

Independent Auditor's Report



Department of Veterans Affairs Office of Inspector General

REPORT OF THE AUDIT OF THE DEPARTMENT OF VETERANS AFFAIRS CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2003 AND 2002

Report No. 03-01237-21

VA Office of Inspector General

November 14, 2003



DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

Memorandum to the Secretary

**Report of Audit of the Department of Veterans Affairs Consolidated
Financial Statements for Fiscal Years 2003 and 2002**

1. Attached is the Report of Audit of the Department of Veterans Affairs (VA) Consolidated Financial Statements (CFS) for Fiscal Years (FY) 2003 and 2002. The Chief Financial Officers Act of 1990 requires this audit. The OIG contracted with the independent public accounting firm Deloitte & Touche LLP to perform the audit of VA's FY 2003 CFS.
2. The independent auditors' report by Deloitte & Touche LLP provides an unqualified opinion on VA's FYs 2003 and 2002 CFS. The report on internal control identifies four reportable conditions, of which two are material weaknesses. The two material weaknesses are (i) information technology security controls and (ii) integrated financial management system. The two reportable conditions are (i) operational oversight, and (ii) medical malpractice claims data. Three of the four findings were reported last year; the medical malpractice claims data is the new reportable condition for FY 2003. During FY 2003, VA management has taken corrective action to eliminate the following two reportable conditions reported in the FY 2002 audit report: (i) loan guaranty business process, and (ii) application program and operating system change controls.
3. The report on compliance with laws and regulations continues to conclude that VA is not in substantial compliance with the financial management system requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996. The internal control issues concerning an integrated financial system and information technology security controls indicate noncompliance with the requirements of Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," which incorporates by reference OMB Circulars A-123, "Management Accountability and Control," and A-130, "Management of Federal Information Resources."
4. The material weakness and FFMIA noncompliance issues concerning VA's financial management systems underscore the importance that VA must continue its efforts to implement a replacement integrated core financial management system. The auditors' unqualified opinion was achieved through the extensive efforts of program and financial management staff, as well as the auditors, to overcome material weaknesses in internal control to produce auditable information after the fiscal year-end. Although these efforts resulted in materially correct annual financial statements, reliable information was not readily available during the year. The risk of materially misstating financial information remains high with the existing financial management systems.
5. The independent auditors will follow up on these internal control findings and evaluate any corrective actions during the audit of the Department's FY 2004 Consolidated Financial Statements.
6. VA is to be congratulated for its remarkable accomplishment in accelerating the issuance of its audited financial statements by November 15, 2003, while maintaining an unqualified audit opinion. This accomplishment is achieved well in advance of the January 31, 2004 deadline established by the Office of Management and Budget (OMB). With the success in accelerating the FY 2003 financial statement audit, VA is on target to meet the OMB required November 15 due date for FY 2004 audited financial statements.

A handwritten signature in black ink, appearing to read "Michael Slachta, Jr." with a stylized flourish at the end.

MICHAEL SLACHTA, JR
Assistant Inspector General for Auditing

Attachment



Deloitte & Touche LLP
1750 Tysons Boulevard
McLean, Virginia 22102-4219

Tel: (703) 251-9000
Fax: (703) 251-3400
www.us.deloitte.com

INDEPENDENT AUDITORS' REPORT

To the Secretary
Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs (VA) as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, financing and the combined statements of budgetary resources for the years then ended (collectively referred to as the financial statements). These financial statements are the responsibility of the management of VA. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and the requirements of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of VA as of September 30, 2003 and 2002, and its net costs, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 11, 2003, on our consideration of VA's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

VETERANS DAY, 11:00 AM
November 11, 2003



Deloitte & Touche LLP
1750 Tysons Boulevard
McLean, Virginia 22102-4219

Tel: (703) 251-1000
Fax: (703) 251-3400
www.us.deloitte.com

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

To the Secretary
Department of Veterans Affairs

We have audited the financial statements of the Department of Veterans Affairs (VA), as of and for the year ended September 30, 2003, and have issued our report thereon dated Veterans Day, November 11, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the requirements of the Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements", as amended.

INTERNAL CONTROL OVER FINANCIAL REPORTING

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

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.

We identified the following matters involving the internal control over financial reporting and operations that we consider to be material weaknesses and other reportable conditions as defined above. Material weaknesses and other reportable conditions that we identified in our prior year report dated December 16, 2002 are identified as repeat conditions. The material

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weaknesses and the reportable conditions are categorized under the headings Information Technology and Operations.

Four reportable conditions are described in the following paragraphs and include significant departures from certain requirements of OMB Circular A – 127, "Financial Management Systems," which incorporates by reference Circulars A – 123, "Management Accountability and Control," and A – 130, "Management of Federal Information Resources," among other requirements. We believe that the two reportable conditions identified as "Information Technology (IT) Security Controls" and "Integrated Financial Management System," are also material weaknesses.

INFORMATION TECHNOLOGY

Information Technology (IT) Security Controls – Material Weakness

(Repeat Condition)

During fiscal year 2003, VA made organizational changes in the information technology area that facilitated IT security controls improvements through centralization of certain information technology controls initiatives. Application program offices have also initiated corrective actions to remediate material weaknesses reported in the prior year internal control report. However, VA's program and financial data continue to be at risk due to serious weaknesses related to the VA's implementation and enforcement of controls and oversight over access to and recovery of its information systems. These weaknesses placed sensitive information, including financial data and veterans' medical and benefit information, at risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction, possibly occurring without detection. The VA Office of Inspector General (OIG) first reported this condition in its fiscal year 1997 audit report and made recommendations for VA to implement a comprehensive security program that would improve these controls. VA has acknowledged these weaknesses and first reported IT security controls as a material weakness in its Federal Managers' Financial Integrity Act (FMFIA) report for fiscal year 1998.

Our testing of key controls over security administration for the general computer systems at VA's primary data centers and fourteen medical facilities, as well as the payroll system (Personnel and Accounting Integrate Data – PAID), and the Integrated Funds Distribution, Control Point Activity, Accounting and Procurement (IFCAP) and the OIG's testing for Federal Information Security Management Act (FISMA) reporting identified the following control weaknesses. The systems control weaknesses are summarized below:

- For general computer systems including network, operating systems and databases, the control weaknesses included inconsistent implementation of network access authentication mechanism and administration of user access at medical centers; inadequate accountability through sharing of generic administrator accounts; inappropriate access privileges due to non-restrictive system and database access profiles for internal operations and programming staff, and inconsistent monitoring and review of user access.
- In the PAID and IFCAP applications, we identified security weaknesses including improper design of system controls to support segregation of duties, inappropriate

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access privileges and inadequate management of access privileges, and inadequate segregation of duties.

- Continuity of Operations Plans (COOPS) at certain medical centers and medical facilities has not been fully tested. A business continuity plan at the VA's level has not been fully developed to provide overall guidance, directions and coordination.

These weaknesses increase the risk of unauthorized or erroneous data transfer, and inability to fully recover production programs and data, resulting in unreliable data that are used for VA's financial reporting.

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

Recommendation

We reaffirm our prior year recommendations and the OIG's recommendation in the FISMA report that VA:

1. Apply appropriate resources and accountability mechanisms in order that the planned actions be accomplished within an acceptable timeframe and will remediate the deficiencies identified in the IT Security Certification and Accreditation (C&A) and FISMA process.
2. Communicate and implement standardized information systems security administration policies and procedures, improve information systems security and segregation of duties controls over general systems and key financial applications such as the PAID and IFCAP systems, and assign, communicate, and coordinate responsibility for monitoring and enforcing such controls in a consistent fashion throughout VA.
3. Develop a business plan at the VA level that will facilitate effective communication and implementation of overall guidance and standards, and provide coordination of VA's business continuity effort to ensure that timely resumptions of normal business operations can be accomplished.

OPERATIONS

Integrated Financial Management System – Material Weakness

(Repeat Condition)

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

With respect to system requirements in the area of financial reporting, OMB Circular A – 127 provides that an agency's financial management system should generate reliable, timely, and consistent information necessary for meeting management's responsibilities, including the preparation of financial statements. Within OMB Circular A – 123, the management control processes necessary to ensure that "reliable and timely information is obtained, maintained, reported and used for decision making" are set forth, including prompt and appropriate recording and classification.

During our audit of VA's consolidated financial statements, we noted continuing difficulties related to the preparation, processing, and analysis of financial information to support the efficient and effective preparation of VA's consolidated financial statements. Significant efforts were made at the component and consolidated levels to assemble, compile, and review the necessary financial information for annual financial reporting requirements. However, in many cases, significant manual work-arounds and out-of-date feeder systems were still in place, as VA had not yet completed its transition to a fully integrated financial management system. Some manual controls were not effective to ensure the quality and accuracy of data in an information system. For example, we noted that:

- In the Veterans Health Administration (VHA), some medical centers were not performing account reconciliations on a consistent basis and assets were not capitalized in a timely manner.
- VBA Management identified 8,575 direct loans (15% reduction from fiscal year 2002) that were not correctly amortized for subsequent loan modifications resulting in an unpaid principal balance of \$37.0 million on their scheduled maturity dates. VBA management provided a detailed analysis of the loans. Management asserted that the likely unpaid balance of direct loans that would reach maturity for which VA would have limited recourse would be approximately \$1.6 million.

Given the size and complexity of the VA, as well as the current status of the system development and implementation cycles for planned improvements, it is critical that enhanced control, monitoring and reconciliation processes be in place and functioning appropriately throughout the year to ensure accurate and complete financial reporting.

Recommendation

4. We affirm our prior year's recommendation that even though fully automated processes may not yet be in place, supplemental manual processes should be implemented and enforced to meet appropriate control objectives.
5. Account reconciliations need to be performed on a more consistent basis to ensure the quality and accuracy of the financial data.

Operational Oversight

(Repeat Condition)

During our audit, we conducted site visits to selected VA medical centers or stations to test compliance with identified control and reconciliation processes. We continued to note a number

of previously reported instances where application of control and reconciliation processes were not performed consistently or completely. If the condition existed at over 25% of the sites, then we deem the condition to be significant noncompliance. In several instances, existing Department procedures for supervisory review were not applied consistently or timely. Examples include instances where medical centers were not adequately billing some medical services to patients with third party insurance. Individuals had multiple obligation and payment authority. This precluded a proper separation of duties. We frequently observed ineffective or inefficient processes in the areas of property, plant and equipment; medical accounts receivable; and accounts payable during our site visits.

Recommendation

6. We reaffirm our prior year's recommendation that procedures for appropriate and timely management reviews, separation of duties and account reconciliations be formalized and implemented to achieve improved internal control over financial reporting. VHA Management should improve the monitoring of existing policies and procedures implemented.

Medical Malpractice Claims Data

The Office of General Counsel (OGC) did not adequately review the medical malpractice and tort claims data from the claims reporting system for completeness and accuracy. Multiple errors were detected in data submitted to outside actuarial specialists. Consequently, the specialists received several versions of claims data to calculate the actuarial valuation of the medical malpractice liability as of September 30, 2003. The following items were noted:

- Early in fiscal year 2003, OGC completed the installation of GCLAWS, a claims tracking system, at the 23 Regional Counsel offices. GCLAWS replaced the Regional Council Management Information System (RCMIS). During a reconciliation of the GCLAWS and RCMIS paid medical malpractice claims data as of September 30, 2002, an outside consultant identified an \$11 million difference. OGC's detailed review of the difference determined that paid claims data was not recorded in the RCMIS prior to extracting data for GCLAWS.
- In addition, the contract actuaries determined the reserve estimate was understated by approximately 4% (\$18.6 million) as of September 30, 2002.
- Based on the paid medical malpractice claims data in GCLAWS, the consultant initially calculated the loss paid data as of September 30, 2003 incorrectly and provided the information to the contract actuaries. Our reconciliation of the paid loss detail to the report showed a \$12 million difference. A review of the difference by the consultant determined the paid loss data for five accident years was incorrectly calculated.

Recommendation

7. We recommend that OGC management validate data sent to outside consultants in order to reduce the occurrence of error due to completeness and accuracy. This process will increase the timeliness and accuracy of the valuation.

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Follow-up on Previous Report

In our report in connection with the fiscal year 2002 VA financial statements dated December 16, 2002, we reported five reportable conditions (with two material weaknesses) in the areas of (1) Information Technology (IT) Security Controls, (2) Application Program and Operating System Change Controls, (3) Integrated Financial Management System, (4) Loan Guaranty Business Process and (5) Operational Oversight. The material weaknesses repeated in fiscal year 2003 are items (1) and (3). Item (5) remains as a reportable condition in fiscal year 2003.

With respect to the internal control related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not provide an opinion on such controls.

In addition, we considered VA's internal control over Supplementary Information by obtaining an understanding of VA's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin 01-02. Our procedures were not designed to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

COMPLIANCE

VA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether VA's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants; noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*, and are described below.

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

The material weaknesses in internal control over financial reporting discussed above and identified as "Integrated Financial Management System" and "Information Technology (IT) Security Controls", indicate that VA is not in full compliance with the requirements of OMB Circulars A - 123, A - 127, and A - 130. As discussed above, we found material weaknesses in (1) the design and operation of internal controls over financial reporting, particularly with

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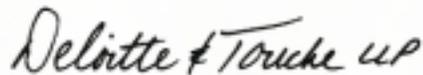
effectiveness of the control, monitoring and reconciliation processes in support of the preparation of the Department's consolidated financial statements, given the status of the transition to a fully integrated financial management system; and (2) the effectiveness of the information technology security controls.

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

In addition, we noted other matters involving the internal control and compliance over financial reporting that we have reported to management of the VA in a separate letter dated Veterans Day, November 11, 2003.

DISTRIBUTION

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



VETERANS DAY, 11:00 AM
November 11, 2003

Department of Veteran's Affairs

Memorandum

Date: NOV 10 2003

From: Assistant Secretary for Management (004)

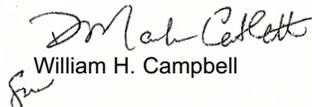
Subj: Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2003 and 2002

To: Assistant Inspector General for Auditing (52)

We have reviewed the Report of the Office of Inspector General Audit for Fiscal Years 2003 and 2002 and are pleased with receipt of an unqualified opinion. We are especially proud that we were able to meet the Fiscal Year 2004 timeframe requirements established by the Office of Management and Budget one year ahead of schedule. Please extend to your staff, and the staff of Deloitte & Touche, LLP, our appreciation for their detailed planning, hard work and cooperation during this year's audit.

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

Thank you again for your efforts in bringing us to another successful conclusion of the audit cycle. If you have any questions, please contact me at 273-5589.


William H. Campbell