DEPARTMENT OF VETERANS AFFAIRS

# OFFICE OF INSPECTOR GENERAL

*Office of Audits and Evaluations*

DEPARTMENT OF VETERANS AFFAIRS

# Audit of VA's Financial Statements for Fiscal Years 2018 and 2017

AUDIT | REPORT #18-01642-09 | NOVEMBER 26, 2018

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Fiscal Year 2018 Agency Financial Report



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**Department of Veterans Affairs**

# Memorandum

**Date:** November 26, 2018

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

**Subj:** Audit of VA's Financial Statements for Fiscal Years 2018 and 2017

**To:** Secretary of Veterans Affairs (00)

1. We contracted with the independent public accounting firm, CliftonLarsonAllen LLP, to audit VA's financial statements as of September 30, 2018 and 2017, and for the fiscal years (FYs) 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 report.

2. CliftonLarsonAllen LLP provided an unmodified opinion on VA's financial statements for FYs 2018 and 2017. With respect to internal control, CliftonLarsonAllen LLP identified five material weaknesses. A material weakness is a deficiency, or 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.

- Community care obligations, reconciliations, and accrued expenses, which has been reported as a material weakness since FY 2016
- Financial systems and reporting, which has been reported as a material weakness since FY 2015, with "systems and" added to the title for FY 2018
- Information technology security controls, which has been reported as a material weakness for more than 10 years
- Compensation, pension, burial, and education actuarial estimates, which is a combination of two material weaknesses reported first in FY 2016 and combined in FY 2017
- Entity level controls including Chief Financial Officer organizational structure, which has been reported as a material weakness in part since FY 2016 and was expanded to include entity level controls for FY 2018

3. CliftonLarsonAllen LLP identified two significant deficiencies. 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.

- Loan guarantee liability, which was reported as a material weakness in FY 2017 and a significant deficiency in FY 2016
- Procurement, undelivered orders, accrued expenses, and reconciliations, which has been reported as a significant deficiency since FY 2016

4. CliftonLarsonAllen LLP identified the following conditions regarding noncompliance with laws and regulations:

- Substantial noncompliance with federal financial management systems requirements and the United States Standard General Ledger at the transaction level under the Federal Financial Management Improvement Act (FFMIA) of 1996, which has been reported in part for more than 10 years.

- Improvements needed in order to fully comply with the intent of the Federal Managers' Financial Integrity Act, which has been reported since FY 2015.

- Instances of noncompliance with Title 38 United States Code §5315 pertaining to the charging of interest and administrative costs, which has been reported for more than 10 years.

- Noncompliance with Title 38 United States Code §3733 pertaining to the vendee loan program, which has been reported since FY 2016.

- VA reported one violation of the Antideficiency Act, Title 31 United States Code §1341 (a), in September 2018 and is in the process of reporting a second violation identified in FY 2018. In addition, VA identified five other violations that are carried forward from prior years and are under further discussion with the Office of Management and Budget's Office of General Counsel. CliftonLarsonAllen LLP has reported violations of the Antideficiency Act since FY 2012.

- Noncompliance with the Improper Payments Elimination and Recovery Act for FY 2017, as reported by the Office of Inspector General since 2012.

5. CliftonLarsonAllen LLP is responsible for the attached audit report dated November 26, 2018, and the conclusions expressed in the report. 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 FY 2019 audit of VA's financial statements.

Larry M. Reinkemeyer

LARRY M. REINKEMEYER

Attachment

# Section I

## Independent Auditors’ Report

CliftonLarsonAllen

CliftonLarsonAllen LLP

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## INDEPENDENT AUDITORS' REPORT

To the Secretary
And Inspector General
United States Department of Veterans Affairs

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements (financial statements) of the United States Department of Veterans Affairs (VA), which comprise the consolidated balance sheets as of September 30, 2018 and 2017, and the related consolidated statements of net cost and changes in net position and the combined statements of budgetary resources for the years then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

VA management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America (U.S.); this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the U.S.; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements* (OMB Bulletin 19-01). Those standards and OMB Bulletin 19-01 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion on the Financial Statements*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the United States Department of Veterans Affairs (VA) as of September 30, 2018 and 2017, and its net costs, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the U.S.

### *Emphasis of Matter*

As discussed in Note 13 to the financial statements, VA provides four education/retraining type programs to eligible veterans and their dependents. VA separately developed an estimate for each of the programs in FY 2017 and continued to refine the estimates in FY 2018. A material weakness in Compensation, Pension, Burial and Education Actuarial Estimates is included in the Report on Internal Control over Financial Reporting. Our opinion is not modified with respect to this matter.

### *Other Matters*

<u>*Required Supplementary Information*</u>
Accounting principles generally accepted in the U.S. require that the information in the VA's Management Discussion and Analysis (MD&A), Required Supplementary Information (RSI), and Required Supplementary Stewardship Information (RSSI) sections 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 (FASAB), which 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 required supplementary information 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 this information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

<u>*Other Information*</u>
Our audit were conducted for the purpose of forming an opinion on the financial statements as a whole. All other information exclusive of the financial statements, MD&A, RSI, and RSSI as listed in the table of contents of the Agency Financial Report is presented for purposes of additional analysis and is not a required part of the financial statements. In addition, management has included references to information on websites or other data outside of the Agency Financial Report. This information has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

## Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

### *Internal Control over Financial Reporting*

In planning and performing our audit of the financial statements, we considered VA's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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 or on management's assertion on internal control included in the MD&A. Accordingly, we do not express an opinion on the effectiveness of VA's internal control or on management's assertion on internal control included in the MD&A.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, we identified certain deficiencies in internal control, described below and in Exhibits A and B, respectively, that we consider to be material weaknesses and significant deficiencies.

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 VA's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described below and in Exhibit A to be material weaknesses.

Community Care Obligations, Reconciliations, and Accrued Expenses

The Veterans Health Administration (VHA) continues to have weaknesses in its design and implementation of controls over the Community Care programs - from transaction obligations, liquidation of unfulfilled authorizations, and reconciliations to the related accrued expenses.

Financial Systems and Reporting

Due to its age and limited functionality, VA's legacy Financial Management System (FMS) continues to require extensive manipulations, journal entries, manual processes, and reconciliations in order for VA to produce a set of auditable financial statements. VA continues to have various financial reporting issues though some improvements have occurred since the prior year in certain areas.

Information Technology Security Controls

VA continues to have control weaknesses in Configuration Management, Access Controls, Security Management, and Contingency Planning.

Compensation, Pension, Burial and Education Actuarial Estimates

The Veterans Benefits Administration (VBA) still needs to complete actions to put in place a sufficient and permanent team to manage and take full responsibility for CP&E modeling activities. In addition, the actuarial models developed by VBA to estimate the education and training programs' benefits for veterans and their dependents warrants management's continued focus.

Entity Level Controls including Chief Financial Officer (CFO) Organizational Structure

VA continues to have serious control weaknesses throughout the organization with respect to financial reporting, as described in this report. These weaknesses are attributed to a decentralized and fragmented organizational structure for financial management; the lack of an effective, comprehensive, and integrated financial management system and a challenging IT environment; and the undue reliance placed on manual processes to identify or correct errors with financial information.

A *significant deficiency* is a deficiency, or 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 deficiencies described below and in Exhibit B to be significant deficiencies.

Loan Guarantee Liability

In FY 2018, VBA took several steps to improve its existing Variable Default model (VDM) and Cash Flow model by addressing some of the model deficiencies we identified in prior years. Despite these improvements, major deficiencies remained.

Procurement, Undelivered Orders, Accrued Expenses, and Reconciliations

The internal controls over VA's procurement activities needs strengthening. Specifically, VA does not sufficiently perform reconciliations of its feeder/subsidiary systems to FMS and monitoring activities to validate the accuracy and completeness of balances derived from its procurement process.

***Compliance with Laws, Regulations, Contracts, and Grant Agreements***

As part of obtaining reasonable assurance about whether VA's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements noncompliance with which could have a material effect on the financial statements.

The results of our tests disclosed instances of noncompliance or other matters, described below and in Exhibit C, that are required to be reported in accordance with *Government Auditing Standards* or OMB Bulletin 19-01.

We also performed tests of compliance with certain provisions of the Federal Financial Management Improvement Act (FFMIA). Under FFMIA, each agency must implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Standard General Ledger (USSGL) at the transaction level. As described in Exhibit C, the results of our tests of these provisions disclosed instances in which VA's financial management systems did not substantially comply with (1) Federal financial management systems requirements and (2) the USSGL at the transaction level.

***Management's Responsibility for Internal Control and Compliance***

VA management is responsible for (1) evaluating the effectiveness of internal control over financial reporting based on criteria established under the Federal Managers' Financial Integrity Act (FMFIA), (2) providing a statement of assurance on the overall effectiveness on internal control over financial reporting, (3) ensuring VA's financial management systems are in substantial compliance with FFMIA requirements, and (4) complying with other applicable laws, regulations, contracts, and grant agreements.

***Auditors' Responsibilities***

We are responsible for (1) obtaining a sufficient understanding of internal control over financial reporting to plan the audit, (2) testing whether VA's financial management systems substantially comply with the FFMIA requirements referred to above, and (3) testing compliance with certain provisions of laws, regulations, contracts, and grant agreements.

We did not evaluate all internal controls relevant to operating objectives as broadly established by the FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. 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.

We did not test compliance with all laws, regulations, contracts, and grant agreements applicable to VA. We limited our tests to certain provisions of laws, regulations, contracts, and grant agreements noncompliance with which could have a direct effect on the determination of the material financial statement amounts and disclosures. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes. Also, our work on FFMIA would not necessarily disclose all instances of noncompliance with FFMIA requirements.

***Management’s Response to Findings***

Management has presented a response to the findings identified in our report. We did not audit VA’s response and, accordingly, we express no opinion on it.

***Status of Prior Year’s Control Deficiencies and Noncompliance Issues***

We have reviewed the status of VA’s corrective actions with respect to the findings included in the prior year’s Independent Auditors’ Report, dated November 15, 2017. The status of prior year findings is presented in Exhibit D.

***Purpose of the Report on Internal Control over Financial Reporting and on Compliance***

The purpose of the Report on Internal Control over Financial Reporting and on Compliance is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of VA’s internal control or on compliance. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering VA’s internal control and compliance. Accordingly, these reports are not suitable for any other purpose.

**CLIFTONLARSONALLEN LLP**

CliftonLarsonAllen LLP

Greenbelt, Maryland
November 26, 2018

**EXHIBIT A**
**Material Weaknesses**

## 1. Community Care Obligations, Reconciliations and Accrued Expenses

***Background:***

VHA purchases medical services for veterans from community health care providers under its VA Community Care (Community Care) programs. These programs and related activities are funded from the following three appropriation accounts:

0140 – Medical Community Care
0160 – Expenses, Medical Services
0172 – Veterans Choice Fund

The VA no longer received Community Care funding through Account 0160, starting in FY 2017. However, the funding for these activities comes from Account 0172 and Account 0140. In FY 2018, approximately $7.3 billion was appropriated for the Choice program (Account 0172) and $9.8 billion was appropriated for the remaining Community Care programs (Account 0140). The programs for Account 0140 include a range of medical services such as inpatient care, outpatient care, community nursing home program, civilian health and medical program as well as dental services of VA. The combined undelivered orders and accrued expenses for all Community Care programs approximated $4.4 billion as of September 30, 2018.

The VA modified the existing Patient Centered Community Care (PC3) program contracts, serviced by TriWest Healthcare Alliance Corporation (TriWest) and Health Net Federal Services, LLC (Health Net) also referred to as third party service providers, when Congress passed the Veterans Access, Choice, and Accountability Act of 2014 (Choice Act) in the prior year. The primary responsibilities of these contractors for the Choice program are to maintain a network of non-VA providers, coordinate with veterans eligible for Choice to schedule appointments, pay providers for services provided to the veterans, maintain a call center, and distribute Choice Cards. Since the VA relies primarily on two service providers to process claims for the Choice program at private hospital networks, each should receive independent examinations that provide sufficient audit coverage in order for VA to rely on the service organization's controls relevant to VA's financial reporting.

VHA's Office of Community Care (OCC) was authorized to manage all VA Community Care programs under Section 106 of the Choice Act. VHA uses the Fee Basis Claims System (FBCS) to authorize, process and pay for claims from non-VA providers supplying services such as inpatient and outpatient care. Each medical center or Veterans Integrated Service Network (VISN) had its own instance of FBCS which results in a decentralized and fragmented information system structure. This decentralized structure remains for the Community Care programs, except that OCC has centralized the Choice program and managed it through a single instance of FBCS.

***Conditions:***

VHA continues to have weaknesses in the internal control design and operating effectiveness of its financial reporting controls over the Community Care programs. Last year, we reported that VA did not effectively execute the control activities related to transaction authorization and obligation, monitoring and timely liquidation of unfulfilled authorizations and reconciliations. These conditions have not been corrected in the current fiscal year. Further, VA did not accurately calculate the obligation and related accrued expense balances using its estimation methodologies throughout the entire fiscal year. The continuance of these internal control weaknesses impede the VA's ability to accurately report balances related to its Community Care programs without significant manual adjustments recorded at year-end.

**EXHIBIT A**
**Material Weaknesses**

A. Manual and Inconsistent Nature of Estimating Costs of Care

Once a veteran is approved to receive care, such as outpatient care, from a non-VA provider, an authorization and the related cost estimate for the type of care is processed in FBCS. The VA uses a variety of estimation tools to develop the cost estimate for the Community Care programs. However, we found that the Community Care program staff did not use the cost estimation tools in a consistent manner which resulted in a wide variation of its cost estimates across the Community Care programs. The OCC in conjunction with the FSC developed a nationwide dashboard reconciliation process late in FY 2017 and made additional enhancements in FY2018 to address the inconsistent cost estimation process for certain types of care within account 0140. In addition, other methodologies were developed to estimate the remaining types of care in account 0140 and separately for accounts 0160 and 0172 to remediate the inconsistent cost estimation processes. Although VA implemented these overarching processes in FY 2018, our tests results revealed that VA continues to have significant differences between the calculated estimated cost of care and the actual payments.

B. Limited Centralized Monitoring of Open Authorizations

The open authorizations for the Community Care program is the primary source needed to calculate the estimated costs of care for veterans. In prior years, we found that OCC did not have a centralized and integrated system to track the life cycle of all Community Care consults that includes authorization, appointments and payment. Further, these authorizations were not validated or monitored at a centralized nationwide level. There have been no significant changes to the processes and the control activities in FY 2018.

C. Accrued Expense Methodology

VHA generally obligates its Community Care funds through an estimation process using VA Form 1358, “Obligation or Change in Obligation” (1358s). These estimates are performed at the beginning of each fiscal year and subsequent adjustments are made throughout the period to derive the final estimated obligation for each category of care (e.g. inpatient care, outpatient care, dentist, etc.) on a monthly basis. The VA uses an auto accrual process in FMS to record an adjustment for the remaining outstanding 1358 obligations between the undelivered orders and the accounts payable balance on a monthly basis regardless of whether the services were provided. This flawed process continues to result in significant overstatements of VA’s accounts payable balance.

During FY 2018, the FSC developed separate estimated accrued expense methodologies to accrue for the Community Care program activities associated with account 0140 and 0172. These methodologies were needed because VA does not have a sufficient process in place to estimate and accrue the cost of care at the detail level within its financial system. During FY 2018, we received numerous iterations of VA’s documented accrued expense methodologies for its Community Care programs. For each iteration, VA’s accrual methodology lacked the statistical integrity needed to support their position. More importantly, the sampling methodology and the related documentation used to support the sampling selection process and projected results was incomplete and inaccurate. In addition, the data attributes included in FMS for the receipt date of services could not be relied upon by management which required additional sampling and validation procedures to support the data inputs used in the accrual methodology. These identified weaknesses in VA management’s accrued expense methodology could not remediate the systemic accrued estimation deficiencies previously discussed. Consequently, a material manual adjustment was recorded at year end to accurately report the community care program accrued expenses and related balances at September 30.

**EXHIBIT A**
**Material Weaknesses**

D. <u>Service Organization Report</u>
Each of the third party service providers received an independent examination of their controls during FY 2018, in accordance with Statement on Standards for Attestation Engagements (SSAE), No. 18, *Reporting on Controls at a Service Organization*, published by the American Institute of Certified Public Accountants. However, we found that one service provider lacked the testing of a significant control objective related to verification of the accrual for services rendered but not reported to VA at September 30.

***Criteria:***

OMB Circular A-123, *Management's Responsibility for Enterprise Risk Management and Internal Control* (OMB Circular A-123), provides guidance to Federal managers on improving accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls. Management is 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:***

The VA does not have a consolidated instance of FBCS. In addition, there are significant system limitations that hinder effective and efficient operations and controls for the Community Care programs. For example, FBCS does not directly interface with IFCAP and FMS. Further, the cost estimation tools used for obligations were manual and not consistently applied across all medical centers. In addition, FMS's auto-accrual function did not reflect actual liabilities at year- end.

Further, VA did not adequately perform its due diligence responsibility when preparing the accrued expense methodology. Moreover, the appropriate level of statistical scrutiny was not applied when developing the sampling methodology and evaluating the projected results. Finally, the combination of ad hoc methods contributed to the flawed methodology.

***Effect:***

These conditions led to misstatements for obligations, accrued expenses, and undelivered orders (UDOs) which required manual adjustments to accurately report balances at September 30.

***Recommendations:***

We recommend that the Executive in Charge, VHA:

1. Establish and implement detailed guidance and procedures to assist staff in reviewing open authorizations and obligations and automated accruals for potential adjustment. Include instructions on performing root cause analysis and performing follow-up analysis on aged authorizations and obligations – including direct follow up with medical providers when a transaction has no activity for over 90 days (for appointment and invoicing). Supplement the guidance with training at medical centers and VISNs.

2. Ensure the close coordination and integration between the CFOs, OCC, VISN, and medical centers so key accounting and financial management controls are properly designed, implemented and monitored for Community Care programs.

3. Implement policies, procedures, and a reliable and accepted pricing tool to ensure:
   a) FBCS authorization estimation methodology is consistently applied across all medical

centers.

b) Validation of obligated amounts is performed monthly and cost estimation methodology is adjusted/revised as warranted.
c) Expired authorization estimates are promptly liquidated from both FBCS and IFCAP.
d) Transaction level details in FBCS, IFCAP, and FMS for obligations and disbursements are reconciled monthly in a complete and nationwide consolidated manner (including the month-end cut-off date to be on the last date of the month).

4. Continue efforts to develop auditable methodologies for establishing and validating Community Care obligations and accruals. Community Care obligations by nature are generally based on estimates, and are set to auto-accrue per the system formula. The obligations as estimates may not reflect the authorized care and accruals may not fairly represent the services provided to the veterans by the year-end date. As the overall Community Care program is still evolving, the methodologies used to calculate the obligations and accrual should be adapted continually to adjust to the risks and operations of the underlying programs. Elements that require a change to the obligation and accrual methodologies should be documented and supported.

5. Improve the periodic look-back validations and analyses on obligation and accrual balances reported for all Community Care programs against subsequent activity to:
   a) Ensure accuracy of financial reporting and to maximize budgetary resources.
   b) Identify significant differences to be investigated and researched.
   c) Adjust the accrual methodology to reflect actual Community Care spending patterns.
   d) Review the current contracts for its third party service providers and require a SSAE No. 18 examination be performed. In addition, VA management should ensure that all control objectives related to the accuracy and completeness of liabilities reported to VA are tested.

6. Ensure that management's monitoring controls include:
   a) Detailed reviews and validation of cost estimations and reconciliations performed.
   b) Timely liquidation of long outstanding or canceled appointments.
   c) Measurement of the number of days for financial events, such as appointment fulfillment, provider invoicing, and payments to be completed.

7. Work with Office of Information and Technology (OI&T) to modernize the information technology (IT) infrastructure supporting key Community Care programs to:
   a) Facilitate data transparency from inception (authorization) to completion (payment and receipt of medical records) that also can be interfaced with the general ledger system.
   b) Consider web-based management and real-time interactive engagement with providers on consults, authorizations, receipt of claims and medical records, adjudication of claims, and notification of provider payments.
   c) Decrease manual processes where possible.

8. Work to ensure the two-way interface of financial data between the FBCS, procurement systems, and the general ledger system is part of VA's ongoing systems modernization efforts. In the meantime, establish common data elements and fields to facilitate the flow and reconciliation of information between the general ledger and subsidiary systems, including Electronic Contract Management System (eCMS), FBCS, etc. to facilitate a consolidated, comprehensive reconciliation between FMS and the various subsidiary systems where the underlying transactions are initiated.

## 2. Financial Systems and Reporting

***Background:***

An agency's financial systems and reporting are essential when preparing accurate and timely financial statements. VA implemented its legacy core financial management and general ledger system, FMS, in 1992. There have been a variety of federal financial reporting requirements that have been increasingly demanding and complex for agencies to implement. VA's current financial system has limited functionality to meet the current financial management and reporting needs. VA utilizes another application, the Management Information Exchange (MinX) system, to consolidate general ledger activities from FMS and create financial statements for external financial reporting. This process requires significant manual intervention and creates risks to the accuracy and completeness of financial reporting.

***Conditions:***

VA continues to refine its current financial reporting practices and we have observed improvements in areas such as reduced use of journal vouchers (JVs). However, many of these issues have existed for years and require extensive efforts to change existing business processes, research legacy differences and implement solutions to resolve them. Those long standing issues require time and sustained VA wide efforts to ensure their proper implementation. Through FY 2018, VA's financial reporting issues continued to exist in the following areas:

A. <u>Lack of FMS Reconciliations with Subsidiary Systems</u>
VA has several legacy subsidiary systems that no longer meet financial management system requirements and do not have a two-way interface with FMS. Key VBA and VHA subsidiary systems - including Veterans Health Information Systems and Technology Architecture (VistA), Benefits Delivery Network (BDN), the Veterans Service Network (VETSNET) and the Insurance General Ledger (IGL) - only have a one way interface with FMS. Although FMS returns transaction processing results (such as success/failure or accept/reject status) for some of these subsidiary systems, this is not considered a two-way interface.

In addition, the interface from the Long Term Solutions system (LTS) to BDN is a one-way process. Education benefit payments were determined and processed in LTS and transferred through the system interface to BDN for payments. However, the payment data in BDN does not feed back into LTS to show the entire history from eligibility and entitlement determinations, to actual payments processed.

Reconciliations between the subsidiary systems where the financial transactions were initiated and FMS were either not performed, partially performed, performed decentralized, or performed manually. As a result, VA's accounting and financial reporting is severely hindered by system and business process limitations. Subsidiary systems where the financial events were initiated, were not always the systems that directly fed information into FMS, which further exacerbated the reconciliation issues.

B. <u>Extensive Reliance on the Use of Journal Vouchers (JVs)</u>
Although we observed a reduction in the use of journal vouchers, the VA still records a large number of manual adjustments to prepare its financial statements. Most of these adjustments consist of "top-side" entries recorded into MinX. Top-side entries are manual adjustments recorded outside of VA's general ledger system and are used to accurately report financial statement balances at a point in time. Each accounting period in MinX is independent which requires numerous JVs, manual reconciliations, and analyses to be re-performed and re-entered

to produce VA's quarterly financial statements and trial balances. The use of manual adjustments such as top-side entries often bypass controls instituted for ordinary transaction processing and increases the risk of introducing errors into financial reporting.

C. Issues with Intragovernmental Agreements and Reconciliations
VA does not have a complete centralized repository for all active intragovernmental agreements to support and facilitate its transaction level research and reconciliation. As a result, accounts involving intragovernmental financial transactions, such as obligations, unfilled customer orders, and offsetting collections recorded in FMS, did not agree to the intra-agency agreement amounts. The VA intragovernmental differences by trading partner approximated $3.4 billion as of June 30, 2018.

Due to FMS system limitations, transactions were mapped to the incorrect Federal or Non-Federal attributes as a default. FMS does not have the system functionality to meet the Governmentwide Treasury Account Symbol Adjusted Trial Balance System (GTAS) reporting requirements. The high-volume, high dollar JVs are entered into MinX to adjust trading partner and general ledger attributes in order for VA's trial balance submission to pass GTAS edits. The JVs recorded by management include categories such as "No Trading Partner," "IntraVA," "Unknown," etc.

D. Recording of Prior Year Budgetary Recoveries
VA does not have a centralized and consolidated process to properly report, reconcile, and monitor the Prior Year Recoveries (PYR) account balances. In FY 2018, herculean efforts were needed to provide a detail transaction file to support the PYR obligation balances. During our testing, we found significant transactions recorded throughout the fiscal year did not represent valid transactions. Consequently, VA management performed a series of analysis at year-end to support the accuracy and completeness of the Recoveries population. Further, VA management recorded material adjustments to accurately report its Recoveries balance at September 30.

E. Budgetary to Proprietary Analyses (Tie Points) Contained Material Differences
The Budgetary to Proprietary analysis (i.e. tie points) is a monitoring control used to identify potential recording errors that exist between the United States Standard General Ledger (USSGL) budgetary accounts and the corresponding proprietary accounts. In prior years, we found that VA did not perform a comprehensive reconciliation of certain key tie points. Instead, VA management stated that its reliance on other controls such as the GTAS edits checks ensured the accuracy of trial balance accounts. This practice continued until the fourth quarter of FY 2018.

Consistent with the prior year, VA believed that certain tie point variances were due to system limitations (limited attributes available in FMS and MinX). We performed a series of follow up inquiries with VA about researching the underlying causes to its tie point differences and adequately resolving the outstanding reconciling transactions and/or balances. VA management conducted further research and subsequently made four adjustments ($3.5 billion absolute value with a $64 million net value) to clear reconciling variances. Most of the variance related to prior year and the net adjustments did not have a material impact to VA's financial statements.

F. Lack of Reconciliation and Timely Clearing of Deposit/Clearing Account Activities
VA continues to lack a centralized and consolidated process to properly report, reconcile, and monitor the outstanding unapplied deposit/clearing account activities, which resulted in year-end reporting with over $115 billion of transactions in absolute value, relating to the net value of $219 million in Note 3, Fund Balance with Treasury, to the financial statements. Management was unable to provide a detailed report containing valid and outstanding transactions that still needed to be researched and applied to the proper account at year-end.

**EXHIBIT A**
**Material Weaknesses**

***Criteria:***

OMB Circular A-123 makes management 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.

OMB Memorandum M-13-23, Appendix D to Circular No. A-123, *Compliance with the Federal Financial Management Improvement Act of 1996* (Appendix D), states as part of its scope: "Transactions are posted to the financial system in accordance with the standard general ledger accounting requirements the Department of Treasury (Treasury) published in the USSGL supplement to the Treasury Financial Manual (TFM)."

Appendix D also states, "The Federal Government's financial management system policy is to make the best use of financial management systems to initiate, record, process, and report transactions to support agency missions in making business decisions and to provide transparency to the public. These systems shall help agencies ensure the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."

OMB Circular A-11, Preparation, Submission, and Execution of the Budget, Appendix F, provides the following guidance with regard to recording recoveries:

- A change in budget/accounting structure (i.e., object class, direct/reimbursable, budget (cost) center, program, Federal/Nonfederal indictor, vendor code, etc.) [within a Treasury Account Funds Symbol (TAFS)]) in a current or subsequent fiscal year to an obligation, should be treated as an adjustment to unpaid obligations.
- Increase/decrease in dollar contract change/modification in the current year requires an adjustment to unpaid obligations
- Increase/decrease in dollar contract change/modification in the subsequent year (year 2 and later) requires an upward/downward adjustment of prior year unpaid obligations.
- An unpaid obligation recorded in an incorrect TAFS in the subsequent year should be treated as a downward adjustment of prior year unpaid obligations in the TAFS where the unpaid obligation was originally incurred.
- An error or mistake does not constitute an upward or downward adjustment.

***Cause:***

The age and limitations of VA's various financial management systems caused VA to record numerous manual JVs and implement extensive manual processes and controls to prepare its financial statements for external reporting purposes. In addition, adequate internal controls were lacking in the following key areas: 1) centralized and consolidated reconciliations for key accounts, 2) complete inventory, proper accounting and monthly reconciliation of intra and interagency agreements 3) reporting for recoveries transactions, 4) budgetary to proprietary analyses, and 5) researching and clearing of deposit/clearing account activities

***Effect:***

These weaknesses increased the risk of errors in the financial reporting process.

***Recommendations:***

We recommend that the Assistant Secretary for Management/CFO in coordination with the VHA CFO and the VBA CFO:

1. With respect to FMS reconciliations with subsidiary systems:
   a) Perform an enterprise risk management (ERM) review that includes all of VA's subsidiary systems to inventory all types of VA's financial transactions and how they are initiated, interfaced, and ultimately recorded in FMS. Such an analysis can be performed in conjunction with the system modernization efforts including identifying the gaps and developing gap alternatives to address the systems that will not be part of the modernization.
   b) Establish a risk register for each of those systems and prioritize system modernization or institute system fix efforts. Coordinate efforts with the OI&T and the relevant business offices to ensure complete and consolidated reconciliations between those subsidiary systems and the general ledger system are performed on a monthly basis.
   c) Strengthen the FMS cumulative reconciliation with the subsidiary systems that includes performing complete and consolidated reconciliations between those subsidiary systems and FMS on a predetermined frequency basis to support the accuracy and completeness of financial reporting.

2. With respect to JVs:
   a) Continue to monitor the JV recording process surrounding the research and review of account differences and subsequent adjustments. Focus on addressing the common root causes of these JVs in order to:
      - Implement the necessary system fixes to reduce the volume and value of JVs prior to system modernization.
      - Ensure any risks identified are considered and addressed in the upcoming system modernization efforts.
      - Continue reviewing and researching all JVs recorded in the FMS Station 151 default account and reclassify them to the proper funds and accounts promptly.
      - Elevate unusual JVs to upper management for their review and approval.
   b) Perform a pro forma analysis to validate major accounting entries with their posting logic and attribute settings in FMS and the subsidiary ledgers used by the various business lines, e.g. BDN and VETSNET. Continue efforts to correct and establish missing FMS transaction posting logic to minimize the use of manual JVs. Manual JVs should be used only for unusual transactions, as a general rule (e.g., quarterly accruals, timing differences, or unusual one-time entries, etc.).
   c) Perform the following analyses:
      - Upon the recording of significant or material adjustments for budgetary entries, financial managers should review the entries with the budget officials to ensure both are in agreement prior to posting. The review should include JVs proposed by financial management as well as JVs proposed by the VA budget staff to ensure consistency with all financial reporting documents (i.e., SF-132 and SF-133, and Continuing Resolutions funding calculations).
      - In addition, provide the trending analysis from period to period as to the number of budgetary adjustments recorded to ensure their corrective actions are being implemented by responsible parties.

3. With respect to intra-governmental agreements and reconciliations:
   a) Continue to work to maintain and validate all intragovernmental agreements in the

centralized repository to ensure that all agreements are current and contain all the required terms and conditions. Perform an inventory review of those agreements to:
- Determine whether balances are recorded in FMS accurately.
- Ensure that agreements in the repository reflect an active or closed status, identify obligation amounts separately from contract/agreement values, and ensure that values are supported by agreements or task orders released against the agreement.

b) Continue to review closed agreements and determine whether these agreements need to be renewed, maintained in the repository, or archived.

c) Produce reliable subsidiary trading partner reports with details at the transaction level that can be linked to the agreement level to facilitate management's review and reconciliation with the trading partner reporting in GTAS and in the financial statements. Any corrections made as a result of the research should be documented and recorded in FMS at the transaction level.

d) Continue to strengthen VA's controls and processes as described in the Treasury Financial Manual Volume I, Part 2, Chapter 4700, Appendix 10, *Intragovernmental Transaction Guide*, issued in July 2017, Section 2.3, for:
- Authoritative Source Reconciliation (subsection 2.3.1)
- Material Difference Reports (subsection 2.3.2)
- Root Cause/Corrective Action Plan Process (subsection 2.3.3)
- Dispute Resolution Process (subsection 2.3.4)
- Measure IGT Activity/Scorecards (subsection 2.4)

e) Continue to provide training/webinars/guidance documents on the use, accounting and reconciliation of intragovernmental agreements to ensure their proper implementation throughout VA (including the newly added FMS reimbursable fund codes and using correct vendor code structure with GTAS main account codes).

f) As part of the system modernization:
- Develop a two-way interface between the repository and the general ledger system when a transaction occurs.
- Automate cumulative reconciliation between the repository and the general ledger system monthly.
- Provide automate notification to the agreement holder when the agreement is expiring in 60 days (or based on management's own set timelines) and when it has expired. *Until system modernization occurs, management must continue to improve their controls and processes as recommended in the other Recommendations.*

4. With respect to prior year budgetary recoveries:
   a) Implement a process to validate the transactions included in the details supporting prior year recoveries on a quarterly basis, at a minimum.
   b) Develop procedures to perform monthly reconciliations of the prior year recoveries detailed report to the trial balance.

5. With respect to budgetary to proprietary analysis:
   a) Perform budgetary to proprietary account relationship tests each time management runs a trial balance report to ensure the trial balance is accurate (at least monthly).
   b) Continue to research discrepancies to determine the cause, and document resolution of variances.

6. With respect to deposit/clearing account activities:
   a) Enhance the new F858 report to centralize the process of identifying and reconciling all deposit/clearing activities. The report should contain valid and outstanding transactions

that still need to be researched and applied to the proper account. Perform analyses to identify issues/trending such as transactions not resolved in 60 days, administrations or stations with the most outstanding transactions, etc. to implement targeted corrective actions. Unreconciled differences should be researched and resolved within 60 days pursuant to management policy. This should be performed as part of the Fund Balance with Treasury reconciliation to ensure completeness.

### 3. Information Technology Security Controls

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. Many of VA's legacy systems have been obsolete for several years. For example, VA's core financial accounting system, FMS, is coded in Common Business Oriented Language (COBOL) - a programming language developed in the late 1950s and VA's system employed at the medical centers - Veterans Health Information Systems and Technology Architecture (VistA) - was built in the late 1970s. Because of their age, legacy systems are more burdensome and costly to maintain, cumbersome to operate, and difficult to adapt to meet today's operational and security requirements. 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 24 selected VA medical centers, regional offices, and major data centers. As noted in prior years' audits, VA continues to have weaknesses in Configuration Management, Access Controls, Security 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 and systems; however, weaknesses still persist. Examples of VA improvements in its IT control environment include improved security documentation, and further implementation of system monitoring and logging tools and techniques. Additionally, in order to establish more consistent processes, VA began centralizing some control functions that in prior years were disbursed across the field sites. VA also has continued predictive scanning of its networks allowing for the identification of vulnerabilities across field offices. Further, VA has continued to utilize and mature their IT Governance, Risk and Compliance (GRC) Tool to improve the process for assessing, authorizing, and monitoring the security posture of the agency.

The aforementioned controls require time to mature and show evidence of their effectiveness. Additionally, controls need to be applied in a holistic manner to information systems across VA in order to be considered consistent and fully effective. Accordingly, we continue to see information system security deficiencies similar in type and risk level to our findings in prior years and an overall inconsistent implementation of the security program. Moving forward, VA needs to ensure a proven process is in place across the agency. VA also needs to continue to address control deficiencies that exist in other areas across all VA locations.

We continue to find control deficiencies in Configuration Management, Access Controls, Security Management, and Contingency Planning domains. 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. This is a result of an inconsistent application of vendor patches and outdated system software that could jeopardize the data integrity and confidentiality of VA's financial and sensitive information. VA has made progress in deploying current security patches; however, older patches and previously identified vulnerabilities related to configuration weaknesses and outdated system software continue to persist on its networks. While some progress was made in these areas, VA needs to improve deployment of security patches, system upgrades, and system configurations that will mitigate significant security vulnerabilities and enforce a consistent process across all field offices. We also identified significant issues related to access controls and configuration management for financially significant applications. In addition, VA continues to operate key financial management systems using outdated technology that hinders mitigation of certain vulnerabilities.

Many of these weaknesses can be attributed to an 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 performance monitoring to ensure controls are operating as intended for all systems and at all facilities and communicate security deficiencies to the appropriate personnel, who take responsibility for implementing corrective actions and ensuring those actions are taken. 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. The deployment of vendor patches and system upgrades to mitigate the vulnerabilities was decentralized, inconsistent, and not effective across all VA facilities. Furthermore, VA did not have a complete inventory of the devices connected to its networks and thus we could not verify that all of VA's computers undergo continuous monitoring to ensure they remain securely configured, free of technical vulnerabilities, and adequately patched.
- Key financial management systems use outdated technology that hinders mitigation of certain vulnerabilities. While VA has purchased extended support for some of its software, we noted many instances of unsupported software that did not have extended vendor support. This has resulted in numerous unresolved security issues that expose other VA systems to possible security breaches stemming from unmitigated software vulnerabilities.
- VA needs to strengthen its methodologies for monitoring medical devices and ensuring they are properly segregated from other networks.
- VA did not effectively scan all devices connected to VA's network to mitigate security risks posed by these devices. Additionally, significant vulnerabilities were identified on trusted hosts that had the capability to communicate with medical devices protected by network segmentation.
- Although VA continued to document and implement new baselines, weaknesses remain in the process for developing, approving, and implementing configuration baseline standards. Specifically, VA was in the process of reviewing its systems environment, identifying systems that did not have secure baseline configuration guides in place and developing baseline configuration guides for those systems. In addition, VA's baseline security process does not address emerging security threats and vulnerabilities that could adversely impact mission critical systems.

- Change management policies and procedures for authorizing, testing, and approving system changes were not consistently implemented for networks and mission-critical systems.
- An agency-wide process was not fully implemented for identifying and removing unauthorized application software on Agency systems. VA has made progress by expanding automated software monitoring and continues to work on implementing an enterprise wide continuous monitoring solution for unauthorized software.

*Access Controls*

- Password standards were not consistently implemented and enforced across multiple VA systems, including the network domain, databases, and key financial applications. Specifically, we identified default passwords, easily guessed passwords, and blank passwords.
- Inconsistent reviews of user access resulting in numerous generic, system, terminated, and inactive user accounts that were not removed from the applications and networks. Several financial applications were identified with inadequate controls related to inactive accounts, audit logging, and segregation of duties. In addition, inconsistent exit clearance processes for employees contributed to an increase number of separated employees with active system user accounts.
- Proper completion of user access requests was not consistently performed to eliminate conflicting roles and enforce principles of least system privilege. In addition, technical access controls were not implemented in key financial applications to ensure access was based on defined roles and adequate separation of duties.
- Multi-factor authentication was not fully in place throughout the period. VA has implemented multi-factor authentication on approximately 85% of user accounts in 2018.
- Monitoring of access for individuals with elevated application privileges was lacking within several major application’s production environments.
- Identification, notification, and remediation of security and privacy incidents were not consistently implemented to ensure incidents were resolved timely. In addition, network and application security event logs, which provide audit trails, were not consistently maintained, correlated and/or reviewed across all facilities and systems.

*Security Management*

- System Security Plans were incomplete and did not reflect the current environment. In addition, Medical and Special Purpose Systems were assigned to the Regional General Support System boundaries; however, the inventory of these devices was not reflected in the associated system security plans and the control implementation details specific to these devices were not addressed.
- VA issued Authority to Operate to several systems prior to completion of the Security Control Assessment (SCA); contrary to VA policy. SCA’s are performed to assess the operating effectiveness of operational, management, and technical controls of a system.
- Security deficiencies and weaknesses for several controls were improperly consolidated into one control weakness. This process did not effectively communicate or track the breadth and depth of the risk affecting the environment.
- Background reinvestigations were not performed timely and tracked effectively and VA’s system of record was inaccurate. In addition, some personnel did not receive the proper level of investigation for their position sensitivity levels and there was no centralized method for monitoring the investigation status of contractors.

- Plans of Action and Milestones were not consistently updated to incorporate all known control weaknesses from SCAs, to reflect changes in milestones, and documentation was inadequate to support closed actions.

*Contingency Planning*

- There were instances of unplanned outages or disruptions where systems or services were not recovered within prescribed Recovery Time Objectives. Additionally, these instances did not prompt Contingency Plan reviews or updates in accordance with defined policy.
- Backup tapes were not encrypted for all systems across the agency.

***Criteria:***

OMB Circular A-130, Appendix I, *Responsibilities for Protecting and Managing Federal Information Resources,* states that, "Federal agencies must implement information security programs and privacy programs with the flexibility to meet current and future information management needs and the sufficiency to comply with Federal requirements and manage risks. As technologies and services continue to change, so will the threat environment. Agency programs must have the capability to identify, respond to, and recover from current threats while protecting their information resources and the privacy of the individuals whose information they maintain. The programs must also have the capability to address new and emerging threats. To be effective, information security and privacy considerations must be part of the day-to-day operations of agencies. This can best be accomplished by planning for the requisite security and privacy capabilities as an integral part of the agency strategic planning and risk management processes, not as a separate activity. This includes, but is not limited to, the integration of Federal information security and privacy requirements (and security and privacy controls) into the enterprise architecture, system development life cycle activities, systems engineering processes, and acquisition processes."

OMB A-130 also states that, "Agencies shall implement an agency-wide risk management process that frames, assesses, responds to, and monitors information security and privacy risk on an ongoing basis across the three organizational tiers (i.e., organization level, mission or business process level, and information system level)."

The Federal Information Security Modernization Act of 2014 (FISMA), which amended the FISMA Act of 2002, requires each agency to 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 for 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 of applications have impacted facilities' and management's ability to consistently remediate IT security deficiencies across the enterprise. For example, VA's complex and disparate 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. VA has had several leadership and organizational changes over the last several years. The lack of consistent leadership and continued reorganization of components within VA, such as the centralization of data centers and the shift of control from the local sites to regional and enterprise levels, has caused delays in communicating established policies with personnel throughout VA. In addition, VA lacks an effective and consistent corrective action process for addressing and monitoring known internal security vulnerabilities on databases and network 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. Further, key financial management systems use outdated technology that hinders mitigation of certain security vulnerabilities. Without remediating all significant security vulnerabilities, systems could be compromised resulting in potential harm to confidentiality, integrity, and availability of VA sensitive data.

***Recommendations:***

The Executive in Charge for the OI&T should continue to analyze and prioritize remediation efforts to accomplish security and control objectives. Key tasks should include, but are not limited to:

1. Continue to implement mechanisms to continuously identify and remediate security deficiencies on VA's network infrastructure, database platforms, and Web application servers in support of the established policy timeframes.

2. Implement improved processes to ensure all VA organizations and systems are included in the vulnerability management program. Implement processes to consolidate the security responsibilities for local facility systems, not managed by OI&T, and ensure security scans are performed with credentials and the subsequent vulnerabilities are remediated in a timely manner.

3. Develop and implement a strategic plan to address unsupported technology.

4. Strengthen processes and controls to monitor medical devices and ensure they are properly segregated and protected from other networks.

5. Maintain up-to-date, complete, accurate, and readily available security baseline configurations for all platforms. Ensure that all baselines are appropriately implemented, tested, and monitored for compliance with established VA security standards.

6. Implement improved change control procedures to ensure the consistent testing and approval of system changes for VA financial applications and networks.

7. Fully develop a comprehensive list of approved and unapproved software and implement continuous monitoring processes to identify and prevent the use of unauthorized software on agency devices.

8. Implement improved procedures for establishing, documenting, and monitoring an accurate software and hardware inventory across the enterprise.

9. Implement improved processes to ensure compliance with VA password policy and security configuration baselines on domain controllers, operating systems, databases, applications, and network devices.

10. Implement improved processes for periodic reviews of network and financial applications to ensure appropriate user access rights. Remove generic and inactive accounts on systems and networks.

11. Implement improved processes to ensure the proper completion and retention of user access request forms that enforce principles of least system privilege, prior to granting system access.

12. Implement improved processes to ensure the proper completion of termination exit checklists for separated employees. Verify that VA property, including access badges, are returned and system accounts are disabled.

13. Implement technical access controls that will restrict user access based on defined roles and enforce adequate separation of duties principles.

14. Fully implement two-factor authentication for system access throughout the agency.

15. Implement improved access monitoring within production environments for individuals with elevated system privileges.

16. Strengthen agency-wide incident response procedures to ensure timely notification, reporting, updating, and resolution of computer security incidents in accordance with VA standards.

17. Implement improved processes for monitoring system audit logs for unauthorized or unusual activities across all systems and platforms. Implement improved procedures for analyzing all significant audit logs and ensure audit logs are maintained in accordance with VA 6500 policy.

18. Implement improved processes for reviewing and updating key security documentation, including control assessments on an annual basis or as needed. Such updates will ensure all

required information is included and accurately reflects the current environment, new security risks, and applicable Federal standards.

19. Implement an improved continuous monitoring program in accordance with the NIST Risk Management Framework: Specifically, regarding evaluating the effectiveness of security controls prior to granting authorization decisions.

20. Implement processes to ensure security control implementation status and risks are accurately reported to support a comprehensive risk management program across the organization.

21. Implement processes to ensure that deficiencies are tracked individually for each control weakness instead of consolidating findings under one control.

22. Strengthen processes to ensure appropriate levels of background investigations are completed for applicable VA employees and contractors in a timely manner.

23. Strengthen processes to ensure local facilities track reinvestigations for employees and contractors in high-risk positions and the Security Investigation Center initiates all reinvestigations in a timely manner.

24. Implement improved processes for local facilities to accurately and timely report any changes in position sensitivity levels. Furthermore, local facilities should ensure position descriptions are appropriately marked for position risk and sensitivity levels in accordance with the Office of Personnel Management Position Designation Automation Tool.

25. Formalize the Position Descriptions and Position Designation Automation Tool methodology within the Human Resource system to ensure that employees with similar positions are required to have the same level of background investigation.

26. Implement improved processes for establishing and maintaining accurate investigation data within the system of record.

27. Strengthen processes to ensure that plans of action and milestones are developed for known weaknesses and they are tracked and updated in a timely manner.

28. Implement improved processes to ensure closed plans of action and milestones are adequately supported with appropriate documentation.

29. Implement improved processes for the review of system outages and disruptions for contingency plan improvements.

30. Implement improved processes to ensure the encryption of backup data prior to transferring storage media offsite.

**4. Compensation, Pension, Burial and Education Actuarial Estimates**

***Background:***

VA provides compensation, pension, burial and education benefits to eligible veterans and their beneficiaries. The VBA Office of Financial Management (OFM) estimates the present value of these future veterans' benefits as of the end of the fiscal year, and VA reports these amounts in its financial statements. VA reported a compensation and burial benefits liability in the amount of approximately $2.96 trillion on its balance sheet as of September 30, 2018. The present value of future pension benefits is reported as a disclosure in the notes to the financial statements. VA also reported an education benefits accrued liability of approximately $65.7 billion on its balance sheet as of September 30, 2018.

VBA manages several education benefit programs with total disbursements of $14.0 billion in FY 2018. The Post-9/11 GI Bill (Chapter 33) is the largest program (approximately 80 percent of total disbursements) and is available for individuals who served in active duty after September 10, 2001. Since the establishment of this program in FY 2009, the total education benefits paid has steadily increased. The other education programs included in the estimate are the (1) Montgomery GI Bill Active Duty (Chapter 30), (2) Vocational Rehabilitation and Employment (Chapter 31), and (3) Survivors' and Dependents' Educational Assistance Program (Chapter 35).

***Conditions:***

The accuracy of these estimates is highly dependent on the models maintained by the contractors under the Lead Actuary including the reasonableness of the assumptions and the completeness of the underlying data provided to the actuaries for input into the actuarial models which are further described in the conditions below:

A. Control Environment Surrounding the Compensation, Pension, Burial and Education (CP&E) Actuarial Estimates

VA's combined compensation, burial and education actuarial estimate is the single largest liability balance on VA's financial statements. Consistent with our prior year observation, VBA did not have a permanent actuary team in place to manage and take full responsibility for VA's CP&E modeling activities in FY 2018. However, VBA made progress in its efforts to implement prior year recommendations which included hiring a credentialed Lead Actuary to oversee these actuarial estimates using outside contractors who manage the actuarial models. Further, VBA is in the process of recruiting three actuarial positions to develop a permanent team. Still, the lack of a sufficient and permanent team resulted in a higher risk of not being able to provide accurate and complete estimates for VA. The most significant refinement to the Chapter 33 education model was an on-top adjustment to account for future new entrants (explained further below). Other errors and observations related to the education models were: a correction to model input (i.e., prior year initial population data); change in assumption from an estimated to an actual status (due to data and time limitations in the prior year); additional data for purchase cards was not included in the prior year model; certain assumptions that were planned to be updated were not as management stated that all required data elements were not available to adequately perform the studies; and the policy was outdated. For the compensation, pension, and burial (C&P) model, assumption updates were made as a result of our observations related to mortality updates and cost of living.

B. Understatement of the Education Benefits Actuarial Liability Estimate

As described in our Independent Auditors' Report on VA's FY 2017 financial statements, we recommended that VBA perform the necessary analyses to compare estimates with subsequent results to assess the reliability of the assumptions and data used to develop the estimates. This "look-back analysis" was important since the education benefits actuarial liability models are relatively new, starting in FY 2016 for Chapter 33 (Post 9/11 GI Bill) with the remaining chapter models (Chapter 30, 31, and 35) developed in FY 2017. These models were developed to project the liability for future education benefits based on beneficiaries who have already started to use their benefits. Currently, these models do not include assumptions for expected future new beneficiaries. However, based on the "look-back" analysis to validate the reasonableness of the estimates, the models projected a liability that was underestimated as they did not include these expected future new beneficiaries. VA has not developed a practical way to measure the future number of new beneficiaries in its models, in accordance with recognizing a liability as prescribed in Statements of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*. The Chapter 33 model, which is the single largest education program and represents over 86 percent of the total estimated education liability, was initially $44.5 billion without this consideration. As an alternative approach, VBA made an on-top adjustment of $12.0 billion to account for the future new entrants in the next fiscal year, which significantly increased the estimated liability. VBA observed that there has been a steady decline in the number of new beneficiaries enrolled in the Post 9/11 program over the past five years. For estimation purposes, VBA assumed that a static number of new beneficiaries helped to account for new beneficiaries in the other Education programs.

C. <u>Data Input Validation and Reconciliations of the Education Models</u>
Assuring the data being provided to the actuaries is complete and accurate requires a number of analyses, adjustments, and reconciliations prior to providing the data to the actuaries. Much effort and coordination is needed by various offices for this collaborative process, which was also evident during our review of the reconciliations and from our inquiries of differences between input data for the model and the data's source based on a sample. The data used by OFM for the actuarial models is provided by the VBA Office of Performance Analysis and Integrity (PA&I) and respective Benefit Program Offices, while the reconciliations are performed by the Accounting Policy and Reporting Division (APRD).

The OFM policy and procedures discuss the reconciliation process and compares the actuarial input data to the payment amounts. The policy states "If the variance is less than 2% then no action is required, however if greater than 2% additional research should be done." For Chapter 31 and 35, the reconciliations had variances over management's 2% threshold; however, management did not research the variances further as the actuaries accepted the data to use as inputs into the models.

Since these models are relatively new (Chapter 33 started in FY 2016 and the other chapters in FY 2017), the data input validation and reconciliations continue to require further analysis and enhancements, including reconciliations to VA's general ledgers. In addition, there were Standard Operating Procedures (SOP) written for all chapters except 35 for the payment reconciliation.

***Criteria:***

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* provide criteria for designing, implementing and operating an effective internal control system, and such criteria is defined through five components and seventeen principles. One of the principles, "Demonstrate Commitment to Competence," states "Management should demonstrate a commitment to recruit, develop, and retain competent individuals. The following attributes contribute to the design, implementation, and operating effectiveness of this principle:

- Expectations of Competence
- Recruitment, Development, and Retention of Individuals
- Succession and Contingency Plans and Preparation"

OMB Circular A-123, provides guidance to Federal managers on improving accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls. Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, and reliable financial reporting.

FASAB Handbook (June 2018 version) SFFAS 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates*, Section 35, “Reasonable Estimates,” states, “The entity's estimates should reflect its judgment about the outcome of events based on past experience and expectations about the future. Estimates should reflect what is reasonable to assume under the circumstances. The entity's own assumptions about future cash flows may be used. However, the entity should review assumptions used generally in the federal government as evidenced by sources independent of the reporting entity, for example, those used by the Bureau of Economic Analysis for the National Income and Product Accounts and, if its assumptions do not reflect such data, explain why it is inappropriate to do so.”

***Cause:***

Due to the lack of a sufficient and permanent team, there is only a Lead Actuary who is a VBA employee. The VBA Lead Actuary oversees and manages the contractor support who maintain the CP&E modeling. In addition, the education models are relatively new and historical experience/review of data is needed to further refine or stabilize the education models which did not account for future new entrants to the education programs.

***Effect:***

The lack of a properly executed internal control structure (i.e., a sufficient and permanent team) resulted in late refinements/adjustments to the CP&E models. VBA’s reliance on a contractor with only one VBA employee, i.e., the Lead Actuary, providing oversight surrounding these key actuarial estimates placed a higher risk on VA’s largest liability. In addition, the lack of adequate reconciliations resulted in incomplete data/information being used in the model as the causes of the reconciling differences were not documented and identified.

***Recommendations:***

We recommend that the Assistant Secretary for Management/CFO and the VBA CFO:

1. Continue to develop a permanent team with the necessary expertise to estimate VA’s compensation, pension, burial, and education (CP&E) liabilities.

2. Strengthen controls to ensure the modeling for VA’s actuarial CP&E estimates is performed by the appropriate level of personnel to:
   a) Conduct the appropriate analyses and validation of data sources.
   b) Review and ensure the reasonableness of assumptions used and document the rationale behind these assumptions.
   c) Actuarial assumptions should be updated as credible experience dictates.
   d) Consider changes in conditions or programs that require further research and analysis and to update the assumptions when necessary.
   e) Compare estimates with subsequent results to assess the reliability of the assumptions and data used to develop estimates. Perform periodic look-back analyses on assumptions and other relevant factors used in the calculation, as well as the total cost estimated to ensure accuracy of financial reporting.
   f) Prepare analyses benchmarking VA’s assumptions and results to other relevant reports or studies (i.e. Department of Defense (DoD) actuary reports); assess the impact, if any, to ensure consistency in trending; document the assessment’s results; and update the

assumptions when necessary.

g) Continue to perform sensitivity analyses to determine the effect of changes in the assumptions on these accounting estimates.

3. Document the following key elements related to management's assessment of the liability estimates and assumptions in the financial statement disclosures and/or the yearend actuary reports:
   a) Consideration of alternative assumptions or outcomes and why management has rejected them or how management has otherwise addressed estimation uncertainty in making the accounting estimate (e.g., a sensitivity study, etc.).
   b) Sources of data used by management in its calculation and any data limitations of which financial statement readers should be made aware.
   c) Assessment that the significant assumptions used by management are reasonable.

4. Continue to work to fully develop, document, and refine the current policies, procedures, and process narratives relevant to VBA's accounting and financial reporting of education benefits, including:
   a) reconciling education data on a quarterly basis including the process of accumulating and providing relevant and accurate data to the actuaries. Improve the reconciliation process of the inputs with VA's general ledger data to ensure the accuracy, existence, and completeness of data used by the model.
   b) all items in Recommendation #2.
   c) the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed. Ensure the data validation (including the actuary's investigation of data sources, anomalies, etc.), judgments and assumptions used in the modelling are adequately and consistently performed and documented.
   d) updating variance thresholds including dollar amounts, and if refined, reassessment of management's 2% variance threshold for the education reconciliations and consideration of the total magnitude of all the variances in addition to the variances of individual chapters.
   e) ensuring the education liability model is adequately documented in the Standard Operating Procedures.

5. For the education models, we recommend VBA work with their actuaries to conduct the appropriate analyses of the assumptions used with the most relevant information, through an experience study, in order to calculate a more precise estimate. In addition, the appropriateness of the accountable triggering point and the necessary data elements required for a full estimate must be identified, evaluated, confirmed and measured.

## 5. Entity Level Controls including CFO Organizational Structure

***Background:***

The establishment and execution of an internal controls system is critical to meet an agency's operational, programmatic and financial objectives. Entity-level controls have a pervasive effect on VA's internal control system and encompass the elements of control environment, control activities, monitoring, risk assessment, and information and communication.

With respect to the control environment, management is responsible for establishing an organizational structure, assigning responsibility, and delegating authority to achieve the entity's objectives. VA's financial management structure is decentralized, with most of VA's budget authority and financial statement accounts under the operational control of its major administrations and offices. The reliability of VA's financial reporting as a whole is largely dependent on the quality of financial management at these organizations.

The Assistant Secretary for Management is VA's statutory CFO, as required under the CFO Act. The VA CFO has responsibility for establishing financial policy, systems and operating procedures for all VA financial entities; providing guidance on all aspects of financial management; and producing VA's consolidated financial reports. VA administrations and other offices are responsible for implementing those policies and producing the financial information that the VA CFO's office consolidates. Business components, such as VHA, VBA, and the National Cemetery Administration (NCA), have their own CFOs, who oversee financial management operations and follow the chain of command within those organizations. These CFOs have reporting lines of authority to the head of their components, not to the VA CFO. Further, VHA's financial management functions are managed by three categories of CFOs - the VHA CFO, the OCC CFO, and 18 VISN CFOs, each under different lines of reporting. According to management, VA is organized for the direct delivery of benefits and services to veterans.

***Condition:***

VA continues to have serious control weaknesses throughout the organization with respect to financial reporting. Many of these weaknesses are attributed to a decentralized and fragmented organizational structure for financial management and reporting; the lack of an effective, comprehensive, and integrated financial management system and a challenging IT environment; and/or the undue reliance placed on manual processes to identify or correct errors with financial information. Active involvement from VA's senior leadership on a continued basis is needed to effectively mitigate the control weaknesses identified in this report.

A. <u>Control Environment</u>
During FY 2018, VA established the CFO Council to serve as an advisory committee to the VA CFO to address longstanding financial management control weaknesses. The Council's charter documents its goals and responsibilities that include providing oversight on the design, implementation, and operation of VA's internal control system supporting the annual Statement of Assurance as well as coordinating and carrying out annual requirements on programming, budgeting, capital asset management and the financial audit. In FY 2018, we found that the control environment merits VA's continued focus. Specifically, we identified the following:

- Numerous instances where VA lacked the additional oversight and coordination needed, given the system issues and decentralization, in providing reliable and accurate financial information to support certain financial statement line items in a timely and auditable manner. For example, this information was needed to support VA's balances for obligations and recoveries.
- VA does not provide sufficient organizational authority for the VA CFO to fully perform all responsibilities under the CFO Act, such as overseeing financial personnel or developing and maintaining an integrated agency accounting and financial management system, including financial reporting and internal controls. The different CFOs report through their own organizational chains of command rather than to the VA CFO. The VA CFO also does not have, as an alternative, formal authority to participate in matters such as performance evaluations of financial personnel. As a result, responsibility and accountability are not effectively aligned.

Although VA has implemented the CFO Council to address some of its fragmented or decentralized reporting structure, the assessment of its impact is too early to determine. Consistent with our prior year observation, VA's current governance structure does not include strong accountability controls for financial management at the enterprise level.

B. Control Activities, Monitoring and Risk Assessment
The control activities of an organization are the policies, procedures, and techniques that management uses to address operational, programmatic and financial reporting risks. These activities require sufficient and descriptive documentation that is clear and concise to ensure that the appropriate steps are executed to achieve the desired objective. In addition, the active monitoring by the VA at the entity level and within each business line (e.g. VHA, VBA, and NCA) is critical to evaluating the effectiveness of the internal control system. An effective monitoring system uses control activities such as regular management and supervisory reviews, reconciliation, automated tools and other activities to identify deficiencies in need of corrective action. Overall, VA's risk assessment process should provide the principal basis for developing the appropriate responses to risks. However, we continue to report repeated weaknesses in VA's financial management and IT environment. VA has not effectively mitigated these weaknesses in a timely manner.

In FY 2018, we continue to identify the following deficiencies in control activities, monitoring and risk assessment at the entity level:

- Incomplete documentation for all key significant business processes (called process narratives) affecting financial management that describe VA's most current key control activities
- Incomplete reconciliations for all subsidiary/feeder systems to FMS (general ledger)
- Insufficient assessment of key estimation methodologies used to support material general ledger account balances
- Incomplete or insufficient analysis of material account balance relationships
- Insufficient or inadequate development and execution of IT control activities
- In some instances, management incorrectly accepted the results of inadequate control activities. For example, VA primarily relied on GTAS edit checks to validate its trial balance relationship even though known material differences existed throughout the fiscal year.

Details can be found in the sections of this report describing individual material weaknesses, significant deficiencies, and noncompliance with FFMIA and FMFIA. Although VA has been working to identify root causes and made some improvement, many of these issues have existed for years and require change to the existing business processes and systems to resolve them. The resolution of these longstanding weaknesses requires senior management attention and VA-wide efforts and time to ensure consistent and focused implementation.

C. Information and Communication
The quality of information within VA is vital to users for decision-making purposes and the evaluation of key operational, programmatic and financial reporting measures. Also, the IT systems and communication infrastructure should produce information that is relevant, reliable and free from material errors or inconsistencies. Throughout the fiscal year, we found that VA management could not provide accurate and complete data to support certain account balances in a timely manner. In some instances, great efforts were needed to provide the required support for examination. These efforts were specific to the following:

- Transaction detail for the Recoveries of Prior Year Obligations
- Transaction detail support for the Accounts Payable and Accrued Expenses estimation methodology
- Transaction detail for Construction Work in Process samples
- Budgetary to proprietary account analysis to validate trial balance amounts

***Criteria:***

GAO's *Standards for Internal Control in the Federal Government* provides criteria for designing, implementing and operating an effective internal control system. It defines entity-level control as controls that have a pervasive effect on an entity's internal control system. Entity-level controls may include controls related to the entity's risk assessment process, control environment, service organizations, management override, and monitoring.

OMB Circular A-123, provides guidance to Federal managers on improving accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls. Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, and reliable financial reporting.

The CFO Act of 1990 stipulates the following:

**Sec. 902. Authority and functions of agency Chief Financial Officers, states:**
"a. An agency Chief Financial Officer shall—

1. report directly to the head of the agency regarding financial management matters;
2. oversee all financial management activities relating to the programs and operations of the agency;
3. develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls, which—
   A. complies with applicable accounting principles, standards, and requirements, and internal control standards;
   B. complies with such policies and requirements as may be prescribed by the Director of the Office of Management and Budget;
   C. complies with any other requirements applicable to such systems; and
   D. provides for--
      i. complete, reliable, consistent, and timely information which is prepared on a uniform basis and which is responsive to the financial information needs of agency management;
      ii. the development and reporting of cost information;
      iii. the integration of accounting and budgeting information; and
      iv. the systematic measurement of performance;
4. make recommendations to the head of the agency regarding the selection of the Deputy Chief Financial Officer of the agency;
5. direct, manage, and provide policy guidance and oversight of agency financial management personnel, activities, and operations, including-
   A. the preparation and annual revision of an agency plan to-- (i) implement the 5-year financial management plan prepared by the Director of the Office of Management and Budget under section 3512(a)(3) of this title; and (ii) comply with the requirements established under sections 3515 and subsections (e) and (f) of section 3521 of this title;

   B. the development of agency financial management budgets;
   C. the recruitment, selection, and training of personnel to carry out agency financial management functions;
   D. the approval and management of agency financial management systems design or enhancement projects;
   E. the implementation of agency asset management systems, including systems for cash management, credit management, debt collection, and property and inventory management and control;
6. monitor the financial execution of the budget of the agency in relation to actual expenditures, and prepare and submit to the head of the agency timely performance reports."

***Cause:***

VA's CFO organizational structure has historically been decentralized. VA also has a complex, disjointed, and legacy financial system architecture that cannot fully support financial management needs without significant manual intervention.

***Effect:***

The lack of an effective entity level control system, including the decentralized reporting structure coupled with legacy system issues, has led to systemic and pervasive control deficiencies that impedes the Department's ability to process, summarize and report reliable financial information in a timely manner. Also, VA may not fully comply with existing federal financial reporting guidelines and related laws, regulations, contracts and grant agreements.

***Recommendations:***

We recommend that the VA Secretary and Deputy Secretary:

1. At a minimum, provide the VA CFO office with sufficient authority to oversee all financial management activities relating to the programs and operations of the agency. The VA CFO should have specific formal authority and active participation for:
   - Approving job descriptions and skill requirements for those who head VA components' financial management activities and operations.
   - Participating in the selection and recommendation of those individuals.
   - Participating in their annual performance evaluation.

2. Document an assessment of the VA CFO Council's impact on achieving its intended goals and objectives on an annual basis as required by the VA CFO Council Charter. These achievements of goals should be measured by the resolution of control deficiencies identified in the financial statement audit, at a minimum.

3. Implement ERM in accordance with OMB Circular A-123. As part of this implementation:
   a) Enable the VA CFO's office to centralize and consolidate its oversight and monitoring role.
   b) Establish a sound and integrated governance structure that engages all members within VA management, and focuses on having the right competencies in place across accounting, financial reporting, and financial management roles.
   c) Work to develop a transparent and accountable culture to:

i) Openly share information regarding its financial analyses, including root causes of issues/findings, best practices and engage responsible parties to actively address financial management and reporting risks.
ii) Work with responsible parties to implement corrective actions to timely address and mitigate the identified issues/risks.
iii) Encourage communication and collaboration under the CFO's leadership to establish working level committees to resolve any identified accounting, financial management, and financial reporting issues.
iv) Involve other stakeholders such as key leaders from Acquisition, Logistics and Asset Management to collaboratively address financial management issues and develop risk mitigation strategies.
v) Provide the necessary financial management training and performance monitoring to continuously elevate the financial management capabilities and knowledge within VA.

We recommend that the VA Assistant Secretary for Management/CFO, in coordination with the Deputy Secretary:

4. Ensure that system modernization efforts address and support remediation of the material weaknesses, significant deficiencies, and system deficiencies identified in this report, as well meet all Federal system requirements.

We recommend that the Executive in Charge, VHA:

5. Evaluate the financial management reporting structure within VHA to ensure that the VHA CFO's office has the necessary authority to oversee all VHA accounting, budgeting, and financial management activities relating to all VHA programs and operations. The VHA CFO's responsibilities, in coordination with and in support of the VA CFO, should include the following:
   a) Developing and maintaining integrated accounting and financial management systems;
   b) Directing, managing, and providing policy guidance and oversight of all VHA financial management businesses processes, key financial activities, and operations;
   c) Approving and managing VHA financial management systems design and enhancement projects;
   d) Implementing VHA asset management systems, including systems for cash management, credit management, debt collection, and property and inventory management and control;
   e) Monitoring the financial execution of the VHA budget in relation to actual expenditures;
   f) Ensuring the proper and consistent implementation of corrective actions for key audit findings throughout VHA. Developing a financial management matrix and sharing its monitoring results with the field staff. Implementing follow-up actions to ensure corrective actions are taken in a timely manner;
   g) Providing timely and necessary communication and training to field staff and program offices; and
   h) Participating in the annual performance evaluation of the field staff when performance improvement is needed.

**EXHIBIT B**
**Significant Deficiencies**

## 1. Loan Guarantee Liability

***Background:***

VA's Home Loan Guaranty program provides a guaranty to commercial lenders against losses from veterans' mortgage loan defaults. VBA uses complex models (regression-based variable default model and cash flow-model) to estimate future cash flows over the life of the loans and determine the cost of these guarantees on a present value basis for budgetary and for financial reporting purposes. These models ultimately produce an estimate that is reported as the largest component of the Liability for Loan Guarantee (LLG) in the balance sheet.

VBA's OFM headed by VBA's CFO, is responsible for preparing the LLG estimate and maintaining the models. OFM considers its model to be an econometric model.

***Conditions:***

In FY 2018, VBA took several steps to improve its existing Variable Default Model (VDM) and Cash Flow model by addressing some of the model deficiencies we identified in prior years. Despite these improvements, major deficiencies remained as summarized in three main areas below:

A. VDM model assumptions and specification
- The VDM model is designed to estimate the probability of default at the loan cohort level. Specifically, cohorts are defined by the year of loan origination and the type of loan product (for example: ARM/Hybrid). The lack of loan level modeling to include location, mark-to-market and other underwriting characteristics at the individual loan level creates potential for bias and/or inefficiencies in assumptions. Forecasting estimates using loan-level data would allow for more robust modeling and the amount and timing of each cash flow.
- The model uses a moving average versus a predictive approach, where predictive models are able to factor in the fundamental drivers of the cash flows and cohort performance.
- VA changed from an Ordinary Least Squares (OLS) estimator to Logistic Regression (logit) estimator in FY 2018. Estimating the proportion of loan balances default at a cohort level is not an appropriate use of the logit estimator. As currently employed, the estimator is estimating the probability that the entire cohort defaults, which is an unlikely scenario representing a flawed estimation approach.
- The use of forecasting zero fee refunds is unjustified and undocumented making the use of this assumption within the estimate questionable.

B. The use of Excel to carry out complex modeling calculations and estimates
- Using Excel as the software package for specifying and executing the model is suboptimal in producing reliable reestimates.
- Excel's lack of efficiency makes evaluating the model unduly cumbersome. This methodology reduces the transparency and readability of the model, complicates error checking and makes sensitivity analysis difficult at best. As an example, we noted a formula error as a result of the size and complexity of the arrays and repeated calculations done across numerous sheets and cells within Excel. This increases the risk that errors will go undetected and the estimate is misstated.

C. Internal control
- The model documentation lacks information on why certain choices are made. For example, it does not provide justification for the selection or results of statistical tests used

to identify the functional form of the model and does not provide a basis for several management overrides. Also, the use of a 5-year moving average in several calculations is not justified through proper documentation or testing.

- VBA has improved its documentation by defining the processes for engaging and involving senior leadership outside of the budget office within OFM for critical decisions and oversight over various loan guarantee subsidy modelling activities, including; model development, risk assessment, assumption development and review, and model validation. However, there was limited evidence that these control activities were implemented and, in some cases, approvals were verbal where no evidence could be provided.
- Inadequate evidence documenting that the cash flow model is tested for reliability by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate program performance.

Without sufficient and appropriate documentation to support the assumptions used in the estimate, their use by management is not sufficiently supported, heightening the risk of management bias and potential misstatement.

***Criteria:***

Federal Financial Accounting and Auditing Technical Release (TR) No. 6*: Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, states that:

- Cash flow models should be tested for reliability as part of the approval process by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate a credit program's performance.
- Preparing reliable and timely direct loan and loan guarantee subsidy estimates must be a joint effort between the budget, CFO and program offices at each agency.
- *Special emphasis for programs that have peak periods* – Where applicable, an acceptable monitoring process should provide extra emphasis during periods when cohorts are experiencing significant increases or decreases in defaults, prepayments, recoveries, or other cash flows.
- If the most recent estimated cash flows of a cohort are different from the actual experience, these differences and the reasons for these differences may affect the future estimated cash flows of that cohort. The effects on the future cash flows of that cohort need to be assessed and included in the reestimate, and the reasons for the estimated effects need to be documented.
- Documentation must be provided to support the assumptions used by the agency in the subsidy calculations. This documentation will only facilitate the agency's review of the assumptions, a key internal control, it will also facilitate the auditor's review.
- Documentation should be complete and stand on its own, i.e., a knowledgeable independent person could perform the same steps and replicate the same results with little or no outside explanation or assistance.

***Cause:***

Management believes that it takes several years to implement the corrective actions related to the models and has been slow in addressing the issues noted in prior management communications.

***Effect:***

The deficiencies reported above may result in significant misstatement of the LLG liability and related accounts within the financial statements, and ineffective monitoring and oversight by those parties ultimately responsible for these estimates.

***Recommendations:***

We recommend that the Assistant Secretary for Management/CFO and the VBA CFO:

1. Evaluate the appropriateness of using the current Variable Default Model estimator.

2. As recommended in the VA LGY CLA FY 2017 Independent Assessment Report:
   a) Switch to loan level data as input to the default model versus at a cohort level.
   b) Include variables at the loan level to account for underwriting characteristics, geographic specific house price appreciation and mark-to-market loan-to-value.
   c) Switch from moving average to predictive model.
   d) Remove the fee assumption override as fee refunds historically occur beyond policy year 2 and forecasting zero fee refunds beyond policy year 2 may bias the LLG estimate.

3. Move from an Excel based model to using a statistical software package appropriate for estimating proportional probabilities.

4. Follow Appendix A: Acceptable Sources of Documentation for Subsidy Estimates and Reestimates, listed in the Federal Financial Accounting and Auditing Technical Release 3 (Revised): Auditing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform – Amendments to TR 3
   a) Include in the model documentation why certain choices are made. For example, provide justification for the selection or results of statistical tests used to identify the functional form of the model, and provide the basis for management overrides, including the use of a 5-year moving average.
   b) Include adequate evidence documenting the cash flow model is tested for reliability by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate program performance.

5. Implement a set of policies and procedures for a model risk management oversight and governance structure, with a control framework that defines the roles and responsibilities for program, budget, department and other government stakeholders. Ensure policies and procedures for management oversight and governance are evidenced with proper documentation and sign off.

6. Implement the remaining unresolved recommendations noted within the VA Budget Model Verification Report issued in FY 2017.

## 2. Procurement, Undelivered Orders, Accrued Expenses and Reconciliations

***Background:***

VA obligates its budgetary resources when it enters into a binding legal agreement, such as a contract with a third party, or through an estimation process using 1358s. After the receipt of goods and services or at the end of the agreement period, any previously obligated but undisbursed amounts, i.e., UDOs, should be de-obligated, enabling the unused funds to potentially become available for other agency program needs. When the unneeded obligations continue to remain on VA's books, they are considered to be inactive and invalid obligations.

## EXHIBIT B
## Significant Deficiencies

***Condition:***

VA's overall monitoring of obligations and accrued expenses needed improvement during FY 2018 as certain control deficiencies continued to exist. VA also does not sufficiently perform reconciliations of its feeder/subsidiary systems to FMS, and procurement issues related to financial reporting remained pervasive.

A. <u>Reconciliations</u>
VA utilizes the IFCAP and CAATS system to initiate and authorize requests for goods and services, monitor status of funds, establish obligations, confirm receipt of goods and services, and record vendor payments. In addition, VA also utilizes the Electronic Contract Management System (eCMS) to maintain procurement documentation. As reported in previous years and in the Financial Systems and Reporting material weakness, VA does not perform a complete reconciliation of all outstanding obligations and expenditures between IFCAP, CAATS, eCMS, and FMS at the transaction level. Not performing periodic cumulative reconciliations between these subsidiary systems and FMS increases the risk that all activities are not accurately reflected in the financial records, and ultimately, in the financial statements.

B. <u>Lack of Control Surrounding the Extensive Use of 1358s</u>
VA has used 1358s for over 60 years and utilizes them for the procurement of goods and services extensively. As of September 30, 2018, VA's obligations based on 1358s approximated $4 billion. VA allows 21 different categories of use, and they are integral to the operation of some large VA programs. In most cases, 1358s bypass conventional contracting controls by design, in order to support program circumstances or needs. Further, 1358 transactions were not closely monitored and validated by management to ensure recorded obligations and accrued expenses were not overstated.

C. <u>Lack of Comprehensive Look-back Analysis</u>
VA's accrued operating expenses are comprised of two components—invoices received but not yet paid, and goods and services received but not yet invoiced. VA estimates the amount of goods and services received but not yet invoiced using either an automatic calculation by FMS or a manual process. VA did not have an adequate process to validate these estimates against actual payment data from FMS throughout the period. A comprehensive look-back analysis or validation of its accrual methodology was not performed for the majority of the fiscal year which resulted in a significant manual adjustment of approximately $ 2.8 billion at year end to accurately report the Accounts Payable balance at September 30.

D. <u>Pervasive and Long-Standing Procurement Related Issues Affecting Financial Reporting</u>
We observed instances of the following across VA from our sample testing that affect the accuracy of financial reporting:

- Untimely liquidation of inactive UDOs – Delays ranged from four months to three years.
- Untimely recording of contracts or modifications into the general ledger system (FMS) – Delays ranged from approximately two months to eight months.
- Recording of obligations prior to contract execution – Obligations, including purchases through the National Acquisition Center (NAC), were recorded in FMS up to 1 year and 1 month prior to the execution of the contracts or contract amendments.
- Over-obligation of funds – Recorded obligations exceeded the contract or purchase order amounts.
- Proper procurement procedures were not followed in obtaining goods or services – We noted a variety of exceptions.

**EXHIBIT B**
**Significant Deficiencies**

***Criteria:***

The FMFIA requires agencies to implement controls that ensure obligations and costs are in compliance with applicable laws and that revenues and expenditures are properly recorded and accounted for to permit the preparation of reliable financial and statistical reports. According to 31 U.S.C. 1501 (a), an amount shall be recorded as an obligation of the United States Government only when supported by documentary evidence of a binding agreement between an agency and another person.

***Cause:***

These conditions were due to a highly decentralized organization accompanied by the lack of effective oversight and monitoring controls, system limitations, policy weaknesses, and lack of adequate training for personnel involved in the requisitions and financial reporting processes. Communication between business lines and administrative offices within VA did not always take place in a timely manner. In addition, an effective validation process for the accrued expenses balance, including a look-back analysis, was lacking.

***Effect:***

Material misstatements of obligations incurred, UDOs and accrued expenses may occur and not be detected timely as a result of these control weaknesses.

***Recommendations:***

We recommend that the Assistant Secretary for Management/CFO:

1. Work with OI&T to ensure the two-way interface of financial data between the procurement subsidiary systems and the general ledger system is part of the VA's ongoing systems modernization efforts. Develop common data elements and fields to facilitate the reconciliation and flow of information between the general ledger system and subsidiary procurement systems, including IFCAP, eCMS, and CAATS, to enable a consolidated and comprehensive reconciliation.

2. In coordination with appropriate procurement and program officials, assess whether key controls established for 1358 obligations, are adequately designed to ensure that the use of 1358s is extremely limited and for obligations immaterial in dollar amounts as the use of 1358s often bypasses the procurement processes outlined in the Federal Acquisition Regulation (FAR). In addition, establish controls to ensure that the responsibility of those utilizing 1358s is properly delegated to the appropriate officials as the obligation is similar to the financial responsibility associated with an executed contract.

3. Evaluate the design and execution of controls around the use of 1358s as follows:
   a) Work in coordination with the administrations to perform a complete assessment of existing goods and services procured through 1358s to determine whether contract execution/ratification is necessary.
   b) Include a standard methodology within policies and procedures that the users of 1358s should follow to support the amounts obligated by type of transaction, including guidance on how to perform a look-back analysis to ascertain the validity of the estimation process.
   c) Engage the help of the Office of Acquisition, Logistics, and Construction (OALC) and the Budget Office to review and develop policies and procedures for 1358s to ensure the documentation supports the use of 1358s and is compliant with VA's appropriations law and the FAR.

d) Work with OALC to establish the necessary acquisition structure and provide training to 1358 preparers and approvers on the use of contracts, inter-agency agreements, and reimbursable agreements in place of 1358s.
e) Establish a policy that requires the automatic liquidation of remaining balances on 1358s within a reasonable timeframe. In addition, this policy needs to be implemented in coordination with the automated accrual methodology within FMS to ensure the accrued expenses balance reflects the actual liability incurred and can be substantiated.

4. Closely monitor the use of 1358 obligations, particularly when the Form 1358 is used as a vehicle for recording inter-agency agreements. For any instances where the “MISCN” vendor code is associated with a Federal obligation, review transaction activity to ensure that the appropriate trading partner codes are used. If Federal trading partner codes are not associated with the obligation, evaluate for potential misclassification between Federal and non-Federal activity and evaluate the impact, if any, on VA’s GTAS reporting.

5. Perform monthly consolidated reconciliations of obligations and expenditures recorded in IFCAP, CAATS, eCMS, and FMS for all open documents to ensure the accounting information is valid and proper. Develop a plan to research and adjust the balances based on documentary evidence.

6. With respect to accrued expenses:
   a) Develop procedures for validating the completeness and accuracy of underlying data used in preparing the accrual estimate, including contract performance periods, an analysis of subsequent payments, and acceptable levels of precision.
   b) Develop a process to validate accounts payable accrual methodology by comparing the estimates with subsequent payments. Such validation should be performed for all program elements included in the accrual process and over a few years to show a trend of the estimates. Unusual fluctuations, if any, should be investigated and research conclusions documented.

We recommend that the Executive in Charge, VHA, the Under Secretary for Benefits, and the Principal Executive Director and Chief Acquisition Officer (CAO), OALC in coordination with the Assistant Secretary for Management/CFO:

7. Implement the existing procurement and contracting controls to ensure that all acquisitions, obligations, and procurement-related documents are maintained in accordance with the FAR to support acquisition decisions made by management and the obligation amount recorded in VA’s financial statements.
   a) Contracting personnel, along with each Administration’s CFO, should develop a process to periodically and proactively monitor all open projects in IFCAP, CAATS, etc. to ensure their understanding of the order’s status and determine the validity of the outstanding UDOs.
   b) Fiscal staff should work closely with Contracting to ensure that contract or purchase order modifications, if reasonably justified, are executed prior to the project end date previously agreed upon.

8. Continue to implement VA’s Financial Policies and Procedures to ensure the following:
   a) Dollar amounts in FMS accurately reflect the status of the obligation.
   b) Timeframe for the obligation recorded in FMS is valid (i.e., both the beginning and end dates are correctly reflected in the obligation).
   c) Obligations are supported by sufficient detail (documentary evidence), which should also include the project performance period in the contract/purchase order and in their

subsequent modifications to ensure proper accounting.

d) Obligations are reconciled to source documents, to include obligating documents, receiving reports, invoices and payments.
e) Aged obligations are valid and recorded correctly.

9. Strengthen controls to ensure that facility asset acquisition and planning is well-coordinated among all key parties involving capital asset management, construction and facilities management, contracting, logistics, fiscal service, etc., so that funds are obligated when the facility is ready to execute the service, construction, purchase, etc.; and that all relevant source documentation is maintained for the record (e.g., procurement files, signed contracts, etc.).

10. Provide the necessary periodic training and implement controls at the facility level to strengthen staff's knowledge and compliance with appropriations law, to reinforce the importance of reviewing the obligating documentation and relevant files, including invoices prior to payment certification, so that payments are made properly, recorded promptly, represent authorized services, and are posted to the correct obligation.

11. Implement controls to record transactions timely only based on executed contracts in FMS in the correct funding year and ensure that contractor performance does not begin without the official contract.

12. Establish an automatic notification mechanism in which the Contracting Officer's Representative and the Contracting Officer can receive advance notification upon the contract's expiration to renew, extend or close out the expiring contract before the performance period ends. Controls should be implemented to ensure timely processing of contract amendments so that contract performance periods remain current and accurate, and that inputs for calculating accruals and other contract milestones with financial impact are tracked appropriately.

13. Monitor active interagency and reimbursable agreements where a VA party is either the buyer or the seller to ensure timely and accurate recording of revenues, accounts receivable, obligations, undelivered orders, expenses, unfilled customer orders, etc.

We recommend that the Executive in Charge, VHA, the Under Secretary for Benefits, and the Principal Executive Director and CAO, OALC:

14. Ensure obligations are not being incurred without the bona fide need that derives from robust acquisition planning and procurement for services. In addition, work with NAC to ensure that high tech medical equipment acquisitions are executed in a timely manner, to prevent delinquent obligations or obligations that are unsupported by contract activity. Provide the necessary medical center training to ensure documentation for requisition requests is complete and compliant with NAC's procurement policies and procedures. Consider a mechanism to allow NAC to directly record obligations on medical center's books upon signing of the contract/purchase order with the vendor.

15. Implement reconciliation controls to ensure stations timely liquidate their excess obligations upon the issuance of NAC purchase orders so that the amounts obligated in VHA's account agree to the reimbursement amount to be paid to NAC.

**EXHIBIT C**
**Compliance Findings**

## 1. Noncompliance with FFMIA

### Financial Management Systems

VA's complex, disjointed, and legacy financial management system architecture has continued to deteriorate and no longer meets the increasingly stringent and demanding financial management and reporting requirements mandated by the Treasury and OMB. VA continues to be challenged in its efforts to apply consistent and proactive enforcement of established policies and procedures throughout its geographically dispersed portfolio of legacy applications and systems. As a result, VA's financial management systems do not substantially comply with the Federal financial management systems requirements and the USSGL at the transaction level, as required by FFMIA Section 803(a). These conditions should be read in conjunction with all material weaknesses reported in Exhibit A, including the data processing control environment reported in Material Weakness No. 3.

A. Federal Financial Management System Requirements

VA's core accounting system, FMS, was implemented in 1992. Since that time, Federal financial reporting requirements have become more complicated and the level of financial information needed by Congress and other oversight bodies has become increasingly demanding and complex. Some of the effects of FMS's limited functionality are described in the material weakness, "Financial Reporting." Due to these limitations, VA utilizes MinX to consolidate general ledger activities from FMS to produce auditable financial statements and GTAS trial balances. Further, each accounting period in MinX is independent and thus numerous manual JVs, reconciliations, and analyses must be reperformed and reentered in each period to produce VA's financial statements and GTAS trial balances. FMS's functionality limitations are further exacerbated due to the age of FMS.

As reported in previous years, complete and consolidated reconciliations between FMS and the following subsidiary/feeder systems were not performed throughout FY 2018:

- Electronic Contract Management System (eCMS). eCMS is an intranet-based contract management system mandated by VA policy. Source documentation of all actions pertaining to open-market procurements over $3,500 must be maintained in eCMS. However, VA does not utilize eCMS to electronically process the approval and reviews performed for its acquisitions. Obligation of funds and assignment of purchase order numbers are still performed in IFCAP.

  In addition, VA has not fully implemented a standard procurement file structure in eCMS to maintain acquisition documentation in a consistent and efficient manner. As a result, it was difficult at times to find acquisition documentation to support the procurement process followed by VA. The information in this system is incomplete and can be unreliable.

- *Veterans Health Information Systems and Technology Architecture (VistA).* VistA is VHA's decentralized system utilized for patient billing and collection transactions. Each medical center has its own instance of VistA that must be separately maintained and updated. VistA contains the detailed subsidiary records that support the FMS general ledger control accounts.

  In the case of the Medical Care Collections Fund (MCCF), VistA does not provide management with the ability to effectively and efficiently monitor MCCF activities at the transaction level. In particular, although billing and collection functions have been centralized at the Consolidated Patient Accounting Centers (CPACs), CPAC personnel still cannot generate combined reports for all the facilities under their purview. Reports are generated separately for individual medical centers, which leads to inefficiencies in operations and revenue management. Further, a nationwide report at a sufficient level of detail cannot be generated. For financial reporting, MCCF revenues are recorded in FMS through a lump-sum journal entry based on station-by-station data. This complicates reconciliation of revenue transactions to collections and the supporting audit trail. In addition, as VistA is not able to produce a consolidated accounts receivable aging report at a sufficient level of detail, management does not have the tools to properly assess the reasonableness of its allowance for loss provision or perform a retrospective analysis to ascertain the reasonableness of its allowance methodology.

- IFCAP *Integrated Funds Distribution Control Point Activity, Accounting and Procurement System (IFCAP)*. IFCAP is a module within *VistA* that is used by VHA, contracting officers, and other VA personnel to initiate and authorize purchase requisitions for goods and services, as well as to accumulate vendor invoices for payment. Further, transactions initiated and recorded in IFCAP cannot be centrally and completely reconciled to those in FMS or to the procurement source documentation maintained in the eCMS.

- *Fee Basis Claims System (FBCS)*. FBCS is used to manage the authorization and payment processes for VHA's Community Care programs. FBCS sits "on top" of VistA and is run in a decentralized manner similar to VistA. In addition, FBCS does not enable the end users to make adjustments to inpatient authorizations after the authorization is approved in FBCS. As a result, the system does not allow for upward or downward adjustments in estimates based on a patient's changing needs, causing reconciling items to permanently exist between FBCS and FMS. Further, automated and comprehensive nationwide reconciliations between authorizations initiated in FBCS and obligations recorded in FMS could not be performed due to the lack of system interface between FBCS and FMS, resulting in a wide variety of reconciliation issues.

Further, the following subsidiary systems do not have two-way interface among key systems that share financial data or with FMS:

- The Centralized Administrative Accounting Transaction System (CAATS)
- The Benefits Delivery Network (BDN)
- The Veterans Services Network (VETSNET)
- The interface from the Long Term Solutions (LTS) system to BDN is a one-way process. Education benefit payments were determined and processed in LTS and transferred through the system interface to BDN for payments by the VBA. However, the payment data in BDN did not feed back into LTS to show the entire history from eligibility and entitlement determinations, to actual payment processed. No reconciliation is performed to ensure consistency of relevant data in both systems.
- The Education Benefits for the various programs are processed using different applications (e.g., BDN, LTS, C-WINRS (system used to process chapter 31 benefits), FOCAS (system used for Flight on the Job Training program), TIMS (The Image Management System), etc.); some of which do not interface with FMS. Further, due to the limited functionality of these systems, intensive manual efforts are necessary to adjudicate and process education benefits. These manual processes create additional inherent risk and leave room for error.

Moreover, certain subsidiary systems were not integrated with each other resulting in additional manual input that produced inefficiencies and manual errors. For example, for veterans who submit applications for Education benefits through the VA Online Application System (VONAPP), the applications are scanned into TIMS and then manually input into LTS for the processing of each initial claim. The lack of information interface from VONAPP to LTS creates additional inherent risk and leaves room for manual input error.

B. <u>USSGL at the Transaction Level</u>
FMS did not substantially comply with the USSGL at the transaction level for the following:

- Certain USSGL transaction codes continue to be missing from FMS. For example, VA cannot record in its financial system USSGL transaction code A118. As a result, a workaround is required to put anticipated funds apportioned into the proper account 4590 - Apportionments - Anticipated Resources - Programs Subject to Apportionment.
- FMS does not allow for 6-digit USSGL account reporting as required by Treasury Financial Manual.
- FMS is outdated and unable to keep up with the existing Treasury reporting requirements.
  - ➢ The existing FMS posting logic was not updated for required Treasury account attributes established in the USSGL. As a result, work arounds were necessary to address missing required attributes defined by Treasury Financial Manual. An example of VA's work around is the modification of the FMS chart of accounts to incorporate letters and general ledger numbers in subsidiary ledger accounts to classify Federal and non-Federal transactions. However, mapping issues prevent the proper application of Federal and non-Federal attributes when a business event occurs. This situation created the need for VA to record significant journal vouchers.
  - ➢ FMS also lacks the appropriate edit checks to ensure the proper posting of intragovernmental transactions which results in significant trading partner-related adjustments as part of its GTAS submission to the Treasury.
  - ➢ The VA's GTAS trial balance for the FMS and MinX Charts of Accounts were not consistent with USSGL.
  - ➢ FMS commingled "Direct" and "Reimbursable" funds under a single fund code which have led to errors in the recording of transactions using reimbursable funds. For example, the USSGL account 3107, Unexpended Appropriations, and 5700, Appropriations Used accounts are improperly recorded against reimbursable transactions causing errors within the VA trial balance and the Cumulative Results of Operations and Unexpended Appropriations line items on the Statement of Changes in Net Position. Refer to the *Financial Systems and Reporting* material weakness for additional details of intragovernmental and budgetary to proprietary conditions.
  - ➢ Financial systems limitations resulted in the inaccurate reporting of Prior Year Recoveries. For example, an adjustment for approximately $68 million was recorded due to an internal reclassification of the obligation from stations. However, OMB Circular A-11, Preparation, Submission, and Execution of the Budget, Appendix F states that changes in budget/accounting structure within a TAFS are not to be treated as a downward adjustment. *See Financial Systems and Reporting* material weakness.

### 2. Noncompliance with FMFIA

VA management continues to make progress in FY 2018 by strengthening VA Administrations' use of the Entity Level Internal Control Assessment (ELICA) tool to assess VA wide entity level risk and to consolidate various on-going assessment efforts throughout VA to increase efficiency. However, according to management, efforts were invested in certain processes that will be impacted by the system modernization initiative.

The guidance established by OMB Circular A-136, *Financial Reporting Requirements*, identified the following assurances to be provided by management:

- Effectiveness and efficiency of internal control over programmatic operations (FMFIA § 2)
- Conformance with financial systems requirements (FMFIA § 4)
- Effectiveness of internal control over financial reporting (FMFIA § 2)
- A summary of material weaknesses (FMFIA § 2), instances of non-compliance (FMFIA § 4), a summary of the assurance (unmodified, modified, or no assurance), and a summary of corrective actions to resolve the material weaknesses and instances of non- compliance

We found the following areas in need of improvement in order to fully comply with the intent of FMFIA:

- VA did not implement best practices to use transactional level testing to support the assurance statements at the individual reporting entity level, which ultimately support the Secretary's assurance statement.
- Management continued to report internal control deficiencies (FMFIA §2 and §4) based on findings identified by the Office of Inspector General or other independent auditors.
- Material weaknesses were not properly identified by the VA Administrations along with their corrective actions.
- VA did not perform tests of effectiveness over all key cycles in FY 2018.
- VA's process for assessing and monitoring department-wide internal control of information and financial management systems continued to be ineffective. The previously reported material weakness in VA's IT security controls continues to exist in FY 2018.

**3. 38 USC 5315**

Consistent with previous years, our testing of a sample of receivables from debtors continued to note the following exceptions:

- In a sample of compensation and pension related receivables, 27 of 30 items tested still had a balance and were over 90 days delinquent at the time of testing. VBA did not charge interest on any of the delinquent receivables.
- In a sample of 15 education receivables, 13 of 15 items tested were outstanding over 90 days. VBA did not charge interest or administrative costs on any of the delinquent receivables.

The requirement to charge interest and administrative costs on receivables not paid "within a reasonable period of time" after notification is specified in 38 USC Sec 5315, *Interest and administrative cost charges on delinquent payments of certain amounts due the United States*. VA's policy to not charge interest has been long-standing and is based on a former VA Deputy Secretary's July 1992 instruction.

As a result of the directive, VA is noncompliant with 38 USC 5315.

**4. 38 USC 3733**

When a defaulted mortgage loan guaranteed by VA goes to foreclosure, the property associated with the loan may be conveyed by the lender back to VA. Properties conveyed to VA can then be sold for cash or sold by VA with VA "Vendee" Loan financing. VA offers Vendee loan financing as a tool to reduce the amount of time that property remains in its inventory, thereby reducing the cost of maintaining the property.

VA did not comply with 38 USC 3733, which requires VA to offer loan financing for the sale of no less than 50 percent of VA owned foreclosed properties for most of FY 2018. Potential borrowers did not have an opportunity to apply for approximately $4.4 billion in financing for foreclosed properties from FY 2013 through FY 2018. VA issued a stop-work order to its servicer on August 27, 2012, to stop the origination of Vendee loans until such time the stop-work order was lifted. VA completed the appropriate rulemaking to address issues that halted the vendee loan program in August 2017. However, the program did not go live until August 13, 2018.

**Other Matters**

**5. Actual and Potential Violations of the Antideficiency Act**

VA reported one violation of the Antideficiency Act, 31 U.S.C 1341 (a) in September 2018 and is in the process of reporting a second violation identified in FY 2018. In addition, VA identified five other violations which are carried forward from prior years and are under further discussion with OMB's Office of General Counsel (OGC).

**6. Noncompliance with Improper Payments Elimination and Recovery Act**

On May 15, 2018, the VA Office of Inspector General reported that VA did not fully comply in FY 2017 with the Improper Payments Elimination and Recovery Act, 31 U.S.C. 3321.

## EXHIBIT D
## Status of Prior Year Findings

Our assessment of the current status of the recommendations from the prior year audit is presented below.

| *Type of Finding* | *FY 2017 Finding* | *Fiscal Year 2018 Status* |
|---|---|---|
| Material Weakness | Compensation, Pension, Burial, and Education Actuarial Estimates | Repeat – See FY 2018 Material Weakness Finding 4 |
| Material Weakness | Community Care Obligations, Reconciliations, and Accrued Expenses | Repeat – See FY 2018 Material Weakness Finding 1 |
| Material Weakness | Financial Reporting | Modified Repeat – See FY 2018 Material Weakness Finding 2 |
| Material Weakness | Loan Guarantee Liability | Repeat – See FY 2018 Significant Deficiency Finding 1 |
| Material Weakness | CFO Organizational Structure | Modified Repeat – See FY 2018 Material Weakness Finding 5 |
| Material Weakness | Information Technology Security Controls | Repeat – See FY 2018 Material Weakness Finding 3 |
| Significant Deficiency | Procurement, Undelivered Orders, Accrued Expenses, and Reconciliations | Repeat – See FY 2018 Significant Deficiency Finding 2 |
| Compliance Finding | Noncompliance with FFMIA | Repeat – See Compliance Finding 1 |
| Compliance Finding | Noncompliance with FMFIA | Repeat – See Compliance Finding 2 |
| Compliance Finding | Noncompliance with 38 U.S.C. 5315 | Repeat – See Compliance Finding 3 |
| Compliance Finding | Non-compliance with 38 U.S.C. 3733 | Repeat – See Compliance Finding 4 |
| Compliance Finding | Actual and Potential Violations of the Antideficiency Act | Repeat – See Compliance Finding 5 |
| Compliance Finding | Noncompliance with Improper Payments Elimination and Recovery Act | Repeat – See Compliance Finding 6 |

# Section II

## Agency Comments

- A Message from VA's Secretary
- A Message from VA's Chief Financial Officer
- VA Response to the Auditors' Report

# A MESSAGE FROM VA'S SECRETARY

THE SECRETARY OF VETERANS AFFAIRS
WASHINGTON

November 26, 2018

To the President of the United States, President of the Senate, President Pro Tempore of the Senate, and Speaker of the House of Representatives:

This report highlights the Department of Veterans Affairs' (VA) accomplishments and challenges in providing health care and benefits delivery to our Veterans according to our duty to care for Veterans and their families. To accomplish this sacred mission, we provide timely access to health care and benefits for millions of Veterans. It is a responsibility that we do not take lightly.

During this last fiscal year, VA has made groundbreaking progress particularly in the areas of accountability, transparency, and efficiency across the Department while enjoying an unprecedented series of legislative successes. As part of this effort, the Department is tackling head-on issues that have lingered for years, including the following:

- Giving Veterans more choice in their health care decisions;
- Increasing accountability and protecting whistleblowers;
- Improving transparency by becoming the first hospital in the Nation to post online wait times, opioid prescription rates, accountability and settlement information, and chief executive travel;
- Adopting the same electronic health record as the Department of Defense (DoD), permitting seamless transfer of medical information for Veterans leaving the Armed Services;
- Establishing the first ever 24/7 White House VA Hotline that helps Veterans cut through red tape by giving them a direct, dedicated line to highly-trained, live agents, regardless of their needs and concerns; and
- Increasing suicide prevention and mental health care efforts working with DoD and other departments to develop a plan to ensure all new Veterans receive mental health care for at least 1 year following their separation from the service.

As VA Secretary, I will be focusing on the following priorities: customer service, electronic health record modernization, the Maintaining Internal Systems and Strengthening Integrated Outside Networks (MISSION) Act, and business transformation.

VA will focus on improving customer service not only to our external customers but to our employees. Customer service must start with VA employees talking with each other across all Staff Offices and Administrations. We will listen to each other so that we are better able to listen to our Veterans and their families so that we can provide the world-class customer service they deserve.

## A MESSAGE FROM VA'S SECRETARY

VA will modernize our electronic health record system to create a continuum of care among VA, the DoD, and private doctors. The new system will organize VA health care around our Veterans' needs while keeping VA at the center of their health care as well as make our delivery of services more efficient and timely.

Through this landmark legislation, the MISSION Act, VA will consolidate our community care efforts into a single program that is much easier to navigate for Veterans, families, VA employees, and community providers. The MISSION Act will ensure our Veterans receive the best health care possible, whether delivered in VA facilities or in the community. It will also improve Veterans benefits and services.

If VA is to move past compartmentalization of the past and empower our employees serving Veterans in the field to provide world-class customer service, business transformation is essential. This means reforming administrative systems to give those professionals more leeway to manage budgets; improve logistics and purchasing; and recruit, retain, and relocate the staff needed to serve Veterans. It also signifies entering into more robust partnerships with state and local communities to address Veteran homelessness.

CliftonLarsonAllen (CLA), an independent public accounting firm, reviewed our financial statements and provided an unmodified opinion for the 20th consecutive year, demonstrating VA's successful efforts to ensure that taxpayer resources are used effectively and efficiently in support of Veterans and their families. Although VA received an unmodified audit opinion, we must continue to improve our financial management in Fiscal Year (FY) 2019, as CLA identified a number of areas that require improvement within the Department.

Based on internal evaluations, I can provide reasonable assurance that the financial and performance information contained in this report is complete, reliable, and accurately describes VA's results for FY 2018. The Agency Performance Plan and Report, due in February 2019, will contain more detail on VA's performance measures. Caring for our Nation's Veterans is the highest honor and privilege for the men and women who serve VA. I thank you for consideration of our annual report and appreciate your continued support of our mission.

Sincerely,

Robert L. Wilkie

# A MESSAGE FROM VA'S CHIEF FINANCIAL OFFICER

DEPARTMENT OF VETERANS AFFAIRS
ASSISTANT SECRETARY FOR MANAGEMENT
WASHINGTON DC 20420

November 26, 2018

The VA is very pleased to have received its 20th consecutive unmodified ("clean") audit opinion on the Department's consolidated financial statements. The enclosed audit provides an assessment of the Department's financial performance and results. Entrusted to serve our Nation's 23 million living Veterans, as well as memorialize those who have died, we believe the Department must be transparent and accountable to Veterans and its broad community of stakeholders.

I am especially proud of VA's progress in its Financial Management Business Transformation (FMBT) initiative which will provide a modern financial and acquisition management solution with standardized business processes and reporting capabilities. These efforts reflect VA's commitment to increasing the transparency, accuracy, timeliness, and reliability of financial information across VA, resulting in improved fiscal accountability to American taxpayers and improved care and services to the Veteran.

In Fiscal Year (FY) 2018, VA faced a number of significant financial management challenges. Auditors noted five material weaknesses: IT Security Controls (repeat finding); Community Care obligations, reconciliations, and accrued expenses (repeat finding); Financial Systems and Reporting (repeat finding); Entity Level Controls including Chief Financial Officer organizational structure (repeat finding); and compensation, pension, burial, and education actuarial estimates (repeat finding).

It is important to note that some of these deficiencies are highly correlated to limitations in our current antiquated financial and acquisition systems, and complete resolution will only be possible upon the successful completion of FMBT.

VA was not in compliance with a number of laws, including the Federal Financial Management Improvement Act, Federal Manager's Financial Integrity Act of 1996, and Implementation of the Payments Elimination and Recovery Act (IPERA).

VA recognizes these significant challenges and is committed to working vigorously to improve its financial stewardship and has set ambitious goals designed to enhance performance.

Jon J. Rychalski

# VA RESPONSE TO THE AUDITORS' REPORT

DEPARTMENT OF VETERANS AFFAIRS
ASSISTANT SECRETARY FOR MANAGEMENT
WASHINGTON DC 20420

November 26, 2018

Larry Reinkemeyer
Assistant Inspector General for Audits and Evaluations
Department of Veterans Affairs
810 Vermont Avenue
Washington DC 20420

Dear Mr. Reinkemeyer,

We have reviewed the Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2018 and 2017 and are pleased with the receipt of an unmodified opinion. 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.

The Department's senior officials and I, as well as program managers in VHA, VBA, NCA, and affected Staff Offices are aware of the results of the audit. We will focus on developing remediation plans and taking corrective actions to address the findings and recommendations in your audit report.

Thank you again for your efforts in helping us reach another successful conclusion of the audit cycle.

Jon J. Rychalski

# Section III

## Financial Statements

- Financial Statements
- Notes to the Financial Statements
- Required Supplementary Stewardship Information (Unaudited)
- Required Supplementary Information (Unaudited)

## DEPARTMENT OF VETERANS AFFAIRS
## CONSOLIDATED BALANCE SHEETS (dollars in millions)
## AS OF SEPTEMBER 30, 2018 AND 2017

| | 2018 | 2017 |
|---|---|---|
| **Assets** | | |
| Intragovernmental | | |
| Fund Balance with Treasury (Note 3) | $ 66,099 | $ 52,928 |
| Investments (Notes 5 and 19) | 4,742 | 5,495 |
| Accounts Receivable (Note 6) | 29 | 31 |
| Other Assets | 1,246 | 601 |
| **Total Intragovernmental Assets** | **72,116** | **59,055** |
| Cash (Note 4) | 4 | 3 |
| Investments (Note 5) | 140 | 140 |
| Accounts Receivable, Net (Note 6) | 2,565 | 2,607 |
| Direct Loans and Loan Guarantees, Net (Note 7) | 1,336 | 1,453 |
| Inventory (Note 8) | 40 | 45 |
| General Property, Plant, and Equipment, Net (Note 9) | 26,479 | 25,922 |
| Other Assets | 65 | 37 |
| **Total Assets** | **$ 102,745** | **$ 89,262** |
| Heritage Assets (Note 10) | | |
| **Liabilities** | | |
| Intragovernmental | | |
| Accounts Payable | $ 213 | $ 281 |
| Debt (Note 11) | 539 | 564 |
| Other Liabilities (Note 15) | 4,484 | 3,018 |
| **Total Intragovernmental Liabilities** | **5,236** | **3,863** |
| Accounts Payable | 13,474 | 3,561 |
| Loan Guarantee Liability, Net (Note 7) | 8,722 | 10,568 |
| Federal Employee and Veterans Benefits (Note 13) | 3,024,368 | 2,863,110 |
| Environmental and Disposal Liabilities (Note 14) | 926 | 943 |
| Insurance Liabilities (Note 17) | 6,396 | 6,936 |
| Other Liabilities (Note 15) | 5,173 | 5,747 |
| **Total Liabilities** | **$ 3,064,295** | **$ 2,894,728** |
| Commitments and Contingencies (Note 18) | | |
| **Net Position** | | |
| Unexpended Appropriations – All Other Funds | $ 37,780 | $ 34,594 |
| Cumulative Results of Operations – Funds from Dedicated Collections (Note 19) | 868 | 823 |
| Cumulative Results of Operations – All Other Funds | (3,000,198) | (2,840,883) |
| **Total Net Position** | **(2,961,550)** | **(2,805,466)** |
| **Total Liabilities and Net Position** | **$ 102,745** | **$ 89,262** |

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

**DEPARTMENT OF VETERANS AFFAIRS**
**CONSOLIDATED STATEMENT OF NET COST (dollars in millions)**
**FOR THE PERIODS ENDED SEPTEMBER 30, 2018 AND 2017**

| | 2018 | 2017 |
|---|---|---|
| **Net Program Costs By Administration** | | |
| Veterans Health Administration | | |
| Gross Cost | $ 84,486 | $ 77,917 |
| Less Earned Revenue | (4,288) | (4,204) |
| Net Program Cost | 80,198 | 73,713 |
| Veterans Benefits Administration | | |
| Gross Cost | | |
| Program Costs | 105,761 | 101,703 |
| Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13) | 82,102 | 75,353 |
| Less Earned Revenue | (847) | (880) |
| Net Program Cost | 187,016 | 176,176 |
| National Cemetery Administration | | |
| Gross Cost | 332 | 354 |
| Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13) | - | (200) |
| Net Program Cost | 332 | 154 |
| Indirect Administrative Program Costs | | |
| Gross Cost | 2,107 | 2,154 |
| Less Earned Revenue | (372) | (469) |
| Net Program Cost | 1,735 | 1,685 |
| Net Program Costs by Administration Before (Gain)/Loss From Changes in Veterans Benefits Actuarial Assumptions | 269,281 | 251,728 |
| (Gain)/Loss From Changes in Actuarial Assumptions (Note 13) | 79,153 | 229,673 |
| **Net Cost of Operations** | **$ 348,434** | **$ 481,401** |

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 PERIOD ENDED SEPTEMBER 30, 2018

| | Funds from Dedicated Collections (Note 19) | All Other Funds | Consolidated Total |
|---|---|---|---|
| **Unexpended Appropriations** | | | |
| Beginning Balance | $ - | $ 34,594 | $ 34,594 |
| Beginning Balance, as adjusted | - | 34,594 | 34,594 |
| **Budgetary Financing Sources** | | | |
| Appropriations received | - | 195,552 | 195,552 |
| Appropriations transferred in/out | - | 131 | 131 |
| Other Adjustments | - | (2,182) | (2,182) |
| Appropriations Used | - | (190,315) | (190,315) |
| Total Budgetary Financing Sources | - | 3,186 | 3,186 |
| **Total Unexpended Appropriations** | - | 37,780 | 37,780 |
| **Cumulative Results of Operations** | | | |
| Beginning Balance | 823 | (2,840,883) | (2,840,060) |
| Beginning Balance, as adjusted | 823 | (2,840,883) | (2,840,060) |
| **Budgetary Financing Sources** | | | |
| Other adjustments | - | (16) | (16) |
| Appropriations used | - | 190,315 | 190,315 |
| Donations and forfeitures of cash and cash equivalents | 21 | - | 21 |
| Transfers in/out without reimbursement | (3,428) | 3,640 | 212 |
| **Other Financing Sources (Nonexchange)** | | | |
| Donations and Forfeitures of Property | 25 | - | 25 |
| Transfers In/Out Without Reimbursement | (12) | 21 | 9 |
| Imputed Financing | - | 2,752 | 2,752 |
| Other | - | (4,154) | (4,154) |
| Total Financing Sources | (3,394) | 192,558 | 189,164 |
| Net (Cost)/Benefit of Operations (Note 21) | 3,439 | (351,873) | (348,434) |
| Net Change | 45 | (159,315) | (159,270) |
| **Cumulative Results of Operations** | **868** | **(3,000,198)** | **(2,999,330)** |
| **Net Position** | **$ 868** | **$ (2,962,418)** | **$ (2,961,550)** |

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 PERIOD ENDED SEPTEMBER 30, 2017**

| | Funds from Dedicated Collections (Note 19) | All Other Funds | Consolidated Total |
|---|---|---|---|
| **Unexpended Appropriations** | | | |
| Beginning Balance | $ - | $ 32,920 | $ 32,920 |
| Beginning Balance, as adjusted | - | 32,920 | 32,920 |
| **Budgetary Financing Sources** | | | |
| Appropriations received | - | 187,396 | 187,396 |
| Appropriations transferred in/out | - | 137 | 137 |
| Other Adjustments | - | (8,940) | (8,940) |
| Appropriations Used | - | (176,919) | (176,919) |
| Total Budgetary Financing Sources | - | 1,674 | 1,674 |
| **Total Unexpended Appropriations** | - | 34,594 | 34,594 |
| **Cumulative Results of Operations** | | | |
| Beginning Balance | 865 | (2,537,446) | (2,536,581) |
| Beginning Balance, as adjusted | 865 | (2,537,446) | (2,536,581) |
| **Budgetary Financing Sources** | | | |
| Other adjustments | - | 325 | 325 |
| Appropriations used | - | 176,919 | 176,919 |
| Donations and forfeitures of cash and cash equivalents | 20 | - | 20 |
| Transfers in/out without reimbursement | (3,492) | 3,736 | 244 |
| **Other Financing Sources (Nonexchange)** | | | |
| Donations and Forfeitures of Property | 23 | - | 23 |
| Transfers In/Out Without Reimbursement | (10) | 30 | 20 |
| Imputed Financing | - | 2,583 | 2,583 |
| Other | - | (2,212) | (2,212) |
| Total Financing Sources | (3,459) | 181,381 | 177,922 |
| Net (Cost)/Benefit of Operations (Note 21) | 3,417 | (484,818) | (481,401) |
| Net Change | (42) | (303,437) | (303,479) |
| **Cumulative Results of Operations** | **823** | **(2,840,883)** | **(2,840,060)** |
| **Net Position** | **$ 823** | **$ (2,806,289)** | **$ (2,805,466)** |

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, 2018

| | Budgetary | Non-Budgetary Credit Reform Financing Account |
|---|---|---|
| **Budgetary Resources (discretionary and mandatory)** | | |
| Unobligated balance from prior year budget authority, net | $ 24,676 | $ 11,114 |
| Appropriations | 198,727 | - |
| Borrowing authority | - | 108 |
| Spending authority from offsetting collections | 5,541 | 4,704 |
| **Total Budgetary Resources** | **$ 228,944** | **$ 15,926** |
| | | |
| **Status of Budgetary Resources (Note 22)** | | |
| New obligations and upward adjustments (total) | $ 203,919 | $ 4,783 |
| Unobligated balance, end of year: | | |
| Apportioned, unexpired account | 21,846 | - |
| Unapportioned, unexpired accounts | 90 | 11,143 |
| Unexpired unobligated balance, end of year | 21,936 | 11,143 |
| Expired unobligated balance, end of year | 3,089 | - |
| Unobligated Balance, end of year (total) | 25,025 | 11,143 |
| **Total Status of Budgetary Resources** | **$ 228,944** | **$ 15,926** |
| | | |
| **Outlays, Net** | | |
| Outlays, net (total) (discretionary and mandatory) | $ 184,775 | $ 29 |
| Distributed offsetting receipts (-) | (3,789) | (2,477) |
| **Agency Outlays, net (discretionary and mandatory)** | **$ 180,986** | **$ (2,448)** |

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

## DEPARTMENT OF VETERANS AFFAIRS
## COMBINED STATEMENT OF BUDGETARY RESOURCES (dollars in millions)
## AS OF SEPTEMBER 30, 2017

| | Budgetary | Non-Budgetary Credit Reform Financing Account |
|---|---|---|
| **Budgetary Resources (discretionary and mandatory)** | | |
| Unobligated balance from prior year budget authority, net | $ 23,857 | $ 10,494 |
| Appropriations | 184,275 | - |
| Borrowing authority | - | 67 |
| Spending authority from offsetting collections | 5,530 | 4,879 |
| **Total Budgetary Resources** | **$ 213,662** | **$ 15,440** |
| | | |
| **Status of Budgetary Resources (Note 22)** | | |
| New obligations and upward adjustments (total) | $ 191,705 | $ 4,259 |
| Unobligated balance, end of year: | | |
| Apportioned, unexpired account | 18,977 | - |
| Unapportioned, unexpired accounts | 335 | 11,181 |
| Unexpired unobligated balance, end of year | 19,312 | 11,181 |
| Expired unobligated balance, end of year | 2,645 | - |
| Unobligated Balance, end of year (total) | 21,957 | 11,181 |
| **Total Status of Budgetary Resources** | **$ 213,662** | **$ 15,440** |
| | | |
| **Outlays, Net** | | |
| Outlays, net (total) (discretionary and mandatory) | $ 181,538 | $ (602) |
| Distributed offsetting receipts (-) | (3,785) | (1,703) |
| **Agency Outlays, net (discretionary and mandatory)** | **$ 177,753** | **$ (2,305)** |

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

# NOTES TO THE FINANCIAL STATEMENTS

## NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### A. ORGANIZATION

VA's mission is to serve America's Veterans, their dependents, and beneficiaries with dignity and compassion and to be their principal advocate in ensuring that they receive medical care, benefits, social support, and lasting memorials (38 U.S.C. Section 301(b) 2011). The Department is organized under the Secretary of Veterans Affairs (the Secretary or SECVA). The Secretary's office includes a Deputy Secretary and a Chief of Staff. SECVA has direct lines of authority over the Under Secretary for Health, the Under Secretary for Benefits, and the Under Secretary for Memorial Affairs. Additionally, seven Assistant Secretaries, an Inspector General, a General Counsel, and the Chairman of the Board of Veterans' Appeals support the Secretary.

### B. REPORTING ENTITY AND BASIS OF PRESENTATION

VA's Consolidated Financial Statements and the Combined Statement of Budgetary Resources (SBR) report all VA component activities. VA components are fully described in the Management's Discussion and Analysis of Section I. The consolidated financial statements meet the requirements of the CFO Act of 1990 and the Government Management Reform Act of 1994. The principal financial statements have been prepared to report the financial position and results of VA operations, pursuant to the requirements of 31 U.S.C. 3515(b). While the statements have been prepared from VA books and records in accordance with GAAP for Federal entities and the formats prescribed by 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 understanding 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, the results of all financial decisions reflected in these consolidated financial statements are not the sole decisions of VA as a stand-alone entity. VA's fiscal year end is September 30.

The Statement of Federal Financial Accounting Standards (SFFAS) No. 47, *Reporting Entity*, is effective for periods beginning after September 30, 2017. The standard establishes principles to identify organizations for which elected officials are accountable and guides preparers of general purpose Federal financial reports in determining what organizations to report upon, whether such organizations are considered "consolidation entities" or "disclosure entities," and what information should be presented about those organizations.

The standard also requires information to be provided on related-party relationships. VA has relationships with many organizations from non-profits to special interest groups that provide support to VA and advocacy for Veterans. However, none of VA's relationships is of such significance as to warrant separate or individual disclosure as specified in SFFAS No. 47.

Public Law (P.L.) 100-322, now codified at sections 7361-66 of title 38, U.S.C., permits the SECVA to authorize the establishment of Nonprofit Research and Education Corporations at VA medical centers.

## C. 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. 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 Statement 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 Sheet, Statement of Net Cost, and Statement of Changes in Net Position. To prepare reliable consolidated financial statements, transactions occurring among VA components must be eliminated. All significant intra-entity transactions are eliminated from VA's consolidated financial statements. However, to remain consistent with the aggregate of the account-level information presented in budgetary reports, the Statement of Budgetary Resources is not consolidated but combined; therefore, elimination of intra-entity transactions is not permitted.

## D. 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 intragovernmental 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 Statement of Budgetary Resources is the basic financial statement that reports the Department's budgetary resources, status of budgetary resources, and outlays, net for the 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 Statement of Budgetary Resources are included in the Required Supplementary Information (RSI) section on the Schedule of Budgetary Activity shown by major account. The Statement of Budgetary Resources is prepared on a combined basis, not a consolidated basis, and therefore, does not include intra-entity eliminations.

See Note 22 for further disclosure on budgets and budgetary accounting.

## E. REVENUES AND OTHER FINANCING SOURCES

VA collects revenues for both exchange and non-exchange activities. Recognition of these revenues is based upon the exchange versus non-exchange determination and is further discussed below.

Exchange revenue is an inflow of resources to VA that is recognized when earned from exchange transactions with other Federal agencies or the public where each party to the transaction sacrifices value and receives value in return. Exchange revenues are discussed further in Note 20, Exchange Transactions.

Non-exchange revenue is an inflow of resources to VA that is recognized when VA establishes a specifically identifiable, legally enforceable claim to cash or other assets, to the extent that collection is probable and the amount is measurable, from non-exchange transactions with other Federal agencies or the public where VA does not give value directly in exchange for the inflow of resources.

VA receives non-exchange revenue in the form of voluntary donations or has the power to demand or compel payment in the form of a penalty. Non-exchange revenue consists primarily of imputed financing, but also includes forfeitures of property, donations, and transfers in/out without reimbursement. 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).

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, U.S.C., 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 Code of Federal Regulations (CFR) 17.101. Under this methodology, the billable amounts for services provided by VA represent the 80$^{th}$ 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 1, and nationwide average rates for billable amounts for outpatient and professional care are updated annually effective January 1. The updated charges are published by a Notice in the Federal Register, and the charges are available on the VHA Office of Community Care (OCC) website under Reasonable Charges Rules, Notices, and Federal Register Information or https://www.va.gov/COMMUNITYCARE/revenue_ops/payer_rates.asp. 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 consists of benefits revenue from reimbursement of education benefit programs from Servicemember 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.

## F. TRANSFERRING BUDGET AUTHORITY TO OTHER AGENCIES

VA, as the transferring (parent) entity, is a party to allocation transfers with the Department of Defense (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.

## G. FUND BALANCE WITH TREASURY

Treasury performs cash management activities for all Federal Government agencies. The fund balance with Treasury (FBWT) represents VA's right to draw funds from the Treasury for allowable expenditures. These balances in Note 3 are reconciled to Treasury and primarily consist of trust, revolving, special, and appropriated funds.

## H. INVESTMENTS

Investments are reported in Note 5 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. Interest rates for Treasury special securities are initially set based on average market yields for comparable Treasury issues. See Note 19 for additional disclosure of Treasury securities in funds from dedicated collections.

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.

## I. ACCOUNTS RECEIVABLE

Accounts receivable are reported in Note 6 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 contractual nature of the balance due and VA's historical experience with collection efforts including a rolling 12-month analysis. 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.

Overpayments to Veterans/beneficiaries are the main cause of Compensation, Pension and Education receivables.

VA is required by P.L. 96-466 to charge interest and administrative costs on benefit debts similar to charges levied on other debts owed the Federal Government. VA's current practice 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. Such debts are derived from overpayments to Veterans and beneficiaries.

## J. DIRECT LOANS AND LOAN GUARANTEES

Direct loan obligations and loan guarantee commitments made after FY 1991, are governed by the Federal Credit Reform Act of 1990 (the Credit Reform Act). The financial statement disclosures herein (Note 7) are in accordance with SFFAS 2, *Accounting for Direct Loans and Guarantees*; SFFAS 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees;* and SFFAS 19, *Technical Amendments to Accounting Standards for Direct Loans and Loan Guarantees*. 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 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 re-estimates of interest rates, and application of loan technical/default provisions approved by OMB.

When the present value of cash inflows is less than the present value of cash outflows, a subsidy cost is incurred and reported as an allowance for subsidy costs, reducing direct loans and guaranteed loans receivable reported in the 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 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 re-estimates of interest rates, and application of loan technical/default provisions approved by OMB.

Direct loans obligated before October 1, 1991, are not subject to the Credit Reform Act and are recorded at the net realizable value given the remaining balance of amounts disbursed plus accrued and unpaid interest receivable. The allowance for loan losses on direct loans obligated before October 1, 1991, 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 re-estimated each year as of the date of the financial statements. Loan losses are re-estimated 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.

## K. PROPERTY, PLANT, AND EQUIPMENT (PP&E)

VA has a significant construction 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 for each type of project, as authorized, for major and minor construction and non-recurring maintenance projects.

Construction project costs are recorded in construction work-in-process (WIP) accounts. The assets are transferred to either capitalized or noncapitalized 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 $1 million or greater. Buildings are depreciated on a straight-line basis over estimated useful lives of 25 to 40 years. Equipment is depreciated on a straight-line basis over its useful life, usually 5 to 20 years.

Internal use software (IUS) is also subject to the $1 million threshold for capital assets. The costs subject to capitalization are incurred during the software development phase. 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. The useful life regarding capitalization of IUS is determined on a per project basis, no less than two years, and consistent with the solution's longevity as limited by legal, regulatory, and/or contractual provisions.

A summary of PP&E components is reported in Note 9.

## L. OTHER ASSETS

Intragovernmental other assets are reported at cost, consist primarily of intragovernmental advances, and are principally advances to the U.S. Army Corps of Engineers and the General Services Administration (GSA).

Public other assets are reported at cost and consist of public advance payments made by VHA mostly 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.

## M. ACCOUNTS PAYABLE

Accounts payable are amounts owed by VA for goods and services received, progress in contract performance, and rents due. Accounts payable also include payables to Veterans such as scheduled compensation, pension, and education benefits. When VA accepts title to goods, whether the goods are delivered or in transit, or incurs costs for services received, VA recognizes a liability for the unpaid amount of the goods and services. If invoices for those goods and services are not available when financial statements are prepared, the amounts owed are estimated.

Accounts payable also include payables to Veterans such as scheduled compensation, pension, and education benefits incurred on the last day of the month. Significant variances can occur from year to year depending on the timing of compensation and pension benefit payments. By law these monthly recurring payments are due on the first day of the month, unless that day is a Saturday, Sunday, or Federal Holiday per 38 U.S.C. Section 5120 (e). When the first falls on a weekend or Federal Holiday, payments are made on the last working day of the benefit month. FY 2018 payments were made on Monday, October 1; whereas, FY 2017 payments were made on Friday, September 29. This is the primary reason for the accounts payable liability increase in FY 2018.

Accruals for VHA's OCC are developed by utilizing predictive analysis of subsequent disbursement data, performing historical trend analysis (or lag analysis), monthly Incurred But Not Reported (IBNR) reports from major VA service providers, and consideration of current fiscal year expenditure activity. For VA Community Care, the lag analysis is based on historical trends of quarterly disbursement activity used to forecast the accrual. For VA Choice, a methodology is established to ensure accrued expense amounts correspond to and are supported by the IBNR reports, VA obligations, invoices billed by the providers but not yet processed, and monthly provider agreement expenditures. Accruals are made monthly and are covered by budgetary resources.

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.

## N. INSURANCE LIABILITIES

Insurance liabilities in Note 17 for VA's life insurance programs include policy reserves, unearned premiums, insurance dividends left on credit or deposit and related interest payable, accrued interest payable on insurance policies, dividends payable to policyholders, and unpaid policy claims. There were no changes in the assumptions from prior year for the insurance reserves.

United States Government Life Insurance (USGLI) permanent plan policy reserves are based on the American Experience Table with 2.0 percent interest and are held on a net single premium basis.

National Service Life Insurance (NSLI) basic policy reserves for permanent plans are based on the American Experience Table with 3.0 percent interest, except for the modified life plans, which are based on the 1958 Commissioner's Standard Ordinary (CSO) Basic Table with 3.0 percent interest, and paid-up additions purchased by dividends, which are based on the 2001 Valuation Basic Male (VBM) Table with 3.0 percent interest. The reserve for term policies is based on the 2001 VBM Table with 3.0 percent interest and the age 70 rate (the capped premium) of $6.18 per month per $1,000 face amount.

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 2001 VBM Table with 4.0 percent interest. The reserve for term policies is based on the 2001 VBM Table with 4.0 percent interest and the age 70 rate (the 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 4.0 percent interest for "J," the 1958 CSO Basic Table and 4.0 percent interest for "JR," and 150 percent of the 1958 CSO Basic Table and 4.0 percent interest for "JS."

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 five-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.

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 comprises 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 FY 2018 and FY 2017, the interest rates ranged from 3.5 percent to 4.25 percent.

The SECVA 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 both FY 2018 and FY 2017, a discount rate of 3.0 percent for NSLI, 2.0 percent for USGLI, and 4.0 percent for VSLI and VRI, along with the appropriate accrual factor was used. 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.

The financial statement disclosures herein (Note 17) are in accordance with SFFAS 5, *Accounting for Liabilities*.

### O. ANNUAL LEAVE

Federal employees' annual leave (reported in Note 15) 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 nonvested 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.

### P. 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 comprises 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 (reported in Note 15), and (2) the actuarial liability for compensation cases to be paid beyond the current year (reported in Note 13).

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.

### Q. 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 (reported in

Note 13). Factors used in the calculation of these pension, 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 contributes 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.

## R. 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, COLA, presumptive service conditions resulting in disability benefits coverage, and life expectancy impact the amount of the liability.

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 estimated changes in the number of participants covered (enrollment) such as deaths, new cases, and changes in degree of disability during the fourth 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 FY 2018, valuation techniques or their application used to measure the fair value of the actuarial liabilities are consistently applied compared to the previous year.

For eligible Veterans and their dependents, the VA provides four unique education/retraining programs:

- Post-9/11 GI Bill (Chapter 33);
- Montgomery GI Bill Active Duty (Chapter 30);
- Vocational Rehabilitation and Employment (Chapter 31); and
- Dependents Education Assistance (Chapter 35).

The liability for future education benefits is reported on VA's balance sheet at the present value of expected future payments, and is developed on an actuarial basis. FY 2017 was the first year that VA reported actuarial liability for Montgomery GI Bill Active Duty, Vocational Rehabilitation and Employment, and Dependents Education Assistance. VA first reported actuarial liability for Post-9/11 GI Bill at the end of FY 2016. Various assumptions in the actuarial model, such as the total number of Veterans with entitlement, average usage of entitlement, the program stop and restart rate, the number of Veterans and dependents receiving payments, and discount rates adjustments impact the amount of the liability.

Estimated liabilities for the Post-9/11 GI Bill obligations in the financial statements are measured on the academic year of August 1 to July 31, adjusted for known material changes. Since the Post-9/11 GI Bill dropout assumption rates were derived on an academic year basis, the estimated liabilities are measured on an academic year basis instead of a fiscal year basis. Estimated liabilities for the all other education obligations in the financial statements are as of the end of the fiscal year based on June 30th beneficiary data that is adjusted for known material changes during the fourth quarter. The method used to measure the liabilities provides for consistency in the underlying relationship between discount rate, and the other economic assumptions.

From time to time, VA may determine it is preferable to make refinements to the valuation techniques or their application used to measure the present value of the actuarial liabilities because VA management concludes that the resulting measurements are equally or more representative of present value of the actuarial liabilities in the circumstances and are due to improved computer software modeling capability and/or improved information. The resulting changes in present 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.

All the projected liabilities do 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 Statement of Net costs.

The financial statement disclosures herein (Note 13) are in accordance with SFFAS 33, *Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting Gains and Losses from Changes in Assumptions, and Selecting Discount Rates and Valuations Dates*.

## S. COMMITMENTS AND 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 resolution 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, Commitments and Contingencies.

## T. 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.

### U. SUBSEQUENT EVENTS

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

## NOTE 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 included in FBWT, downward re-estimates 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 balance sheet for the non-entity assets reported below. Offsetting liabilities are included in intragovernmental accounts payable and other liabilities, along with public accounts payable, insurance liabilities, and other liabilities. There is no balance in the consolidated net position from the non-entity assets.

**Non Entity Assets (dollars in millions)**
**As of September 30, 2018 and 2017**

| | | 2018 | | 2017 |
|---|---|---|---|---|
| Intragovernmental: | | | | |
| Fund Balance with Treasury | $ | 170 | $ | 146 |
| Accounts Receivable | | 13 | | 13 |
| Total Intragovernmental | $ | 183 | $ | 159 |
| | | | | |
| Accounts Receivable | | 48 | | 47 |
| **Total Non-Entity Assets** | | **231** | | **206** |
| **Total Entity Assets** | | **102,514** | | **89,056** |
| **Total Assets** | **$** | **102,745** | **$** | **89,262** |

## NOTE 3. FUND BALANCE WITH TREASURY

Funds with Treasury primarily represent trust, revolving, appropriated, and special funds.

Trust fund balances consist primarily of amounts related to the Post-Vietnam Veterans Educational Assistance Program Trust Fund, NSLI Fund, USGLI Fund, VSLI Fund, General Post Fund, and National Cemetery Gift Fund. The use of these funds is restricted.

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

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 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 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. Examples include medical services, major construction, and Veterans Choice funds.

The Status of Fund Balance with Treasury represents VA's unobligated balances, obligated balances, deposit funds, clearing accounts, unavailable general funds receipts, and unavailable receipts accounts. The SF-133, Report on Budget Execution and Budgetary Resources, allows the monitoring of the status of funds that are apportioned. As such, the status of obligations presented in the following schedule is derived from the SF-133. The obligated and unobligated balances reported on the SF-133 are supported by FBWT, as well as other budgetary resources that do not affect FBWT, primarily special funds, general receipts, and medical care funds.

**Fund Balance with Treasury (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 |
|---|---|---|
| **Status of Fund Balance with Treasury** | | |
| Unobligated Balance | | |
| Available | $ 20,238 | $ 16,179 |
| Unavailable | 13,559 | 14,369 |
| Obligated Balance Not Yet Disbursed | 31,799 | 21,932 |
| Deposit funds, clearing accounts and unavailable general fund receipts | 219 | 176 |
| Unavailable Receipts Account | 284 | 272 |
| **Fund Balance with Treasury** | **$ 66,099** | **$ 52,928** |

## NOTE 4. CASH

Cash consists of Veterans Canteen Service and Agent Cashier advances at VA field stations. Treasury processes all other cash receipts and disbursements.

| Cash (dollars in millions)<br>As of September 30, 2018 and 2017 | 2018 | 2017 |
|---|---|---|
| **Cash** | | |
| Canteen Service | $ 3 | $ 2 |
| Agent Cashier Advance | 1 | 1 |
| **Total Cash** | **$ 4** | **$ 3** |

## NOTE 5. INVESTMENTS

Treasury Securities, which comprise most of VA's investments, are non-marketable special bonds and notes. Special bonds, which mature during various years through 2033, are generally held to maturity unless needed to finance insurance claims and dividends. None of the Special bonds has been reclassified as available for sale or early redemption, nor are there any permanent impairments on these investments. Treasury notes help finance operations and events supported by the General Post Fund for the benefit of Veterans and their beneficiaries.

Public securities consist of Loan Guarantee Program investments in housing trust certificates.

| Investments (dollars in millions) As of September 30, 2018 | Cost | Amortization Method | Amortized (Premium)/ Discount | Interest Receivable | Investments, Net | Market Value Disclosure |
|---|---|---|---|---|---|---|
| **Treasury Securities (Note 19)** | | | | | | |
| Special Bonds | $4,605 | N/A | $ - | 46 | 4,651 | $ 4,651 |
| Notes | 91 | Effective Interest | (1) | 1 | 91 | 91 |
| **Total** | **4,696** | | **(1)** | **47** | **4,742** | **4,742** |
| **Public Securities** | | | | | | |
| Trust Certificates (Loan Guaranty) | 140 | N/A | - | - | 140 | 140 |
| **Total** | **$ 140** | | **$ -** | **-** | **140** | **$ 140** |
| **As of September 30, 2017** | | | | | | |
| **Treasury Securities (Note 19)** | | | | | | |
| Special Bonds | $5,333 | N/A | $ - | 53 | 5,386 | $ 5,386 |
| Notes | 109 | Effective Interest | (1) | 1 | 109 | 109 |
| **Total** | **5,442** | | **(1)** | **54** | **5,495** | **5,495** |
| **Public Securities** | | | | | | |
| Trust Certificates (Loan Guarantee) | 140 | N/A | - | - | 140 | 140 |
| **Total** | **$ 140** | | **$ -** | **-** | **140** | **$ 140** |

## NOTE 6. ACCOUNTS RECEIVABLE, NET

Accounts receivable consist of intragovernmental 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 consist 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 and medical research.

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, 2018 and

2017, respectively. The total Compensation, Pension and Education adjustments and allowance for loss provision as a percentage of total public accounts receivable was approximately 58 percent and 39 percent at September 30, 2018 and 2017, respectively.

Effective with FY 2018 reporting, a separate disclosure is required for criminal restitution amounts included in accounts receivable. This includes the gross amount of receivables related to monitored criminal restitution orders, and the estimate of net realizable value determined to be collectible for monitored criminal restitution orders. VA's FY 2018 accounts receivable includes $53 million related to monitored criminal restitution orders, for which an estimate of net realizable value is currently undeterminable but is considered negligible.

**Accounts Receivable, Net (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 |
|---|---|---|
| **Intragovernmental Accounts Receivable** | **$ 29** | **$ 31** |
| **Accounts Receivable** | | |
| Medical Care | $ 3,159 | $ 3,162 |
| Contractual Adjustment and Allowance for Loss Provision | (1,536) | (1,568) |
| Net Medical Care | 1,623 | 1,594 |
| Compensation and Pension | 1,432 | 1,511 |
| Allowance for Loss Provision | (698) | (862) |
| Net Compensation and Pension | 734 | 649 |
| Education Benefits | 601 | 494 |
| Allowance for Loss Provision | (474) | (210) |
| Net Education Benefits | 127 | 284 |
| Other | 107 | 102 |
| Allowance for Loss Provision | (26) | (22) |
| Net Other | 81 | 80 |
| Total Accounts Receivable | 5,299 | 5,269 |
| Total Contractual Adjustment and Allowance for Loss Provision | (2,734) | (2,662) |
| **Accounts Receivable, Net** | **$ 2,565** | **$ 2,607** |

# NOTE 7. DIRECT LOANS AND LOAN GUARANTEES

The accounting for direct loans and loan guarantees made after FY 1991 is governed by the Credit Reform Act.

VA operates the following direct loan and loan guarantee programs:

| Program Name | Program Group | Program Type |
|---|---|---|
| Vendee Loans | Home Loan | Direct |
| Acquired Loans | Home Loan | Direct |
| Native American Direct Loans | Home Loan | Direct |
| Housing Guaranteed Loans | Home Loan | Guarantee |
| Vocational Rehabilitation and Employment | Other | Direct |
| Insurance | Insurance | Direct |
| Loan Sale Guarantees | Loan Sale Guarantees | Guarantee |

## LOAN PROGRAMS

### HOME LOANS

The VA Home Loan Program is the largest of the VA loan programs. The Home Loan Program provides loan guarantees and direct loans to Veterans, Servicemembers, qualifying dependents, and limited non-Veterans to purchase homes and retain homeownership with favorable market terms.

Vendee loans are direct loans issued to a third-party borrower for the acquisition price of foreclosed real estate. VA acquires the foreclosed property from a private sector mortgage lender upon default of a loan subject to the VA Loan Guarantee Program.

Acquired loans are VA guaranteed loans in default that VA purchases from the private sector mortgage lender. VA subsequently services the loan directly with the Veteran after VA determines the Veteran can meet debt payments.

Native American direct loans are special financing loans that enable Native Americans to purchase or construct a home on federally-recognized trust land.

Under the Home Loan Guarantee 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 that 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 operates in the broader mortgage marketplace; as a result, the VA housing program is affected by overall housing market conditions. The current mortgage market has demonstrated steady improvements, and homeowner equity is recovering. For the most part, 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. The Economic Growth Regulatory Relief, and Consumer Protection Act (P.L. 115-174) was signed into law on May 24, 2018 which may limit the options Veterans have to utilize their home loan refinancing benefits. For example, borrowers must be able to recoup upfront fees in the form of lower monthly payments within 36 months; interest rates on refinances must be a certain minimum level below the rate of the original loan; and lenders are required to provide borrowers with net tangible benefit tests demonstrating that borrowers would benefit from home loan refinancing.

### VOCATIONAL REHABILITATION AND EMPLOYMENT LOANS

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. The loans receivable balances as of September 30, 2018, and September 30, 2017 were $0.6 million and $0.7 million, respectively. Due to the immaterial amounts, these loans are not included in the tables throughout this note.

### INSURANCE POLICY LOANS

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.

### LOAN SALE GUARANTEES

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 has the authority to bundle these 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 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.

## LOANS RECEIVABLE

Loans receivable consist of direct loans and defaulted guaranteed loans receivable. The loans receivable is secured by the underlying real estate and insurance policies, with the exception of loans obligated prior to FY 1992.

Prior to November 2, 1987, life insurance policy loans were issued at fixed rates depending on the fund and time period. The fixed rate loans that remain are at 4.0 percent and 5.0 percent. All policy loans issued since November 2, 1987, have a variable interest rate with a minimum of 5.0 percent and a maximum of 12 percent. Rate changes are tied to the 10-year constant maturity of the U.S. Treasury Securities Index and may only change on October 1. The variable rate has been 5.0 percent since October 1, 2001.

The recorded value of loans receivable, net, and the value of assets related to 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, which will result in a realized gain or loss on sale.

The amount of new direct loans disbursed as of September 30, 2018, and September 30, 2017, was $53 million and $55 million, respectively.

An analysis of loans receivable and the nature and amounts of the subsidy costs associated with the loans is provided in the table that follows:

**Loans Receivable and Related Foreclosed Property from Direct and Guaranteed Loans**
**(dollars in millions)**
**As of September 30, 2018**

| | Loans Receivable, Gross | Interest Receivable | Allowance for Loan Losses | Allowance for Subsidy Cost (Present Value) | Foreclosed Property | Value of Assets Related to Loans, Net |
|---|---|---|---|---|---|---|
| **Loans Obligated Prior to FY 1992 (Allowance for Loan Loss Method)** | | | | | | |
| Direct Home Loans | $ 1 | 9 | - | - | - | $ 10 |
| Defaulted Guaranteed Home Loans | 16 | - | (15) | - | 1 | 2 |
| **Loans Obligated After FY 1991 (Present Value Method)** | | | | | | |
| Direct Home Loans | 370 | 22 | - | 29 | 2 | 423 |
| Defaulted Guaranteed Home Loans | 4 | - | - | - | 667 | 671 |
| Direct Insurance Policy Loans | 224 | 6 | - | - | - | 230 |
| **Total Loans Receivable** | **$ 615** | **37** | **(15)** | **29** | **670** | **$ 1,336** |

**Loans Receivable and Related Foreclosed Property from Direct and Guaranteed Loans**
**(dollars in millions)**
**As of September 30, 2017**

| | Loans Receivable, Gross | Interest Receivable | Allowance for Loan Losses | Allowance for Subsidy Cost (Present Value) | Foreclosed Property | Value of Assets Related to Loans, Net |
|---|---|---|---|---|---|---|
| **Loans Obligated Prior to FY 1992 (Allowance for Loan Loss Method)** | | | | | | |
| Direct Home Loans | $ 2 | - | - | - | - | $ 2 |
| Defaulted Guaranteed Home Loans | 20 | - | (18) | - | 1 | 3 |
| **Loans Obligated After FY 1991 (Present Value Method)** | | | | | | |
| Direct Home Loans | 403 | 24 | - | 33 | 3 | 463 |
| Defaulted Guaranteed Home Loans | 4 | - | - | - | 727 | 731 |
| Direct Insurance Policy Loans | 248 | 6 | - | - | - | 254 |
| **Total Loans Receivable** | **$ 677** | **30** | **(18)** | **33** | **731** | **$ 1,453** |

Direct home loans obligated prior to FY 1992 consist of Vendee and Acquired loans. Direct home loans obligated after FY 1991 consist of Vendee, Acquired, and Native American Housing loans. Pre-FY 1992 defaulted guaranteed home loans consist of Veterans Housing Benefit loans. Post-FY 1991 defaulted guaranteed home loans consist of Housing Loans For Homeless Veterans and Veterans Housing Benefit loans.

## 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 a delegated Staff Appraisal Reviewer to substantiate the fair market value. To determine the net value of the property, VA costs (e.g., 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 U.S. 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 period ended September 30, 2018 and September 30, 2017.

As of September 30, 2018, and September 30, 2017, the number of residential properties in VA's inventory was approximately 5,365 and 6,285, respectively. For both FY 2018 and 2017, the average holding period from the date properties were conveyed to VA until the date properties were sold was approximately 6 months. The number of properties for which foreclosure proceedings are in process was approximately 39,501 and 40,741 as of September 30, 2018, and September 30, 2017, respectively.

## ALLOWANCE FOR SUBSIDY FOR DIRECT LOANS (POST-FY 1991)

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.

| Schedule for Reconciling Subsidy Cost Allowance Balances (dollars in millions) As of September 30, 2018 and 2017 | 2018 | 2017 |
|---|---|---|
| **Allowance balance as of October 1,** | **$ (33)** | **$ (24)** |
| Add: Subsidy expense for direct loans disbursed during the reporting years by component: | | |
| Interest rate differential costs | (1) | (2) |
| Default costs (net of recoveries) | 1 | 1 |
| Fees and other collections | - | - |
| Other subsidy costs | - | - |
| **Total of the above subsidy expense components** | **$ 0** | **$ (1)** |
| **Adjustments:** | | |
| Loan Modifications | $ - | $ - |
| Fees Received | - | - |
| Foreclosed property acquired | (10) | (9) |
| New Loans | 2 | (1) |
| Loans written off | - | - |
| Subsidy allowance amortization | (8) | (6) |
| Change in re-estimate approved by OMB | 7 | 10 |
| Total Adjustments | **$ (9)** | **$ (6)** |
| **Ending balance of the subsidy cost allowance before re-estimates** | **$ (42)** | **$ (31)** |
| **Add or subtract subsidy re-estimates by component** | | |
| Interest rate re-estimate | $ 6 | $ - |
| Technical/default re-estimate | 7 | (2) |
| **Total of the above re-estimate components** | **$ 13** | **$ (2)** |
| **Ending balance of the subsidy cost allowance** | **$ (29)** | **$ (33)** |

## SUBSIDY EXPENSE

Subsidy expense is defined by the Federal Credit Reform Act of 1990. The Act defines subsidy expense as the budgetary costs of Federal loan guarantees and direct loans, excluding all administrative costs. The budgetary costs are present values of cash flows for Federal loans. VA reports subsidy expense in the financial statements annually. VA also reports revisions to subsidy expense, which are categorized as subsidy re-estimates.

VA uses cash flow models to estimate subsidy expense and re-estimates. The primary VA model is a limited dependent econometric model for VA home loan guarantees. The VA models transform accounting cash flow inputs with assumptions into future cash flows and subsidy estimates. The key model inputs are loan disbursements, claims, recoveries, mortgage rates, Treasury bond note yields, home price appreciation, and borrower payments.

VA updates the models with actual data and data assumptions every year. VA periodically upgrades the models and obtains independent review of the models. The updated models are used to estimate future cash flows that are transformed into subsidy expenses and re-estimates. Subsidy re-estimates are the difference between estimated and actual cash flows.

VA has experienced prolonged growth in lending volume since 2010. This growth in lending has caused the overall number of claims to rise, while keeping the percentage of claims lower mainly attributed to high performance of the portfolio. Actual loan volume and claims drive cash spending on subsidy expense and re-estimates.

## BUDGETARY SUBSIDY RATES BY COMPONENT (POST-FY 1991)

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

| Direct and Guaranteed Loans Subsidy Rates | Defaults, net of recoveries | Interest | Fees | All Other | Total Subsidy Rate |
|---|---|---|---|---|---|
| Veterans Housing Direct Acquired Loans | 9.32% | -1.34% | 0.00% | -0.04% | 7.94% |
| Veterans Housing Direct Vendee Loans | 0.41% | -27.03% | 0.00% | 0.13% | -26.49% |
| Native American Housing Loans | 0.00% | -28.28% | -0.52% | 8.58% | -20.22% |
| Housing Guaranteed Loans | 1.65% | 0.00% | -1.39% | 0.00% | 0.27% |

## SUBSIDY EXPENSE FOR DIRECT HOME LOANS AND LOAN GUARANTEES (POST-FY 1991)

| Direct and Guaranteed Loan Subsidy Expense Post FY 1991 (dollars in millions) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Interest Differential | Defaults | Fees | Interest Rate Re-estimates | Technical Re-estimates | | Total Subsidy Expense |
| **As of September 30, 2018** | | | | | | | | |
| Direct Home Loans | $ | (1) | 1 | - | 6 | 7 | $ | 13 |
| Guaranteed Home Loans | | - | 2,584 | (2,167) | (233) | (2,981) | | (2,797) |
| Loan Sale Guarantees | | - | - | - | (49) | (18) | | (67) |
| **Total Subsidy Expense** | **$** | **(1)** | **2,585** | **(2,167)** | **(276)** | **(2,992)** | **$** | **(2,851)** |
| **As of September 30, 2017** | | | | | | | | |
| Direct Home Loans | $ | (1) | | - | - | - | $ | (1) |
| Guaranteed Home Loans | | - | 3,020 | (2,128) | (40) | (1,482) | | (630) |
| Loan Sale Guarantees | | - | - | - | 2 | (1) | | 1 |
| **Total Subsidy Expense** | **$** | **(1)** | **3,020** | **(2,128)** | **(38)** | **(1,483)** | **$** | **(630)** |

## OUTSTANDING LOAN GUARANTEES

In the table that follows, the face value of the principal of guaranteed loans represent the unpaid balances of home loans made to eligible borrowers by financial institutions.

The outstanding principal guaranteed amounts represent the portion of unpaid home loan and loan sale balances that VA has guaranteed.

| Guaranteed Loans Outstanding | | | | |
|---|---|---|---|---|
| | | **Principal of Guaranteed Loans, Face Value (dollars in millions)** | | **Amount of Outstanding Principal Guaranteed (dollars in millions)** |
| **As of September 30, 2018** | | | | |
| **Pre-FY 1992** | | | | |
| Home Loan Guarantees | $ | 23 | $ | 10 |
| **Post-FY 1991** | | | | |
| Home Loan Guarantees | | 663,633 | | 167,930 |
| Loan Sale Guarantees | | - | | 725 |
| **Total** | **$** | **663,656** | **$** | **168,665** |
| **As of September 30, 2017** | | | | |
| **Pre-FY 1992** | | | | |
| Home Loan Guarantees | $ | 45 | $ | 19 |
| **Post-FY 1991** | | | | |
| Home Loan Guarantees | | 596,422 | | 151,892 |
| Loan Sale Guarantees | | - | | 878 |
| **Total** | **$** | **596,467** | **$** | **152,789** |

| New Guaranteed Loans Disbursed | | | | | |
|---|---|---|---|---|---|
| | | **Principal of Guaranteed Loans, Face Value** | | **Amount of Outstanding Principal Guaranteed (dollars in millions)** | **Number of Loans Disbursed** |
| **As of September 30, 2018** | | | | | |
| New Guaranteed Home Loans | $ | 144,882 | $ | 35,878 | 553,975 |
| **As of September 30, 2017** | | | | | |
| New Guaranteed Home Loans | $ | 160,078 | $ | 39,812 | 637,136 |

During the period FY 1992 through 2012, total loans sold amounted to $14 billion. There have been no new loan sale guarantees since 2012. There are no outstanding loan sale guarantees made prior to FY 1992.

Outstanding principal of loan sale guarantees at the start of the year for FY 2018 and 2017 was $878 million and $1,046 million, respectively. Payments, repayments, and terminations of loan sale guarantees made during FY 2018 and 2017 were $153 million and $168 million, respectively.

## LOAN GUARANTEE LIABILITIES

The liability on the guaranteed loans 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.

For home loan guarantees, 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.

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.

| Schedule for Reconciling Guarantee Loan Liability Balance (dollars in millions) | Home Loans Post-FY 1991 | Loan Sales Post-FY 1991 | Home Loans Pre-FY 1992 | Total |
|---|---|---|---|---|
| **As of September 30, 2018** | | | | |
| **Liability balances as of October 1, 2017** | **$ 10,184** | **125** | **259** | **$ 10,568** |
| Add: Subsidy expense for guaranteed loans disbursed during the reporting years by component: | | | | |
| Interest rate differential costs | - | - | - | - |
| Default costs (net of recoveries) | 2,584 | - | - | 2,584 |
| Fees and other collections | (2,167) | - | - | (2,167) |
| Other subsidy costs | - | - | - | - |
| **Total of the above subsidy expense components** | **$ 417** | **-** | **-** | **$ 417** |
| **Adjustments:** | | | | |
| Loan Guarantee Modifications | - | - | - | - |
| Fees received | 2,025 | - | - | 2,025 |
| Interest supplements paid | - | - | - | - |
| Foreclosed property acquired | (246) | - | 2 | (244) |
| Claim payments to lenders | (664) | (9) | 1 | (672) |
| Interest accumulation on the liability balance | 221 | 7 | - | 228 |
| Veteran liability debts | - | | 12 | 12 |
| Amortization of liability balance | - | - | - | - |
| Changes in re-estimate approved by OMB | (330) | (1) | - | (331) |
| **Total Adjustments** | **$ 1,006** | **(3)** | **15** | **$ 1,018** |
| **Ending balance of the liability before reestimates** | **$ 11,607** | **122** | **274** | **$ 12,003** |
| **Add or subtract subsidy re-estimates by component:** | | | | |
| Interest rate re-estimate | (233) | (49) | - | (282) |
| Technical/default re-estimate | (2,981) | (18) | - | (2,999) |
| Total of the above re-estimate components | (3,214) | (67) | - | (3,281) |
| **Ending balance of the loan guarantee liability** | **$ 8,393** | **55** | **274** | **$ 8,722** |

| Schedule for Reconciling Guarantee Loan Liability Balance (dollars in millions) | Home Loans Post-FY 1991 | Loan Sales Post-FY 1991 | Home Loans Pre-FY 1992 | Total |
|---|---|---|---|---|
| **As of September 30, 2017** | | | | |
| **Liability balances as of October 1, 2016** | **$ 9,650** | **123** | **246** | **$ 10,019** |
| Add: Subsidy expense for guaranteed loans disbursed during the reporting years by component: | | | | |
| Interest rate differential costs | - | - | - | - |
| Default costs (net of recoveries) | 3,020 | - | - | 3,020 |
| Fees and other collections | (2,128) | - | - | (2,128) |
| Other subsidy costs | - | - | - | - |
| **Total of the above subsidy expense components** | $ 892 | - | - | $ 892 |
| **Adjustments:** | | | | |
| Loan Guarantee Modifications | - | - | - | - |
| Fees received | 2,128 | - | - | 2,128 |
| Interest supplements paid | - | - | - | - |
| Foreclosed property acquired | (125) | - | (3) | (128) |
| Claim payments to lenders | (1,117) | (15) | - | (1,132) |
| Interest accumulation on the liability balance | 200 | 7 | - | 207 |
| Veteran liability debts | - | - | 14 | 14 |
| Amortization of liability balance | - | - | 2 | 2 |
| Changes in re-estimate approved by OMB | 78 | 9 | - | 87 |
| **Total Adjustments** | **$ 1,164** | **1** | **13** | **$ 1,178** |
| **Ending balance of the liability before reestimates** | **$ 11,706** | **124** | **259** | **$ 12,089** |
| **Add or subtract subsidy re-estimates by component:** | | | | |
| Interest rate re-estimate | (40) | 2 | - | (38) |
| Technical/default re-estimate | (1,482) | (1) | - | (1,483) |
| Total of the above re-estimate components | (1,522) | 1 | - | (1,521) |
| **Ending balance of the loan guarantee liability** | **$ 10,184** | **125** | **259** | **$ 10,568** |

### LOAN GUARANTEE MODIFICATIONS

OMB Circular No. A-11, Section 185, specifies that modifications to existing loan guarantee subsidy costs 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, which results in a modification gain being recognized. An increase in the loan guarantee liability due to a modification reflects increased costs to VA, which results in a modification loss being recognized. The carrying amount of the loan guarantee liability reflects the post-modification liability balance.

Loan servicers perform loan modifications under current laws without the need to modify executed subsidy estimates for existing loan guarantees from FY 1992 to 2018.

### ADMINISTRATIVE EXPENSE

The administrative expense for direct and guaranteed loans for the period ended September 30, 2018 and September 30, 2017, are $151 million and $196 million, respectively.

## NOTE 8. INVENTORY

Inventory consists primarily of Veterans Canteen Service (VCS) retail store stock held for current sale and is reported at cost using the weighted-average cost method. VCS provides retail merchandise, food, and vending services across the country.

Inventory also contains operating, medical, and pharmaceutical supplies at cost that are not in the hands of end users. Upon transfer to end users, these supplies are expensed. VA defines an end user as a VA medical center, regional office, or cemetery.

**Inventory (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 |
|---|---|---|
| VCS Retail Store Stock | $ 29 | $ 31 |
| Operating, Medical, and Pharmaceutical Supplies | 11 | 14 |
| **Total Inventory** | **$ 40** | **$ 45** |

## NOTE 9. GENERAL PROPERTY, PLANT AND EQUIPMENT, NET

The majority of general property, plant, and equipment owned or leased by VA is used to provide medical care to Veterans. Property, plant, and equipment, including transfers from other Federal agencies, other structures not classified as buildings, and capital leases are valued at net cost. Other structures include leasehold improvements; capital lease components of both buildings and equipment are identified in Note 16 as capital lease assets. Multi-use heritage assets are recognized and presented with general property, plant, and equipment in the basic financial statements.

Consistent with Governmentwide reporting, two components of property, plant, and equipment have been regrouped according to Treasury guidelines. Land improvements, previously included with land and improvements, is now grouped with buildings; and, internal use software in development, previously separately identified, is now grouped with internal use software.

Depreciation and amortization expense totaled $2.1 billion and $1.9 billion in FY 2018 and 2017, respectively. Loss on disposition of assets totaled $265 million and $338 million in FY 2018 and 2017, respectively.

**General Property, Plant and Equipment (dollars in millions)**
**As of September 30, 2018**

| | Cost | Accumulated Depreciation/ Amortization | Net Book Value |
|---|---|---|---|
| Land | $ 506 | $ - | $ 506 |
| Buildings | 36,015 | (19,060) | 16,955 |
| Equipment | 3,979 | (2,773) | 1,206 |
| Other Structures | 5,126 | (2,831) | 2,295 |
| Internal Use Software | 4,055 | (2,279) | 1,776 |
| Construction Work in Progress | 3,741 | - | 3,741 |
| **Total Property, Plant, and Equipment** | **$ 53,422** | **$ (26,943)** | **$ 26,479** |

| General Property, Plant and Equipment (dollars in millions) As of September 30, 2017 | Cost | Accumulated Depreciation/ Amortization | Net Book Value |
|---|---|---|---|
| Land | $ 491 | $ - | $ 491 |
| Buildings | 33,890 | (18,151) | 15,739 |
| Equipment | 4,099 | (2,786) | 1,313 |
| Other Structures | 4,833 | (2,666) | 2,167 |
| Internal Use Software | 3,490 | (1,824) | 1,666 |
| Construction Work in Progress | 4,546 | - | 4,546 |
| **Total Property, Plant, and Equipment** | **$ 51,349** | **$ (25,427)** | **$ 25,922** |

## NOTE 10. HERITAGE ASSETS

Heritage assets are properties that possess one or more of the following characteristics: historical or natural significance; cultural, educational, or aesthetic importance; or significant architectural characteristics. VA has properties at medical centers, regional offices, and national cemeteries that meet the criteria for heritage assets. Historic heritage assets allow VA to meet its responsibilities under the National Historic Preservation Act to preserve Federal owned, administered, or controlled historic resources in a spirit of stewardship for the inspiration and benefit of present and future generations.

Generally, increases and decreases of VA's inventory result from field station condition assessment surveys, which identify items such as new collections or newly designated assets. There were no heritage assets transferred between Federal entities or acquired through donation or devise that were considered material to the consolidated financial statements for FY 2018 and 2017, therefore, fair value disclosure is not required for heritage assets acquired by donation or devise. VA classifies its heritage assets as art collections (including artwork, archives, historic medical equipment, medals and awards, furniture, archaeological materials, and photographs); archaeological sites; buildings (including historic hospitals, quarters, lodges, warehouses, laboratories, and chapels, but excluding multi-use buildings); monuments; non-buildings (including flag poles, structures, rostrums, gates and historic walls); and cemeteries. According to VA’s policy for heritage assets, only developed sections of national cemeteries are classified as heritage assets.

VA has 1,271 multi-use heritage assets that are included in general PP&E. Multi-use heritage assets have both operating and historic characteristics and are being utilized predominantly in Government operations such as administration, operation, engineering, and maintenance buildings.

VA expensed $0.8 million and $2.0 million for the periods ended September 30, 2018, and 2017, respectively, of heritage asset costs associated with acquisition, construction, renovation, and/or modification of VA-owned personal property and buildings and structures declared as heritage assets.

See Required Supplementary Information for Deferred Maintenance and Repairs Information.

**Heritage Assets (in Units)**
**As of September 30, 2018**

| | 2018 Beginning Balance | 2018 Increases | 2018 Decreases | 2018 Ending Balance |
|---|---|---|---|---|
| Archaeological Sites | 10 | 5 | (3) | 12 |
| Art Collections | 28 | 24 | (11) | 41 |
| Buildings | 607 | 70 | (129) | 548 |
| Monuments | 1,107 | 212 | (15) | 1,304 |
| Multi-Use Buildings in PP&E | 1,216 | 190 | (135) | 1,271 |
| Non-Buildings | 1,055 | 435 | (438) | 1,052 |
| **Total Heritage Assets in Units** | **4,023** | **936** | **(731)** | **4,228** |
| | | | | |
| **Cemeteries, Soldier's Lots and Monument Sites** | **170** | **1** | **-** | **171** |

# NOTE 11. DEBT

| Other Intragovernmental Debt (dollars in millions) As of September 30, 2018 and 2017 | 2017 Beginning Balance | 2017 Net Borrowing | 2017 Ending Balance | 2018 Net Borrowing | 2018 Ending Balance |
|---|---|---|---|---|---|
| **Debt to the Treasury** | | | | | |
| Loan Guarantee Debt | $ 566 | $ (7) | $ 559 | $ (25) | $ 534 |
| Direct Loans Debt* | 1 | - | 1 | - | 1 |
| **Total Debt to the Treasury** | **567** | **(7)** | **560** | **(25)** | **535** |
| **Debt to the Federal Financing Bank** | | | | | |
| Loan Guarantee Debt | 5 | (1) | 4 | - | 4 |
| **Total Debt to the Federal Financing Bank** | **5** | **(1)** | **4** | **-** | **4** |
| **Total Other Intragovernmental Debt** | **$ 572** | **$ (8)** | **$ 564** | **$ (25)** | **$ 539** |

* Direct Loans Debt relates strictly to the Vocational Rehabilitation Program

At September 30, 2018 and 2017, all debt is classified as intragovernmental debt.

Loan Guarantee 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 FY 2018 ranged from 2.93 to 3.09 percent and 3.0 to 3.15 percent for debt issued in FY 2017. The interest rates on all outstanding debt issued ranged from 2.27 to 7.59 percent for FY 2018 and 1.00 to 7.59 percent for FY 2017.

Vocational Rehabilitation Program Direct Loan debt has a two-year term from the date of issuance and bears interest at the Treasury securities rate at the time of borrowing. The interest rate on debt issued was 1.42 percent for FY 2018 and 1.18 for FY 2017.

Interest expense was $23 million for both FY 2018 and 2017.

Net borrowings related to the Loan Guarantee 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 FY 2018 or 2017. There were no redemptions or calls of debts before maturity or write-offs of debt owed to the Treasury.

## NOTE 12. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities not covered by budgetary resources are unfunded liabilities that require Congressional action before budgetary resources can be provided. VA's unfunded liabilities are listed below and are explained in the Notes referenced in the schedule.

Liabilities not requiring budgetary resources are liabilities that have not and will never require Congressional action. These are primarily deposit and clearing accounts, custodial liabilities, and general fund receipts. They can be fully liquidated without the use of budgetary resources.

**Liabilities Not Covered By Budgetary Resources (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 |
|---|---|---|
| **Intragovernmental** | | |
| Workers Compensation (FECA) and Other Employee Benefits | $ 446 | $ 464 |
| Future Funded Expense - Contract Dispute Act | 233 | 244 |
| **Total Intragovernmental (Note 15)** | **679** | **708** |
| Federal Employee and Veteran Benefits (Note 13) | 3,024,368 | 2,863,110 |
| Environmental and Disposal Liabilities (Note 14) | 926 | 943 |
| Insurance (Note 17) | 1,603 | 1,602 |
| Other (Note 15) | 3,428 | 4,108 |
| **Total Liabilities Not Covered By Budgetary Resources** | **3,031,004** | **2,870,471** |
| **Total Liabilities Covered By Budgetary Resources** | **32,042** | **22,933** |
| **Total Liabilities Not Requiring Budgetary Resources** | **1,249** | **1,324** |
| **Total Liabilities** | **$ 3,064,295** | **$ 2,894,728** |

## NOTE 13. FEDERAL EMPLOYEE AND VETERANS BENEFITS LIABILITIES

Federal employee and Veterans benefits liabilities comprises workers' compensation [Federal Employees' Compensation Act (FECA)], compensation and burial benefits paid to Veterans and their beneficiaries, and education benefits provided to Veterans and their dependents. The table below summarizes employee and Veteran benefit liabilities reported by VA on the Balance Sheet.

**Federal Employee and Veterans Benefits Liabilities (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 |
|---|---|---|
| Workers' Compensation (FECA) | $ 2,399 | $ 2,396 |
| Compensation | 2,949,100 | 2,805,100 |
| Burial | 7,200 | 4,900 |
| Education Benefits | 65,669 | 50,714 |
| **Total Federal Employee and Veterans Benefits Liabilities** | **$ 3,024,368** | **$ 2,863,110** |

### 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 titled "Imputed Financing under Other Financing Sources (Nonexchange)" in the 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.

A liability is recorded for estimated and actual future payments to be made for workers' compensation pursuant to the FECA. The FECA component of the Federal employee and Veteran benefit liability consists of the actuarial liability for compensation cases to be paid beyond the current year.

| Federal Employee Benefits: Imputed Expenses Employee Benefits (dollars in millions) As of September 30, 2018 and 2017 | | | | |
|---|---|---|---|---|
| | | 2018 | | 2017 |
| Civil Service Retirement System | $ | 631 | $ | 247 |
| Federal Employees Health Benefits | | 1,999 | | 1,483 |
| Federal Employees Group Life Insurance | | 5 | | 5 |
| **Total Imputed Expenses-Employee Benefits*** | **$** | **2,635** | **$** | **1,735** |

* The total imputed expenses – employee benefits, when combined with the imputed financing paid by other entities reported in Note 18, reconciles to the total imputed financing costs reported in the Statement of Changes in Net Position with the FY 2018 difference being $2 million for Department of Homeland Security (DHS) imputed costs associated with cybersecurity services.

## VETERAN BENEFITS (COMPENSATION AND BURIAL)

Eligible Veterans who die or are disabled during active military service-related causes, as well as their dependents, and dependents of service-members who died during active military service, receive compensation benefits. In addition, service members who die during active military service and Veterans who separated under other than dishonorable conditions are provided a burial flag, headstone/marker, and grave liner 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.

VA provides eligible Veterans and/or their dependents with pension benefits if the Veteran died, is over age 65 or is totally disabled, based on annual eligibility reviews. The pension program is not accounted for as a "federal employee pension plan" under SFFAS 5 and therefore a future liability for pension benefits is not recorded due to differences between its eligibility conditions and those of Federal employee pensions. The present value of projected amount of future payments for pension benefits (presented for informational purposes only) as of September 30, 2018 and 2017, was $104.8 billion and $87.6 billion, respectively.

### ASSUMPTIONS USED TO CALCULATE THE VETERAN BENEFITS LIABILITY (COMPENSATION AND BURIAL)

Survivor new case rate assumption and Survivor termination rate assumption were both updated based on results from experience studies performed earlier in FY 2018. Adjustments related to contaminated water at Camp Lejeune and Mental Health Initiative (Character of Discharge) were applied in the FY 2018 model.

A liability was recognized for the present value of projected benefit payments to: (1) those beneficiaries, including Veterans and survivors, currently receiving benefit payments; (2) current Veterans who become future beneficiaries of the compensation program; and (3) a proportional share of those on active military service as of the valuation date who are expected to be future Veterans. Future benefits payments to survivors of those Veterans in classes (1), (2), and (3) above are also incorporated into the projection.

Discount rates at September 30, 2018 and 2017 were computed based on the average of the last 10-year quarterly spot rates. These averages were provided by the U.S. Department of the Treasury. The ranges of spot rates for the next 100 years were from 0.48 percent to 3.97 percent and from 0.62 percent to 4.07 percent as of September 30, 2018 and 2017, respectively. These spot rates produced a single average discount rate of 3.52 percent and 3.66 percent as of September 30, 2018 and 2017, respectively that could be applied to the expected future cash flows to produce a present value that is not materially different from 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, and 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, changes to the average level of benefits paid and the impact of those changes on future years.

Changes in actuarial assumptions include changes in the average of the last 10-year quarterly spot rates, COLA, mortality, and future new compensation rates. Prior service costs relate to new benefits due to administrative, judicial, or legislative changes. Amounts paid are the projected payments in the prior year model.

The total number of estimated Veterans and total number of beneficiary participants are determined through actual record level data and Survey data. The amount of benefits by beneficiary category and age were based on current amounts being paid, future COLA, change in degree of disability connected with military service, and changes in other factors that affect benefits.

Life expectancies of beneficiaries collecting benefits from the Compensation program were based on the Mortality Experience Study of the same population between 2011 and 2015. Life expectancies of Veterans not yet collecting these benefits used in the calculation of the liability for future beneficiaries are based on mortality rates developed by the Office of Predictive Analytics and Actuary for the 2016 Veteran Population Model (VetPop2016). 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, 2018.

The VA Compensation and Burial programs are not defined benefit plans and have 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 that are recognized in Program Costs under Veterans Benefits Administration in the Statements of Net Cost and in Amounts Paid in the Reconciliation of Veterans Compensation and Burial Actuarial Liabilities table that follows below.

The reconciliation table that follows the narrative below shows that the total September 30, 2018 liability for Compensation and Burial of $2,956 billion. This represents an increase of $146 billion from the September 30, 2017 liability of $2,810 billion.

The change in liability was primarily driven by a $95 billion increase due to the change in the discount rate assumptions. The single average discount rate decreased from 3.66 percent to 3.52 percent in FY 2018. The COLA change decreased the liability by $4 billion. The single average COLA rate used for all future years at September 30, 2018 and 2017 was 2.28 percent and 2.275 percent, respectively. The other assumption changes decreased the liability by $22 billion and were comprised of a $7 billion decrease from the updated new survivor compensation and termination rates, a $16 billion decrease from using the mid fiscal year Treasury spot rates and implied inflation rates, a $1 billion decrease from the updated 2018 Social Security Administration (SSA) mortality rates, and a $2 billion increase from revised burial cost assumption. Legislative and administrative changes led to an increase in the liability by $14 billion. The changes in experience, which include the beneficiary and Veteran counts and benefit amount, increased the liability by $45 billion. In addition, the estimated interest on the liability increased the liability by $103 billion and benefit payments decreased the liability by $85 billion.

## VETERANS EDUCATION BENEFIT LIABILITY

For eligible Veterans and their dependents, the VA provides four unique education/retraining type programs:

- Post-9/11 GI Bill (Chapter 33);
- Montgomery GI Bill – Active Duty (Chapter 30);
- Vocational Rehabilitation and Employment (Chapter 31); and
- Dependents Education Assistance (Chapter 35).

### POST-9/11 GI BILL

Veterans with at least 90 days of aggregate service after June 10, 2001, or individuals discharged with a service-connected disability after 30 days are eligible to receive Post-9/11 GI Bill (Chapter 33) benefits, which include tuition and fees and a monthly housing allowance. Veterans are eligible for up to 36 months of enrollment in an educational institution, which includes a monthly housing allowance, yearly textbook and supplies stipend, and one-time payment for relocation. The Veteran's eligibility for these amounts is based on the length of their active duty service. VA recognizes an education benefit liability once VA has approved an original enrollment certification in the Long-Term Solution system.

Except for discount rates and subsidies from the DoD, all assumptions in the FY 2018 actuarial model were carried forward from the prior year model. Expected benefit payments have been explicitly modeled for the next 63 years.

### MONTGOMERY GI BILL-ACTIVE DUTY (MGIB-AD)

The MGIB-AD is an authorized program by Congress under Title 38, Chapter 30. The MGIB-AD program provides education benefits to Veterans and Servicemembers who have at least 2 years of active duty and have had their pay reduced by $1,200 or meet other eligibility requirements.

Eligible Servicemembers have 10 years to use their MGIB benefits, but the time limit can be fewer or more years depending on the situation. Servicemembers may receive up to 36 months of education benefits. Benefits are paid monthly based on the type of training, length of service, category, and college fund eligibility. Veterans usually have 10 years to use their MGIB benefits, but the time limit can be fewer or more years depending on the situation. VA recognizes an education benefit liability once VA has approved an original enrollment certification.

In addition to the discount rate update decrement rates, number of eligibility units use, payment rate inflation, and payment per unit of eligibility were also updated based on results from experience studies performed earlier in FY 2018. Expected benefit payments have been explicitly modeled for the next 20 years.

### VOCATIONAL REHABILITATION AND EMPLOYMENT (VR&E)

The VR&E Program is an authorized program by Congress under Title 38, Chapter 31. VR&E helps Veterans and Active Duty Servicemembers transitioning to civilian employment with service-connected disabilities and an employment handicap prepare for, obtain, and maintain suitable careers.

The basic period of eligibility for Chapter 31 benefits is 12 years, beginning on the date of the event that occurred last from the following options:

- Separation from active military duty;
- First notification of a service-connected disability rating; and
- The basic period of eligibility may be extended if a Vocational Rehabilitation Counselor (VRC) determines that a Veteran has a Serious Employment Handicap.

Once eligibility is established, the Veteran is scheduled to meet with a VRC for a comprehensive evaluation to determine if he/she is entitled to services. The VRC works with the Veteran to complete a determination if an employment handicap exists. An employment handicap exists if the Veteran's service connected disability impairs his/her ability to obtain and maintain a job.

The VRC and Veteran will agree to a rehabilitation plan, which is an individualized, written plan of services that outlines the resources and criteria that will be used to achieve employment or independent living goals. The plan is an agreement that is signed by the Veteran and the VRC and is updated as needed to assist the Veteran to achieve his/her goals.

The approved plan would establish the Veteran into one of five rehabilitations "tracks":

- Reemployment (with a former employer);
- Direct job placement services for new employment;
- Self-employment;
- Employment through long-term services including on-the-job training, college, and other training; and
- Independent living services.

Benefits paid can include a monthly subsistence payment, tuition, books, and supplies. For those who are eligible, a Veteran could choose to be paid the Post-9/11 GI Bill housing rate instead of the basic VR&E subsistence rate. VA recognizes a VR&E benefit liability once a Rehabilitation Plan has been signed by the Veteran and VRC.

Except for discount rates and payment card payments, all the assumptions in the FY 2018 actuarial model were carried forward from the prior year model. Expected benefit payments have been explicitly modeled for the next 13 years.

### DEPENDENT EDUCATION ASSISTANCE (DEA)

The DEA Program (Chapter 35) offers education and training opportunities to eligible dependents of Veterans who are permanently and totally disabled due to a service-related condition or of Veterans who died while on active duty or as a result of a service-related condition.

To receive benefits for attending school or job training, a son or daughter must be between the ages of 18 and 26. This benefit may not be available for active duty personnel who are in the armed forces. A child over 18 years old using DEA will not be eligible to receive Dependency Indemnity Compensation (DIC) payments from VA.

For a spouse, benefits end 10 years from the date VA determines eligibility or from the date of death of the Veteran. If VA rated the Veteran permanently and totally disabled with an effective date of three years from discharge, a spouse will remain eligible for 20 years from the effective date of the rating. For surviving spouses of Servicemembers who died on active duty, benefits end 20 years from the date of death.

A beneficiary may be entitled to receive up to 45 months of DEA benefits. Effective August 1, 2018, the number of months of entitlement will be reduced to 36 months under the Forever GI Bill.

Benefits are paid monthly directly to the Dependent. VA recognizes an education benefit liability once VA has approved an original enrollment certification.

Except for discount rates and inflation rates, all the assumptions in the FY 2018 actuarial model were carried forward from the prior year model. Expected benefit payments have been explicitly modeled for the next 10 years.

## ASSUMPTIONS USED TO CALCULATE THE VETERANS EDUCATION BENEFIT LIABILITY

### ALL PROGRAMS

The liability for future Education and Vocational Rehabilitation and Employment payments is reported on VA's balance sheet at the present value of expected future payments and is developed on an actuarial basis. Several significant actuarial assumptions were used in the valuation of education benefits to calculate the present value of the liability.

For the Post-9/11 GI Bill, discount rate was based on 10-year average spot rates rather than the previous five-year average spot rates. The spot rates are published by the U.S. Department of the Treasury. The spot rates ranged from 0.48 percent to 3.90 percent and 0.45 percent to 3.54 percent as of September 30, 2018 and 2017, respectively. These spot rates produced a single average discount rate of 3.10 and 2.70 percent as of September 30, 2018 and 2017, respectively. For all Education programs, the single average discount rates at September 30, 2018 were based on the 10-year average historical spot rates published by the US Treasury. 10-year average historical interest for matching the rate yield curve on Treasury securities for each year of expected future payments range from 0.48 percent to 3.97 percent as of September 30, 2018 and from 0.72 percent to 4.11 percent as of September 30, 2017. These spot rates produced a single average discount rate of 1.18 percent and 1.35 percent for MGIB, 1.35 percent and 1.56 percent for VR&E and 1.24 percent and 1.38 percent for DEA as of

September 30, 2018, and September 30, 2017 that could be applied to the expected future cash flows to produce a present value that is not materially different. The liability is impacted by interest on the liability balance, changes in experience, and changes in actuarial assumptions, 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 benefit liability balance for the prior year.

The Education and VR&E actuarial modeling estimates are based on beneficiaries who have already started to use their benefits. Currently, these models do not include assumptions for expected future new beneficiaries as an input to calculate the estimated liability. However, based on experience, it is probable that new beneficiaries will enroll in these programs in future years. As of September 30, 2018, VA has not developed a practicable way to measure the future number of new beneficiaries in its models, in accordance with recognizing a liability as prescribed in SFFAS 5, *Accounting for Liabilities of the Federal Government*. Further, these models have been placed in operation for the past two years and additional analysis of the assumptions used and the most relevant information as compared to experience to calculate a more precise estimate is needed. As an alternative approach, VA developed an estimate to account for potential new enrollees for the following year and recognized a total increase to the liability of $12.0 billion based on the number of new beneficiaries who began to use their Post-9/11 GI Bill benefits in 2018. There are some inherent limitations to this estimate and further analysis of this estimate as compared to experience is required. VA only used Post-9/11 GI Bill case counts since this is the single largest education program and represents over 86% of total estimated education actuarial estimate for all programs. There has been a steady decline in the number of new beneficiaries enrolled in the Post-9/11 program over the past five years. For estimation purposes, we assumed that a static number of new beneficiaries helps to account for new beneficiaries in the other Education programs. Also, VA assumed there would be no additional Congressional changes to the program and that there would be no changes in the current model assumptions.

### POST-9/11 GI BILL

The FY 2018 estimated liability is estimated at $56.5 billion compared to the FY 2017 amount of $42.5 billion, an increase of $14 billion. Below is a list of the main changes in assumptions or experience that caused the increase:

- An Increase of $12 billion for the estimate to account for potential new enrollees in the following year;
- An increase of $9 billion for changes in experience due to population growth.
- A decrease of $8 billion due to estimated amounts paid;
- An increase of $1.6 billion for benefit inflation;
- A decrease of $1.5 billion due to change in discount rate assumption;
- An increase of $1.1 billion due to interest on liability; and
- A decrease of $0.2 billion due to a revised valuation date of July 31, 2018.

This decrease is due to an elimination of a two-month inflation adjustment. Since the schedule of Post-9/11 GI Bill benefits is updated once a year on August 1, the 2-month inflation adjustment is not needed between August 1 and September 30.

### MGIB

The FY 2018 estimated liability for MGIB FY 2018 is $0.2 billion compared to the FY 2017 amount of $1.1 billion, a decrease of $0.9 billion. Below is a list of the main changes in assumptions or experience that caused the decrease:

- A decrease of $0.9 billion due to the use of actual status rather than estimated status;
- An increase of $0.5 billion to the liability due to change in experience which includes changes in Veteran demographics, beneficiary counts, benefit type, benefit degree, and average benefit amount; and
- A decrease of $0.5 billion due to estimated amounts paid.

### VR&E

The FY 2018 estimated liability for VR&E is $6.5 billion compared to the FY 2017 amount of $5.4 billion, an increase of $1.1 billion. Below is a list of the main changes in assumptions or experience that caused the increase:

- An increase of $1.9 billion due to change in experience which includes changes in Veteran demographics, beneficiary counts, benefit type, benefit degree, and average benefit amount;
- A decrease of $1.8 billion due to estimated amounts paid;
- An increase of $0.7 billion due to a correction of the yearend FY 2017 estimations;
- An increase of $0.1 billion due to interest on liability;
- An increase of $0.1 billion due to updated discount rates and the use of actual delimiting date rather than estimated delimiting date; and
- An increase of $0.1 billion for Purchase Cards benefits not included in the input data.

### DEA

The FY 2018 estimated liability for DEA is $2.3 billion compared to the FY 2017 amount of $1.8 billion, an increase of $0.5 billion. Below is a list of the main changes in assumptions or experience that caused the increase:

- An increase of $0.8 billion to the liability due to change in experience which includes changes in Veteran demographics, beneficiary counts, benefit type, benefit degree;
- A decrease of $0.6 billion due to estimated amounts paid; and
- An increase of $0.3 billion due to a large one-time mandated benefit increase.

| Reconciliation of Veterans Compensation, Burial, and Education Actuarial Liabilities (dollars in millions) For the Period Ended September 30, 2018 and 2017 | Compensation | Burial | Education | TOTAL |
|---|---|---|---|---|
| **Liability at October 1, 2016** | **$ 2,491,400** | **$ 4,900** | **$ 59,588** | **$ 2,555,888** |
| Expense: | | | | |
| Interest on the Liability Balance* | 97,900 | 200 | 677 | 98,777 |
| Actuarial (Gain)/Loss | | | | |
| Changes in Experience (Veterans Counts, Status)* | 50,700 | (200) | 9,447 | 59,947 |
| Changes in Assumptions: | | | | |
| Changes in Discount Rate Assumption | 137,800 | 200 | (38) | 137,962 |
| Changes in COLA Rate Assumption | (13,300) | - | 439 | (12,861) |
| Changes in Other Assumptions | 119,800 | - | (15,228) | 104,572 |
| Net (Gain)/Loss from Changes in Assumptions | 244,300 | 200 | (14,827) | 229,673 |
| Other Actuarial Changes* | - | - | 8,678 | 8,678 |
| Total Expense | 392,900 | 200 | 3,975 | 397,075 |
| Less Amounts Paid* | (79,200) | (200) | (12,849) | (92,249) |
| Net Change in Actuarial Liability | 313,700 | - | (8,874) | 304,826 |
| **Liability at September 30, 2017** | **$ 2,805,100** | **$ 4,900** | **$ 50,714** | **$ 2,860,714** |
| | | | | |
| **Liability at October 1, 2017** | **$ 2,805,100** | **$ 4,900** | **$ 50,714** | **$ 2,860,714** |
| Expense: | | | | |
| Interest on the Liability Balance** | 102,700 | 200 | 1,281 | 104,181 |
| Actuarial (Gain)/Loss | | | | |
| Changes in Experience (Veterans Counts, Status)** | 45,500 | (100) | 14,596 | 59,996 |
| Changes in Assumptions: | | | | |
| Changes in Discount Rate Assumption | 94,900 | 200 | (1,454) | 93,646 |
| Changes in COLA Rate Assumption | (3,600) | - | - | (3,600) |
| Changes in Other Assumptions | (24,500) | 2,200 | 11,407 | (10,893) |
| Net (Gain)/Loss from Changes in Assumptions | 66,800 | 2,400 | 9,953 | 79,153 |
| Prior Service Costs ** | 14,300 | - | - | 14,300 |
| Total Expense | 229,300 | 2,500 | 25,830 | 257,630 |
| Less Amounts Paid** | (85,300) | (200) | (10,875) | (96,375) |
| Net Change in Actuarial Liability | 144,000 | 2,300 | 14,955 | 161,255 |
| **Liability at September 30, 2018** | **$ 2,949,100** | **$ 7,200** | **$ 65,669** | **$ 3,021,969** |

* The sum of these changes represents Veterans benefits actuarial cost, excluding changes in actuarial assumptions on the Statement of Net Cost for FY 2017.

** The sum of these changes represents Veterans benefits actuarial cost, excluding changes in actuarial assumptions on the Statement of Net Cost for FY 2018.

## NOTE 14. ENVIRONMENTAL AND DISPOSAL LIABILITIES

VA has unfunded environmental and disposal liabilities in the amount of $926 million and $943 million as of September 30, 2018, and 2017, 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. As of September 30, 2018, the liabilities for friable and non-friable asbestos removal are $232 million and $431 million, respectively.

While some facilities have applied prevailing state regulations that are more stringent than Federal guidelines, Occupational Safety and Health Administration and Environmental Protection Agency regulations are the legal basis 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.

## NOTE 15. OTHER LIABILITIES

Other liabilities are liabilities not reported elsewhere in the Balance Sheets. They consist of funded and unfunded liabilities within the intragovernmental and public categories. Funded liabilities are generally considered to be current liabilities. Unfunded liabilities represent future financial commitments that are currently not funded and considered non-current.

| Other Liabilities (dollars in millions)<br>As of September 30, 2018 | FUNDED | UNFUNDED |
|---|---|---|
| Intragovernmental | | |
| Credit Reform Act Subsidy Re-estimates * | $ 3,362 | $ - |
| General Fund Receipt Accounts Liability | 60 | - |
| Workers Compensation (FECA) and Other Employee Benefits | 356 | 446 |
| Future Funded Expense - Contract Dispute Act ** | - | 233 |
| Other | 27 | - |
| Accrued Annual Leave*** | 23 | 2,325 |
| Accrued Payables | 139 | - |
| Accrued Salaries and Benefits | 1,327 | - |
| Contingent Legal Liabilities (Note 18) | - | 1,103 |
| Deposit and Clearing Account Liability | 217 | - |
| Other | 39 | - |
| **Total Other Liabilities** | **$ 5,550** | **$ 4,107** |

| Other Liabilities (dollars in millions)<br>As of September 30, 2017 | FUNDED | UNFUNDED |
|---|---|---|
| Intragovernmental | | |
| Credit Reform Act Subsidy Re-estimates * | $ 1,883 | $ - |
| General Fund Receipt Accounts Liability | 60 | - |
| Workers Compensation (FECA) and Other Employee Benefits | 339 | 464 |
| Future Funded Expense - Contract Dispute Act ** | - | 244 |
| Other | 28 | - |
| Accrued Annual Leave*** | 24 | 2,244 |
| Accrued Payables | 145 | - |
| Accrued Salaries and Benefits | 1,251 | - |
| Contingent Legal Liabilities (Note 18) | - | 1,860 |
| Deposit and Clearing Account Liability | 174 | - |
| Other | 45 | 4 |
| **Total Other Liabilities** | **$ 3,949** | **$ 4,816** |

*Credit Reform Act Subsidy Re-estimates represents excess subsidy due to Treasury as a result of downward re-estimates.

**Future Funded Expense – Contract Dispute Act represents a liability to Treasury's Judgment Fund Branch for amounts paid by Treasury on behalf of the VA for claims related to Contract Dispute Acts (CDAs). VA is required to reimburse Treasury for claims involving CDAs.

*** 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.

## NOTE 16. LEASES

VA has both capital and operating leases. The net capital lease liability is $0.2 million for both September 30, 2018, and 2017. Capital leases consist primarily of information and computer technology, medical equipment, office equipment, and buildings. Since capital leases entered into after 1991 are required to be fully funded by budgetary resources in the first year of the lease, the capital lease liabilities are classified as a component of other public-funded liabilities in Note 15.

The following is an analysis of the leased property under capital leases by major classes that is included in general PP&E as disclosed in Note 9.

**Capital Lease Assets (dollars in millions)**
**As of September 30, 2018**

| | Cost | Accumulated Amortization | Net Book Value |
|---|---|---|---|
| Buildings | $ 13.0 | $ (12.6) | $ 0.4 |
| Equipment | 23.6 | (21.6) | 2.0 |
| **Leased Property Under Capital Lease** | **$ 36.6** | **$ (34.2)** | **$ 2.4** |
| **Amortization Expense** | | **$ 1.4** | |

**Capital Lease Assets (dollars in millions)**
**As of September 30, 2017**

| | Cost | Accumulated Amortization | Net Book Value |
|---|---|---|---|
| Buildings | $ 13.0 | $ (12.5) | $ 0.5 |
| Equipment | 24.2 | (20.8) | 3.4 |
| **Leased Property Under Capital Lease** | **$ 37.2** | **$ (33.3)** | **$ 3.9** |
| **Amortization Expense** | | **$ 1.9** | |

Operating leases consist of equipment and real property leases that are funded annually and expensed as incurred. Operating equipment leases generally consist of medical and office equipment with terms of 5 years or less and level payments over the lease term. Operating real property leases generally consist of Veterans medical facilities and clinics, regional and district benefits offices, and administrative facilities that enable VA to fulfill its mission to care for and provide benefits to Veterans.

For the period ended September 30, 2018, VA has 1,942 real property leases in effect consisting of approximately 27 million square feet and base annual minimum rental obligations of approximately $855 million. Of the operating real property leases, VHA accounts for 85.5 percent, VBA accounts for 9.3 percent, Indirect Administrative Program offices account for 4.9 percent, and NCA accounts for 0.3 percent. These real property leases generally have lease terms ranging from 1 to 50 years and all operating leases are funded annually by appropriation of funds by Congress. Approximately 64 percent of the real property leases have an initial lease term of 5 years or less; approximately 28 percent have initial lease terms of 6 to 10 years; approximately 4.0 percent have initial lease terms of 11 to 15 years; and approximately 4.0 percent have initial lease terms of 16 years and more. Certain leases contain renewal, termination, and cancellation options.

Approximately 84 percent of VA leases are executed directly with third-party commercial property owners (public third-party direct leases) with the balance of the leases executed by GSA (intragovernmental leases) on behalf of VA. GSA charges rental rates for space that approximates commercial rental rates for similar properties. The terms of occupancy agreements (OAs) with GSA vary according to whether the underlying assets are owned directly by the Federal Government or rented by GSA from third-party commercial property owners. VA executes cancellable and non-cancellable OAs with GSA. GSA OAs can be cancellable with varying periods of notice required (generally four to six months). For OAs executed after October 2011, periods of occupancy are generally one year. GSA OAs that are cancelled require a payment of all unamortized tenant improvements and rent concessions not yet earned. GSA OAs may also be non-cancellable, where VA would be financially responsible for rent payments on vacated space until the expiration of the OA, the termination of the OA permitted under the lease terms, or the occupancy by a replacement tenant covers the total rent obligation of VA. However, VA normally occupies the leased properties for an extended period of time without exercising cancellation or termination clauses in the leases.

Annual base rent for operating real property leases is generally flat over the lease term; however, certain GSA OAs and third-party direct leases contain rent abatement and rent escalation clauses. For certain GSA OAs, the base rent is set for periods up to but not beyond five years. For certain GSA OAs with occupancy terms in excess of five years or that incur capitalized building improvement or replacement costs, the base rental rate is reassessed every five years to reflect current market rental rates and additional real property investments. The GSA OAs and third-party direct leases also require VA to reimburse increases in common area maintenance costs and operating costs over base year amounts annually based on increases in the CPI. Additionally, these GSA OAs and third-party direct leases require VA to reimburse increases in real estate taxes over a base year amount at least annually and, in certain cases, VA may pay the common area maintenance costs, operating costs, and real estate taxes directly.

Future commitments for real property and equipment operating leases are based on leases in effect as of September 30, 2018. VA normally occupies leased real property for the entire initial lease term without exercising cancellation and termination options. As a result, the operating lease commitment table that follows includes real property leases over the non-cancellable initial lease term. Real property lease data is maintained in a centralized database and does not capture future fixed rent increases, which are considered immaterial to the financial statements taken as a whole and are therefore excluded from the operating lease commitment table that follows.

Due to the number of equipment operating leases and the decentralization of equipment lease records, VA does not present information on non-cancellable equipment leases.

VA's FY 2018 operating lease rental costs are $189 million for real property rentals and $180 million for equipment rentals. The FY 2017 operating lease costs are $823 million for real property rentals and $205 million for equipment rentals.

Excluded from the following table are leases of properties that have expired as of September 30, 2018, and prior, but are still occupied by VA. On occasion, VA will retain occupancy of properties once the full term of the lease has expired and continue to remit rent on a monthly basis in accordance with the holdover provisions of the expired lease agreement. In other instances, VA enters into a standstill agreement that simply preserves the terms and conditions of the lease, providing continuation of required rent payments to maintain occupancy. These commitments are excluded from the five-year lease commitment table pending a long-term lease renewal contract or the vacancy of the space by VA. The rent expense associated with standstill and holdover leases is considered immaterial and is reflected in the FY 2018 expense in the statements of net costs. The following table represents VA's projected future non-cancellable operating lease commitments.

**Future Payments Due for Non cancellable Real Property Operating Leases**
**(dollars in millions)**

| For the Years Ending: | GSA OAs | Third-Party Direct Leases | Total Real Property |
|---|---|---|---|
| 2019 | $ 212 | $ 394 | $ 606 |
| 2020 | 193 | 364 | 557 |
| 2021 | 136 | 338 | 474 |
| 2022 | 76 | 301 | 377 |
| 2023 | 69 | 278 | 347 |
| 2024 and Thereafter (in total) | 260 | 2,274 | 2,534 |
| **Total Future Lease Payments** | **$ 946** | **$ 3,949** | **$ 4,895** |

VA is a lessor of certain underutilized real estate properties within the Department under its enhanced-use lease (EUL) program authorized by Congress. Title 38, U.S.C. Section 8161-8169, Enhanced-Use Leases of Real Property, authorizes VA to lease real property under VA's control or jurisdiction to other public and private entities on a long-term basis (up to 75 years) only for the provision of supportive housing, in return for cash consideration or no consideration. VA's previous EUL authority expired on December 31, 2011, and was reauthorized on August 6, 2012, effective January 1, 2012 under Public Law 112-154, Section 211, limited to supportive housing and set to expire on December 31, 2023. The previous authority under which all current operational leases were executed allowed VA to enter into EULs for receipt of rental income or in-kind consideration (such as cost avoidance, cost savings, and enhanced services benefitting Veterans) as all or part of the consideration for the lease to further its mission to effectively serve Veterans and was not limited to supportive housing.

The leases related to NCA's leasing of excess land and buildings at cemeteries are more fully described in Note 20 under the caption, Public Exchange Transactions. The EUL program consists of 69 operational leases of land and/or buildings to the public and private sector. The rental income recognized from the EUL program and the NCA leasing program is $2 million for each of the periods ended September 30, 2018 and 2017. The future rental income to be recognized over the next five years and thereafter from the EUL program and NCA leasing program described above approximates $72 million.

## NOTE 17. LIFE INSURANCE LIABILITIES

Through VA, the Federal Government administers six life insurance programs:

(1) United States Government Life Insurance (USGLI) program
(2) National Service Life Insurance (NSLI) program
(3) Veterans Special Life Insurance (VSLI) program
(4) Veterans Reopened Insurance (VRI) program, which cover Veterans who served during World Wars I, II, and the Korean Conflict eras
(5) Service-Disabled Veterans Insurance (S-DVI) program, which was established in 1951 to meet the insurance needs of Veterans who received a service-connected disability rating and is open to new issues
(6) Veterans Mortgage Life Insurance (VMLI) program, which covers severely disabled Veterans and is open to new issues; VMLI is part of the Veterans Insurance and 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 insured Veterans are automatically covered under the Traumatic Injury Protection (TSGLI) program, which provides for insurance payments to Veterans 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 families 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 SECVA 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 identified by the SECVA 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. Title 38, U.S.C. 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 2.0 to 4.0 percent. The mortality assumptions include the American Experience Table, the X-18 Table, the 1941 CSO Table, the 1958 CSO Basic Table, and the 2001 VBM Table.

With the exception of the S-DVI and VMLI programs, which remain open to new issues, the liability for the other administered programs that cover World War II and Korean War Era Veterans will continue to decline due to the declining numbers of policyholders.

| Insurance Liability (Reserve) Balances (dollars in millions) As of September 30, 2018 | | | | |
|---|---|---|---|---|
| **Program** | **Insurance Death Benefits** | **Death Benefit Annuities** | **Disability Income & Waiver** | **Reserve Totals** |
| NSLI | $ 2,276 | $ 30 | $ 10 | $ 2,316 |
| USGLI | - | 1 | - | 1 |
| VSLI | 1,088 | 3 | 5 | 1,096 |
| S-DVI | 711 | 6 | 770 | 1,487 |
| VRI | 73 | - | 1 | 74 |
| VMLI | 243 | - | - | 243 |
| Subtotal | $ 4,391 | $ 40 | $ 786 | $ 5,217 |
| Unearned Premiums | | | | 31 |
| Insurance Dividends Left on Credit or Deposit and Related Interest Payable | | | | 921 |
| Dividend Payable to Policy Holders | | | | 28 |
| Unpaid Policy Claims | | | | 199 |
| Insurance Liabilities Reported on the Balance Sheet | | | | 6,396 |
| Less Liability not Covered by Budgetary Resources (Note 12) | | | | (1,603) |
| **Liability Covered by Budgetary Resources** | | | | **$ 4,793** |

| Insurance Liability (Reserve) Balances (dollars in millions) As of September 30, 2017 | | | | |
|---|---|---|---|---|
| **Program** | **Insurance Death Benefits** | **Death Benefit Annuities** | **Disability Income & Waiver** | **Reserve Totals** |
| NSLI | $ 2,788 | $ 35 | $ 14 | $ 2,837 |
| USGLI | - | 1 | - | 1 |
| VSLI | 1,184 | 4 | 6 | 1,194 |
| S-DVI | 679 | 6 | 782 | 1,467 |
| VRI | 90 | - | 1 | 91 |
| VMLI | 241 | - | - | 241 |
| Subtotal | $ 4,982 | $ 46 | $ 803 | $ 5,831 |
| Unearned Premiums | | | | 35 |
| Insurance Dividends Left on Credit or Deposit and Related Interest Payable | | | | 1,035 |
| Dividend Payable to Policy Holders | | | | 32 |
| Unpaid Policy Claims | | | | 3 |
| Insurance Liabilities Reported on the Balance Sheet | | | | 6,936 |
| Less Liability not Covered by Budgetary Resources (Note 12) | | | | (1,602) |
| **Liability Covered by Budgetary Resources** | | | | **$ 5,334** |

## CHANGE IN PRESENTATION ON BALANCE SHEET AND NOTE 17

The current year presentation of the Balance Sheet and the associated Note 17 has been changed from the prior year, FY 2017, presentation. This change is considered a reclassification and has no other effect on the Financial Statements.

Beginning in FY 2018, in order to better align VA's life insurance liabilities, VA reclassified $199 million of Unpaid Policy Claims from the Accounts Payable line to the Insurance Liabilities line of the Balance Sheet. Unpaid Policy Claims consists of insurance claims that are pending at the end of the reporting period, an estimate of claims that have been incurred but not yet reported, and a liability for disbursements in transit. These amounts represent insurance liabilities that have been incurred prior to the end of the reporting period and are payable from the insurance funds.

## 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 at 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 5,405,620 and 5,436,017 policy holders with a face value of $1,208 billion and $1,207 billion for FY 2018 and 2017, respectively.

The face value of the insurance provided by Prudential and its reinsurers represents 99 percent of the total insurance in-force for both FY 2018 and 2017.

| | 2018 Policies | 2017 Policies | 2018 Face Value | 2017 Face Value |
|---|---|---|---|---|
| | (# of policies) | | (dollars in millions) | |
| **Supervised Programs (UNAUDITED)** | | | | |
| SGLI Active Duty | 1,427,000 | 1,406,000 | $ 545,317 | $ 536,719 |
| SGLI Ready Reservists | 711,500 | 729,500 | 228,737 | 237,295 |
| SGLI Post Separation | 83,000 | 87,000 | 30,241 | 31,736 |
| SGLI Family - Spouse | 979,000 | 978,000 | 96,316 | 96,246 |
| SGLI Family - Children | 1,773,000 | 1,804,000 | 17,730 | 18,040 |
| TSGLI* | - | - | 213,850 | 213,550 |
| VGLI | 432,120 | 431,517 | 75,636 | 73,457 |
| **Total Supervised** | **5,405,620** | **5,436,017** | **$ 1,207,827** | **$ 1,207,043** |
| | | | | |
| **Administered Programs** | | | | |
| NSLI | 203,807 | 253,731 | $ 2,597 | $ 3,218 |
| VSLI | 90,488 | 101,004 | 1,335 | 1,476 |
| S-DVI | 277,063 | 275,208 | 2,911 | 2,888 |
| VRI | 7,902 | 9,854 | 84 | 105 |
| USGLI** | 20 | 124 | - | - |
| VMLI | 2,614 | 2,632 | 354 | 351 |
| **Total Administered** | **581,894** | **642,553** | **$ 7,281** | **$ 8,038** |
| | | | | |
| **Total Supervised and Administered Programs** | **5,987,514** | **6,078,570** | **$ 1,215,108** | **$ 1,215,081** |

* TSGLI is an automatic rider for all SGLI-insured Servicemembers and is not considered a separate policy.

**Less than $1 million

## POLICY DIVIDENDS

The SECVA determines annually the excess funds available for dividend payment. Policy dividends for FY 2018 and 2017 were $60 million and $70 million, respectively.

# NOTE 18. COMMITMENTS AND CONTINGENCIES

VA is a party in administrative proceedings, legal actions, and tort claims arising from various sources including disputes with contractors, challenges to compensation and education award decisions, loan guarantee indemnity debt cases, and allegations of medical malpractice. Certain legal matters to which VA may be a named party are administered by and, in some instances, litigated by, the Department of Justice. Generally, amounts (more than $2,500 for Federal Tort Claims Act cases) to be paid under any decision, settlement, or award are funded from the Judgment Fund, which is maintained by Treasury. Judgment Fund payments for FY 2018 and 2017 were $126.2 million and $859 million, respectively.

VA records a liability for pending legal claims that are estimated to be paid by the Judgment Fund. This liability is established for all pending claims whether reimbursement is required or not and was $1.1 billion and $1.9 billion for FY 2018 and FY 2017, respectively. This figure comprises the liability for contract and personnel claims and an estimated liability for medical malpractice and other tort claims.

The liability for contract and personnel claims decreased by $128.6 million. For contract and personnel law cases, where there was at least a reasonable possibility that a loss may occur, the estimated potential loss ranges from $499.7 million to $551.1 million in aggregate for FY 2018. Within that range, $346.9 million is considered probable and is recorded as a liability. In FY 2017, the estimated range of potential loss was $539.2 million to $690.4 million, of which $475.5 million was considered probable and recorded as a liability. Additionally, as of September 30, 2018, and 2017, there are cases, where there was at least a reasonable possibility that a loss may occur, for which the potential range of loss could not be determined.

The liability from existing medical malpractice and other tort claims is estimated using generally accepted actuarial standards procedures. The amount recorded as a liability was $756.2 million for FY 2018 and $1,384.4 million for FY 2017. Estimates of future claim payments were discounted using Treasury spot rates as of August 2018 and September 2017, respectively.

The decrease of $628.2 million in the medical malpractice liability and other torts estimate is primarily due to the impact of the updates to the paid claim data, which reflect a significant reduction in the amount for claim payments. Because the estimate of the unpaid liability is calculated based on the actual claim payments to date, a reduction in claim payments results in a reduction in the estimated claim liability.

VA is also required to record an expense and imputed financing source for the Judgment Fund's pending claims and settlements. There was a significant reduction in expense due to the decrease in medical malpractice and other torts liability as mentioned above. There was also a significant reduction in imputed financing related to the Judgment Fund this year. The reason for this decrease is because there were two large non-reimbursable payments issued on behalf of the VA for settled lawsuits during FY 2017 and no similarly large payments were made in FY 2018. The Judgment Fund accounting is shown in the following table.

| Judgment Fund (dollars in millions)<br>For the Periods Ended September 30, 2018 and 2017 | 2018 | 2017 |
|---|---|---|
| Fiscal Year Settlement Payments | $ 126 | $ 859 |
| Less Contract Dispute and "No Fear" Payments | (11) | (11) |
| Imputed Financing - Paid by Other Entities* | $ 115 | $ 848 |

*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 with the FY 2018 difference being $2 million for Department of Homeland Security (DHS) imputed costs associated with cybersecurity services.

It is the opinion of management that resolution of pending legal actions as of September 30, 2018, will not materially affect operations or the financial position when consideration is given to the availability of the Judgment Fund appropriation to pay some court-settled legal cases.

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 for both September 30, 2018 and 2017 was $1 billion.

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), the SECVA makes an annual enrollment decision that identifies which Veterans, by priority, 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 FY 2014 through FY 2018, the average medical care cost per year was $63.2 billion.

## NOTE 19. FUNDS FROM DEDICATED COLLECTIONS

SFFAS 43, *Funds from Dedicated Collections*: Amending SFFAS 27, *Identifying and Reporting Funds from Dedicated Collections*, defines funds from dedicated collections as an individual fund with explicit authority to retain revenues and/or other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes and to account for and report on the receipt, use, and retention of the revenues, and/or other financing sources that distinguishes the fund from the Federal Government's general revenues.

The source of revenue and other financing sources is a material public source that requires disclosure and program management responsibility. VA's funds from dedicated collections consist of trust, special, and revolving funds that remain available over time. Trust funds do not involve a fiduciary relationship with an individual or group but are designated exclusively for a specific activity, benefit, or purpose.

Treasury does not set aside assets to pay future expenditures associated with these funds. The cash receipts collected from the public for funds from dedicated collections are deposited in the Treasury and are used for general Government purposes.

Treasury security investments, discussed in Note 1 and presented in Note 5, are assets of funds from dedicated collections that are issued as evidence of specific dedicated receipts from fund activities by the fund and that provide the fund the authority to draw upon the Treasury for future authorized expenditures related to the fund's specific purpose. When the fund redeems its Treasury securities to make expenditures, Treasury will finance those expenditures in the same manner that it finances all other expenditures.

Treasury securities held by a fund from dedicated collections are an asset of the fund and a liability of the Treasury, so they are eliminated in consolidation for the Financial Report of the U.S. Government.

VA's funds are grouped as insurance, medical care, benefits, and burial in the condensed financial statements that follow.

| Dedicated Collections Fund Name | Authority | Purpose of Fund | Financing Source |
|---|---|---|---|
| **Servicemen's Group Life Insurance** | 38 U.S.C. 1965 | Insurance to active duty, ready and retired reservists and cadets attending service academies and ROTC. | Public, Veterans |
| **Veterans Reopened Insurance Fund** | 38 U.S.C. 1925 | Insurance to World War II and Korean Veterans. | Public, Veterans |
| **Service-Disabled Veterans Insurance Fund** | 38 U.S.C. 1922 | Insurance to Veterans with service-connected disabilities. | Public, Veterans |
| **National Service Life Insurance Fund** | 38 U.S.C. 1920 | Insurance - Premiums insure WWII Veterans. | Public, Veterans |
| **U.S. Government Life Insurance** | 38 U.S.C. 1955 | Insurance - Premiums insure WWI Veterans. | Public, Veterans |
| **Veterans Special Life Insurance Fund** | 38 U.S.C. 1923 101-228 | Insurance - Premiums insure Korean conflict Veterans. | Public, Veterans |
| **Canteen Service Revolving Fund** | 38 U.S.C. 78 | Medical Care - Operates the canteen services at hospitals. | Revenue from product sales |
| **Medical Care Collections Fund** | P.L. 105-33 111 Stat 665 | Medical Care - Third-party and patient co-payments for medical services. | Public, primarily insurance carriers |
| **General Post Fund, National Homes** | 38 U.S.C. 8301 | Medical Care - Donations for patient benefits. | Public, mostly Veterans |
| **Post-Vietnam Era Education Assistance** | 38 U.S.C. 3222 | Benefits - Subsidizes the cost of education to Veterans. | Veterans, DoD |
| **Cemetery Gift Fund** | 38 U.S.C. 2407 | Burial - Donations for Veterans cemeteries. | Public donors |
| **National Cemetery Administration Facilities Operation Fund** | P.L. 108-454 | Burial - Proceeds benefit land and buildings. | Proceeds from buildings/land leases |

The following tables provide consolidated condensed information on assets, liabilities, cumulative results of operations, net cost of operations, and changes in net positions related to funds from dedicated collections.

**Balance Sheet Funds from Dedicated Collections (dollars in millions)**
**As of September 30, 2018**

| | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| **Assets:** | | | | | |
| Fund Balance with Treasury | $ 54 | $ 363 | $ 63 | $ 2 | $ 482 |
| Investments with Treasury (Note 5) | 4,651 | 91 | - | - | 4,742 |
| Other Assets | 232 | 1,611 | - | 10 | 1,853 |
| **Total Assets** | **$ 4,937** | **$ 2,065** | **$ 63** | **$ 12** | **$ 7,077** |
| **Liabilities and Net Position:** | | | | | |
| Payables to Beneficiaries | $ 10 | $ 22 | $ 1 | $ - | $ 33 |
| Other Liabilities | 6,146 | 30 | - | - | 6,176 |
| **Total Liabilities** | **$ 6,156** | **$ 52** | **$ 1** | **$ -** | **$ 6,209** |
| Cumulative Results of Operations | (1,219) | 2,013 | 62 | 12 | 868 |
| **Total Liabilities and Net Position** | **$ 4,937** | **$ 2,065** | **$ 63** | **$ 12** | **$ 7,077** |

**Statement of Net Cost Funds from Dedicated Collections (dollars in millions)**
**For the Period Ending September 30, 2018**

| | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| Gross Program Costs | $ 534 | $ 627 | $ - | $ 2 | $ 1,163 |
| Less Earned Revenues | 447 | 4,155 | - | - | 4,602 |
| **Net Cost/(Benefit) of Operations** | **$ 87** | **$ (3,528)** | **$ -** | **$ 2** | **$ (3,439)** |

**Statement of Changes in Net Position Funds from Dedicated Collections (dollars in millions)**
**For the Period Ending September 30, 2018**

| | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| **Net Position Beginning of Period** | **$ (1,220)** | **$ 1,967** | **$ 62** | **$ 14** | **$ 823** |
| Budgetary and Other Financing Sources | 88 | (3,482) | - | - | (3,394) |
| Net (Cost)/Benefit of Operations | (87) | 3,528 | - | (2) | 3,439 |
| **Change in Net Position** | **1** | **46** | **-** | **(2)** | **45** |
| **Net Position End of Period** | **$ (1,219)** | **$ 2,013** | **$ 62** | **$ 12** | **$ 868** |

| Balance Sheet Funds from Dedicated Collections (dollars in millions) As of September 30, 2017 | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| **Assets:** | | | | | |
| Fund Balance with Treasury | $ 45 | $ 336 | $ 63 | $ 3 | $ 447 |
| Investments with Treasury (Note 5) | 5,386 | 109 | - | - | 5,495 |
| Other Assets | 256 | 1,586 | - | 11 | 1,853 |
| **Total Assets** | **$ 5,687** | **$ 2,031** | **$ 63** | **$ 14** | **$ 7,795** |
| **Liabilities and Net Position:** | | | | | |
| Payables to Beneficiaries | $ 214 | $ 36 | $ 1 | $ - | $ 251 |
| Other Liabilities | 6,693 | 28 | - | - | 6,721 |
| **Total Liabilities** | **$ 6,907** | **$ 64** | **$ 1** | **$ -** | **$ 6,972** |
| Cumulative Results of Operations | (1,220) | 1,967 | 62 | 14 | 823 |
| **Total Liabilities and Net Position** | **$ 5,687** | **$ 2,031** | **$ 63** | **$ 14** | **$ 7,795** |

| Statement of Net Cost Funds from Dedicated Collections (dollars in millions) For the Period Ending September 30, 2017 | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| Gross Program Costs | $ 587 | $ 555 | $ - | $ 1 | $ 1,143 |
| Less Earned Revenues | 496 | 4,064 | - | - | 4,560 |
| **Net Cost/(Benefit) of Operations** | **$ 91** | **$ (3,509)** | **$ -** | **$ 1** | **$ (3,417)** |

| Statement of Changes in Net Position Funds from Dedicated Collections (dollars in millions) For the Period Ending September 30, 2017 | Insurance | Medical Care | Benefits | Burial | Funds from Dedicated Collection |
|---|---|---|---|---|---|
| **Net Position Beginning of Period** | $ (1,200) | $ 1,988 | $ 62 | $ 15 | $ 865 |
| Budgetary and Other Financing Sources | 71 | (3,530) | - | - | (3,459) |
| Net (Cost)/Benefit of Operations | (91) | 3,509 | - | (1) | 3,417 |
| **Change in Net Position** | **(20)** | **(21)** | **-** | **(1)** | **(42)** |
| **Net Position End of Period** | **$ (1,220)** | **$ 1,967** | **$ 62** | **$ 14** | **$ 823** |

## NOTE 20. EXCHANGE TRANSACTIONS

### EXCHANGE REVENUES

Exchange revenue consists primarily of medical revenue recognized when earned from other Federal agencies or the public as a result of costs incurred or services performed on their behalf; benefits revenue from reimbursement of education benefit programs from Servicemember contributions that are transferred to the general fund account with Treasury; insurance revenue from insurance policy premiums paid by policyholders; and housing revenue from interest earned on direct loans. Exchange revenues are discussed further in Note 1.E - Revenues and Other Financing Sources.

Exchange revenue is usually based on the full cost associated with the goods exchanged or services performed. 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.

## PUBLIC EXCHANGE TRANSACTIONS

VA's Loan Guarantee Program collects certain fees that are set by law. VA's Loan Guarantee Program collects rental fees on a small number of properties during the period when the property is titled to VA.

The loan guarantee funding fees collected for September 30, 2018, and September 30, 2017, are $2.0 billion and $2.2 billion, respectively. The loan guarantee lender participation fees collected for September 30, 2018, and September 30, 2017, are $2.2 million and $2.3 million, respectively.

NCA leases lodges at seven cemeteries to not-for-profit groups, four for historic preservation and two for office space at no cost. These groups are required to provide the upkeep and pay the costs for utilities, insurance, minor repairs, maintenance, and any other costs associated with the lodges. NCA has agricultural licenses at 14 cemeteries with private sector entities, for which it receives rental payments and 1 with a not-for-profit group at no cost. Two permits are licensed to the Federal Aviation Administration and Department of Interior at no cost. Two easements are leased to commercial entities, which are required to pay annual fees for access to the land. Total rental revenues earned under the agreements above are $0.2 million for both September 30, 2018, and September 30, 2017.

The VHA OCC, Revenue Operations Payer Relations Office (PRO) Rates and Charges is responsible for implementing and maintaining these reasonable costs for billing third-party payers for services provided to insured Veterans for treatment of nonservice-connected conditions.

Under 38 CFR 17.101, reasonable costs are used to bill for reimbursable health care services, public workers' compensation, and tort and no-fault or uninsured motorists' insurance cases.

Reasonable costs are based on provider costs in the market area of each VA facility. Under regulations issued pursuant to Section 38 U.S.C. 1729 and published at 38 CFR 17.101, third-party payers may elect to pay VA's billed costs (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.

Per 38 CFR 17.102, cost-based and inter-agency per diems are calculated annually to produce rates used to bill for medical care or services provided by VA:

(a) Furnished in error or based on tentative eligibility;

(b) In a medical emergency, workers' compensation (Intragovernmental only), 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 DoD 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 the VHA Office of Finance (OF) Cost Reports.

## 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 sharing agreements 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. Under 38 U.S.C. 1729, VA has the right to recover or collect from a third party the reasonable costs of care or services so furnished or paid for to the extent that the recipient or provider of the care or services would be eligible to receive payment for such care or services from such third party if the care or services had not been furnished or paid for by VA. VHA captures the total amount of reimbursements received under DoD sharing agreements; additionally, VHA and DoD are currently working to develop a national billing methodology and reimbursement process.

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 OCC, Revenue Operations PRO Rates and Charges. Interagency billing rates are determined from cost and workload data in the VHA OF Cost Reports.

# NOTE 21. NET PROGRAM COSTS BY ADMINISTRATION

**Schedule of Net Program Costs by Administration (dollars in millions)**
**For the Period Ended September 30, 2018**

| | Veterans Health Administration | Veterans Benefits Administration | National Cemetery Administration | Indirect Administrative Program Costs | Total |
|---|---|---|---|---|---|
| **Intragovernmental Costs** | | | | | |
| Program Costs | $ 11,427 | $ 795 | $ 53 | $ 459 | $ 12,734 |
| Less Earned Revenues | (58) | (459) | - | (223) | (740) |
| **Net Intragovernmental Program Costs** | **11,369** | **336** | **53** | **236** | **11,994** |
| **Program Costs** | 73,059 | 104,966 | 279 | 1,648 | 179,952 |
| Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13) | - | 82,102 | - | - | 82,102 |
| Less Earned Revenues | (4,230) | (388) | - | (149) | (4,767) |
| **Net Program Costs** | **68,829** | **186,680** | **279** | **1,499** | **257,287** |
| Net Program Cost by Administration Before Changes in Veterans Benefits Actuarial Liability Assumptions | 80,198 | 187,016 | 332 | 1,735 | 269,281 |
| Net (Gain)/Loss from Actuarial Liability Assumptions (Note 13) | - | 79,153 | - | - | 79,153 |
| **Net Cost of Operations** | **$ 80,198** | **$ 266,169** | **$ 332** | **$ 1,735** | **$ 348,434** |

**Schedule of Net Program Costs by Administration (dollars in millions)**
**For the Period Ended September 30, 2017**

| | Veterans Health Administration | Veterans Benefits Administration | National Cemetery Administration | Indirect Administrative Program Costs | Total |
|---|---|---|---|---|---|
| **Intragovernmental Costs** | | | | | |
| Program Costs | $ 10,912 | $ 839 | $ 53 | $ 457 | $ 12,261 |
| Less Earned Revenues | (77) | (471) | - | (226) | (774) |
| **Net Intragovernmental Program Costs** | **10,835** | **368** | **53** | **231** | **11,487** |
| **Program Costs** | 67,005 | 100,864 | 301 | 1,697 | 169,867 |
| Veterans Benefits Actuarial Cost, Excluding Changes in Actuarial Assumptions (Note 13) | - | 75,353 | (200) | - | 75,153 |
| Less Earned Revenues | (4,127) | (409) | - | (243) | (4,779) |
| **Net Program Costs** | **62,878** | **175,808** | **101** | **1,454** | **240,241** |
| Net Program Cost by Administration Before Changes in Veterans Benefits Actuarial Liability Assumptions | 73,713 | 176,176 | 154 | 1,685 | 251,728 |
| Net (Gain)/Loss from Actuarial Liability Assumptions (Note 13) | - | 229,473 | 200 | - | 229,673 |
| **Net Cost of Operations** | **$ 73,713** | **$ 405,649** | **$ 354** | **$ 1,685** | **$ 481,401** |

## CHANGE IN PRESENTATION ON THE STATEMENT OF NET COST AND NOTE 21

The current year presentation of the Statements of Net Cost and the associated Note 21 has been changed from the prior year, FY 2017, presentation. This change is a considered a reclassification and has no other effect on the Consolidated Financial Statements or net position.

Beginning in FY 2018, in order to better align its costs with the Department's appropriation rollup structure, VA has consolidated the presentation of Veterans Benefits Actuarial Costs for Burial under VBA. These costs were previously shown under NCA. This presentation has been adjusted because, while the activity is related to burial-type functions, the associated costs are funded by the VBA Compensation and Pensions (C&P) appropriation and the programs themselves are administered by VBA. In FY 2018, the amount of cost reclassed from NCA to VBA was ($100 million) related to non-assumption changes and $2.4 billion from assumption changes.

## NOTE 22. DISCLOSURES RELATED TO THE STATEMENT OF BUDGETARY RESOURCES

### BUDGETARY ACCOUNTING

Effective FY 2018, the Statement of Budgetary Resources presentation was streamlined to reflect requirements of FASAB standards. The new Statement of Budgetary Resources format displays significant balances at a highly summarized and aggregated level by major categories deemed most relevant for Governmentwide display purposes. As a result of the format changes, the FY 2017 Statement of Budgetary Resources data was reclassified to conform with the new presentation. There are no other effects on the consolidated or combined financial statements.

Budgetary Resources, which includes prior year unobligated balances, new appropriations, borrowing authority, and direct spending authority, are forms of budget authority given to VA allowing it to incur obligations. Budget authority is provided by annual appropriation acts to enter into financial obligations that will result in immediate or future outlays involving VA funds. Budget authority may be classified by the period of availability (annual, 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 funds, 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 Treasury's 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 intragovernmental and public 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) 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 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.

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 five 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 cancelled.

An outlay is the amount of checks, disbursement of cash, or electronic transfer of funds to liquidate an intragovernmental 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.

Appropriations under Budgetary Resources in the Statement of Budgetary Resources do not agree to Appropriations Received under Budgetary Financing Sources in the Statements of Changes in Net Position. The amount in the Statement of Budgetary Resources includes appropriations from the general funds and special receipt funds, while the Statement of Changes in Net Position includes appropriations from the general funds only.

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

## APPORTIONMENT CATEGORIES OF OBLIGATIONS INCURRED

Apportionment categories are determined in accordance with the guidance provided in OMB Circular No. A-11, *Preparation, Submission and Execution of the Budget*. Category A consists of amounts requested to be apportioned by each calendar quarter in the fiscal year. Category B 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. Direct obligations are for statutory work, programs, or projects. Reimbursable obligations are for business-like transactions with the public or other Government agencies. Obligations incurred for direct and reimbursable obligations by apportionment category are shown below.

**Apportionment Categories of Obligations Incurred (dollars in millions)**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 | Change |
|---|---|---|---|
| Category A, Direct | $ 95,906 | $ 90,849 | $ 5,057 |
| Category B, Direct | 107,071 | 100,023 | 7,048 |
| Category A, Reimbursable | 555 | 506 | 49 |
| Category B, Reimbursable | 5,170 | 4,586 | 584 |
| **Total Obligations Incurred** | **$ 208,702** | **$ 195,964** | **$ 12,738** |

## BORROWING AUTHORITY

The Loan Guarantee Program principal repayment is expected over a 30-year period from the date of issuance of debt. 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 principal repayment is expected over a 2-year period from the date of issuance of debt. Loans generally had a duration of 1 year, and repayment was made from offsetting collections.

For September 30, 2017, Borrowing Authority was incorrectly reported as $82 and $2.5 million for Home Loan Guarantee Program and Vocational Rehabilitation Program Direct Loans, respectively; the total for both programs is correctly reported below as $67 million.

**Borrowing Authority**
**As of September 30, 2018 and 2017**

| | 2018 | 2017 | 2018 | 2017 |
|---|---|---|---|---|
| | Dollars In Millions | | Interest Rate | |
| Home Loan Guarantee Program | $ 107 | $ 66 | 2.9% to 3.1% | 1% to 4.8% |
| Vocational Rehabilitation Program Direct Loans | $ 1 | $ 1 | 1.4% | 1.6% |

## PERMANENT INDEFINITE APPROPRIATIONS

VA has three permanent and indefinite appropriations to cover unexpected housing losses. The Veterans Housing Benefit Program Account covers all estimated subsidy costs arising from post-1991 loan obligations for Veterans Housing Benefits. The fund’s objective is to encourage and facilitate the extension of favorable credit terms by private lenders to eligible Veterans and their families for the purchase, construction, or improvement of homes they occupy. The Native American Veteran Housing Loan Program Account was established to cover all subsidy costs arising from direct loan obligations related to a Veteran’s purchase, construction, or renovation of a dwelling on trust land. The Veterans Housing Benefit Program Liquidating Account is a Loan Guarantee Revolving Fund that contains all of VA’s pre-credit reform direct and guaranteed loans. It holds fund balances received from reimbursements from financing accounts for loan modifications and rentals of foreclosed properties not yet transferred to VA. This account is responsible for the property management expenses prior to the sale of foreclosed properties.

## EXPLANATIONS OF DIFFERENCES BETWEEN THE STATEMENT OF BUDGETARY RESOURCES AND THE BUDGET OF THE US GOVERNMENT

The table below documents the material differences between the FY 2017 Statement of Budgetary Resources and the actual amounts reported in the FY 2019 Budget of the U.S. Government. The FY 2020 Budget of the United States with the actual FY 2018 Statement of Budgetary Resources amounts will not be available until February 2019. Once published, the FY 2018 actual data will be available on the OMB Web site at http://www.whitehouse.gov/omb.

**Explanations of Differences Between the SBR and the Budget of the U.S. Government (dollars in millions)**

**For the Year Ended September 30, 2017**

| | Budgetary Resources | Obligations Incurred | Distributed Offsetting Receipts | Net Outlays |
|---|---|---|---|---|
| **Actual Balances per the 2019 Budget of the U.S. Government** | $ 225,241 | $ 195,968 | $ 33 | $ 180,937 |
| **Reconciling Items: *** | | | | |
| Expired Unobligated Funds | 2,645 | - | - | - |
| Expired Prior Year Budget Authority | 1,213 | | | |
| Medical Care Collections Fund health care Veterans co-payments excluded from the U.S. Budget but in the SBR | - | - | (3,508) | - |
| Special Funds not in the U.S. Budget but in the SBR | 6 | 1 | (1) | 1 |
| Offsetting Differences between the U.S. Budget and the SBR | - | - | (2,012) | - |
| Miscellaneous Differences | (3) | (5) | - | (2) |
| **Per the 2017 Statement of Budgetary Resources** | $ 229,102 | $ 195,964 | $ (5,488) | $ 180,936 |

*The material reconciling items are: expired unobligated balances, health care co-payments, special and trust funds, and distributed offsetting receipts. These items are reported in the Statement of Budgetary Resources and the SF 133, Report on Budget Execution and Budgetary Resources but are not in the Budget of the U.S. Government.

## USE OF UNOBLIGATED BALANCES OF BUDGET AUTHORITY

Available unobligated balances on the Statement of Budgetary Resources comprise 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 comprise unobligated funds that were not apportioned by OMB for FY 2018 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 the 2018 Appropriation Acts (P.L. 115-141 and 115-182). These purposes include Veterans medical care, research, education, construction and maintenance of VA buildings, Veterans and dependents benefits, Veterans life insurance, loan guarantee programs, Veterans burial benefits, and administrative functions. Various obligation limitations are imposed on individual VA appropriations.

## UNDELIVERED ORDERS AT THE END OF A PERIOD

| Undelivered Orders (dollars in millions) As of September 30, 2018 and 2017 | 2018 | | 2017 | |
|---|---|---|---|---|
| | Paid | Unpaid | Paid | Unpaid |
| Intragovernmental Undelivered Orders | $ 1,251 | $ 2,323 | $ 601 | $ 2,325 |
| Undelivered Orders | 59 | 13,785 | 33 | 14,095 |
| **Total Undelivered Orders** | **$ 1,310** | **$ 16,108** | **$ 634** | **$ 16,420** |

## CONTRIBUTED CAPITAL

| Contributed Capital (dollars in millions) As of September 30, 2018 and 2017 | 2018 | 2017 |
|---|---|---|
| General Post Fund | $ 45.6 | $ 42.2 |
| Supply Fund | 0.2 | 0.2 |
| National Cemetery Gift Fund | 0.1 | 0.5 |
| **Total Donations** | **$ 45.9** | **$ 42.9** |

## LEGAL ARRANGEMENTS AFFECTING THE USE OF UNOBLIGATED BALANCES

| Legal Arrangements Affecting the Use of Unobligated Balances (dollars in millions) As of September 30, 2018 and 2017 | 2018 | 2017 |
|---|---|---|
| Unapportioned Amounts Unavailable for Future Apportionments | $ 11,233 | $ 11,516 |
| Expired Authority | 3,089 | 2,645 |
| **Total Unobligated Balances** | **$ 14,322** | **$ 14,161** |

Unobligated balances of amounts available for apportionment are restricted by public law. Unobligated balances with expired authority remains available for 5 additional fiscal years for recording and adjusting previously recorded obligations properly charged or to record unrecorded obligations for the period of availability, but cannot be used to fund new obligations. VA's unapportioned balances for FY 2018 and 2017, respectively, are disclosed in the table above.

## NOTE 23. BUDGET AND ACCRUAL RECONCILIATION

VA presents its Statement of Net Cost using the accrual basis of accounting. This differs from the obligation-based measurement of total resources supplied, both budgetary and from other sources, on the Statement of Budgetary Resources. The objective of the information shown below is to present the relationship between budgetary and financial (proprietary) accounting through a Budget and Accrual Reconciliation (BAR) that reconciles VA's net budgetary outlays to the net cost of operations.

The schedule below begins with proprietary net cost of operations and is adjusted by components of net cost that are not part of net outlays, components of net outlays that are not part of net cost, and other temporary timing differences to reconcile with budgetary net outlays.

The Net Cost of Operations section matches the proprietary Statement of Net Cost and is the starting point for the reconciliation.

The components of net cost that are not part of net outlays section accounts for proprietary items that do not result in budgetary outlays during the current fiscal year. This includes depreciation, credit reform re-estimates, changes to assets and liabilities (including actuarial liabilities), transfers, and imputed financing.

The components of net outlays that are not part of net cost section accounts for budgetary outlays that do not result in proprietary cost for the current fiscal year. This includes prior year credit reform subsidy re-estimates and acquisition of assets.

The other temporary timing differences section accounts for other differences between budgetary and proprietary reporting that amount to temporary timing differences and are not captured in the prior sections.

The net outlays section matches Net Agency Outlays on the Statement of Budgetary Resources and sum of all prior BAR sections.

**DEPARTMENT OF VETERANS AFFAIRS**
**Budget and Accrual Reconciliation**
**For the Year Ended September 30, 2018**

| | Intragovernmental | With the Public | Total FY 2018 |
|---|---|---|---|
| **Net Operating Cost (SNC)** | $ 11,995 | $ 336,439 | $ 348,434 |
| **Components of Net Operating Cost Not Part of the Budgetary Outlays** | | | |
| Property, plant, and equipment depreciation | - | (2,061) | (2,061) |
| Property, plant, and equipment disposal and reevaluation | - | (265) | (265) |
| Year-end credit reform subsidy re-estimates | (94) | 2,477 | 2,383 |
| Other | (1,103) | 1,897 | 794 |
| **Increase/(decrease) in assets:** | | | |
| Accounts receivable | 1,268 | (42) | 1,226 |
| Loans receivable | - | (56) | (56) |
| Other assets | 646 | 29 | 675 |
| Investments | (1) | - | (1) |
| **(Increase)/decrease in liabilities not affecting Budget Outlays:** | | | |
| Accounts payable | 14 | (9,909) | (9,895) |
| Salaries and benefits | (17) | (74) | (91) |
| Insurance and guarantee program liabilities | - | 1,846 | 1,846 |
| Environmental and disposal liabilities | - | 17 | 17 |
| Other liabilities (Unfunded leave, unfunded FECA, actuarial FECA) | (2,555) | (160,052) | (162,607) |
| **Other financing sources** | | | |
| Federal employee retirement benefit costs paid by OPM and imputed to agency | (2,752) | - | (2,752) |
| Transfers out (in) without reimbursement | (221) | - | (221) |
| **Total Components of Net Operating Cost Not Part of the Budget Outlays** | **(4,815)** | **(166,193)** | **(171,008)** |
| **Components of the Net Outlays That Are Not Part of Net Cost** | | | |
| Effect of Prior Year Agencies Credit Reform Subsidy Re-estimates | (1,479) | - | (1,479) |
| Acquisition of capital assets | 409 | 2,198 | 2,607 |
| Acquisition of inventory | - | 1 | 1 |
| Other | (132) | 115 | (17) |
| **Total Components of Net Outlays That are Not Part of Net Cost** | **(1,202)** | **2,314** | **1,112** |
| **Net Outlays (Calculated Total)** | $ **5,978** | $ **172,560** | $ **178,538** |

| | |
|---|---|
| **Related Amounts on the Statement of Budgetary Resources** | |
| **Outlays, Net (SBR 4210)** | $ 184,804 |
| **Distributed offsetting receipts** | (6,266) |
| **Agency Outlays, Net** | $ **178,538** |

# SECTION II: REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED)

## 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.

| Non Federal Physical Property Investments (dollars in millions) For the Periods Ended September 30, 2014 2018 | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| State Extended Care Facilities | $ 90 | $ 90 | $ 140 | $ 105 | $ 92 |
| State and Tribal Veterans Cemeteries | 45 | 52 | 49 | 47 | 52 |
| **Total Grant Program Costs** | **$ 135** | **$ 142** | **$ 189** | **$ 152** | **$ 144** |

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, and day healthcare for Veterans in state homes. VA participates in two grant-in-aid programs for states. Under Title 38 CFR Part 59, VA may participate in up to 65 percent of the cost of construction or acquisition of state nursing homes or domiciliaries or in renovations of existing state homes. Over the last 5 fiscal years, the State Home Construction Grant Program has awarded grants in excess of $1 billion. VA also provides per diem payment for the care of eligible Veterans in state homes.

The Veterans Cemetery Grants Program was established in 1978. The program assists states, territories and federally-recognized tribal governments in providing gravesites for Veterans in those areas where VA's national cemeteries cannot fully satisfy their burial needs. State or tribal organizations provide the land and agree to operate the cemeteries in accordance to the operational standards and measures of the VA National Cemetery Administration (NCA). VA has awarded grants totaling more than $816 million to establish, expand, improve, operate, and maintain 111 Veterans cemeteries in 48 states and territories including tribal trust lands, Guam, Saipan, and Puerto Rico. And NCA-supported state cemeteries provided more than 39,500 interments in 2018.

# SECTION II: REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED)

## HUMAN CAPITAL

Investment in Human Capital through the Post-9/11 GI Bill programs, and the VR&E program is comprised of expenses for educational resources to supplement opportunities missed due to military service for Veterans, Servicemembers, reservists, and certain family members of Veterans.

These programs strengthen the Armed Forces both in recruiting and retaining members. For members of the Armed Forces, VA educational benefits assist in the readjustment to civilian life. On a broader scale, educational benefits are meant to enhance the Nation's competitiveness through the development of a more highly educated and more productive workforce.

VA education benefit programs serve approximately 1 million students and trainees annually and its largest program, the Post-9/11 GI Bill, alone provides over $10 billion a year in benefit payments to schools and trainees.

The VR&E program provides comprehensive services and assistance necessary to enable Veterans with service-connected disabilities and an employment handicap to obtain stable and suitable employment. The VR&E program also assists Veterans to achieve maximum independence in daily living when the severity of their disability prohibits suitable employment.

## PROGRAM OUTCOME

**Human Capital Investments (dollars in millions)**
**For the Periods Ended September 30, 2014 2018**

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **Program Expenses** | | | | | |
| Education and Training-Dependents of Veterans | $ 584 | $ 537 | $ 526 | $ 493 | $ 518 |
| Vocational Rehabilitation and Education Assistance | 13,975 | 13,960 | 14,503 | 13,543 | 14,206 |
| Administrative Program Costs | 537 | 536 | 533 | 512 | 502 |
| **Total Program Expenses** | **$ 15,096** | **$ 15,033** | **$ 15,562** | **$ 14,548** | **$ 15,226** |
| | | | | | |
| **Program Outputs (Participants)** | | | | | |
| Dependent Education | 103,644 | 99,265 | 95,477 | 91,755 | 90,641 |
| Veterans Rehabilitation | 132,189 | 117,742 | 107,491 | 86,928 | 93,363 |
| Veterans Education | 851,157 | 898,633 | 931,097 | 922,497 | 970,765 |

# SECTION II: REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED)

## HEALTH PROFESSIONALS EDUCATION

Title 38 U.S.C. mandates that VA assist in the training of health professionals for its own needs and those of the Nation. 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 partnerships between VA and the Nation's academic institutions, VA plays a leadership role in defining the education of future health care professionals to meet the changing needs of the Nation's health care delivery system.

VA's education mission contributes to high-quality health care of Veterans by providing a climate of scientific inquiry and evidence-based practice, rapid application of medical advances, supervised trainees who provide clinical care, and the recruitment of highly qualified health care professionals.

## PROGRAM OUTCOMES

**Health Professionals Education Investments**
**For the Periods Ended September 30, 2014   2018**

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| **Program Expenses (dollars in millions)** | | | | | |
| Physician Residents and Fellows | $ 767 | $ 746 | $ 715 | $ 689 | $ 748 |
| Associated Health Residents and Students | 167 | 162 | 171 | 168 | 157 |
| Instructional and Administrative Support | 935 | 892 | 903 | 851 | 905 |
| **Total Program Expenses** | **$ 1,869** | **$ 1,800** | **$ 1,789** | **$ 1,708** | **$ 1,810** |
| **Program Outputs (in units)** | | | | | |
| Health Professions Rotating Through VA: | | | | | |
| Physician Residents and Fellows | 44,028 | 43,100 | 43,400 | 41,534 | 40,420 |
| Medical Students | 24,683 | 24,683 | 24,283 | 22,931 | 21,541 |
| Nursing Students | 27,519 | 27,519 | 28,389 | 27,275 | 29,067 |
| Associated Health Residents and Students | 26,277 | 26,292 | 27,121 | 28,663 | 27,771 |

# SECTION II: REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED)

## INVESTMENT IN RESEARCH AND DEVELOPMENT (R&D)

VA's Research and Development (R&D) program is unique. It focuses on health issues that affect the daily lives of Veterans and all Americans through health care discovery and innovation in helping them regain their health, resume an active lifestyle, or reclaim their vital roles in family and community.

It is comprised of expenses incurred to support the programs which span the continuum from biomedical research through the translation of research into practice in the VA Health Care System. The R&D activities are presented in three major categories:

(1) Basic research, the systematic study to discover new knowledge or refined knowledge that advances health care for Veterans and the Nation.

(2) Applied research, the systematic work to apply scientific knowledge to develop effective individualized care solutions for Veterans.

(3) Experimental development, the systematic use of the knowledge and understanding gained from researches for the useful materials, devices, systems, or methods, including the design and development of prototypes and processes.

**Research & Development Investments (dollars in millions)**
**For the Periods Ended September 30, 2014 2018**

| | FY 2018 | FY 2017 | FY 2016 | FY 2015 | FY 2014 |
|---|---|---|---|---|---|
| Basic Research | $ 514 | $ 501 | $ 368 | $ 367 | $ 245 |
| Applied Research | 701 | 721 | 769 | 673 | 904 |
| Experimental Development | 28 | 24 | 30 | 29 | 37 |
| **Total Program Expenses** | **$ 1,243** | **$ 1,246** | **$ 1,167** | **$ 1,069** | **$ 1,186** |

Nested within the Veterans Health Administration—the Nation's largest health care system—VA Research and Development is viewed by many experts as a model for rigorous, impactful research. It consists of four main research services working together to address the full spectrum of Veterans' health needs. These investments are treated as expenses in determining the net cost of operations and divided up between Basic/Applied/Experimental Development on a percentage basis just to divide it up in the categories reported.

(1) **Biomedical Laboratory R&D Service:** 100% Basic conducting preclinical and clinical research to understand life processes from the molecular, genomic, and physiological level in regarding to diseases and disability affecting Veterans. It includes research on animal models and investigations of tissues, blood, or other biologic specimens from humans. It also

includes studies on humans of moderately limited scope.

(2) **Clinical Science R&D Service:** 100% Applied conducting research that focuses on intact human beings as the unit of examination. Examples include interventional and effectiveness studies, clinical, epidemiological, and technological studies.

(3) **Health Services R&D Service**: 100% Applied pursuing research at the interface of health care systems, patients, and health care outcomes. Health Services R&D underscores all aspects of VA health care such as specifically in quality, access, patient outcomes, and health care costs.

(4) **Rehabilitation R&D Service**: 85% Applied, 15% Experimental Development being dedicated to the well-being of America's Veterans through a full spectrum of research: from approved rehabilitation research projects through evaluation and technology transfer to final clinical application.

**Research and Development Measures Actual**
**For the Periods Ended September 30, 2014 2018**

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Number of Research and Development Projects | 2,180 | 2,150 | 2,205 | 2,224 | 2,184 |

The following are significant outcomes of the research and experimental development projects and their accomplishments in FY 2018:

**Post-Deployment Health:**

Comprehensive researches developed with input from leading scientists, physicians, and Veterans themselves that identify and address autoimmune disease, neurodegenerative disease, trauma, different pattern of disorders and injuries from explosions, and mental health issues affecting Veterans after they return home from deployment including Gulf War Veterans; Afghanistan and Iraq Veterans; Vietnam Veterans.

**Women's Health:**

Currently, there are 2 million living women Veterans who make up 10 percent of the total Veteran population. VA researchers are looking at a broad range of health issues related to women Veterans, including gender differences in health status and health care; risk and resilience factors; mental and behavioral health; the impacts of military service, era of service and combat; sexual trauma; gynecological and reproductive care; access to care; and women Veterans' experiences of and preferences for care. Recent research is also addressing issues related to intimate partner violence and homelessness among women Veterans, as well as special needs of specific populations of women (e.g., rural dwellers, minorities, and Lesbian, Gay, Bisexual, Transgender (LGBT) Veterans).

**Spinal Cord Injuries (SCI):**

SCIs impair the brain's ability to send messages to the rest of the body. These injuries can result in paralysis, loss of feeling, chronic pain, and other serious medical problems below the site of injury. SCIs are estimated to affect as many as 337,000 Americans, with about 12,500 new injuries occurring each year. VA provides care to more than 27,000 Veterans with SCIs and related disorders each year, making the department the largest health care system in the world providing lifelong spinal cord care.

**Diabetes:**

More than 29 million Americans have diabetes, according to the Center for Disease Control (CDC), and 86 million more Americans are at risk to develop the disease. Many Veterans have the disease, including some who developed it as a result of being exposed to herbicides while serving in Vietnam. VA researchers are studying innovative strategies and technologies, including group visits, telemedicine, peer counseling, and Internet-based education and case management to enhance access to diabetes care and to improve outcomes for patients

**Complementary and Integrative health:**

In VA, complementary and integrative health approaches are most commonly used to help Veterans manage stress, or to promote general wellness. They are also often used to treat posttraumatic stress disorder (PTSD), depression, back pain, headache, arthritis, fibromyalgia (long-term pain throughout the body), and substance abuse.

One of the greatest challenges in this area of medicine is critically examining popular claims about the effectiveness of therapies that have not been rigorously tested in formal research. VA researchers are committed to filling in scientific gaps. They are conducting studies to determine which therapies are truly safe and effective, and for which conditions and populations they work best. VA lands some studies on meditation, yoga, electroacupuncture as other low cost and low risk means but useful and getting high national attention on reducing cardiovascular disease, on improving adverse effects of menopause or easing physical pain.

**PTSD and heart disease:**

When most people think of PTSD the first thing that comes to mind is, well, stress. But mental health isn't the only body system that can suffer from the effects of PTSD. Researchers have known for quite some time that prolonged stress can affect multiple organ systems, for example, the cardiovascular system—which consists of the heart and blood vessels.

**Brain Health Traumatic Brain Injury:**

The DoD estimates that 22 percent of all combat casualties from Iraq and Afghanistan are brain injuries. TBI is also a significant cause of disability outside of military settings, most often as the result of assaults, falls, automobile accidents, or sports injuries. It can involve symptoms ranging from headaches, irritability, and sleep disorders to memory problems, slower thinking, and depression.

**Substance Use Disorders:**

Substance use and abuse, with its associated health consequences, is a major public health problem. Substance use disorders (SUD) include dependencies on alcohol, illicit and prescription drugs, and nicotine. SUDs have substantial negative consequences on Veterans' mental and physical health, work performance, housing status, and social function. VA supports a broad portfolio of research looking at substance abuse prevention, screening, and treatment.

**Mental Health**

- PTSD

In earlier wars, it was called soldier's heart, shell shock, or combat fatigue. Today, doctors recognize these terms as a distinct medical condition called posttraumatic stress disorder. The disorder can lead to distressing and persistent symptoms, including re-experiencing trauma through flashbacks or nightmares, emotional numbness, insomnia, relationship problems, sudden anger, and drug and alcohol abuse.

- Suicide Prevention

Veterans can be at risk for suicide for a variety of reasons. Some are coping with aging, stress, or lingering effects stemming from their military service that have never been addressed. Many have underlying mental health conditions or substance use disorders, in some cases aggravated by their military service. Many recently discharged Veterans have difficulty with personal relationships or their transition back to civilian life.

- Brain stimulation technique shows promise in reducing fear in Veterans with PTSD

The technique—transcranial direct current stimulation (tDCS)—has been tested experimentally to help treat a range of conditions, including depression, schizophrenia, stroke, obsessive-compulsive disorder, and chronic pain. This is the first study to evaluate whether tDCS may improve the ability of Veterans with PTSD to withstand potentially fearful moments.

# SECTION II: REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED)

## 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 and 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 repair estimates are recorded for capitalized assets and are distinguished from capital improvements that expand the capacity of an asset or otherwise upgrade it to serve needs different from, or significantly greater than, its current use.

In April 2012, FASAB issued SFFAS No. 42, *Deferred Maintenance and Repairs: Amending Statements of Federal Financial Accounting Standard 6, 14, 29, and 32,* which is effective for periods beginning after September 30, 2014. The standard required expanded qualitative and quantitative disclosure of deferred maintenance and repairs.

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 (FCA) Surveys, which are inspections of property, plant and equipment based on generally accepted methods and standards consistently applied, are used to assign condition ratings and estimate costs for each fixed asset to correct deficiencies. An independent interdisciplinary professional contractor team tours and evaluates approximately 6,000 VA buildings on a three-year cycle, assessing all components. Building components assessed include architectural structural, mechanical, plumbing, and electrical systems. Also included for assessment are capitalized, fully depreciated, and noncapitalized elements of general PP&E, heritage assets, and stewardship land. Each property, plant, and equipment component is given a description, an estimate of remaining useful life, and a grade from "A" to "F" based on VA's standard evaluation guidelines. Any building component graded "D" (poor) and "F" (critical) is given an estimated correction cost and recorded in Deferred Maintenance and Repairs, except where deficiencies will be replaced by capital expenditures. See Notes 1, 9, and 10 for additional information on general PP&E and heritage assets.

# SECTION II: REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED)

VA is experiencing an upward trend in Deferred Maintenance and Repairs as a result of (1) increased maintenance and repair costs as buildings age, (2) maintenance and repair budgets that have not grown in proportion with an increasing portfolio of owned space and inflation rates, and (3) expanded scope of FCA survey requirements significantly increase cost estimates when sites are reevaluated.

**Schedule Of Deferred Maintenance And Repairs (dollars in millions)**
**As of September 30, 2018**

| | 2018 Beginning Balance | 2018 Ending Balance |
|---|---|---|
| General PP&E | $ 10,047 | $ 11,330 |
| Heritage Assets | 977 | 939 |
| **Total Deferred Maintenance and Repairs** | **$ 11,024** | **$ 12,269** |

# SECTION II: REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED)

**Schedule of Budgetary Activity (dollars in millions)**
**As of September 30, 2018**

| | New Obligations and Upward Adjustments | Unexpired Unobligated Balance, end of year | Expired Unobligated Balance, end of year | Total Budgetary Resources | Total Outlays, net |
|---|---|---|---|---|---|
| **Veterans Health Administration** | | | | | |
| 0152 Medical Admin | $ 6,802 | $ 112 | $ 329 | $ 7,243 | $ 6,550 |
| 0160 Medical Care | 49,341 | 1,388 | 2,057 | 52,786 | 48,942 |
| 0162 Medical Facilities | 6,434 | 1,078 | 157 | 7,669 | 5,512 |
| 0167 Medical Facilities | 4,143 | 207 | 293 | 4,643 | 4,173 |
| 0172 Veterans Choice Fund | 4,683 | 4,644 | - | 9,327 | 3,991 |
| All Other | 15,501 | 3,845 | 110 | 19,456 | 12,501 |
| **Total** | **86,904** | **11,274** | **2,946** | **101,124** | **81,669** |
| **Veterans Benefits Administration** | | | | | |
| 0102 Compensation, Pension, & Burial Benefits | 92,357 | 2,098 | - | 94,455 | 84,568 |
| 0137 Readjustment Benefits | 13,431 | 6,824 | - | 20,255 | 12,455 |
| 4127 Direct Loan Financing | 40 | 90 | - | 130 | (30) |
| 4129 Guaranteed Loan Financing | 4,716 | 10,923 | - | 15,639 | 57 |
| 8132 National Service Life | 752 | - | - | 752 | 776 |
| 0151 General Operating Expenses | 3,987 | 111 | 59 | 4,157 | 2,814 |
| All Other | 2,523 | 1,482 | 16 | 4,021 | 1,423 |
| **Total** | **117,806** | **21,528** | **75** | **139,409** | **102,063** |

(continues on next page)

# SECTION II: REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED)

| Schedule of Budgetary Activity (dollars in millions) As of September 30, 2018 | New Obligations and Upward Adjustments | Unexpired Unobligated Balance, end of year | Expired Unobligated Balance, end of year | Total Budgetary Resources | Total Outlays, net |
|---|---|---|---|---|---|
| **National Cemetery Administration** | | | | | |
| **Total** | **367** | **14** | **7** | **388** | **342** |
| **Indirect Administrative Program Cost** | | | | | |
| 0142 General Administration | 707 | 11 | 48 | 766 | 313 |
| 1122 Board of Veterans Appeals | 152 | 18 | 5 | 175 | 143 |
| 4537 Supply Fund | 1,532 | 200 | - | 1,732 | 92 |
| All Other | 1,234 | 34 | 8 | 1,276 | 182 |
| **Total** | **3,625** | **263** | **61** | **3,949** | **730** |
| **Total of all Administrations** | **$ 208,702** | **$ 33,079** | **$ 3,089** | **$ 244,870** | **$ 184,804** |

# Report Distribution

## VA Distribution

Office of the Secretary
Veterans Benefits Administration
Veterans Health Administration
National Cemetery Administration
Assistant Secretaries
Office of General Counsel
Office of Acquisition, Logistics, and Construction
Board of Veterans' Appeals

## Non-VA Distribution

House Committee on Veterans' Affairs
House Appropriations Subcommittee on Military Construction, Veterans Affairs, and Related Agencies
House Committee on Oversight and Government Reform
Senate Committee on Veterans' Affairs
Senate Appropriations Subcommittee on Military Construction, Veterans Affairs, and Related Agencies
Senate Committee on Homeland Security and Governmental Affairs
National Veterans Service Organizations
Government Accountability Office
Office of Management and Budget

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