation fees collected for FY 2004 and FY 2003 were both $1.9 million.

## Intragovernmental Exchange Transactions

This section discloses intragovernmental exchange transactions in which VA provides goods or services at a price less than the full cost, or does not charge a price at all, with explanations for disparities between the billing and full cost.

VA and the Department of Defense (DoD) have authority to enter into agreements and contracts for the mutual use or exchange of use of hospital and domiciliary facilities and other resources. The providing agency shall be reimbursed for the cost of the health care resources based on the methodology agreed to by VA and DoD. Facility directors have the flexibility to consider local conditions and needs and the actual costs of providing the services. VA's General Counsel has determined that full cost recovery is not mandated. VHA captures the total amount of reimbursements received under DoD sharing agreements, but the total amount billed below full cost is not readily available. VHA is in the process of developing mechanisms to report this information in the future. VBA collects funding from DoD in order to administer certain education programs. DoD transferred $280.1 million during FY 2004 for the Post-Vietnam Era Education Assistance Program, Reinstated Entitlements Program for Survivors, and the New GI Bill for Veterans.

When VA furnishes medical care or services for beneficiaries of other Federal agencies, and that care or service is not covered by an applicable local sharing agreement, the billing rates used are determined and published annually by the VHA CFO. Similar to the tort rates, interagency billing rates are determined from cost and workload data in the Cost Distribution Report.

# 18. Net Cost of Veterans Affairs Programs

All of VA's net program costs are part of the 700 budget functional classification (Veterans Benefits and Services).

Schedule of Net Program Cost

| For the Year Ended September 30, 2004 (Dollars in Millions) | Medical Care | Medical Education | Medical Research | Compensation | Pension | Education | Vocational Rehab | Loan Guaranty | Insurance | Burial | Non-Program | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Production Costs** | | | | | | | | | | | | |
| **Intragovernmental Costs** | $ 1,310 | $ 6 | $ 22 | $ 54 | $ 5 | $ 3 | $ 3 | $ 4 | $ 31 | $ 16 | $ 97 | $ 1,551 |
| **Less Earned Revenues** | (73) | - | (25) | - | (7) | (272) | - | (1,047) | (893) | - | (1,363) | (3,680) |
| **Net Intragovernmental Production Costs** | 1,237 | 6 | (3) | 54 | (2) | (269) | 3 | (1,043) | (862) | 16 | (1,266) | (2,129) |
| **Public Costs** | 26,460 | 1,105 | 912 | (2,848) | 3,528 | 2,518 | 673 | 2,263 | 1,529 | 416 | 2,086 | 38,642 |
| **Less Earned Revenues** | (2,301) | - | (11) | - | - | (212) | - | (79) | (604) | - | (39) | (3,246) |
| **Net Public Production Costs** | 24,159 | 1,105 | 901 | (2,848) | 3,528 | 2,306 | 673 | 2,184 | 925 | 416 | 2,047 | 35,396 |
| **Non-Production Costs** | - | - | - | - | - | - | - | - | - | - | - | - |
| **Hazardous Waste Clean-up** | - | - | - | - | - | - | - | - | - | - | - | - |
| **Total Net Cost of Operations** | $ 25,396 | $ 1,111 | $ 898 | $ (2,794) | $3,526 | $2,037 | $676 | $1,141 | $63 | $432 | $781 | $33,267 |

Schedule of Net Program Cost

| For the Year Ended September 30, 2003 (Dollars in Millions) | Medical Care | Medical Education | Medical Research | Compensation | Pension | Education | Vocational Rehab | Loan Guaranty | Insurance | Burial | Non-Program | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Production Costs** | | | | | | | | | | | | |
| **Intragovernmental Costs** | $ 3,542 | $ 30 | $ 76 | $ 139 | $ 9 | $ 8 | $ 6 | $ 816 | $ 43 | $ 56 | $ 170 | $ 4,895 |
| **Less Earned Revenues** | (61) | | (35) | | (7) | (256) | | (706) | (949) | | (1,029) | (3,043) |
| **Net Intragovernmental Production Costs** | 3,481 | 30 | 41 | 139 | 2 | (248) | 6 | 110 | (906) | 56 | (859) | 1,852 |
| **Public Costs** | 21,583 | 1,006 | 795 | 131,207 | 3,489 | 2,209 | 643 | (991) | 1,642 | 69 | 1,488 | 163,140 |
| **Less Earned Revenues** | (1,592) | | (10) | | | (221) | | (107) | (645) | | (47) | (2,622) |
| **Net Public Production Costs** | 19,991 | 1,006 | 785 | 131,207 | 3,489 | 1,988 | 643 | (1098) | 997 | 69 | 1,441 | 160,518 |
| **Non-Production Costs** | | | | | | | | | | | | |
| **Hazardous Waste Clean-up** | 104 | | | | | | | | | | | 104 |
| **Total Net Cost of Operations** | $ 23,576 | $ 1,036 | $ 826 | $ 131,346 | $3,491 | $1,740 | $649 | $ (988) | $ 91 | $ 125 | $582 | $ 162,474 |

## 19. Disclosures Related to the Statements of Budgetary Resources

Apportionment categories of obligations incurred

| Obligations<br>Years Ended September 30, | 2004 | 2003 |
|---|---|---|
| Category A, Direct | $ 31,972 | $ 29,252 |
| Category B, Direct | 37,398 | 34,432 |
| Reimbursable | 4,657 | 4,434 |
| Exempt from Apportionment | 394 | 1,231 |
| **Total Obligations** | $ 74,421 | $ 69,349 |

### Borrowing Authority

Loan Guaranty had borrowing authority of $1.1 billion and $1.3 billion as of September 30, 2004 and 2003, respectively. The Vocational Rehabilitation Program had borrowing authority of $4.1 and $3.5 million as of September 30, 2004 and 2003, for making direct loans. Loan Guaranty borrowing is repaid to Treasury through the proceeds of portfolio loan collections, funding fees, and the sale of loans to Vinnie MAC trusts. The Vocational Rehabilitation loans generally had duration of 1 year, and repayment was made from offsetting collections.

### Adjustments to Budgetary Resources

During the reporting period, adjustments to budgetary resources available at the beginning of the year included VA appropriations that were subjected to a rescission that totaled $443 million. Additionally, unobligated balances of prior year recoveries of $270 million were rescinded. Various VA program accounts received a cut in discretionary budget authority.

## Permanent Indefinite Appropriations

VA has three permanent and indefinite appropriations. The Veterans Housing Benefit Program Fund covers all estimated subsidy costs arising from post-1991 loan obligations for veterans housing benefits. The Fund's objective is to encourage and facilitate the extension of favorable credit terms by private lenders to veterans for the purchase, construction, or improvement of homes to be occupied by veterans and their families. The Loan Guarantee Revolving Fund is a liquidating account that contains all of VA's pre-credit reform direct and guaranteed loans. It also holds fund balances received from reimbursements from financing accounts for loan modifications and rentals of foreclosed properties not yet transferred to financing accounts. The Native American Direct Loan Account was established to cover all subsidy costs arising from direct loan obligations related to a veteran's purchase, construction, or renovation of a dwelling on trust land.

## Use of Unobligated Balances of Budget Authority

Available unobligated balances on the Statement of Budgetary Resources are composed of current fiscal year apportioned funds for annual, multi-year, and no-year appropriations from Congress as well as revolving and trust funds. Other balances not available are composed of expired appropriation unobligated amounts, which generally are not available for new obligations, but can be used to increase existing obligations under certain circumstances. This amount also includes unobligated funds that were not apportioned by OMB for FY 2004 use.

Unobligated VA funds are available for uses defined in VA's FY 2004 Appropriation Law (P.L. 108-199). These purposes include veterans medical care, research, education, construction and maintenance of VA buildings, veterans and dependents benefits, veterans life insurance, loan guaranty programs, veterans burial benefits, and administrative functions. Various obligation limitations are imposed on individual VA appropriations. Examples include travel obligation limitations and limitation of the use of medical care multi-year funds to object classes for equipment, structures, and land.

## Explanation of Differences Between Statement of Budgetary Resources and the Budget

As a result of an analysis of aged obligations, obligations were reduced by $90 million on the Statements of Budgetary Resources for both FY 2004 and FY 2003. These adjustments were not reflected in the FACTS II data used to prepare the President's Budget. No other differences were identified as of the preparation date of the financial statements.

## Contributed Capital

The amount of contributed capital received during FY 2004 consisted of donations in the amount of $40.5 million to the General Post Fund and $0.1 million to the National Cemetery Gift Fund.

## 20. Disclosures Related to the Statements of Financing

The Statement of Financing section "Costs That Do Not Require Resources in the Current Period" includes only the fiscal year increases in liabilities not covered by budgetary resources. For existing liabilities, there will always be a difference between this section and the value of liabilities not covered by budgetary resources disclosed in Note 10 and included in the liabilities section of the Balance Sheet.

## 21. Dedicated Collections

In the Federal Government, dedicated collections are accounted for in trust funds and special funds. The term "trust funds" as used in this report and in Federal budget accounting is frequently misunderstood. In the private sector, "trust" refers to funds of one party held by a second party (the trustee) in a fiduciary capacity. In the Federal budget, the term "trust fund" means only that the law requires that funds be accounted for separately and used only for specified purposes and that the account be designated as a "trust fund."

A change in law may change the future receipts and the terms under which the fund's resources are spent. The "trust fund assets" represent all sources of receipts and amounts due the trust fund regardless of source. This includes "related governmental transactions," which are transactions between two different entities within the Federal Government. The "Investments with Treasury" assets are comprised of investments in Federal debt securities and related accrued interest. These securities will require redemption if a fund's disbursements exceed its receipts. Unless specifically provided for by law, trust funds may only place excess funds in Federally backed investments (e.g., Federal debt securities).

The table below summarizes the name, type, and purpose of the funds within VA that receive dedicated collections. All of the funds listed use the accrual basis of accounting. However, collections are reported as actually received in accordance with OMB Circular A-34. The insurance funds listed also adhere to the requirements of FASB No. 120, "Accounting and Reporting by Mutual Life Insurance Enterprise," and issue a separate annual report. All of the funds generally receive authority to use current year contributions as well as a portion of previously contributed amounts.

| Fund Name | Fund Type | Treasury Symbol | Authority | Purpose of Fund | Financing Sources |
|---|---|---|---|---|---|
| **Medical Care Collections Fund** | Special | 36x5287 | P.L. 105-33<br>111 Stat 665 | Accumulates recoveries from third parties and patient co-payments. | Public, primarily insurance carriers. |
| **Health Service Improvement Fund** | Special | 36x5358 | P.L 106-117<br>113 Stat 1561 | Accumulates recoveries from enhanced use leases and patient co-payments. | Public. |
| **Escrowed Funds for Shared Medical Equipment Purchases** | Deposit | 36x6019 | 106 Stat 1974 | Receives payments from public companies involved in joint purchases of medical equipment. | Public, universities, pharmaceuticals & other medical organizations. |
| **Personal Funds of Patients** | Deposit | 36x6020 | 38 U.S.C. 3204 | Temporarily holds funds. | Public, patients. |
| **Employee Allotments for Savings Bonds** | Deposit | 36x6050 | 31 U.S.C. 3105 | Temporarily holds funds. | Employees. |
| **Cemetery Gift Fund** | Trust | 36x8129 | 38 U.S.C. 1007 | Receives donations for veteran cemeteries. | Public donors. |
| **National Service Life Insurance Fund** | Trust | 36x8132 | 38 U.S.C. 720 | Accumulates premiums to insure veterans of WWII. | Public, veterans. |
| **Post-Vietnam Era Education Assistance Program** | Trust | 36x8133 | 38 U.S.C. 1622 | Subsidizes the cost of education to veterans. | Veterans, DoD. |
| **U.S. Government Life Insurance** | Trust | 36x8150 | 38 U.S.C. 755 | Premiums insure WWI veterans. | Public, veterans. |
| **Veterans Special Life Insurance Fund** | Trust | 36x8455 | 38 U.S.C. 723<br>101-228 | Premiums insure Korean conflict veterans without Service-related disabilities. | Public, veterans. |
| **General Post Fund, National Homes** | Trust | 36x8180 | 38 U.S.C. 101-228 | Receives restricted and unrestricted use donations | Public, mostly veterans. |

The following tables provide condensed information on assets, liabilities, fund balances, net costs, and changes in fund balances:

| For the year ended September 30, 2004 Fund Symbol | 5287 | 5358 | 6020 | 8132 | 8133 | 8150 | 8455 | 8180 | Total |
|---|---|---|---|---|---|---|---|---|---|
| **Assets:** | | | | | | | | | |
| Fund balance with Treasury | $ 155 | $ - | $ 45 | $ 10 | $ 75 | $ - | $ 1 | $ - | $ 286 |
| Investments with Treasury | - | - | - | 11,121 | -- | 51 | 1,923 | 68 | 13,163 |
| Other Assets | 555 | 5 | - | 545 | 1 | 2 | 109 | 18 | 1,235 |
| **Total Assets** | 710 | 5 | 45 | 11,676 | 76 | 53 | 2,033 | 86 | 14,684 |
| **Liabilities:** | | | | | | | | | |
| Payables to Beneficiaries | - | - | - | 142 | 1 | 1 | 10 | - | 154 |
| Other Liabilities | - | - | 45 | 11,251 | - | 50 | 1,955 | 2 | 13,303 |
| **Total Liabilities** | - | -- | 45 | 11,393 | 1 | 51 | 1,965 | 2 | 13,457 |
| **Net Position:** | | | | | | | | | |
| Cumulative Results | 710 | 5 | - | 283 | 75 | 2 | 68 | 84 | 1,227 |
| **Total Liabilities & Net Position** | $ 710 | $ 5 | $ 45 | $ 11,676 | $ 76 | $ 53 | $ 2,033 | $ 86 | $ 14,684 |

For the year ended September 30, 2004

| **Fund Symbol** | 5287 | 5358 | 8132 | 8133 | 8150 | 8455 | 8180 | Total |
|---|---|---|---|---|---|---|---|---|
| **Revenues:** | | | | | | | | |
| Exchange - Federal | $ (24) | $ - | $ 718 | $ - | $ 3 | $ 141 | $ - | $ 838 |
| Exchange - Public | 2,006 | (114) | 466 | 1 | - | 72 | 2 | 2,433 |
| Non-Exchange - Federal | - | - | - | - | - | - | - | - |
| Non-Exchange - Public | - | - | - | - | - | - | - | - |
| **Total Revenues** | 1,982 | (114) | 1,184 | 1 | 3 | 213 | 2 | 3,271 |
| **Expenses:** | | | | | | | | |
| Program Expenses | 212- | (19) | 1,211 | 4 | 4 | 215 | 40 | 1,667 |
| **Total Expenses** | 212 | (19) | 1,211 | 4 | 4 | 215 | 40 | 1,667 |
| **Net Change from Operations** | | | | | | | | |
| Beginning Net Position | 568 | 132 | 309 | 77 | 2 | 69 | 80 | 1,237 |
| Total Financing Sources | (1,628) | (31) | 1 | - | - | - | 42 | (1,616) |
| Change in Accounting Policy | - | - | - | - | - | - | - | - |
| Net Cost of Operations | 1,770 | (96) | (27) | (2) | - | (1) | (38) | 1,606 |
| **Ending Equity** | $ 710 | $ 5 | $ 283 | $ 75 | $ 2 | $ 68 | $ 84 | $ 1,227 |

# Independent Auditor's Report

## Department of Veterans Affairs
## Office of Inspector General

# REPORT OF THE AUDIT OF THE DEPARTMENT OF VETERANS AFFAIRS CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2004 AND 2003

Report No. 04–00986-14

November 15, 2004

VA Office of Inspector General
Washington, DC 20420

DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

**Memorandum to the Secretary**

**Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2004 and 2003**

1. Attached is the Report of Audit of the Department of Veterans Affairs (VA) Consolidated Financial Statements (CFS) for Fiscal Years (FY) 2004 and 2003, 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 2004 CFS.

2. The independent auditors' report by Deloitte & Touche LLP provides an unqualified opinion on VA's FYs 2004 and 2003 CFS. The report on internal control identifies four reportable conditions, of which two are material weaknesses. The two material weaknesses are (i) information technology security controls and (ii) integrated financial management system. The two reportable conditions are (i) operational oversight and (ii) judgments and claims. During FY 2004, VA management took corrective action to eliminate the medical malpractice and claims data reportable condition reported in the FY 2003 audit report.

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 of 1996. The internal control issues concerning an integrated financial system and information technology security controls indicate noncompliance with the requirements of Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," which incorporates by reference OMB Circulars A-123, "Management Accountability and Control," and A-130, "Management of Federal Information Resources."

4. The auditors' unqualified opinion was achieved through the extensive efforts of program and financial management staff, as well as the auditors, to overcome material weaknesses in internal control to produce auditable information after the fiscal year-end. Although these efforts resulted in materially correct annual financial statements, reliable information was not readily available during the year. The risk of materially misstating financial information remains high using the existing financial management systems.

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 2005 CFS.

Michael L. Staley
Assistant Inspector General for Auditing

Attachment

Deloitte.

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**INDEPENDENT AUDITORS' REPORT**

Secretary
Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs (VA) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, financing 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. 01-02, *Audit Requirements for Federal Financial Statements*, as amended. 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 2004 and 2003, and the respective net costs, changes in net position, financing 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 4, 2004, 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 grant agreements 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 4, 2004

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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***

Secretary
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, 2004, and have issued our report thereon dated November 4, 2004. 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. 01-02, *Audit Requirements for Federal Financial Statements,* as amended.

**INTERNAL CONTROL OVER FINANCIAL REPORTING**

In planning and performing our audit, we considered VA's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect VA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions 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 reportable conditions. Reportable conditions that we identified in our prior year report dated November 11, 2003 are identified as repeat conditions.

Four reportable conditions are described in the following paragraphs and include significant departures from certain requirements of OMB Circular A–127, "Financial Management Systems," which incorporates by reference Circulars A–123, "Management Accountability and Control," and A–130, "Management of Federal Information Resources," among other requirements. We believe that the two reportable conditions identified

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as "Information Technology (IT) Security Controls" and "Integrated Financial Management System" are also material weaknesses.

**INFORMATION TECHNOLOGY**

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

VA continued to make organizational changes in the IT area during fiscal year (FY) 2004 that facilitated IT security controls improvements through centralization of certain information technology controls initiatives. Many application program offices have also taken corrective actions to remediate material weaknesses reported in our prior year report. However, VA's program and financial data continue to be at risk due to serious weaknesses related to: 1) inadequate implementation and enforcement of controls and oversight over access to information systems; 2) improper segregation of key duties and responsibilities of employees; and 3) underdeveloped contingency planning. These weaknesses placed sensitive information, including financial data and sensitive veteran medical and benefit information, at risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, possibly occurring without detection.

Our testing of key controls over the general computer systems at the VA's primary data centers and 14 medical facilities, the Veterans Health Information Systems and Technology Architecture (VISTA) application, and our external and internal network vulnerability assessment of the VA's network infrastructure, identified the following control weaknesses:

*Access Control*

- For general computer systems including network and operating systems, the control weaknesses included inconsistent implementation of internal wide area network access authentication mechanisms and administration of user access, inappropriate access privileges due to non-restrictive system access profiles for internal operations and programming staff, and inconsistent monitoring and review of user access.

- The internal vulnerability assessment disclosed vulnerabilities related to weak operating systems configurations and passwords on administrative level accounts, a lack of robust intrusion detection alerts, and coordination and communication between security functions.

*Segregation of Duties*

- In the Integrated Funds Distribution, Control Point Activity, Accounting and Procurement (IFCAP) and Automated Engineering Management System/Medical Equipment Reporting System (AEMS/MERS) applications, we identified improper design of system controls to support segregation of duties and responsibilities of employees who had super user rights.

*Service Continuity*

- A business continuity plan at the VA level has not been fully developed to provide overall guidance, direction and coordination for IT service continuity. The *"Bull"* operating system, supporting VBA's applications such as compensation, pension and education programs and data, has not been tested for the service continuity purpose because the backup hardware does not have adequate memory and processing capacity. Certain legacy loan guaranty system components, such as the Property

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Management System and Guaranteed and Insured Loan System, are not likely to be recovered within the specified timeframe due to inadequate technical documentation on these applications. In addition, testing of the Continuity of Operations Plan at certain medical facilities has not been consistently scheduled and performed.

VA's success in improving information security is dependent on VA's continued effort in comprehensively addressing these weaknesses at an enterprise level, including continuing its high level of coordination and obtaining adequate resources to implement the plan.

**Recommendations:**

The VA Chief Information Officer (CIO) should:

1. Apply appropriate resources and establish a clear chain of command and accountability structure in implementing and enforcing information technology internal controls in order to implement planned corrective actions and remediate identified deficiencies within a reasonable timeframe. Perform proactive oversight of compliance with established IT internal control policies and procedures.

2. Improve access control policies and procedures to provide actionable steps for configuring security settings on operating systems, improving administration of user access, and intrusion detection alerting.

3. Evaluate user functional access needs and privileges to ensure proper segregation of duties within financial applications such as the IFCAP and AEMS/MERS. Assign, communicate, and coordinate responsibility for enforcing and monitoring such controls in a consistent fashion throughout VA.

4. Develop a business continuity plan at the VA level that will facilitate effective communication and implementation of overall guidance and standards, and provide coordination of VA's business continuity effort. Schedule and test IT disaster recovery plans to ensure continuity of operations in the event of a disruption of service.

**OPERATIONS**

**Integrated Financial Management System – Material Weakness**
**(Repeat Condition)**

As defined in OMB Circular A–127, "a financial management system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions." Such financial management systems shall be designed to provide for an effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems.

With respect to system requirements in the area of financial reporting, OMB Circular A–127 provides that 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. Within OMB Circular A–123, 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.

During our audit of VA's consolidated financial statements, we noted continuing difficulties related to the preparation, processing, and analysis of financial information to support the efficient and effective

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preparation of VA's consolidated financial statements. While significant efforts are made at the component and consolidated levels to assemble, compile, and review the necessary financial information for annual financial reporting requirements, in many cases, components of certain feeder systems and financial applications are not fully integrated with the core Financial Management System. As a result, significant manual work-arounds and out-of-date systems impede the process. For example, we noted that:

- Reconciliations of property records in the loan guaranty programs continue to identify significant differences from non interfaced systems;
- Within the compensation, pension and education programs, there are a number of programs that do not directly interface with the general ledger or they interface at various intervals. As a result, numerous adjusting entries resulting from timing differences are necessary to reconcile balances with the general ledger to ensure the amounts are properly stated; and
- In the life insurance programs, the lack of system interface with the VA's general ledger creates the need for a significant amount of adjusting entries. We observed that some journal entries were not posted to the general ledger nor were reconciling items identified and posted timely.

*Recommendation:*

5. The VA CIO and Chief Financial Officer (CFO) should develop and implement a fully integrated financial management system. The VA CFO should implement and enforce supplemental manual processes to meet appropriate control objectives until a fully integrated financial management system is implemented.

**Operational Oversight**
**(Repeat Condition)**

With more than 150 medical centers nationwide, management oversight at the medical centers is essential to ensure compliance with Departmental established policies and procedures. To assess the effectiveness of internal controls at the medical center level, we conducted tests at 14 medical centers within 11 Veterans Integrated Service Networks (VISNs) to (1) determine whether staffs were aware of key internal controls, (2) review evidence to determine whether internal controls were functioning as intended and (3) assess the effectiveness of the internal controls.

During our testing, we continued to find a number of previously reported instances where key internal controls and reconciliation processes were not performed consistently or completely. The Veterans Health Administration (VHA), Office of the CFO, has implemented a monthly reconciliation monitoring process. VHA also conducted training designed specifically for medical center accountants and developed performance measures for the VISN's scorecard to monitor medical center progress in complying with certain Departmental policies and procedures. Although there has been improvement, our testing at the medical centers showed continued noncompliance with certain established policies and procedures. Among the control exceptions found at the medical centers were:

- Supervisory reviews of medical accounts receivable reconciliations were not completed in accordance with certain VA procedures;
- Completed construction or upgrade projects were not capitalized in a timely manner;

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- Non-expendable equipment inventories were not completed or were not completed in accordance with certain VA policies and procedures;
- Accounts receivable collections were not properly completed or were not completed in a timely manner;
- Monitoring of accrued services payable transactions was not effectively performed;
- Estimated environmental clean-up costs were not reported in a timely manner; and
- Deferred maintenance costs were not recorded or were incorrectly recorded in the general ledger.

*Recommendations:*

6. The VHA CFO should continue monitoring monthly reconciliations at the medical centers, develop training programs in areas where noncompliance continues to exist, and use the VISN scorecards to measure compliance with VA policies and procedures to improve internal controls over financial reporting; and

7. Management at the medical centers should take action necessary to comply with VA policies and procedures.

**Judgments and Claims**

VA's Office of General Counsel (OGC) GCLAWS claims tracking system records medical malpractice claims and is used as an input to the model which estimates the value of future settlements pursuant to Statement of Federal Financial Accounting Standard Number 5, *Accounting for Liabilities of the Federal Government*. VA management was unable to explain differences between the amount of settled tort claims recorded in the GCLAWS system and the amount of paid claims recorded in the Judgment Fund maintained by the Department of the Treasury. The Judgment Fund is an appropriated government-wide fund from which settlement payments can be made for both tort and other claims and settlements against the VA based on the authorization of the OGC or the Department of Justice. As a result, the VA could not determine that it provided the appropriate information to the estimation model or that charges to the Judgment Fund were appropriate.

*Recommendation:*

8. The CFO should establish a process to regularly reconcile and investigate differences between the paid claim amounts recorded in GCLAWS and amounts paid from the Judgment Fund.

**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 11, 2003, we reported four reportable conditions (with two material weaknesses) in the areas of (1) Information Technology (IT) Security Controls, (2) Integrated Financial Management System, (3) Operational Oversight and (4) Medical Malpractice Claims Data. In FY 2004, the material weaknesses repeated are items (1) and (2), and the repeat reportable condition is item (3). Item (4) has been corrected.

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With respect to the internal control 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, as required by OMB Bulletin No. 01-02, as amended. 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. 01-02 as amended. Our procedures were not designed to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

**COMPLIANCE AND OTHER MATTERS**

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, noncompliance 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. 01-02, as amended, 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 noncompliance or other matters that are required to be reported under *Government Auditing Standards*, and are described below.

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 "Information Technology (IT) Security Controls" and "Integrated Financial Management System" indicate that VA is not in full compliance with the requirements of OMB Circulars A–123, A–127, and A-130. As discussed above, we found material weaknesses in (1) the effectiveness of the information technology controls; and (2) the design and operation of internal controls over financial reporting, particularly with effectiveness of the control monitoring and reconciliation processes in support of the preparation of the Department's consolidated financial statements.

We believe these material weaknesses, in the aggregate, result in departures from certain of the requirements of OMB Circulars A–123, A–127 and A-130, and are, therefore, instances of substantial noncompliance with the Federal financial management systems requirements under FFMIA.

In addition, we noted other matters involving the internal control and compliance over financial reporting that we have reported to the VA, in a separate letter dated November 4, 2004.

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**DISTRIBUTION**

This report is intended solely for the information and use of the VA Office of Inspector General, the management of the 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 4, 2004

**Department of Veterans Affairs**

# Memorandum

Date: NOV 10 2004

From: Acting Assistant Secretary for Management (004)

Subj: Report of Audit of VA's Consolidated Financial Statements for FY 2004 and 2003

To: Assistant Inspector General for Auditing (52)

1. The Office of Management is pleased to receive an unqualified opinion in the Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2004 and 2003. We are especially proud in meeting the FY 2004 timeframe requirements established by the Office of Management and Budget. Please extend to your staff and the staff of Deloitte & Touche, LLP, my appreciation for their detailed planning, hard work and cooperation during this year's audit.

2. We will share the results of the audit, as well as the findings on internal controls over financial reporting and regulatory compliance, with senior officials in the Administrations and with other VA staff and program managers. We will continue to provide you with updates on our progress in implementing management plans to correct the two material weaknesses, Integrated Financial Management System and Information Technology Security Controls.

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

William A. Moorman

# Required Supplementary Stewardship Information (Unaudited)

*These materials are not audited.*

## 1. Heritage Assets

Heritage assets are properties that possess one or more of the following characteristics: historical or natural significance; cultural; educational or aesthetic value; or significant architectural characteristics. The monetary value of heritage assets is often not estimable or relevant. By nature they are expected to be maintained in perpetuity. VA has properties at medical centers and national cemeteries that meet the criteria for a heritage asset. During the reporting period, all maintenance expenses were recorded as incurred. Heritage assets are reported in terms of physical units. Generally, additions to VA's Heritage Asset inventory result from field station surveys, which identify items such as new collections or newly designated assets. Items are generally donated or existing VA assets are designated as heritage. Most are used for mission purpose and maintained in working order. Remaining items are mothballed.

**Heritage Assets in Units**

| **As of September 30,** | **2004** | **2003** |
|---|---|---|
| Art Collections | 33 | 30 |
| Buildings and Structures | 1,817 | 1,815 |
| Monuments/Historic Flag Poles | 724 | 969 |
| Other Non-Structure Items | 76 | 71 |
| Archaeological | 11 | 11 |
| Cemeteries | 157 | 157 |
| **Total Heritage Assets in Units** | 2,818 | 3,053 |

## 2. Non-Federal Physical Property

Annually, VA provides funding to state governments for the purchase, construction, or major renovation of physical property owned by the state. In most cases these grant programs involve matching funds from the states.

**Grant Program Costs**

| **Years Ended September 30,** | **2004** | **2003** |
|---|---|---|
| State Extended Care Facilities | $ 66 | $ 121 |
| State Veterans Cemeteries | 34 | 30 |
| **Total Grant Program Costs** | $ 100 | $ 151 |

The Extended Care Facilities Grant Program assists states in acquiring facilities to provide domiciliary, nursing home, and other day health care for veterans, and to expand, remodel, or alter existing buildings to provide domiciliary, nursing home, hospital, and day health care for veterans in state homes. VA participates in two grant-in-aid programs for states. VA may participate in up to 65 percent of the cost of construction or acquisition of state nursing homes or domiciliaries or in renovations of existing state homes. Over the last five fiscal years, the State Home Construction Grant Program has awarded grants in excess of $424 million. VA also provides per diem payment for the care of eligible veterans in state homes.

Since the cemetery program was established in 1980, VA has awarded grants totaling more than $208.6 million to 33 states and the Commonwealths of Guam and the Northern Marianas. The program provides up to 100 percent of the cost to establish, expand, or improve state veterans' cemeteries. States provide the land and agree to operate the cemeteries.

## 3. Human Capital

Investment in human capital comprises those expenses for education and training programs for the general public that are intended to increase or maintain national economic productive capacity. It does not include expenses for internal Federal education and training of civilian employees.

| **Veterans and Dependents Education**<br>**Years ended September 30,** | **2004** | **2003** |
|---|---|---|
| **Program Expenses** | | |
| Education and Training-Dependents of Veterans | $ 320 | $ 266 |
| Vocational Rehabilitation and Education Assistance | 2,517 | 2,309 |
| Administrative Program Costs | 230 | 288 |
| **Total Program Expenses** | $ 3,067 | $ 2,863 |
| **Program Outputs (Participants)** | | |
| Dependent Education | 67,420 | 64,582 |
| Veterans Rehabilitation | 75,409 | 71,549 |
| Veterans Education | 409,695 | 400,289 |

### Program Outcomes

VA's education and training programs are intended to provide higher education to dependents who might not be able to participate otherwise. Veterans rehabilitation and employment programs are provided to service-disabled veterans; they are designed to improve employability and promote independence for the disabled. Educational programs for active duty personnel, reservists, and veterans provide higher education assistance to those who are eligible under the MGIB and the Veterans Educational Assistance Program. Education and training assistance are provided to dependents of veterans who died of service-connected disability or whose service-connected disability was rated permanent and total. The Vocational Rehabilitation and Employment program is open to veterans who have a 10 percent or greater service-connected disability rating and are found to have a serious employment handicap. The program provides evaluation services, counseling, and training necessary to assist them in becoming employable and maintaining employment to the extent possible. The Veterans Education program provides educational assistance to eligible servicemembers and veterans.

## 4. Health Professions Education

| Health Professions Education | | |
|---|---|---|
| **Years Ended September 30,** | **2004** | **2003** |
| **Program Expenses** | | |
| Physician Residents and Fellows | $ 420 | $ 404 |
| Associated Health Residents and Students | 62 | 60 |
| Instructional and Administrative Support | 401 | 367 |
| **Total Program Expenses** | $ 883 | $ 831 |
| **Program Outputs** | | |
| Health Professions Rotating Through VA: | | |
| Physician Residents and Fellows | 29,179 | 28,000 |
| Medical Students | 16,740 | 16,000 |
| Nursing Students | 20,275 | 17,000 |
| Associated Health Residents and Students | 16,921 | 15,000 |
| **Total Program Outcomes** | 83,115 | 76,000 |

### Program Outcomes

VA's education mission contributes to high-quality health care for veterans by providing a climate of scientific inquiry between trainees and teachers; application of medical advances more readily through an academic setting; supervised trainees who provide clinical care; and educational programs that enable VA to recruit highly qualified health care professionals.

The Veterans Health Administration (VHA) conducts education and training programs to enhance the quality of care provided to veterans within the VA health care system. Building on the long-standing, close relationships among VA and the Nation's academic institutions, VA plays a leadership role in defining the education of future health care professionals that helps meet the changing needs of the Nation's health care delivery system. Title 38 U.S.C. mandates that VA assist in the training of health professionals for its own needs and those of the Nation. Through its partnerships with affiliated academic institutions, VA conducts the largest education and training effort for health professionals in the Nation. Each year, over 83,000 medical and other students receive some or all of their clinical training in VA facilities through affiliations with over 1,200 educational institutions including 107 medical schools. Many have their health profession degrees and contribute substantially to VA's ability to deliver cost-effective and high-quality patient care during their advanced clinical training at the VA.

## 5. Research and Development

Investments in research and development comprise those expenses for basic research, applied research, and development that are intended to increase or maintain national economic productive capacity or yield other benefits.

| Program Expense Year ended September 30, | Basic | Applied | Development | 2004 Total |
|---|---|---|---|---|
| Medical Research Service | $ 172.9 | $ 81.8 | $ - | $ 254.7 |
| Rehabilitative Research and Development | 3.5 | 27.9 | 17.0 | 48.4 |
| Health Services Research and Development | - | 61.8 | - | 61.8 |
| Cooperative Studies Research Service | - | 27.7 | - | 27.7 |
| Medical Research Support | - | 452.0 | - | 452.0 |
| Prosthetic Research Support | - | 4.8 | - | 4.8 |
| **Total Program Expenses** | $ 176.4 | $ 656.0 | $ 17.0 | $ 849.4 |

| Program Expense Year ended September 30, | Basic | Applied | Development | 2003 Total |
|---|---|---|---|---|
| Medical Research Service | $ 141 | $ 80.7 | $ - | $ 221.7 |
| Rehabilitative Research and Development | 3.1 | 27.5 | 20.3 | 50.9 |
| Health Services Research and Development | - | 61.5 | - | 61.5 |
| Cooperative Studies Research Service | - | 27.0 | - | 27.0 |
| Medical Research Support | - | 402.9 | - | 402.9 |
| Prosthetic Research Support | - | 4.7 | - | 4.7 |
| **Total Program Expenses** | $ 144.1 | $ 604.3 | $ 20.3 | $ 768.7 |

In addition, VHA researchers received $459 million in grants from the National Institutes of Health and $252 million in other grants during FY 2004. These grants went directly to researchers and are not considered part of the VA entity. They are being disclosed here but are not accounted for in the financial statements.

## Program Outcomes

For FY 2004, VA's R&D general goal for stewardship was to ensure that VA medical research programs met the needs of the veteran population and contributed to the Nation's knowledge about disease and disability. Target levels were established for the: (1) percent of funded research projects relevant to VA's health-care mission in designated research areas and (2) number of research and development projects. Strategies were developed in order to ensure that performance targets would be achieved.

VA's Medical Research Program goal is to be the premier research organization, leading our Nation's efforts to discover knowledge and create innovations that promote and advance the health and care of veterans and the Nation. To achieve this goal, VA targets research projects that address special needs of veteran patients and balance research resources among basic and applied research, in order to ensure a complementary role between the discovery of new knowledge and the application of these discoveries to medical practice.

| Research and Development Measures-Actual Year ended September 30, | 2004 | 2003 |
|---|---|---|
| Percent of Funded Research Projects Relevant to VA's Health-Care Mission | 97.1% | 95.6% |
| Number of Research and Development Projects | 2,165 | 2,075 |

# Required Supplementary Information (Unaudited)

*These materials are not audited.*

## 1. Deferred Maintenance

Deferred maintenance is classified as not performed when it should have been or as scheduled but delayed to a future period. It is VA policy to ensure that medical equipment and critical facility equipment systems are maintained and managed in a safe and effective manner; therefore, deferred maintenance is not applicable to them.

VA facilities reported their cost estimates for deferred maintenance by utilizing either the Condition Assessment Survey or the Total Life-Cycle Cost Method.

| Deferred Maintenance as of September 30, | 2004 | 2003 |
|---|---|---|
| General PP&E | $ 1,649 | $ 1,433 |
| Heritage Assets | 34 | 30 |
| **Total Deferred Maintenance** | $ 1,683 | $ 1,463 |

**Balances with Other Federal Entities**

**Intragovernmental Assets as of September 30, 2004**

| Trading Partners | Fund Balance with Treasury | Investments | Accounts Receivable | Other Assets |
|---|---|---|---|---|
| Treasury | $ 16,741 | $ 13,643 | $ - | $ 8 |
| DoD - Defense Agencies | | | 64 | |
| All Other | | | 68 | 114 |
| **Total Intragovernmental Assets** | $ 16,741 | $ 13,643 | $ 132 | $ 122 |

**Intragovernmental Liabilities as of September 30, 2004**

| Trading Partners | Accounts Payable | Debt | Other |
|---|---|---|---|
| Treasury | $ 46 | $ 2,618 | $ 1,311 |
| Other | 26 | | 823 |
| **Total Intragovernmental Liabilities** | $ 72 | $ 2,618 | $ 2,134 |

**Intragovernmental Earned Revenue and Related Cost (trade activity)**
**Year Ended September 30, 2004**

| Trading Partner | Earned Revenue |
|---|---|
| DoD - Defense Agencies | $ 830 |
| Health & Human Services | 132 |
| Justice | 101 |
| All Other | 676 |
| **Total Earned Revenue** | $ 1,739 |
| **Related Cost** | $ 1,551 |

**Intragovernmental Non-Exchange Revenue**
**Year Ended September 30, 2004**

| Trading Partner | Transfers-Out |
|---|---|
| Treasury | $ 1,941 |

**Schedule of Budgetary Activity**
**Year Ended September 30, 2004**

| | Total Budgetary Resources | Obligations Incurred | Spending Authority from Offsetting Collections and Adjustments | Obligated Balance net, Oct 1 | Obligated Balance net, Sept. 30 | Total Outlays |
|---|---|---|---|---|---|---|
| **VHA** | | | | | | |
| 0152 Medical Admin | 4,123 | 4,086 | 23 | 13 | 656 | 3,420 |
| 0160 Medical Care | 22,855 | 21,112 | 282 | 3,351 | 2,311 | 21,870 |
| 0161 Medical & Prosthetic Research | 501 | 434 | 41 | 119 | 123 | 389 |
| 0162 Medical Facilities | 3,201 | 3,142 | 11 | - | 658 | 2,473 |
| All Other | 1,268 | 907 | 289 | 636 | 827 | 427 |
| **Total** | 31,948 | 29,681 | 646 | 4,119 | 4,575 | 28,579 |
| **VBA** | | | | | | |
| 0102 Compensation, Pension, & Burial Benefits | 31,020 | 29,959 | - | 2,267 | 2,441 | 29,785 |
| 0137 Readjustment Benefits | 3,212 | 2,965 | 272 | 72 | 82 | 2,683 |
| 4025 Housing Credit Liquidating | 60 | 32 | 100 | (23) | 2 | (93) |
| 4127 Direct Loan Financing | 773 | 571 | 781 | 78 | 71 | (203) |
| 4129 Guaranteed Loan Financing | 7,524 | 3,330 | 1,811 | 20 | 22 | 1,517 |
| 8132 National Service Life Insurance Fund | 11,093 | 1,603 | 365 | 1,461 | 1,468 | 1,231 |
| All Other | 4,039 | 1,847 | 1,249 | 399 | 418 | 579 |
| **Total** | 57,721 | 40,307 | 4,578 | 4,274 | 4,504 | 35,499 |
| **NCA** | | | | | | |
| 0129 National Cemetery Adm. | 149 | 144 | - | 25 | 33 | 136 |
| All Other | 38 | 34 | - | 36 | 31 | 39 |
| **Total** | 187 | 178 | - | 61 | 64 | 175 |
| **ADM** | | | | | | |
| 0151 General Operating Expenses | 1,945 | 1,851 | 530 | 244 | 308 | 1,257 |
| All Other | 2,763 | 2,404 | 2,145 | 323 | 676 | (94) |
| **Total** | 4,708 | 4,255 | 2,675 | 567 | 984 | 1,163 |
| **Total of all Business Lines** | 94,564 | 74,421 | 7,899 | 9,021 | 10,127 | 65,416 |

**Segment Information**

| Condensed Balance Sheet as of September 30 | Supply Fund 2004 | Supply Fund 2003 | Enterprise Fund 2004 | Enterprise Fund 2003 |
|---|---|---|---|---|
| **Assets** | | | | |
| Fund Balance with Treasury | $ 921 | $ 775 | $ 96 | $ 90 |
| Accounts Receivable, Net | 133 | 220 | 28 | 28 |
| General Property, Plant and Equipment | 4 | 5 | 22 | 24 |
| Other Assets Including Inventory | 27 | 25 | 6 | 8 |
| **Total Assets** | $ 1,085 | $ 1,025 | $ 152 | $ 150 |
| **Liabilities and Net Position** | | | | |
| Accounts Payable | $ 67 | $ 49 | $ 4 | $ 8 |
| Deferred Revenues | 338 | 438 | - | - |
| Other Liabilities | 524 | 380 | 57 | 34 |
| **Total Liabilities** | 929 | 867 | 61 | 42 |
| Cumulative Results of Operations | 156 | 158 | 91 | 108 |
| **Total Liabilities and Net Position** | $ 1,085 | $ 1,025 | $ 152 | $ 150 |
| **Condensed Net Cost Information** | | | | |
| **Total Program Costs** | $ 1,829 | $ 1,375 | $ 230 | $ 188 |
| **Earned Revenues** | | | | |
| Intra-Departmental | (573) | (448) | (143) | (185) |
| Other Federal Entities | (1,225) | (911) | (66) | (29) |
| Non-Federal | (27) | (36) | - | - |
| **Total Earned Revenues** | $ (1,825) | $ (1,395) | $ (209) | $ (214) |
| **Net Program Costs** | $ 4 | $ (20) | $ 21 | $ (26) |

## 2. Enterprise Fund Services

VA was approved by OMB in May 1996 as one of six pilot franchise fund agencies operating within the Executive Branch of Government. VA's Franchise Fund was established as a revolving fund and began operations in FY 1997. By law, the business lines within the Fund can only sell to Federal entities on a fee-for-service basis.

The VA Franchise Fund supports VA's mission by supplying common administrative services to both VA and other Federal entities at competitive prices. Most of the Fund's customers are within VA; business from VA customers accounted for 68.55 percent of FY 2004 revenue. VHA is the largest customer for the following VA Enterprise Centers: Austin Automation Center, Financial Services Center, Law Enforcement Training Center, Security and Investigations Center and VA Records Center and Vault. VBA is the largest customer for the Debt Management Center.

The Fund accounts for its funds in six lines of business (VA Enterprise Centers) and one administrative organization. A brief description of each center is listed below:

**Austin Automation Center (AAC)** - Located in Austin, Texas, the AAC provides comprehensive e-government solutions to match the critical needs of VA and other Federal agency customers, from managing data to automating business processes. The AAC supports over 100 customer applications that provide mission-critical data for financial management, payroll, human resources, logistics, medical records, eligibility benefits, and supply functions. In addition, the AAC offers a full complement of technical solutions (information technology system hosting, application management, information assurance, customer business continuity, configuration management, data conversion and data interfacing, and acquisition services) to best meet customers' varied project needs.

**Debt Management Center (DMC)** - Located in St. Paul, Minnesota, the DMC is a centralized facility that provides direct collection of delinquent consumer debt owed to VA. The DMC also provides administrative support for a local Cooperative Administrative Support Unit.

**Financial Services Center (FSC)** - Located in Austin, Texas, the FSC provides VA and other government agencies with a full range of financial services, which include financial reports, accounting, invoice payments, credit card payments, medical claims payments, vendor file maintenance, discount subsistence purchases, payroll processing, travel payment processing, electronic commerce/electronic data interchange, automated document management, audit recovery, data matching and reconciliation, and consulting.

**Law Enforcement Training Center (LETC)** - Located in Little Rock, Arkansas, the LETC provides special training for police officers working in a health care or service-oriented environment. Emphasizing training in medical center patient situations, the LETC is available to approximately 2,400 law enforcement personnel working at VHA health care facilities and to Federal law enforcement professionals at other Federal agencies.

**VA Records Center and Vault (VA RC&V)** - Located in a subterranean, climate-controlled, secure facility in the Midwest, the VA RC&V provides records storage, protection, and retrieval services for official Federal records. The facility has been certified by the National Archives and Records Administration to operate as an agency records center. The VA RC&V can store records in any type of medium. This includes off-site storage of systems backups, as well as general, vital, and classified records on paper, film, and electronic media.

**Security and Investigations Center (SIC)** - Located in Washington, DC, the SIC provides quality and timely background investigations and adjudications for employees and contractors in sensitive positions for all VA entities nationwide. The SIC also issues and manages employee identification badges and provides fingerprint processing for VA employees and other Federal customers in the Washington, DC area.

**Enterprise Fund Office (EFO)** - The VA Enterprise Centers are supported by the EFO, which is responsible for overall fund operations including administering the financial resources of the Fund, coordinating all business activities, and serving as the liaison between the Enterprise Centers, their customers, and the Franchise Fund Board of Directors.

The Enterprise Fund allows VA and other government agency customers to conserve their budgetary resources through new innovative methods and/or efficiencies of scale with the same or lower unit costs, while improving the quality of services provided. As the Fund successfully expands its services to other Federal agencies, those agencies will derive similar benefits.

For more information, visit the VA Enterprise Centers online at www.va.gov/fund.

## 3. Supply Fund Services

Supply Fund functions include contracting for medical supplies, equipment, and services; stocking, repairing, and distributing supplies, medical equipment, and devices; providing forms, publications, and a full range of printing and reproduction services; training VA medical acquisition, supply, processing, and distribution personnel; and increasing small and disadvantaged business participation in VA contracts. The two largest customers for the Supply Fund are VA and DoD, but the Fund also has significant sales to other Federal agencies including the Department of Health and Human Services.

# Major Management Challenges

Identified by VA Office of Inspector General

# Major Management Challenges

Identified by the Government Accountability Office

# Major Management Challenges

As we strive to provide the highest quality benefits and services to our Nation's veterans, we realize we have many program and management challenges to overcome. Following are descriptions of our major challenges as identified by the VA Office of Inspector General (OIG) and the Government Accountability Office (GAO) along with the VA program's response. *(In this report, years are fiscal years unless stated otherwise.)*

## *Challenges Identified by VA Office of Inspector General*

The VA OIG has implemented a strategic planning process designed to identify and address the key issues facing VA. These issues, which include health care delivery, benefits processing, procurement, financial management, and information management, are presented in the OIG Strategic Plan 2001-2006. The following summarizes the most serious management problems facing VA in each of these areas, and assesses the Department's progress in addressing them. While these issues guide our oversight efforts, we continually reassess our goals and objectives to ensure that our focus remains relevant, timely, and responsive to changing priorities. *(On these pages, the words "we" and "our" refer to the OIG.)*

## *OIG1. Health Care Delivery*

VA reports that the number of veterans using the Department's health care system has risen dramatically, increasing from 2.9 million in 1995 to nearly 4.5 million in 2003. This increase has significantly challenged the Department's capacity to treat these veterans. In addition, the Veterans Health Administration (VHA) restructured health care delivery to emphasize managed care through an extended network of community-based outpatient clinics and ambulatory care settings. This transition raised new issues concerning the utilization of facilities and the allocation of resources. Opening VA health care to nonservice-connected veterans created an unprecedented increase in demand for VHA, leading to inordinately high waiting times and insufficient resources. Providing safe, high-quality medical care, reasonable waiting times, and accessibility to care are just some of the fundamental delivery of service issues that present challenges on a continuous basis.

The political leadership in both the legislative and executive branches should confront this reality and codify the long-term health care benefits that will be provided to our Nation's veterans, and fund them accordingly. VHA needs to continue the trend of increasing revenue growth from non-appropriated sources and pursue every avenue possible to maximize the economy and efficiency of its programs and activities. The following issues present major challenges and opportunities to do just that.

### 1A. OIG Issue - Part-Time Physician Time and Attendance

Our April 2003 report, *Audit of VHA's Part-Time Physician Time and Attendance* (Report No. 02-01339-85), identified VA physicians who were not present during their scheduled tours of duty, were not providing VA the services obligated by their employment agreement, or were "moonlighting" on VA time. Currently 11 of 12 recommendations on management controls remain unimplemented. We concluded that VA medical center (VAMC) managers did not ensure that part-time physicians met employment obligations, and that VAMCs did not perform workload analyses to determine the number of full-time equivalent employees needed or evaluate hiring alternatives (such as part-time, full-time, intermittent, or fee-basis).

Additionally, our Combined Assessment Program (CAP)[1] reviews assessed physician time and attendance issues at 54 facilities and identified deficiencies at 28.

Our February 2004 report, *Follow-up of the VHA's Part-Time Physician Time and Attendance* (Report No. 03-02520-85), found that at 15 medical facilities where we conducted unannounced follow-ups 8 percent of the part-time physicians scheduled for duty were not on duty, approved leave, or authorized absence and were potentially not meeting their VA employment obligations. All six recommendations remain unimplemented. We concluded that VHA's implementation of management controls continues to need improvement to ensure that part-time physicians meet their employment obligations. OIG CAP reviews conducted at VHA facilities in FY 2004 also continue to identify systemic weaknesses associated with controls over part-time physicians' time and attendance and show that some part-time physicians are not fully meeting their employment obligations.

**VA's Program Response:** VHA now conducts a monthly survey of all sites to determine whether facilities are monitoring time and attendance of part-time physicians. VHA uses a statistically generated program to select a random sample of the part-time physicians at each facility. The facilities are asked to verify the presence of these physicians either through electronic means or by direct physical verification. If any discrepancies are identified, appropriate actions are taken locally. In addition, the issue of part-time physician time and attendance is discussed at the quarterly performance reviews with the network directors. VA has also developed revised policies and procedures that will enable it to more easily meet patient care requirements and schedule physicians in a manner that is more consistent with their practice patterns. The policies and procedures are being paired with modifications to VA's electronic time and attendance (ETA) system. Anticipated completion date for the modifications to VA's ETA is May 2005.

## 1B. OIG Issue - Staffing Guidelines

The lack of staffing standards for physicians and nurses as required by Public Law 107-135 continues to impair VHA's ability to adequately manage personnel resources. Congress passed Public Law 107-135, *Department of Veterans Affairs Health Care Program Enhancement Act of 2001*, on January 23, 2002, which requires the Secretary, in consultation with the Under Secretary for Health, to establish a policy to ensure that staffing for physicians and nurses at VA medical facilities is adequate to provide veterans appropriate, high-quality care and services. VHA recently issued a policy that provides standards for physicians and support staff in primary care that is tied to the number of veterans receiving care. The OIG believes VHA needs to incorporate this requirement into performance plans and hold managers accountable for implementing the policy. VHA is further behind in its process of establishing staffing models for subspecialty medical physicians. Currently, all five recommendations relating to physician staffing remain unimplemented from our April 2003 report, *Audit of VHA's Part-Time Physician Time and Attendance* (Report No. 02-01339-85).

There is and will continue to be a national nursing shortage. The absence of nurse staffing guidelines impedes hospital management's ability to ensure that the nursing mix on a ward is adequate to meet the needs of the patient population. Recent legislative changes will help in recruitment and retainment of nursing staff, but staffing guidelines are still needed to ensure quality of patient care. In August 2004, we issued the report, *Healthcare Inspection, Evaluation of Nurse Staffing in VHA Facilities* (Report Number 03-00079-183) that addressed this subject.

[1] Through this program, auditors, investigators, and health care inspectors collaborate to assess key operations and programs at VA health care systems and VA regional offices on a cyclical basis.

**VA's Program Response:** A draft directive on staffing guidelines for VHA health care providers, including nurses, is targeted for completion by the end of December 2004. On July 6, 2004, VHA Directive 2004-031, "Guidance on Primary Care Panel Size," was issued and distributed to the field for implementation. It requires VHA primary care practices to establish maximum panel sizes for all primary care providers. VA continues to work on developing a productivity model for specialty care providers. It is expected to be completed by the end of 2005.

## 1C. OIG Issue - Quality Management (QM)

Although VHA managers are vigorously addressing the Department's QM procedures in an effort to strengthen patients' confidence, issues remain. OIG and GAO reviews in the 1990s found that managers needed to improve efforts for collecting, trending, and analyzing clinical data. During fiscal year 2003, we conducted QM reviews at 31 VA health care facilities during CAP reviews. All of the facilities we reviewed during 2003 had established comprehensive QM programs and performed ongoing reviews and analyses of mandatory areas. We noted improvements in several areas compared with our 2002 review. While we found improvements in QM programs, our July 2004 summary report, *Healthcare Inspection, Evaluation of Quality Management in VHA Facilities Fiscal Year 2003* (Report No. 03-00312-169), found that facility managers need to strengthen QM programs through increased attention to: the disclosure of adverse events, the utilization management program, the patient complaints program, and medical record documentation reviews. Senior managers need to strengthen designated employees' data analysis skills, benchmarking, and corrective action identification, implementation, and evaluation across all QM monitors.

Because of continued weaknesses in QM data management, particularly the implementation and evaluation of corrective actions, facility senior managers need to clearly state their expectations to all managers, program coordinators, and committee chairpersons who are responsible for QM monitors that corrective actions must be evaluated until resolution is achieved. To provide reasonable assurance that its facilities are thoroughly addressing quality of care and patient safety issues, VHA needs a stronger system for corrective action implementation and evaluation.

**VA's Program Response:** VHA has convened a quality management workgroup, consisting of six subcommittees: 1) Disclosure of Adverse Events, 2) Utilization Management, 3) Patient Complaints, 4) Joint Commission on Accreditation of Healthcare Organizations Medical Record Review Requirements, 5) Data Management, and 6) Quality Improvement. The groups fielded a Web-based survey to assess current field activities in each of these areas on October 22, 2004. The survey will be used to conduct a gap analysis and prepare preliminary recommendations on gaps, addressing gaps, and monitoring implementation and progress in each of the subcommittee areas for the Deputy Undersecretaries. A report of preliminary recommendations in each of these areas will be delivered to the Deputy Undersecretaries for Health and of Operations and Management by the end of calendar year 2004. Further work of these groups will be dependent on these early findings and the recommendations of VHA leadership. Some will become ongoing committees while others may be time-limited once the recommendations are reviewed.

## 1D. OIG Issue - Long-Term Health Care

VHA established a number of programs to provide long-term health care to aging veterans, but the OIG found that serious challenges continue to exist. For example, in 2003 we completed reviews of VHA's Community Nursing Home (CNH) Program and Homemaker/Home Health Aide (H/HHA) Program, and in 2004 we completed a review of VHA's Community Residential Care (CRC) Program. We identified several issues warranting VHA's attention.

While VHA has contracted with CNHs to provide care for aging veterans, it has taken years to implement standardized monitoring/inspection procedures, as noted in our December 2002 report, *Healthcare Inspection - Evaluation of VHA's Contract Community Nursing Home Program* (Report No. 02-00972-44). This has caused VA facilities to be inconsistent in overseeing the care and service provided to veterans residing in community facilities. We made recommendations to further clarify and strengthen the VHA CNH oversight process and to reduce the risk of veterans in CNHs from adverse incidents. VHA issued a new CNH handbook; however, the following actions remain to be completed in order to close all the recommendations: finalize new performance indicators that show nurses and social workers are visiting veterans at the recommended frequency and gathering the recommended information, finalize the Web site and schedule audio training broadcasts, complete guidance on Web site links and special broadcasts related to new criteria to exclude CNH homes from the program when involved with neglect and abuse, and finalize efforts on how VHA and Veterans Benefits Administration (VBA) employees can complement each other and share information.

We found VHA's H/HHA program also needed improvements. We issued a summary evaluation in December 2003, *Healthcare Inspection - Evaluation of VHA Homemaker and Home Health Aide Program* (Report No. 02-00124-48). As part of the OIG's CAP reviews, we inspected the program at 17 VA medical facilities. We found that 14 percent of the patients receiving program services in our sample did not meet clinical eligibility requirements. Two OIG recommendations remain open.

We also found VHA's CRC program needed improvement. We issued a report in May 2004, *Healthcare Inspection - VHA's Community Residential Care (CRC) Program* (Report No. 03-00391-138). We found VAMC inspection teams did not consistently inspect their CRC homes; VAMC clinicians did not always conduct interdisciplinary assessments, advise CRC caregivers about patients' conditions or special needs, conduct monthly visits as required, and ensure caregivers received appropriate training. Also, VAMC clinicians and VA regional office (VARO) fiduciary activity supervisors did not meet at least once a year to discuss services to incompetent veterans. We made 11 recommendations for improvement.

**VA's Program Response:** The VBA Fiduciary Program has had a long-standing requirement to establish annual visits with each VAMC in the Fiduciary Activity's jurisdiction for the purpose of discussing cross-cutting program issues and cases of mutual concern. The VA Central Office (VACO) Fiduciary Program staff reminded all Fiduciary Program managers nationwide of this requirement in an e-mail message on June 20, 2002. Additionally, this was extensively discussed in the quarterly Fiduciary Program Teleconference on July 18, 2002, and was an agenda item on the Veterans Service Center Manager call on July 19, 2002.

Beginning October 2002, compliance with this requirement has been monitored during routine site visits, and VBA is satisfied that such meetings are taking place. In December 2003, VACO Fiduciary Program staff met with VHA's Director of Long-Term Care Contracts to discuss the OIG findings and any cooperative actions necessary to fully implement the recommendations. As a result of that meeting, the director undertook a project to update the VHA handbook on VHA community nursing home oversight procedures.

The revised VHA Handbook 1143.2, "Community Nursing Home (CNH) Oversight," was published on June 4, 2004. This document implemented the majority of the OIG recommendations. Work on the education Web site and associated training material is ongoing, and the Web site is scheduled for release in December 2004. VHA established a monitor for tracking efforts by VAMCs and regional offices to identify cases of neglect and abuse. Both VBA and VHA handbooks now mandate annual meetings for regional office and medical center staff. VA is in the process of identifying points of contact in both administrations. VHA is planning to highlight some best practices this coming year on the CNH Web site and in a joint audio conference. VHA's efforts focus on the quality of care delivered by CNHs, as measured by Centers for Medicaid and Medicare Service (CMS) quality profiles. VHA has clearly stated its intention to measure CNH quality in this manner.

VHA developed a Homemaker/Home Health Aide (H/HHA) program monitor to measure improvements in meeting the target population for this program, thus ensuring better utilization of resources for those veterans most in need of H/HHA services. VHA's handbook, "Home Health and Hospice Care Reimbursement Policy," which establishes benchmark rates, was published August 16, 2004.
VHA concurred with the 11 OIG recommendations on the Community Residential Care (CRC) Program. An action plan has been developed and a process to track the implementation of the recommendations has been established.

## 1E. OIG Issue - Security and Safety

On March 19, 2002, the OIG issued 16 recommendations to improve overall security, inventory, and internal controls over biological, chemical, or radioactive agents at VHA facilities. We performed this review at the request of the VA Secretary in October 2001 following the September 11, 2001, terrorist attacks and the anthrax infiltration in the U.S. Postal System.

In the report, *Review of Security and Inventory Controls over Selected Biological, Chemical and Radioactive Agents Owned by or Controlled at Department of Veterans Affairs Facilities* (Report No. 02-00266-76), we identified that security and physical access controls were needed in research and clinical laboratories and other areas in which high risk or sensitive materials may be used or stored, or where those materials were actually in use (e.g., biological agents [bioagents], chemicals, gases, and certain radioactive materials). We found inventories of these types of sensitive materials were often incomplete or inadequate. While most facilities we visited had complied with requirements for disaster planning and preparedness, many had not updated these plans to include considerations for terrorist threats or actions. We also found inadequacies in background screening and assurance procedures for employees and contractors allowed to access sensitive areas.

Most of the report's recommendations were made to the Under Secretary for Health; however, several recommendations required joint efforts on the part of VHA and the Office of Security and Law Enforcement. Recently, the Office of Security and Law Enforcement completed its actions by revising two security publications cited in the OIG report. Although numerous VHA actions have been completed, such as the newly issued research handbook and clinical handbook, 15 of the 16 report recommendations remain open.

We will not close these recommendations until laboratory security upgrades have been made, training is developed and provided to all applicable employees, and VAMC directors certify implementation of directives and security requirements. The purpose of the certification requirement is to document compliance with the directives and provide assurance that the intent of our recommendations to address all the security and control vulnerabilities presented in our report have been addressed and corrected at each facility.

**VA's Program Response:** Significant progress has been made on all of the OIG recommendations identified in Report Number 02-00266-76. VHA Handbook 1106.2, "Pathology and Laboratory Medicine Service Bio-security and Bio-safety," was published in May 2004. This handbook provides general security and additional safety procedures for clinical laboratories in the possession, handling, and shipping of biological materials identified as potential agents of terrorism within VA facilities. The Office of Research and Development also issued VHA Handbook 1200.6, "Control of Hazardous Agents in Research Laboratories," in June 2004 that further addresses the OIG recommendations.

The OIG will not close the recommendation on laboratory security upgrades until all eligible VA facilities have received the equipment for which the Office of Research and Development (ORD) grants funding. ORD initiated a program to spend more than $2 million to upgrade laboratory security in February 2002. Of the 64 research sites identified as needing upgrades, 62 sites have been funded for a total of $2.35 million. Funding for the remaining two sites is pending and will be distributed in the first quarter of FY 2005. In addition to the above initiative, ORD has conducted infrastructure site visits at 40 sites.

The OIG will not close the recommendation on training until ORD develops and implements a program of instruction for laboratory security. Each facility is currently developing training in all aspects of responding to intrusions and/or terrorist events. ORD is currently developing a Web-based educational program that outlines security training requirements that will be in operation by December 2004 and available through the Intranet in late January 2005. A VA-specific training program is being developed that will reflect requirements that are found in the new directive on control of hazardous agents in research laboratories. Since 2002, ORD has included sessions on research laboratory security in two national meetings and works with individual facilities as needed.

The OIG mandated that VAMC directors certify implementation of directives and security requirements before the OIG will close these recommendations. VHA will submit a consolidated certificate to the OIG by December 31, 2004.

## 1F. OIG Issue - Management of Violent Patients

While our May 2004 report, *Healthcare Inspection, Healthcare Program Evaluation VHA's Management of Violent Patients* (Report No. 02-01747-139), found opportunities for improvement in the management of violent patient events at the facilities visited, we also found that several components for successful violence prevention programs were in place. Nevertheless, employees made suggestions that would enhance security in their work area, some of which VHA managers should consider. Several recommendations were made for improvement.

**VA's Program Response:** VHA has implemented a network director performance indicator regarding the implementation of interdisciplinary teams at each facility. The expected revisions to existing automated reporting systems are currently with the Office of Information and are expected to be implemented in FY 2005. The establishment of interdisciplinary Disruptive Behavior Committees (DBC) has been verified at all facilities. VHA's Employee Educational System (EES) hosted two system-wide series of conference calls on patient record flagging, one on the information technology/application implementation, and the other on threat assessment and management strategies. A Patient Record Flagging summit was held in early September 2004. A data call to collect information on DBC performance was issued at the end of FY 2004.

## *OIG2. BENEFITS PROCESSING*

VBA has made progress in veterans benefits processing in recent years, but significant challenges remain in terms of timeliness and accuracy. Because of the total dollar value of claims, the volume of transactions, the complexity of the criteria used to compute benefits payments, and the number of erroneous and improper payments already identified, we consider these issues high risk areas and major management challenges for VBA. VA must report erroneous[2] and improper[3] payments on four of its major programs[4] in its annual budget submissions and the Performance and Accountability Report beginning in 2004. We believe VA needs to be more aggressive in identifying and eliminating erroneous and improper payments to comply with this reporting requirement.

[2] The Office of Management and Budget defines erroneous payments as payments made that should not have been made or were made for incorrect amounts (including payments that do not necessarily involve cash disbursements).

[3] The Improper Payments Information Act of 2002 defines improper payments as payments made that should not have been made or that were made in incorrect amounts (including overpayments and underpayments).

[4] The four programs are Compensation, Dependency and Indemnity Compensation, Pension, and Insurance.

## 2A. OIG Issue - Compensation and pension (C&P) Timeliness

As of June 26, 2004, VBA reports about 469,000 total C&P claims are pending, including about 325,000 that require rating action. VA made progress in addressing its claims processing backlog that once peaked at about 601,000 outstanding claims. Although the number of claims pending rating decisions is continuing to increase, C&P rating actions that once averaged 195 days for completion are averaging 168 days as of June 2004. The backlog of claims pending increased primarily because VBA was unable to make decisions on cases as a result of a court decision invalidating a provision that permitted VA to decide a claim prior to the expiration of the 1-year notice in the Veterans Claims Assistance Act. However, correcting legislation was signed by the President in December 2003 that states that VA may make a decision on a claim before the expiration of the 1-year notice period. VBA remains challenged to reduce the outstanding backlog and to improve the timeliness in its claims processing activities.

VA credits many of its recent improvements to the reforms recommended by the Secretary's Claims Processing Task Force, which was charged with identifying ways to expedite claims and deliver more timely benefits to veterans. In October 2001, the Task Force recommended measures to increase the efficiency and productivity of VBA operations, shrink the backlog of claims, reduce the time it takes to decide a claim, and improve the accuracy of decisions. The Task Force made 34 recommendations (20 short-term and 14 medium-term), and VBA defined 70 actions to accomplish the 34 recommendations. VBA has implemented 55 of the 70 action items. The Task Force report has helped facilitate improvements in claims processing activities.

CAP reviews performed at VAROs since 2001 found that C&P claims processing failed to achieve prescribed timeliness goals at 15 of 18 facilities. VBA still needs to address recommendations made in the CAP reviews and fully implement the Task Force recommendations.

**VA's Program Response:** VBA has had marked success in reducing the number of pending rating claims and improving the timeliness of rating-related actions. The organization reduced the pending rating inventory from a high of 432,000 claims in January 2002 to 253,000 in September 2003. The timeliness of VBA's pending inventory improved from 203 days in January 2002 to 111 days in September 2003. The average length of time to provide veterans with a decision on their claims improved from a high of 233 days in March 2002 to 156 days in September 2003. However, as noted by the OIG, court decisions interpreting the Veterans Claims Assistance Act of 2000 (VCAA) significantly affected the gains made by VBA in claims processing.

Specifically, the September 2003 decision of the U.S. Federal Circuit Court of Appeals in *PVA v. Principi* caused VBA to stay the processing of over 62,000 claims. The *PVA* decision, issued in response to a challenge to VA's regulations implementing the VCAA, held that unless VA could grant a claim for benefits, VA was required to wait 1 year before it could deny a claim in order to afford the claimant time to submit information or evidence to substantiate the claim. This, in effect, resulted in a stay of any rating action that would, in whole or in part, contain a denial of a claimed benefit.

As a result, VBA lost nearly 3 months of full production, and the volume and age of the rating inventory continually increased until Congress clarified the language of the law in a December 16, 2003, amendment, expressly allowing VA to decide claims for benefits prior to the expiration of the 1-year time period in the law during which a claimant could submit evidence on a claim. Consequently, VBA produced 64 percent fewer rating decisions in the first 3 months of FY 2004 than in the first 3 months of FY 2003 (69,316 versus 192,669). Once VA could resume normal rating production, it was faced with the prospect of addressing the backlog of claims while keeping pace with processing incoming claims. The average processing time for claims completed in January 2004 reached 189 days as we began to process the deferred claims. Timeliness of completed actions is back down to 163 days during the month of September 2004, and we continue to make progress toward the Secretary's goal. Two years ago, 35 percent of VBA's rating inventory was comprised of cases pending over 6 months. As of September 2004, that percentage has been reduced to 21 percent.

VBA has also experienced a significant increase in disability claim receipts. During FY 2004, VBA recorded a 5 percent increase in disability claims. The majority of the increased receipts were original disability claims. Specifically, our original claim receipts are up by 17 percent over last year, most likely attributable to the impact of claims filed by servicemembers returning from Operation Enduring Freedom and Operation Iraqi Freedom. Despite these challenges, VBA continues to make progress toward the high expectations set by the Secretary.

VBA continues to place an increasing emphasis on oversight and accountability through program reviews conducted by business lines, the Office of Resource Management, and the OIG. The results of these reviews are used to highlight best practices and address areas where an out-of-line situation may be occurring at more than one regional office. In addition, VBA's four area directors routinely review the results of OIG CAP reviews conducted for the regional offices in their jurisdiction and follow up to ensure corrective actions are implemented.

The Task Force made 34 recommendations (20 short-term and 14 medium-term), and VBA defined 70 action items to accomplish the 34 recommendations. To date, action has been taken on 65 of those 70 items. Fifty-five have been fully completed, and 10 are in various stages of implementation. The other five action items have been determined not to be feasible at this time.

## 2B. OIG Issue - Compensation and Pension Program's Internal Controls

In 1999, the former Under Secretary for Benefits asked the OIG for assistance to help identify internal control weaknesses that might facilitate or contribute to fraud in VBA's C&P program. In June 1999, we issued a vulnerability assessment on the management implications of employee thefts from the C&P system. We identified 18 internal control vulnerabilities.

Our July 2000 report, *Audit of the C&P Program's Internal Controls at VARO St. Petersburg, FL* (Report No. 99-00169-97), confirmed that 16 of the 18 categories of vulnerability reported in our 1999 vulnerability assessment were present at VA's largest VARO. We made 26 recommendations for improvement. Currently, 5 of the 26 recommendations are unimplemented, including controlling adjudication of employee claims, use of a third-person authorization control in the Benefits Delivery Network, and verification of continued entitlement of certain beneficiaries. Our regional office CAP reviews have identified that vulnerabilities remain in 13 of the 18 categories in the 2000 report.

**VA's Program Response:** As of September 2004, five C&P action items remain open.

The following two action items are pending the completion of VBA's Modern Award Processing application, the testing of which began in March 2004 at the VA Regional Office in Lincoln, Nebraska: (1) establish a positive control system edit keyed to employees to ensure employee claims are adjudicated at the assigned regional office and to prevent employees from adjudicating matters involving fellow employees and veterans service organizations at their home office and (2) establish a Benefits Delivery Network (BDN) system field for third-person authorization with a control preventing release of payments greater than $15,000 without the third-person authorization.

To address the action item on direct input and storage of rating decisions in the BDN, VBA released an updated version of Rating Board Automation (RBA 2000) in September 2004 containing fixes for defects impacting 100 percent utilization of RBA 2000. Upon conclusion of a 60-day validation period, VBA will determine the schedule for retirement of the old RBA application.

The last two action items related to use of employee social security numbers (SSN) as employee identification numbers in the BDN and the replacement VETSNET system. VBA is in the process of validating and documenting steps taken to use SSN as employee identification numbers and to tie VETSNET access to SSN. This will also ensure perpetual VETSNET transaction files are maintained and include a unique user identification number identifying employees associated with recorded transactions.

## 2C. OIG Issue - Fugitive Felon Program

The Veterans Education and Benefits Expansion Act of 2001 prohibits veterans who are fugitive felons, or their dependents, from receiving specified veterans benefits. The OIG has established a fugitive felon program to identify VA benefits recipients and employees who are fugitives from justice. This program is a collaborative effort involving the OIG, VBA, VHA, and VA Police Service. The program consists of conducting computerized matches between fugitive felon files of law enforcement organizations and VA benefit files. Location information is provided to the law enforcement organization responsible for serving the warrant for those veterans identified as fugitive felons. Fugitive information is subsequently provided to VA so that benefits may be suspended and recovery action for any overpayments can be initiated.

Memoranda of Understanding have been completed with the U.S. Marshals Service; Federal Bureau of Investigation National Crime Information Center (NCIC); and the States of California, New York, Tennessee, Washington, and Pennsylvania. Agreements are pending with those states that do not enter all felony warrants into the NCIC. In addition, the VA Secretary signed a directive establishing VA procedures for dealing with fugitive felons.

As of June 2004, more than 2.2 million warrant files received from law enforcement agencies have been matched to more than 11 million records contained in VA benefit system files, resulting in the identification of 32,346 matched records. The records match has resulted in 11,153 referrals to various law enforcement agencies throughout the country and has led to the apprehension of 402 fugitive felons, including the arrest of 38 VA employees. In addition, 8,299 fugitive felons identified in these matches have been referred to the Department for benefit suspension resulting in the creation of $54.5 million in overpayments and an estimated cost avoidance of over $100 million. With an estimated 1.9 million felony warrants outstanding in the United States and an estimated 2 million new felony warrants added each year, should this program be fully funded, the estimated cost avoidance is projected to reach $209.6 million per year.

Since the beginning of the program, VBA has received 3,839 referrals from the VA OIG and has used new policies and procedures to implement the benefit suspension requirements of the law. As of June 2004, VHA has received 4,465 referrals from the VA OIG. VHA used some of the initial referrals to implement a pilot program involving 10 VAMCs. VHA officials are using the results of the pilot program to help finalize a new handbook on fugitive felons. VHA plans to forward more referrals to additional VAMCs once the new handbook is finalized. Collaborative efforts must continue if we are to successfully achieve the full potential of this mandate.

**VA's Program Response:** VBA continues to work closely with the OIG in implementing the fugitive felon program. The Vocational Rehabilitation and Employment Service (VR&E) received a list of nine veteran fugitive felons and notified the appropriate regional offices with jurisdiction. VR&E is in the process of finalizing guidance to address handling of veteran fugitive felons participating in the VR&E program. During the past 2 years, the Education Service has processed a total of 97 fugitive felon referrals, creating slightly over $420,000 in debts. Since the beginning of the program, the C&P Service has received 3,572 referrals from the OIG. As a result of the fugitive felon program, actual overpayments of $20,426,509 have been identified. Loan Guaranty Service (LGY) staff attended initial meetings with the OIG to discuss how to meet the requirements of the Fugitive Felon Act. Under the current arrangement, the OIG has agreed to provide LGY with the OIG's list of fugitive felons. LGY has agreed to work with the OIG to check LGY databases against the listings to determine whether any individual on the felons list has attempted to use his/her home loan benefit. Any matches will be forwarded to the OIG for action. The Insurance Service has participated in the fugitive felon process since March 2004. The OIG provided 161 referrals of fugitive names to the Insurance Service. As a result, the Insurance Service froze the insurance accounts. The Insurance Service continues to monitor fugitive lists for signs of activity and has implemented processes to alert both the veteran and the OIG of any changes affecting the fugitive felon status.

The Office of Security and Law Enforcement has been an active collaborator with the OIG since 2002 in implementing the fugitive felon program within VA. The office was a task force member charged with the development of a VHA directive on the fugitive felon program and provided guidance and coordination to the VA police units during the VHA pilot program. Cooperative efforts with the OIG continue, including a presentation by the OIG at the VA Police Chiefs' conference in August 2004.

The VHA fugitive felony program (FFP) handbook has been finalized and will be issued by the end of the first quarter of FY 2005. The handbook will address areas identified for improvement through the VHA pilot. To address the high number of warrants that have already been satisfied, VA police will be asked to validate warrants with the issuing agency prior to any veteran being notified of his/her fugitive felon status. In addition, once the warrant is validated, the veteran will have a 60-day time frame to clear or provide proof that the warrant is satisfied before his/her health care benefits are suspended. Additionally, any veteran requiring continued care will have a transition of care plan developed prior to dis-enrollment. Upon its publication, the roll-out of the FFP to all VHA facilities will begin. The roll-out is expected to be completed by January 2005.

## 2D. OIG Issue - Incarcerated Veterans

In February 1999, the OIG published the report, *Evaluation of Benefit Payments to Incarcerated Veterans* (Report No. 9R3-B01-031). The review found that VBA officials did not implement a systematic approach to identify incarcerated veterans and adjust their benefits as required by Public Law 96-385. The evaluation included a review of 527 veterans randomly sampled from the population of veterans incarcerated in six states. Projecting the sample results nationwide, we estimated that about 13,700 incarcerated veterans had been, or will be, overpaid a total of about $100 million.

VBA has implemented the recommendations in the report. VBA reached an agreement with the Social Security Administration (SSA) to use the State Verification and Exchange System to identify claimants incarcerated in state and local facilities. VBA is now processing both a Bureau of Prisons match and SSA prison match on a monthly basis. By September 2002, over 18,500 veterans were identified who received VA benefits and were potentially incarcerated. Additional potentially incarcerated veterans are being identified at the rate of 600-700 monthly. VBA has indicated it is tracking the disposition of a 20 percent sample of the monthly SSA prison match cases. The OIG believes this case disposition sampling should continue, and we will monitor whether this sampling is adequate. VBA should set up a database for tracking the total dollar value of incarcerated overpayments, which VA is required to report annually with other erroneous payments.

**VA's Program Response:** During FY 2004, over 41,000 veterans were identified who received VA benefits and were potentially incarcerated. VBA is tracking the disposition of a 20 percent sample of the monthly SSA prison match cases. Actual FY 2003 overpayments identified from the 20 percent sample total $5,721,640. The 20 percent sample is not a random sample. They are cases with the largest potential overpayments. It is VBA's opinion that tracking 100 percent of these cases would not be cost beneficial.

In regard to the reporting requirements for erroneous payments, VBA continues to work with OMB and the Department to comply with the Improper Payments Information Act of 2002. C&P currently uses the Statistical Technical Accuracy Review (STAR) database to identify and project erroneous payments for the compensation and pension programs.

## *OIG3. PROCUREMENT*

VA faces major challenges in implementing a more efficient, effective, and coordinated acquisition program. The Department spends about $6 billion annually for pharmaceuticals, medical and surgical supplies, prosthetic devices, information technology, construction, and services. High-level management support and oversight are needed to ensure VA leverages its full buying power, maximizes the benefits of competition, and improves contract administration.

In response to an IG report issued in May 2001, the VA Secretary established a Procurement Reform Task Force. In May 2002, the Task Force recommended improvements to better leverage VA's substantial purchasing power and to improve the overall effectiveness of procurement operations. By June 2002, VA began implementing Task Force recommendations. For example, to leverage its purchasing power, VA established a contract hierarchy which mandates use of VA Federal Supply Schedule (FSS)[5] Groups 65 and 66 for procurement of health care supplies.

OIG reviews continue to identify problems with FSS contracts and blanket purchase agreements (BPAs)[6], along with procurements for health care items, scarce medical services, and construction. We also continue to identify weaknesses in the management of purchase cards and problems with inventory management, as discussed below.

### 3A. OIG Issue - Federal Supply Schedule (FSS) Contracts

In March 2004, the OIG issued the report, *Audit of VAMC Procurement of Medical, Prosthetic, and Miscellaneous Operating Supplies* (Report No. 02-01481-118). The audit found that VAMCs needed to make more effective use of the best purchasing sources. Large proportions of VAMC supply purchases were not made from the best contract/BPA source, and VAMCs paid higher prices than necessary. In addition, some networks and VAMCs established contracts that were not beneficial because they covered supply products that were available from other sources (primarily FSS contracts) at equal or lower prices. To help ensure that VAMCs purchase supplies from the best sources, the audit recommended that VHA fully implement and monitor compliance with its purchasing hierarchy.

The audit also found that significant portions of the supplies purchased by VAMCs were not covered by VA national and FSS contracts and were only available on the open market. For these open market supply purchases, VAMCs paid a wide range of prices for the same products. The audit estimated that improving VAMC purchasing practices and increasing efforts to award more national contracts for supplies would result in cost reductions of about $214 million a year. Over 5 years (the typical life of national contracts and BPAs), the potential savings would be about $1.4 billion taking into account inflation and projected increases in supply usage.

To help minimize the amount of open market purchases and better leverage VA's purchasing power, the audit recommended that VHA and the Office of Acquisition and Materiel Management increase efforts to award new national contracts and BPAs for supply products.

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5 The General Services Administration (GSA) provides Federal agencies with a simplified process for obtaining commonly used commercial supplies and services at prices associated with volume buying. GSA issues Federal Supply Schedules containing the information necessary for placing delivery orders with schedule contractors. GSA has delegated authority to VA to award and administer schedules for pharmaceuticals and medical/surgical supplies and equipment.

6 BPAs are a simplified method of filling anticipated repetitive needs for services and supplies. Contractual terms and conditions are contained in a GSA Schedule contract and do not need to be re-negotiated for each use.

**VA's Program Response:** Each VISN chief logistics officer conducted training of all VISN contracting officers and purchase card holders to ensure full understanding of the requirements of the purchasing hierarchy. The VISNs are providing advance notice of all BPAs to VA's National Acquisition Center (NAC) and the Clinical Logistics Office (CLO) for a review to determine if a multi-VISN or national BPA is available or should be awarded. This is in accordance with VHA Directive 2003-018, "Review of Blanket Purchase Agreements (BPAs) for Multi-VISN or VISN Groups." A CLO workgroup has been formed to develop a list of performance measures and best practices for field contracts and logistics personnel. The list was made available on October 30, 2004.

The Prosthetic and Sensory Aid Strategic Health Care Group (PSAS SHG) has been monitoring a total of 20 national Prosthetic Clinical Management Program (PCMP) contracts for network compliance since the end of the third quarter, FY 2004. The target is 95 percent compliance with the contracts. Of the 20 national contracts, the networks as a whole are achieving a 95 percent compliance rate on 9 of the 20 contracts. These nine national contracts were implemented in FY 2002 or FY 2003. The 11 remaining contracts where a 95 percent compliance rate was not met were implemented in the fourth quarter of FY 2003 and FY 2004. This trend indicates that facilities' transition to procuring devices off the new national PCMP contracts is a work in progress and improvement is noted quarterly. PSAS SHG continues to track and monitor network compliance with national PCMP contracts.

All VISNs have had their staff complete the Simplified Acquisition Procurement training. There is at least one individual within each VISN who has a high warrant level to procure high-ticket items such as the computerized leg.

In coordination with the VHA Chief Logistics Officer, the Office of Acquisition and Materiel Management (OA&MM) has issued a list of priorities for use of government supply sources. In light of this direction, VHA mandated purchasing hierarchy training for all field staff employees responsible for the purchase of supplies and equipment. The field chief logistics officers certified this training in April 2004.

OA&MM sales generated from medical/surgical BPAs, basic order agreements, and other national contracts increased 336 percent for the third quarter of FY 2004, as compared with the third quarter of FY 2003, minimizing the amount of local purchases. OA&MM will continue to be proactive in supporting contract hierarchy as outlined in published guidance. OA&MM will continue to work with the VHA Chief Logistics Officer to increase the use of the mandatory sources of supply.

## 3B. OIG Issue - Contracting for Health Care Services

OIG reviews have identified conflicts of interest in the request for approval of contracts, preparation of solicitations, contract negotiations, and contract administration efforts. The most frequent violations are where VA physicians, who also receive compensation from the affiliate and/or the affiliate's practice group, are involved in the contracting process as VA employees, in violation of Federal ethics laws and regulations. Violations carry both civil and criminal penalties. In several cases, in addition to being involved in multiple aspects of the procurement process, the VA physician was expected to perform services at VA for compensation under the contract. We have received opinions from the VA Designated Agency Ethics Official (DAEO) in the Office of General Counsel, as well as from regional counsel, which have determined that certain participation in the contract process by such "affiliated" physicians violated Federal law. We believe VA needs to increase awareness among physician staff of, and enforce compliance with, the requirements of VHA Handbook 1660.3, *Conflict of Interest Aspects of Contracting for Scarce Medical Services, Enhanced Use Leases, Health Care Resource Sharing, Fee Basis and Intergovernmental Personnel Art Agreements (IPAs).* Toward this end, the DAEO has added to its ethics training video a section on this issue.

Also, we continue to see that legal, technical, and preaward price reasonableness reviews are not always performed on non-competitive contract awards. Some contracts and solicitations do not contain terms and conditions that adequately protect the Department's interests. Lastly, we have found instances where VA has allowed the affiliated medical schools to dictate the terms and conditions of contracts, including the services to be provided. For example, the services of an individual in training do not qualify as a "commercial service" under the sole-source authority of title 38, United States Code, Section 8153. In another instance, because the physician expected to provide services to VA under the contract was not an employee of the affiliate, the affiliate could not meet certain contract requirements.

**VA's Program Response:** The Resources Sharing Office staff hosted 2 conferences for over 100 contracting officers and other VHA facility staff. Topics included contracting with affiliated institutions and conflict-of-interest issues. A draft directive on procuring services under sharing authority, including guidelines for price with affiliated institutions, is in the concurrence process with expected publication this fall.

The Deputy Under Secretary for Health for Operations and Management (O&M) notified network directors that O&M monitors are being modified to require certification that VHA facilities are in compliance with VHA Handbook 1660.3. This policy requires that facility directors ensure that each chief of staff and physician, clinician or allied health supervisor, or manager receive a copy of Handbook 1660.3 and the Acknowledgement Form (VA Form 10-21009 {NR}). A copy of the signed acknowledgement must be placed in the clinician's personnel folder. A workgroup has been formed to address "national clinical contract strategy" issues that have emerged from the VA Capital Asset Realignment for Enhanced Services (CARES) report. This workgroup will support the Secretary's national health care strategy. To promote the development of sound contracts, the Clinical Logistics Office is preparing guidance (to be issued in January 2005) for the field on the development of service contracts, with an emphasis on statements of work.

OA&MM has conducted acquisition business reviews and made recommendations for appropriate corrective actions, which are often the same as the OIG recommendations. OA&MM acquisition business reviews will continue to look for the problems identified by the OIG and make recommendations to correct deficiencies. In addition to the required ethics training offered by the Department, acquisition professionals have participated in OA&MM-sponsored training in conflict-of-interest issues.

The DAEO video is the principal training vehicle for the VHA managers and executives who are mandated by an ethics program regulation to have ethics training each year. These employees, including many physicians, viewed the video in calendar years 2003 and 2004. In late 2003, the Deputy Under Secretary for Health went beyond the ethics program mandate and required annual ethics training for all VHA physicians, including researchers. The video focuses on conflicts of interest affecting contracts for scarce medical services.

The DAEO has been featuring the subject matter of the handbook in each of the annual ethics videos since 2001. The DAEO staff has also emphasized the handbook guidance in training sessions at various national and regional conferences for VHA procurement and contracting officers, for staff of the sharing program, and for VHA executive candidates.

## 3C. OIG Issue - Government Purchase Card Activities

The OIG identified systemic management weaknesses in VA's oversight and use of government purchase cards. We found instances of wasteful spending (buying without regard to need or price), purchases that exceeded the cardholder's authority, and purchases that were inappropriately split to avoid competition requirements. Some cardholders did not use existing contracts, which has resulted in paying higher prices for the same items.

VA management controls over purchase card transactions need to be strengthened so that VA buying power is leveraged to the maximum extent possible and discounts are not lost. Increased visibility and oversight over procurements are needed to ensure price reasonableness so that VA procurement needs are met effectively and economically. In our April 2004 report, *Evaluation of the Department of Veterans Affairs Purchase Card Program* (Report No. 02-01481-135), we identified additional opportunities for VBA, VHA, and the Office of Management to provide greater assurance that purchase cards are used properly.

**VA's Program Response:** To rectify the systemic management weaknesses in the oversight and use of government purchase cards, VBA has finalized a new handbook that sets forth sound policy, procedures, and guidance for all participants of the purchase card program. Major emphasis in the re-write of the handbook was placed on increased management oversight, internal controls, a procedural checklist, span of control, purchasing from GSA/VA-required vendors, best pricing, and commercial vendor rebates. Additionally, the Director, Vocational Rehabilitation & Employment Service (VR&E) is addressing the "buying power" issue. Contract options are being pursued, in particular, the use of the agency Procurement of Computer Hardware and Software (PCHS) contract, using VA-negotiated pricing. Currently, VR&E has an exemption from use of the PCHS contract.

During the past 12 months, VBA has administered three VBA-wide hands-on training courses to over 150 individuals. This training addressed some of the purchase weaknesses identified by the OIG in its April 2004 purchase card program evaluation report. Additionally, VBA's Office of Resource Management Financial Operations staff performs field station on-site financial surveys, which include review of the purchase card program. VBA will continue to provide the necessary resources and oversight to ensure efficient and effective use of purchasing authorities.

The documented occurrence of fraud and misuse in VHA's purchase card program is remarkably low. A recent GAO report summarized 83 OIG reports from March 1999 through September 2003. GAO identified a total of $435,900 in fraudulent activity in this period. This represents less than 0.01 percent of VA purchase card activity over this period. VHA will continue working toward eliminating vulnerabilities to fraud and misuse.

The VHA Clinical Logistics Office has required that VISN chief logistics officers conduct training of all VISN contracting officers and purchase card holders to ensure full understanding of the requirements of the purchasing hierarchy. Each VISN has certified the completion of this training. Given the issues currently surrounding the CoreFLS roll-out, VHA is in the process of hiring a contractor to work on development of programming changes to the Integrated Funds Distribution, Control Point Activity, Accounting & Procurement Package (IFCAP) program to allow VHA to pull compliance information from its current procurement history file. The anticipated date for the expected IFCAP program changes to be developed is December 31, 2004. In the meantime, interim measures for determining compliance rely on management reviews at the field level. VHA is updating its purchase card guidance, to be issued this coming year, to address internal control weaknesses.

Among the OIG recommendations were that VA management should strengthen internal controls and provide greater oversight to ensure that VA policies and the Federal Acquisition Regulation are effectively implemented in order to prevent and detect fraudulent, improper, and questionable uses of purchase cards. Based on the OIG recommendations, the Office of Management issued Office of Finance (OF) Bulletin 04GC1.03 to include span of control criteria for approving officials, limiting the number of cardholders for which an approving official can be responsible — from a minimum of 10 to a maximum of 20. Exceeding that limit would require approval from the facility director.

The GAO conducted an audit (report number GAO-04-737, dated May 2004) entitled, *Veterans Health Administration (VHA) Purchase Cards – Internal Controls over the Purchase Card Program Need Improvement*. In response to the GAO recommendation to substitute convenience checks in lieu of the use of purchase cards, the Treasury Financial Manual reference on other small purchase methods was incorporated into OF Bulletin 04GC1.04.

## 3D. OIG Issue - Inventory Management

Since 1999, we have issued six national audits of inventory management practices for various supply categories, identifying potential cost savings of about $388.5 million. We noted potential savings ($ in millions) could be achieved in the management of the following:

| | |
|---|---|
| • Medical Supply Inventories | $ 75.6 |
| • Prosthetic Supply Inventories | $ 31.4 |
| • Pharmaceutical Inventories | $ 30.6 |
| • Engineering Supply Inventories | $168.4 |
| • Miscellaneous Supply Inventories | $ 53.7 |
| • Consolidated Mail Outpatient Pharmacy Inventories | $ 28.8 |
| Total | $388.5 |

In March 2004, we issued an *Interim Report on Patient Care and Administration Issues at VA Medical Center in Bay Pines, Florida* (Report No. 04-01371-108). Reported problems involving the unavailability of medical-surgical supplies was only one of a number of long-standing problems identified at the Medical Center that went uncorrected. Other deficiencies included inadequate inventory practices.

In August 2004, our report, *Issues at VA Medical Center Bay Pines, Florida and Procurement and Deployment of the Core Financial and Logistics System (CoreFLS)* (Report Number 04-01371-177), concluded that in spite of repeated notices by VHA of the need for an efficient inventory management program, the medical center did not fully or adequately implement VA's Generic Inventory Program (GIP) to manage inventories. Consequently, conversion of inventory data to CoreFLS failed. VA should ensure all facilities have certified the accuracy and reliability of GIP data so problems encountered at Bay Pines do not occur at other sites.

Further, CAP reviews continue to identify systemic problems with the Department's inventory management caused by inaccurate information, lack of expertise needed to use the electronic inventory management system, and non-use of the system at some supply points in medical centers. Since January 1999, we have examined supply inventory management practices during CAP reviews at 82 facilities and reported inventory management deficiencies to VHA management at 68 facilities. VA continues to face significant challenges in deploying an accurate inventory management information system, nationwide.

**VA's Program Response:** The VHA Clinical Logistics Office has created an inventory management workgroup with representatives from the field and VHA Central Office. This workgroup developed an action plan that is being used by VHA for improving inventory management practices throughout all medical centers. An initiative to fully implement VA's Generic Inventory Program (GIP) for all supply inventories excluding prosthetics, pharmaceuticals, and subsistence is nearing completion. At completion, a listing of all inventories found at VHA medical centers will be established. A monitoring system using the inventory listing will track key indices of medical center inventories. Improvements to the monitoring system are being planned to more effectively trend data, provide management reports, and provide accurate information. Implementing the GIP and monitoring key indices are two of the three factors to improve inventory management practices. The third is a renewal of a national training program. As of September 17, 2004, 78 percent of the facilities had GIP fully implemented. GIP is expected to be fully implemented VHA-wide by the end of the second quarter of FY 2005. VHA has implemented all the recommendations from the six national audits of inventory management.

Inventory management at medical centers is a local operation under the auspices of VHA management. OA&MM is responsible for overall Departmental guidance on the processes and procedures for managing inventories. The deficiencies continually cited by the OIG are largely a result of local operations failing to follow prescribed policy and practices issued by both OA&MM and VHA. Use of IFCAP/GIP was mandated several years ago by VHA Directive and Handbook 1761.2, but many facilities did not comply. A memorandum was issued by the Deputy Under Secretary for Operations and Management over a year ago reaffirming this mandate.

OA&MM assists the field in better inventory management by conducting a business review program that performs site visits to medical center logistics activities, reviewing materiel management operations and providing findings to VHA and medical center management, and conducting on-site training when possible. OA&MM is also working with the VHA Clinical Logistics Office to implement improved reporting to follow up on previously described actions.

The Office of Management reorganization re-established the position of accountable officer at each medical center. The director delegates the responsibility of the accountable officer position to an appropriate person, who is responsible for inventory management compliance and performance. This is the first time in many years that one VA official is responsible for inventory management.

## *OIG4. FINANCIAL MANAGEMENT*

Since 1999, VA has achieved unqualified audit opinions on its consolidated financial statements. Material weaknesses related to information technology security controls and implementing an integrated financial management system continue, and corrective actions to address these weaknesses are expected to take several years to complete.

Over the last few years, the OIG reported that VHA needs to: (i) strengthen procedures and controls for means testing, billings, and collections; (ii) reduce the rate of coding and billing errors; (iii) decrease the time it takes to bill for services; (iv) improve medical record documentation for billing purposes; and (v) perform reconciliations. In addition, VA reported in the past that VHA's Revenue Office believes that significant amounts of revenue have yet to be collected. While VA has addressed many of the concerns we reported over the last few years, our most recent audits continue to identify major challenges where VHA could improve debt management, financial reporting, and data validity. In addition, VA needs to correct problems we have identified in the employees workers' compensation program.

### 4A. OIG Issue - Financial Management and Reporting

VA program, financial management, and audit staffs perform certain manual compilations and labor-intensive processes in order to attain auditable consolidated financial statements. These manual compilations and processes should be automated and performed by VA's financial management system. In the meantime, we consider the risk of materially misstating financial information as high.

For the past few years, VA has responded that its new integrated financial management systems under development, CoreFLS, would resolve many OIG concerns. VA implemented CoreFLS at three test sites in October 2003, with implementation at further sites to be phased in, and full implementation scheduled for March 2006. However, problems occurred with data conversion, training, testing, segregation of duties, and access controls at the VHA test site, causing further deployment to be delayed. These issues are included in our March 2004 interim report on patient care and administrative issues at VAMC Bay Pines, and in our August 2004 report on issues at VAMC Bay Pines and procurement and deployment of CoreFLS.

**VA's Program Response:** In 1997, the financial statement auditors identified the lack of integrated financial management systems as a noncompliance under the Federal Financial Management Improvement Act (FFMIA). In 2000, the auditors elevated this noncompliance to a material weakness. The Department continues to face challenges in building and maintaining financial management systems that comply with Federal requirements. Until recently, the Department intended to replace the current financial system with CoreFLS. During the testing phase of the CoreFLS project, problems occurred with data conversion, training, testing, segregation of duties, and access controls. As a result, VA is reevaluating the current plans for CoreFLS. To address the material weakness, task groups will investigate the feasibility of developing tools to support the effective and efficient preparation of financial statements to eliminate significant manual workarounds, improve interfaces between legacy systems and VA's core accounting system (Financial Management System), enhance data consistency between the core accounting and subsidiary systems, and automate reconciliation processes.

VHA concurs with the finding that the Department lacks adequate automation in its financial reporting and that current processes require excessive manual intervention. This is labor intensive and therefore inefficient, and it increases the potential for error. Recognizing the unanticipated challenges in developing and implementing CoreFLS, VHA cannot confidently forecast when these reporting concerns will be effectively addressed.

## 4B. OIG Issue - Data Validity

The Government Performance and Results Act (GPRA) requires agencies to develop measurable performance goals and report results against those goals. Successful implementation requires that information be accurate and complete. VA has made progress in implementing GPRA, but additional improvement is needed to ensure that stakeholders have useful and accurate performance data. In 1997, we initiated a series of audits assessing the quality of data used to compute the Department's key performance measures. The eight audits completed to date validated the underlying data in only two of the nine key measures reviewed. While VA has corrected the deficiencies cited in our reports involving the 7 measures that had validity problems, we are concerned that the remaining 17 key performance measures identified in the 2003 Performance and Accountability Report that have not been reviewed may have similar problems. Until the remaining 17 measures are reviewed, this issue will remain a major management challenge. VA staff should do a thorough review of the remaining measures and provide the OIG assurance that data validity problems do not exist or have been corrected.

**VA's Program Response:** Data validity can be viewed in a larger context than the reporting of performance goals. Valid data on the number of veterans and their characteristics are important for placing VA performance goals into a larger context. Such data are critical to making forecasts of future utilization of VA resources as well as evaluating the propriety of current resource allocations. The forecasts in turn are important for budgeting, decision-making, strategic planning, and liability calculations. Because of the nature of the veteran population, VA cannot ascertain exact historical values. Thus, historical data must be estimated.

The Office of the Actuary (OACT) is charged with making the official estimates and forecasts of the number of veterans and their characteristics. OACT regularly updates its estimate of the past and forecast of the future with new data and improved modeling, while providing expanded information. The latest revision, "VetPop2001Adj," was adjusted to match public summary data from Census 2000 and was distributed in the second quarter of FY 2003. OACT is currently finalizing a new revision, "Veterans Actuarial Model 3 (VAM3)." It should be available by the end of CY 2004. An independent validation of the OACT model is being initiated.

The Office of Policy, Planning, and Preparedness' Data Management and Analysis Service provides veteran data to members of the general public as well as various organizations within VA. These data are obtained through an array of both internal sources (Office of the Actuary, VHA, VBA, and NCA) and external sources, such as the U.S. Census Bureau and the Department of Defense. In order to ensure that the data are accurate and consistent with previously released figures, the Data Management and Analysis Service validates the data through various methods.

VHA recognizes that additional progress needs to be made in this area and continues to take steps to improve data quality. Regional "data management and analysis" training programs were completed in the fourth quarter of FY 2004. These programs focused on: data collection, data management, data analysis for decision-making, data display, benchmarking, and national VA data access. There were approximately two quality managers from each VA facility who participated in the 2-day program and who are now available to support data quality issues at their respective medical centers.

VBA's Office of Performance Analysis and Integrity conducts data validation studies to ensure the integrity of VBA's performance data and improve the value and quality of such data. This office also maintains a corporate Data Warehouse and an Operational Data Store that facilitate the ability to have reliable, timely, and accurate data.

During FY 2004, VBA conducted validation reviews on two of its nine key measures contained in the Performance and Accountability Report. These included the review of Loan Guaranty's Foreclosure Avoidance Through Servicing ratio and VR&E's Rehabilitation Rate measure. The Office of Performance Analysis and Integrity plans to continue validation reviews in 2005.

NCA continues efforts to ensure that stakeholders have useful and accurate performance data. NCA has initiated the Organizational Assessment and Improvement Program to identify and prioritize improvement opportunities and to enhance program accountability by providing managers and staff at all levels with one NCA "scorecard." In 2004, assessment teams drawn from national cemeteries, Memorial Service Network offices, and NCA Central Office began conducting site visits to all national cemeteries on a rotating basis to validate performance reporting.

For further information on the Department's efforts to improve its data quality, see the Assessment of Data Quality section on page 120.

## 4C. OIG Issue - Workers' Compensation Program (WCP)

VA continues to be at risk for significant WCP abuse, fraud, and unnecessary costs because of inadequate case management and fraud detection. Prior OIG audit[7] recommendations to enhance the Department's case management and fraud detection efforts and to avoid inappropriate dual benefit payments have not been fully implemented.

Reducing the risk of abuse, fraud, and unnecessary costs is important due to the significance of the Department's WCP costs. Since 1998, Department costs have totaled $876 million. In 2003, costs totaled $157 million. Our audit findings show that WCP costs could be significantly lower if prior OIG audit recommended case management improvements were fully implemented.

Our August 2004 report, *Follow-Up Audit of Department of Veterans Affairs Workers' Compensation Program Cost* (Report No. 02-03056-182), found that ineffective case management and program fraud results in potential unnecessary/inappropriate costs to the Department totaling $43 million annually. These costs represent significant potential lifetime[8] compensation payments to claimants totaling $696 million. Additionally, an estimated $113 million in avoidable past compensation payments were made that are not recoverable.

Given the continued risk of program abuse, fraud, and unnecessary costs, we recommend that the Assistant Secretary for Management continue to designate the WCP as an internal high priority area with increased program monitoring and oversight. This should include

[7] Report No. 8D2-G01-67, "Audit of VA's Worker's Compensation Program Costs," dated 7/1/98 and Report No. 99-00046-16, "Audit of High Risk Areas in VHA Workers' Compensation Program," dated 12/21/98.

[8] Lifetime estimates were calculated using the VBA life expectancy table for net worth determinations contained in VBA Manual M21-1, Part IV, Chapter 16, Addendum B. The annual dollar impact was multiplied by the number of years of life expectancy. The estimates did not include future increases in WCP benefits.

preparation of an action plan and timeline to correct this program weakness. The WCP requires priority attention to address significant case management deficiencies, program fraud, and future program costs. The Department faces a significant liability for future compensation payments that is estimated at $1.9 billion. The Department's decentralized approach to administration is not effective. There is a lack of effective case management and fraud detection Department-wide and VA needs to establish a more coordinated approach to administration and implement necessary case management improvements. We recommend that this effort be directed by the Office of Human Resources and Administration, which has overall Department responsibility for the program.

**VA's Program Response:** VA generally concurs with the OIG findings and recommendations presented in the OIG report. In response to the report, VA workers' compensation management is now being monitored by the Deputy Secretary at his monthly performance review meetings. The Deputy Secretary has also directed the Acting Assistant Secretary for Human Resources and Administration and the Acting Under Secretary for Health to work together to develop a plan for addressing the OIG recommendations. The Office of Management (OM) will continue to designate WCP as an internal high priority area with increased program monitoring and oversight. OM will monitor the detailed corrective action plan addressing the 10 actions identified in recommendation 2 of the OIG audit report.

## *OIG5. INFORMATION MANAGEMENT*

VA faces significant challenges addressing Federal information security program requirements and establishing a comprehensive, integrated VA security program. Information security is critical to the confidentiality, integrity, and availability of VA data, and to protect the assets required to support health care and benefits delivery. Lack of management oversight contributes to inefficient practices and weaknesses in electronic information and physical security. We continue to identify serious Department-wide vulnerabilities.

### 5A. OIG Issue - Information Security

In our December 2003 report, *Audit of the Department of Veterans Affairs Information Security Program* (Report No. 02–03210–43), we concluded that VA has made insufficient progress in improving its information security posture. VA is not in compliance with the requirements of the Federal Information Security Management Act. VA's information security vulnerabilities have not been adequately addressed because the Department did not complete necessary corrective actions in response to our audit findings. Serious security vulnerabilities have continued to exist over a multi-year period that place VA systems, data, and delivery of services to the Nation's veterans at risk. In our 2004 work, we found that many information system security vulnerabilities reported in our 2001 through 2003 national audits are unresolved, and we have identified additional vulnerabilities. VA needs to devote sufficient resources to implement the 16 OIG recommendations. The OIG has reviewed the June 2004 status update from the Associate Deputy Assistant Secretary for Cyber and Information Security, and while VA has made progress in addressing the issues raised in our report, all recommendations remain open pending receipt of satisfactory implementation documentation.

In our January 2004 report, *Evaluation of the Department of Veterans Affairs' Installation of the Microsoft Blaster Worm Patch* (Report No. 03-02970-55), we found that the security patch was not effectively installed leaving VA systems vulnerable to a denial of service attack. Oversight of the installation of the patch was unsystematic and VA's Central Incident Response Capability Service (VA-CIRC) did not provide effective assistance to solve installation problems. VA systems were not protected because VA has not established a patch management program meeting guidance established by the National Institute of Standards and Technology (NIST), and the responsibility and accountability for VA-wide patch management is not specifically assigned. The Associate Deputy Assistant Secretary for Cyber and Information Security is responsible for issuing guidance on installing security patches through VA-CIRC. However, VA-CIRC does not have direct line authority to ensure the implementation of patches by facility level information technology officials. All three recommendations remain open.

OIG CAP reviews for FY 2003 and the first 6 months of FY 2004 found security weaknesses at 32 of 34 VAMCs and 12 of 14 VAROs where we reviewed information security management. We made recommendations to improve contingency planning, background checks, systems certification, and other internal controls. VA has not implemented all planned security measures and has not ensured compliance with established security policies, procedures, and controls requirements.

**VA's Program Response:** VA is actively working to implement recommendations in the OIG report, *Audit of the Department of Veterans Affairs Information Security Program* (Report No. 02-03210-43), consistent with available funding and personnel. As of this date, the Office of Cyber and Information Security (OCIS) has completed actions on 6 of the 16 audit issues, with progress being made on all the remaining recommendations. VA recognizes that although it has provided its completed actions to the OIG, the OIG will determine whether those actions will close the recommendations. The planned completion date for the majority of the remaining recommendations is the end of calendar year 2004, and full implementation of all the recommendations is at the end of calendar year 2005. The need to devote resources to additional high-priority projects and the extensive periods for initiating, developing, and implementing some of the proposed solutions have resulted in remediation progress constituting a multi-year effort for many of the remaining issues.

Progress has been made in implementing the recommendations that a patch management program be established that (1) follows the guidance contained in NIST Special Publication (SP) 800-40, Procedures for Handling Security Patches, (2) identifies authorities and responsibilities for implementation of the patch management program, and (3) establishes accountability for compliance.

In December 2003, through funding commitments from the Administrations and staff offices, the VA Enterprise Information Board approved implementation of the Security Configuration and Management Program (SCAMP). Over the past several months, SCAMP has established and implemented several components of a patch management program/security configuration management program in accordance with NIST (SP) 800-40. As of September 2004, 9 of the 16 milestones established for the SCAMP program have been achieved including development of patch management (still in draft) and cyber incident "rules of engagement" policies and implementation of several point patch systems, an enterprise Hercules/Stat solution, and an enhanced VA-CIRC reporting capability. Additional SCAMP activities will include creating an organizational hardware and software inventory, prioritizing patch applications, creating an organization-specific patch database, testing patches for functionality and security, and training system administrators in the use of vulnerability databases. Implementation of the remaining seven milestones is currently scheduled for December 2005; however, SCAMP is in the process of formally requesting an extension until December 2006 to allow for proper and effective implementation of an enterprise level, network structured, configuration management framework capability to centrally manage all desktops, servers, communications, and security devices in the VA environment. This additional time is being requested based on input received from private industry, lessons learned from the SCAMP pilot, and evaluations of several framework technologies. The additional time will allow for discovery, planning, and training to take place in FY 2005 with implementation in FY 2006.

The responsibility and accountability for the management of desktop functions has always resided at the facility level within the Administrations. The "Cyber

Incident Rules of Engagement" policy mentioned above defines organizational responsibilities for future incidents. The SCAMP program provides the opportunity for that responsibility and accountability to be centralized under the VA Chief Information Officer (CIO). When the SCAMP program becomes fully functional, the VA CIO will have the opportunity to assign accountability when functions are not carried out.

The OIG CAP reviews and the annual information technology (IT) security audit, independent reviews conducted by OCIS, and VA IT security self-assessments conducted by facility information security personnel for each VA system and major application have determined that VA has not implemented all planned security measures, nor are all facilities in compliance with established security policies, procedures, and control requirements. The Department has developed a centralized process to assist facilities in documenting these deficiencies and in managing associated remediation activities. To place emphasis on CAP issues, OCIS, in coordination with VHA, provides the Deputy Secretary with a quarterly report on progress to remediate identified deficiencies.

Although a significant number of deficiencies still exist, the Department is making measured progress to correct identified security weaknesses, with the average number being identified for each system/major application steadily decreasing each year. These deficiencies averaged approximately 23 per system/major application for FY 2001, 16 per system/major application for FY 2002, and 10 per system/major application for FY 2003. OCIS will continue to assist the Administrations and staff offices with their remediation planning and management activities in order to ensure that appropriate emphasis is placed on bringing VA into compliance with security legislation, executive branch guidance, and Department policies and procedures.

## *Major Management Challenges Identified by the Government Accountability Office (GAO)*

In January 2003, GAO issued its special series of reports entitled the *Performance and Accountability Series: Major Management Challenges and Program Risks*. One of the reports described major management challenges and high-risk areas facing the Department of Veterans Affairs (GAO-03-110). The following is excerpted from the report in which GAO discusses the actions VA has taken to address the challenges identified and major events that have significantly influenced the environment in which the Department carries out its mission. The report can be viewed in its entirety at the GAO Web site: http://www.gao.gov/cgi-bin/getrpt?GAO-03-110.

## *GAO1. Ensure Access to Quality Health Care*

### 1A. Access

Although VA has opened hundreds of outpatient clinics, waiting times are still a significant problem. To help address this, VA has taken several actions including the introduction of an automated system to schedule appointments. Over the past several years, VA has done much to ensure that veterans have greater access to care and that the care they receive is appropriate and of high quality. Yet VA remains challenged to ensure that veterans receive the care they need, when they need it — a challenge that has become even greater with the recent expansion of benefits.

**VA's Program Response:** VHA has been working on an initiative called Advanced Clinic Access (ACA) since 1999. The ACA initiative provides principles for office practice efficiencies that are not resource intensive. Adoption of these key principles in VA clinics gives a better idea of the status of waiting times and the capacity and demand on the system. The goal is to meet the demand of the patient population for care at the time the demand occurs.

In addition to working on ACA, VHA has made a concerted effort to improve waiting times in a variety of ways. The measuring system has been enhanced so that waiting times for nearly every patient are being measured. In conjunction with the Office of the Chief Information Officer, we developed a National Waiting Times Web site that hosts a variety of documents and information on ACA. VA has developed a monitor for the Primary Care Management Module (PCMM) that will identify the percent of active patients assigned to an active primary care provider and the percent of primary care provider capacity utilized by active patients assigned in PCMM. VA has developed both a guide for schedulers in how to properly use the scheduling package and an electronic waiting list in *VistA* to obtain a better assessment of the demand on the system. We are revising the scheduling package so that it will provide flexibility to accurately schedule patients. This is expected to be completed in 2005. VHA has established a workgroup on Provider Productivity and Staffing Standards as well as a core group of national Access Coaches to promote the ACA initiative. VHA issued three directives that define the business processes for waiting times: Directive 2003-068, "Process for Managing Patients When Patient Demand Exceeds Current Clinical Capacity;" Directive 2003-062, "Priority Scheduling for Outpatient Medical Services and Inpatient Hospital Care for Service Connected Veterans;" and Directive 2002-059, "Priority for Outpatient Medical Services and Inpatient Hospital Care."

## 1B. Long-Term Care

VA must also better position itself to meet the changing needs of an aging veteran population by improving nursing home inspections and increasing access to non-institutional long-term care services. In FY 2001, VA spent 92 percent of its long-term care dollars in institutional settings, such as nursing homes — the costliest long-term care setting. However, VA's oversight of community nursing homes — where about 4,000 veterans received care each day in FY 2001 — has not been adequate to ensure acceptable quality of care. While VA has begun to implement certain policies to improve oversight of these homes, as GAO recommended in July 2001, VA has yet to develop a uniform oversight policy for all community nursing homes under VA contract. Further, VA plans to rely increasingly on the results of state inspections of community nursing homes rather than conducting its own inspections, but VA has not developed plans for systematically reviewing the quality of state inspections.

**VA's Program Response:** VA has implemented this recommendation. The Department now has a single, structured, comprehensive oversight policy for community nursing homes, outlined in VHA Handbook 1143.2, "VA Community Nursing Home Oversight Procedures," dated June 4, 2004. Further, VA has a system for identifying states that may be unreliable in their surveys of nursing homes, also found in VHA Handbook 1143.2.

## 1C. Hepatitis C

Since 1999, VA's budgets submitted to the Congress have included a total of $700 million to screen, test, and provide veterans who test positive for hepatitis C with a recommended course of treatment. In June 2001, GAO testified that VA missed opportunities to screen as many as 3 million veterans who visited medical facilities during FY 1999 and 2000, potentially leaving as many as 200,000 veterans unaware that they have hepatitis C. In response to GAO testimony, VA has begun to improve screening and testing procedures. In 2002, VA established a process to monitor screening and testing performance. In addition to monitoring VA's progress in screening and testing veterans for hepatitis C, GAO is assessing VA's efforts to notify veterans who test positive and to evaluate veterans' medical conditions regarding potential treatment options.

**VA's Program Response:** VA has instituted a number of steps to improve screening, testing, medical treatment, data-based quality improvement, communication, and education in the care of veterans at risk for and infected with hepatitis C. VA instituted network performance measures for universal hepatitis C risk assessment (screening) and testing of those at risk in 2002. Performance is measured by independent chart reviews conducted through the External Peer Review Program (EPRP). In FY 2003, in a review of over 52,000 medical records, 95 percent contained evidence of risk factor screening and over 85 percent of those at risk had been tested for or diagnosed with hepatitis C. An enhanced electronic clinical reminder is being developed and piloted to prompt testing based not only on patient-reported risk behavior but also on information from the electronic medical record indicating increased risk. VA is monitoring timeliness of test notification and disease management decisions through the EPRP program. A telephone reminder system and other electronic means of ensuring notification of test results are being developed. Comprehensive recommendations regarding antiviral therapy and management of cirrhosis and portal hypertension have been published and are now available on VA's hepatitis C Web site (http://www.hepatitis.va.gov). The number of hepatitis C patients receiving antiviral therapy increased by over 30 percent from FY 2002 to FY 2003, with over 9,000 patients receiving treatment in FY 2003. VA has developed and implemented a system-wide electronic case registry of hepatitis C patients for administrative oversight, quality improvement, and patient safety monitoring. As of March 2004, over 250,000 patients had been added to the registry, and over 180,000 of those had at least one VA admission or outpatient encounter in FY 2003. VA has developed a broad-based approach to provider and patient education and communication. Lead clinicians have been identified at each VA facility, and regular contact is maintained through e-mail groups and an electronic news service. Patient education materials have been distributed to all VA facilities.

## *GAO2. Manage Resources and Workload to Enhance Health Care Delivery*

### 2A. Veterans' Equitable Resource Allocation (VERA) System

In FY 1997, VA began allocating most of its medical care appropriations under the VERA system, which aims to provide VA networks comparable resources for comparable workloads. In response to recommendations GAO made in February 2002 regarding VERA's case-mix categories and Priority 7 workload, VA said that further study was needed to determine how and whether to change VERA. In November 2002, VA announced its intention to make changes to VERA for FY 2003 when VA's appropriation was finalized. Some of the planned changes, if implemented, could address recommendations GAO made. Delaying these improvements to VERA means that VA will continue to allocate funds in a manner that does not align workload and resources as well as it could.

**VA's Program Response:** In FY 2003, the Secretary approved expanding VERA from a 3-price case-mix to a 10-price case-mix model, including six (1 through 6) Basic Care price groups and four (7 through 10) Complex Care price groups. This change follows the recommendation provided in the GAO and RAND Corporation reports and recognizes a differentiation in VA's "core mission" patients (veterans with service-connected disabilities, those with incomes below the current threshold, or those with special needs, for example, the homeless) not present in the previous three VERA price groups. The change also improved allocation equity among the 21 health care networks and modified the funding allocation split between Basic Care and Complex Care to reflect the current cost experience between these groups rather than using a fixed ratio that reflects their FY 1995 relative costs.

For FY 2004, the Secretary approved including all Priority Group 7 Basic Care veterans in the VERA model.

Previously, only Priority Group 7 Complex Care veterans were included. Because FY 2002 is the base year for the FY 2004 VERA model, VERA includes only veterans in Priority Groups 1 through 7 (Priority Group 8 was established on October 1, 2002; it will not have an impact until the FY 2005 VERA model, which will use FY 2003 as the base year). This change is consistent with GAO's recommendation to include all Priority 7 veterans in VERA. Including all Priority Group 7 Basic Care patients in VERA is more consistent with VA's current enrollment policy and better aligns the VERA workload with actual workload served. In conjunction with this change, the VERA price groups were modified, and there is now a separate price for Priority Group 7 veterans in each of the 10 price groups based on their relative cost to Priority Group 1 through 6 veterans. As a result, VERA now has 20 prices, 2 in each price group.

## 2B. CARES

VA has begun to make more efficient use of its health care resources to serve its growing patient base. However, to meet the growing demand for care, VA must carry out its plan to realign its capital assets and acquire support services more efficiently. At the same time, VA needs to improve its process for allocating resources to its 21 health care networks to ensure more equitable funding. VA must also seek additional efficiencies with the Department of Defense (DoD), including more joint purchasing of drugs and medical supplies.

VA is one of many Federal agencies facing challenges in managing problems with excess and underutilized real property, deteriorating facilities, and unreliable property data. In 1998, GAO reported that in the Chicago area alone, as much as $20 million could be freed up annually if VA served area veterans with three instead of four hospitals. In response, in October 2000, VA established the Capital Asset Realignment for Enhanced Services (CARES) program, which called for assessments of veterans' health care needs and available service delivery options to meet those needs in each health care market — a geographic area with a high concentration of enrolled veterans. VA needs to build and sustain the momentum necessary to achieve efficiencies and effectively meet veterans' current and future needs. The challenge is to do this while mitigating the impact on staffing, communities, and other VA missions. Successfully completing this capital asset realignment will depend on VA's ability to strategically and expeditiously complete the implementation of CARES.

**VA's Program Response:** CARES is the most comprehensive analysis of VA's health care infrastructure that has ever been conducted, and it provides a 20-year blueprint for the critical modernization and realignment of VA's health care system. The CARES process provided a data-driven assessment of veterans' health care needs within each market, the condition of the infrastructure, and the strategic realignment of capital assets and related resources to better serve the needs of veterans. This process identified the necessary infrastructure to provide high-quality health care to veterans where it is most needed now and in the future. Through CARES, VA based its plan for enhanced health care services on objective criteria and analysis as well as cost-effectiveness, and in some cases, significant capital asset restructuring. In designing the CARES process, VA explicitly followed GAO recommendations, such as working to eliminate subjective judgments, developing methods to quantify the benefits of locations and facilities, and seeking the best defined measurement standards. CARES became a comprehensive, data-driven, objective capital investment planning process with extensive stakeholder involvement.

The "roll-out" of CARES began on June 5, 2002, when the Secretary of Veterans Affairs announced the initiation of the CARES process. Fourteen months later, on August 1, 2003, the draft National CARES Plan was presented to the CARES Commission for its review and to provide recommendations to the Secretary. The CARES Commission developed and applied six factors in the review of each proposal in the draft plan: 1) impact on veterans' access to health care; 2) impact on health care quality; 3) veteran and stakeholder views; 4) economic impact on the community; 5) impact on VA missions and goals; and 6) cost to the government. Commission members visited 81 VA and DoD medical facilities and state veterans homes, conducted 38 public hearings, and analyzed more than 212,000 comments from stakeholders. The CARES Commission submitted its report to the Secretary in February 2004.

In May 2004, the Secretary announced his CARES decisions. He accepted the majority of the recommendations of the Commission report including:

- Construction of new medical centers in Orlando, Florida and Las Vegas, Nevada and a replacement hospital in Denver, Colorado.
- Replacement and major expansion of the Columbus, Ohio, VA Outpatient Clinic.
- New bed towers in Tampa, Florida and San Juan, Puerto Rico.
- 156 new community-based outpatient clinics by 2012, about 55 to 60 of which will open in the next 2 years.
- Consolidations of medical center divisions in Pittsburgh, Pennsylvania; Cleveland, Ohio; and Biloxi, Mississippi.
- Creation of four new and expansion of five existing spinal cord injury centers.
- Two new blind rehabilitation centers.

The Secretary's CARES decisions call for additional studies to refine the analyses developed in the CARES planning and decision-making process, which VA is already formulating. Master plans as referenced in the Secretary's decision document have been redefined to be more specific regarding the work to be done at each site and have been divided into two categories - capital plans and reuse plans. A statement of work is being developed for contractor(s) to conduct site-specific studies and capital and reuse planning for sites for which the Secretary requested further study. Local site task forces that will include VA staff and stakeholder representatives are in the process of being formulated to interact with the national contractor.

The objective of a capital plan is to provide the best configuration of capital assets for modern health care delivery. Capital plans will be developed in conjunction with the reuse plans and health care delivery studies (if appropriate) to assist in development of overall options to determine the best method, location, and cost-effective physical configuration of VA capital assets to deliver health care services while improving or maintaining the level of access and the quality of VA health care. The reuse plans will include highest and best use determination for the property and a cost-effectiveness analysis. VA will pursue enhanced use (EU) opportunities for vacant and underutilized space.

Overall, the CARES plan identified more than 100 major construction projects in 37 states, the District of Columbia, and Puerto Rico. When implemented, CARES will dramatically improve access to primary care, especially for veterans living in rural areas. In 2001, VA met inpatient care access guidelines in only 28 of our 77 health care market areas. When the CARES process is complete, VA will meet that standard in 73 of its health care market areas. Implementation of the CARES plan will decrease vacant space within VHA from 8.57 million square feet to 4.93 million square feet, a reduction of 42.5 percent.

In addition, VHA has created the Office of Strategic Initiatives to oversee and coordinate CARES implementation across the country. CARES' actions will also be incorporated in the VISN FY 2005 strategic plans. A CARES implementation board has been established and is composed of senior level VA officials, chaired by the Secretary, to ensure Department-level oversight of CARES implementation plans.

In June 2004, the Department produced its first 5-year capital plan, a systematic and comprehensive framework for managing VA's portfolio of more than 5,500 buildings and approximately 32,000 acres of land. This plan is a sound blueprint for managing the Department's capital investments and will lead to improved use of resources and more effective delivery of health care and benefits. This plan outlines CARES implementation by identifying priority projects that will improve the environment of care at VA medical facilities and ensure more effective operations by redirecting resources from maintenance of vacant and underused buildings and reinvesting the resources in veterans' health care. The plan is being reviewed by Congress and serves as a budget request for 30 major construction projects that would be funded using FY 2004 available dollars and the FY 2005 requested amount. The plan reflects a need for additional investments of approximately $1 billion per year for the next 5 years to modernize VA's medical infrastructure and enhance veterans' access to care. Through CARES and improved asset management strategies, VA is meeting the challenge identified by GAO for Federal agencies in managing problems with excess and underutilized real property.

## 2C. Alternative Methods for Patient Care Support Services

VA's transformation from an inpatient to an outpatient-based health care system has significantly reduced the need for certain patient care support services such as food and laundry. In November 2000, GAO recommended that VA conduct studies at all of its food and laundry service locations to identify and implement the most cost-effective way to provide these services at each location. In August 2002, the Department issued a directive establishing policy and responsibilities for VA networks to follow in implementing a competitive sourcing analysis to compare the cost of contracting versus in-house performance to determine the appropriate entity to do the work. VA needs to follow through on its commitment to ensure that the most cost-effective, quality service options are applied throughout its health care system and to conduct system-wide feasibility assessments for consolidation and competitive sourcing.

**VA's Program Response:** VA has stopped developing studies that examine competitive sourcing of consolidated laundry services because VA's General Counsel has determined that VHA is not authorized to use appropriated funds to conduct competitive sourcing studies under current law. VA has been authorized to conduct such studies in the past and is now requesting this authority. The Nutrition and Food Service (NFS) in VHA Central Office continues to assess the efficiency and cost effectiveness of its VA food service operations in order to identify potential alternative service delivery options. The NFS Product Standardization User Group is in the process of developing a national cook/chill equipment model to realize cost savings on high-cost equipment items. Effective July 2004, the Veterans Canteen Service (VCS) now shares the efficiencies and cost savings of the NFS/VHA subsistence prime vendor (SPV) contract as the VCS purchases its food products from the SPV contract. The estimated food purchases by VCS are approximately $18-20 million annually. A national benchmarking program was established in partnership with a private sector organization to compare VA operations with private non-contract health care facilities.

## 2D. VA/DoD Sharing

In an effort to save Federal health care dollars, VA and DoD have sought ways to work together to gain efficiencies. To ensure sharing occurs to the fullest extent possible, VA needs to continue to work with DoD to address remaining barriers, as GAO recommended in its 2000 report. It is particularly critical that VA take a long-term approach to improving the VA/DoD sharing database, which VA administers. Currently, VA and DoD do not collect data on the volume of services provided, the amount of reimbursements collected, or the costs avoided through the use of sharing agreements. Without a baseline of activity or complete and accurate data, neither VA, DoD, nor the Congress can assess the progress of VA and DoD sharing.

**VA's Program Response:** Upon further review, VA believes that the investment of dollars and effort spent to modify the database to include utilization data would not result in improved management of VA/DoD sharing agreements. Several local factors (for example, not having excess capacity to provide services to active military personnel without impacting care for veterans) can influence the level of VA/DoD sharing. VA/DoD reimbursement amounts are currently tracked but have not yet been integrated within the VA/DoD database. VA plans to continue efforts to integrate utilization and reimbursement data into the database in the future.

Over the past 3 years, VA and DoD have undertaken unprecedented efforts to remove barriers impeding interagency collaboration in order to improve access to quality health care and increase efficiency. Using the President's Management Agenda and the Final Report of the President's Task Force to Improve Health Care Delivery for Our Nation's Veterans, the Departments have developed a strategy to institutionalize VA/DoD partnering and focus collaboration in areas that will ensure enhanced services to veterans and military beneficiaries.

VA's commitment to this effort is demonstrated through the Joint Executive Council structure, which has brought the senior leadership of both Departments into collaborative discussions at an earlier stage, thus increasing both oversight and accountability. When the Under Secretary of Defense for Personnel and Readiness and the Deputy Secretary of Veterans Affairs signed the VA/DoD Joint Strategic Plan in April 2003, it was a significant step forward in the partnership between the two Departments. The first document of its kind, the Joint Strategic Plan articulates a vision for collaboration, establishes priorities for partnering, launches processes to develop and implement interagency policy decisions, develops joint operations guidelines, and institutes performance monitors to track progress. While some of the target dates included in the initial joint strategic plan were overly ambitious, much has been accomplished.

Through the Health Executive Council, VA and DoD have adopted a schedule to develop interoperable electronic medical records by the end of FY 2005. This agreement (the VA/DoD Joint Electronic Health Records Plan – Health*e*People strategy) is outlined in the VA/DoD Joint Strategic Plan and calls for joint development of a virtual health record that will be accessible by authorized users throughout DoD and VA.

Significant progress has also been made to improve the transition of separating servicemembers, with particular emphasis on those who have sustained injuries, illnesses, and disabilities in Operation Enduring Freedom (OEF) and Operation Iraqi Freedom (OIF). Examples of this include placement of full-time VA social workers and veterans' service representatives at military medical centers receiving large numbers of OEF/OIF casualties, while part-time VA staff liaisons were assigned to other military treatment facilities. We also established specific points of contact and case managers at all VHA and VBA sites. These individuals work closely with active duty health care teams to ensure the optimal seamless transition from DoD to VA for servicemembers who will require VA care upon separation from active service.

Through the Benefits Executive Council, we have simplified the transition from active military to veteran status by developing a single physical examination that meets both the military services' separation requirements and VA's disability compensation examination criteria. A national memorandum of agreement to codify this policy is scheduled for implementation in the second quarter of FY 2005.

The VA/DoD Joint Executive Council also established a Joint Capital Asset Planning Committee. The Committee provides a formalized structure to facilitate collaboration in achieving an integrated approach to capital coordination that considers both short-term and long-term strategic capital issues mutually beneficial to both Departments. The Committee provides the final review of all joint capital asset initiatives recommended by the executive council structure or Department-specific body, including the VA CARES and DoD Base Realignment and Closure (BRAC) programs, and provides the oversight necessary to ensure that collaborative opportunities for joint capital asset planning are maximized.

Many other joint projects in the areas of procurement, provider credentialing, health care and business operations, data exchange, and information management are also underway. Although proud of these successes, VA recognizes there is still much work to be done. Therefore, at the April 2004 meeting of the Joint Executive Council, the co-chairs of the Health and Benefit Executive Councils and Capital Asset Planning Committee were charged with updating the VA/DoD Joint Strategic Plan. That process is currently underway. The updated plan will build on the successes that have been achieved over the last year, include medium- and long-range objectives, refine the performance measures, and continue to emphasize the issues raised by the President's Task Force to Improve Health Care Delivery for Our Nation's Veterans as well as our efforts to enhance the transition from active duty to veteran status. The revised plan is expected to be completed in the first quarter of 2005.

The accomplishments of the first joint strategic plan will be outlined in the first annual report of the VA/DoD Joint Executive Council to be submitted to the Secretaries and the Congress in the first quarter of FY 2005.

## 2E. Third-Party Collections

VA's third-party collections increased in FY 2001 — reversing a trend of declining collections — and again in FY 2002. However, over the past several years, GAO has reported on persistent collections process weaknesses — such as lack of information on patient insurance, inadequate documentation of care, a shortage of qualified billing coders, and insufficient automation — that have diminished VA's collections. VA has taken several steps to improve its collections performance, including developing the Veterans Health Administration Revenue Cycle Improvement Plan in 2001, which aims to address VA's long-standing collections problems. More recently, in May 2002, VA created a Chief Business Office that planned additional initiatives to improve collections. However, by the end of FY 2002, VA was still working to implement proposed initiatives for resolving its long-standing collection problems. To ensure it maximizes its third-party collections, VA will need to be vigilant in implementing its plan and initiatives.

**VA's Program Response:** Collections through August 2004 totaled $1.5 billion, which is $175 million above last fiscal year's record collection rate as of the same date. Estimated collections for this fiscal year are approximately $1.7 billion, representing the largest amount collected in the history of the revenue program. In addition, and consistent with industry measurement approaches, VHA continues to reduce gross days revenue outstanding, accounts receivable greater than 90 days, and days to bill.

VHA has made considerable improvement in operating processes and systems, migrating from a labor-intensive manual process to automated billing and collection activities. Upon creation of the Chief Business Office, VHA initiated a comprehensive assessment of ongoing activities within the revenue program. The 2001 revenue improvement plan was integrated into the 2003 revenue action plan. This assessment focused on "industry best" practices and resulted in the identification of a series of objectives in addition to those originally included in the 2001 revenue improvement plan. The revenue action plan is a living document. As we continue to develop additional initiatives and projects intended to improve revenue business processes, we will add to the plan.

The immediate improvement strategies include development of the Medical Care Collections Fund (MCCF) performance metrics, an expanded focus on contracting for collection of accounts receivable over 60 days, and utilization of available contract support encompassing collections, insurance identification and verification, and coding. Currently, over 70 outsourcing contracts are being used throughout VHA. Many of these are structured to allow contractors to retain a percentage of collections, which minimizes operational costs. Another significant accomplishment is the development and implementation of electronic data interchange for third-party claims to meet Health Insurance Portability and Accountability Act (HIPAA) deadlines. The initial e-Claims software is operational at all VA facilities, and as of July 2004, more than 11.4 million claims have been generated.

An important improvement in the revenue action plan, targeted for completion this fall, will be the completion of the Medicare Remittance Advice project. This project is designed to improve the quality of the many Medicare supplemental claims and accurately identify deductible and coinsurance amounts that Medicare supplemental insurers calculate to determine reimbursement to VA. This effort will also allow VA to more accurately identify accounts receivable. Numerous other improvement strategies are underway to improve data quality, expand data sharing capabilities, and allow the receipt of electronic payments from insurers. Additionally, a major tactical initiative currently underway is the phased piloting of Consolidated Patient Account Centers. Modeled after private industry as an effort to enhance revenue consolidation efforts throughout VA, the initiative is targeted for deployment in September 2005 and is designed to gain economies of scale by regionally consolidating key business functions.

A major focus of VHA's long-term strategy is the implementation of an industry-proven patient financial services system (PFSS) that will yield dramatic improvements in both the timeliness and quality of claims and collections. VA's Chief Information Officer will provide additional oversight and monitoring to ensure the project stays on schedule. The PFSS project is targeted for rollout at the first test site in VISN 10 (Cleveland) in October 2005, with subsequent rollout to the remaining four test sites in this network.

In order to alleviate weaknesses in the collection process caused by a shortage of qualified coders and to improve the documentation of care, VHA has taken several steps. Coding Blanket Purchase Agreements were signed and issued to the field for use in September 2003. These allow the field to implement coding contracts quickly without conducting an entire bid solicitation. Hybrid Title 38 status was given for medical record coding positions. While this will not solve the scarcity issue, it will shorten the hiring delay, allowing VHA to compete for the best coders in the marketplace. The Health Data and Informatics, Health Information Management program, in conjunction with the Employee Education System, will continue to offer educational coding satellite sessions in FY 2005 to assist coding staff in improving and retaining coding skills.

## *GAO3. Prepare for Biological and Chemical Acts of Terrorism*

Following the attacks of September 11, 2001, VA determined that it needed to stockpile pharmaceuticals and improve its decontamination and security capabilities. VA also has new responsibilities to establish four medical emergency preparedness centers and carry out other activities to prepare for potential terrorist attacks.

**VA's Program Response:** The Department has completed its procurement of 143 pharmaceutical caches located at VA medical centers. Decontamination/hazmat training and equipment were initially provided to the 78 medical centers determined to be the highest priority. VA completed training and equipment for a second group of 53 facilities in September 2004. The week-long course is provided to trainees from about six medical centers at a time, four students per facility. Recurring training will continue at a reduced but still significant level due to staff turnover.

Although Congress directed VA to establish four medical emergency preparedness centers, previous appropriations language prohibited VA from using funds on these centers.

The full assessment of 18 and preliminary assessment of 100 of VA's critical facilities was completed in July 2004. The 18 facilities receiving full assessments represent unique facilities, facilities with national responsibilities, and facilities where CARES major construction projects are funded or planned. In July 2004, VA obtained an electronic database to capture vulnerability assessment data. The data will be linked with existing VA space and building databases as well as law enforcement databases.

The study to assess the Department's ability to reconstitute its essential business papers was completed and the Office of Information and Technology has presented VA leadership with an implementation plan.

Recommendations emerging from the study of preparedness of VA personnel are currently under review, and a major revision of the Department's Continuity of Operations plan is in final coordination.

Under a new contract with a major consulting firm, VA is also conducting an independent evaluation of VA medical centers to assess their emergency preparedness posture and capability in the event of a chemical, biological, or weapons of mass destruction event. The focus of the study is to provide a comprehensive, independent, and current assessment of the capabilities of our hospital system and to focus VA management efforts on improvement of related policies, resource allocation, and training.

## *GAO4. Improve Veterans' Disability Program: A High-Risk Area*

VA acted to improve its timeliness and quality of claims processing, but is far from achieving its goals. Of greater concern are VA's outmoded criteria for determining disability and its capacity to handle the increasing number and complexity of claims. VA will need to seek solutions to provide meaningful and timely support to veterans with disabilities. While the Department is taking actions to address these problems in the short term, longer-term solutions may require more fundamental changes to the program including those that require legislative action. For these reasons, GAO has added VA's disability benefits program, along with other federal disability programs, to the 2003 "high-risk" list.

The Secretary made improving claims processing performance one of VA's top management priorities, setting a 100-day goal for VA to make accurate decisions on rating-related compensation and pension claims, and a reduction in the rating-related inventory to about 250,000 claims by the end of FY 2003.

## 4A. Challenges to Improving Timeliness

While VA has made some progress in improving production and reducing inventory, the Department is far from achieving the Secretary's goals. Improving timeliness, both in the short and long term, requires more than just increasing production and reducing inventory. VA must also continue addressing delays in obtaining evidence to support claims, ensuring that VA has experienced staff for the long term, and implementing information systems to help improve productivity.

**VA's Program Response:** VBA has had marked success in reducing the number of pending rating claims and improving the timeliness of rating-related actions. The organization reduced the pending rating inventory from a high of 432,000 claims in January 2002 to 253,000 in September 2003. The timeliness of our pending inventory improved from 203 days in January 2002 to 111 days in September 2003. The average length of time to provide veterans with a decision on their claims improved from a high of 233 days in March 2002 to 156 days in September 2003. However, as noted by the Office of the Inspector General, court decisions interpreting the Veterans Claims Assistance Act of 2000 (VCAA) significantly adversely affected the gains made by VBA in claims processing.

Specifically, the September 2003 decision of the U.S. Federal Circuit Court of Appeals in *PVA v. Principi* caused VBA to stay the processing of over 62,000 claims. The *PVA* decision, issued in response to a challenge to VA's regulations implementing the VCAA, held that unless VA could grant a claim for benefits, VA was required to wait 1 year before it could deny a claim in order to afford the claimant time to submit information or evidence to substantiate the claim. This, in effect, resulted in a stay of any rating action that would, in whole or in part, contain a denial of a claimed benefit.

As a result, VBA lost nearly 3 months of full production, and the volume and age of the rating inventory continually increased until Congress clarified the language of the law in a December 16, 2003, amendment, expressly allowing VA to decide claims for benefits prior to the expiration of the 1-year time period in the law during which a claimant could submit evidence on a claim. Consequently, VBA produced 64 percent fewer rating decisions in the first 3 months of FY 2004 than in the first 3 months of FY 2003 (69,316 versus 192,669). Once VA could resume normal rating production, it was faced with the prospect of addressing the backlog of claims while keeping pace with processing incoming claims. The average processing time for claims completed in January 2004 reached 189 days as we began to process the deferred claims. Timeliness of completed actions is back down to 163 days during the month of September 2004, and we continue to make progress toward the Secretary's goal. Two years ago, 35 percent of VBA's rating inventory was comprised of cases pending over 6 months. As of September 2004, that percentage has been reduced to 21 percent.

VBA has also experienced a significant increase in disability claim receipts. During FY 2004, VBA recorded a 5 percent increase in disability claims. The majority of the increased receipts were original disability claims. Specifically, our original claim receipts are up by 17 percent over last year, most likely attributable to the impact of claims filing by servicemembers returning from Operation Enduring Freedom and Operation Iraqi Freedom. Despite these challenges, VBA continues to make progress toward the high expectations set by the Secretary.

VBA is working to ensure that it has a well-trained workforce for the long term with efforts underway to facilitate the necessary knowledge transfer due to expected retirements. The organization is implementing a workforce and succession planning strategy to ensure current and future capability to provide a comprehensive program of benefits to veterans. This strategy includes workforce development, innovative technology, recruitment, retention, and succession planning. VBA will continue these efforts and pursue innovations and adjustments to enable the organization to compete for talent and foster a high-performing workforce.

The organization remains committed to the transition from our older technology base for claims processing to the Modern Award Processing applications as part of the Veterans Services Network (VETSNET). Rating Board Automation (RBA) 2000, Modern Award Processing – Development (MAP-D), SHARE (a computer application used by regional office employees to establish pending issue claim data), and other VETSNET applications have been deployed and are in use at all VA regional offices. Currently, testing of the award processing component of VETSNET is ongoing at the Lincoln Regional Office. The development and deployment of a modern information technology infrastructure continues to be a priority for VBA.

## 4B. Decision Accuracy and Consistency

To help improve decision accuracy and consistency across regional offices, VA established the Training and Performance Support System (TPSS), a computer-assisted system designed to provide standardized training for staff at all regional offices. However, many of the modules were not available to help train the new claims processing staff VA hired during FY 2001 and 2002, and, in May 2001, GAO reported that VA had pushed back its completion of all TPSS modules until sometime in 2004. Until VA completes TPSS implementation, the Department will not be able to evaluate the program's impact on claims processing accuracy and consistency. More recently, GAO recommended in August 2002 that VA establish a system to regularly assess and measure the degree of consistency across all levels of VA claims adjudication and to improve the quality of decisions made by VA's Board of Veterans' Appeals.

**VA's Program Response:** Developing and sustaining a knowledgeable workforce is a significant challenge for VBA, and the Training and Performance Support System (TPSS) is just one initiative to address this critical issue. We recognize that we must have a properly trained workforce to analyze the complex details of veterans' medical conditions and to adjudicate claims for other benefits. This workforce has to be able to assess veterans' benefits claims in the context of a dynamic environment of ever-changing statutes, regulations, and veterans' needs.

TPSS is a dynamic training system that will constantly evolve as requirements change. Since the GAO Report on Training for Claims Processors was published in May 2001, for example, the claims processing improvement (CPI) initiative, recommended by the Secretary's Claims Processing Task Force, necessitated significant change in the design of TPSS. The CPI changed the basic foundations of how the work is performed, and therefore training must adapt accordingly. There remain numerous advanced level modules to be developed, not only for Veterans Service Representatives (VSRs) and Rating VSRs, but also for other key decision-making positions within a service center, such as Decision Review Officer.

Evaluating the direct impact of TPSS on claims processing accuracy and consistency may be difficult to achieve. TPSS is effective in providing employees the knowledge they need to accurately and consistently process claims. In applying that knowledge, a number of factors may intervene, making it difficult to isolate the effects of TPSS training from other factors that might influence those same results. This remains a critical issue and a great challenge for all organizations.

VBA believes that consistency of the adjudication process is an important goal that is best achieved by comprehensive training and communication throughout all steps of the process. Significant individual and joint training efforts are underway to improve the quality and consistency of the adjudication process. VBA continues to use the national Statistical Technical Accuracy Review (STAR) process to ensure quality and consistency. The CPI model's creation of specialized teams focusing on discrete steps in the claims adjudication process, thereby building considerable expertise in the skill set required for that step, leads to more consistent decision-making. In addition, VA is in the process of revising 38 CFR Part 4, Part B, Schedule for Rating Disabilities, to remove criteria for evaluating disabilities that are inherently subjective (for example, "slight" limitation of motion) and replacing these criteria with objective measures (for example, limitation of motion to 20 degrees), thereby ensuring consistent application of the evaluation criteria.

In response to the GAO finding that the Board of Veterans' Appeals (BVA) understated the quality of its decisions by affording nonsubstantive errors the same weight as substantive errors, BVA modified its system to capture only substantive errors. BVA also modified its decision sampling method to ensure review of a statistically valid sampling of work products. Finally, BVA amplified its training efforts, using information gathered in the quality review process to target specific problem areas. As a result of these efforts, decisional quality has improved significantly. For example, in April 2003, the error-free decision rate was 84.5 percent; for FY 2004, the rate was up to 93 percent.

The Secretary concurred in principle with GAO's recommendation that VA develop a system to regularly assess consistency through all levels of the adjudication system. However, the Secretary stated that this could best be done by "comprehensive communication and training" by all involved in the process. To this end, BVA has been deeply involved in training efforts for its own personnel as well as in continuing intra-Departmental training and improvement programs. These programs include the Compensation and Pension Examination Project (CPEP) program to improve Compensation and Pension medical examinations; joint VBA, OGC, and BVA bimonthly satellite training broadcasts to all VA regional offices; participation in VBA's quarterly Judicial Review Hotline; training sessions for BVA, VBA, and OGC personnel at the Adjudication Academy; and training provided to VHA adjudication personnel.

## 4C. Disability Criteria

Of greater concern is VA's use of outmoded criteria for determining disability. In 1997, GAO reported that VA's disability rating schedule is still primarily based on physicians' and lawyers' judgments made in 1945 about the effect service-connected conditions had on the average individual's ability to perform jobs requiring manual or physical labor.

More recently, GAO reported that the criteria used by VA and other Federal programs to determine disability have not been fully updated to reflect medical and technological advances and have not incorporated labor market changes. GAO recommended that VA use its annual performance plan to delineate strategies for and progress in periodically updating its disability criteria. GAO also recommended that VA study and report to the Congress the effect that a comprehensive consideration of medical treatment and assistive technologies would have on VA disability programs' eligibility criteria and benefit package. VA did not concur with the recommendations. The Secretary of Veterans Affairs stated that the current medically-based criteria are an equitable method for determining disability and that VA is in the process of updating its criteria to account for advances in medicine. However, GAO believes that until VA aligns its disability criteria with medical and technological advances and holds itself accountable for ensuring that disability ratings are based on current information, future decisions affecting its disability program will not be adequately informed. This fundamental problem and sustained challenges in processing disability claims put the VA disability program at high risk of poor performance.

**VA's Program Response:** VA disagrees with the assessment of GAO that VA's rating schedule is "…still primarily based on physicians' and lawyers' judgments made in 1945 about the effect service-connected conditions had on the average individual's ability to perform jobs requiring manual or physical labor."

38 U.S.C. § 1110 provides (in part) that veterans be compensated for disability resulting from personal injury suffered or disease contracted in the line of duty. 38 U.S.C. §1114 provides the dollar amount for each level of disability.

38 CFR 4.1 states that "the percentage (disability) ratings represent as far as can practicably be determined the average impairment in earning capacity resulting from such diseases and injuries . . ." The American Medical Association (AMA) Guides to the Evaluation of Permanent Impairment (AMA 2001) are a well-known and authoritative treatise on disability. The guides provide percentages or ratings for impairment based on the severity of the medical condition (using specific and objective criteria) and the degree to which the impairment decreases an individual's ability to perform common activities of daily living, excluding work (AMA Guide, page 4). As far as VA can practicably determine, the rating schedule represents the average impairment in earning capacity as a consequence of service-connected disease and injury.

When considering the effect of a disability on the ability to earn a living, VA is cognizant of the potential interrelationship between a physical disability and the veteran's ability to earn a living. VA recognizes that its rating schedule may not accurately compensate veterans in every specific case. To accord justice, 38 CFR 3.321 provides that VA can go outside the schedule when determining compensation ratings.

VA has reviewed and revised, or reviewed and proposed revisions, for the major body systems in VA's rating schedule. The revisions in the rating schedule reflect advances in medicine. To ensure that similarly disabled veterans are similarly evaluated, VA has adopted and continues to adopt objective rating criteria.

VA withdrew a proposal for the musculoskeletal system because of the nature of the comments VA received. Adopting some of the suggestions (with which we concurred) would have produced a rule that would not have been seen as a "logical outgrowth" of the proposed rule. VA is working on a new proposal. VA believes that its rating schedule equitably determines the level of disability, across disabilities, because the evaluation criteria reflect advances in medicine and are objective.

The Americans with Disabilities Act (ADA) mandates that employers make reasonable accommodations for those with disabilities. Labor markets have changed over the past several decades, and the labor market varies across the Nation. VA continues to believe that its rating schedule is the fairest way to compensate veterans who have suffered a disease or an injury while serving in the military.

## *GAO5. Develop Sound Departmentwide Management Strategies to Build a High-Performing Organization*

Since 1997, VA has spent about $1 billion annually on its information technology. VA has established executive support and is making strides in developing an integrated Departmentwide enterprise architecture. To safeguard financial, health care, and benefits payment information and produce reliable performance and workload data, VA must sustain its commitment.

## 5A. Link Health Care Budget Formulation and Planning Processes

Establishing a close link between budgeting and planning is essential to instilling a greater focus on results. While VA's health care budget formulation and planning processes are centrally managed, they are not closely linked. VA's annual performance plan describes the Department's goals, strategies, and performance measures. However, the relationship between its performance plan and its health care budget formulation is unclear.

VA officials noted that steps are being taken to better integrate the health care budget formulation and planning processes. However, VA continues to face challenges in further integrating these processes and in defining areas for improvement.

**VA's Program Response:** VA continues to make a number of advancements toward integrating budget planning, operational execution, and performance monitoring. As part of the budget formulation process, VHA sometimes develops budget scenarios. Associated with each funding option are performance goals that are tied to the varying resource levels. This approach gives senior leadership the information needed to help make funding decisions based, at least in part, on the expected performance to be achieved with these resources. These scenarios are based on prior years' outcomes and budget allocations. This process is used to predict costs, number and mix of veterans served, and types of employees required to provide services to veterans. The budget scenario process is a key component in VHA's budget formulation and future services plans.

Managers throughout the VA health care system have strongly embraced linking performance with resource and operations management responsibilities. Prior to the start of each year, VA central management enters into written performance plan agreements with each network director. In turn, each network director has written performance plan agreements with their medical facility directors. These agreements contain detailed standards for VA's key measures that must be achieved and establish expected levels of performance in a wide range of administrative, financial, and clinical areas. The types of measures that are tracked include waiting time standards, financial indices, quality of care, clinical intervention standards, and work force planning.

Monthly performance reviews involving VA senior leadership have created the forum for a continual review of financial and program performance, workload, and major construction and information technology projects at and below the national program level. The purpose of these regularly scheduled reviews, chaired by the Deputy Secretary, is to monitor operations and to inform while identifying issues through a detailed review of Department operations. Because all programs are represented at this meeting, the resulting management decisions are immediately communicated and plans are put in place to implement actions needed to help ensure that the Department makes the most efficient and effective use of resources and makes progress toward achievement of performance goals.

## 5B. Information Technology Challenges: A High-Risk Area

GAO has designated protecting information systems supporting the Federal government and the Nation's critical infrastructures as a governmentwide high-risk area. Over the past 2 years, VA's commitment to addressing critical weaknesses in the Department's IT management has been evident. Nonetheless, challenges to improve key areas of IT performance remain. Specifically, VA's success in developing, implementing, and using a complete and enforceable enterprise architecture hinges upon continued attention to putting in place a sound program management structure. In addition, VA's computer security management program requires further actions to ensure that the Department can protect its computer systems, networks, and sensitive health and benefits data from vulnerabilities and risks.

VA is also challenged to develop an effective IT strategy for sharing information on patients who are both VA and DoD beneficiaries or who seek care from DoD under a VA/DoD sharing agreement. The lack of complete, accurate, and accessible data is particularly problematic for veterans who are prescribed drugs under both systems. While each department has established safeguards to mitigate the risk of medication errors, these safeguards are not necessarily effective in a shared environment — in part because VA's and DoD's IT systems are separate. Consequently, DoD providers and pharmacists cannot electronically access health information captured in VA's system to aid in making medication decisions for veterans, nor can they take advantage of electronic safeguards such as computerized checks for drug allergies and interactions.

**VA's Program Response:** In order to maximize limited resources to make the most significant improvement in the Department's overall security posture in the near term, the VA Chief Information Officer (CIO) sponsors an annual program review to prioritize Federal Information Security Management Act (FISMA) remediation activities. To establish FY 2004 remediation priorities, the VA CIO, in conjunction with program managers and VA Deputy CIOs, reviewed the summary results of the recently completed 2003 FISMA self-assessment survey as well as the results of OIG and GAO audits conducted during the past year. With advice from the program managers and Deputy CIOs, and in consultation with the OIG, the VA CIO identified 11 key weakness areas for priority remediation during FY 2004.

Two new "priority remediation areas" were identified for FY 2004: (1) establishing policies and controls related to the use of wireless devices and (2) Departmentwide deployment of authentication and authorization technologies. These priorities were identified by the OIG and included in its draft *2003 Audit of the Department of Veterans Affairs Information Security Program* report. The OIG has reported that wireless security assessments identified vulnerabilities that would allow a potential hacker to gain unauthorized access to VA systems and data, including circumventing security measures VA has established as part of its firewall protection. Additionally, the OIG has reported vulnerabilities associated with the transmission of patient data in clear text, as VA's legacy medical and benefit systems do not have a viable encryption application that can adequately protect the electronic transfer of sensitive data. The Department, following the OIG's recommendations, made these additional activities a priority for FY 2004 in order to enhance protection of its computer systems, networks, and sensitive health and benefits data from identified vulnerabilities and risks.

The 11 priority remediation goals for FY 2004 are depicted in priority order as follows: (1) certification and accreditation of key financial and human resource systems; (2) a Departmentwide critical infrastructure protection plan; (3) data center contingency planning; (4) configuration management; (5) enterprise-wide intrusion detection system capability; (6) upgrade of external connections; (7) relocation of the VACO server farm from a sub-ground location to preclude flooding; (8) application program/operating system change controls; (9) physical access controls at data centers; (10) deployment of authorization and authentication technologies; and (11) a standardized Department-level wireless device policy.

During 2004, VA began a very effective collaboration with the DoD Joint Requirements and Integration Office, concerning the introduction and integration of DoD Defense Integrated Military Human Resource System (DIMHRS) veteran service history data. VA is developing consolidated data requirements across all business lines for submission to DoD. VA expects DoD to provide a draft data specification and dictionary by December 2004 and to provide live DIMHRS data for the Army, as a pilot, by September 2005. The Office of Enterprise Architecture Management in VA's Office of Information and Technology is working directly with VHA, VBA, and NCA to achieve DIMHRS data integration and to further numerous short-term initiatives for improved data sharing in support of returning Operation Iraqi Freedom and Operation Enduring Freedom servicemembers.

An example of the improvement in the collaboration between VA and DoD is the VA Seamless Transition Task Force formed to better serve our newest veterans from Operation Iraqi Freedom and Operation Enduring Freedom. By sharing early information about servicemembers who are injured but still in the military, VA can provide a seamless transition to civilian life. VA medical and benefits personnel can visit these veterans while they are still in the military medical facility. VA personnel interview the veteran and enter the data in a centralized database. This will not only improve service to the veteran, but he or she will also have a better entry experience into the VA system.

## 5C. Financial Management Material Weaknesses

In December 2002, VA's independent auditor issued an unqualified audit opinion on VA's consolidated financial statements for fiscal years 2002 and 2001. However, the unqualified opinion was achieved, for the most part, through extensive efforts of both program and financial management staff and the auditors to overcome material internal control weaknesses to produce auditable information after year-end. The auditor reported two long-standing systems and control problems that remain unresolved. In addition, VA's accounting systems — similar to those of most major agencies — did not comply substantially with Federal Financial Management Improvement Act requirements. These weaknesses continue to make VA's program and financial data vulnerable to error and fraud and limit the Department's ability to monitor programs through timely internal financial reports throughout the fiscal year.

VA has demonstrated management commitment to addressing material internal control weaknesses previously reported and has made significant improvements in financial management. For example, in February 2001, the auditor reported that VA had improved on its reporting and reconciling of fund balances with Treasury — removing this as a material weakness. VA also continued to make progress in implementing recommendations from the GAO March 1999 report, which resulted in improved control and accountability over VA's direct loan and loan sale activities and compliance with credit reform requirements.

However, during its audit of VA's FY 2002 financial statements, the auditor reported that two previously reported material weaknesses still exist in the areas of information systems security and financial management system integration.

Departmentwide weaknesses in security controls over automated data processing continue to make VA's sensitive financial and veteran medical and benefit information at risk of inadvertent or deliberate misuse or fraudulent use.

Material weaknesses continue to hamper timely completion of financial statements. Specifically, VA continues to have difficulty related to the preparation, processing, and analysis of financial information to support the efficient and effective preparation of its financial statements.

**VA's Program Response:** VA's Office of Information and Technology (OIT) has developed and monitors the implementation of a Departmentwide information security controls plan that details corrective actions through March 2005. Currently, OIT is in the process of refining the Departmentwide plan to include specific information recently received from the auditors. In the meantime, OIT continues to ensure the Department moves forward in eliminating the risk of inadvertent or deliberate misuse or fraudulent use of VA's sensitive financial and veteran medical and benefits information.

The Department continues to face challenges in building and maintaining financial management systems that comply with federal requirements. Until recently, the Department intended to replace the current financial system with the Core Financial and Logistics System (CoreFLS). During the testing phase of the CoreFLS project, problems occurred with data conversion, training, testing, segregation of duties, and access controls. As a result, VA is reevaluating the current plans for CoreFLS. To address the material weakness, Lack of Integrated Financial Management System, task groups will investigate the feasibility of developing tools to support the effective and efficient preparation of financial statements to eliminate significant manual workarounds, improve interfaces between legacy systems and VA's core accounting system (Financial Management System), enhance data consistency between the core accounting and subsidiary systems, and automate reconciliation processes.

## *GAO6. Federal Real Property: A High-Risk Area*

GAO has designated "federal real property" as a governmentwide high-risk area. There is a need for a comprehensive and integrated real property transformation strategy that could identify how best to realign and rationalize federal real property and dispose of unneeded assets; address significant real property repair and restoration needs; develop reliable, useful real property data; resolve the problem of heavy reliance on costly leasing; and minimize the impact of terrorism on real property.

VA has struggled to respond to asset realignment challenges due to its mission shift to outpatient, community-based services. GAO reported in 1999 that VA had 5 million square feet of vacant space and that utilization will continue to decline. VA has recognized that it has excess capacity and has an effort underway known as the Capital Asset Realignment for Enhanced Services (CARES) that is intended to address this issue. VA's environment contains a diverse group of competing stakeholders who could oppose realignment plans that they feel are not in their best interests, even when such changes would benefit veterans.

Improvements in capital planning are needed. For example, GAO reported in 1999 that VA's capital asset decision-making process appeared to be driven more by the availability of resources within VA's different appropriations than by the overall soundness of investments. This resulted in VA's spending millions more on leasing property instead of ownership because funds were more readily available in the appropriation that funds leases than in the construction appropriation.

In recent years, VA has also developed legislative proposals to establish a capital asset fund, which would, among other things, be aimed at improving VA's capability to dispose of unneeded real property by helping to fund related costs such as demolition, environmental cleanup, and repairs.

**VA's Program Response:** VA concurs with GAO's recommendation. VA is committed to a comprehensive, corporate-level approach to capital asset management. This approach helps VA closely align asset decisions with its strategic goals, elevate awareness of its assets, and employ performance management techniques to monitor asset performance on a regular basis through the entire lifecycle of an asset. Each significant capital investment is tracked through its lifecycle from formulation to execution, steady-state, and disposal. At the core of VA's capital asset business strategy is value management – striving to return value to VA's business and managing existing value for greater return.

VA began its pursuit of a comprehensive capital asset planning process and management strategies in 1997. VA developed a structure that facilitated a comprehensive system-wide integrated capital investment planning process. The fundamental goal of the new process was to ensure that all major capital investment proposals, including high-risk and/or mission-critical projects, were based upon sound business and economic principles; promoted the *One-VA* vision by linking diverse but complementary objectives; were aligned with VA's overall strategic goals and objectives; addressed the Secretary's priorities by emphasizing program objectives in support of internal goals; and supported the President's Management Agenda. Each year, VA re-evaluates its capital investment decision models to ensure alignment with the administration's management agenda and the strategic plan, goals, and objectives.

In June 2004, the Department produced its first 5-year capital plan, a systematic and comprehensive framework for managing the Department's portfolio of more than 5,500 buildings and approximately 32,000 acres of land. This plan is a sound blueprint for managing the Department's capital investments and will lead to improved use of resources and more effective delivery of health care and benefits. This plan outlines CARES implementation by identifying priority projects that will improve the environment of care at VA medical facilities and ensure more effective operations by redirecting resources from maintenance of vacant and underused buildings and reinvesting them in veterans' health care. The plan reflects a need for additional investments of approximately $1 billion per year for the next 5 years to modernize VA's medical infrastructure and enhance veterans' access to care. The plan is being reviewed by Congress and serves as a budget request for 30 major construction projects that would be funded using FY 2004 available dollars and the FY 2005 requested amount.

In February 2004, the President signed Executive Order 13327, Federal Real Property Asset Management. This order was created to promote the efficient and economical use of federal real property assets and to ensure management accountability for implementing federal real property management reforms. The order also encourages federal departments and agencies to recognize the importance of effective real property management and the establishment of clear goals and objectives, as well as improved policies and levels of accountability. One central component of the order was the establishment of the Federal Real Property Council (FRPC), whose membership consists of the Real Property Officers from each designated agency or department. This council has a broad range of responsibilities including creating government-wide principles for effective asset management. The FRPC is in the process of finalizing first-tier performance measures, which are measures that all federal agencies are expected to calculate, track, and monitor on an agency-wide basis. The primary first-tier performance measures address significant real property issues of quality, quantity, and cost. These measures include such things as facility condition index, facility sustainment rate, facility recapitalization rate, facility utilization index, and mission dependency investment. In addition, the FRPC encourages agencies to implement second-tier performance measures, which are measures that are tracked by an agency and are either not rolled up for agency-wide use or may not be directly applicable as a real property management measure. VA is transitioning to implementing both first and second-tier performance measures. Another important requirement found in the order was that all federal departments and agencies must develop an asset management plan (AMP). VA is in the process of completing its AMP. The VA AMP reflects the initiatives VA has implemented and is developing in order to meet and/or exceed its own requirements as well as those found in both the executive order and the guiding principles developed by the FRPC. The AMP serves as a companion document to the recently published VA 5-year capital plan. The long-term plan provides detailed descriptions of current and future capital investments, including the investments needed to implement the recent decisions made by the Secretary regarding the CARES process. The AMP provides information, descriptions, and examples of the following:

- The Department's capital budget for FY 2005, which identifies and categorizes an inventory of assets owned, leased, or managed by VA.
- The VA capital asset management philosophy, which is grounded in the life-cycle approach and details the guiding principles used at each phase. This includes tracking the performance and making necessary adjustments for all capital assets in our portfolio during all stages of an investment lifecycle (formulation through disposal).
- A description of VA's capital portfolio goals and illustration of how they serve as both our short-term and long-term objectives.
- A description of the important elements found in the "building block" business case (OMB Exhibit 300), including strategic alignment, alternatives considered, risk analysis, and cost effectiveness analysis.
- Illustration of the actions being taken by VA to improve the formulation and operational management of our portfolio, including the development of our capital portfolio system known as the Capital Asset Management System (CAMS).
- A description of VA's sustainment model, which was recently created to assist in developing facility maintenance needs and measures.
- A description of the valuation mechanism used at VA, including fair market value, replacement value, book value, and land value.
- A description of the human capital strategies employed, including the policies developed to govern asset management at VA.

Over the past several years, VA has undertaken some major initiatives in order to improve and strengthen the capital asset management program. VA has integrated best practices into the fabric of the capital investment process, learning from the best planning and performance measurement found in government and private industry. Initiatives include: 1) creation of the VA Office of Asset Enterprise Management (OAEM); 2) reorganization of the Office of Management; 3) establishing Capital Asset Managers at the local level; 4) initiation of the CARES process; 5) creation and deployment of CAMS; and 6) introduction of pertinent legislation. Details of each initiative are as follows.

1) Creation of OAEM: The Secretary has taken steps to significantly improve the Department's management of capital assets, including the establishment of OAEM in 2001. OAEM promotes capital programming strategies including the development of integrated approaches to transform underutilized or unneeded capital assets from liabilities to potential capital resources through the use of existing authorities (enhanced-use leasing and enhanced sharing) and legislative and policy changes when necessary.

2) Office of Management Reorganization: In November 2002, the Secretary approved the Office of Management's plan to implement a major reorganization of finance, acquisition, and capital asset functions throughout VA into regional centers with delegations of authority and increased responsibility and accountability. By combining multiple functions into a single office of business oversight and streamlining field operations to a manageable size via regional business offices, VA can realize both efficiencies and improvements in its business activities.

3) Establishing Capital Asset Managers at the local level: In November 2002, the Secretary approved implementation of a major reorganization of finance, acquisition, and capital asset functions throughout VA into regional centers with clearer delegations of authority and increased responsibility and accountability. The VISN Capital Asset Manager (CAM) will provide corporate (VISN) leadership, directing activities relating to the planning, acquisition, management, and disposal of capital assets. This includes management of all capital programs including major and minor construction, non-recurring maintenance, enhanced-use leasing, sharing agreements, leasing, real property, major medical and non-medical equipment, and energy conservation/savings initiatives and associated resources. It also involves developing and monitoring VISN capital program goals and performance as well as

any corrective action plans to bring capital assets into compliance and adherence with VISN and national benchmarks and portfolio performance standards. As of October 2004, all the capital asset managers have been selected and are in place at their respective VISN.

4) CARES Process: VA's CARES process was launched to align capital assets to meet veterans' future needs for accessible, quality health care. VA's enhanced-use lease authority will play a major role in the realignment of VHA's capital assets by transforming underutilized space from a liability to an important component of VA's overall capital portfolio.

5) CAMS: VA is in the final stages of developing and deploying CAMS, which is a portfolio management tool for all significant VA capital assets. Investment protocols and capital asset management policies were developed to provide guidelines for each major phase or milestone in the life cycle of a capital asset decision. These assets are monitored and evaluated against a set of performance measures (including capital assets that are underutilized and/or vacant) and capital goals to maximize highest return on the dollar to support veteran needs. VA established the following Department-level portfolio goals:

- Decrease operational costs.
- Reduce energy utilization.
- Decrease underutilized capacity.
- Increase intra/inter-agency and community-based sharing.
- Increase revenue opportunities.
- Maximize highest and best use.
- Safeguard assets.

As mentioned previously, VA is transitioning to the above goals to be consistent with the FRPC "Tier 1" measures where appropriate.

CAMS represents the first successful attempt to link asset managers in the field with corporate and oversight branches of VA so that current data are electronically shared and vetted according to a set schedule. In FY 2004, CAMS was deployed with portfolios for leased assets, owned buildings and land, major equipment, and asset-related agreements. In FY 2005, CAMS will add an inter-portfolio capacity, which will allow for better integration of data. The information harnessed via CAMS will lead to improved asset performance measurement, which ultimately will provide VA decisionmakers with the information needed to either repair and restore assets or to divest assets that are no longer needed.

6) Legislation: For FY 2004, VA again introduced legislation that would allow the Department to dispose of, sell, transfer and/or exchange excess properties and retain the proceeds by establishing a capital asset fund. This incentive would allow VA to better manage its underutilized or excess real property by improving its capability to dispose of unneeded property. Funds may also be used to pay for related significant costs such as environmental clean-up and demolition. A majority of the proceeds received would be used to fund CARES capital needs. The improvements to VA's infrastructure would also allow dollars currently being spent on maintenance and operations to be diverted to enhance veterans' health care delivery.

VA has also performed security studies that assess the vulnerabilities (including terrorist attacks) of its infrastructure. As of July 2004, the Department completed full assessments of 18 facilities and preliminary assessments of 100 of VA's critical facilities. VA is working to appropriately address any issues or deficiencies identified by these assessments.

## *GAO7. Strategic Human Capital Management: A High-Risk Area*

GAO has designated "strategic human capital management" as a governmentwide high-risk area. It was also placed at the top of the President's Management Agenda (PMA). Please see the discussion on pages 50-51 in the PMA section regarding VA's progress on strategic human capital management.