Letter from the Chief Financial Officer

November 17, 2008

The Department of Veterans Affairs (VA) completed another successful year by receiving an unqualified audit opinion for the 10th consecutive year from our external auditors, Deloitte & Touche. We are extremely proud of this continued accomplishment.

VA continued to implement corrective actions to address the material weaknesses identified in the FY 2007 audit (Financial Management System Functionality, Information Technology Security Controls, Financial Management Oversight, and Retention of Computer Generated Detail Records in the Benefits Delivery Network (BDN) System). During this year, we successfully remediated and removed the Retention of Computer Generated Detail Records in the Benefits Delivery Network (BDN) System material weakness, reducing the total number of VA material weaknesses from four to three.

VA also made progress on the Financial Management System Functionality material weakness through our Financial & Logistics Integrated Technology Enterprise (FLITE) program. This important VA initiative is being developed to integrate disparate VA systems, standardize functional processes, and modernize the information technology environment across the entire VA. The FLITE program is following a multiple-year phased approach comprised of two major components: the logistics and asset management system component, referred to as Strategic Asset Management (SAM), and the financial management component, referred to as the Integrated Financial Accounting System (IFAS).

In 2008 VA completed initial planning and documentation of business requirements for SAM and IFAS. Key program management activities were also implemented, including establishment of a Risk Management Control Board, base lining the life cycle cost estimate,

schedule and milestones, initiating organizational change management communications targeted toward stakeholders, and continued engagement of the FLITE Governance Structure to provide senior level oversight and guidance. Major program accomplishments included awarding the contract for SAM hardware, issuing the request for proposals for the SAM Pilot implementation and program management office support services, and conducting a site selection survey to determine pilot sites for IFAS and beta sites for SAM and IFAS.

In 2008, the FLITE program also implemented the final planned interfaces into the Financial Reporting Data Warehouse (FRDW) production environment. These include the Loan Guarantee Program interfaces for the Centralized Property Tracking System (CPTS), Countrywide Home Loans (CHL), Funding Fee Payment System (FFPS), VistA Account Receivable (AR), and VistA FEE. This will substantially improve VA's ability to capture transaction details from targeted interface systems and reconcile data interfacing to the VA legacy Financial Management System (FMS) resulting in an enhanced reconciliation process between FMS and legacy subsidiary systems.

VA also made improvements to the intragovernmental accounting and reporting process. A review of the intragovernmental vendor list was conducted and obsolete and redundant vendor IDs were removed. In addition, a Hyperion-based intragovernmental reporting tool was developed and tested. This reporting enhancement tool will be in production in the first quarter of FY 2009 and will significantly improve the accuracy of reporting VA's reciprocal intragovernmental accounts.

Progress has also been made in addressing the Information Technology (IT) Security Controls material weakness. The Department's overall information security posture has been improved with the establishment of the Information Protection and Risk Management (IPRM) organization to centralize security and privacy staff and business functions, increase accountability, and standardize security processes. With IPRM, VA has established the organizational foundation to ensure VA has a stronger security program well into the future. VA continues to implement the comprehensive Data Security - Assessment and Strengthening of Controls Program to govern the multiple, concurrent security activities already underway to remediate this material weakness. Other achievements include the certification and accreditation of over 600 VA operational systems including the testing of over 9,000 system security controls. As of September 2008, all of these systems have received full authorization to operate. Innovative technical solutions like portable device encryption, enterprise network monitoring, secure remote access, and port security and device control were implemented to enhance the protection of access to sensitive information and improve VA's overall information security posture.

During 2008, initiatives related to remediating the Financial Management Oversight material weakness were also implemented. VA procured contractor support to provide financial process improvement, audit readiness, and audit remediation services. VA also started the 3-year Financial Policy Improvement Initiative to ensure that financial policy and procedural information is standardized, accurate, clear, and readily available across the Department.

Corrective action plans for each of the three material weaknesses guide VA's efforts as we continue to work diligently and proactively to address and remove them. However, these weaknesses are complex and involve corrective actions over several years. OMB recognized VA's improvements by upgrading our "progress" score on the President's Management Agenda Financial Performance scorecard from red to yellow.

We also continued efforts to ensure VA's compliance with OMB Circular A-123, Appendix A, Internal Control over Financial Reporting. Based on the approved implementation plan, VA completed the first full cycle of all actions identified for its 3-year plan. As a result of the completion of the assessment of VA's eleven key business processes, no material weaknesses were identified. Remediation actions were identified and implemented to address all findings.

VA continues to implement new strategies to meet existing and new requirements under OMB Circular A-123, Appendix B. We increased our ability to track and monitor training for the purchase and travel card programs through the implementation of specific training courses offered via VA's online Learning Management System. This training is required for Agency/Organization Program Coordinators (AOPCs) and all cardholders prior to being issued a card. AOPCs are also now required to complete GSA's online Purchase Card Training course in addition to VA's course. VA's Government Purchase Card Procedures Directive and Handbook were rewritten to enhance the administration of the program, strengthen internal controls and incorporate the latest guidance and recommendations from OMB, GSA and GAO. A 2008 OIG audit found that VHA purchase card controls were generally effective at preventing or detecting questionable, improper, or fraudulent medical facility purchases, and that all 707 transactions reviewed were purchases for goods or services for valid medical facility needs. However, better documentation was needed. In response to OMB concerns about Premium Class Travel (PCT), we revised our PCT policy and strengthened internal controls.

VA successfully completed risk assessments, statistical sampling, and all requirements for programs under the Improper Payments Information Act (IPIA) of 2002. VA met improper payment reduction and audit recovery targets for three out of five programs. VA also received approval from OMB to remove VA's Insurance and the Vocational Rehabilitation & Employment programs from IPIA reporting requirements until FY 2009 and FY 2010, respectively. This year, VA maintained a green score for "progress" on the President's Management Agenda scorecard for Eliminating Improper Payments.

VA continued to advance e-Gov initiatives and aggressively worked with the General Services Administration and Electronic Data Systems, VA's selected e-Gov travel prime contractor, to implement an electronic travel solution for VA. VA completed Departmentwide implementation of FedTraveler on schedule in December 2007. VA's implementation (1) eliminated four separate travel systems previously in use in VA, providing a cost avoidance of $1.9 million annually from maintaining these older legacy systems, and (2) exceeded a key performance measure of having 75% of travel plans with air reservations made using the online booking engine – VA's online adoption rate averaged 82 percent, and leads all of EDS's government deployments. For the e-Payroll e-Gov initiative, VA has successfully migrated 16,417 employees to the Defense Finance and Accounting Service for payroll servicing. The remaining VA population, 251,905, is scheduled to migrate in 2009.

VA's Franchise Fund is expected to receive its 11th successive unqualified audit opinion on its FY 2008 consolidated financial statements.

VA's Supply Fund received a clean opinion in 2007 on its balance sheet; this was the first independent audit by an outside audit firm on this component of their financial statements.

We are proud that in FY 2008, medical care collections continued to improve to over $2.4 billion. VA plans to continue to increase these collections, reaching nearly $2.5 billion in FY 2009. Additionally, VA has developed a Departmental managerial cost accounting (MCA) system to enable managers at all levels to review and analyze cost data at the detail and programmatic levels. All MCA processes within VA's Administrations became operational during FY 2008.

Under the Government Performance and Results Act, we continuously assessed and refined our performance measures, quality of data, and compilation procedures. We developed procedures to assure our stakeholders that we have the most useful and accurate performance data available.

We are proud of our many accomplishments, and know that a lot of work remains. We continually strive to improve our financial stewardship and have set new goals to improve our performance. We will continue to promote sound business practices and improve accountability while fulfilling our mission of service to our Nation's veterans.

Robert J. Henke

Consolidated Financial Statements

DEPARTMENT OF VETERANS AFFAIRS		
CONSOLIDATED BALANCE SHEETS (dollars in millions)		
As of September 30,	**2008**	**2007**
ASSETS		
INTRAGOVERNMENTAL		
Fund Balance with Treasury (Note 3)	$ 26,292	$ 22,213
Investments (Note 5)	11,924	12,427
Accounts Receivable, Net (Note 6)	52	79
Other Assets	593	42
TOTAL INTRAGOVERNMENTAL ASSETS	**38,861**	**34,761**
PUBLIC		
Investments (Note 5)	183	177
Accounts Receivable, Net (Note 6)	1,760	1,329
Loans Receivable, Net (Note 7)	2,908	2,858
Cash (Note 4)	40	34
Inventories and Related Properties, Net (Note 8)	61	54
General Property, Plant and Equipment, Net (Note 9)	13,068	12,176
Other Assets	33	28
TOTAL PUBLIC ASSETS	**18,053**	**16,656**
TOTAL ASSETS	**$ 56,914**	**$ 51,417**
Heritage Assets (Note 10)		
LIABILITIES		
INTRAGOVERNMENTAL		
Accounts Payable	$ 79	$ 115
Debt	1,580	1,052
Other Liabilities (Note 14)	1,903	2,140
TOTAL INTRAGOVERNMENTAL LIABILITIES	**3,562**	**3,307**
PUBLIC		
Accounts Payable	4,141	3,938
Liabilities for Loan Guarantees (Note 7)	3,452	3,769
Federal Employee and Veterans Benefits Liability (Note 12)	1,468,605	1,129,527
Environmental and Disposal Liabilities (Note 13)	928	558
Insurance Liabilities (Note 16)	10,751	11,217
Other Liabilities (Note 14)	7,433	7,710
TOTAL PUBLIC LIABILITIES	**1,495,310**	**1,156,719**
TOTAL LIABILITIES	**1,498,872**	**1,160,026**
NET POSITION		
Unexpended Appropriations – Earmarked Funds (Note 18)	(11,627)	(9,184)
Unexpended Appropriations – All Other Funds	15,621	11,291
Cumulative Results of Operations – Earmarked Funds (Note 18)	12,983	10,076
Cumulative Results of Operations – All Other Funds	(1,458,935)	(1,120,792)
TOTAL NET POSITION	**(1,441,958)**	**(1,108,609)**
TOTAL LIABILITIES AND NET POSITION	**$ 56,914**	**$ 51,417**

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,	**2008**	**2007**
NET PROGRAM COSTS (NOTE 20)		
Medical Care	$ 35,019	$ 32,013
Medical Education	1,367	1,267
Medical Research	917	843
Compensation	37,869	34,897
Pension	3,978	3,902
Education	2,537	2,348
Vocational Rehabilitation and Employment	787	722
Loan Guaranty	(565)	(200)
Insurance	118	94
Burial	448	355
NET PROGRAM COSTS BEFORE CHANGES IN VETERANS BENEFITS ACTUARIAL LIABILITIES	**82,475**	**76,241**
Compensation	338,100	(26,000)
Burial	900	(100)
SUBTOTAL	339,000	(26,100)
NET NON-PROGRAM COSTS	1,147	953
NET COST OF OPERATIONS (NOTE 20)	**$ 422,622**	$ **51,094**

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

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2008

	Earmarked Funds	All Other Funds	Eliminations	FY 2008 Consolidated Total
Cumulative Results of Operations				
Beginning Balance	$ 10,156	$ (1,120,792)	$ (80)	$ (1,110,716)
Budgetary Financing Sources				
Appropriations Used	-	87,147	-	87,147
Nonexchange Revenue	-	12	-	12
Donations	36	-	-	36
Transfer without Reimbursement	33	-	(33)	-
Other Financing Sources (Non-Exchange)				
Donations of Property	20	1	-	21
Transfers In/Out Reimbursement	-	(335)	96	(239)
Imputed Financing	-	1,375	-	1,375
Other	-	(870)	(96)	(966)
Total Financing Sources	89	87,330	(33)	87,386
Net Cost of Operations	(2,738)	425,360	-	422,622
Net Change	**2,827**	**(338,030)**	**(33)**	**(335,236)**
Ending Balance – Cumulative Results	12,983	(1,458,822)	(113)	(1,445,952)
Unexpended Appropriations				
Beginning Balance	(9,184)	11,211	80	2,107
Budgetary Financing Sources				
Appropriations Received	-	89,084	-	89,084
Appropriations Transferred In/Out	(2,443)	2,455	33	45
Other Adjustments	-	(95)	-	(95)
Appropriations Used	-	(87,147)	-	(87,147)
Total Budgetary Financing Sources	(2,443)	4,297	33	1,887
Total Unexpended Appropriations	**(11,627)**	**15,508**	**113**	**3,994**
Total Net Position	**$ 1,356**	**$ (1,443,314)**	**$ -**	**$ (1,441,958)**

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

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2007

	Earmarked Funds	All Other Funds	Eliminations	FY 2007 Consolidated Total
Cumulative Results of Operations				
Beginning Balance	$ 7,887	$ (1,146,470)	$ (38)	$ (1,138,621)
Budgetary Financing Sources				
Appropriations Used	-	78,983	-	78,983
Nonexchange Revenue	-	9	-	9
Donations	27	-	-	27
Transfer without Reimbursement	42	-	(42)	-
Other Financing Sources (Non-Exchange)				
Donations of Property	19	1	-	20
Transfers In/Out Reimbursement	-	(1,448)	1,206	(242)
Imputed Financing	-	1,408	-	1,408
Other	-	-	(1,206)	(1,206)
Total Financing Sources	88	78,953	(42)	78,999
Net Cost of Operations	(2,181)	53,275	-	51,094
Net Change	**2,269**	**25,678**	**(42)**	**27,905**
Ending Balance – Cumulative Results	10,156	(1,120,792)	(80)	(1,110,716)
Unexpended Appropriations				
Beginning Balance	(6,965)	8,201	38	1,274
Budgetary Financing Sources				
Appropriations Received	-	79,817	-	79,817
Appropriations Transferred In/Out	(2,219)	2,210	42	33
Other Adjustments	-	(35)	-	(35)
Appropriations Used	-	(78,982)	-	(78,982)
Total Budgetary Financing Sources	(2,219)	3,010	42	833
Total Unexpended Appropriations	**(9,184)**	**11,211**	**80**	**2,107**
Total Net Position	**$ 972**	**$ (1,109,581)**	**$ -**	**$ (1,108,609)**

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

DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (NOTE 21) (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2008

	Budgetary	Non-Budgetary Credit Program
Budgetary Resources		
Unobligated Balance at the Beginning of the Period	$ 18,312	$ 2,950
Recoveries of Prior Year Obligations	3	-
Budget Authority		
Appropriations Received	92,718	-
Borrowing Authority	-	1,294
Spending Authority from Offsetting Collections		
Earned	5,120	2,872
Unfilled Customer Orders	(133)	-
Subtotal	116,020	7,116
Nonexpenditure Transfers, net	45	-
Temporarily Not Available Pursuant to Public Law (Note 23)	(8,352)	-
Permanently Not Available	(126)	(766)
Total Budgetary Resources	**$ 107,587**	**$ 6,350**
Status of Budgetary Resources		
Obligations Incurred	$ 97,028	$ 3,065
Unobligated Balance Available	7,907	-
Unobligated Balance Not Yet Available	2,652	3,285
Total Status of Budgetary Resources	**$ 107,587**	**$ 6,350**
Change in Obligated Balance		
Obligated Balance, Net Beginning of Period	$ 12,911	$ 87
Obligations Incurred	97,028	3,065
Less Gross Outlays	(94,170)	(3,157)
Less Recoveries of Prior Year Unpaid Obligations, Actual	(3)	-
Change in Uncollected Customer Payments from Federal Sources	158	67
Obligated Balance, Net End of Period	**$ 15,924**	**$ 62**
Net Outlays		
Gross Outlays	$ 94,170	$ 3,157
Less Offsetting Collections	(5,145)	(2,938)
Less Distributed Offsetting Receipts	(2,879)	(1,364)
Net Outlays	**$ 86,146**	**$ (1,145)**

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

DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (NOTE 21) (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2007

	Budgetary	Non-Budgetary Credit Program
Budgetary Resources		
Unobligated Balance at the Beginning of the Period	$ 16,958	$ 3,560
Recoveries of Prior Year Obligations	6	-
Budget Authority		
Appropriations Received	82,630	-
Borrowing Authority	-	590
Spending Authority from Offsetting Collections		
Earned	5,261	1,522
Change in Unfilled Customer Orders	(250)	-
Subtotal	104,605	5,672
Nonexpenditure Transfers, net	33	-
Permanently Not Available	(77)	(521)
Total Budgetary Resources	**$ 104,561**	**$ 5,151**
Status of Budgetary Resources		
Obligations Incurred	$ 86,249	$ 2,201
Unobligated Balance Available	15,702	-
Unobligated Balance Not Yet Available	2,610	2,950
Total Status of Budgetary Resources	**$ 104,561**	**$ 5,151**
Change in Obligated Balance		
Obligated Balance, Net Beginning of Period	$ 8,109	$ 127
Obligations Incurred	86,249	2,201
Less Gross Outlays	(81,747)	(2,267)
Less Recoveries of Prior Year Unpaid Obligations, Actual	(6)	-
Change in Uncollected Customer Payments from Federal Sources	306	26
Obligated Balance, Net End of Period	**$ 12,911**	**$ 87**
Net Outlays		
Gross Outlays	$ 81,747	$ 2,267
Less Offsetting Collections	(5,317)	(1,548)
Less Distributed Offsetting Receipts	(2,560)	(1,050)
Net Outlays	**$ 73,870**	**$ (331)**

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

Notes to Consolidated Financial Statements

For the Years Ended September 30, 2008 and 2007 (dollars in millions, unless otherwise noted).

1. Summary of Significant Accounting Policies

Reporting Entity and 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 Act (CFO) 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.

Organization

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, an Executive-In-Charge for Human Resources and Administration, 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 principal financial statements are prepared in accordance with generally accepted accounting principles (GAAP) as promulgated by the Federal Accounting Standards Advisory Board (FASAB) and the Office of Management and Budget (OMB) Circular A-136, Financial Reporting Requirements. The American Institute of Certified Public Accountant's (AICPA) Statement on Auditing Standards No. 91, Federal GAAP Hierarchy, established a hierarchy of GAAP for Federal financial statements.

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 the Department of Treasury's (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.

Transferring Budget Authority to Other Agencies

The VA is a party to allocation transfers with the Department of Defense (DoD) as a transferring (parent) entity. Allocation transfers are legal delegations by one department of its authority to obligate budget authority and outlay funds to another department. A separate fund account (allocation account) is created in the U. S. Treasury as a subset of the parent fund account for tracking and reporting purposes. All allocation transfers of balances are credited to this account, and subsequent obligations and outlays incurred by the child entity are charged to this allocation account as they execute the delegated activity on behalf of the parent entity. Generally, all financial activity related to these allocation transfers (e.g. budget authority, obligations, outlays) is reported in the financial statements of the parent entity, from which the underlying legislative authority, appropriations and budget apportionments are derived.

Fund Balance with 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. Funds held by non-federal trusts are restricted and may be used only in accordance with the terms of the trust agreements.

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 initially set based on average market yields for comparable Treasury issues. Special bonds, which mature during various years through the year 2023, 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 non-federal Trust investments in mutual funds 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. VA continues to use the income from these subordinated certificates to fund the American Housing Trust Reserve Fund, which is used in turn to fund deficiencies in scheduled monthly principal and interest on the loans as well as to cover any realized losses incurred in the prior month. Any excess funds in the Reserve Fund are reimbursed to VA upon request.

Accounts Receivable
Intragovernmental accounts receivable consists of amounts due from other federal government agencies and are considered to be fully collectible.

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 2008, contractual adjustments were 20 percent of the Medical Care Collection Fund third party receivables. The bad debt allowances for medical-related receivables were 13 percent. For FY 2007, contractual adjustments were 56 percent and bad debt allowances for medical-related receivables were 10 percent. Educational–related receivables bad debt allowances were 47 percent for FY 2008 and 36 percent for FY 2007. Compensation and pension benefits overpayment-related bad debt allowances were 72 percent for FY 2008 and 68 percent for FY 2007.

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 then-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 adjusts the loans receivable. This adjustment 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 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 Work in Progress until completion, and then transferred to the appropriate property account. Other Structures and Capital Leases includes items such as leasehold improvements and structures not classified as buildings. 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. For disclosure regarding Heritage Assets see Note 10.

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 Army Corps of Engineers (Corps) and the General Services Administration (GSA). Advances to the Corps are primarily for non-recurring maintenance of VHA medical facilities. Advances to the GSA are primarily 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 Direct Loan and Loan Guaranty Program. The interest rates ranged from 2.40 to 4.58 percent in FY 2008 and 4.73 to 4.99 percent in FY 2007.

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 2008 and FY 2007 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 used, 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 other than disclosed in Note 17, Contingencies.

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. 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.

2. Non-Entity Assets

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

Non-Entity Assets
as of September 30,

	2008	2007
Fund Balance with Treasury	$ 96	$ 47
Intragovernmental Accounts Receivable	1	1
Public Accounts receivable	34	22
Total Non-Entity Assets	$ 131	$ 70

3. Fund Balance with Treasury

Fund Balance with Treasury
as of September 30,

	2008	2007
Entity Assets		
Trust Funds	$ 93	$ 76
Revolving Funds	3,734	3,476
Appropriated Funds	22,110	18,433
Special Funds	214	178
Other Fund Types	45	3
Total Entity Assets	26,196	22,166
Non-Entity Assets		
Other Fund Types	96	47
Total Non-Entity Assets	96	47
Total Entity and Non-Entity Assets	$ 26,292	$ 22,213
Reconciliation of VA General Ledger Balances with Treasury		
Entity VA General Ledger	$ 27,774	$ 23,630
Reconciled Differences, principally timing	(1,537)	(1,419)
Unreconciled Differences	55	2
Fund Balance with Treasury	$ 26,292	$ 22,213
Status of Fund Balance with Treasury		
Unobligated Balance		
Available	$ 7,852	$ 7,282
Unavailable	4,010	3,623
Obligated Balance not yet Disbursed	14,076	11,079
Deposit /Clearing Account Balances	354	229
Fund Balance with Treasury	$ 26,292	$ 22,213

4. Cash

Cash as of September 30,	2008	2007
Canteen Service	$ 2	$ 1
Agent Cashier Advance	6	4
Loan Guaranty Program	32	29
Total Cash	$ 40	$ 34

5. Investments

Investment Securities as of September 30, 2008	Cost	Amortization Method	Unamortized (Premium) Discount	Interest Receivable	Investments, Net	Market Value
Intragovernmental Securities						
Marketable (T-Bills)	$ 26	Straight-line	$ -	-	26	$ 26
Non-Marketable: Special Bonds	11,657	Interest	-	168	11,825	11,825
Treasury Notes	73	N/A	(1)	1	73	73
Total	$ 11,756		$ (1)	169	11,924	$ 11,924
Other Securities						
Trust Certificates (Loan Guaranty)	$ 140	N/A	$ -	-	140	$ 140
Mutual Funds (Non-Federal Trusts)	46	Straight-line	(3)	-	43	43
Total	$ 186		$ (3)	-	183	$ 183
as of September 30, 2007						
Intragovernmental Securities						
Marketable (T-Bills)	$ 26	Straight-line	$ -	-	26	$ 26
Non-Marketable: Special Bonds	12,151	Interest	-	180	12,331	12,331
Treasury Notes	69	N/A	-	1	70	70
Total	$ 12,246		$ -	181	12,427	$ 12,427
Other Securities						
Trust Certificates (Loan Guaranty)	$ 130	N/A	$ -	-	130	$ 130
Mutual Funds (Non-Federal Trusts)	50	Straight-line	(3)	-	47	47
Total	$ 180		$ (3)	-	177	$ 177

6. Accounts Receivable, Net

Accounts Receivable, Net
as of September 30,

	2008	2007
Intragovernmental Accounts Receivable, Net	$ 52	$ 79
Public Accounts Receivable		
Public Accounts Receivable, Gross	$ 3,041	$ 2,745
Allowance for Loss Provision	(1,281)	(1,416)
Net Public Accounts Receivable	$ 1,760	$ 1,329

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). This disclosure is also in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 2, Accounting for Direct Loans and Guarantees. 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 at present value. 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, 2008

	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)	$ 25	10	(6)	-	$ 29
Insurance Policy Loans	569	14	-	-	583
Total Loans Receivable and Related Foreclosed Property Excluding Direct Loans Obligated After 1991, Net					$ 612

	Loans Receivable Gross	Interest Receivable	Allowance for Subsidy (Present Value)	Foreclosed Property	Value of Assets Related to Loans
Direct Loans Obligated After FY 1991	$ 721	10	748	29	$ 1,508
Total Loans Receivable and Related Foreclosed Property from Direct Loans, Net					$ 2,120

Loans Receivable and Related Foreclosed Property From Direct Loans as of September 30, 2007

	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)	$ 36	12	(1)	-	$ 47
Insurance Policy Loans	608	15	-	-	623
Total Loans Receivable and Related Foreclosed Property Excluding Direct Loans Obligated After 1991, Net					$ 670

	Loans Receivable Gross	Interest Receivable	Allowance for Subsidy (Present Value)	Foreclosed Property	Value of Assets Related to Loans
Direct Loans Obligated After 1991	$ 868	13	620	32	$ 1,533
Total Loans Receivable and Related Foreclosed Property from Direct Loans, Net					$ 2,203

Direct Loans Disbursed
The total amount of new direct loans disbursed for the years ended September 30, 2008 and 2007, was $130 and $127, 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 vendee or direct loans will default over a 12-year period. For FY 2008, 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.

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
for the years ended September 30,

	2008	2007
Interest Differential	$ (18)	$ (13)
Defaults*	9	11
Fees**	(1)	(1)
Other***	13	9
Subtotal	3	6
Interest Rate Reestimates	(10)	(220)
Technical Reestimates	12	(323)
Total Direct Loan Subsidy Expense	$ 5	$ (537)

* Includes approximately $5 thousand and $8 thousand in defaults and other expenses for the Vocational Rehabilitation Program in FY 2008 and 2007, 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	(25.86%)
Defaults	16.74%
Fees	(1.79%)
Other	18.16%

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 2008, the subsidy rate is (1.59) percent for Veterans Housing Direct – Vendee Loans, 8.84 percent for Veterans Housing Direct – Acquired Loans, and (14.48) percent for Native American Direct. In FY 2007, the subsidy rate was (3.46) percent for Veterans Housing Direct – Vendee Loans, 10.43 percent for Veterans Housing Direct – Acquired Loans, and (13.46) percent for Native American Direct. The allowance for subsidy as of September 30, 2008 and 2007 is $(748) and $(620), respectively.

Schedule for Reconciling Subsidy Cost Allowance Balances

Beginning Balance, Changes and Ending Balance

	FY 2008	FY 2007
Beginning balance of the allowance	$ (620)	$ (82)
Subsidy expense for direct loans disbursed during the reporting years by component:		
Interest subsidy costs	(18)	(13)
Default costs (net of recoveries)	9	11
Fees and other collections	(1)	(1)
Other subsidy costs	13	9
Total of the above subsidy expense components	3	6
Adjustments:		
Fees received	2	3
Foreclosed property acquired	(16)	3
Loans written off	(2)	(5)
Subsidy allowance amortization	(33)	(2)
Change in execution	(84)	-
Ending balance of the allowance before reestimates	(750)	(77)
Subsidy reestimates by component		
Interest rate reestimate	(10)	(220)
Technical/default reestimate	12	(323)
Total of the above reestimate components	2	(543)
Ending balance of the allowance	$ (748)	$ (620)

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, 2008

	Loans Receivable Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Defaulted Guaranteed Loans - Pre-1992 Guarantees	$ 49	-	(39)	9	$ 19
Defaulted Guaranteed Loans Post-1991	5	-	-	764	769
Total Loans Receivable and Related Foreclosed Property from Loan Guarantees					$ 788

Loans Receivable and Related Foreclosed Property from Loan Guarantees as of September 30, 2007

	Loans Receivable Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Defaulted Guaranteed Loans - Pre-1992 Guarantees	$ 80	-	(74)	11	$ 17
Defaulted Guaranteed Loans Post-1991	5	-	-	633	638
Total Loans Receivable and Related Foreclosed Property from Loan Guarantees					$ 655

Total Loans Receivable and Related Foreclosed Property, Net

as of September 30,	2008	2007
Total Direct Loans	$ 2,120	$ 2,203
Total Guaranteed Loans	788	655
Total Loans Receivable and Related Foreclosed Property, Net	$ 2,908	$ 2,858

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 to make a determination of the fair market value. To determine the net value of the property, VA costs such as acquisition, management, and disposition of the property, as well as estimated losses on property resale, are subtracted from the estimated fair market value. The amount recorded for foreclosed property is estimated based upon the present value of future cash flows to be received upon the disposition of the property. Future cash flows are estimated based on the estimated selling price less the amounts paid at foreclosure plus estimated costs to carry the property. Recent volatility in the United States housing market could change the estimates and assumptions used for these calculations in the future, which could impact the amounts reported and disclosed herein.

As of September 30, 2008 and 2007, the estimated number of residential properties in VA's inventory was 7,605 and 6,975, respectively. For FY 2008 and FY 2007, the average holding period from the date properties were conveyed to VA until the properties were sold was estimated to be 11.7 months and 11.3 months, respectively. The number of properties for which foreclosure proceedings are in process is estimated to be 9,077 and 4,696 as of September 30, 2008 and 2007, respectively.

Guaranteed Loans
as of September 30,

		2008		2007
Guaranteed Loans Outstanding:				
Outstanding Principal Guaranteed Loans, Face Value	$	220,839	$	207,644
Amount of Outstanding Guarantee		63,921		61,456
New Guaranteed Loans Disbursed:				
Outstanding Principal Guaranteed Loans, Face Value	$	36,090	$	24,889
Amount of Outstanding Guarantee		9,236		6,438
Liabilities for Loan Guarantees Post 1991 (Present Value)	$	3,452	$	3,769

Guaranty Commitments
VA guaranteed 179,671 loans in FY 2008. The FY 2008 total guaranty amount is $9.2 billion. The total amount of loans guaranteed is $36 billion.

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,

		2008		2007
Defaults	$	454	$	312
Fees*		(587)		(394)
Subtotal		(133)		(82)
Interest Rate Reestimates		(212)		(37)
Technical Reestimates		(230)		193
Total Guaranteed Loan Subsidy Expenses**	$	(575)	$	74

* 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.
** A negative subsidy rate indicates cash inflows from interest and fees are greater than disbursements.

Loan Sale-Guaranteed Loan Subsidy Expense for the years ended September 30,		2008		2007
Defaults	$	5	$	-
Other		(1)		-
Subtotal		4		-
Interest Rate Reestimates		(49)		58
Technical Reestimates		(52)		13
Total Loan Sale-Guaranteed Subsidy Expense	$	(97)	$	71

Total Subsidy Expense for the years ended September 30,		2008		2007
Total Direct Loans	$	5	$	(537)
Total Guaranteed Loans		(575)		74
Total Sale Loans		(97)		71
Total Subsidy Expense	$	(667)	$	(392)

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	1.26%
Fees	(1.63)%

Loan Sales

VA has vendee loan sales to reduce the administrative burden of servicing vendee loans. During the period FY 1992 through FY 2008, the total loans sold amounted to $14 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 2008, servicing was performed by Countrywide Home Loans, Inc. The Master Servicer is responsible for performing all the servicing functions under the separate Pooling and Servicing Agreements created for each Vendee Mortgage Trust. The Master Servicer is entitled to be compensated by retaining, from amounts received on each Mortgage Loan or Real Estate Owned (REO) Mortgage Loan (including REO Proceeds and Liquidation Proceeds) that are allocable to interest in accordance with the related Mortgage Note or, in the case of REO Proceeds and Liquidation Proceeds an amount equal to such amount allocable to interest multiplied by a fraction, the numerator of which is 0.2075% and the denominator of which is the Mortgage Rate for the related Mortgage Loan.

Additional servicing compensation in the form of prepayment charges, assumption fees, and late payment charges shall be retained by the Master Servicer as received. The Master Servicer also shall be entitled to withdraw and retain, as additional compensation, investment income on amounts on deposit in the Certificate Account. The Master Servicer shall be entitled to receive as additional compensation the interest earned on amounts remitted by the Master Servicer to the Trustee and deposited by the Trustee in the Distribution Account. The Master Servicer shall be required to pay all expenses incurred by it in connection with its servicing activities hereunder (including, without limitation, the fees and expenses of the Trustee, and the fees of the Sub-Servicers under the respective Sub-Servicing Agreements, if any) and shall not be entitled to reimbursement therefore except as specifically provided in each Pooling and Servicing Agreement.

VA completed one vendee loan sale of $193 during FY 2008 and none in FY 2007. The components of the vendee sale are summarized in the tables below.

Loan Sales
Years Ended September 30,

	2008	2007
Loans Receivable Sold	$ (193)	$ -
Net Proceeds from Sale	197	-
Gain on Receivables Sold	$ 4	$ -

Outstanding Balance of Loan Sale Guarantees
The outstanding balance for guaranteed loans sold is summarized in the table below:

Guaranteed Loans Sold as of September 30,	2008	2007
Outstanding Balance Guaranteed Loans Sold, Start of Year	$ 1,958	$ 2,364
Sold to the Public	193	-
Payments, Repayments, and Terminations	(250)	(406)
Outstanding Balance Guaranteed Loans Sold, End of Year	$ 1,901	$ 1,958

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 loan sold 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 2008 and 2007 is 2.14 percent and 3.99 percent, respectively. The liability for loan sale guarantees as of September 30, 2008 and 2007 is $73 and $166, respectively.

Schedule for Reconciling Loan Sale Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance	**2008**	**2007**
Beginning balance of the liability	$ 166	$ 102
Subsidy expense for guaranteed loans disbursed during the reporting years by component:		
Default costs (net of recoveries)	5	-
Other subsidy costs	(1)	-
Total of the above subsidy expense components	4	-
Adjustments:		
Claim payments to lenders	(10)	(12)
Interest accumulation on the liability balance	10	4
Other	4	-
Ending balance of the liability before reestimates	174	94
Subsidy reestimates by component		
Interest rate reestimate	(49)	59
Technical/default reestimate	(52)	13
Total of the above reestimate components	(101)	72
Ending balance of the liability	$ 73	$ 166

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 2008 and FY 2007 subsidy rate was (0.37) and (0.36) percent, respectively. The liability for loan guarantees as of September 30, 2008 and 2007 is $3,379 and $3,603, respectively.

Schedule for Reconciling Loan Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance

	2008	**2007**
Beginning balance of the liability	$ 3,603	$ 3,170
Subsidy expense for guaranteed loans disbursed during the reporting years by component:		
Default costs (net of recoveries)	454	312
Fees and other collections	(587)	(394)
Total of the above subsidy expense components	(133)	(82)
Adjustments:		
Fees received	584	432
Foreclosed property and loans acquired	(132)	(24)
Claim payments to lenders	(246)	(178)
Interest accumulation on the liability balance	145	129
Ending balance of the liability before reestimates	3,821	3,447
Subsidy re-estimates by component		
Interest rate reestimate	(212)	(37)
Technical/default re-estimate	(230)	193
Total of the above reestimate components	(442)	156
Ending balance of the liability	$ 3,379	$ 3,603

Administrative Expense

Administrative expense on direct and guaranteed loans for the fiscal years ended September 30, 2008 and 2007 was $155 and $154, respectively.

8. Inventories and Related Properties

Inventories
as of September 30,

	2008	**2007**
Held for Current Sale	$ 58	$ 53
Other	3	1
Total Inventories	$ 61	$ 54

9. General Property, Plant and Equipment

Depreciation and amortization expense totaled $1,024 and $895 in FY 2008 and FY 2007, respectively.

General Property, Plant and Equipment as of Sept. 30, 2008

	Cost	Accumulated Depreciation	Net Book Value
Land and Improvements	$ 576	$ (47)	$ 529
Buildings	17,355	(9,088)	8,267
Equipment	3,351	(1,786)	1,565
Other Structures and Capital Leases	2,324	(1,392)	932
Internal Use Software	274	(200)	74
Construction Work in Progress	1,459	-	1,459
Internal Use Software in Development	242	-	242
Total Property, Plant, and Equipment	$ 25,581	$ (12,513)	$ 13,068

General Property, Plant and Equipment as of Sept. 30, 2007

	Cost	Accumulated Depreciation	Net Book Value
Land and Improvements	$ 421	$ (32)	$ 389
Buildings	16,411	(8,497)	7,914
Equipment	3,116	(1,727)	1,389
Other Structures and Capital Leases	2,108	(1,306)	802
Internal Use Software	293	(184)	109
Construction Work in Progress	1,375	-	1,375
Internal Use Software in Development	198	-	198
Total Property, Plant, and Equipment	$ 23,922	$ (11,746)	$ 12,176

10. 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. VA has properties at medical centers and National Cemeteries that meet the criteria for heritage assets. Heritage assets allow VA to meet its responsibilities under the National Historic Preservation Act to administer federally owned, administered, or controlled prehistoric or historic resources in a spirit of stewardship for the inspiration and benefit of present and future generations.

Generally, additions to VA's heritage assets inventory result from field station surveys, which identify items such as new collections or newly designated assets. VA classifies its heritage assets as: Art Collections (including artwork, archives, historic medical equipment, medals and awards, furniture, archaeological materials, and photographs); Buildings and Structures (including historic hospitals, quarters, lodges, and chapels); Monuments/Historic Flag Poles: Other Non-Structure Items (including rostrums, gates and historic walls); Archaeological Sites; and Cemeteries. According to VA's policy for heritage assets, only developed sections of National Cemeteries are classified as heritage assets; while undeveloped sections are not until they are developed. VA's policy for heritage assets can be found, in its entirety, in Directive and Handbook 7545, Cultural Resources Management Procedures.

Heritage Assets in Units		
As of September 30,	**2008**	**2007**
Art Collections	211	211
Buildings and Structures	1,543	1,543
Monuments/Historic Flag Poles	984	984
Other Non-Structure Items	225	225
Archaeological	34	34
Cemeteries	158	158
Total Heritage Assets in Units	3,155	3,155

11. Liabilities Not Covered By Budgetary Resources

The total amount of VA liabilities not covered by budgetary resources was $1,472.9 billion and $1,133.2 billion as of September 30, 2008 and 2007, respectively, as shown in the following table.

Components of Unfunded Liabilities as of September 30	**2008**	**2007**
Workers' Compensation*	$ 2,304	$ 2,208
Annual Leave	1,509	1,365
Judgment Fund	604	650
Environmental and Disposal	928	558
Accounts Payable – Canceled Appropriations	10	8
Veterans Compensation and Burial	1,466,700	1,127,700
Insurance	796	741
Total	$ 1,472,851	$ 1,133,230

* The actuarial estimate for workers' compensation provided by DOL was computed using interest rates of 4.77 percent and 5.08 percent to discount the projected annual benefit payments as of FY 2008 and FY 2007, respectively.

12. Federal Employee and Veterans Benefits

Federal Employee Benefits: Imputed Expenses-Employee Benefits

Years ended September 30,		2008		2007
Civil Service Retirement System	$	266	$	276
Federal Employees Health Benefits		1,025		1,049
Federal Employees Group Life Insurance		3		2
Total Imputed Expenses-Employee Benefits	$	1,294	$	1,327

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,

		2008		2007
FECA	$	1,905	$	1,827
Compensation		1,462,000		1,123,900
Burial		4,700		3,800
Total Federal Employee and Veterans Benefits Liabilities	$	1,468,605	$	1,129,527

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, 2008 and 2007 was $97.3 billion and $81.4 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, 2008, ranging from 1.80 to 4.61 percent, and on September 30, 2007, ranging from 3.97 to 4.99 percent. 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 2002 and 2008. 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 2004 U.S. Life Table. Applying mortality improvements at a rate that varies by age of between 0.85 and 1.00 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 beneficiary category and age were based on current amounts being paid, future cost of living adjustments (COLAs) to determine the average benefits per veteran for each future time period, and changes in other factors that affect benefits. A COLA of 2.3 percent was applied for FY 2008. For fiscal years after 2006, 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 Chief Actuary of the Social Security Administration (SSA). 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 for the years 74 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, 2008.

New Accounting Standard

On October 14, 2008 the FASAB issued SFFAS No. 33, Pensions, Other Retirement Benefits, and Other Post-employment benefits: Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates, effective for periods beginning after September 30, 2009.

The changes resulting from implementing the standards in SFFAS No. 33 include: (1) disclosure of gains and losses from changes in long-term assumptions; (2) disclosure of the components of the expense associated with federal employee pensions, other retirement benefits, and other post-employment benefits pension liability balances, including veterans compensation; and (3) standards for selecting the discount rate assumption and valuation dates for estimating the liability.

13. Environmental and Disposal Liabilities

VA had unfunded environmental and disposal liabilities in the amount of $928 and $558 as of September 30, 2008 and 2007, 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 are 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.

14. Other Liabilities

Other liabilities are liabilities not reported elsewhere. They consist of Funded and Unfunded 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,		2008		2007
Deposit and Clearing Account Liabilities	$	100	$	37
Accrued Expenses - Federal		232		109
Deferred Revenue		11		94
Resources Payable to Treasury		197		210
Custodial Liabilities*		769		1,200
General Fund Receipts Liability		5		5
Accrued VA Contributions for Employee Benefits		190		103
Total Other Intragovernmental Funded Liabilities	$	1,504	$	1,758

* 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,		2008		2007
Accrued FECA Liability	$	395	$	378
Unfunded Employee Liability		4		4
Total Other Intragovernmental Unfunded Liabilities	$	399	$	382
Total Other Intragovernmental Liabilities	$	1,903	$	2,140

Other Public Funded Liabilities as of September 30,		2008		2007
Accrued Funded Annual Leave	$	12	$	12
Accrued Expenses		2,197		2,765
Accrued Salaries and Benefits		908		701
Unearned Premiums		81		88
Insurance Dividends Left on Deposit and Related Interest Payable*		1,712		1,725
Dividend Payable to Policyholders		157		172
Capital Lease Liability		16		17
Other		53		28
Total Other Public Funded Liabilities	$	5,136	$	5,509

* 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,	2008	2007
Annual Leave*	$ 1,510	$ 1,365
Accounts Payable from Cancelled Appropriation	10	8
Amounts due to non-federal trust	173	178
Judgment Fund-Unfunded**	604	650
Total Other Public Unfunded Liabilities	$ 2,297	$ 2,201
Total Other Public Liabilities	$ 7,433	$ 7,710

* 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 (see Note 17, Contingencies).

15. Leases

VA has both capital and operating leases. The capital lease liability is $16 and $17 as of September 30, 2008 and 2007, respectively. Real property leases reflect those that VA has committed to as of September 30, 2008. Due to the number of equipment operating leases and the decentralization of records, the future commitment for equipment operating leases is projected assuming annual increases between 4.1 and 4.2 percent. VA's FY 2008 operating lease costs were $348 for real property rentals and $112 for equipment rentals. The FY 2007 operating lease costs consisted of $299 for real property rentals and $101 for equipment rental. The following chart represents VA's projected operating lease commitments or costs for the next 5 years.

Leases: Year	Real Property	Percentage	Equipment
2009	$ 260	4.2	$ 117
2010	239	4.2	122
2011	198	4.2	127
2012	166	4.1	133
2013	128	4.1	139

16. 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 Service members' 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 service members 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 service members 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 service members 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 service members 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 thousand. 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 Service members' Group Life Insurance (SGLI) program was established in 1965 for Vietnam-era service members. SGLI is supervised by VA and is administered by the Office of Service members' Group Life Insurance (OSGLI) under terms of a group policy. This program provides low-cost term insurance protection to service members and their families.

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 service member's separation from service.

The Traumatic Injury Protection (TSGLI) program became effective December 1, 2005. TSGLI, which automatically covers all who participate in SGLI, provides for insurance payments to members who suffer a serious traumatic injury in service. These payments range from $25,000 to a maximum of $100,000, depending on the type and severity of injury.

Public Insurance Carriers
VA supervises the administration of the SGLI and VGLI programs. VA has entered into a group policy with Prudential Insurance Company of America whereby Prudential and its reinsurers provide service members and veterans coverage in multiples of $50 thousand up to a maximum of $400 thousand. 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 thousand of coverage can be purchased in increments of $10 thousand, not to exceed the amount of the service member's coverage. Each dependent child of every active duty service member or reservist insured under SGLI is automatically insured for $10 thousand 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 service member'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. Prudential administers the TSGLI program under an Administrative Services Only agreement with VA. Under the law, DoD pays for any claim costs for this program in excess of premiums collected.

The Secretary of Veterans Affairs determines the claim 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 costs so identified by the Secretary are paid by the uniformed services, not from the service members' premiums, as are all other programs costs.

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 and its reinsurers. 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 percent. The mortality assumptions include the American Experience Table, the 1941 Commissioners Standard Ordinary (CSO) Table, the 1958 CSO Basic Table, the 1980 CSO Basic Table, and the 2001 CSO Table.

Insurance Liability (Reserve) Balances

As of September 30, 2008

Program	Insurance Death Benefits	Death Benefit Annuities	Disability Income & Waiver	Reserve Totals
NSLI	$ 7,768	$ 115	$ 78	$ 7,961
USGLI	16	3	-	19
VSLI	1,567	9	20	1,596
S-DVI	341	3	437	781
VRI	295	1	3	299
VI&I	95	-	-	95
Subtotal	$ 10,082	$ 131	$ 538	$ 10,751
Less Liability not Covered by Budgetary Resources				(796)
Liability Covered by Budgetary Resources				$ 9,955

As of September 30, 2007

Program	Insurance Death Benefits	Death Benefit Annuities	Disability Income & Waiver	Reserve Totals
NSLI	$ 8,229	$ 127	$ 93	$ 8,449
USGLI	19	3	-	22
VSLI	1,565	9	23	1,597
S-DVI	329	3	400	732
VRI	318	2	3	323
VI&I	94	-	-	94
Subtotal	$ 10,554	$ 144	$ 519	$ 11,217
Less Liability not Covered by Budgetary Resources				(741)
Liability Covered by Budgetary Resources				$ 10,476

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 5,891,781 and 5,859,136 insured for a face value of $1,072 billion and $1,069.8 billion as of September 30, 2008 and 2007, respectively. The face value of the insurance provided by Prudential and its reinsurers represents 99 percent of the total insurance in-force as of September 30, 2008 and 2007. The number of policies represents the number of active policies remaining in the program as of the end of each fiscal year.

	2008 Policies	2007 Policies	2008 Face Value	2007 Face Value
Supervised Programs				
SGLI Active Duty	1,498,000	1,496,000	$ 580,589	$ 582,600
SGLI Ready Reservists	764,500	755,500	273,667	271,299
SGLI Post Separation	94,000	102,000	35,574	38,909
SGLI Family - Spouse	1,077,000	1,050,000	106,258	103,480
SGLI Family - Children	2,027,000	2,025,000	20,270	20,250
VGLI	431,281	430,636	55,636	53,260
Total Supervised	5,891,781	5,859,136	$ 1,071,994	$ 1,069,798
Administered Programs				
NSLI	921,942	1,013,557	$ 10,651	$ 11,516
VSLI	183,778	191,735	2,348	2,406
S-DVI	194,583	187,904	1,965	1,885
VRI	39,331	43,720	383	418
USGLI	5,620	6,720	17	21
VMLI	2,309	2,368	165	165
Total Administered	1,347,563	1,446,004	$ 15,529	$ 16,411
Total Supervised and Administered Programs	7,239,344	7,305,140	$ 1,087,523	$ 1,086,209

Policy Dividends

The Secretary of VA determines annually the excess funds available for dividend payment. Only administered policies are eligible for dividends. 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 2008 and 2007 were $338 and $365, respectively.

17. 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 $2.5 thousand 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 74 percent in FY 2008 and 84 percent in FY 2007. Contract dispute payments for FY 2008 and FY 2007 were $20.3 and $5.4, respectively. The discrimination case payments for FY 2008 were $1.7 and $3.3 for FY 2007.

VA uses accepted actuarial methods to estimate the liability resulting from medical malpractice and other tort claim exposure. VA discounted future estimated payments using U.S. Treasury spot rates as of September 30, 2008 and 2007.

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 $604 for FY 2008 and $650 for FY 2007. The contract and personnel law cases where there was at least a reasonable possibility that a loss may occur were 11 cases totaling $19.1, excluding the data theft litigation explained below, for FY 2008 and 18 cases totaling $228.7 for FY 2007. 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 below:

Judgment Fund

For the Years Ended September 30,

	2008	**2007**
Fiscal Year Settlement Payments	$ 103	$ 89
Less Contract Dispute and “No Fear” Payments	(22)	(8)
Imputed Financing-Paid by Other Entities	81	81
Increase (Decrease) in Liability for Claims	46	(35)
Operating Expense	$ 127	$ 46

It is the opinion of VA's management that resolution of pending legal actions as of September 30, 2008 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 2008 tort payments were $81.

The amount of unobligated and obligated authority relating to appropriations cancelled on September 30, 2008 and 2007 was $28 and $21.2, 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 2004-2008, the average medical care cost per year was $30 billion.

Haas v. Nicholson

The United States Court of Appeals for Veterans Claims (Veterans Court) issued a decision in Haas v. Nicholson, 20 Vet. App. 257 (2006), that reversed a decision of the Board of Veterans' Appeals, which denied service connection for disabilities claimed as a result of exposure to herbicides. VA disagreed with the court's decision in Haas and appealed to the United States Court of Appeals for the Federal Circuit. On May 8, 2008 the Federal Circuit ruled in favor of the VA; however, Mr. Haas has filed a petition asking the U.S. Supreme Court to hear the case. Pending a decision on appeal, the Veterans Court had stayed cases affected by the Haas decision pending before that court or at VA. Should the Supreme Court hear the case and overturn the Federal Circuit's decision, the adjudication of any stayed cases would resume and new adjudications would have to conform to the Supreme Court's decision, with the consequence that a liability for potential additional benefit costs may exist, but the amount or range of the possible liability cannot reasonably be estimated at this time. No claims have been paid or accrued as of this date.

VA Data Theft Litigation

VA is the subject of a class action lawsuit alleging breach of the Privacy Act, 5 U.S.C 552a (e) (10), in connection with the theft of a laptop computer containing sensitive personal information for approximately 17.5 million veterans. The plaintiffs seek statutory damages of at least $1 thousand per purported class member. The case is currently in pre-discovery mediation. An estimated range of potential loss, if any, is unknown at this stage of the litigation.

18. Earmarked Funds

SFFAS No. 27, *Identifying and Reporting Earmarked Funds*, requires disclosure of all earmarked funds for which VA has program management responsibility. Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, and are required by statute to be used for designated activities or purposes. They are accounted for separately from the Government's general revenues. VA's earmarked funds consist of trusts, special and revolving funds and remain available over time. The "trust" funds do not involve a fiduciary relationship with an individual or group but are designated exclusively for a specific activity, benefit or purpose. The investments (Treasury Securities) are assets of earmarked funds and are available for authorized expenditures. Treasury Securities are issued to the earmarked fund as evidence of earmarked receipts and provide the fund the authority to draw upon the US Treasury for future expenditures. When the earmarked fund redeems its Treasury Securities to make expenditures, the US Treasury will finance those expenditures in the same manner that it finances all other expenditures.

The VA's Earmarked Funds are as follows:

Fund Name	Fund Type	Treasury Symbol	Authority	Purpose of Fund	Financing Sources
Medical Care Collections Fund	Special	36x5287	P.L. 105-33 111 Stat 665	Third-party and patient co-payments for medical services.	Public, primarily insurance carriers.
Cemetery Gift Fund	Trust	36x8129	38 U.S.C. 1007	Donations for veterans' cemeteries.	Public donors.
National Service Life Insurance Fund	Trust	36x8132	38 U.S.C. 720	Premiums insure WWII veterans.	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. 723 101-228	Premiums insure Korean conflict veterans.	Public, veterans.
General Post Fund, National Homes	Trust	36x8180	38 U.S.C. 101-228	Donations for patient benefits.	Public, mostly veterans.
Canteen Service Revolving Fund	Revolving	36x4014	38 U.S.C. 78	Operates the canteen services at hospitals.	Revenue from sales.
National Cemetery Administration Facilities Operation Fund	Special	36x5392	P.L. 108-454	Proceeds benefit land and buildings.	Proceeds from leases.
Service-Disabled Veterans Insurance Fund	Revolving	36x4012	38 U.S.C. 1922	Provides insurance to veterans with service-connected disabilities	Public, veterans.
Servicemen's Group Life Insurance	Revolving	36x4009	38 U.S.C. 1965	Provides insurance to active duty, ready reservists, retired reservists and cadets attending service academies and ROTC.	Public, veterans.
Veterans Reopened Insurance Fund	Revolving	36x4010	38 U.S.C. 1925	Provides insurance to World War II and Korea veterans	Public, veterans.
Enhanced-Use Lease Trusts	Trust	N/A	38 U.S.C 8162	Lease underutilized VA property.	Public.

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

Balance Sheet as of September 30, 2008	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Assets:					
Fund Balance with Treasury	$ 45	$ 233	$ 67	$ 1	$ 346
Investments with Treasury	11,826	98	-	-	11,924
Other Assets	587	1,519	-	3	2,109
Total Assets	$ 12,458	$ 1,850	$ 67	$ 4	$ 14,379
Liabilities and Net Position:					
Payables to Beneficiaries	$ 199	$ 22	$ 1	$ 1	$ 223
Other Liabilities	12,607	193	-	-	12,800
Total Liabilities	$ 12,806	$ 215	$ 1	$ 1	$ 13,023
Unexpended Appropriations	-	(11,627)	-	-	(11,627)
Cumulative Results of Operations	(348)	13,262	66	3	12,983
Total Liabilities and Net Position	$ 12,458	$ 1,850	$ 67	$ 4	$ 14,379

Statement of Net Cost for the Year Ended September 30, 2008					
Gross Program Costs	$ 1,256	$ 381	$ 3	$ -	$ 1,640
Less Earned Revenues	1,155	3,261	1	-	4,417
Net Program Costs	101	(2,880)	2	-	(2,777)
Costs Not Attributable to Program Costs	-	40	-	-	40
Net Cost of Operations	$ 101	$ (2,840)	$ 2	$ -	$ (2,737)

Statement of Changes in Net Position for the Year Ended September 30, 2008					
Net Position Beginning of Period	$ (280)	$ 1,182	$ 67	$ 3	$ 972
Budgetary and Other Financing Sources	33	(2,387)	1	-	(2,353)
Net Cost of Operations	(101)	2,840	(2)	-	2,737
Change in Net Position	(68)	453	(1)	-	384
Net Position End of Period	$ (348)	$ 1,635	$ 66	$ 3	$ 1,356

Balance Sheet
as of September 30, 2007

	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Assets:					
Fund Balance with Treasury	$ 40	$ 191	$ 69	$ 1	$ 301
Investments with Treasury	12,330	96	-	-	12,426
Other Assets	626	1,106	1	2	1,735
Total Assets	$12,996	$ 1,393	$ 70	$ 3	$ 14,462
Liabilities and Net Position:					
Payables to Beneficiaries	$ 168	$ 15	$ 1	$ -	$ 184
Other Liabilities	13,108	197	1	-	13,306
Total Liabilities	$13,276	$ 212	$ 2	$ -	$ 13,490
Unexpended Appropriations	-	(9,184)	-	-	(9,184)
Cumulative Results of Operations	(280)	10,365	68	3	10,156
Total Liabilities and Net Position	$12,996	$ 1,393	$ 70	$ 3	$ 14,462

Statement of Net Cost
for the Year Ended September 30, 2007

	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Gross Program Costs	$ 1,292	$ 467	$ 3	$ -	$ 1,762
Less Earned Revenues	1,222	2,750	-	-	3,972
Net Program Costs	70	(2,283)	3	-	(2,210)
Costs Not Attributable to Program Costs	-	29	-	-	29
Net Cost of Operations	$ 70	$ (2,254)	$ 3	$ -	$ (2,181)

Statement of Changes in Net Position
for the Year Ended September 30, 2007

	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Net Position Beginning of Period	$ (252)	$ 1,101	$ 70	$ 3	$ 922
Budgetary and Other Financing Sources	42	(2,173)	-	-	(2,131)
Net Cost of Operations	(70)	2,254	(3)	-	2,181
Change in Net Position	(28)	81	(3)	-	50
Net Position End of Period	$ (280)	$ 1,182	$ 67	$ 3	$ 972

19. 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 2008, 49 contracts at 10 medical facilities were reviewed by the Management Quality Assurance Service (MQAS) to determine compliance with SFFAS No. 7 and the Chief Financial Officers Act of 1990. MQAS found 7 contracts (14 percent) contained no cost analyses, 8 contracts (16 percent) had incomplete or outdated cost analyses, and 5 contracts (10 percent) had no billing documents. In addition, one medical facility erroneously certified (did not disclose losses) recovery of cost on four contracts for non-essential veteran services. Another medical facility certified and properly disclosed a loss on one contract for non-essential veteran services.

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 15 cemeteries to not-for-profit groups for no fee. These 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 five agricultural licenses and one agricultural lease with private companies/individuals. NCA licenses and leases land for growing crops and, on certain licenses, receives services in exchange from the licensee for brush and weed cutting, fence maintenance, removal services, backfilling and grading of roads, and welding services.

Exchange Transactions with Public

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 Business Office (CBO) 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, tort feasor and no-fault or uninsured motorists insurance cases. Reasonable charges are based on provider charges in the market area of each VA facility. Under regulations issued pursuant to section 1729 and published at section 17.101, title 38, Code of Federal Regulations, third party payers may elect to pay VA's billed charges (less applicable deductible or co-payment amounts) for the care and services provided to veterans. Alternatively, third party payers may elect to pay VA an amount, generally known as usual and customary, that it would pay to other providers for care and services in the same geographic area.

Cost-based per diems are calculated annually to produce rates used to bill for medical care or services provided by the VA:

- (a) in error or on tentative eligibility;
- (b) in a medical workers' compensation (other than federal), humanitarian emergency;
- (c) to pensioners of allied nations;
- (d) for research purposes in circumstances under which VA medical care appropriation is to be reimbursed by VA research appropriation; and
- (e) to beneficiaries of the Department of Defense or other federal agencies, when the care or service provided is not covered by an applicable sharing agreement.

These per diem costs are derived primarily from cost and workload data from a national cost allocation report.

VA's Loan Guaranty Program collects certain fees that are set by law. The loan guarantee funding fees collected for FY 2008 were $567 and for FY 2007 were $435. The loan guarantee lender participation fees collected for FY 2008 were $2.1. The lender participation fees collected for FY 2007 were $1.5.

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.

Intragovernmental costs relate to the source of goods and services purchased by VA and not to the classification of related intragovernmental revenue.

VA and 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 $341.5 during FY 2008 for the Post-Vietnam Era Education Assistance Program, Reinstated Entitlements Program for Survivors, and the New GI Bill for Veterans.

VA reports intragovernmental trading partner information to the US Treasury through Treasury's Intragovernmental Reporting and Analysis System (IRAS). VA and its trading partners are not able to completely reconcile all activities and balances with each other due to several factors including transaction volumes, recognition of timing differences, and system limitations between trading partners. In FY 2008 VA made improvements to the intragovernmental reporting process. A review of the intragovernmental vendor list was conducted and obsolete and redundant vendor IDs were removed. A Hyperion-based intragovernmental reporting tool is currently under development and testing. Delivery is scheduled for FY 2009.

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.

20. 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, 2008 (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	$ 5,678	$ 106	$ 119	$ 275	$ 35	$ 8	$ 25	$ 933	$ 8	$ 57	$ 55	$ 7,299
Less Earned Revenues	(50)	-	(32)	-	-	(396)	-	(249)	(701)	-	(780)	(2,208)
Net Intragovernmental Production Costs	5,628	106	87	275	35	(388)	25	684	(693)	57	(725)	5,091
Public Costs	32,821	1,261	842	375,694	3,943	3,118	762	(1,195)	1,267	1,291	1,924	421,728
Less Earned Revenues	(3,430)	-	(12)	-	-	(193)	-	(54)	(456)	-	(52)	(4,197)
Net Public Production Costs	29,391	1,261	830	375,694	3,943	2,925	762	(1,249)	811	1,291	1,872	417,531
Total Net Cost of Operations	$ 35,019	$ 1,367	$ 917	$375,969	$ 3,978	$ 2,537	$ 787	$ (565)	$ 118	$ 1,348	$ 1,147	$ 422,622

Schedule of Net Program Cost

For the Year Ended September 30, 2007 (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	$ 4,582	$ 95	$ 97	$ 223	$ 27	$ 16	$ 18	$ 93	$ 8	$ 46	$ 70	$ 5,275
Less Earned Revenues	(113)	-	(35)	2	-	(427)	-	(743)	(742)	-	(1,064)	(3,122)
Net Intragovernmental Production Costs	4,469	95	62	225	27	(411)	18	(650)	(734)	46	(994)	2,153
Public Costs	30,450	1,172	794	8,672	3,875	2,962	704	513	1,310	209	1,996	52,657
Less Earned Revenues	(2,906)	-	(13)	-	-	(203)	-	(63)	(482)	-	(49)	(3,716)
Net Public Production Costs	27,544	1,172	781	8,672	3,875	2,759	704	450	828	209	1,947	48,941
Total Net Cost of Operations	$ 32,013	$ 1,267	$ 843	$ 8,897	$ 3,902	$ 2,348	$ 722	$ (200)	$ 94	$ 255	$ 953	$ 51,094

21. Disclosures Related to the Statements of Budgetary Resources

Apportionment categories of obligations incurred Obligations Years Ended September 30,	2008	2007
Category A, Direct	$ 41,643	$ 38,989
Category B, Direct	52,739	43,473
Reimbursable	5,711	5,959
Exempt from Apportionment	-	29
Total Obligations	$ 100,093	$ 88,450

Borrowing Authority
Loan Guaranty had borrowing authority of $1.3 billion and $0.7 billion as of September 30, 2008 and 2007, respectively. The Vocational Rehabilitation Program had borrowing authority of $4.0 and $2.7 as of September 30, 2008 and 2007, 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 one 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 $69. Additionally, unobligated balances of prior year recoveries of $3 were rescinded.

Permanent Indefinite Appropriations
VA has four 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 2008 use.

Unobligated VA funds are available for uses defined in VA's FY 2008 Appropriation Law (P.L. 110-161) and Supplemental Appropriations Law (P.L. 110-252). 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.

Explanation of Differences Between Statement of Budgetary Resources and the Budget
As a result of analysis of obligations and advances, obligations were reduced by $137 for FY 2008 on the Combined Statement of Budgetary Resources. This adjustment was 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.

Undelivered Orders at the End of Period
The amount of budgetary resources obligated for undelivered orders at the end of 2008 and 2007 was $8,462 and $5,690, respectively.

Contributed Capital
The amount of contributed capital received during FY 2008 consisted of donations in the amount of $55.9 to the General Post Fund and $0.1 to the National Cemetery Gift Fund. For FY 2007 $45.5 was donated to the General Post Fund and $0.1 to the National Cemetery Gift Fund.

22. Dedicated Collections

The table below summarizes the name, type, and purpose of the funds within VA that receive dedicated collections, other than earmarked funds which are separately disclosed in Note 18. All of the funds listed use the accrual basis of accounting. However, collections are reported as actually received in accordance with OMB Circular A-11. 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
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.

The following tables provide condensed information on assets, liabilities, fund balances.

For the year ended September 30, 2008

Fund Symbol	6020	6050	TOTAL
Assets:			
Fund balance with Treasury	$ 39	$ 1	$ 40
Investments with Treasury	-	-	-
Other Assets	-	-	-
Total Assets	$ 39	$ 1	$ 40
Liabilities:			
Payables to Beneficiaries	-	-	-
Other Liabilities	39	1	40
Total Liabilities	39	1	40
Net Position:			
Cumulative Results	-	-	-
Total Liabilities & Net Position	$ 39	$ 1	$ 40

23. Reconciliation of Net Cost of Operations to Budget

The objective of the information shown below is to provide an explanation of the differences between budgetary and financial (proprietary) accounting. This is accomplished by means of a reconciliation of budgetary obligations and non-budgetary resources available to the VA with its net cost of operations.

DEPARTMENT OF VETERANS AFFAIRS				
RECONCILIATION OF NET COSTS OF OPERATIONS TO BUDGET (dollars in millions)				
for the Years Ended September 30,		**2008**		**2007**
Resources Used to Finance Activities				
Obligations Incurred	$	100,093	$	88,450
Less Spending Authority from Offsetting Collections and Adjustments		(7,861)		(6,539)
Obligations Net of Offsetting Collections and Adjustments		92,232		81,911
Less Offsetting Receipts		(4,243)		(3,610)
Net Obligations		87,989		78,301
Donations of Property		21		20
Transfers-out		(239)		(241)
Imputed Financing		1,375		1,408
Other Financing Sources		(966)		-
Total Resources Used to Finance Activities		**88,180**		**79,488**
Resources That Do Not Fund Net Cost of Operations				
Change in Amount of Goods, Services and Benefits Ordered But Not Yet Provided		(3,597)		(1,078)
Resources that Finance the Acquisition of Assets		(5,093)		(3,736)
Resources that Fund Expenses Recognized in Prior Periods		(1,676)		(633)
Budgetary Offsetting Collections and Receipts that Do Not Affect Net Cost of Operations		4,553		2,842
Total Resources that Do Not Fund Net Costs of Operations		(5,813)		(2,605)
Total Resources Used to Finance the Net Cost of Operations		**82,367**		**76,883**
Costs That Do Not Require Resources in the Current Period				
Increase in Annual Leave Liability		144		118
Increase in Environmental and Disposal Liability		370		174
Reestimates of Credit Subsidy Expense		(675)		(402)
Increase in Exchange Revenue Receivable from the Public		(366)		(276)
Increase (Decrease) in Veterans Benefits Actuarial Liability		339,233		(26,045)
Depreciation and Amortization		1,024		895
Bad Debts Related to Uncollectible Non-Credit Reform Receivables		424		314
Loss on Disposition of Assets		130		134
Other		(29)		(701)
Total Costs That Do Not Require Resources in the Current Period		**340,255**		**(25,789)**
Net Cost of Operations	**$**	**422,622**	**$**	**51,094**

24. Reclassifications, Changes in Accounting Policy and Changes in Financial Statement Presentation

Heritage Assets

In FY 2008 the presentation of heritage asset information changed. In accordance with SFFAS No. 29, Heritage Assets and Stewardship Land, the basic information regarding Heritage Assets has been moved from Required Supplementary Information to a Note on the Balance Sheet (see Note 10).

Trust Funds with Collections Precluded from Obligations

The FY 2008 presentation of budgetary resources and status of budgetary resources within the Statement of Budgetary Resources has been prospectively changed to report unobligated balances in the National Service Life Insurance Fund and the United States Government Life Insurance Fund (the Trust Funds) as precluded from obligations. The precluded balance is reported on the line "Temporarily Not Available Pursuant to Public Law". The precluded balance, with authorization from OMB, is available to cover program obligations in current or future years in accordance with the legislation establishing the Trust Funds. In prior periods, the unobligated balances were reported as "Unobligated Balance Available".

Department of Veterans Affairs
Office of Inspector General

Audit of VA's Consolidated Financial Statements for Fiscal Years 2008 and 2007

Report No. 08-00870-24 November 17, 2008
VA Office of Inspector General
Washington, DC 20420

DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

TO: Secretary of Veterans Affairs (00)

SUBJECT: Audit of VA's Consolidated Financial Statements for Fiscal Years 2008 and 2007

1. We contracted with the independent public accounting firm, Deloitte & Touche LLP, to audit VA's consolidated financial statements as of September 30, 2008 and 2007 and for the years then ended. This audit is an annual requirement of the Chief Financial Officers Act of 1990. The results of Deloitte and Touche LLP's audit are presented in the attached reports.

2. Deloitte and Touche LLP provided an unqualified opinion on VA's fiscal year 2008 and 2007 consolidated financial statements. They also identified three material weaknesses, all of which are repeat conditions from the prior year's audit. They are (i) financial management system functionality, (ii) information technology security controls and (iii) financial management oversight.

3. Deloitte and Touche LLP reported that VA is not in substantial compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996 because VA did not substantially comply with Federal financial management systems requirements. They also noted two other instances of non-compliance with law and referenced a violation of the Antideficiency Act reported by the Secretary to the President of the United States and the Director of the Office of Management and Budget in October 2008 related to activity in fiscal year 2007.

4. Deloitte & Touche LLP is responsible for the attached auditor's report dated November 17, 2008, and the conclusions expressed in the report. We do not express opinions on VA's financial statements or internal control or on whether VA's financial management systems substantially complied with FFMIA; or conclusions on compliance with laws and regulations. The independent auditors will follow up on these internal control findings and evaluate the adequacy of corrective actions taken during the FY 2009 audit of VA's consolidated financial statements.

Linda A. Halliday

BELINDA J. FINN
Assistant Inspector General
for Auditing

Attachments

Deloitte.

Deloitte & Touche LLP
Suite 900 West
1001 G Street NW
Washington, DC 20001
USA

Tel: +1 202 378 5100
www.deloitte.com

INDEPENDENT AUDITORS' REPORT

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

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs ("VA") as of September 30, 2008 and 2007, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources for the years then ended which collectively comprise VA's basic financial statements. These financial statements are the responsibility of VA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VA as of September 30, 2008 and 2007, and its net costs, changes in net position, and budgetary resources thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 17, 2008, on our consideration of VA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte + Touche LLP

November 17, 2008

Deloitte.

Deloitte & Touche LLP
Suite 900 West
1001 G Street NW
Washington, DC 20001
USA

Tel: +1 202 378 5100
www.deloitte.com

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

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

We have audited the basic financial statements of the Department of Veterans Affairs (VA) as of and for the year ended September 30, 2008, and have issued our report thereon dated November 17, 2008. 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 Office of Management and Budget (OMB) Bulletin No. 07-04, *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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the VA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the VA's internal control over financial reporting.

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

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

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

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

We identified the matters in Sections I and II involving the internal control over financial reporting and its operation that we consider to be significant deficiencies. The significant deficiencies that we identified in our prior year report dated November 15, 2007 are identified in this report as "Repeat Condition".

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

Distribution

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

Deloitte + Touche LLP

November 17, 2008

SECTION I — MATERIAL WEAKNESSES

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

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

The VA operates different legacy financial systems to support its missions including a core accounting system and business line specific financial systems, such as the Financial Management System (FMS), Benefits Delivery Network (BDN), the Fixed Asset Package, and medical center systems. The business line financial systems provide summary transactions to the core general ledger system to generate the VA's consolidated financial statements. Many of these systems are outdated, leading to inefficiencies in the reliable, timely and consistent preparation, processing, and analysis of financial information for VA's consolidated financial statements and are inherently more difficult to integrate than systems based on newer technologies.

To assist in managing the preparation of consolidated financial statements, VA management implemented a reporting system (MinX) to automate the preparation of the consolidated financial statements in fiscal year 2006. Although it has provided significant improvement, we identified continuing difficulties with the legacy systems related to the reliable, timely and consistent preparation, processing, and analysis of financial information for VA's consolidated financial statements. VA management continues to work to remediate the integration and functionality issues but significant challenges remain. Key examples of significant deficiencies resulting from the legacy systems are:

***Conditions*:**

- VA closes its general ledger system at year-end on September 30 and then allows additional entries to be recorded in a "period 13" general ledger. Under the current process, period 13 is kept open on October 1 for one day. However, many entries cannot be identified and recorded in just one day and need to be recorded after period 13 is closed. These entries often are the result of routine account analysis and reconciliation. Business lines also need more time to record their normal recurring or year-end entries. Because the general ledger is closed after October 1, VA uses the MinX reporting system as a de facto general ledger.

  This limitation contributes to a significant number of manual entries being posted through the MinX reporting system at year-end to prepare the financial statements. Further, since the MinX reporting system does not automatically carry forward prior year adjustments to the beginning balance of the following year, to make sure those entries carry forward, VA makes rollover adjusting entries at the beginning of a new fiscal year in MinX. As a result, entries are booked, reversed, and then rebooked, creating significant risk of error. For example, during the fiscal year 2008 closing procedures, a one-sided "plug" entry was recorded in MinX and was not detected.

- Due to the lack of integration between the business line financial systems and FMS, VBA could not provide certain sub-ledgers to support the amount recorded in the FMS, such as a detailed listing of Veterans Services Network (VETSNET) accounts receivable, detailed support for miscellaneous "A-28" adjusting entries to Compensation and Pension (C&P) benefit expenses, and a detailed transaction listing to support certain education deductions from overpayments to veterans.
- The BDN and VETSNET systems do not retain detail transactional data supporting the general ledger activity for more than 60 to 90 days. During fiscal year 2008, VBA put into operation a Data Warehouse that allowed BDN and VETSNET data to be retained and retrieved to support the financial statements. No formal internal control policies and procedures were established for the transfer of data to the Data Warehouse, or for the maintenance of such data.
- The Fixed Asset Package (FAP) does not readily provide information to support activity in the related general ledger accounts. The FAP cannot readily identify all current year property, plant and equipment additions and reclassifications of work in process due to system limitations.
- The VETSNET system does not include data mining capabilities to allow financial management the ability to analyze transactions at a level needed to prepare routine reconciliations.
- Automated inventory systems at the Consolidated Mail Order Pharmacy (CMOP) facilities were primarily developed for operations and accordingly cannot provide the data needed to record the proper cost of inventory for financial statement purposes. Automated systems implemented at the CMOP facilities have different software versions which prevent standardized control and summary reports from being generated.
- While a central database to record contracts, Electronic Contract Management System (ECMS), has been established, no system is in place to track all obligations and purchases made by the VA by vendor. For example, VA must rely on vendors to supply sales data on medical center purchases from the Federal Supply Schedule Contracts administered by the VA's National Acquisition Center.

***Criteria*:**

31 U.S.C. § 902(a) (3) states that an agency Chief Financial Officer shall "develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls, which—

> (A) complies with applicable accounting principles, standards, and requirements, and internal control standards;
> (B) complies with such policies and requirements as may be prescribed by the Director of the Office of Management and Budget;
> (C) complies with any other requirements applicable to such systems; and
> (D) provides for—
>
> > (i) complete, reliable, consistent, and timely information which is prepared on a uniform basis and which is responsive to the financial information needs of agency management…"

OMB Circular A-127, *Financial Management Systems,* states that agency financial management systems "shall be designed to provide for effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems…."

***Cause*:**

Many of these systems are outdated, leading to inefficiencies in the reliable, timely and consistent preparation, processing, and analysis of financial information for VA's consolidated financial statements and are inherently more difficult to integrate than systems based on newer technologies.

Effect:

The system deficiencies result in significant manual workarounds and the posting of a large number of general ledger adjustments that increase the risk of processing errors and misstatements in the financial statements.

Recommendation:

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

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

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

The VA continued to make progress in addressing information technology (IT) security weaknesses during fiscal year 2008. The Office of Chief Information Officer (OCIO) took action to remediate elements of the IT security weaknesses reported in prior years. In Fiscal Year 2008, the OCIO revised information security directives and handbooks, implemented Federal Information Processing Standards (FIPS) Publication 140-2 encryption for specific storage devices, performed a Certification and Accreditation (C&A) process for Major Applications (MA) and General Support Systems (GSS), and updated security awareness training and privacy training. In addition, the OCIO, utilizing the Office of IT Oversight and Compliance (ITOC), continued to conduct IT security assessments across the VA.

While progress has been made, management has acknowledged many IT security weaknesses require multi-year solutions. In Fiscal Year 2008, legacy IT infrastructure security weaknesses remain pervasive due to the lack of effective implementation and enforcement of an agency-wide information security program. These security weaknesses continue to place VA's program and financial data at risk. Our assessment of the general and application controls of VA's key IT infrastructure and financial systems identified the following conditions.

Conditions:

Agency-wide Security Program

- Information security deficiencies were not effectively mitigated resulting in a large backlog in the VA Plan of Action and Milestones (POA&M) system. In addition POA&M did not contain necessary documentation to support that deficiencies were adequately evaluated and remediated prior to closure.
- The risk assessments conducted for financial management systems did not always accurately identify the existence or effectiveness of certain system controls, and appropriate control recommendations were not consistently identified in the risk assessments.

Access Control

- Password standards were not consistently implemented and enforced across multiple VA systems including the network domain, mainframe systems and databases supporting key financial applications.
- Access to BDN and Veterans Health Information Systems and Technology Architecture (VistA) applications were not adequately restricted for system users and IT personnel.
- Review of user access to multiple financial applications, security violations, and system audit logs were not consistently performed or documented.

Segregation of Duties

- Legacy application VistA contained users with access to both Create and Approve purchase orders. In addition, IT personnel had Update access to the production environment supporting VistA and BDN applications.

Change Control

- Change control policy and procedures for authorizing, testing and approval were not consistently implemented and enforced to reduce the risk of data integrity issues related to VETSNET, BDN, VistA and Insurance System.
- VETSNET data updates were performed outside of the standard change control process.
- Systems were not patched in a timely manner to mitigate vulnerabilities.

Service Continuity

- A service continuity plan at the departmental level was not fully developed to provide overall guidance, direction, and coordination for entity-wide IT service continuity.
- Testing of contingency plans for financial management systems at selected facilities and data centers was not routinely performed and documented to meet the requirements of VA Handbook 6500.

Criteria:

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

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

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

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

Cause:

At the end of Fiscal Year 2007, the OCIO issued Directive/Handbook 6500 that established the policy, procedures, and operational requirements of the information security program. While VA management has taken positive steps toward reducing the number of deficiencies, the consistent and proactive enforcement of the established security policies and procedures continue to be a challenge for a large, geographically dispersed organization such as VA that supports a diverse portfolio of legacy applications and newly implemented systems. The amount of accumulated deficiencies continues to require multi-year resource commitment.

Effect:

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

In addition, inconsistent or inadequate contingency planning and testing increases the risk the VA would not be able to recover their systems and data in the timeframe required by the business owners to support their operations and financial reporting requirements.

Recommendations:

VA management should continue to devote resources, analyze the cause of reported deficiencies and prioritize remediation activities to accomplish its security and control objectives. Key tasks should include, but are not limited to, the following:

- Continue to provide necessary training and improve the quality of risk assessments. Assign proper resources to implement corrective action plans to remediate deficiencies reported in the POA&M system. Proactively apply controls to all key financial management systems based on the lessons learned developed through audits and management self-assessments.
- Provide actionable steps for ensuring that user access to VA financial management systems is authorized based on need; that system logical security settings and updates are properly implemented for all interconnected networks, systems, and applications; and that proper oversight of system activities is performed.
- Support proper segregation of duties by providing adequate human resources and configuring financial management systems. In addition, perform proper management oversight of incompatible activities.
- Facilitate a consistent enforcement of change control polices and procedures for the development, testing, and implementation of changes to VA financial applications.
- Complete and implement service continuity procedures that will provide effective guidance, communication, and coordination of service continuity planning and testing activities; perform contingency plan testing in compliance with the VA Handbook 6500.

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

Conditions:

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

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

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

- ***Accrued Services Payable and Undelivered Orders - VHA***
  Veterans Health Administration (VHA) financial management did not perform adequate reviews to ensure that invalid obligations were de-obligated timely and that expenses were accrued and recorded in the correct period.
- ***Property, Plant and Equipment - VHA***
  VHA financial management demonstrated little evidence of improvement over monitoring internal controls and accounting for property, plant and equipment, including capitalization and disposals. Poor communications between financial and facilities management contributed to this internal control finding.

- ***Environmental and Disposal Liabilities - VHA***
  VHA financial management did not effectively monitor proper accounting and reporting of environmental liabilities. Environmental data provided by facilities management to support the accrual often did not meet documentation requirements for financial accounting purposes.
- ***Accrual for Unbilled Receivables and Allowance for Contractual Adjustments - VHA***
  VHA financial management has not initiated adequate processes to review the allowance for contractual adjustments and information used in the calculation of accrual for unbilled receivables to assure these amounts are recorded in accordance with generally accepted accounting principles.
- ***Benefit Expense Reconciliation - VBA***
  We noted there was a lack of reconciliations being performed on the monthly benefit payments to veterans, and the corresponding amounts recorded in the general ledger (FMS).
- ***Outsourced Portfolio Loan Servicing - VBA***
  The VA contracts with an outside contractor to service the mortgage loans in its portfolio. The files maintained by the outside contractor did not contain a copy of the original loan document, or modifications to the original loan documents for some mortgage loans selected for testing.
- ***Compensation and Pension Actuarial Liability Calculation - VBA***
  VBA management has not completely reconciled recorded expense data to inputs in the actuarial liability model, provided the external actuary with all relevant data, or considered the impact of this relevant data to the liability.
- ***VA Housing Model - VBA***
  VBA management did not perform an effective review of the formulas within the Variable Default model.
- ***Software - Office of Information and Technology (OI&T)***
  Management was unable to gather actual expenditures to properly record software costs on a timely basis.

Criteria:

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

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

Cause:

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

Effect:

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

***Recommendation*:**

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

SECTION II — SIGNIFICANT DEFICIENCIES

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

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

Condition- We noted the following with respect to accrued services payable and undelivered orders.

- During our medical center site visits, we noted several instances where accrued services payable and undelivered orders were not properly monitored in accordance with VA policy to ensure they were valid and correctly calculated.
  - -- We noted instances of invalid residual balances for obligations and accrued services payable that should have been de-obligated or closed out.
  - -- We also noted potential duplicate transactions, an outstanding payable for equipment that was received in fiscal year 2006, and a wrong accrual period. In one instance, prepaid expenses were expensed and not recorded as an advance payment and undelivered order.

- The FMS has an automatic accrual "flag" function which when activated allows expenses to be recorded in the correct accounting period. However, we noted both manual and system problems with this function:
  - -- We noted instances where the accrual flag was not manually set when it needed to be, or where it was incorrectly activated for equipment and other services resulting in recognition of an expense before the item was received.
  - -- Due to a limitation in FMS, the automatic accrual function cannot cross fiscal years unless there is manual intervention. Without manual intervention, services will be fully accrued at year-end regardless of future activity. As a result, we noted several instances where services were fully accrued as of September 30, 2007 although those services were to be provided during fiscal year 2008. This resulted in classification errors between expenditures, undelivered orders and accrued services payable.
- We noted instances where invoices had not been received, but an estimate for work performed should have been accrued under work in process.

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

Cause- Invalid undelivered orders or accrued services payable occurred because of the lack of adequate review and follow-up procedures with individuals who initiated the purchase orders. Medical center staff identified the system limitation where FMS did not allow the accrual flag to continue past the current fiscal year without manual intervention. No process was in place to accrue for construction or other products that did not use receiving reports unless invoices had been received from vendors or contractors.

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

Recommendation- We recommend that the VHA CFO, in coordination with the Veterans Integrated Service Network (VISN) CFOs:

- Consider a system control to identify payments as final to help eliminate residual balances.
- Ensure medical center staff are trained on the proper use of the accrual flag; specifically, when to set it and how to manually intervene so that accruals can cross fiscal years; and ensure staff properly use the function.
- Seek a solution to the FMS limitation that prevents accruals from automatically crossing fiscal years.
- Enhance the tool used in monitoring aged undelivered orders to include construction orders.

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

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

- Completed projects were not always transferred from work in process to property in service, and depreciated on a timely basis.
- Some assets remained capitalized even though they were traded in or disposed of and were no longer property of VA.
- Some discrepancies existed in the estimated useful life of equipment as recorded in the fixed assets subsidiary ledger and the VA Supply Catalog.
- A portion of a project was incorrectly coded to an expense account, rather than recorded as an asset.
- An MRI machine purchased on behalf of another medical center was incorrectly capitalized by the medical center that purchased the asset. The medical center that had custody of the asset should have recorded the machine in their accounting records. Instead, that medical center only included the machine in their Equipment Inventory Listing (EIL) for accountability purposes.
- A panic alarm system was not capitalized because the various individual components, i.e. installation costs, computer equipment, and software licenses, were below the capitalization threshold. A capitalizable account should have been used for the components since they were part of one system and in the aggregate exceeded the capitalization threshold.

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

Cause- These exceptions were caused at least in part because of:

- Lack of timely communication between accounting and facilities management.
- Lack of adequate reviews and controls in place to ensure that assets that are no longer in VA's possession are taken off the books.
- Misinterpretation of accounting policy regarding capitalization threshold and related accounts.
- Ineffective communication between two medical centers resulted in incorrect recording of an asset.
- To a large extent, accounting is reliant on effective communications from facilities management on the status of projects. This communication has not been effective.

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

Recommendation- We recommend that VHA CFO, in coordination with the VISN CFOs, take action to ensure:

- Better coordination between financial and facilities management.
- Work-in-process projects are reviewed for completion dates and are recorded timely as property in service. Management should consider enhancing the fixed assets reporting module to include project estimated completion date to assist in monitoring of the untimely transfer to property in service.
- Management should put procedures in place to ensure that projects no longer in use are removed from the general ledger.
- Management should review the estimated useful life of equipment recorded in the fixed asset subsidiary ledger with the VA Supply Catalog for consistency.
- Ensure that inventory procedures include that assets are recorded in the proper location.
- When acquiring systems, ensure that procedures are in place to capitalize all components of the system.

3. Environmental and Disposal Liabilities—VHA*

Condition- During our medical center site visits, we noted that stations had recorded estimates for environmental and disposal liabilities. However, at certain stations in the selection, balances were not supported by sufficient information such as the "RSMeans Guide" or other industry tools and publications or surveys, as required by Office of Finance Bulletin 07GB1.01. Often the support provided by facilities management was not sufficient to support the environmental liability calculation. In addition, stations currently use inconsistent methodologies for estimating their liabilities.

Criteria- With respect to clean-up costs, *SFFAS 6 – Accounting for Property, Plant and Equipment Recognition and Measurement* states:

> "Estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing…"

With respect to maintenance of documentation, *GAO Internal Control Standards* states:

> "Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained."

Cause- Medical center staff did not prepare and maintain sufficient documentation, or ensure calculations were prepared in accordance with VA policy, and were periodically reviewed.

Effect- Recorded estimates may be inaccurate if they cannot be supported by documentation.

Recommendation- We recommend that the VHA CFO, in coordination with the VISN CFOs, take action to ensure that these estimates are supported by auditable information such as vendor quotes, use of RSMeans Guide, and other industry tools. Management should analytically review the environmental liability balances by station and perform spot checks to promote compliance.

4. Accrual for Unbilled Receivables and Allowance for Contractual Adjustments—VHA*

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

- Accrual for unbilled receivables is calculated using a three-month moving average of change in accounts receivable, write-offs and collections multiplied by the number of days it takes to bill a receivable after services are provided. However, management has not validated the reasonableness of the accrual methodology by analyzing actual billings subsequent to the accounting period.

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

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

Cause- VHA central office did not perform a sufficient financial management review.

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

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

5. Benefit Expense Reconciliation – VBA

Condition- We noted that VBA financial management was not performing critical reconciliations on veteran benefit payments as follows:

The following deficiencies support the finding identified:

- **Compensation & Pension (C&P) Benefit Expense Reconciliation**
  Veterans Benefit Administration (VBA) financial management did not perform reconciliations of C&P benefit expense between the two systems which calculate and initiate such payments (BDN and VETSNET) and FMS on a monthly basis prior to March 2008.

- **Education Benefit Expense Reconciliation**
  VBA financial management did not perform reconciliation of education benefit expense between BDN and FMS on a monthly basis prior to March 2008, and could not provide a detail transaction listing to support certain education deductions from overpayments to veterans reported in the FMS.

Cause- The operational causes for the deficiencies include a lack of resources with the appropriate skills to appropriately prepare and review the requisite reconciliations.

Criteria- In accordance with "Standards for Internal Control in the Federal Government," issued by the Government Accountability Office (GAO):

"Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations. It includes regular management and supervisory activities, comparisons, reconciliations, and other activities people take in performing their duties."

Effect- Recording financial data without sufficient monitoring and control procedures increases the likelihood that an error in the financial statements will occur and that it will go undetected. In addition, the inability to provide detail transaction listings for items recorded in FMS could result in accounting errors going uncorrected or inappropriate disbursements being made and going undetected.

Recommendation– VBA financial management should review its financial management organizational structure to determine if the financial management organization has sufficient authority and resources to prepare and review the necessary reconciliations on a monthly basis. Resources need to include adequate staff that is trained and knowledgeable to effectively perform the required reconciliations and analyses. Any initiative should promote strong financial management and coordination amongst all operational levels to ensure financial management can promote change within the overall organization.

6. Compensation and Pension Actuarial Liability Calculation – VBA*

Condition- We performed reconciliations of the actuarial model inputs and FMS expense data to ensure the accuracy, existence and completeness of VA data used by the model. Based on testing, we noted differences that could potentially significantly affect the actuarial liability.

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

Cause- VBA financial management did not perform sufficient reconciliations of the actuarial model inputs to FMS expense data.

Effect- VBA financial management has not provided the actuary with all of the relevant data and accurate data nor have they considered the impact of this relevant data to the liability.

Recommendation- We recommend that VBA financial management prepare a reconciliation between the BDN net payment file and the gross summary payment file provided to the actuary. Reconciling items identifying data relevant to the calculation of the estimated liability should be provided to the actuary. Also, we recommend the data used in the model for burial expenses be checked for accuracy.

7. Outsourced Portfolio Loan Servicing - VBA

Condition- The VA contracts with an outside contractor to service the mortgage loans in its portfolio. The files maintained by the outside contractor should have the source documents needed to support the initial loan and any subsequent modifications of the loan documents. We selected 45 loan files from the outside contractor to test various attributes for compliance with policies and procedures. The following exceptions were noted with respect to the attributes tested:

--Five loan files did not contain a copy of the original loan document supporting the mortgage loan.

--Four loan files contained the original mortgage loan documents but did not contain the modifications to the original loan documents that appear to have been executed based on the carrying amount of the mortgage loan on VA's general ledger.

Criteria- OMB Circular A-123, *Management's Responsibility for Internal* Control, requires that management be responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Effective internal controls over new loan set up require that appropriate supporting documentation is obtained to verify key terms and amounts.

Cause- The outside contractor retains documents provided to it when the loan is initially set up but the outside contractor is not required to have a checklist to assure that required documents are provided to it nor does it follow up on documents not provided.

Effect- Mortgage loans receivable on VA's general ledger may not be supported by source documentation and such amounts may be recorded at inaccurate amounts in the financial statements.

Recommendation- We recommend that polices are established to require the outside contractor to use a checklist to assure that all needed documents are provided to it at the time the loan is initially set up. In addition, the outside contractor should be responsible for following up with the VA, lender, title company and/or law firm associated with the closing or modification of the mortgage loan to obtain any missing documents.

8. VA Housing Model - VBA

Condition- The loan guaranty program performs a calculation periodically to reestimate the projected default rates and resulting estimated costs to the VA on its guaranteed and direct loans. The Variable Default Model is used to calculate the required reestimate adjustments each year. A component of the model is the default rate curve which estimates the number and amount of defaults on guaranteed and direct loans in future periods. During our review of the model, we noted a formula used for the calculation of estimated defaults for certain guaranteed loans was incorrect. When the correct formula was applied, an adjustment was necessary to properly reflect the reestimate for the Loan Guaranty program.

Criteria- OMB Circular A-123, Management's Responsibility for Internal Control, requires that management be responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Effective internal controls over financial reporting require that management establishes policies and procedures that provide reasonable assurance of reliable accounting estimates, including procedures to ensure that the Variable Default Model calculations are proper and effective in producing reasonable reestimates.

Cause- Lack of sufficient controls to ensure that the Variable Default Model calculations are accurate.

Effect- Reestimates reported by management could be materially misstated.

Recommendation- VBA financial management should ensure that the Variable Default Model formulas and calculations are correct.

9. Capitalization of Software Development Costs – Office of Management

Condition- Although certain VA program offices have established work-in-process accounts to capture software projects that are in the development phase, we noted certain program offices incorrectly expensed them. Management was unable to support recorded amounts in work-in-process accounts.

Criteria- SFFAS 10 Accounting for Internal Use Software, Recognition, Measurement, and Disclosure – Capitalized Cost

Paragraph 16 - For internally developed software, capitalized cost should include the full cost (direct and indirect cost) incurred during the software development stage. Such cost should be limited to cost incurred after:

a. management authorizes and commits to a computer software project and believes that it is more likely than not that the project will be completed and software will be used to perform the intended function with an estimated service life of 2 years or more and

b. the completion of conceptual formulation, design, and testing of possible software project alternatives (the preliminary design stage).

Cause- VA does not have a systematic process of tracking all projects that are on-going to ensure that all projects that are in the development phase are tracked and recorded in the general ledger.

Effect- Understatement of general property, plant and equipment and overstatement of operating and net program costs.

Recommendations- We recommend that the CFO in coordination with the CIO establish a systematic process whereby costs incurred that meet the capitalization criteria of SFFAS 10 are accumulated within the general ledger on a timely basis. This would include the accumulation of both direct and indirect costs after management authorizes and commits to a software project. To facilitate this process, training should be provided to individuals responsible for and involved in this process to ensure that appropriate treatment of costs has occurred. This would include accounting staff responsible for classifying certain expenditures within the general ledger and employees who are involved in project development who must track and segregate their time eligible for capitalization.

10. Property, Plant and Equipment Activity Rollforward - VHA*

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

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

Cause- System limitation.

Effect- Inaccurate financial information may not be detected.

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

11. Inventory - VHA

Condition- VHA maintains inventories of prescription medications at the Consolidated Mail Outpatient Pharmacies (CMOPs) located in seven states. Inventory is managed through automated systems which streamline receiving, processing, and dispensing information. During our audit, we noted limitations in the usage and capabilities of the CMOPs automated inventory systems. Automated systems use different software versions which prevent standardized control and summary reports from being issued. Also, the systems cannot provide the data needed to record the proper cost of inventory for financial statement purposes.

Criteria- OMB Circular A–127, Financial Management Systems states:

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

"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."

Cause- These systems were primarily developed for operations, rather than for financial statement reporting.

Effect- VHA does not have the ability to efficiently record inventory on the financial statements.

Recommendations- VHA should consider enhancing financial functionality with their present inventory system. Also, periodic physical counts, and a year-end physical count should be taken to validate the accuracy of the perpetual system.

12. Operating Lease Commitments - Office of Management*

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

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

Cause- Information needed to prepare the footnote is maintained at each individual medical center, and there is no systematic methodology to accumulate the information on a VA-wide basis.

Effect- Footnote disclosure may not reflect all future commitments.

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

13. Intra-Governmental Reconciliations and Related Controls - Office of Management*

Condition- Unreconciled differences exist throughout the year and at year-end, primarily with the VA's trading partner, the Department of Defense. Also, unreconciled differences are not aged to determine how long they have been outstanding.

Criteria- The Treasury Financial Manual, Bulletin No. 2007-03 section VII, outlines the difference resolution procedures that trading partners must follow. These rules apply to all intra-governmental trading partners.

Cause- VA does not have sufficient data from their trading partners to properly reconcile all the accounts. VA does not elevate its differences with the Department of Defense to the CFOs Council's Intragovernmental Dispute Resolution Committee for resolution of differences within 60 days of their identification in the material differences report.

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

Recommendation- All significant differences should be resolved with trading partners as outlined in Section VII, Resolving Intra-governmental Disputes and Major Differences, including the escalation of unresolved differences to the CFOs Council's Intragovernmental Dispute Resolution Committee. Differences should be aged to assist in the resolution of outstanding items.

14. Statement of Net Cost - Office of Management*

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

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

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

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

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

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

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

15. Payroll Agreed-Upon Procedures Report - Review of Reports Supporting OPM Submission – Office of Management*

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

Criteria- In accordance with "Standards for Internal Control in the Federal Government," issued by the Government Accountability Office (GAO):

"Internal control should generally be designed to assure that ongoing monitoring occurs in the course of normal operations. It includes regular management and supervisory activities, comparisons, reconciliations, and other activities people take in performing their duties.'

Cause- The reports did not receive a primary review by VA personnel with a financial accounting background that would have allowed the reviewer to detect reportable differences between the ad-hoc reports and the OPM submissions.

Effect- Inaccurate reports could impact the evaluation by OPM of the VA's Retirement, Health Insurance, and Life Insurance obligations.

Recommendation- We recommend that ad-hoc reports generated from the PAID legacy financial system used to support OPM submissions receive a primary financial review by an appropriate level of management with a sufficient financial background as necessary for appropriate internal control. This reviewer should ensure that differences are resolved. We recommend programming adjustments to correct the ad-hoc reports as necessary to support the standard supplemental reporting requirements of the VA to OPM.

16. Payroll Agreed-Upon Procedures Report – Maintenance of Official Personnel Files – Office of Human Resources and Administration

Condition- In connection with required testing of payroll compliance to support the financial statements, Deloitte noted that official personnel files could not be located to support one salary and five health insurance deductions from a sample of 25 selected employees.

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

"Personnel Action Processing: Incumbent-related information such as date of hire, service computation date, retirement service date, severance pay date, Civil Service Retirement System, Federal Employees Retirement System, Federal Employees Group Life Insurance and Thrift Savings Plan eligibility dates, Federal Employee Health Benefits enrollment date, step increase and prior military service information must also be recorded. There is also a need for the capability to correct or cancel these actions, and provide the necessary audit trail."

Cause- Management stated that the missing files are due to migration of a high volume of personnel files from paper to electronic format.

Effect- Incomplete personnel files may not properly support salary and withholding amounts recorded in the financial system.

Recommendation- We recommend that the VA implement a tracking mechanism to ensure that paper personnel files are properly accounted for during the transition to electronic personnel files.

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 15, 2007, we reported four material weaknesses in the areas of (1) Financial Management System Functionality, (2) Information Technology (IT) Security Controls, (3) Financial Management Oversight, and (4) Retention of Computer Generated Detail Records in BDN system. The Retention of Computer Generated Detail Records in BDN system has been addressed, and is no longer reported as a material weakness this year.

Other

The VA engaged an independent public accounting firm to assist in an internal control assessment pursuant to OMB Circular A-123 Appendix A, *Management's Responsibility for Internal Control*. During fiscal year 2008 the firm issued seven reports titled *Findings and Recommendation* and also reported significant deficiencies.

SECTION III - COMPLIANCE AND OTHER MATTERS

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, and assessed control risk as required by OMB Bulletin No. 07-04, as amended. Our procedures were not designed to provide assurance on these internal controls and accordingly, we do not provide an opinion on such controls.

As part of obtaining reasonable assurance about whether VA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, non-compliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04, 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. Except as discussed below, the results of our tests disclosed no instances of noncompliance which are required to be reported herein under *Government Auditing Standards*. Items with an asterisk (*) are repeat conditions included in last year's report.

1. Non-compliance with FFMIA*

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

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

2. Non-compliance with Debt Collection Improvement Act*

Condition- We selected sample transactions to test various attributes for the VA's compliance with the Debt Collection Improvement Act of 1996 ("DCIA"). The following exceptions were noted with respect to the attributes tested:

- Interest and administrative costs are required to be charged to VA's delinquent debtors. The rates are determined by the Treasury on a yearly basis. However, VBA did not charge interest or administrative costs on delinquent payments from veterans related to certain education loans, and payments due to VBA Life Insurance.

- Write-off of accounts receivable greater than $100,000 are required to be approved by the Department of Justice. We tested 3 write-offs from VBA that should have had this approval and noted one such write-off that was not approved by the Department of Justice.

- VBA – Life Insurance did not follow the requirements for cross servicing and Treasury offset during the prescribed timeframes for several of the selections tested. The DCIA requires federal agencies to refer debt to Treasury for cross servicing if they are delinquent for a period of 180 days.

- VBA – Life Insurance did not maintain adequate documentation to support actions taken to demonstrate timely compliance with DCIA and VA policies on debt collection for many of the selections tested.

- VBA – Life Insurance did not follow up on delinquent debt in a timely manner for many of the selections tested.

Criteria-

- 38 U.S.C. § 501(a) and 5315, and 38 CFR 1.919 require VA to charge interest on any amount owed the United States.

- 31 U.S.C. § 3711 describes VA's requirement to submit debt to Treasury for cross-servicing, and to obtain approval from Department of Justice to write-off debts in excess of $100,000.

Cause- In July 1992, a former VA Deputy Secretary instructed VA to not charge interest or administrative costs on compensation and pension debts. The accounts receivable write-offs greater than $100,000 must be manually sent to Department of Justice for approval and VA does not have automated, systematic procedures across the organization to assure appropriate procedures are followed for debt collection. Adequate documentation was not maintained for delinquent debt files.

Effect- These findings represent noncompliance by VBA with Debt Collection Improvement Act (DCIA) of 1996

Recommendation- We recommend the VBA CFO, in coordination with the Veterans Integrated Service Network CFOs should take action to:

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

- Ensure that systematic debt collection procedures are in-place and effective.

3. Non-compliance with 5 U.S.C. §552A subsection D5 –VBA*

Condition- There were several instances in our testing of VBA where the appropriate documents were not available to substantiate the amounts recorded. Some of these were comprised of instances where key forms were missing from the veteran's file.

Criteria- 5 U.S.C. §552A subsection D5 states:

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

Cause- Inadequate control over the retention of documents in the veteran files.

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

Recommendation- We recommend that the VBA implement procedures to ensure that all documents that should be retained in the veteran files are retained and can be located.

4. Other

In October 2008, the Secretary reported a violation of the Anti-Deficiency Act (ADA), 31 U.S.C. 1341(a) in connection with activity related to fiscal year 2007 at VBA. The Secretary reported that the violation occurred on September 28, 2007, when redemption of debt payments to the Treasury exceeded the available unobligated budgetary resources, and the remaining budgetary resources were less than unpaid obligations at the end of the fiscal year. The VA has identified a number of steps to be taken to prevent a reoccurrence of the violation.

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

Department of Veterans Affairs

Memorandum

Date: NOV 17 2008

From: Assistant Secretary for Management (004)

Subj: Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2008 and 2007

To: Assistant Inspector General for Auditing (52)

1. We have reviewed the Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2008 and 2007, and are pleased with the receipt of an unqualified opinion. We are also proud that we were able to meet the FY 2008 reporting timeline established by the Office of Management and Budget. Please extend to your staff and the staff of Deloitte & Touche, LLP our appreciation for their detailed planning, hard work, and cooperation during this year's audit.

2. The Department's senior officials and I, as well as program managers in VHA, VBA, NCA, and affected staff offices, are aware of the results of the audit. We will continue to focus on completing corrective actions as detailed in the remediation plans for the three material weaknesses, Financial Management System Functionality, Financial Management Oversight, and Information Technology Security Controls. These existing remediation plans will be revised and expanded, as needed, to address the findings and recommendations in your audit report. We will forward copies of each of these plans to you during the second quarter of FY 2009, and will keep you apprised of our progress in remediating these weaknesses throughout FY 2009.

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

Robert J. Henke

Required Supplementary Stewardship Information

These materials are not audited
(Dollars in millions, unless otherwise noted)

1. 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,	2008	2007	2006	2005	2004
State Extended Care Facilities	$ 162	$ 138	$ 85	$ 183	$ 66
State Veterans Cemeteries	37	46	18	36	34
Total Grant Program Costs	$ 199	$ 184	$ 103	$ 219	$ 100

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 5 fiscal years, the State Home Construction Grant Program has awarded grants in excess of $634. 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 $316 million to 38 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.

2. 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		
Years ended September 30,		
	2008	**2007**
Program Expenses		
Education and Training-Dependents of Veterans	$ 451	$ 450
Vocational Rehabilitation and Education Assistance	3,102	3,095
Administrative Program Costs	251	243
Total Program Expenses	$ 3,804	$ 3,788
Program Outputs (Participants)		
Dependent Education	80,409	79,134
Veterans Rehabilitation	68,826	69,409
Veterans Education	459,594	490,826

Veterans and Dependents Education		
Years ended September 30,		
	2006	**2005**
Program Expenses		
Education and Training-Dependents of Veterans	$ 430	$ 405
Vocational Rehabilitation and Education Assistance	2,943	2,779
Administrative Program Costs	232	226
Total Program Expenses	$ 3,605	$ 3,410
Program Outputs (Participants)		
Dependent Education	79,430	75,072
Veterans Rehabilitation	71,627	71,956
Veterans Education	461,488	444,359

Veterans and Dependents Education	
Year ended September 30,	
	2004
Program Expenses	
Education and Training-Dependents of Veterans	$ 320
Vocational Rehabilitation and Education Assistance	2,517
Administrative Program Costs	230
Total Program Expenses	$ 3,067
Program Outputs (Participants)	
Dependent Education	67,420
Veterans Rehabilitation	75,409
Veterans Education	409,695

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 is 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 provides evaluation services, counseling, and training necessary to assist veterans in becoming employable and maintaining employment to the extent possible. The 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 Veterans Education program provides educational assistance to eligible servicemembers and veterans.

3. Health Professions Education

Health Professions Education					
Years Ended September 30,					
	2008	**2007**	**2006**	**2005**	**2004**
Program Expenses					
Physician Residents and Fellows	$ 508	$ 469	$ 462	$ 438	$ 420
Associated Health Residents and Students	88	81	65	63	62
Instructional and Administrative Support	623	606	452	430	401
Total Program Expenses	$ 1,219	$ 1,156	$ 979	$ 931	$ 883
Program Outputs					
Health Professions Rotating Through VA:					
Physician Residents and Fellows	34,003	33,775	31,290	30,903	29,179
Medical Students	18,135	18,728	17,289	16,750	16,740
Nursing Students	28,320	27,515	24,870	22,675	20,275
Associated Health Residents and Students	20,946	20,875	18,990	16,862	16,921
Total Program Outcomes	101,404	100,893	92,439	87,190	83,115

Program Outcomes
VA's education mission contributes to high quality health care of 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 100,000 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 VA.

4. Research and Development (R&D)

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, 2008

	Basic	Applied	Development	Total
Medical Research Service	$ 155.3	$ 84.7	$ -	$ 240.0
Rehabilitative Research and Development	4.8	36.6	28.0	69.4
Health Services Research and Development	-	76.7	-	76.7
Cooperative Studies Research Service	32.9	61.0	-	93.9
Medical Research Support	-	411.0		411.0
Total Program Expenses	$ 193.0	$ 670.0	$ 28.0	$ 891.0

Program Expense
Year ended September 30, 2007

	Basic	Applied	Development	Total
Medical Research Service	$ 171.3	$ 56.9	$ -	$ 228.2
Rehabilitative Research and Development	4.8	24.5	24.4	53.7
Health Services Research and Development	-	58.2	-	58.2
Cooperative Studies Research Service	32.9	41.0	-	73.9
Medical Research Support	-	408.6		408.6
Total Program Expenses	$ 209.0	$ 589.2	$ 24.4	$ 822.6

Program Expense Year ended September 30,				2006
	Basic	Applied	Development	Total
Medical Research Service	$ 172.1	$ 57.2	$ -	$ 229.3
Rehabilitative Research and Development	5.4	27.1	21.7	54.2
Health Services Research and Development	-	59.7	-	59.7
Cooperative Studies Research Service	30.6	38.2	-	68.8
Medical Research Support	-	353.0	-	353.0
Total Program Expenses	$ 208.1	$ 535.2	$ 21.7	$ 765.0

Program Expense Year ended September 30,				2005
	Basic	Applied	Development	Total
Medical Research Service	$ 154.4	$ 59.4	$ -	$ 213.8
Rehabilitative Research and Development	4.9	23.9	19.6	48.4
Health Services Research and Development	-	61.7	-	61.7
Cooperative Studies Research Service	.5	47.8	-	48.3
Medical Research Support	-	381.7	-	381.7
Total Program Expenses	$ 159.8	$ 574.5	$ 19.6	$ 753.9

Program Expense Year ended September 30,				2004
	Basic	Applied	Development	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

In addition, VHA researchers received grants from the National Institutes of Health in the amount of $569 and $190 in other grants during FY 2008. 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 Outputs/Outcomes

For FY 2008, VA's R&D general goal related to 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.

Research and Development Measures-Actual
Years ended September 30,

	2008	2007	2006	2005	2004
Percent of Funded Research Projects Relevant to VA's Health-Care Mission	100.0%	100.0%	100.0%	94.3%	97.1%
Number of Research and Development Projects	1,956	2,019	2,190	2,107	2,165

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 to ensure a complementary role between the discovery of new knowledge and the application of these discoveries to medical practice.

Required Supplementary Information

(Dollars in millions, unless otherwise noted)

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 the Facility Condition Assessment Survey.

Deferred Maintenance As of September 30,	2008	2007
General PP&E	$ 3,844	$ 3,524
Heritage Assets	522	183
Total Deferred Maintenance	$ 4,366	$ 3,707

2. Schedule of Budgetary Activity Year Ended September 30, 2008

	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	$ 4,186	$ 3,913	$ 58	$ 552	$ 773	$ 3,634
0160 Medical Care	31,679	30,578	211	4,425	4,754	30,038
0162 Medical Facilities	4,759	4,659	30	1,555	1,943	4,241
0167 Medical Facilities	2,447	2,161	52	710	829	1,990
All Other	6,033	2,848	350	1,424	2,354	1,568
Total	$ 49,104	$ 44,159	$ 701	$ 8,666	$ 10,653	$ 41,471
VBA						
0102 Compensation, Pension, & Burial Benefits	$ 42,486	$ 40,471	$ -	$ 3,163	$ 3,393	$ 40,241
0137 Readjustment Benefits	3,991	3,623	396	72	89	3,210
4127 Direct Loan Financing	951	896	383	43	1	555
4129 Guaranteed Loan Financing	4,951	1,901	2,145	41	58	(261)
8132 National Service Life Insurance Fund	1,400	1,400	255	1,428	1,409	1,164
All Other	5,188	2,965	2,017	466	482	932
Total	$ 58,967	$ 51,256	$ 5,196	$ 5,213	$ 5,432	$ 45,841
NCA						
Total	$ 238	$ 230	$ -	$ 81	$ 113	$ 198
ADM						
0151 General Operating Expenses	$ 2,223	$ 1,953	$ 306	$ 283	$ 300	$ 1,630
4537 Supply Fund	2,911	2,133	1,435	(1,204)	(508)	2
All Other	494	362	220	(41)	(4)	105
Total	$ 5,628	$ 4,448	$ 1,961	$ (962)	$ (212)	$ 1,737
Total of all Business Lines	$ 113,937	$ 100,093	$ 7,858	$ 12,998	$ 15,986	$ 89,247

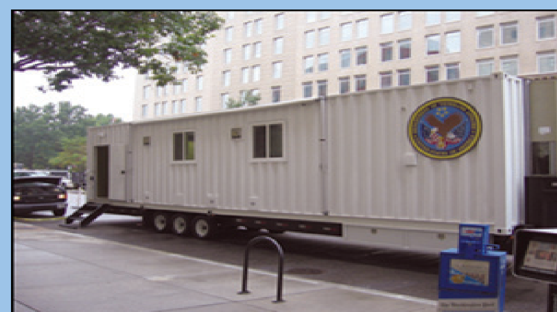
Snapshot

Skeeter: Providing Comfort to Veterans

Skeeter is no ordinary dog; that's why he just received the Kentucky Veterinary Medical Association Animal Hall of Fame Hero's Award for his work at the Lexington, Kentucky, VA Medical Center nursing home care unit. The 6-year-old Pomeranian arrived at the medical center a year ago. "He quickly made this unit his home," said Paula Bayer, RN, nurse manager on the VA nursing home care unit. Staff and patients cite Skeeter's unconditional love. No one can explain how Skeeter determines which patient needs his attention the most, but somehow he consistently seeks out those in need. "His ability to provide comfort to an end stage patient is remarkable," says Paula. The consulting unit psychiatrist comments that Skeeter provides emotional and psychological comfort, which affects the stability of the patient. Skeeter's Hall of Fame award celebrates the bond between animals and people, which enriches human life.

Snapshot

VA Mobile Pharmacies: Delivering Medicines During Emergencies



To support veterans and their families during major emergencies, especially natural disasters, the Department of Veterans Affairs (VA) has begun to deploy mobile pharmacies that will provide vital medicine when patients are unable to fill their prescriptions. VA will also open up the facilities to help communities during major disasters and other emergencies.

"The mobile pharmacies give VA the ability to provide critical medications to veterans when disaster strikes," said Secretary of Veterans Affairs Dr. James B. Peake. "VA is committed to ensuring our veterans receive their care and prescriptions as soon as possible during an emergency."

Each VA mobile pharmacy is housed in a 40-foot-long solid steel trailer built to withstand winds in a Category 3 storm. The units include a satellite connection with VA's Consolidated Mail Outpatient Pharmacy system. Pharmacists can use the satellite system to obtain a veteran's prescription data to dispense the drugs on site. In addition, VA can send replacement medications during an emergency by mail or another carrier to a veteran's home or temporary address.

VA recognized the need for mobile pharmacies in 2005 after hurricanes Katrina and Rita severely damaged VA medical centers along the Gulf Coast. The Department deployed several mobile medical clinics as part of its response to the disasters.

To ensure rapid response to a wide range of emergencies, VA's mobile pharmacies will be strategically placed across the Nation.