Letter from the Chief Financial Officer

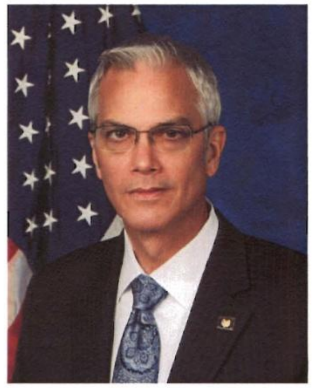
November 15, 2012

The Department of Veterans Affairs (VA) is very pleased to have received its 14th consecutive unqualified ("clean") audit opinion on the Department's consolidated financial statements.

Following the elimination of three material weaknesses in 2010, and the reduction of significant deficiencies from five to two in 2011, VA made additional progress by reducing the number of significant deficiencies in 2012. The auditor also reported one significant deficiency, "undelivered orders," as a partial repeat condition and retitled it from "accrued operating expenses." The Department has taken corrective actions sufficient to address the reasonable estimation of the accrued operating expenses portion of unpaid obligations and therefore "accrued operating expenses" has been removed from the significant deficiency for this year. The Department has also taken corrective actions sufficient to eliminate one other significant deficiency, "loan guaranty reporting," previously cited last year.

Substantial work was done in 2012 on remediating the Department's one remaining material weakness, "information technology (IT) security controls." Improvements were cited by the auditors, but this material weakness will be carried forward into 2013. VA's success in 2012 reflects the dedication and hard work of staff throughout the Department. Congratulations to all who helped make 2012 a year of high achievement in VA financial management.

VA remains committed to meeting its four financial management goals: reducing operating costs, eliminating improper payments, strengthening internal controls, and enhancing data and analysis.



Since 2010, VA has used these four goals to establish and drive its annual suite of management initiatives. Following the completion of 7 of the 11 financial management initiatives in 2011, VA continued work during 2012 on the remaining 4 that are multi-year initiatives. The Systems to Drive Performance initiative was completed and moved to sustainment. This initiative delivered 17 unique dashboards that provide cost and workload program data to management and enhance decision-making. VA completed increments 3 and 4 of the Web-based Time and Attendance system initiative, and will complete the final increment – system testing – and implementation in 2013. Completion is also expected in 2013 on a final rule to implement electronic invoicing requirements. Progress is continuing on the multi-year initiative to modernize Fee Basis payment capabilities. The Department also continued its commitment to a well-trained financial management workforce, providing training to over 400 additional employees, bringing the total percentage trained since 2010 to 85 percent.

In 2012, VA established its highest financial priority – a new initiative to reduce improper payments in order to comply with the Improper

Payments Elimination and Recovery Act (IPERA). VA formed a task force, governed by the Chief Financial Officer, senior accountable officials, and program managers from VA's Administrations, to focus on increasing knowledge about VA improper payments, especially root causes, and on ways the Department can eliminate and reduce erroneous payments, ensure greater accuracy and improve precision of improper payment data, and adequately explain to stakeholders the causes of VA's improper payments. Action plans are also being developed and will be monitored during 2013 to improve compliance with IPERA.

In 2012, VA continued to ensure that all Recovery Act transparency, reporting, and accountability goals were met. By September 30, 2012, VA had made outlays totaling over $1.7 billion (96 percent) of Recovery Act funds. For USAspending.gov, VA reported 100 percent of all required contract, grant, loan, and other assistance program spending, totaling $96 billion. Additionally, VA exceeded reduced spending targets established by the Office of Management and Budget (OMB), implementing Executive Order 13589, "Promoting Efficient Spending." The Executive Order, dated November 15, 2011, directs agencies to cut waste in spending and identify opportunities to promote efficient and effective spending in specific areas, including travel, printing, supplies and materials, employee IT devices, promotional items, and executive fleet inventories. Mandated reductions in spending for management support contracts were also included. VA developed and executed a plan to reduce the costs associated with these activities and exceeded the total spending reduction target of $173.4 million by an additional $69 million. VA monitors spending monthly and reports the status to OMB quarterly.

VA's Franchise Fund is expected to receive its 15th successive unqualified audit opinion on its 2012 consolidated financial statements. In addition, the Supply Fund received an unqualified opinion in 2011 and anticipates another unqualified opinion in 2012.

VA is dedicated to ensuring the proper stewardship of resources entrusted to it by Congress and the American people. The Department of Veterans Affairs is proud of its many accomplishments, but knows that a lot of work remains.

We will continue to improve financial stewardship and set ambitious goals designed to enhance performance. We are dedicated to promoting sound business practices and improving accountability, with the ultimate goal of providing more and better services to our Nation's Veterans.

W. Todd Grams

Consolidated Financial Statements

DEPARTMENT OF VETERANS AFFAIRS				
CONSOLIDATED BALANCE SHEETS (dollars in millions)				
AS OF SEPTEMBER 30,		**2012**		**2011**
ASSETS				
INTRAGOVERNMENTAL				
Fund Balance with Treasury (Note 3)	$	40,574	$	40,211
Investments (Note 5)		9,309		10,032
Accounts Receivable, Net (Note 6)		40		6
Other Assets		799		784
TOTAL INTRAGOVERNMENTAL ASSETS		**50,722**		**51,033**
PUBLIC				
Cash (Note 4)		16		18
Investments (Note 5)		178		186
Accounts Receivable, Net (Note 6)		1,789		1,934
Direct Loans and Loan Guarantees, Net (Note 7)		1,996		2,105
Inventories and Related Property, Net (Note 8)		56		71
General Property, Plant and Equipment, Net (Note 9)		20,631		18,686
Other Assets		28		30
TOTAL PUBLIC ASSETS		**24,694**		**23,030**
TOTAL ASSETS	**$**	**75,416**	**$**	**74,063**
Heritage Assets (Note 10)				
LIABILITIES				
INTRAGOVERNMENTAL				
Accounts Payable (Note 24)	$	342	$	310
Debt (Note 11)		843		1,680
Other Liabilities (Notes 15 and 24)		1,352		1,009
TOTAL INTRAGOVERNMENTAL LIABILITIES		**2,537**		**2,999**
PUBLIC				
Accounts Payable (Note 24)		9,657		4,939
Liabilities for Loan Guarantees (Note 7)		5,561		5,062
Federal Employee and Veterans Benefits Liabilities (Notes 13 and 24)		1,763,614		1,535,591
Environmental and Disposal Liabilities (Note 14)		851		884
Insurance Liabilities (Note 17)		10,581		11,113
Other Liabilities (Notes 15 and 24)		3,936		3,773
TOTAL PUBLIC LIABILITIES		**1,794,200**		**1,561,362**
TOTAL LIABILITIES		**1,796,737**		**1,564,361**
Commitments and Contingencies (Note 18)				
NET POSITION				
Unexpended Appropriations – Earmarked Funds (Note 19)		-		-
Unexpended Appropriations – All Other Funds		4,131		12,048
Cumulative Results of Operations – Earmarked Funds (Note 19)		745		899
Cumulative Results of Operations – All Other Funds		(1,726,197)		(1,503,245)
TOTAL NET POSITION		**(1,721,321)**		**(1,490,298)**
TOTAL LIABILITIES AND NET POSITION	**$**	**75,416**	**$**	**74,063**

The accompanying notes are an integral part of these Consolidated Financial Statements.

DEPARTMENT OF VETERANS AFFAIRS		
CONSOLIDATED STATEMENTS OF NET COST (dollars in millions)		
FOR THE YEARS ENDED SEPTEMBER 30,	**2012**	**2011**
NET PROGRAM COSTS BY ADMINISTRATION (Notes 21 & 24)		
Veterans Health Administration		
Gross Cost	$ 56,888	$ 56,240
Less Earned Revenue	(3,460)	(3,719)
Net Program Cost	53,428	52,521
Veterans Benefits Administration		
Gross Cost		
Program Costs	74,524	69,777
Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13)	78,700	3,100
Less Earned Revenue	(1,666)	(2,027)
Net Program Cost	151,558	70,850
National Cemetery Administration		
Gross Cost		
Program Costs	294	279
Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13)	(100)	(100)
Less Earned Revenue	-	-
Net Program Cost	194	179
Indirect Administrative Program Costs		
Gross Cost	1,972	2,112
Less Earned Revenue	(595)	(673)
Net Program Cost	1,377	1,439
NET PROGRAM COSTS BY ADMINISTRATION BEFORE CHANGES IN VETERANS BENEFITS ACTUARIAL LIABILITY ASSUMPTIONS	**206,557**	**124,989**
CHANGES IN ACTUARIAL LIABILITY ASSUMPTIONS (Note 13)		
COMPENSATION:		
Changes in Discount Rate Assumption	66,100	51,600
Changes in COLA Rate Assumption	(40,300)	4,000
Changes in Disability Claims Rates	123,400	-
TOTAL COMPENSATION	149,200	55,600
BURIAL:		
Changes in Discount Rate Assumption	200	200
Changes in COLA Rate Assumption	(100)	100
TOTAL BURIAL	100	300
NET (GAIN)/LOSS FROM ACTUARIAL LIABILITY ASSUMPTIONS	**149,300**	**55,900**
NET COST OF OPERATIONS (Note 21)	**$ 355,857**	**$ 180,889**

The accompanying notes are an integral part of these Consolidated Financial Statements.

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2012

	(Note 19) Earmarked Funds	All Other Funds	Eliminations	2012 Consolidated Total
Cumulative Results of Operations				
Beginning Balance	$ 899	$ (1,503,045)	$ (200)	$ (1,502,346)
Budgetary Financing Sources				
Appropriations Used	-	131,269	-	131,269
Nonexchange Revenue	-	8	-	8
Donations and Forfeitures of Cash and Cash Equivalents	23	-	-	23
Transfer In/Out Without Reimbursement	(2,830)	2,830	-	-
Other Financing Sources (Nonexchange)				
Donations and Forfeitures of Property	22	1	-	23
Transfers In/Out Without Reimbursement	-	-	-	-
Imputed Financing	-	1,795	-	1,795
Other	-	(367)	-	(367)
Total Other Financing Sources	(2,785)	135,536	-	132,751
Net Cost/(Benefit) of Operations	(2,631)	358,488	-	355,857
Net Change	**(154)**	**(222,952)**	**-**	**(223,106)**
Ending Balance – Cumulative Results	745	(1,725,997)	(200)	(1,725,452)
Unexpended Appropriations				
Beginning Balance	-	11,848	200	12,048
Budgetary Financing Sources				
Appropriations Received	-	125,255	-	125,255
Appropriations Transferred In/Out	-	185	-	185
Other Adjustments	-	(2,088)	-	(2,088)
Appropriations Used	-	(131,269)	-	(131,269)
Total Budgetary Financing Sources	-	(7,917)	-	(7,917)
Total Unexpended Appropriations	**-**	**3,931**	**200**	**4,131**
Total Net Position	**$ 745**	**$ (1,722,066)**	**$ -**	**$ (1,721,321)**

The accompanying notes are an integral part of these Consolidated Financial Statements.

DEPARTMENT OF VETERANS AFFAIRS

CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION (dollars in millions)

FOR THE YEAR ENDED SEPTEMBER 30, 2011

	(Note 19) Earmarked Funds	All Other Funds	Eliminations	2011 Consolidated Total
Cumulative Results of Operations				
Beginning Balance	$ 892	$ (1,448,295)	$ (200)	$ (1,447,603)
Budgetary Financing Sources				
Appropriations Used	-	124,513	-	124,513
Nonexchange Revenue	-	13	-	13
Donations and Forfeitures of Cash and Cash Equivalents	25	-	-	25
Transfer In/Out Without Reimbursement	(2,775)	2,775	-	-
Other Financing Sources (Nonexchange)				
Donations and Forfeitures of Property	24	2	-	26
Transfers In/Out Without Reimbursement	-	-	-	-
Imputed Financing	-	1,978	-	1,978
Other	-	(409)	-	(409)
Total Other Financing Sources	(2,726)	128,872	-	126,146
Net Cost/(Benefit) of Operations	(2,733)	183,622	-	180,889
Net Change	**7**	**(54,750)**	**-**	**(54,743)**
Ending Balance – Cumulative Results	899	(1,503,045)	(200)	(1,502,346)
Unexpended Appropriations				
Beginning Balance	-	14,185	200	14,385
Budgetary Financing Sources				
Appropriations Received	-	122,580	-	122,580
Appropriations Transferred In/Out	-	93	-	93
Other Adjustments	-	(497)	-	(497)
Appropriations Used	-	(124,513)	-	(124,513)
Total Budgetary Financing Sources	-	(2,337)	-	(2,337)
Total Unexpended Appropriations	**-**	**11,848**	**200**	**12,048**
Total Net Position	**$ 899**	**$ (1, 491,197)**	**$ -**	**$ (1,490,298)**

The accompanying notes are an integral part of these Consolidated Financial Statements.

DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2012

	Budgetary	Non-Budgetary Credit Reform Financing Account
Budgetary Resources (Note 22)		
Unobligated Balance brought forward, October 1	$ 23,118	$ 3,430
Adjustment to Unobligated balance brought forward, October 1	(10)	-
Unobligated balance brought forward, October 1, adjusted	23,108	3,430
Recoveries of Prior Year Unpaid Obligations*	14	-
Other Changes in Unobligated Balance	(327)	(160)
Unobligated balance from Prior Year Budget Authority, net	22,795	3,270
Appropriations	127,519	-
Borrowing Authority	-	313
Spending Authority from Offsetting Collections	5,233	3,457
Total Budgetary Resources	**$ 155,547**	**$ 7,040**
Status of Budgetary Resources		
Obligations Incurred*	$ 139,630	$ 3,034
Unobligated Balance, end of year		
Apportioned	12,673	-
Unapportioned	3,244	4,006
Total Unobligated Balance, end of year	15,917	4, 006
Total Status of Budgetary Resources	**$ 155,547**	**$ 7,040**
Change in Obligated Balance		
Unpaid Obligations, brought forward, October 1 (gross)	$ 17,876	$ 292
Uncollected Customer Payments from Federal Sources, brought forward	(1,355)	(6)
Obligated Balance start of year (net), before adjustments	16,521	286
Adjustment to Obligated Balance, start of year	10	-
Obligated Balance start of year (net), as adjusted	16,531	286
Obligations Incurred*	139,630	3,034
Outlays (gross)	(132,596)	(3,016)
Change in Uncollected Customer Payments from Federal Sources	(236)	6
Recoveries of Prior Year Unpaid Obligations*	(14)	-
Obligated Balance, end of year		
Unpaid Obligations, end of year (gross)	$ 24,906	$ 310
Uncollected Customer Payments from Federal Sources, end of year	(1,591)	-
Obligated Balance, end of year, (net)	**$ 23,315**	**$ 310**

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DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (dollars in millions) (continued)
FOR THE YEAR ENDED SEPTEMBER 30, 2012

	Budgetary	Non-Budgetary Credit Reform Financing Account
Budget Authority and Outlays, net		
Budget Authority, gross	$ 132,753	$ 3,770
Actual Offsetting Collections	(5,004)	(4,449)
Change in Uncollected Customer Payments from Federal Sources	(236)	6
Anticipated Offsetting Collections	-	-
Budget Authority, net	**$ 127,513**	**$ (673)**
Outlays, gross	$ 132,596	$ 3,016
Actual Offsetting Collections	(5,004)	(4,449)
Outlays, net	127,592	(1,433)
Distributed Offsetting Receipts	(3,161)	(304)
Agency Outlays, net	**$ 124,431**	**$ (1,737)**

* Estimated recoveries of prior year unpaid obligations (not recorded) range from $1,200 million-$2,300 million for 2012 and range from $1,100 million-$2,100 million for 2011. The effect of recording the adjustments would be to increase "Recoveries of Prior Year Unpaid Obligations" and increase "Obligations Incurred" (see Note 22 for more information).

The accompanying notes are an integral part of these Consolidated Financial Statements.

DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (dollars in millions)
FOR THE YEAR ENDED SEPTEMBER 30, 2011

	Budgetary	Non-Budgetary Credit Reform Financing Account
Budgetary Resources (Note 22)		
Unobligated Balance brought forward, October 1	$ 23,791	$ 2,373
Adjustment to Unobligated balance brought forward, October 1	-	-
Unobligated balance brought forward, October 1, adjusted	23,791	2,373
Recoveries of Prior Year Unpaid Obligations*	8	-
Other Changes in Unobligated Balance	(97)	(115)
Unobligated balance from Prior Year Budget Authority, net	23,702	2,258
Appropriations	126,003	(428)
Borrowing Authority	-	566
Spending Authority from Offsetting Collections	5,302	4,444
Total Budgetary Resources	**$ 155,007**	**$ 6,840**
Status of Budgetary Resources		
Obligations Incurred*	$ 131,889	$ 3,410
Unobligated Balance, end of year		
Apportioned	20,345	-
Unapportioned	2,773	3,430
Total Unobligated Balance, end of year	23,118	3,430
Total Status of Budgetary Resources	**$ 155,007**	**$ 6,840**
Change in Obligated Balance		
Unpaid Obligations, brought forward, October 1 (gross)	$ 21,508	$ 286
Uncollected Customer Payments from Federal Sources, brought forward	(1,440)	(7)
Obligated Balance start of year (net), before adjustments	20,068	279
Adjustment to Obligated Balance, start of year	-	-
Obligated Balance start of year (net), as adjusted	20,068	279
Obligations Incurred*	131,889	3,410
Outlays (gross)	(135,513)	(3,404)
Change in Uncollected Customer Payments from Federal Sources	85	1
Recoveries of Prior Year Unpaid Obligations*	(8)	-
Obligated Balance, end of year		
Unpaid Obligations, end of year (gross)	$ 17,876	$ 292
Uncollected Customer Payments from Federal Sources, end of year	(1,355)	(6)
Obligated Balance, end of year, (net)	**$ 16,521**	**$ 286**

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DEPARTMENT OF VETERANS AFFAIRS

COMBINED STATEMENT OF BUDGETARY RESOURCES (dollars in millions) (continued)

FOR THE YEAR ENDED SEPTEMBER 30, 2011

	Budgetary	Non-Budgetary Credit Reform Financing Account
Budget Authority and Outlays, net		
Budget Authority, gross	$ 131,305	$ 4,582
Actual Offsetting Collections	(5,276)	(4,445)
Change in Uncollected Customer Payments from Federal Sources	85	1
Anticipated Offsetting Collections	-	-
Budget Authority, net	**$ 126,114**	**$ 138**
Outlays, gross	$ 135,513	$ 3,404
Actual Offsetting Collections	(5,276)	(4,445)
Outlays, net	130,237	(1,041)
Distributed Offsetting Receipts	(3,056)	(264)
Agency Outlays, net	**$ 127,181**	**$ (1,305)**

* Estimated recoveries of prior year unpaid obligations (not recorded) range from $1,200 million-$2,300 million for 2012 and range from $1,100 million-$2,100 million for 2011. The effect of recording the adjustments would be to increase “Recoveries of Prior Year Unpaid Obligations” and increase “Obligations Incurred” (see Note 22 for more information).

The accompanying notes are an integral part of these Consolidated Financial Statements.

Notes to Consolidated Financial Statements

For the Years Ended September 30, 2012, and 2011 (dollars in millions, unless otherwise noted)

1. Summary of Significant Accounting Policies

Organization

The mission of the Department of Veterans Affairs (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.

Reporting Entity and Basis of Presentation

The VA consolidated financial statements, including the Combined Statements of Budgetary Resources, report all activities of VA components. VA components include the Veterans Health Administration (VHA), Veterans Benefits Administration (VBA), National Cemetery Administration (NCA), and Indirect Administrative Program Costs. 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 principal financial statements have been prepared to report the financial position and results of operations of VA, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of VA in accordance with Generally Accepted Accounting Principles (GAAP) for Federal entities and the formats prescribed by the Office of Management and Budget (OMB), the statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that VA is a component of the U.S. Government, a sovereign entity. VA 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. VA's fiscal year end is September 30th.

Basis of Accounting

The principal financial statements are prepared in accordance with GAAP as promulgated by the Federal Accounting Standards Advisory Board (FASAB) and OMB Circular No. A-136, *Financial Reporting Requirements*, as revised. The Statement of Federal Financial Accounting Standards (SFFAS) 34, *The Hierarchy of Generally Accepted Accounting Principles, Including the Application of Standards Issued by the Financial Accounting Standards Board*, establishes a hierarchy of GAAP for Federal financial statements. The principal financial statements prepared in accordance with GAAP include the consolidated financial statements prepared on an accrual basis of accounting and the combined statements of budgetary resources which reflect the appropriation and consumption of budget and spending authority and other budgetary resources before eliminations.

The consolidated financial statements include the balance sheets, statements of net cost, and statements of changes in net position. In order to prepare reliable consolidated financial statements, transactions occurring among VA components must be eliminated. All significant intra-entity transactions were eliminated from VA's consolidated financial statements. However, to remain consistent with the aggregate of the account-level information presented in budgetary reports the statements of budgetary resources are not consolidated but combined, therefore elimination of intra-entity transactions is not permitted.

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 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.

The Combined Statements of Budgetary Resources (SBR) are the basic financial statements that report the Department's Budgetary Resources, Status of Budgetary Resources, Net Outlays for the year ended and the Change in Obligated Balance as of year-end. Specific forms of budget authority that the Department receives are appropriations, borrowing authority and spending authority from offsetting collections. Details on the amounts shown in the Combined Statements of Budgetary Resources are included in the Required Supplementary Information section on the Schedule of Budgetary Activity shown by major account. The Combined Statements of Budgetary Resources are prepared on a combined basis, not a consolidated basis and therefore, do not include intra-entity eliminations.

See Note 22 for further disclosure on Budgets and Budgetary Accounting.

Revenues and Other Financing Sources
Exchange revenue, which is primarily medical revenue, is recognized when earned from other federal agencies or the public as a result of costs incurred or services performed on their behalf. Medical revenue is earned by VA when services are provided and are billable to the first party (Veterans) and third party insurance companies. Under chapter 17, title 38, United States Code, VHA is authorized to bill a Veteran's third-party health insurer for health care provided at VA and non-VA medical facilities. Generally, VA considers a Veteran's health care billable if the treatment is not for a service-connected disability.

Billable amounts are based on reasonable charges by locality for services provided as determined under the methodology prescribed by 38 CFR Regulation 17.101. Under this methodology, the billable amounts for services provided by VA represent the 80th percentile of nationwide average rates developed from commercial and Medicare statistical data by locality throughout the nation. The statistical data is adjusted by the Consumer Price Index (CPI) to account for the historical nature of the data being utilized. The billable amounts by service provided are developed based on the classification of services as inpatient, outpatient, professional and surgical or non-surgical. The nationwide average rates used to determine billable amounts for services provided for inpatient care are updated annually effective October 1st and nationwide average rates for billable amounts for outpatient and professional care are updated annually effective January 1st . The updated charges are published by a Notice in the Federal

Register and the charges are available on the VHA Chief Business Office (CBO) website (http://www1.va.gov/CBO/apps/rates/). Revenue earned but unbilled is estimated using historical average data. An allowance for contractual adjustments from insurance companies and uncollectible amounts is determined using historical average data.

Exchange revenue also consist of: benefits revenue from reimbursement of education benefit programs from service member contributions that are transferred to the general fund account with the Department of the Treasury (Treasury); insurance revenue from insurance policy premiums paid by policyholders; and housing revenue from interest earned on direct loans.

Nonexchange revenue (e.g., donations) is recognized when received, and the related receivables, refunds, and offsets are recognized when measurable and legally collectible. Nonexchange revenue also consist of: benefits revenue from reimbursement of education benefit programs by Department of Defense (DoD) that are transferred to the general fund account with Treasury; insurance revenues from interest earned from Treasury on investments of insurance policy premiums; and housing revenue from interest earned from Treasury on uninvested balances in financing accounts and reestimates of subsidy.

Imputed financing sources consist of imputed revenue for expenses relating to legal claims paid by the Treasury Judgment Fund and post-retirement benefits for VA employees paid by the Office of Personnel Management (OPM).

Transferring Budget Authority to Other Agencies

VA, as the transferring (parent) entity, is a party to allocation transfers with DoD, the transferee (child) 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 (transfer appropriation account) is created in the 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 transfer appropriation 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.

Federal Credit Reform Act of 1990

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 Credit Reform Act). The financial statement disclosures herein are also in accordance with Statement of Federal Financial Accounting Standards (SFFAS) 2, *Accounting for Direct Loans and Guarantees*, as amended. The Credit Reform Act provides that the present value of the estimated net cash flows to be paid by VA for subsidy costs associated with direct loans and loan guarantees be recognized as a cost in the year the direct or guaranteed loan is disbursed as a result of its borrowing from Treasury. Direct loans and guaranteed loans receivable are reported net of an allowance for subsidy costs at present value, and loan guarantee liabilities are reported at present value.

The subsidy costs related to direct loans and guaranteed loans receivable consist of the interest rate differential between the loans to Veterans and the borrowing from Treasury, estimated default costs, net of recoveries, offsets from fees and collections, and other estimated subsidy costs affecting cash flows. Adjustments to the allowance for subsidy costs affecting cash flows consist of fees received, foreclosed property acquired, loans written off, subsidy allowance amortization and reestimates of interest rates and application of loan technical/default provisions approved by OMB.

When the present value of cash inflows to VA is less than the present value of cash outflows made by VA, a subsidy cost is incurred by VA and reported as an allowance for subsidy costs that reduces direct loans and guaranteed loans receivable reported in the consolidated balance sheet. However, a negative subsidy occurs when the present value of cash inflows to VA exceeds the present value of cash outflows made by VA. The resulting negative subsidy is reported as an allowance for subsidy costs that increases direct loans and guaranteed loans receivable reported in the consolidated balance sheet.

The cash flow costs used to calculate the present value of the liability for loan guarantees and loan sale guarantees consist of the estimated default costs, net of recoveries, fees and other collections, adjustments for fees received, foreclosed property and loans acquired, claim payments to lenders, interest accumulation on the liability balance, modifications, changes in reestimates of interest rates and application of loan technical/default provisions approved by OMB.

Direct loans obligated before October 1, 1992, are not subject to the Federal Credit Reform Act. Direct loans obligated before October 1, 1992, are recorded at net realizable value of the remaining balance of amounts disbursed plus accrued and unpaid interest receivable. The allowance for loan losses on direct loans obligated before October 1, 1992, is recognized when it is more likely than not that the direct loans will not be totally collected. The allowance of the uncollectible amounts is reestimated each year as of the date of the financial statements. Loan losses are reestimated by program. Risk factors are evaluated for each program and separate loan year disbursed. Risk factors include historical loan experience, regional economic conditions, financial and relevant characteristics of borrowers, value of collateral to loan balance, changes in recoverable value of collateral and new events that would affect the loans' performance. A systematic methodology based on an econometric model is used to project default costs by risk category. Actual historical experience includes actual payments, prepayments, late payments, defaults, recoveries, and amounts written off.

Fund Balance with Treasury

Treasury performs cash management activities for all Federal Government agencies. The Fund Balance with Treasury (FBWT) 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 Veterans Educational Assistance Program (VEAP) Trust Fund, the National Service Life Insurance (NSLI) Fund, the United States Government Life Insurance (USGLI) Fund, the Veterans Special Life Insurance (VSLI) Fund, the General Post Fund, and the National Cemetery Gift Fund. The use of these funds is restricted.

Revolving funds, used by the Supply Fund and Franchise Fund, finance a cycle of business-like operations through amounts received from the sale of products or services. The collections are used to finance its spending, usually on a self-sustaining basis. Revolving funds record the collections and the outlays in the same Treasury account. A revolving fund is a form of permanent appropriation receiving authority to spend their collections and do not generally receive appropriations.

Appropriated funds are general fund expenditure accounts established to record amounts appropriated by law for the general support of Federal Government activities and the subsequent expenditure of these funds. It includes spending from both annual and permanent appropriations.

Special funds are an appropriation account established to record appropriations, obligations, and outlays financed by the proceeds of special fund receipts which are dedicated collections by law for a specific purpose or program. Medical Care Collections Fund and Lease of Land and Building (NCA Facilities Operation Fund) are special funds.

The Status of Fund Balance with Treasury shown in Note 3 represents the VA's unobligated balances, obligated balances and deposit and clearing accounts. The unobligated and obligated balances presented in that section may not equal related amounts reported on the Combined Statements of Budgetary Resources (SBR). The unobligated and obligated balances reported on the SBR are supported by FBWT, as well as other budgetary resources that do not affect FBWT, primarily expired authority.

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 the 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 net of amortized premiums or discounts and accrued interest, which approximates market value, and are redeemable at any time for their original purchase price. Insurance program investments, which comprise most of the 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 2025, 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 housing trust certificates. No securities have been reclassified as securities available for sale or early redemption. Additionally, no permanent impairments of securities have occurred.

Allowances are recorded to reflect estimated losses of principal as a result of the subordinated position in housing trust certificates. The estimated allowance computations are based upon discounted cash flow analysis. VA continues to use the income from these subordinated housing trust certificates to fund the Housing Trust Reserve Fund (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

Accounts receivable are reported at net realizable value measured as the carrying amount less an allowance for loss provision or contractual adjustment for medical care as considered necessary. Contractual adjustments are estimated for Medical Care Collection Fund (MCCF) receivables due from patients and insurance companies using the allowance method. The allowance is determined based on the VA's historical experience and collection efforts and the contractual nature of the balance due. Uncollectible amounts are written off against the allowance for loss provision or contractual adjustment for medical care once VA determines an amount, or a portion thereof, to be uncollectible.

Accounts receivable consists of intragovernmental accounts receivable and public accounts receivable. Intragovernmental accounts receivable consists of amounts due from other Federal Government agencies primarily for reimbursement of costs and lease payments receivable. All amounts due from Federal Government agencies are considered fully collectible; therefore, no allowance for loss provision is recognized.

Public accounts receivable consists primarily of (a) amounts due for Veterans' health care, (b) amounts due for compensation, pension, and readjustment benefit overpayments, (c) amounts due for education benefits and readjustment overpayments and (d) other miscellaneous receivables due primarily for general fund advances, insurance, Loan Guaranty receivables and medical research.

VA is required by Public Law (P.L.) 96-466 to charge interest and administrative costs on benefit debts similar to charges levied on other debts owed the Federal Government. The VA's current policy is not to charge interest on compensation, pension debts and certain education benefits based on a July 1992 decision by the then-VA Deputy Secretary.

Loans Receivable

Loans receivable consist of direct loans and defaulted guaranteed loans receivable. Included in direct loans are vendee loans, acquired loans, and Native American direct loans. These three types of loans receivable are part of the VA Loan Guaranty Program. Direct loans also include loans on Veterans' insurance policies. The loans receivable are secured by the underlying real estate and insurance policies. The present value of the cost VA will bear as guaranteed loans default is an element of the mortgage loan benefit that VA provides to Veterans. This cost is reflected in the financial statements as the liability for guaranteed loans and the allowance for subsidy for defaulted guaranteed loans included in the balance of loans receivable.

Vendee loans are direct loans issued to a third party borrower for the acquisition price of foreclosed real estate sold by VA after the transfer of the property to VA by a private sector mortgage lender upon default of a loan subject to the VA Loan Guaranty Program. Acquired loans are VA guaranteed loans in default that VA purchases from the private sector mortgage lender and services the loan with the Veteran directly after VA determines that the Veteran can service the debt service payments. Native American direct loans are special financing that enables Native Americans to purchase a home on federally recognized trust land.

Veterans that are government life insurance policyholders with permanent plan coverage or paid-up additional insurance can borrow against the cash value of their policy, creating an insurance policy direct loan. The loan amount may not exceed 94 percent of the cash surrender value of the policy or the paid-up additional insurance. Prior to November 2, 1987, policy loans were issued at fixed rates depending on the fund and time period.
The remaining fixed rate loans are at 4 percent and 5 percent. All policy loans issued since November 2, 1987, have a variable interest rate

with a minimum of 5 percent and a maximum of 12 percent. Rate changes are tied to the ten-year constant maturities, U.S. Treasury Securities Index and may only change on October 1. The variable rate has been 5 percent since October 1, 2001.

The interest due is equal to the interest rate times the loan balance as of the loan anniversary date. Any interest for the year not paid within 20 days of the anniversary date is added to the loan balance. Policyholders may repay loans at their discretion as long as the loan amount plus accumulated interest does not exceed 94 percent of the cash surrender value. If this occurs, the policyholder is notified that their policy will be surrendered unless a minimum payment is received within 90 days. At the policyholder's death or the maturity of the policy, any loan indebtedness is deducted from the insurance proceeds.

Loans receivable for direct loans are recorded as funds are disbursed. The carrying amount of direct loans receivable includes the remaining balance of the amount disbursed, interest receivable, an allowance for loan losses using the allowance method for pre-1992 loans, the present value of an allowance for subsidy costs for post-1991 loans and the fair market value less cost to dispose of foreclosed property based on the present value of future cash flows from the property.

Loans receivable for defaulted guaranteed loans are recorded when amounts are disbursed by VA to fund its guaranty with the lender for defaulted loans and represents the net value of the assets related to the pre-1992 and post-1991 guaranteed loans that defaulted. The carrying amount of the guaranteed loans receivable includes the amount dispersed by VA for its guaranty under the defaulted loans, an allowance for loan losses using the allowance method for pre-1992 loans and the fair market value less cost to dispose of foreclosed property based on the present value of future cash flows from the property.

For loans obligated prior to October 1, 1991, the loan loss allowance is estimated based on past experience and an analysis of outstanding balances. For loans obligated after September 30, 1991, the allowance for subsidy costs 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.

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 the VA's outstanding vendee or direct loans will default over a 12-year period. For 2012 and 2011, VA determined that these vendee loans have sufficient equity, due to real estate appreciation and buy-down of principal, to minimize or eliminate any potential loss to VA.

The 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. To determine the future cash flows from a foreclosed property, VA obtains an independent appraisal of the property to determine fair market value which is reduced by estimated future carrying and disposal costs such as acquisition, management, selling and transfer costs and estimated gains or losses on property resale.

VA accrues interest on performing and non-performing loans receivable until the outstanding balance is paid in full. Performing loans receivable are those loans where the amount due on the outstanding balance is paid in full by the established due date. Non-performing loans receivable are those loans where the amount due on the outstanding balance is not paid in full by the established due date which results in a delinquency of the indebtedness. Interest receivable is accrued on the non-performing loan balance until the amount due is paid to a current status, debt is paid in full or otherwise resolved through compromise, waiver of the charges or termination of collection action. VA charges a fixed interest rate on loans issued for the duration of the loan term, including any delinquency period. The interest rate is set at loan inception based on three benchmark interest rates tracked by VA. VA will apply payments received from the debtor first to penalties and administrative costs, second to interest receivable and third to outstanding debt principal.

The recorded value of loans receivable, net, and the value of assets related to direct loans receivable are not the same as the proceeds that VA would expect to receive from selling its loans. It is at least reasonably possible that the proceeds from the sale of its loans will differ from the reported carrying value of the loans receivable and the underlying value of their related assets resulting in a realized gain or loss on sale.

Inventories

Inventories consist primarily of items such as Canteen Service retail store stock held for current sale and are reported at cost using the weighted-average cost method. Inventory that is excess, obsolete or unserviceable is reported at its estimated net realizable value. Upon disposal, any difference between the inventory's recorded amount and the value received for the inventory will be recognized as a gain or loss.

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 are used to provide medical care to Veterans. Property, plant, and equipment, including transfers from other federal agencies, leasehold improvements, other structures not classified as buildings and capital leases are valued at net carrying cost. When the capitalization criteria are met, major additions, replacements, and alterations are capitalized, whereas routine maintenance is expensed when incurred.

VA has a significant construction project program for medical facilities, national cemeteries, and other veteran related projects. VA submits its major construction project plans for medical facilities and national cemeteries to Congress for approval prior to receiving appropriated funds. VA maintains separate appropriated fund accounts on each project, as authorized, for major and minor construction and non-recurring maintenance projects.

Construction project costs incurred during the design and development phases are recorded in the appropriate Construction Work-in-Process (WIP) accounts including all materials, supplies, services, capital equipment, transportation costs, incremental overhead or support costs, and other construction-related costs directly attributable to the project. The assets are transferred to either capitalized or non-capitalized property, plant, and equipment, as appropriate, when placed in service. Construction projects completed in multiple phases are recorded as Construction WIP until the project phase is placed in service. Personal property and equipment not meeting the capitalization criteria is expensed upon being placed in service.

Individual items are capitalized if the useful life is two years or more and the unit price is $100 thousand 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.

Internal use software is also subject to the $100 thousand threshold for capital assets. The costs subject to capitalization are incurred during the software development phase, and include the design of the chosen path, programming development, installation of hardware and testing, and are accumulated in Software in Development until a project is successfully tested and placed in service. The capitalized costs are amortized on a straight-line basis, and the amortization term is in accordance with the planned life cycle established during the software's planning phase which generally ranges from 2 to 4 years. Preliminary design phase costs and post implementation costs are expensed as incurred.

Property, plant and equipment, including construction WIP, internal use software and capitalized lease assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If the carrying value of the long-lived asset or asset group is not recoverable, an impairment loss is recognized to the extent that the carrying value exceeds its fair value. Fair value is determined through various valuation techniques, including quoted market values and third party independent appraisals, as considered necessary.

There are no restrictions on the use or convertibility of general property, plant, and equipment. For disclosure regarding Heritage Assets see Note 10.

SFFAS No. 40, *Definitional Changes to Deferred Maintenance; Amending Statement of Federal Financial Accounting Standards 6, Accounting for Property, Plant, and Equipment*, is effective for periods after September 30, 2011. This standard clarifies that repair activities should be included to better reflect asset management practices, and improve reporting on deferred maintenance and repairs activities not performed when they should have been or were scheduled to be, therefore, are put off or delayed for a future period. For additional disclosure see Required Supplementary Activities.

Other Assets

Intragovernmental Other Assets are reported at cost and consist primarily of Intragovernmental Advances - Federal and are primarily advances to the Army Corps of Engineers (Corps) and the General Services Administration (GSA). Public Other Assets are reported at cost and consist of Public Advance Payments made by VHA primarily to hospitals and medical schools under house staff contracts, grantees and beneficiaries, with the balance of the advances being made to employees on official travel.

Accounts Payable

Accounts payable are amounts owed by VA for goods and services received from, progress in contract performance made by, and rents due to other entities and recurring scheduled compensation, pension and education benefits payable to Veterans. Accounts payable do not include liabilities related to on-going continuous expenses such as employee's salaries, benefits, annuities for insurance programs, interest payable and loan guarantee losses and non-recurring Veterans compensation, pension and education benefits payable which are covered by other liabilities. When VA accepts title to goods, whether the goods are delivered or in transit, VA recognizes a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed are estimated.

Intragovernmental accounts payable consists of amounts owed to other Federal Government agencies and accounts payable from cancelled appropriations. The remaining accounts payable consist of amounts due to the public. Intragovernmental and public accounts payable are covered by budgetary resources.

Loan Guarantees

VA provides loan guarantees under two types of guaranty programs. Under one program, a loan may be made to an eligible Veteran borrower 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 a default by the Veteran borrower results in a loss by the loan holder. If the loan holder acquires the property which had secured the guaranteed loan at the liquidation sale, the loan holder can elect to convey the property to VA, which then attempts to resell the property at the best possible price and terms.

VA reports the liability on the guarantee of loans in accordance with the requirements of the Credit Reform Act. For these loans, the Liability for Loan Guarantees represents the present value of the estimated net cash outflows considered most likely to be paid by VA as a result of a claim against the guarantee on a defaulted loan. 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.

The second loan guaranty program involves the sale of direct loans. VA will bundle vendee and acquired loans and sell them to a third party investor (Trust) pursuant to a sale agreement. Under the sale agreement, the Trust owns the mortgage loans acquired in the sale and will issue certificates backed by the mortgage loans and installment contracts. The certificates represent interests in the assets of the Trust and investors are paid from the Trust's assets. On the closing date of the certificates, VA transfers its entire interest in the related loans receivable and collateral to the Trustee for the benefit of the related certificate holders pursuant to the sale agreement. It is at least reasonably possible that the proceeds from the sale of VA's loans will differ from the reported carrying value of those loans and the underlying value of their related assets resulting in a realized gain or loss on sale. VA guarantees that the investor will receive full and timely distributions of the principal and interest on the certificates backed by the full faith and credit of the Federal Government.

VA reports the liability on the guarantee of loans sold under the Vendee Mortgage Trust and American Housing Trust programs in accordance with the requirements of the Credit Reform Act. For these loans, the Liability for Loan Guarantees represents the present value of the estimated net cash outflows considered most likely to be paid by VA arising from a claim against the guarantee. These loan 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 will be paid by the 15th of each month. If the payment is not made by the borrower, VA allows the loan servicer to take funds from a cash reserve account for the amount of the deficiency. VA also guarantees the loans against loss at foreclosure. Although VA will not buy back the loan, VA will pay the loan loss and foreclosure expenses.

Insurance Liabilities

Insurance Liabilities for VA's life insurance programs include: policy reserves; unearned premiums; insurance dividends left on deposit and related interest payable; accrued interest payable on insurance policies and dividends payable to policyholders.

Actuarial reserve liabilities for VA's insurance programs for 2012 and 2011 are based on mortality and interest rate assumptions that vary by fund, type of policy, and type of benefit. The interest rate assumptions range from 2.25 to 5.0 percent. The mortality assumptions include the American Experience Table, the X-18 Table, the 1941 Commissioners Standard Ordinary (CSO) Table, the 1958 CSO Basic Table, the 1980 CSO Basic Table, and the 2001 Valuation Basic Male (VBM) Table.

National Service Life Insurance (NSLI) basic policy reserves for permanent plans are based on the American Experience Table with 3 percent interest, except for the Modified Life plans, which are based on the 1958 CSO Basic Table with 3 percent interest, and paid-up additions purchased by dividends, which are based on the 2001 VBM Table with 4 percent interest. The reserve for Term policies is based on the 2001 VBM Table with 4 percent interest and the age 70 rate (the capped premium) of $6.18 per month per $1,000 face amount.

United States Government Life Insurance (USGLI) permanent plan policy reserves are based on the American Experience Table with 3.5 percent interest and are held on a net single premium basis.

Veterans Special Life Insurance (VSLI) permanent plan policy reserves are based on the X-18 Table at 2.5 percent interest, except for paid-up additions, which are based on the 1980 CSO Basic Table with 5 percent interest. The reserve for Term policies is based on the 1980 CSO Basic Table with 5 percent interest and the age 70 rate (the capped premium) of $5.87 per month per $1,000 face amount.

Service-Disabled Veterans Insurance (S-DVI) permanent plan policy reserves are based on the 1941 CSO Table at 3.5 percent interest using rate book premiums. The reserve for 5-Year Term policies is based on varying ratios of the 1941 CSO Table at 3.5 percent interest using rate book premiums and is computed on a complete contract basis. The mortality ratios start at 250 percent for ages 50 and below and grade down to 100 percent of the table for ages 65 and older. The reserve for Term policies renewed at age 70 and over is based on the 1941 CSO Table with 3.5 percent interest and the age 70 Term capped premium of $5.87 per month per $1,000 face amount.

Veterans Reopened Insurance (VRI) basic policy reserves are based on an interest rate of 3.5 percent and a mortality basis that varies by segment ("J", "JR" or "JS") and by rating code within the "JR" segment. For "J", the basis is 100 percent of the 1958 CSO Basic Table. For "JR", the basis is the same as the rating code (150, 175, 200, 250, 300, 400 or 500 percent) of the Basic Table. For "JS", the basis is the American Experience Table, and the reserve is a single premium. Reserves for paid-up additions are based on the 2001 VBM Table and 4 percent interest for "J", the 1958 CSO Basic Table and 4 percent interest for "JR", and 150 percent of the 1958 CSO Basic Table and 4 percent interest for "JS".

The Veterans' Mortgage Life Insurance (VMLI) program is operated through the Veterans' Insurance & Indemnities (VI&I) fund. The reserve for VMLI policies is based on 500 percent of the 1958 CSO Basic Table at 2.5 percent interest.

A reserve for unearned premiums is held for premiums paid for coverage past the date of the statement. It is comprised of an estimate for premiums paid less than one month in advance that are unearned at the end of the reporting period, and a reserve for premiums paid one month or more in advance computed from in-force master records.

Insurance dividends that are left on credit or deposit with VA accrue interest at a rate that varies by fund relative to the fund's investment portfolio earnings. For 2012 and 2011, the interest rates ranged from 4.25 percent to 5.5 percent

The Secretary of VA determines annually the excess funds available for dividend payment. 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. Policies in four of the administered programs are eligible for dividends: NSLI, USGLI, VSLI and VRI. The dividend authorization is based on an actuarial analysis of each program's claims and investment experience, compared to the mortality and interest assumptions utilized in that program, at the end of the preceding calendar year. Dividends are declared on a calendar year basis and paid on policy anniversary dates. 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.

The reserve for Dividends Payable is an estimate of the present value of dividends accrued as of the valuation date. In accordance with GAAP requirements, VA records only that portion of the estimated policy dividend that applies to the current reporting period as a dividend liability. For 2012, a discount rate of 4 percent (5 percent VSLI), along with the appropriate accrual factor, was used. For 2011, the discount rate was 5 percent for all funds, except USGLI, which was 4.5 percent. The methodology employed by VA to estimate the dividend liability reflects expected dividends to be paid by quarter using percentages that are based on the actual distribution of dividend anniversaries at the end of the prior year.

Annual Leave

Federal employees' annual leave is accrued as it is earned, and the accrual is reduced annually for actual leave taken. Each year, the accrued annual leave balance is adjusted to reflect the latest 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, and therefore, these liabilities are not covered by budgetary resources.

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. Consistent with past practice, these projected annual benefit payments have been discounted to present value using the OMB's economic assumptions for 10-year Treasury notes and bonds.

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 OPM to each agency.

VA's employees are covered under the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS); VA makes contributions according to both plan's requirements. CSRS and FERS are multi-employer plans administered by OPM. 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 and burial 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 total number of Veterans, estimated future military separations, the number of Veterans and dependents receiving payments, discount rates, cost of living adjustments, presumptive service conditions resulting in disability benefits coverage and life expectancy, impact the amount of the liability.

Discount rates used to measure the actuarial liabilities are based on spot rates derived from the 10-year average historical interest rate yield curve on Treasury securities at September 30 of each year for the 10-year historical period with maturities consistent with the period of expected future payments. As a result, each year for which expected future payments are projected has a separate discount rate associated with it. However, a single average discount rate is also disclosed that may be used for all projected future payments that results in a present value that is not materially different than the resulting present value using multiple-rates. Estimated liabilities for Veterans compensation and burial obligations in the financial statements are measured as of the end of the fiscal year based on June 30 beneficiary data that is adjusted for material known changes in the number of participants covered (enrollment) during the 4th quarter. The method used to measure the liabilities provides for consistency in the underlying relationship between discount rate, COLA, and the other economic assumptions. For 2012, valuation techniques or their application used to measure the fair value of the actuarial liabilities were consistently applied compared to the previous year.

From time to time, VA may determine it is preferable to make refinements to the valuation techniques or their application used to measure the fair value of the actuarial liabilities because VA management concludes that the resulting measurements are equally or more representative of fair value of the actuarial liabilities in the circumstances and were due to improved computer software modeling capability and/or improved information. The resulting changes in fair value of the actuarial liabilities from the changes in valuation techniques or their application are treated as a change in estimate and accounted for on a prospective basis.

Congress established a process to guide the creation of new presumptive disability benefit payments through the Agent Orange Act of 1991, P.L. No. 102-4. The Secretary of VA relying on independent studies by the Institute of Medicine (IOM) determines whether presumptions of service connection are warranted and presumptive disability benefit payments are due. Upon determination by the Secretary of VA that presumptive disability benefit payments are due, there is a waiting period and a final regulation is issued. In accordance with the Agent Orange Act, the adjudication of cases based on the new presumption can begin and a liability is recognized.

SFFAS 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting Gains and Losses from Changes in Assumptions, and Selecting Discount Rates and Valuation Dates* (SFFAS 33) applies to the actuarial liabilities recognized for Veterans compensation and burial obligations reported in VA's financial reports prepared pursuant to FASAB standards.

SFFAS 33 requires the display of gains and losses from changes in long-term assumptions used to measure liabilities for Veterans compensation and burial obligations, as separate line items on the Statements of Net Cost. The Standard also requires disclosure in notes to the financial statements of a reconciliation of beginning and ending Veterans compensation and burial obligations balances, including all material components of expense "from experience" and "from assumptions changes" by significant programs and in total. In addition, SFFAS 33 provides standards for selecting the discount rate assumption to measure the Veterans compensation and burial obligations as of the reporting date and selecting a valuation date for estimating the obligation which will establish a consistent method for such measurements.

Contingencies

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 as disclosed in Note 18, Contingencies.

Non-Federal Trusts

VA has entered into enhanced-use leases to maximize use of underutilized VA property. In 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 included in the accompanying consolidated financial statements.

Application of Critical Accounting Estimates

The financial statements are based on the selection of accounting policies and the application of significant accounting estimates, some of which require management to make significant assumptions. Further, the estimates are based on current conditions that may change in the future. Actual results could differ materially from the estimated amounts. The financial statements include information to assist in understanding the effect of changes in assumptions to the related information.

Comparative Data
Certain amounts in the 2011 Consolidated Statement of Net Cost were reclassified from Indirect Administrative Program Costs to Veterans Benefits Administration Program Costs to conform to the 2012 direct appropriation and reporting presentation of general operating expenditure (GOE) funds for direct and reimbursable costs incurred to support VBA's programs. In 2011, all VA Staff Office support was appropriated within the same budgetary fund. The reclassification decreased Indirect Administrative Program Costs and increased Veterans Benefits Administration program costs in 2011. There was no other impact on the net position, net cost or budgetary resources reported in the consolidated or combined financial statements.

Similarly, Note 21 Net Program Costs by Administration has also been adjusted to reflect the effects of the reclassification discussed above. Public Costs and Intragovernmental Costs reported under Indirect Administrative Program Costs decreased with an offsetting increase in Public Costs and Intragovernmental Costs reported under Veterans Benefits Administration.

Certain amounts in the 2011 Consolidated Balance Sheet were reclassified from Intragovernmental and Public Other Liabilities to Intragovernmental and Public Accounts Payable to conform to the 2012 presentation in accordance with U.S. Standard General Ledger (USSGL) requirements. The reclassifications had no other effect reported in the consolidated or combined financial statements.

The calculation and presentation of the components of the Reconciliation of Veterans Compensation and Burial Actuarial Liabilities shown in Note 13 were modified for 2012 to more closely align the VA presentation of Veterans Benefits Actuarial Liabilities with other agencies of the Federal Government for improved consistency in government-wide reporting of other post-employment benefits (OPEB). As a result, the 2011 presentation was also modified to conform to the 2012 presentation. The Statements of Net Cost and Note 21 Net Program Costs by Administration were modified to reflect the revised components, Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions and Changes in Actuarial Liability Assumptions; however, the Net Cost of Operations did not change.

Effective for 2012, the SBR presentation has changed to better align with the new format of the report on Budget Execution and Budgetary Resources (SF 133) as required by OMB. The new format has additional reconciliation requirements with budget execution information reported in the Budget of the United States to ensure the integrity of the numbers presented. As a result of the format changes, the 2011 data has been reclassified to conform to the 2012 presentation. There are no other effects reported in the consolidated or combined financial statements.

See Note 24 on Reclassifications for further discussion of the above items.

Subsequent Events
Subsequent events have been evaluated through the auditors' report date which is the date the financial statements were available to be issued, and management determined that there are no other items to disclose.

2. Non-Entity Assets

Entity and Non-Entity assets have been combined on the balance sheet. Non-Entity assets relate primarily to state and local taxes and other employee payroll withholdings and personal funds of patients included in Fund Balance with Treasury; downward reestimates for the Veterans Housing Program included in Intragovernmental Accounts Receivable; and amounts due to Treasury for medical costs billed to Veterans included in Public Accounts Receivable.

There are offsetting liabilities in the consolidated balance sheet for the non-entity assets reported below. Offsetting liabilities are included in Intragovernmental Other Liabilities and Accounts Payable and Public Other Liabilities, Insurance Liabilities and Accounts Payable. There is no balance in the consolidated net position from the non-entity assets.

Non-Entity Assets				
as of September 30,				
		2012		**2011**
Fund Balance with Treasury	$	112	$	144
Intragovernmental Accounts Receivable		1		1
Public Accounts Receivable		68		63
Total Non-Entity Assets	$	181	$	208

3. Fund Balance with Treasury

Fund Balance with Treasury as of September 30,		2012		2011
Entity Assets				
Trust Funds	$	94	$	79
Revolving Funds		4,872		4,309
Appropriated Funds		35,143		35,407
Special Funds		293		272
Other Fund Types		60		-
Total Entity Assets		40,462		40,067
Non-Entity Assets				
Other Fund Types		112		144
Total Non-Entity Assets		112		144
Total Entity and Non-Entity Assets	$	40,574	$	40,211
Reconciliation of VA General Ledger Balances with Treasury				
Balance per VA General Ledger	$	40,386	$	43,456
Reconciled Differences, Principally Timing		118		(3,334)
Unreconciled Differences		70		88
Fund Balance with Treasury	$	40,574	$	40,211
Status of Fund Balance with Treasury				
Unobligated Balance				
Available	$	12,614	$	20,257
Unavailable		5,525		4,429
Obligated Balance Not Yet Disbursed		22,046		15,149
Deposit /Clearing Account Balances		389		376
Fund Balance with Treasury	$	40,574	$	40,211

4. Cash

Cash as of September 30,		2012		2011
Canteen Service	$	2	$	1
Agent Cashier Advance		14		17
Total Cash	$	16	$	18

5. Investments

Investment Securities

as of September 30, 2012

		Cost	Amortization Method		Amortized (Premium)/ Discount	Interest Receivable	Investments, Net		Market Value
Intragovernmental Securities									
Non-Marketable: Special Bonds	$	9,132	N/A	$	-	112	9,244	$	9,244
Treasury Notes		65	Effective Interest		(1)	1	65		65
Total	$	9,197		$	(1)	113	9,309	$	9,309
Public Securities									
Trust Certificates (Loan Guaranty)	$	140	N/A	$	-	-	140	$	140
Mutual Funds (Non-Federal Trusts)		43	Straight-line		(5)	-	38		38
Total	$	183		$	(5)	-	178	$	178
as of September 30, 2011									
Intragovernmental Securities									
Non-Marketable: Special Bonds	$	9,821	N/A	$	-	127	9,948	$	9,948
Treasury Notes		85	Effective Interest		(2)	1	84		84
Total	$	9,906		$	(2)	128	10,032	$	10,032
Public Securities									
Trust Certificates (Loan Guaranty)	$	140	N/A	$	-	-	140	$	140
Mutual Funds (Non-Federal Trusts)		51	Straight-line		(5)	-	46		46
Total	$	191		$	(5)	-	186	$	186

6. Accounts Receivable, Net

Accounts Receivable, Net
as of September 30,

	2012	2011
Intragovernmental Accounts Receivable, Net	$ 40	$ 6
Public Accounts Receivable		
Medical Care	$ 2,224	$ 2,265
Contractual Adjustment and Allowance for Loss Provision	(1,017)	(997)
Net Medical Care	1,207	1,268
Compensation and Pension	1,067	1,225
Allowance for Loss Provision	(665)	(846)
Net Compensation and Pension	402	379
Education Benefits	365	336
Allowance for Loss Provision	(269)	(132)
Net Education Benefits	96	204
Other	102	96
Allowance for Loss Provision	(18)	(13)
Net Other	84	83
Total Public Accounts Receivable	3,758	3,922
Total Contractual Adjustment and Allowance for Loss Provision	(1,969)	(1,988)
Public Accounts Receivable, Net	$ 1,789	$ 1,934

The Total Contractual Adjustment and Allowance for Loss Provision as a percentage of Total Public Accounts Receivable was approximately 52 percent and 51 percent at September 30, 2012 and 2011, respectively. The Medical Care Contractual Adjustment and Allowance for Loss Provision as a percentage of Total Medical Care related accounts receivable was approximately 46 percent and 44 percent at September 30, 2012 and 2011, respectively.

Included in the Medical Care Contractual Adjustment and Allowance for Loss Provision is an Allowance for Contractual Adjustment of $593 million and $561 million or approximately 57 percent and 52 percent, respectively of Medical Care Collection Fund third party receivables of $1.04 billion and $1.08 billion at September 30, 2012 and 2011, respectively.

The Compensation and Pension Allowance for Loss Provision as a percentage of Total Compensation, Pension and Readjustment Benefit Overpayment-related accounts receivable was approximately 62 percent and 69 percent at September 30, 2012 and 2011, respectively. The Education Benefits Allowance for Loss Provision as a percentage of Total Education Benefits and Readjustment Benefit Overpayment-related accounts receivable was approximately 74 percent and 39 percent at September 30, 2012 and 2011, respectively.

7. Direct Loans and Loan Guarantees

As more fully discussed in Note 1 under the Loans Receivable and Loan Guarantees sections, the accounting for direct loans receivable and loan guarantee liabilities made after 1991, is governed by the Credit Reform Act. Disclosure of direct loans receivable and loan guarantee liabilities is provided in accordance with SFFAS 2, *Accounting for Direct Loans and Guarantees*, as amended.

VA operates the following direct loan and loan guaranty programs:

- Home Loans
- Vocational Rehabilitation and Employment
- Insurance

The VA Home Loans program is the largest of the VA loan programs. The Home Loan program provides loan guarantees and direct loans to Veterans, Servicemembers, relevant dependents, and limited non-veterans to purchase homes and retain homeownership on favorable market terms.

VA operates in the broader mortgage marketplace; as a result, the VA housing program is affected by the economic conditions in the housing market. These economic conditions have led to declining housing prices and tightening credit. The current mortgage market has not demonstrated a sustainable recovery; however, as home equity begins to recover, VA and loan servicers will be better able to use foreclosure-resolution and avoidance tools to improve the outcomes of servicing efforts offered to borrowers with delinquent VA guaranteed home loans.

VA projects, funds, and reports the long-term direct costs for these loans; that is, reestimates of loan lifetime costs incurred by the government from making VA loans. These reestimates of long-term costs are updated annually and represent funds set aside to cover projected lifetime loan losses.

For the year ended September 30, 2012, VA reestimated the funds set aside for changes in projected lifetime cash flows mainly for loan guarantees for Veterans and Servicemembers based on VA's estimates of strong demand for refinanced loan guarantees, increases in home sales volume and home prices from a sustained housing recovery and demand for homes, historic low mortgage rates with normal increases, and changes in home inventory and foreclosure cash flows from fading legacy mortgage problems. VA performs economic modeling and analysis using available loan portfolio data and economic assumptions correlated with some key loan data (foreclosures, outlays and collections, home prices, interest rates, and loan prepayments and terms). These estimates are based on current conditions that may change in the future. Actual results could differ materially from estimated amounts

The Vocational Rehabilitation and Employment direct loans provide temporary financial assistance to eligible beneficiaries. Loans provided under this program are interest free and must be repaid within 10 months.

Veterans that are government life insurance policyholders with permanent plan coverage or paid-up additional insurance can borrow against the cash value of their policy, creating an insurance policy direct loan. The loan amount may not exceed 94 percent of the cash surrender value of the policy or the paid-up additional insurance.

Direct Loans

The following tables summarize the carrying amount of loans receivable related to pre-1992 and post-1991 direct loans. The carrying amount of direct loans receivable includes the remaining balance of the amount disbursed, interest receivable, an allowance for loan losses using the allowance method (estimated uncollectible loans) for pre-1992 loans, the present value of an allowance for subsidy costs for post-1991 loans and the fair market value less cost to dispose of foreclosed property based on the present value of future cash flows from the property. 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 and Insurance Policy Loans From Direct Loans as of September 30, 2012

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans, Net
Direct Loans Obligated Prior to 1992 (Allowance for Loss Method)	$ 11	10	(1)	-	$ 20
Insurance Policy Loans	423	10	-	-	433
Total Loans Receivable and Related Foreclosed Property and Insurance Policy Loans, Excluding Direct Loans Obligated After 1991, Net					$ 453

	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans, Net
Direct Loans Obligated After 1991	$ 653	15	24	7	$ 699
Total Loans Receivable and Related Foreclosed Property and Insurance Policy Loans from Direct Loans, Net					$ 1,152

Loans Receivable and Related Foreclosed Property and Insurance Policy Loans From Direct Loans as of September 30, 2011

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Direct Loans, Net
Direct Loans Obligated Prior to 1992 (Allowance for Loss Method)	$ 13	10	(1)	-	$ 22
Insurance Policy Loans	464	11	-	-	475
Total Loans Receivable and Related Foreclosed Property and Insurance Policy Loans, Excluding Direct Loans Obligated After 1991, Net					$ 497

	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Foreclosed Property	Value of Assets Related to Direct Loans, Net
Direct Loans Obligated After 1991	$ 723	13	2	8	$ 746
Total Loans Receivable and Related Foreclosed Property and Insurance Policy Loans from Direct Loans, Net					$ 1,243

Direct Loans Disbursed
The total amount of new direct loans disbursed for the years ended September 30, 2012 and 2011 was $159.7 million and $270.7 million, respectively.

Subsidy Expense for Post-1991 Direct Loans
Subsidy expense declined significantly due to one-time estimation method adjustment in 2011 that did not recur in 2012. The one-time upward reestimate adjustment to loan years 1992 through 2006 of approximately $700 million was required in 2011 since VA had actual experience data to adjust for a lack of accurate cash flow data prior to 2006.

Input data and assumptions were changed based on analysis on loan performance and economic conditions in 2012. The changes in economic assumptions were marginal drivers in analysis of change in subsidy estimates for future potential bad loans. Actual home price appreciation, mortgage rate, and Treasury bond yield were better than their predicted values. There was no evidence of relevant VA foreclosure backlog to require related model adjustments.

The subsidy expense for direct loans is as shown:

Direct Loan Subsidy Expense		
for the years ended September 30,		
	2012	**2011**
Interest Differential	$ (28)	$ (49)
Defaults	1	1
Fees*	(1)	(4)
Other**	25	45
Subtotal	(3)	(7)
Interest Rate Reestimates	4	(2)
Technical Reestimates	(19)	407
Total Direct Loan Subsidy Expense	$ (18)	$ 398

* "Fees" expense for direct loans includes estimated down payments and other fees collected when homes are sold with vendee financing.
** "Other" expense for direct loans includes the estimated loss of scheduled principal and interest when vendee loans are sold.

Budgetary Subsidy Rates for Direct Loans by Component
The subsidy rates disclosed below pertain only to the current year loans. 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 both current year loans and prior year(s) loans. The subsidy expense reported in the current year also includes reestimates.

Budgetary Subsidy Rates for Direct Loans by Component	
Interest Differential	(23.14%)
Defaults	10.11%
Fees	(0.83%)
Other	15.83%

Allowance for Subsidy for Direct Loans (Post-1991)

For these loans, the allowance for subsidy represents the difference between the balance of the direct loan and the present value of the estimated net cash flows to be paid by VA. The allowance for subsidy is the result of 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. For 2012, the subsidy rate is (2.12) percent for Veterans Housing Direct – Vendee Loans, (4.09) percent for Veterans Housing Direct – Acquired Loans, and (11.97) percent for Native American Direct. For 2011, the subsidy rate is (2.42) percent for Veterans Housing Direct – Vendee Loans, (0.13) percent for Veterans Housing Direct – Acquired Loans, and (13.65) percent for Native American Direct.

Schedule for Reconciling Subsidy Cost Allowance Balances

Beginning Balance, Changes and Ending Balance

	2012	2011
Beginning balance of the allowance	$ (2)	$ (713)
Subsidy expense for direct loans disbursed during the reporting years by component:		
Interest subsidy costs	(28)	(49)
Default costs (net of recoveries)	1	1
Fees and other collections	(1)	(4)
Other subsidy costs	25	45
Total of the above subsidy expense components	(3)	(7)
Adjustments:		
Fees received	4	4
Foreclosed property acquired	18	(5)
New Loans	5	-
Loans written off	(4)	(3)
Subsidy allowance amortization	(14)	309
Change in reestimate approved by OMB	(13)	8
Total Adjustments	(4)	313
Ending balance of the allowance before reestimates	(9)	(407)
Subsidy reestimates by component		
Interest rate reestimate	4	(2)
Technical/default reestimate	(19)	407
Total of the above reestimate components	(15)	405
Ending balance of the allowance	$ (24)	$ (2)

Loan Guarantees

The following tables summarize the carrying amount of loans receivable related to pre-1992 and post-1991 defaulted guaranteed loans and non-defaulted guaranteed loans. The carrying amount of the guaranteed loans receivable includes the amount dispersed by VA for its guaranty under the defaulted loans, an allowance for loan losses using the allowance method (estimated uncollectible loans) for pre-1992 loans and the fair market value less cost to dispose of foreclosed property based on the present value of future cash flows from the property.

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, 2012

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Defaulted Guaranteed Loans - Pre-1992 Guarantees (Allowance for Loss Method)	$ 32	-	(10)	4	$ 26
Defaulted Guaranteed Loans - Post-1991 Guarantees	5	-		813	818
Total Loans Receivable and Related Foreclosed Property from Loan Guarantees					$ 844

Loans Receivable and Related Foreclosed Property from Loan Guarantees
as of September 30, 2011

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Defaulted Guaranteed Loans - Pre-1992 Guarantees (Allowance for Loss Method)	$ 15	-	(14)	4	$ 5
Defaulted Guaranteed Loans - Post-1991 Guarantees	5	-	-	852	857
Total Loans Receivable and Related Foreclosed Property from Loan Guarantees					$ 862

Foreclosed Property

Prior to the foreclosure of property secured by a VA Loan Guarantee, VA obtains an independent appraisal of the property. This appraisal is reviewed by VA staff or delegated Staff Appraisal Reviewer to substantiate 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.

There has been no change in the methodology for calculating the amount recorded for foreclosed property and there are no restrictions on the use or disposition of foreclosed property for the years ended September 30, 2012, and 2011.

As of September 30, 2012, and 2011, the number of residential properties in VA's inventory was approximately 10,400 and 7,300, respectively. For 2012 and 2011, the average holding period from the date properties were conveyed to VA until the date properties were sold was approximately 8 months and 7 months, respectively. The number of properties for which foreclosure proceedings are in process was approximately 23,400 and 22,000 as of September 30, 2012, and 2011, respectively.

Guaranteed Loans				
as of September 30,				
		2012		**2011**
Guaranteed Loans Outstanding:				
Outstanding Principal of Guaranteed Loans, Face Value	$	286,626	$	247, 658
Amount of Outstanding Principal Guaranteed	$	76,137	$	66,222
New Guaranteed Loans Disbursed:				
Outstanding Principal of Guaranteed Loans, Face Value	$	106,763	$	66,630
Amount of Outstanding Principal Guaranteed	$	27,402	$	17,190
Number of New Loans Disbursed		492,497		322,380

Liabilities for Pre-1992 and Post-1991 Loan Guarantees, Excluding Loan Sale Guarantees (Present Value Method)	$	5,445	$	4,973

Loan Guarantee Modifications
OMB Circular No. A-11, section 185, specifies that modifications to loan guarantees result from the government's decision to alter the percentage of the loan it will guarantee. The subsidy cost of a modification is the difference between the net present value of the remaining estimated cash flows before and after the modification (i.e., post-modification liability minus pre-modification liability) and the change in carrying amount is recognized as a gain or a loss. A reduction in the loan guarantee liability due to a modification reflects as savings to VA resulting in a modification gain being recognized. An increase in the loan guarantee liability due to a modification reflects increased costs to VA resulting in a modification loss being recognized. The carry amount of the loan guarantee liability reflects the post-modification liability balance.

Multiple reestimate discount rates are used to calculate loan subsidy modification costs for existing loan guarantees from 1992 to 2012. The reestimate discount rate is either a weighted average rate (prior to 2001) or a single effective rate depending on the loan issuance year of the cash flows. The discount rates range between 2.31 percent to 7.59 percent. VA recognizes gains or losses on modification as described above. VA performed two loan modifications in 2012. The Honoring America's Veterans and Caring for Camp Lejeune Families Act extended the period of protections for members of uniformed services relating to mortgages, mortgage foreclosure, and eviction. Specifically, section 710 amended section 303 of the Servicemembers Civil Relief Act (SCRA) by extending the period in which a Servicemember may exercise SCRA protections from nine months after the period of service ends to one year. The amendments made by section 710 will expire on December 31, 2014, at which time the protection would revert to the original 90-day period noted under Section 303 of SCRA.

The VA Loan Guaranty Service amended its regulations related to modification of guaranteed housing loans in default via the Loan Guaranty Revised Loan Modification Procedures (RIN 2900-AN78). Specifically, changes were made to the requirements related to maximum interest rates on modified loans, and to items that may be capitalized in a modified loan amount. VA expects that Veteran borrowers would receive loan modifications (as opposed to alternatives to foreclosure and foreclosures) as result of this regulation change, their modified loans would remain in good standing and not result in a net loss to lenders or VA.

Subsidy Expense for Post-1991 Loan Guarantees
Pursuant to the Credit Reform Act, subsidy costs for new loan guarantees, net of up front funding fees, must be obligated at the time the loan is disbursed. The current and prior year upward reestimate was principally caused by a recovering housing market and unexpected demand of VA home loan products in FY 2012. Specifically, the Loan Guarantee Financing Account (4129) operating income deteriorated on lower foreclosure sales proceeds while foreclosure claim total payments were consistent with expectations. The loan guarantee average funding fee rate deteriorated on higher demand for refinance loan guarantees. Deterioration in the average funding fee rate relative to budget contributed to upward reestimates. 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,	2012	2011
Defaults	$ 1,693	$ 1,011
Fees	(1,856)	(1,234)
Subtotal	(163)	(223)
Interest Rate Reestimates	13	(10)
Technical Reestimates	777	801
Total Guaranteed Loan Subsidy Expenses	$ 627	$ 568

Budgetary Subsidy Rates for Loan Guarantees by Component

The subsidy rates disclosed below pertain only to the loans guaranteed in the current year. 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 loan guarantees issued and prior year(s) loan guarantees issued. The subsidy expense reported in the current year also includes reestimates.

Budgetary Subsidy Rates for Loan Guarantees	
Defaults	2.82%
Fees	(2.74)%

Liability for Loan Guarantees (Post-1991)

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. In November 2011, Congress enacted and the President signed PL 112-56 which included a change in the funding fees charged to Veterans who receive a guaranteed loan after November 22, 2011. This change in funding fee affected the cash flows of the program and resulted in a change to the subsidy rate for 2012. Therefore, in 2012, there are two subsidy rates for guaranteed loans. For loans guaranteed between October 1 and November 22, 2011, the subsidy rate is (0.20) percent and for loans guaranteed after November 22, 2011 the subsidy rate is 0.28 percent. The subsidy rate for 2011 was (.31) percent. In the table below, the current year and prior year upward reestimate was principally caused by higher default costs and higher than projected losses on acquired properties as a result of the weak housing market.

Schedule for Reconciling Loan Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance		**2012**		**2011**
Beginning balance of the liability	$	4,973	$	4,823
Subsidy expense for guaranteed loans disbursed during the reporting years by component:				
Default costs (net of recoveries)		1,693		1,011
Fees and other collections		(1,856)		(1,234)
Total of the above subsidy expense components		(163)		(223)
Adjustments:				
Fees received		1,203		904
Foreclosed property and loans acquired		(464)		(468)
Claim payments to lenders		(817)		(908)
Interest accumulation on the liability balance		166		215
Change in reestimate approved by OMB		(222)		(161)
Modification		(4)		-
Other		(17)		-
Total Adjustments		(155)		(418)
Ending balance of the liability before reestimates		4,655		4,182
Subsidy reestimates by component				
Interest rate reestimate		13		(10)
Technical/default reestimate		777		801
Total of the above reestimate components		790		791
Ending balance of the liability	$	5,445	$	4,973

Loan Sales

VA owns mortgages and real estate on certain defaulted loans that were guaranteed by VA and have gone through the foreclosure process with the lender. VA sells the real estate to a third party owner and makes the direct loan for the underlying mortgage loan receivable. To reduce the administrative burden of servicing these loans, VA will bundle these loans and sell them to a third party investor (Trust) pursuant to a sale agreement. It is at least reasonably possible that the proceeds from the sale of its loans will differ from the reported carrying value of the loans and the underlying value of their related assets resulting in a realized gain or loss on sale.

Under the sale agreement, the Trust owns the mortgage loans and other property acquired in the sale and 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. In addition, the Trust will issue certificates backed by mortgage loans and installment contracts. The certificates represent interests in the assets of the Trust and are paid from the Trust's assets. On the closing date of the certificates, VA transfers its entire interest in the related loans receivable and collateral to the Trustee for the benefit of the related certificate holders pursuant to the sale agreement. VA guarantees that the investor will receive full and timely distributions of the principal and interest on the certificates backed by the full faith and credit of the Federal Government.

During the period 1992 through 2012, the total loans sold amounted to $14.2 billion. VA recognized loan sale proceeds of $198 million during 2012 resulting in a gain of $8 million. VA recognized loan sale proceeds of $187 million during 2011 resulting in no gain or loss. As a result of the sale of loans receivable with a carrying amount of $190 million and $187 million in 2012 and 2011, respectively, the amount of guaranteed loans sold increased by the carrying amount of the loans receivable at the date of sale. The components of the loan sale and the outstanding balance for guaranteed loans sold are summarized in the tables below:

Loan Sales Years Ended September 30,	2012	2011
Loans Receivable Sold	$ 190	$ 187
Net Proceeds from Sale	(198)	(187)
Gain on Receivables Sold	$ (8)	$ -

Outstanding Balance of Loan Sale Guarantees - Guaranteed Loans Sold as of September 30,	2012	2011
Outstanding Balance Guaranteed Loans Sold, Start of Year	$ 1,789	$ 1,661
Sold to the Public	190	187
Payments, Repayments, and Terminations	(171)	(59)
Outstanding Balance Guaranteed Loans Sold, End of Year	$ 1,808	$ 1,789

Subsidy Expense for Loan Sale Guarantees

Pursuant to the Credit Reform Act, subsidy costs for new loan sale guarantees must be obligated at the time the loan sale is closed. The subsidy expense for loan sale guarantees is below:

Loan Sale-Guaranteed Loan Subsidy Expense for the years ended September 30,	2012	2011
Defaults	$ 6	$ 5
Fees	14	-
Other	-	(1)
Subtotal	20	4
Interest Rate Reestimates	(2)	-
Technical Reestimates	(11)	26
Total Loan Sale-Guaranteed Subsidy Expense	$ 7	$ 30

Liability for Loan Sale Guarantees (Post-1991)

For these programs, 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. 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 2012 and 2011 is 10.75 percent and 2.00 percent, respectively.

Schedule for Reconciling Loan Sale Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance	**2012**	**2011**
Beginning balance of the liability	$ 89	$ 62
Subsidy expense for guaranteed loans disbursed during the reporting years by component:		
Default costs (net of recoveries)	6	5
Fees	14	-
Other subsidy costs	-	(1)
Total of the above subsidy expense components	20	4
Adjustments:		
Claim payments to lenders	(29)	(28)
Interest accumulation on the liability balance	24	25
Change in reestimate approved by OMB	17	-
Gain on Loan Sales	8	-
Total Adjustments	20	(3)
Ending balance of the liability before reestimates	129	63
Subsidy reestimates by component		
Interest rate reestimate	(2)	-
Technical/default reestimate	(11)	26
Total of the above reestimate components	(13)	26
Ending balance of the liability	$ 116	$ 89

Program Totals

Total Loans Receivable and Related Foreclosed Property, Net as of September 30,		2012		2011
Total Direct Loans	$	1,152	$	1,243
Total Guaranteed Loans		844		862
Total Loans Receivable and Related Foreclosed Property, Net	$	1,996	$	2,105

Total Subsidy Expense for the years ended September 30,		2012		2011
Total Direct Loans	$	(18)	$	398
Total Guaranteed Loans		627		568
Total Loan Sales		7		30
Total Subsidy Expense	$	616	$	996

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Total Liabilities for Loan Guarantees as of September 30,		2012		2011
Total Loan Guarantee Liability	$	5,445	$	4,973
Total Loan Sale Guarantee Liability		116		89
Total Liabilities for Loan Guarantees	$	5,561	$	5,062

Administrative Expense

Administrative expense on direct and guaranteed loans for the fiscal years ended September 30, 2012, and 2011 was $143 million and $142 million, respectively.

8. Inventories and Related Property, Net

Inventories as of September 30,		2012		2011
Held for Current Sale	$	54	$	68
Other		2		3
Total Inventories	$	56	$	71

9. General Property, Plant and Equipment

General Property, Plant and Equipment
as of September 30, 2012

	Cost	Accumulated Depreciation /Amortization	Net Book Value
Land and Improvements	$ 1,006	$ (186)	$ 820
Buildings	24,129	(12,872)	11,257
Equipment	4,110	(2,181)	1,929
Other Structures and Capital Leases	3,314	(1,859)	1,455
Internal Use Software	707	(366)	341
Construction Work in Progress	4,505	-	4,505
Internal Use Software in Development	324	-	324
Total Property, Plant, and Equipment	$ 38,095	$ (17,464)	$ 20,631

General Property, Plant and Equipment
as of September 30, 2011

	Cost	Accumulated Depreciation /Amortization	Net Book Value
Land and Improvements	$ 896	$ (142)	$ 754
Buildings	22,019	(11,647)	10,372
Equipment	3,815	(1,940)	1,875
Other Structures and Capital Leases	3,033	(1,708)	1,325
Internal Use Software	472	(322)	150
Construction Work in Progress	4,041	-	4,041
Internal Use Software in Development	169	-	169
Total Property, Plant, and Equipment	$ 34,445	$ (15,759)	$ 18,686

Depreciation and amortization expense totaled $1.9 billion and $1.9 billion in 2012 and 2011, respectively. Loss on disposition of assets totaled $101.3 million and $110.5 million in 2012 and 2011, respectively.

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.

Heritage Assets in Units					
as of September 30,	**2011 Balance**	**2012 Additions**	**2012 Withdrawals**	**2012 Balance**	**Condition**
Art Collections	245	-	(213)	32	A
Buildings and Structures	1,535	571	(25)	2,081	*U
Monuments/Historic Flag Poles	1,006	587	-	1,593	A
Other Non-Structure Items	247	44	-	291	A
Archaeological Sites	35	-	(25)	10	A
Cemeteries	**164	-	-	**164	A
Total Heritage Assets in Units	3,232	1,202	(263)	4,171	

Explanation of Condition: A = Acceptable (No to slight deterioration); U=Unacceptable (Moderate to significant deterioration)

*Buildings and Structures: Approximately 50% of VA's historic buildings and structures are unoccupied and risk deterioration. Many are in the "U" range.

** This total accounts only for open, operational cemeteries, not those under development.

11. Debt

Intragovernmental Debt as of September 30,	2011 Beginning Balance	2011 Net Borrowing	2011 Ending Balance	2012 Net Borrowing	2012 Ending Balance
Loan Guaranty Debt					
Debt to the Treasury	$ 1,649	$ 25	$ 1,674	$ (837)	$ 837
Debt to the Federal Financing Bank	5	-	5	-	5
Total Loan Guaranty Debt	1,654	25	1,679	(837)	842
Direct Loans Debt – Vocational Rehabilitation Program					
Debt to the Treasury	1	-	1	-	1
Debt to the Federal Financing Bank	-	-	-	-	-
Total Direct Loans Debt	1	-	1	-	1
Total Debt					
Debt to the Treasury	1,650	25	1,675	(837)	838
Debt to the Federal Financing Bank	5	-	5	-	5
Total Debt	$ 1,655	$ 25	$ 1,680	$ (837)	$ 843

At September 30, 2012, and 2011, all debt is classified as intragovernmental debt. Except as noted above, VA had no debt due to any other Federal agency and all debt is covered by budgetary resources.

Loan Guaranty Program debt has a 30-year term from the date of issuance and bears interest at the Treasury securities rate at the time of borrowing. The interest rates on debt issued in 2012 ranged from 2.64 to 3.49 percent and 4.14 to 4.28 percent for debt issued in 2011. The interest rates on all outstanding debt issued ranged from 1.00 to 7.58 percent in 2012 and 1.00 to 7.58 percent in 2011. Interest expense was $116.2 million for 2012 and $142.2 million for 2011.

Vocational Rehabilitation Program Direct Loan debt has a 2-year term from the date of issuance and bears interest at the Treasury securities rate at the time of borrowing. The interest rates on debt issued in 2012 was 1.00 percent and 1.49 percent for debt issued in 2011. The interest rate on all outstanding debt issued was 1.00 to 1.49 percent in 2012 and 2011. Interest expense was $41 thousand for 2012 and $56 thousand for 2011.

Net borrowings related to the Loan Guaranty Program debt and Direct Loans Program debt do not include any amounts that result from refinancing debt.

No debt was held by the public during 2012 or 2011. There were no redemptions or calls of debts before maturity or write-offs of debt owed to the Treasury.

12. Liabilities Not Covered By Budgetary Resources

Liabilities Not Covered By Budgetary Resources
as of September 30,

	2012	2011
Workers' Compensation (FECA)*	$ 2,463	$ 2,327
Annual Leave	1,848	1,797
Judgment Fund	1,178	966
Environmental and Disposal Liabilities	851	884
Veterans Compensation and Burial	1,761,600	1,533,700
Insurance	1,293	1,161
Amounts due to Non-Federal Trust	148	155
Total	$ 1,769,381	$ 1,540,990

* The actuarial estimate for workers' compensation provided by DOL was computed using an interest rate of 3.14 percent and 4.30 percent to discount the projected annual benefit payments as of September 30, 2012 and 2011, respectively.

Liabilities not covered by budgetary resources are liabilities for which Congressional action is needed before budgetary resources can be provided.

Total Unfunded Liabilities include Workers' Compensation (FECA) which is comprised of the actuarial Workers' Compensation (FECA) Liability, Accrued FECA Liability for DOL funded costs not yet appropriated and Unfunded Employee Liability. The Accrued FECA Liability and Unfunded Employee Liability are Intragovernmental Liabilities totaling $449 million and $436 million at September 30, 2012, and 2011, respectively.

13. Federal Employee and Veterans Benefits Liabilities

Federal Employee Benefits
VA is the employer entity that generates employee costs to be funded, not the administrative entity responsible for managing and accounting for VA employees' retirement, health insurance and life insurance benefit plans. As a result, VA recognizes the benefit costs for the reporting period in its financial statements in an amount equal to the service cost for its employees based on the benefit plan's actuarial cost method and assumptions applied to VA and provided by the administrative entity, OPM. The offset to the expense is an increase to an intragovernmental imputed financing source entitled, Imputed Financing under Other Financing Sources (Nonexchange) in the Consolidated Statement of Changes in Net Position, representing the amount being financed directly through the benefit plan's administrative entity. The table below summarizes the imputed expenses reported by VA for its employees' benefit plans.

Federal Employee Benefits: Imputed Expenses-Employee Benefits				
Years ended September 30,				
		2012		2011
Civil Service Retirement System	$	312	$	375
Federal Employees Health Benefits		1,385		1,518
Federal Employees Group Life Insurance		3		2
Total Imputed Expenses-Employee Benefits*	$	1,700	$	1,895

*The total imputed expenses in the table above, when combined with the Imputed Financing – Paid by Other Entities reported in the table reconciliation of judgment fund operating expense in Note 18 reconciles to Imputed Financing Costs reported in the Consolidated Statement of Changes in Net Position.

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 burial flag, headstone/marker and a plot allowance for burial in a private cemetery. These benefits are provided under Title 38, Part 2, Chapter 23 in recognition of a Veteran's military service and are recorded as a liability on the balance sheet in the period the requirements are met.

Federal Employee and Veterans Benefits Liabilities				
as of September 30,				
		2012		2011
Workers' Compensation (FECA)	$	2,014	$	1,891
Compensation		1,757,100		1,529,200
Burial		4,500		4,500
Total Federal Employee and Veterans Benefits Liabilities	$	1,763,614	$	1,535,591

VA provides certain Veterans and/or their dependents with pension benefits if the Veteran died or was disabled from nonservice-related causes, based on annual eligibility reviews. The actuarial present value of the future liability for pension benefits is a nonexchange 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, 2012, and 2011 was $92.8 billion and $89.2 billion, respectively.

Assumptions Used to Calculate the Veterans Benefits Liability

Several significant actuarial assumptions were used in the valuation of compensation 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 program; 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) above are also incorporated into the projection. The projected liability does not include any administrative costs. Actual administrative costs incurred annually are included in the Veterans Benefits Administration's Net Program Costs shown in the accompanying Statements of Net Cost.

The liability for future compensation and burial payments is reported on VA's balance sheet at the present value of expected future payments, and is developed on an actuarial basis. Discount rates at September 30, 2012, and 2011 were based on spot rates derived from the 10-year average historical interest rate yield curve on Treasury securities at September 30 of each year for the period 2003 to 2012 and 2002 to 2011 for September 30, 2012, and 2011, respectively. The spot rates derived from the 10-year average historical interest rate yield curve on Treasury securities for each year of expected future payments range from 1.92 percent to 4.48 percent and from 2.05 percent to 4.70 percent as of September 30, 2012, and 2011, respectively. These spot rates produced a single average discount rate of 4.31 percent and 4.53 percent as of September 30, 2012 and 2011, respectively that could be applied to the expected future cash flows to produce a present value that is not materially different than the present value using multiple rates. All calculations were performed separately by age for the Compensation and Burial programs.

The Veterans benefit liability is impacted by interest on the liability balance, changes in experience, changes in actuarial assumptions, prior service costs and amounts paid for costs included in the liability balance. Interest on the liability balance is based on the prior year liability balance multiplied by the single average discount rate used to compute the Veterans benefit liability balance for the prior year. Changes in experience include the number of Veterans and dependents receiving payments, changes in degree of disability connected with military service and the impact of those changes on future years. Changes in actuarial assumptions include changes in the spot rates derived from the 10-year average historical interest rate yield curve on Treasury securities, cost of living adjustments, presumptive service conditions resulting in benefits coverage, mortality and disability claims rates. Prior service costs relate to new benefits due to administrative, judicial or legislative changes.

The total number of Veterans, estimated future military separations and total number of beneficiary participants are determined through actual and projected data. The amount of benefits by beneficiary category and age were based on current amounts being paid, future cost of living adjustments (COLA), change in degree of disability connected with military service and presumptive service conditions in existence at September 30, 2012, and 2011, respectively, resulting in benefits coverage to determine the average benefits per Veteran for each future time period, and changes in other factors that affect benefits. The average COLA rate used for all future years at September 30, 2012, and 2011 was 2.61 percent and 2.78 percent, respectively. COLA rates for future years are modeled to be consistent with the discount rate assumption described above.

Life expectancies of beneficiaries collecting benefits from the Compensation program 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 2006 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.

Expected benefit payments have been explicitly modeled for the next 100 years. The Compensation projection only reflects benefits associated with military service through September 30, 2012.

The calculation and presentation of the components of the Reconciliation of Veterans Compensation and Burial Actuarial Liabilities shown in the table below were modified for 2012 to more closely align VA's presentation of Veterans Benefits Liabilities with other agencies of the Federal Government for improved consistency in government-wide reporting of other post-employment benefits (OPEB). As a result, the 2011 presentation was also modified to conform to the 2012 presentation. VA has a unique program that is not a defined benefit plan and has no plan assets set aside to fund future costs. VA funds the current year costs of Veterans service related disability compensation and burial costs through its annual appropriations. The change in presentation had no other impact on net position, or budgetary resources in the consolidated or combined financial statements. The Statements of Net Cost were modified to reflect the revised components, Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions and Changes in Actuarial Liability Assumptions; however, the Net Cost of Operations did not change.

The reconciliation table that follows the narrative below indicates that total expense for 2012 of $280.8 billion increased $169.7 billion over 2011 expense of $111.1 billion. The increase was primarily attributable to higher disability claims rates, experience changes due to Veterans counts and the number of claims processed and a lower discount rate partially offset by a lower COLA rate.

The higher disability claims rates are based on emerging experience from initial and reopened claims for the three new presumptive conditions related to Agent Orange. The VA has prioritized the processing of the claims backlog related to Agent Orange which is forecasted through 2015, thereby resulting in the large increase in the assumption costs for 2012. The experience loss for 2012 was caused by the unprecedented number of disability cases processed in 2012 and exceeded the forecasted claims estimated in the actuarial model assumptions for future periods. VBA's efforts to reduce the backlog of pending claims, including the large number of claims from eligible Veterans with preexisting conditions that were recently added to the list of presumptive conditions contributed to the increase in the experience loss. As a result, an upward revision in claims rates for future periods was required for the emerging experience which is estimated to remain at a high level through 2015.

At September 30, 2012, the 10-year average rate used to compute the yield curve spot rates declined and the single average discount rate declined 22 basis points from 4.53 percent to 4.31 percent, resulting in a higher present value of expected future cash outflows than in 2011. The COLA rate assumptions reflect estimated future inflation and are based on and consistent with the decline in the 10-year average historical interest rate yield curve on Treasury securities. The COLA rates declined to 2.61 percent in 2012 from 2.78 percent in 2011 and the rate is applied to future periods. In addition, a single year assumption for the COLA rate is applied in 2013 based on inflation during 2012. The inflation assumption for 2012 is based on the partial year of experience that is known at the time the liability estimate is produced. The partial year of experience known for 2012 is 1.54 percent compared to 3.66 percent in 2011. As a result, the COLA rate assumptions produced a lower expense in 2012 compared to 2011.

While the COLA rates for 2011 declined to 2.78 percent from 2.86 percent in 2010, the partial year of experience known at the time the liability estimate was produced resulted in an assumption of 3.66 percent and applied to the 2012 forecast year. This single year rate produced a net increase in the COLA rate assumption in 2011 when a decrease in the COLA rate assumption would otherwise be expected since the COLA rate declined in 2011 from 2010.

Reconciliation of Veterans Compensation and Burial Actuarial Liabilities
For the Year Ended September 30,

	Compensation	Burial	TOTAL
Liability at October 1, 2010	$ 1,470,500	$ 4,300	$ $1,474,800
Expense:			
Interest on the Liability Balance*	69,500	200	69,700
Actuarial (Gain)/Loss from Current Year Activity			
Changes in Experience (Veterans Counts, Status)*	(14,400)	(100)	(14,500)
Changes in Assumptions:			
Changes in Discount Rate Assumption	51,600	200	51,800
Changes in COLA Rate Assumption	4,000	100	4,100
Net (Gain)/Loss from Changes in Assumptions	55,600	300	55,900
Total Expense	110,700	400	111,100
Less Amounts Paid*	(52,000)	(200)	(52,200)
Net Change in Actuarial Liability	58,700	200	58,900
Liability at September 30, 2011	**1,529,200**	**4,500**	**1,533,700**
Expense:			
Interest on the Liability Balance**	69,300	200	69,500
Actuarial (Gain)/Loss from Current Year Activity			
Changes in Experience (Veterans Counts, Status)**	61,700	(100)	61,600
Changes in Assumptions:			
Changes in Discount Rate Assumption	66,100	200	66,300
Changes in COLA Rate Assumption	(40,300)	(100)	(40,400)
Changes in Disability Claims Rates	123,400	-	123,400
Net (Gain)/Loss from Changes in Assumptions	149,200	100	149,300
Prior Service Costs (Adjustment to Benefits)**	400	-	400
Total Expense	280,600	200	280,800
Less Amounts Paid**	(52,700)	(200)	(52,900)
Net Change in Actuarial Liability	227,900	-	227,900
Liability at September 30, 2012	**$ 1,757,100**	**$ 4,500**	**$ 1,761,600**

* The sum of these changes represents Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions on the Statement of Net Cost for 2011.
** The sum of these changes represents Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions on the Statement of Net Cost for 2012.

14. Environmental and Disposal Liabilities

VA had unfunded environmental and disposal liabilities in the amount of $851 million and $884 million as of September 30, 2012, and 2011, 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.

It is at least reasonably possible that the estimated liabilities will change, possibly materially, as a result of changes in applicable laws and regulations, technology; future location requirements or plans; budgetary resources; and changes in future economic conditions, including inflation and deflation.

Technical Bulletin (TB) 2006-1, *Recognition and Measurement of Asbestos-Related Cleanup Costs*, as amended by TB 2011-2, was issued on September 28, 2006, and is effective for periods beginning after September 30, 2012. TB 2006-1 requires all Federal entities that own tangible property, plant, and equipment (PP&E) that contain asbestos to disclose liabilities related to friable and nonfriable asbestos cleanup costs deemed probable, but not reasonably estimable consistent with SFFAS 5, SFFAS 6, and Technical Releases No. 2, No. 10 and No. 11. VA does not believe adoption of the TB requirements will have a material impact on its consolidated and combined financial statements.

15. Other Liabilities

Other liabilities are liabilities not reported elsewhere in the Consolidated Balance Sheets. 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,

		2012		2011
Deposit and Clearing Account Liabilities	$	315	$	(4)
Accrued Expenses - Federal		6		13
Deferred Revenue		15		33
Resources Payable to Treasury		189		169
Custodial Liabilities		69		187
Credit Reform Act Subsidy Reestimates*		192		64
Accrued VA Contributions for Employee Benefits		117		111
Total Other Intragovernmental Funded Liabilities	$	903	$	573

* The subsidy amount for each guaranteed loan 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 to Treasury.

Other Intragovernmental Unfunded Liabilities

as of September 30,

	2012	2011
Accrued FECA Liability	$ 441	$ 425
Unfunded Employee Liability	8	11
Total Other Intragovernmental Unfunded Liabilities	$ 449	$ 436
Total Other Intragovernmental Liabilities	$ 1,352	$ 1,009

Other Public Funded Liabilities

as of September 30,

	2012	2011
Accrued Funded Annual Leave	$ 19	$ 19
Accrued Expenses	153	255
Accrued Salaries and Benefits	490	475
Capital Lease Liability	10	10
Other	90	96
Total Other Public Funded Liabilities	$ 762	$ 855

Other Public Unfunded Liabilities

as of September 30,

	2012	2011
Accrued Unfunded Annual Leave*	$ 1,848	$ 1,797
Amounts due to non-Federal trust	148	155
Judgment Fund-Unfunded**	1,178	966
Total Other Public Unfunded Liabilities	$ 3,174	$ 2,918
Total Other Public Liabilities	$ 3,936	$ 3,773

* Annual leave is accrued when earned and is adjusted at the end of each reporting period 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 18, Contingencies).

16. Leases

VA has both capital and operating leases. The capital lease liability was $10 million and $10 million as of September 30, 2012, and 2011, respectively. Capital leases consist primarily of information and computer technology, medical equipment, office equipment and real property. The liabilities are classified in Other Public Funded Liabilities in Note 15 since capital leases entered into after 1991 are required to be fully funded in the first year of the lease.

Operating leases consist of equipment and real property leases. Operating equipment leases generally consist of medical and office equipment with terms of five years or less. Operating real property leases generally consist of Veterans medical facilities and clinics, regional and district offices and administrative facilities.

VHA accounts for 84.4 percent, VBA accounts for 10.9 percent, Indirect Administrative Program offices account for 4.4 percent and NCA accounts for the balance of the operating real property leases. These real property leases generally have lease terms ranging from one year to twenty years and are subject to annual appropriation of funds by Congress. Approximately 75.2 percent of the real property leases have a lease term of five years or less; approximately 18.8 percent have lease terms of six to ten years; and approximately 3.3 percent have lease terms of eleven to fifteen years. Certain leases contain renewal or termination options. Annual base rent is generally flat over the lease term; however, certain leases contain rent escalation clauses. The leases also require VA to reimburse common area costs and real estate taxes over a base year or pay the costs directly.

Future commitments for real property and equipment operating leases are based on leases in effect as of September 30, 2012. Due to the number of equipment operating leases and the decentralization of records, the future commitment for equipment leases has been estimated using the expense from 2012 in lieu of actual amounts being available. VA's 2012 operating lease costs were $608 million for real property rentals and $146 million for equipment rentals.

The 2011 operating lease costs were $545 million for real property rentals and $118 million for equipment rentals. The following chart represents VA's projected operating lease commitments or costs for the next five years:

Leases:		
Year	**Real Property**	**Equipment**
2013	$519	$146
2014	452	146
2015	407	146
2016	378	146
2017	357	146
2018 and Thereafter	327	-

17. Insurance Programs

Through VA, the Government administers six life insurance programs: the United States Government Life Insurance (USGLI) program, the National Service Life Insurance (NSLI) program, the Veterans Special Life Insurance (VSLI) program, and the Veterans Reopened Insurance (VRI) program, which cover Veterans who served during World War I, World War II, and the Korean Conflict eras, and also the Service-Disabled Veterans Insurance (S-DVI) program and the Veterans Mortgage Life Insurance (VMLI) program, which cover severely disabled Veterans and are open to new issues. VMLI is part of the Veterans Insurance & Indemnities (VI&I) fund.

In addition, VA supervises the Servicemembers Group Life Insurance (SGLI) and the Veterans Group Life Insurance (VGLI) programs, which provide coverage to members of the uniformed armed services, reservists, and post-Vietnam Veterans and their families. All SGLI insureds are automatically covered under the Traumatic Injury Protection (TSGLI) program, which provides for insurance payments to members who suffer a serious traumatic injury in service. VA has entered into a group policy with the Prudential Insurance Company of America to administer these programs.

Premiums for the SGLI and VGLI programs are set by mutual agreement between VA and Prudential. SGLI premiums for active duty personnel and their spouses are deducted from the Servicemember's pay by the Armed Services components through the 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 VA 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 Servicemembers' premiums, as are all other programs costs.

The insurance reserves for the administered programs are reported as liabilities covered by budgetary resources, while part of the S-DVI and 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. United States Code, Title 38, requires that the Life Insurance programs invest in Treasury securities.

Actuarial reserve liabilities for the administered life insurance programs are based on the mortality and interest assumptions that 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, the 2001 CSO Table and the 2001 Valuation Basic Male (VBM) Table.

Insurance Liability (Reserve) Balances

as of September 30, 2012

Program	**Insurance Death Benefits**	**Death Benefit Annuities**	**Disability Income & Waiver**	**Reserve Totals**
NSLI	$ 5,661	$ 75	$ 41	$ 5,777
USGLI	5	2	-	7
VSLI	1,497	6	13	1,516
S-DVI	510	6	693	1,209
VRI	203	1	2	206
VI&I	201	-	-	201
Subtotal	$ 8,077	$ 90	$ 749	$ 8,916
Unearned Premiums				59
Insurance Dividends Left on Deposit and Related Interest Payable				1,521
Dividends Payable to Policyholders				84
Unpaid Policy Claims				1
Insurance Liabilities reported on the Consolidated Balance Sheet				10,581
Less Liability not Covered by Budgetary Resources				(1,293)
Liability Covered by Budgetary Resources				$ 9,288

as of September 30, 2011

Program	**Insurance Death Benefits**	**Death Benefit Annuities**	**Disability Income & Waiver**	**Reserve Totals**
NSLI	$ 6,187	$ 84	$ 47	$ 6,318
USGLI	8	2	-	10
VSLI	1,528	7	15	1,550
S-DVI	484	6	646	1,136
VRI	227	1	2	230
VI&I	114	-	-	114
Subtotal	$ 8,548	$ 100	$ 710	$ 9,358
Unearned Premiums				65
Insurance Dividends Left on Deposit and Related Interest Payable				1,587
Dividends Payable to Policyholders				101
Unpaid Policy Claims				2
Insurance Liabilities reported on the Consolidated Balance Sheet				11,113
Less Liability not Covered by Budgetary Resources				(1,161)
Liability Covered by Budgetary Resources				$ 9,952

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. The supervised programs' policies and face value 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. As a result, the information provided below under the Supervised Programs is for informational purposes only and is unaudited. Prudential and its reinsurers provided coverage to 6,009,819 and 6,103,250 policy holders with a face value of $1.3 trillion and $1.3 trillion for the years ended September 30, 2012, and 2011, respectively. The face value of the insurance provided by Prudential and its reinsurers represents 99 percent and 99 percent of the total insurance in-force as of September 30, 2012, and 2011, respectively. The number of policies represents the number of active policies remaining in the program as of the end of each fiscal year.

	2012 Policies	2011 Policies	2012 Face Value	2011 Face Value
Supervised Programs (UNAUDITED)				
SGLI Active Duty	1,525,000	1,560,000	$ 588,489	$ 604,138
SGLI Ready Reservists	771,500	774,500	268,153	271,826
SGLI Post Separation	93,000	88,000	34,812	33,097
SGLI Family - Spouse	1,095,000	1,128,000	108,012	111,320
SGLI Family - Children	2,098,000	2,126,000	20,980	21,260
TSGLI*	-	-	229,650	233,450
VGLI	427,319	426,750	62,700	60,694
Total Supervised	6,009,819	6,103,250	$ 1,312,796	$ 1,335,785
Administered Programs				
NSLI	586,450	665,394	$ 7,174	$ 8,040
VSLI	149,947	158,765	2,055	2,141
S-DVI	241,224	227,887	2,499	2,340
VRI	23,983	27,605	249	283
USGLI	2,165	2,958	6	8
VMLI	2,466	2,395	299	179
Total Administered	1,006,235	1,085,004	$ 12,282	$ 12,991
Total Supervised and Administered Programs	7,016,054	7,188,254	$ 1,325,078	$ 1,348,776

*TSGLI coverage is a rider attached to SGLI coverage, so policies under SGLI also have TSGLI.

Policy Dividends

The Secretary of VA determines annually the excess funds available for dividend payment. Policy dividends for 2012 and 2011 were $189 million and $229 million, respectively.

18. Commitments and 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. Medical malpractice cases comprised 90 percent and 78 percent of the amounts funded on behalf of VA by the Judgment Fund in 2012 and 2011, respectively. Contract dispute payments for 2012 and 2011 were $4.3 million and $8.8 million, respectively. The discrimination case payments for 2012 and 2011 were $0.9 million and $4.2 million, respectively. VA uses various 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, 2012, and 2011.

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 and the actuarial projection of potential legal claims determined to be probable whether reimbursement is required or not. This liability was $1.18 billion for 2012 and $966 million for 2011. The contract and personnel law cases where there was at least a reasonable possibility that a loss may occur were 13 cases totaling $203.0 million for 2012 and 12 cases totaling $69.2 million for 2011. A patent infringement lawsuit, regarding the alleged use of patented technology for healthcare treatment of servicemembers and Veterans, is currently pending at the Court of Federal Claims. The estimated amount or range of potential liability cannot reasonably be made at this time. 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,

	2012	2011
Fiscal Year Settlement Payments	$ 100	$ 96
Less Contract Dispute and “No Fear” Payments	(5)	(13)
Imputed Financing-Paid by Other Entities*	95	83
Increase (Decrease) in Liability for Claims	207	168
Operating Expense	$ 302	$ 251

*The Imputed Financing-Paid by Other Entities in the table above, when combined with the Total Imputed Expenses – Employee Benefits reported in Note 13 reconciles to total Imputed Financing costs reported in the Consolidated Statement of Changes in Net Position.

It is the opinion of VA's management that resolution of pending legal actions as of September 30, 2012, 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. The 2012 tort payments were $95 million and 2011 tort payments were $83 million.

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. The amount of unobligated and obligated authority relating to appropriations cancelled on September 30, 2012, and 2011 was $329.4 million and $96.6 million, respectively.

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 2009-2012, the average medical care cost per year was $39 billion.

19. Earmarked Funds

SFFAS 27, *Identifying and Reporting Earmarked Funds*, requires disclosure of all earmarked funds for which VA has program management responsibility. The U.S. Treasury does not set aside assets to pay future expenditures associated with earmarked funds. 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 that are issued as evidence of specific earmarked receipts from fund activities by the earmarked fund and provide the fund the authority to draw upon the Treasury for future authorized expenditures related to the fund's specific purpose. The investments (Treasury Securities) are not general fund assets of the Federal Government, since their use is restricted to the funds' purpose, and are not non-entity assets. When the earmarked fund redeems its Treasury Securities to make expenditures, the Treasury will finance those expenditures in the same manner that it finances all other expenditures.

The VA's Earmarked Funds are as follows and the classification of each fund into the grouping of Insurance, Medical Care, Benefits and Burial as shown in the condensed financial statements that follow is designated in the "Purpose of Fund" column below.

Earmarked Fund Name	Treasury Symbol	Authority	Purpose of Fund	Financing Sources
Medical Care Collections Fund	36x5287	P.L. 105-33 111 Stat 665	Medical Care - Third-party and patient co-payments for medical services.	Public, primarily insurance carriers.
Cemetery Gift Fund	36x8129	38 U.S.C. 1007	Burial - Donations for Veterans cemeteries.	Public donors.
National Service Life Insurance Fund	36x8132	38 U.S.C. 720	Insurance - Premiums insure WWII Veterans.	Public, Veterans.
Post-Vietnam Era Education Assistance Program	36x8133	38 U.S.C. 1622	Benefits - Subsidizes the cost of education to Veterans.	Veterans, DoD.
U.S. Government Life Insurance	36x8150	38 U.S.C. 755	Insurance - Premiums insure WWI Veterans.	Public, Veterans.
Veterans Special Life Insurance Fund	36x8455	38 U.S.C. 723 101-228	Insurance - Premiums insure Korean conflict Veterans.	Public, Veterans.
General Post Fund, National Homes	36x8180	38 U.S.C. 101-228	Medical Care - Donations for patient benefits.	Public, mostly Veterans.
Canteen Service Revolving Fund	36x4014	38 U.S.C. 78	Medical Care -Operates the canteen services at hospitals.	Revenue from sales.
National Cemetery Administration Facilities Operation Fund	36x5392	P.L. 108-454	Burial - Proceeds benefit land and buildings.	Proceeds from leases.
Service-Disabled Veterans Insurance Fund	36x4012	38 U.S.C. 1922	Insurance - Provides insurance to Veterans with service-connected disabilities.	Public, Veterans.
Servicemen's Group Life Insurance	36x4009	38 U.S.C. 1965	Insurance - Provides insurance to active duty, ready reservists, retired reservists and cadets attending service academies and ROTC.	Public, Veterans.
Veterans Reopened Insurance Fund	36x4010	38 U.S.C. 1925	Insurance - Provides insurance to World War II and Korea Veterans.	Public, Veterans.
Enhanced-Use Lease Trusts	N/A	38 U.S.C 8162	Medical Care - Lease underutilized VA property.	Public.

The following tables provide condensed information on assets, liabilities, fund balances, net costs, and changes in fund balances related to Cumulative Results of Operations – Earmarked Funds in the Consolidated Statements of Changes in Net Position:

Balance Sheet – Earmarked Funds as of September 30, 2012	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Assets:					
Fund Balance with Treasury	$ 62	$ 265	$ 65	$ 1	$ 393
Investments with Treasury	9,244	65	-	-	9,309
Other Assets	437	1,368	-	4	1,809
Total Assets	$ 9,743	$ 1,698	$ 65	$ 5	$ 11,511
Liabilities and Net Position:					
Payables to Beneficiaries	$ 187	$ 27	$ 1	$ -	$ 215
Other Liabilities	10,382	169	-	-	10,551
Total Liabilities	10,569	196	1	-	10,766
Unexpended Appropriations	-	-	-	-	-
Cumulative Results of Operations	(826)	1,502	64	5	745
Total Liabilities and Net Position	$ 9,743	$ 1,698	$ 65	$ 5	$ 11,511

Statement of Net Cost – Earmarked Funds for the Year Ended September 30, 2012	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Gross Program Costs	$ 1,057	$ 449	$ 1	$ -	$ 1,507
Less Earned Revenues	951	3,186	1	-	4,138
Net Program Costs	106	(2,737)	-	-	(2,631)
Costs Not Attributable to Program Costs	-	-	-	-	-
Net Cost/(Benefit) of Operations	$ 106	$ (2,737)	$ -	$ -	$ (2,631)

Statement of Changes in Net Position – Earmarked Funds for the Year Ended September 30, 2012	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Net Position Beginning of Period	$ (720)	$ 1,552	$ 64	$ 3	$ 899
Budgetary and Other Financing Sources	-	(2,787)	-	2	(2,785)
Net Cost/(Benefit) of Operations	106	(2,737)	-	-	(2,631)
Change in Net Position	(106)	(50)	-	2	(154)
Net Position End of Period	$ (826)	$ 1,502	$ 64	$ 5	$ 745

Balance Sheet – Earmarked Funds as of September 30, 2011	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Assets:					
Fund Balance with Treasury	$ 45	$ 239	$ 65	$ 1	$ 350
Investments with Treasury	9,948	84	-	-	10,032
Other Assets	478	1,433	-	2	1,913
Total Assets	$ 10,471	$ 1,756	$ 65	$ 3	$ 12,295
Liabilities and Net Position:					
Payables to Beneficiaries	$ 190	$ 33	$ 1	$ -	$ 224
Other Liabilities	11,001	171	-	-	11,172
Total Liabilities	11,191	204	1	-	11,396
Unexpended Appropriations	-	-	-	-	-
Cumulative Results of Operations	(720)	1,552	64	3	899
Total Liabilities and Net Position	$ 10,471	$ 1,756	$ 65	$ 3	$ 12,295

Statement of Net Cost – Earmarked Funds for the Year Ended September 30, 2011	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Gross Program Costs	$ 1,054	$ 548	$ 2	$ -	$ 1,604
Less Earned Revenues	965	3,371	1	-	4,337
Net Program Costs	89	(2,823)	1	-	(2,733)
Costs Not Attributable to Program Costs	-	-	-	-	-
Net Cost/(Benefit) of Operations	$ 89	$ (2,823)	$ 1	$ -	$ (2,733)

Statement of Changes in Net Position – Earmarked Funds for the Year Ended September 30, 2011	Insurance	Medical Care	Benefits	Burial	Total Earmarked Funds
Net Position Beginning of Period	$ (631)	$ 1,455	$ 65	$ 3	$ 892
Budgetary and Other Financing Sources	-	(2,726)	-	-	(2,726)
Net Cost/(Benefit) of Operations	89	(2,823)	1	-	(2,733)
Change in Net Position	(89)	97	(1)	-	7
Net Position End of Period	$ (720)	$ 1,552	$ 64	$ 3	$ 899

20. Exchange Transactions

Exchange Revenues

Although VA recognizes full cost per SFFAS 4, *Managerial Cost Accounting Standards and Concepts*, 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.

The Office of Financial Policy within VA's Office of Finance established policy requiring a four-part biennial self certification program to be implemented by VHA. The first part of the certification program requires each medical facility to certify whether charges established by VHA are sufficient to recover the full cost of providing services. The second part requires each medical facility to certify that its cost accounting procedures comply with SFFAS 4. Any medical facility with a fully functional Decision Support System (DSS) that produces timely (i.e. current year) data will be able to certify compliance with this requirement. The third part requires each medical facility to certify its compliance with Federal pricing policies and that it has fully disclosed situations where it does not comply with those policies as required by SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*. The fourth part requires each medical facility to certify whether its enhanced health care sharing contracts recover full cost or market price as defined in OMB Circular A-25, *User Charges*.

Public Exchange Transactions

VA's Loan Guaranty Program collects certain fees that are set by law. The loan guarantee funding fees collected for 2012 and 2011 were $1.18 billion and $917 million, respectively. The loan guarantee lender participation fees collected for 2012 and 2011 were $1.8 million and $1.6 million, respectively.

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 eight 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, maintenance and any other costs associated with the lodges. NCA has agricultural licenses at eight cemeteries to private sector entities, for which it receives rental payments; one agricultural license to the state of Colorado at no cost, and one permit to the Federal Aviation Administration (FAA) at no cost. NCA also leases buildings at two cemeteries, one to a private sector entity for which it receives rental payments, and one to a not-for-profit group that is responsible for the historic preservation of the building at no cost to NCA.

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 care services, 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 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.

Intragovernmental Exchange Transactions
Intragovernmental costs relate to the source of goods and services purchased by VA and not to the classification of related intragovernmental revenue. Classification of revenue and/or costs as "Intragovernmental" or "With the Public" is determined on a transaction by transaction basis for disclosure purposes. Classification of preceding transactions in a product's life cycle will not have an impact on classification of subsequent transactions. The purpose of this classification is to enable the Federal Government to provide consolidated financial statements, and not to match public and intragovernmental revenue with costs that are incurred to produce public and 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 $364.4 million and $380.0 million during 2012 and 2011, respectively, for the Post-Vietnam Era Education Assistance Program, Reinstated Entitlements Program for Survivors and the New GI Bill for Veterans.

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

21. Net Program Costs by Administration

Schedule of Net Program Costs by Administration					
For the Period Ending September 30, 2012 (Dollars in Millions)	Veterans Health Administration	Veterans Benefits Administration	National Cemetery Administration	Indirect Administrative Program Costs	Total
Program Costs					
Intragovernmental Costs	$ 8,329	$ 318	$ 49	$ 547	$ 9,243
Less Earned Revenues	(106)	(1,141)	-	(402)	(1,649)
Net Intragovernmental Program Costs	8,223	(823)	49	145	7,594
Public Costs	48,559	74,206	245	1,425	124,435
Veterans Benefits Actuarial Costs, Excluding Changes in Actuarial Assumptions (Note 13)	-	78,700	(100)	-	78,600
Less Earned Revenues	(3,354)	(525)	-	(193)	(4,072)
Net Public Program Costs	45,205	152,381	145	1,232	198,963
Net Program Cost by Administration Before Changes in Veterans Benefits Actuarial Liability Assumptions	53,428	151,558	194	1,377	206,557
Net (Gain)/Loss from Actuarial Liability Assumptions (Note 13)	-	149,200	100	-	149,300
Net Cost of Operations	$ 53,428	$ 300,758	$ 294	$ 1,377	$ 355,857

Schedule of Net Program Costs by Administration					
For the Period Ending September 30, 2011 (Dollars in Millions)	**Veterans Health Administration**	**Veterans Benefits Administration**	**National Cemetery Administration**	**Indirect Administrative Program Costs**	**Total**
Program Costs					
Intragovernmental Costs	$ 7,719	$ 1,627	$ 31	$ 299	$ 9,676
Less Earned Revenues	(68)	(1,181)	-	(514)	(1,763)
Net Intragovernmental Program Costs	7,651	446	31	(215)	7,913
Public Costs	48,521	68,150	248	1,813	118,732
Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13)	-	3,100	(100)	-	3,000
Less Earned Revenues	(3,651)	(846)	-	(159)	(4,656)
Net Public Program Costs	44,870	70,404	148	1,654	117,076
Net Program Cost by Administration Before Changes in Veterans Benefits Actuarial Liability Assumptions	52,521	70,850	179	1,439	124,989
Net (Gain)/Loss from Actuarial Liability Assumptions (Note 13)	-	55,600	300	-	55,900
Net Cost of Operations	$ 52,521	$ 126,450	$ 479	$ 1,439	$ 180,889

22. Disclosures Related to the Statements of Budgetary Resources

OMB Required Changes to the Statement of Budgetary Resources

Effective for 2012, the SBR presentation has changed to better align with the new format of the report on Budget Execution and Budgetary Resources (SF 133) as required by OMB. In the new SBR format, significant balances and underlying detail lines from the SF 133 are aggregated to the major categories deemed most significant for broad government-wide display purposes. The new format also has additional reconciliation requirements with budget execution information reported in the Budget of the United States to ensure the integrity of the numbers presented. As a result of the format changes, the 2011 data has been reclassified to conform to the 2012 presentation. There are no other effects on the consolidated or combined financial statements.

Budgetary Accounting

Budgetary resources, which include new budget authority, unobligated balances, direct spending authority, and obligation limitations, are forms of authority given to VA allowing it to incur obligations. Budget authority is provided by Federal law to enter into financial obligations that will result in immediate or future outlays involving Federal Government funds. Budget authority may be classified by the period of availability (1-year, multiple-year, no-year or available until expended), by the timing of congressional action (current or permanent), or by the manner of determining the amount available (definite or indefinite).

Budget authority from appropriations is the most common form of providing for the specific amount of money authorized by Congress for approved work, programs, or individual projects. Appropriations do not represent cash actually set aside in the Treasury for purposes specified in the appropriation act; they represent amounts that VA may obligate during the period of time specified in the respective appropriation acts. An appropriation may make funds available from the general fund, special funds, or trust funds.

Borrowing authority is budget authority enacted to permit VA to borrow money and then to obligate against amounts borrowed. It may be definite or indefinite in nature. The funds are borrowed from the Treasury and Federal Financing Bank.

Spending authority from offsetting receipts and collections is budget authority that permits VA to obligate and expend funds from sources that are not appropriated. Offsetting collections are authorized by law to be credited to appropriation or fund expenditure accounts. They result from (1) business-like transactions or market-oriented activities with the public, (2) intragovernmental transfers, and (3) collections from the public that are governmental in nature but required by law to be classified as offsetting. Collections resulting from business-like transactions with the public and other government accounts are also known as reimbursements. Laws authorizing offsetting collections make them available for obligation to meet the account's purpose without further legislative action.

Offsetting collections include reimbursements, transfers between federal and trust fund accounts, offsetting governmental collections, and refunds. For accounting purposes, earned reimbursements are also known as revenues. These offsetting collections are netted against gross outlays in determining net outlays from such appropriations.

Offsetting receipts are collections that are offset against gross outlays but are not authorized to be credited to expenditure accounts. Offsetting receipts are deposited in receipt accounts. Like offsetting collections, they result from (1) businesslike transactions or market oriented activities with the public, (2) intragovernmental transfers, and (3) collections from the public that are governmental in nature but required by law to be classified as offsetting receipts.

The Status of Budgetary Resources reflects the obligations incurred, the unobligated balances at the end of the period that remain available, and unobligated balances at the end of the period that are unavailable except to adjust or liquidate prior year obligations. Unobligated balances currently unavailable may become available subject to apportionment by OMB and allotment by VA.

Apportionments are distributions made by OMB of amounts available for obligation in an appropriation or fund account. Apportionments divide amounts available for obligation by specific time periods (usually quarters), activities, projects, objects, or a combination thereof. The amounts so apportioned limit the amount of obligations that may be incurred.

Upon apportionment and allotment, obligations can be incurred. Obligations represent a commitment that creates a legal liability for VA to pay for goods and services ordered or received, or a legal duty on the part of VA that could mature into a legal liability by virtue of actions on the part of the other party beyond the control of VA. An obligation is the amount of orders placed, contracts awarded, services received, and other transactions occurring during a given period that would require payments during the same or future period. Obligational authority is an amount carried over from one year to the next if the budget authority is available for obligation in the next fiscal year. Not all obligational authority that becomes available in a fiscal year is obligated and paid out in that same year. Balances are described as (1) obligated, (2) unobligated, or (3) unexpended.

An obligated balance is the amount of obligations already incurred for which payment has not yet been made, including undelivered orders and other unliquidated obligations. Budget authority that is available for a fixed period expires at the end of its period of availability, but the obligated balance of the budget authority remains available to liquidate obligations for 5 additional fiscal years. At the end of the fifth fiscal year, the account is closed and any remaining balance is canceled.
An unobligated balance is the portion of obligational authority that has not yet been obligated. For an appropriation account that is available for a fixed period, the budget authority expires after the period of availability ends but its unobligated balance remains available for 5 additional fiscal years for recording and adjusting obligations properly chargeable to the appropriations period of availability such as to record previously unrecorded obligations or to make upward or downward adjustments in previously recorded obligations, such as contract modifications properly within scope of the original contract. At the end of the fifth fiscal year, the account is closed and any remaining balance is canceled.

Unexpended balance represents the sum of the obligated and unobligated balances.

Outlay is the amount of checks, disbursement of cash, or electronic transfer of funds to liquidate a Federal obligation. Under the Credit Reform Act, the credit subsidy cost is recorded as an outlay when a direct or guaranteed loan is disbursed. Outlays during a fiscal year may be for payment of obligations incurred in prior years (prior-year obligations) or in the same year.

The caption, Appropriations under Budgetary Resources, in the Combined Statements of Budgetary Resources, does not agree to the caption Budgetary Financing Sources – Appropriations Received in the Consolidated Statements of Changes in Net Position. The amount in the Combined Statement of Budgetary Resources includes appropriations from the General Fund and Special Receipt Funds, while the Consolidated Statements of Changes in Net Position includes appropriations from the General Fund only.

The caption, Spending Authority from Offsetting Collections under Budgetary Resources in the Combined Statement of Budgetary Resources, does not agree to the caption Earned Revenue in the Consolidated Statements of Net Cost. The amount in the Combined Statement of Budgetary Resources includes Credit Reform subsidies for interest, fees and principal as required by Treasury reporting requirements, while the Consolidated Statements of Net Cost includes interest only.

Apportionment Categories of Obligations Incurred: Direct vs. Reimbursable Obligations
Years Ended September 30,

Category A, Direct consists of amounts requested to be apportioned by each calendar quarter in the fiscal year. Category B, Direct consists of amounts requested to be apportioned on a basis other than calendar quarters, such as activities, projects, objects, or a combination of these categories.

	2012	2011
Category A, Direct	$ 70,827	$ 68,345
Category B, Direct	66,823	61,707
Reimbursable	5,014	5,247
Total Obligations	$ 142,664	$ 135,299

Adjustments to Budgetary Resources and Prior Year Recoveries

Prior year recoveries consist of cancellations or downward adjustments of obligations incurred in prior fiscal years and recoveries of prior year paid obligations (i.e., cash refunds). Anticipated resources are required to be apportioned by OMB before they can be used. Once apportioned by OMB, they have to be allotted back down to the appropriate facilities or specific program offices. This authority cannot be used until funds are deobligated or refunded and realized. These adjustments relate to the open phase only of multi-year and no-year appropriations beyond the first year of availability of budgetary authority and the expired phase of annual and multi-year appropriations. No-year appropriations have no expiration of budgetary authority unless cancelled by Congress.

VA's systems require modification to properly account for the prior year recoveries as provided by Treasury and the guidance in the Treasury Financial Manual. VA has completed the technical assessment process and has begun to develop detailed requirements to modify its core accounting system. When an automated systems solution is implemented, VA will be enabled to properly identify prior year recoveries, systematically monitor reapportioned budget authority and track both for internal and external financial reporting.

In the interim, VA has implemented a manual review process to identify prior year recoveries and quantify an estimated range of transactions that would be accounted for as and meet the definition of a prior year recovery. Based on the review process, estimated recoveries of prior year unpaid obligations (not recorded) range from $1.2 billion-$2.3 billion for 2012 and range from $1.1 billion-$2.1 billion for 2011. The effect of recording the adjustments would be to increase "Recoveries of Prior Year Unpaid Obligations" and increase "Obligations Incurred" in the Combined Statement of Budgetary Resources.

For 2012 and 2011, VA appropriations were subjected to a rescission of $1.8 billion and $384.3 million, respectively, under the provisions of P.L. 112-10 and P.L. 111-117, *The Department of Defense and Full-Year Continuing Appropriations Act, 2012 and 2011*, respectively.

Borrowing Authority

The Loan Guaranty Program had borrowing authority of $1.32 billion and $1.47 billion as of September 30, 2012 and 2011, respectively. The interest rates on the borrowing authority range from 2.64 to 3.49 percent for 2012 and 4.14 to 4.28 percent for 2011. Principal repayment is expected over a 30-year period from the date of issuance of debt. Direct Loans under the Vocational Rehabilitation Program had borrowing authority of $3.13 million and $3.05 million as of September 30, 2012, and 2011, respectively. The interest rate on the borrowing authority was 1.00 percent for 2012 and 1.49 percent for 2011. Principal repayment is expected over a 2-year period from the date of issuance of debt. The Loan Guaranty Program borrowing is repaid to Treasury through the proceeds of portfolio loan collections, funding fees, and the sale of loans to housing trusts. The Vocational Rehabilitation Program loans generally had a duration of one year, and repayment was made from offsetting collections.

Permanent Indefinite Appropriations

VA has four housing benefit programs that have permanent and indefinite appropriations to cover unexpected losses.

Use of Unobligated Balances of Budget Authority

Available unobligated balances on the Statement of Budgetary Resources (SBR) are comprised 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 comprised of unobligated funds that were not apportioned by OMB for 2012 use and appropriated unobligated amounts that have expired, which generally are not available for new obligations, but can be used to increase existing obligations under certain circumstances.

Unobligated VA funds are available for uses defined in VA's 2012 Appropriation Law (P.L. 112-10). These purposes include: Veteran's 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 the Statement of Budgetary Resources and the Budget of the US Government

Obligations were increased by $20.3 million for 2011 on the Combined Statement of Budgetary Resources to reverse the adjustment recorded in 2010 which was also 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 a Period

The amount of budgetary resources obligated for undelivered orders at the end of 2012 and 2011 was $12.7 billion and $10.5 billion, respectively.

Contributed Capital

The amount of contributed capital received during 2012 consisted of donations in the amount of $43.7 million to the General Post Fund, $1.4 million to the National Cemetery Gift Fund and $ 1.3 million to the Supply Fund. The amount of contributed capital received during 2011 consisted of donations in the amount of $48.8 million to the General Post Fund, $0.2 million to the National Cemetery Gift Fund and $2.0 million to the Supply Fund.

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 VA with its net cost of operations.

DEPARTMENT OF VETERANS AFFAIRS		
RECONCILIATION OF NET COSTS OF OPERATIONS TO BUDGET		
For the Years Ended September 30,	**2012**	**2011**
Resources Used to Finance Activities		
Obligations Incurred	$ 142,664	$ 135,299
Less Spending Authority from Offsetting Collections and Adjustments	(9,697)	(9,643)
Obligations Net of Offsetting Collections and Adjustments	132,967	125,656
Less Offsetting Receipts	(3,465)	(3,320)
Net Obligations	129,502	122,336
Donations of Property	23	26
Transfers-out	-	-
Imputed Financing	1,795	1,978
Other Financing Sources	(367)	(409)
Total Resources Used to Finance Activities	**130,953**	**123,931**
Resources That Do Not Fund Net Cost of Operations		
Change in Amount of Goods, Services and Benefits Ordered But Not Yet Provided	(1,942)	(1,067)
Resources that Finance the Acquisition of Assets	(6,921)	(7,339)
Resources that Fund Expenses Recognized in Prior Periods	(2,332)	(2,190)
Budgetary Offsetting Collections and Receipts that Do Not Affect Net Cost of Operations	4,892	4,708
Total Resources that Do Not Fund Net Cost of Operations	(6,303)	(5,888)
Total Resources Used to Finance the Net Cost of Operations	**124,650**	**118,043**
Costs That Do Not Require Resources in the Current Period		
Increase in Annual Leave Liability	51	64
Increase (Decrease) in Environmental and Disposal Liability	(33)	5
Reestimates of Credit Subsidy Expense	563	1,242
Increase in Exchange Revenue Receivable from the Public	39	(342)
Increase (Decrease) in Veterans Benefits and Other Noncurrent Liabilities	228,418	59,252
Depreciation and Amortization	1,895	1,880
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	284	590
Loss on Disposition of Assets	101	111
Other	(111)	44
Total Costs That Do Not Require Resources in the Current Period	**231,207**	**62,846**
Net Cost (Benefit) of Operations	**$ 355,857**	**$ 180,889**

24. Reclassifications

Presentation of New VBA Appropriation Fund in the Statement of Net Cost

Beginning in 2012, Congress appropriated general operating expenditure (GOE) funds directly to VBA for direct and reimbursable costs incurred to support VBA's programs. These appropriated funds are separate from the appropriation for other VA Staff Office support costs.

In 2011, all VA Staff Office support was appropriated within the same budgetary fund. Since Congress has made a clear distinction between funding of general staff office costs and those costs directly attributable to VBA programs, VA has reclassified comparable 2011 direct and reimbursable costs incurred to support VBA's programs that are funded by separate appropriation in 2012 in the Consolidated Statements of Net Cost. The reclassification decreased Gross Cost reported under Indirect Administrative Program Costs and increased Gross Cost reported under Veterans Benefits Administration by $2.38 billion to conform to the 2012 presentation. There was no other impact on the net position; net cost or budgetary resources reported as a result the reclassification.

Similarly, Note 21 Net Program Costs by Administration has also been adjusted to reflect the effects of the reclassification discussed above. Public Costs reported under Indirect Administrative Program Costs decreased $1.79 billion and Public Costs reported under Veterans Benefits Administration increased by $1.79 billion to conform to the 2012 presentation. Intragovernmental Costs reported under Indirect Administrative Program Costs decreased $0.59 billion and Intragovernmental Costs reported under Veterans Benefits Administration increased by $0.59 billion to conform to the 2012 presentation.

Accounts Payable

During 2012, VA identified certain transactions within Other Liabilities that are more appropriately included within Accounts Payable based on Treasury USSGL guidance. The corrections resulted in the reclassification of $287 million of Intragovernmental Other Liabilities to Intragovernmental Accounts Payable and $3.80 billion of Public Other Liabilities to Public Accounts Payable for 2011 in the Consolidated Balance Sheet to conform to the 2012 presentation. The reclassifications had no other effect on net position, net costs or budgetary resources in the Consolidated and Combined Financial Statements.

Presentation of Change in Veterans Benefits Actuarial Liability in the Statement of Net Cost

The calculation and presentation of the components of the Reconciliation of Veterans Compensation and Burial Actuarial Liabilities shown in Note 13 were modified for 2012 to more closely align VA's presentation of Veterans Benefits Actuarial Liabilities with other agencies of the Federal Government for improved consistency in government-wide reporting of other post-employment benefits (OPEB). As a result, the 2011 presentation was also modified to conform to the 2012 presentation. The Statements of Net Cost and Note 21 were modified to reflect the revised components, Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions and Changes in Actuarial Liability Assumptions; however, the Net Cost of Operations did not change.

Veterans Benefits Actuarial Costs, Excluding Changes in Actuarial Assumptions is reflected as a component of Net Program Costs within the Statements of Net Cost and includes the captions: Interest on the Liability Balance;

Changes in Experience; Prior Service Costs; and Less Amounts Paid from the table in Note 13.

Changes in Actuarial Liability Assumptions represents the Net (Gain)/Loss from Changes in Assumptions from the table in Note 13 and is presented separately within the Statements of Net Cost as required by SFFAS 33.

VA Office of Inspector General

OFFICE OF AUDITS & EVALUATIONS

Department of Veterans Affairs

Audit of VA's Consolidated Financial Statements for Fiscal Years 2012 and 2011

November 8, 2012
12-01284-13

Department of Veterans Affairs

Memorandum

Date: November 8, 2012

From: Assistant Inspector General for Audits and Evaluations (52)

Subj: Audit of VA's Consolidated Financial Statements for Fiscal Years 2012 and 2011

To: Secretary of Veterans Affairs (00)

1. We contracted with the independent public accounting firm, CliftonLarsonAllen LLP, to audit VA's consolidated financial statements as of September 30, 2012 and 2011, and for the years then ended. This audit is an annual requirement of the Chief Financial Officers Act of 1990. The results of CliftonLarsonAllen LLP's audit are presented in the attached reports.

2. CliftonLarsonAllen LLP provided an unqualified opinion on VA's fiscal year 2012 and 2011 consolidated financial statements. With respect to internal control, CliftonLarsonAllen LLP identified one material weakness, information technology security controls, which is a repeat condition. They also reported one significant deficiency, undelivered orders, as a partial repeat condition and retitled it from accrued operating expenses. The department has taken corrective actions sufficient to address the reasonable estimation of the accrued operating expenses portion of unpaid obligations and therefore accrued operating expenses have been removed from the significant deficiency for this year. The department has also taken corrective actions sufficient to eliminate one other significant deficiency, loan guaranty reporting, previously cited last year.

3. CliftonLarsonAllen LLP reported that VA did not substantially comply with the Federal financial management systems requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. They also noted instances of non-compliance with the Debt Collection Improvement Act of 1996. They referenced a violation of the Antideficiency Act, as identified by the department, and an Office of Inspector General report citing less than full compliance with the Improper Payments Elimination and Recovery Act. They also noted a potential issue concerning compliance with 38 U.S.C. § 3732 and 38 C.F.R. § 36.4301, and the Loan Guaranty Service has requested a legal opinion on the matter from VA's Office of General Counsel.

Automated VA FORM 2105

4. CliftonLarsonAllen LLP is responsible for the attached audit reports dated November 8, 2012, and the conclusions expressed in the reports. We do not express opinions on VA's financial statements, internal control, or compliance with FFMIA. We also do not express conclusions on VA's compliance with laws and regulations. The independent auditors will follow up on these internal control and compliance findings and evaluate the adequacy of corrective actions taken during the fiscal year 2013 audit of VA's consolidated financial statements.

Linda A. Halliday

Attachments

Automated VA FORM 2105

CliftonLarsonAllen

CliftonLarsonAllen LLP
www.cliftonlarsonallen.com

Independent Auditor's Report

To the Secretary
and Inspector General
Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs (VA) as of September 30, 2012 and 2011, and the related consolidated statements of net cost, changes in net position, and the combined statements of budgetary resources for the years then ended. 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 applicable provisions of Office of Management and Budget 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VA as of September 30, 2012 and 2011, and its net costs, changes in net position, and budgetary resources 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 reports dated November 8, 2012, on our consideration of VA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws and regulations and other matters. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, not to provide an opinion on internal control over financial reporting or compliance. Those reports are an integral part of our audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Accounting principles generally accepted in the U.S. and OMB 07-04, as amended, require that VA's Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI), be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the

MD&A, RSSI and RSI in accordance with auditing standards generally accepted in the U.S., which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

All other information exclusive of the consolidated financial statements, MD&A, RSSI and RSI listed in the table of contents is presented for additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

CliftonLarsonAllen LLP

Calverton, Maryland
November 8, 2012

CliftonLarsonAllen

CliftonLarsonAllen LLP
www.cliftonlarsonallen.com

Independent Auditor's Report on Internal Control Over Financial Reporting

To the Secretary
and Inspector General
Department of Veterans Affairs

We have audited the financial statements of the Department of Veterans Affairs (VA) as of and for the year ended September 30, 2012, and have issued our report thereon dated November 8, 2012. 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 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

VA management is responsible for designing, implementing, and maintaining internal control to provide reasonable assurance that the broad control objectives of Federal Manager's Financial Integrity Act (FMFIA) are met.

In planning and performing our audit, we considered VA's internal control over financial reporting by obtaining an understanding of the design effectiveness of internal controls, determined whether these controls had been placed in operation, assessed control risk, and performed tests of controls 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 VA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of VA's internal control over financial reporting.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our audit results to future periods is subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. In addition, we caution that our internal control testing may not be sufficient for other purposes.

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 deficiencies, significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be a material weakness, and another deficiency that we consider to be a significant deficiency.

A *deficiency in internal control* 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described below in Section 1 to be a material weakness in internal control over financial reporting.

A significant deficiency is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency described below in Section 2 to be a significant deficiency.

SECTION 1 – MATERIAL WEAKNESS

1. Information Technology (IT) Security Controls (Repeat Condition)

The VA relies extensively on Information Technology (IT) system controls to initiate, authorize, record, process, summarize and report financial transactions in the preparation of its financial statements. Internal controls over these operations are essential to ensure the integrity, confidentiality, and reliability of critical data while reducing the risk of errors, fraud and other illegal acts. Our review of IT controls covered general and selected business process application controls across 22 selected VA medical centers, regional offices and data centers. As noted in prior years' audits, VA continues to have weaknesses in Security Management, Access Controls, Configuration Management and Contingency Planning controls designed to protect mission-critical systems from unauthorized access, alteration, or destruction.

Our current year audit identified security weaknesses that were corrected in some locations and for certain control activities. Examples of VA improvements in its IT control environment include adopting a Continuous Readiness in Information Security Program (CRISP) to ensure continuous monitoring year-round, and establishing a team to oversee the CRISP initiative and resolve the IT material weakness. As part of the CRISP initiative, we noted improvements related to role-based and security awareness training, contingency plan testing, reducing the number of outstanding Plans of Action and Milestones (POA&Ms), developing initial baseline configurations, reducing the number of IT individuals with outdated background investigations, and improving data center web application security. However, the CRISP initiative was not launched until March 2012 and the noted improved processes have not been implemented for an entire fiscal year. Moving forward, VA needs to ensure a proven process is in place to sustain the improvements achieved thus far. VA also needs to continue to address control deficiencies exist in other areas across all VA locations.

We continue to find control deficiencies in Security Management, Access Controls, Configuration Management and Contingency Planning. Most importantly, we continue to identify significant technical weaknesses in databases, servers and network devices that support transmitting financial and sensitive information between VA's Medical Centers, Regional Offices and Data Centers. Many of these weaknesses may be attributed to inconsistent enforcement of an agency-wide information security program across the enterprise and ineffective communication between VA management and the individual field offices. Therefore, VA needs to improve its monitoring process to ensure controls are operating as intended at all facilities and communicate security deficiencies to the appropriate personnel to implement corrective actions.

Our assessment of the general and application controls of VA's key IT infrastructure and financial systems identified the following conditions:

Conditions:

Configuration Management

- Systems including key databases supporting financial applications were not timely patched or securely configured to mitigate known and unknown information security vulnerabilities.

- Baseline configurations, including implementation of the Federal Desktop Core Configuration, were not consistently implemented to mitigate significant system security risks and vulnerabilities across the facilities.
- Change control policies and procedures for authorizing, testing and approving system changes were not consistently implemented for networks and mission critical system hardware and software.

Access Controls

- Password standards were not consistently implemented and enforced across multiple VA systems, including the network domain, databases, and key financial applications. In addition, multi-factor authentication for remote access had not been implemented across the agency.
- Inconsistent reviews of networks and financial application user access resulted in numerous generic, system, and inactive user accounts that were not removed from the system, and users with access rights that were not appropriate.
- Proper completion of user access requests were not consistently performed to eliminate conflicting roles and enforce principles of least system privilege.
- Lack of monitoring of access in the production environment for individuals with elevated application privileges for a major application.

Security Management

- Security management documentation, including the risk assessments and system security plans were outdated and did not accurately reflect the current system environment or federal standards.
- The Regional Office General Support Systems (GSS) did not conduct a timely security impact analysis prior to a major file system structure change.
- Background reinvestigations were not performed timely and tracked effectively. In addition, personnel were not receiving the proper level of investigation for their sensitivity levels of their positions.
- Scheduled completion dates for POA&Ms were updated without written justification and supporting documentation was not adequate to justify POA&M closures.

Contingency Planning

- Contingency plan documentation had not been updated to reflect lessons learned from the contingency and disaster recovery tests, and detailed recovery procedures for all system priority components had not been documented and/or did not reflect current operating conditions.
- Backup tapes were not encrypted prior to being sent to offsite storage at selected facilities and data centers.

Criteria:

OMB Circular A-130, Appendix III, *Security of Federal Automated Information Resources*, states that "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."

The Federal Information Security Management Act of 2002 (FISMA) requires that each agency develop an agency-wide information security program that includes:

- Periodic assessments of risk, including the magnitude of harm that could result from the unauthorized access, use, disclosure, disruption, modification, or destruction of information and information systems that support the operations and assets of the organization;
- Policies and procedures that are based on risk assessments, cost-effectively reduce information security risks to an acceptable level and address information security throughout the life cycle of each organizational information system;
- Plans for providing adequate information security for networks, facilities, information systems, or groups of information systems, as appropriate;
- Security awareness training to inform personnel of the information security risks associated with their activities and their responsibilities in complying with organizational policies and procedures designed to reduce these risks;
- Periodic testing and evaluation of the effectiveness of information security policies, procedures, practices, and security controls to be performed with a frequency depending on risk, but no less than annually;
- A process of planning, implementing, evaluating, and documenting remedial actions to address any deficiencies in the information security policies, procedures, and practices of the organization;
- Procedures for detecting, reporting, and responding to security incidents; and
- Plans and procedures for continuity of operations for information systems that support the operations and assets of the organization.

Cause:

Dispersed locations, continued reorganization, and diversity in applications have impacted facilities and management's ability to consistently remediate IT security deficiencies across the VA enterprise. For example, VA's complex and disjointed financial system architecture has resulted in a lack of common system security controls and inconsistent maintenance of IT mission critical systems. Consequently, VA continues to be challenged with consistent and proactive enforcement of established policies and procedures throughout its geographically dispersed portfolio of legacy applications and newly implemented systems. The continued reorganization of components within the VA, such as centralization of the data centers and shift of control from the Medical Center level to the Veterans Integrated Service Network (VISN) and region levels and from the Regional Office level to the Network Service Center level, has caused delays in communicating established policies with personnel throughout the VA. In addition, VA lacks an effective and consistent corrective action process for identifying, coordinating, correcting, and monitoring known internal security vulnerabilities on databases, web applications, and networks infrastructures.

Effect:

By not effectively implementing and enforcing IT policies and procedures, there is an increased risk that financial and personally identifiable information may be inadvertently or deliberately misused and may result in improper disclosure or theft without detection. Additionally, inappropriate or unnecessary changes may be made to key financial information systems, which could result in materially misstated financial information.

Recommendations:

The Assistant Secretary for Information and Technology should continue to analyze and prioritize remediation efforts to accomplish security and control objectives. Key tasks should include, but are not limited to:

- Consistent with CRISP objectives, implement improved mechanisms to continuously identify and remediate security deficiencies on VA's network infrastructure, database platforms, and Web application servers.
- Implement an improved patch and vulnerability management program to address security deficiencies identified during our assessments of VA's Web applications, database platforms, and network infrastructure.
- Implement improved processes to ensure that workstations are consistently patched, updated and configured to minimize security risks and are in compliance with Federal Desktop Core Configuration requirements.
- Implement improved control procedures to ensure the consistent approval and testing during development and application of system changes to VA financial applications and networks.
- Implement improved processes for the periodic review of network and financial applications to identify and remove generic and inactive accounts on systems and networks. Recertify that access remains appropriate and is restricted to necessary personnel.
- Implement improved processes to ensure the proper completion and retention of the user access request forms that enforce principles of least system privilege, prior to system access being granted.
- Implement monitoring controls of access in production environment for individuals with elevated system privileges.
- Implement improved processes to ensure compliance with VA policy for password and security configuration baselines on the domain controls, operating systems, databases, applications and network devices.
- Implement two-factor authentication for remote access throughout the agency.
- Implement improved processes for reviewing and updating key security documentation, including risk assessments and system security plans on an annual basis. Such updates will ensure all required information is included and accurately reflects the current environment, new security risks, and applicable federal standards.
- Implement processes to ensure security impact assessments are completed in a timely manner when significant system changes occur.
- Implement processes to ensure that facilities track reinvestigations for employees and contractors in high risk positions and the Security Investigation Center (SIC) initiates all reinvestigations in a timely manner. Additionally, implement processes for facilities to accurately and timely report any changes in position sensitivity levels and ensure the position descriptions are appropriately marked for position risk and sensitivity levels in accordance with the OPM Position Designation Automation Tool (PDAT).
- Implement improved processes to ensure that closed POA&Ms are adequately supported with appropriate documentation. In addition, implement processes to ensure adequate justification is documented for updating POA&M completion dates.
- Implement improved processes for annual or as needed review and update of contingency plans to ensure all required information is included and accurately represents the current environment and critical components.
- Develop and implement a process for ensuring the encryption of backup data prior to transfer offsite.

SECTION 2 – SIGNIFICANT DEFICIENCY

1. Undelivered Orders (Partial Repeat Condition)

Condition:

Liquidation of Obligations

VA obligates its budgetary resources when it enters into a binding legal agreement, such as a contract with a third party. At the end of the agreement period, any previously obligated but undisbursed amounts (also known as Undelivered Orders or UDOs) associated with completed or cancelled purchase orders or projects should be deobligated, enabling the unused funds to become available for other agency program needs. When the unneeded obligations continue to remain on VA's books, they are considered to be inactive or invalid obligations. During our testing of the UDO balances at September 30, 2012, we noted a number of instances in which the UDO balance should have been deobligated because the goods or services had been received or the amount recorded was subsequently considered invalid and deobligated by management after year-end.

Criteria:

VA Financial Policies and Procedures Manual, Volume II, Chapter 5, Section 050204 states that, "VA will perform monthly reviews and reconciliations to ensure that open obligations, to include UDOs and delivered unpaid obligations, are valid and appropriate and adjustments are made as necessary."

OMB Circular A-123, *Management Responsibility for Internal Controls*, 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:

Management did not actively monitor and implement the financial close-out of the completed projects after the goods/services had been provided. According to VA management, the outstanding obligation cannot be closed out until the contract is officially reviewed and closed by the Contracting Office. The office administering the contract should close out a contract consistent with Federal Acquisitions Regulations Part 4. 804 Closeout of Contract files. However, management did not make the necessary estimates if its contract administration in the normal course of business does not provide for the transactions to be recorded and reported in accordance with generally accepted accounting principles at period-end.

Effect:

Without an effective review and validation process, VA's estimates of its UDOs may be significantly misstated. The accompanying financial statements have not been corrected for the effect of these errors. We were able to perform sufficient testing to ensure the net impact of these errors was not material to the financial statements as a whole.

Recommendations:

We recommend that VA management:

- Implement VA's recent Financial Policies and Procedures Obligations Policy issued in September, 2012 requiring monthly reviews and reconciliations of obligations recorded in FMS to ensure the accounting information is valid and proper; dollar amounts accurately reflect the status of the obligation; time frame for the obligation is valid; obligations are reconciled to source documents; and aged obligations are valid and recorded correctly. In addition, the procedures should include a reconciliation of the obligations recorded in the medical centers' general ledger to the purchase orders placed by the National Acquisition Center (NAC) with third party vendors.

- Implement controls to ensure that NAC and the medical centers personnel work jointly and collaboratively to review and monitor inactive projects and open obligations. The status of all such projects and obligations reviewed, including the general ledger entries resulting from such reviews, should be determined and conclusions documented quarterly. Management should also ensure that completed projects and deliveries of equipment are being timely communicated, properly reviewed and reconciled to facilitate the timely close out of projects, the liquidation of unexpended obligations, and the accurate financial accounting and reporting for such business events in the general ledger.

- Revise VA's procurement and contracting policies and procedures to clearly outline what is considered a reasonable timeframe between the following: 1) obligation of funds, 2) procurement action and contract award, and 3) anticipated delivery/completion dates. Policies and procedures should also include directives on how to adequately monitor and ensure the timely closeout of contracts based on the receipt of contracted deliverables and the period of performance in the contract.

- Where timely contract close out is not achievable at period-end, an estimation methodology should be established to ensure the reasonableness of the UDO balance included in the financial statements.

STATUS OF PRIOR YEAR'S CONTROL DEFICIENCIES

As required by *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have reviewed the status of VA's corrective actions with respect to the findings and recommendations included in the prior year Independent Auditor's Report on Internal Control over Financial Reporting dated November 10, 2011.

The prior year report identified a material weakness in the area of Information Technology Security Controls. While VA has made progress on this material weakness, it is repeated as a material weakness this year.

AGENCY COMMENTS AND OUR EVALUATION

In commenting on a draft of this report VA management concurred with the facts and conclusions in our report. We did not audit VA's response and, accordingly, we express no opinion on it.

****

We also noted certain other nonreportable matters involving internal control over financial reporting that we will communicate in a separate letter to VA management.

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

CliftonLarsonAllen LLP

Calverton, Maryland
November 8, 2012

CliftonLarsonAllen

CliftonLarsonAllen LLP
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Independent Auditor's Report on Compliance and Other Matters

To the Secretary
and Inspector General
Department of Veterans Affairs

We have audited the financial statements of the Department of Veterans Affairs (VA) as of and for the year ended September 30, 2012, and have issued our report thereon dated November 8, 2012. 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 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

The management of VA is responsible for complying with laws and regulations applicable to the VA. As part of obtaining reasonable assurance about whether VA's financial statements are free of material misstatements, we performed tests of VA's compliance with certain provisions of laws and regulations, 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 07-04, as amended. We limited our tests of compliance to those provisions and we did not test compliance with all laws and regulations applicable to VA. Providing an opinion on compliance with certain provisions of laws and regulations 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 of compliance with laws and regulations described in the preceding paragraph disclosed no instances of reportable noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin 07-04, as amended.

The management of VA is also responsible for ensuring that VA's financial management systems substantially comply with the Federal Financial Management Improvement Act of 1996 (FFMIA). Under FFMIA, we are required to report whether the financial management systems used by VA substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Standard General Ledger (SGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

The objective of our audit was not to provide an opinion on compliance with FFMIA. Accordingly, we do not express such an opinion. However, except for matters described below, where VA did not substantially comply with applicable Federal financial management systems requirements, the results of our work disclosed no other instances in which VA's financial management systems did not substantially comply with Federal accounting standards and the United States SGL at the transaction level.

1. **Non-compliance with FFMIA**

Financial Management Systems

We have concluded that VA's financial management systems do not substantially comply with the Federal financial management systems requirements as required by FFMIA Section 803(a) for the following reasons:

- As reported in our report on internal control over financial reporting, VA has a material weakness over "Information Technology (IT) Security Controls." This is a repeat finding.

- Although VA has made significant progress in remediating significant deficiencies, VA has one significant deficiency in internal control over financial reporting, which is a partial repeat finding.

- VA's complex and disjointed financial system architecture has resulted in a lack of common system security controls and inconsistent maintenance of IT mission critical systems. Consequently, VA continues to be challenged with consistent and proactive enforcement of established policies and procedures throughout its geographically dispersed portfolio of legacy applications and newly implemented systems. As a result, certain financial statement line items may not be readily re-created and supported by audit trails of detailed financial transactions. Not all current systems can be readily accessed and used without extensive manipulation, and manual processing and reconciliation. Some examples of issues we found include:

  - VA is not properly recording recoveries or downward adjustments because the Financial Management System (FMS) limits the total apportionment authority that can be recorded to the amount of appropriations received. Further, FMS is not currently programmed to separately identify and report recoveries and is not recording the apportionment, allotment, suballotment and distribution of recovered funds.

  - The Benefits Delivery Network (BDN) system is not designed to keep a complete history of education benefit related transactions. Detail transaction data on Chapter 34 and 35 education benefit expense could not be retrieved.

  - The fixed asset system (FAS) can not readily provide reports on additions, deletions or current depreciation to support effective and efficient reconciliation of account balances and the investigation of discrepancies.

  - The Veterans Health Information Systems & Technology Architecture (VistA) does not provide VA management with the ability to effectively and efficiently monitor Medical Care Collection Fund (MCCF) activities at the transaction level. Although billing and collection functions have been centralized at the Consolidated Patient Accounting Centers (CPACs) to achieve better revenue cycle management and improve VA's internal controls and quality assurance over its revenue processes, CPAC personnel cannot generate combined reports for all the facilities under their purview. Reports must be separately generated for individual medical facilities, which lead to inefficiencies in operations and financial management. Further, a nationwide report at a sufficient level of detail cannot be generated to aggregate the MCCF transactions residing in the multiple instances of VistA used throughout VA.

2. Non-compliance with Debt Collection Improvement Act

Condition:

We tested various sample transactions for compliance with the Debt Collection Improvement Act of 1996 (DCIA), and noted the following exceptions:

- 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, for 88 sample items out of a total of 90 sample selections tested, VBA did not charge interest or administrative costs on delinquent payments from veterans related to certain receivables for Compensation, Pension, and Education.

Criteria:

Public Law 96-466 and Title 38 U.S.C § 501(a) and §5315, and 38 CFR 1.919 require VA to charge interest and administrative costs on any amount owed to the United States.

Cause:

This has been a long standing issue and is based on a former VA Deputy Secretary's instruction in July 1992 that VA not charge interest or administrative costs on veteran debts.

Effect:

VA is noncompliant with the Debt Collection Improvement Act of 1996.

Recommendation:

We recommend that VA:

- Implement policies and procedures to assess applicable interest and administrative costs or propose a legislative remedy to request a waiver of these requirements.

Other Matters

- In 2012, VA identified a violation of the Antideficiency Act, 31 U.S.C. 1341(a), concerning the combination of two minor construction projects into one major construction project that did not have the required Congressional approval. This incident occurred at the Miami VA Medical Center. VA is in the process of reporting the violation as prescribed by OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*.

- The VA Office of Inspector General, in a report dated March 14, 2012, reported that VA did not fully comply with the Improper Payments Elimination and Recovery Act, (IPERA), 31 U.S.C. 3321.

- During our testing of VA's foreclosed property acquired by the Loan Guaranty Service (LGY), we identified a potential issue of non-compliance concerning VA's "cost factor." VA uses the cost factor in calculating the amount it will pay lenders when it accepts conveyance of foreclosed properties resulting from defaulted guaranteed loans. VA uses the cost factor to estimate VA's acquisition and disposal costs (including losses sustained on resale), which are then deducted from a property's fair market value, consistent with 38 U.S.C. § 3732 and 38 C.F.R. § 36.4301. VA has been using the current cost factor of 11.87% for several years, including through the recent housing crisis, and did not use its most recent calculation for 2012, which was significantly higher. LGY management has relied on broad authority, as outlined in 38 USC 3720, as providing them authority to determine whether or not to use the most recent cost factor calculation. LGY has requested an opinion on this matter from VA's Office of General Counsel.

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

CliftonLarsonAllen LLP

Calverton, Maryland
November 8, 2012

Department of Veterans Affairs

Memorandum

Date: NOV 08 2012

From: Executive in Charge, Office of Management, and Chief Financial Officer (004)

Subj: Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2012 and 2011

To: Assistant Inspector General for Auditing (52)

1. The Office of Management has reviewed the Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2012 and 2011, and we are pleased with the receipt of an unqualified opinion. We are also pleased to have met the 2012 reporting timeline established by the Office of Management and Budget. Please extend to your staff and the staff of CliftonLarsonAllen, LLP our appreciation for their detailed planning, hard work, and cooperation during this year's audit.

2. VA senior officials and program managers in the Administrations and affected staff offices are aware of the unqualified audit opinion. As a result of the dedicated efforts of staff throughout the Department, only one material weakness remains. We will continue to focus on completing corrective actions as detailed in the remediation plans for the remaining material weakness, Information Technology (IT) Security Controls. For this repeat material weakness, the existing remediation plan will be revised and expanded, as needed, to address the findings and recommendations in your audit report.

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

W. Todd Grams

Required Supplementary Stewardship Information (Unaudited)

(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,	2012	2011	2010	2009	2008
State Extended Care Facilities	$ 66	$ 54	$ 242	$ 163	$ 162
Veterans Cemeteries (NCA)	47	44	49	40	37
Total Grant Program Costs	$ 113	$ 98	$ 291	$ 203	$ 199

The Extended Care Facilities Grant Program assists states in acquiring facilities to provide domiciliary, nursing home, and other day health care for Veterans, and to expand, remodel, or alter existing buildings to provide domiciliary, nursing home, hospital, and day health care for Veterans in state homes. VA participates in two grant-in-aid programs for states. VA may participate in up to 65 percent of the cost of construction or acquisition of state nursing homes or domiciliaries or in renovations of existing state homes. Over the last five fiscal years, the State Home Construction Grant Program has awarded grants in excess of $687 million. VA also provides per diem payment for the care of eligible Veterans in state homes.

Since, the cemetery program was established in 1980, VA has awarded grants totaling more than $530 million to 42 states, four tribal organizations and three territories. The program provides up to 100 percent of the cost to establish, expand, or improve state or tribal Veterans cemeteries. State or tribal organizations provide the land and agree to operate the cemeteries.

2. Human Capital

Investment in human capital is comprised of 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,		
	2012	2011
Program Expenses		
Education and Training-Dependents of Veterans	$ 444	$ 567
Vocational Rehabilitation and Education Assistance	11,727	11,259
Administrative Program Costs	389	370
Total Program Expenses	$ 12,560	$ 12,196
Program Outputs (Participants)		
Dependent Education	94,618	96,078
Veterans Rehabilitation	85,436	81,097
Veterans Education	871,188	822,808

Veterans and Dependents Education		
Years Ended September 30,		
	2010	2009
Program Expenses		
Education and Training-Dependents of Veterans	$ 477	$ 464
Vocational Rehabilitation and Education Assistance	9,031	4,393
Administrative Program Costs	348	304
Total Program Expenses	$ 9,856	$ 5,161
Program Outputs (Participants)		
Dependent Education	81,974	82,345
Veterans Rehabilitation	77,176	72,803
Veterans Education *	634,038	822,738

*Due to the implementation of the new Post 9/11 GI Bill during 2009, total participants in the Veterans Education Program for 2009 may include two records for a single participant who switches from the Montgomery GI Bill (MGIB) to the Post-9/11 GI Bill mid-year.

Veterans and Dependents Education		
Years Ended September 30,		
		2008
Program Expenses		
Education and Training-Dependents of Veterans	$	451
Vocational Rehabilitation and Education Assistance		3,102
Administrative Program Costs		251
Total Program Expenses	$	3,804
Program Outputs (Participants)		
Dependent Education		80,409
Veterans Rehabilitation		68,826
Veterans Education		459,594

Program Outcomes

VA's education and training programs are intended to provide higher education to dependents that 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 new Post-9/11 GI Bill, 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, and eligible family members.

3. Health Professions Education

Health Professions Education Years Ended September 30,	2012	2011	2010	2009	2008
Program Expenses					
Physician Residents and Fellows	$ 663	$ 637	$ 584	$ 547	$ 508
Associated Health Residents and Students	153	114	113	99	88
Instructional and Administrative Support	851	819	794	707	623
Total Program Expenses	$ 1,667	$ 1,570	$ 1,491	$ 1,353	$ 1,219
Program Outputs					
Health Professions Rotating Through VA:					
Physician Residents and Fellows	37,104	36,984	36,600	35,099	34,003
Medical Students	21,502	20,516	21,267	20,567	18,135
Nursing Students	32,349	25,931	33,580	31,380	28,320
Associated Health Residents and Students	25,839	31,869	23,416	22,916	20,946
Total Program Outcomes	116,794	115,300	114,863	109,962	101,404

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 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, training over 115,000 individuals each year. Of the 152 VA medical centers and the 6 independent outpatient clinics (IOCs), 124 hospitals and 3 IOCs are affiliated with 114 of the 136 allopathic medical schools and 15 of the 26 osteopathic medical schools. In addition, more than 40 other health professions are represented by affiliation agreements with more than 1,800 colleges and universities. 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, 2012

	Basic	Applied	Development	Total
Medical Research Service	$ 191.0	$ 92.0	$ -	$ 283.0
Rehabilitative Research and Development	6.7	52.0	36.6	95.3
Health Services Research and Development	-	88.6	-	88.6
Cooperative Studies Research Service	40.4	75.2	-	115.6
Medical Research Support	-	581.0	-	581.0
Total Program Expenses	$ 238.1	$ 888.8	$ 36.6	$ 1,163.5

Program Expense
Year Ended September 30, 2011

	Basic	Applied	Development	Total
Medical Research Service	$ 166.1	$ 80.0	$ -	$ 246.1
Rehabilitative Research and Development	8.7	68.6	47.4	124.7
Health Services Research and Development	-	85.3	-	85.3
Cooperative Studies Research Service	43.2	80.3	-	123.5
Medical Research Support	-	579.8	-	579.8
Total Program Expenses	$ 218.0	$ 894.0	$ 47.4	$ 1,159.4

Program Expense
Year Ended September 30, 2010

	Basic	Applied	Development	Total
Medical Research Service	$ 202.9	$ 97.5	$ -	$ 300.4
Rehabilitative Research and Development	6.4	50.6	35.0	92.0
Health Services Research and Development	-	91.0	-	91.0
Cooperative Studies Research Service	34.0	63.6	-	97.6
Medical Research Support	-	581.0	-	581.0
Total Program Expenses	$ 243.3	$ 883.7	$ 35.0	$ 1,162.0

Program Expense
Year Ended September 30, 2009

	Basic	Applied	Development	Total
Medical Research Service	$ 164.4	$ 89.6	$ -	$ 254.0
Rehabilitative Research and Development	5.6	42.7	32.7	81.0
Health Services Research and Development	-	80.0	-	80.0
Cooperative Studies Research Service	33.3	61.7	-	95.0
Medical Research Support	-	510.0	-	510.0
Total Program Expenses	$ 203.3	$ 784.0	$ 32.7	$ 1,020.0

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

In addition, VHA researchers received grants from the National Institutes of Health in the amount of $457 million and $254 million in other grants during 2012. 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 2012, VA's R&D general goal related to stewardship was to ensure that VA's Pre-clinical Research and Clinical Research Program (excluding CSP) 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,					
	2012	**2011**	**2010**	**2009**	**2008**
Percent of Funded Research Projects Relevant to VA's Health-Care Mission	100.0%	100.0%	100.0%	100.0%	100.0%
Number of Research and Development Projects	2,249	2,200	2,350	2,193	1,956

VA's Pre-clinical Research and Clinical Research Program's (excluding CSP) 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 (Unaudited)

(dollars in millions, unless otherwise noted)

1. Deferred Maintenance and Repairs

The Federal Accounting Standards Advisory Board (FASAB) issued SFFAS No. 40, *Definitional Changes to Deferred Maintenance; Amending Statement of Federal Financial Accounting Standards 6, Accounting for Property, Plant, and Equipment*, effective for periods after September 30, 2011. This standard clarifies that repair activities should be included to better reflect asset management practices, and improve reporting on deferred maintenance and repairs. Deferred maintenance and repairs are maintenance and repair activities not performed when they should have been or were scheduled to be, therefore, are put off or delayed for a future period. Activities include preventive maintenance; replacement of parts, systems or components; and other activities needed to preserve or maintain an asset. Maintenance and repairs, as distinguished from capital improvements, exclude activities directed towards expanding the capacity of an asset or otherwise upgrading it to serve needs different from, or significantly greater than, its current use.

Management determines the level of service and condition that is acceptable to carry out VA's mission, which may vary by VA components which include VHA, VBA, NCA, and Indirect Administrative Program Costs. It is VA policy to ensure that medical equipment and critical facility equipment systems are maintained, repaired and managed in a safe and effective manner; therefore, deferred maintenance and repairs are not applicable to them.

VA facilities reported their cost estimates for deferred maintenance and repairs by performing periodic Facility Condition Assessment Surveys, which are inspections of property, plant and equipment based on generally accepted methods and standards consistently applied, to assign condition ratings and estimate costs for each fixed asset to correct deficiencies. The costs assigned "D" (poor) and "F" (critical) ratings, qualify for reporting as deferred maintenance and repairs.

Deferred Maintenance and Repairs		
As of September 30,	**2012**	**2011**
General PP&E	$ 5,911	$ 5,719
Heritage Assets	740	698
Total Deferred Maintenance and Repairs	$ 6,651	$ 6,417

2. Schedule of Budgetary Activity Year Ended September 30, 2012

	Total Budgetary Resources	Obligations Incurred	Spending Authority from Offsetting Collections and Adjustments	Obligated Balance Net, Oct. 1	Obligated Balance Net, Sept. 30	Total Outlays
Veterans Health Administration						
Medical Admin 0152	$ 5,682	$ 5,327	$ 38	$ 893	$ 894	$ 5,288
Medical Care 0160	43,776	42,715	178	5,139	7,477	40,199
Medical Facilities 0162	5,503	5,390	19	3,128	3,185	5,314
Information Technology 0167	3,317	3,182	67	1,785	1,634	3,266
All Other	6,468	3,057	405	2,984	3,029	2,607
Total	$ 64,746	$ 59,671	$ 707	$ 13,929	$ 16,219	$ 56,674
Veterans Benefits Administration						
Compensation, Pension, & Burial Benefits 0102	$ 64,168	$ 59,167	$ -	$ 278	$ 4,691	$ 54,754
Readjustment Benefits 0137	13,695	11,140	365	100	545	10,330
Direct Loan Financing 4127	389	301	1,070	7	-	(762)
Guaranteed Loan Financing 4129	6,284	2,495	3,054	279	306	(586)
National Service Life Insurance Fund 8132	1,157	1,156	177	1,181	1,089	1,071
All Other	8,356	5,924	2,141	1,045	907	3,921
Total	$ 94,049	$ 80,183	$ 6,807	$ 2,890	$ 7,538	$ 68,728
National Cemetery Administration						
Total	$ 321	$ 302	$ 3	$ 178	$ 194	$ 283
Indirect Administrative Program Costs						
General Operating Expenses 0151	$ 2,465	$ 2,381	$ 376	$ 542	$ 403	$ 2,144
Supply Fund 4537	1,949	1,127	1,296	(279)	(513)	65
All Other	(943)	(1,000)	508	(443)	(216)	(1,735)
Total	$ 3,471	$ 2,508	$ 2,180	$ (180)	$ (326)	$ 474
Total of all Administrations	$ 162,587	$ 142,664	$ 9,697	$ 16,817	$ 23,625	$ 126,159