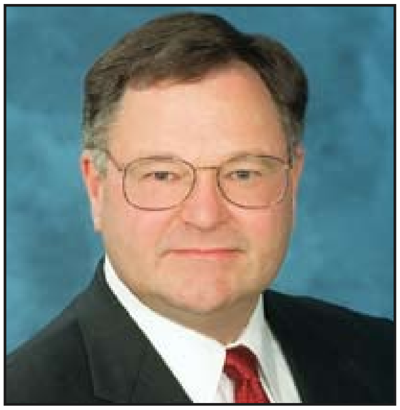
A Letter from the Chief Management Officer

Again in FY 2005 and for the 7th consecutive year, the Department of Veterans Affairs (VA) received an unqualified audit opinion on its financial statements from the external auditors, Deloitte & Touche. We are very proud of this accomplishment.

During FY 2005, we continued progress toward resolving two outstanding audit material weaknesses as reported by Deloitte & Touche – *Information Technology Security Controls* and *Lack of an Integrated Financial Management System*. VA validated that it was compliant with the Health Insurance Portability and Accountability Act (HIPAA) and certified and accredited over 600 information technology systems. We also initiated projects to automate the preparation of our consolidated financial statements using commercial software and are establishing a data warehouse to not only enhance our financial reporting, but also to ensure the integrity of the data used. Following the termination of VA's planned new computerized financial management and logistics system, CoreFLS, VA initiated a thorough review by PriceWaterhouseCoopers of all the Department's current "As Is" and future "To Be" finance and logistic business processes. As a result of this effort, VA is moving forward with a new project initiative: Financial & Logistics Integrated Technology Enterprise (FLITE). This 4-year remediation program will correct financial and logistics deficiencies throughout the Department, standardize many of our business processes and maximize the use of commercial off-the-shelf finance/logistics software. We will continue to work on eliminating all material weaknesses, including the operational oversight material weakness identified in our most recent audit.

VA corrected and closed an FMFIA material weakness, *Personnel Accounting Integrated Data (PAID) System – Mission Performance*, and is on track to correct the *Internal Control Weaknesses in the Compensation and Pension Payment Process* in FY 2006. No additional FMFIA material weaknesses have been identified. Additionally, VA has begun to address the requirements of OMB Circular A-123, Appendix A, on internal controls over financial reporting.



VA successfully completed risk assessments, statistical sampling and all other requirements for all programs under the Improper Payments Information Act of 2002. Furthermore, VA achieved all audit recovery targets for improper payments during the fiscal year. VBA also made progress in simplifying agency regulations for disability determinations which should further decrease improper payments by improving the accuracy of the payment amounts and ensuring that payments are provided to the appropriate beneficiaries.

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

We are proud of our many accomplishments, but realize there is a lot of work yet to be done. We continually strive to improve our financial posture and financial stewardship, and have set new goals to improve our performance. We will continue to promote sound business practices and accountability toward the ultimate goal of fulfilling our mission to serve our Nation's veterans.

Tim S. McClain

Tim S. McClain

Consolidated Financial Statements

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

	2005	2004
ASSETS		
INTRAGOVERNMENTAL		
Fund Balance with Treasury (Note 3)	$ 17,087	$ 16,741
Investments (Note 5)	13,286	13,643
Accounts Receivable, Net (Note 6)	72	132
Other Assets	40	122
TOTAL INTRAGOVERNMENTAL ASSETS	**30,485**	**30,638**
PUBLIC		
Investments (Note 5)	178	184
Accounts Receivable, Net (Note 6)	920	887
Loans Receivable, Net (Note 7)	2,320	2,954
Cash (Note 4)	87	68
Inventories (Note 8)	76	69
General Property, Plant and Equipment, Net (Note 9)	11,232	11,215
Other Assets	46	56
TOTAL PUBLIC ASSETS	**14,859**	**15,433**
TOTAL ASSETS	**$ 45,344**	**$ 46,071**
LIABILITIES		
INTRAGOVERNMENTAL		
Accounts Payable	$ 66	$ 72
Debt	2,193	2,618
Other Liabilities (Note 13)	2,619	2,134
TOTAL INTRAGOVERNMENTAL LIABILITIES	**4,878**	**4,824**
PUBLIC		
Accounts Payable	570	3,003
Liabilities for Loan Guarantees (Note 7)	3,465	4,740
Federal Employee and Veterans Benefits Liability (Note 11)	1,124,376	926,553
Environmental and Disposal Liabilities (Note 12)	376	339
Insurance Liabilities (Note 15)	12,014	12,291
Other Liabilities (Note 13)	7,077	7,047
TOTAL PUBLIC LIABILITIES	**1,147,878**	**953,973**
TOTAL LIABILITIES	**1,152,756**	**958,797**
NET POSITION		
Unexpended Appropriations	2,306	2,642
Cumulative Results of Operations	(1,109,718)	(915,368)
TOTAL NET POSITION	**(1,107,412)**	**(912,726)**
TOTAL LIABILITIES AND NET POSITION	**$ 45,344**	**$ 46,071**

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

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

	2005	2004
NET PROGRAM COSTS (NOTE 18)		
Medical Care	$ 28,399	$ 25,396
Medical Education	542	1,111
Medical Research	659	898
Compensation	29,596	27,306
Pension	3,627	3,526
Education	2,202	2,037
Vocational Rehabilitation and Employment	700	676
Loan Guaranty	(1,432)	1,141
Insurance	148	63
Burial	332	332
NET PROGRAM COSTS BEFORE CHANGES IN VETERANS BENEFITS ACTUARIAL LIABILITIES	**64,773**	**62,486**
Compensation	197,300	(30,100)
Burial	500	100
SUBTOTAL	197,800	(30,000)
NET NON-PROGRAM COSTS	859	781
NET COST OF OPERATIONS (NOTE 18)	**$ 263,432**	**$ 33,267**

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

DEPARTMENT OF VETERANS AFFAIRS
CONSOLIDATED STATEMENT OF CHANGES IN NET POSITION
FOR THE YEAR ENDED SEPTEMBER 30, 2005
(DOLLARS IN MILLIONS)

	Cumulative Results of Operations	Unexpended Appropriations
Beginning Balances	$ (915,368)	$ 2,642
Budgetary Financing Sources		
Appropriations Received	-	69,589
Other Adjustments	-	(282)
Appropriations Used	69,659	(69,659)
Transfers-in	-	16
Nonexchange Revenue	7	-
Donations	27	-
Other Financing Sources		
Donations of Property	15	-
Transfers-out	(1,371)	-
Imputed Financing	1,323	-
Other	(578)	-
Total Financing Sources	**69,082**	**(336)**
Net Cost of Operations	(263,432)	-
Ending Balances	**$ (1,109,718)**	**$ 2,306**

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

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

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

DEPARTMENT OF VETERANS AFFAIRS
COMBINED STATEMENT OF BUDGETARY RESOURCES (NOTE 19) (DOLLARS IN MILLIONS)
FOR THE YEAR ENDED SEPTEMBER 30, 2005

	Budgetary	Credit Financing
Budgetary Resources		
Budget Authority	$ 72,532	$ 1,824
Unobligated Balance at the Beginning of the Period	15,667	4,476
Net Transfers-Prior Year Balance	(155)	-
Spending Authority from Offsetting Collections	5,250	4,422
Adjustments	(328)	(2,248)
Total Budgetary Resources	**$ 92,966**	**$ 8,474**
Status of Budgetary Resources		
Obligations Incurred	$ 76,831	$ 2,767
Unobligated Balance Available	13,570	5
Unobligated Balance Not Yet Available	2,565	5,702
Total Status of Budgetary Resources	**$ 92,966**	**$ 8,474**
Outlays		
Obligations Incurred	$ 76,831	$ 2,767
Less Spending Authority from Offsetting Collections and Adjustments	(5,262)	(4,422)
Obligated Balance, Net Beginning of Period	10,034	93
Less Obligated Balance, Net End of Period	(8,230)	(77)
Outlays	73,373	(1,639)
Less Offsetting Receipts	(2,784)	-
Net Outlays	**$ 70,589**	**$ (1,639)**

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

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

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

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

	2005	2004
Resources Used to Finance Activities		
Obligations Incurred	$ 79,598	$ 74,421
Less Spending Authority from Offsetting Collections and Adjustments	(9,684)	(7,899)
Obligations Net of Offsetting Collections and Adjustments	69,914	66,522
Less Offsetting Receipts	(2,784)	(2,668)
Net Obligations	67,130	63,854
Donations of Property	15	14
Transfers-out	(1,945)	(1,227)
Imputed Financing	1,323	1,252
Other Financing Sources	4	3
Total Resources Used to Finance Activities	**66,527**	**63,896**
Resources That Do Not Fund Net Cost of Operations		
Change in Amount of Goods, Services and Benefits Ordered But Not Yet Provided	(690)	(452)
Resources that Finance the Acquisition of Assets	(3,843)	(5,398)
Resources that Fund Expenses Recognized in Prior Periods	(2,326)	(441)
Budgetary Offsetting Collections and Receipts That Do Not Affect Net Cost of Operations	4,555	3,065
Other	(4)	(3)
Total Resources That Do Not Fund Net Costs of Operations	(2,308)	(3,229)
Total Resources Used to Finance the Net Cost of Operations	**64,219**	**60,667**
Costs That Do Not Require Resources in the Current Period		
Increase in Annual Leave Liability	46	75
Increase in Environmental and Disposal Liability	35	(37)
Reestimates of Credit Subsidy Expense	(437)	2,148
Increase in Exchange Revenue Receivable from the Public	(548)	(295)
Increase in Veterans Benefits Actuarial Liability	197,800	(30,000)
Depreciation and Amortization	1,289	465
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	420	328
Loss on Disposition of Assets	119	99
Other	489	(183)
Total Costs That Do Not Require Resources in the Current Period	**199,213**	**(27,400)**
Net Cost of Operations	**$ 263,432**	**$ 33,267**

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

Notes to Consolidated Financial Statements

For the Years Ended September 30, 2005 and 2004 (dollars in millions, unless otherwise noted).

1. Summary of Significant Accounting Policies

Basis of Presentation

The Department of Veterans Affairs' (VA) consolidated financial statements report all activities of VA components, including the Veterans Health Administration (VHA), Veterans Benefits Administration (VBA), National Cemetery Administration (NCA), and staff organizations. The consolidated financial statements meet the requirements of the Chief Financial Officers Act (CFO) of 1990 and the Government Management Reform Act (GMRA) of 1994. The consolidated financial statements differ from the financial reports used to monitor and control budgetary resources, but are prepared from the same books and records. The statements should be read with the understanding that VA is a component unit of the U.S. Government. VA fiscal year (FY) 2005 and FY 2004 financial statements are presented in conformity with the Office of Management and Budget's (OMB) Circular A-136, Financial Reporting Requirements.

Reporting Entity

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

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

Budgets and Budgetary Accounting

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

Basis of Accounting

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

Revenues and Other Financing Sources

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

Accounting for Intragovernmental Activities

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

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

Fund Balance with Treasury

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

Cash

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

Investments

Investments are reported at cost and are redeemable at any time for their original purchase price. Insurance program investments, which comprise most of VA's investments, are in non-marketable Treasury special bonds and certificates. Interest rates for Treasury special securities are based on average market yields for comparable Treasury issues. Special bonds, which mature during various years through the year 2020, are generally held to maturity unless needed to finance insurance claims and dividends. Other program investments are in securities issued by Treasury, with the exception of Insurance Program holdings in stock received from Prudential as a result of its demutualization and the Loan Guaranty Program investments in trust certificates issued by the American Housing Trusts.

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

Accounts Receivable

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

Public accounts receivable consists mainly of amounts due for veterans' health care and amounts due for compensation, pension, and readjustment benefit overpayments. Allowances are based on prior experience. For FY 2005, contractual adjustments were 54 percent, and bad debt allowances for medical-related receivables were 9 percent. For FY 2004, contractual adjustments were 52 percent and bad debt allowances for medical-related receivables were 9 percent. Educational–related receivables bad debt allowances were 45 percent for FY 2005 and 44 percent for

FY 2004. Compensation and pension benefits overpayment-related bad debt receivables were 73 percent for FY 2005 and 72 percent for FY 2004.

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

Loans Receivable

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

Inventories

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

Property, Plant, and Equipment

The majority of the general property, plant, and equipment is used to provide medical care to veterans and is valued at cost, including transfers from other federal agencies. Major additions, replacements, and alterations are capitalized, whereas routine maintenance is expensed when incurred. Construction costs are capitalized as Construction in Progress until completion, and then transferred to the appropriate property account. Other includes items classified including leasehold improvements and structures not classified as buildings. Individual items are capitalized if the useful life is 2 years or more and the unit price is $100,000 or greater. Buildings are depreciated on a straight-line basis over estimated useful lives of 25 to 40 years. Equipment is also depreciated on a straight-line basis over its useful life, usually 5 to 20 years. There are no restrictions on the use or convertibility of general property, plant, and equipment. All VA heritage assets are multi-use facilities and are classified as general property, plant, and equipment.

Other Assets

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

Accounts Payable

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

Loan Guarantees

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

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

Debt

All intragovernmental debt is due to Treasury and is primarily related to borrowing by the Loan Guaranty Program. The interest rates ranged from 2.94 to 4.72 percent in FY 2005 and from 1.29 to 5.24 percent in FY 2004. VA's financial activities interact with and are dependent upon those of the federal government as a whole.

Insurance Liabilities

Actuarial reserve liabilities for VA's insurance programs are based on mortality and interest rate assumptions at the time of issue. These assumptions vary by fund, type of policy, and type of benefit. The interest rate assumptions range from 2.25 to 5.0 percent for both the FY 2005 and FY 2004 calculations.

Annual Leave

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

Workers' Compensation Liability

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

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

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

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

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

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

Veterans Benefits Liability

VA provides compensation benefits to veterans who are disabled by military service-related causes. Benefits are also provided to deceased veterans' beneficiaries. These benefits are provided in recognition of a veteran's military service. The liability for future compensation payments is reported on

VA's balance sheet at the present value of expected future payments, and is developed on an actuarial basis. Various assumptions in the actuarial model, such as the number of veterans and dependents receiving payments, discount rates, cost of living adjustments, and life expectancy, impact the amount of the liability.

Litigation

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

Non-Federal Trusts

VA has entered into enhanced-use leases to maximize use of underutilized VA property. In seven of these enhanced-use leases, the assets and liabilities were transferred to a non-federal trust. In FY 2005, the assets, liabilities, and results of operations of these seven trusts are consolidated in VA's consolidated financial statements.

Estimates

The preparation of the financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

2. Non-Entity Assets

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

Non-Entity Assets as of September 30,	**2005**	**2004**
Fund Balance with Treasury	$ 47	$ 47
Intragovernmental Accounts Receivable	1	1
Public Accounts Receivable	13	11
Total Non-Entity Assets	$ 61	$ 59

3. Fund Balance With Treasury

Fund Balance with Treasury as of September 30,		2005		2004
Entity Assets				
Trust Funds	$	86	$	86
Revolving Funds		6,499		5,661
Appropriated Funds		10,288		10,917
Special Funds		158		156
Other Fund Types		9		(126)
Total Entity Assets	$	17,040	$	16,694
Non-Entity Assets				
Other Fund Types		47		47
Total Non-Entity Assets		47		47
Total Entity and Non-Entity Assets	$	17,087	$	16,741
Reconciliation of VA General Ledger Balances with Treasury				
Entity VA General Ledger	$	17,504	$	17,159
Reconciled Differences		(410)		(433)
Unreconciled Differences		(7)		15
Fund Balance with Treasury	$	17,087	$	16,741
Status of Fund Balance with Treasury				
Unobligated Balance				
Available	$	4,356	$	3,558
Unavailable		6,326		4,943
Obligated Balance not yet Disbursed		6,349		8,319
Deposit/Clearing Account Balances		56		(79)
Fund Balance with Treasury	$	17,087	$	16,741

4. Cash

Cash as of September 30,		2005		2004
Canteen Service	$	1	$	3
Agent Cashier Advance		4		19
Loan Guaranty Program		35		4
Funds Held by Non-Federal Trusts *		47		42
Total Cash	$	87	$	68

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

5. Investments

Investment Securities as of September 30,	Interest Range	**2005**	**2004**
Intragovernmental Securities			
Special Bonds	3.25-9.25%	$ 12,993	$ 13,329
Treasury Notes *	1.875-4.25%	65	67
Treasury Bills	1.381-3.828%	26	30
Subtotal		13,084	13,426
Accrued Interest		202	217
Total Intragovernmental Securities		$ 13,286	$ 13,643
Other Securities			
Prudential Stock (Insurance)		$ -	$ 6
Trust Certificates (Loan Guaranty)		178	178
Total Other Securities		$ 178	$ 184

*The investment in Treasury Notes includes unamortized premiums of $0.1 both as of September 30, 2005 and as of September 30, 2004. Premiums and discounts are amortized on a straight-line basis over the life of the investments.

Offset for Losses on Investments as of September 30,	**2005**	**2004**
Investment in Subordinate Certificates at Time of Sale	$ 424	$ 424
Cumulative Reductions	(241)	(238)
Subtotal	183	186
Allocation of Loss Provision	(5)	(8)
Trust Certificates (Loan Guaranty)	$ 178	$ 178

6. Accounts Receivable, Net

Accounts Receivable, Net as of September 30,	**2005**	**2004**
Intragovernmental Accounts Receivable	$ 72	$ 132
Public Accounts Receivable, Gross	$ 1,964	$ 2,088
Allowance for Loss Provision	(1,044)	(1,201)
Net Public Accounts Receivable	$ 920	$ 887

7. Direct Loans and Loan Guarantees

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

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

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

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

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

Direct Loans

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

Loans Receivable and Related Foreclosed Property From Direct Loans

as of September 30, 2005	Loans Receivable Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Direct Loans Obligated Prior to FY 1992 (Allowance for Loss Method)	$ 60	$ 5	$ -	$ -	$ 65
Direct Loans Obligated after 1991	956	23	(27)	33	985
Insurance Policy Loans	674	16	-	-	690
Total Loans Receivable and Related Foreclosed Property from Direct Loans, Net					$ 1,740

Loans Receivable and Related Foreclosed Property From Direct Loans

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

Direct Loans Disbursed

The total amount of new direct loans disbursed for the years ended September 30, 2005, and 2004, was $192 and $123, respectively.

Provision for Losses on Pre-1992 Loans

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

The provision for losses on vendee loans is based upon historical loan foreclosure results applied to the average loss on defaulted loans. The calculation is also based on the use of the average interest rate of U.S. interest-bearing debt as a discount rate on the assumption that VA's outstanding guaranteed loans will default over a 12-year period. For FY 2005, VA determined that these vendee loans have sufficient equity due to real estate appreciation and buy-down of principal, to minimize or eliminate any potential loss to VA. The components of the provision are as follows:

Provision for Loss as of September 30,	2005	2004
Offsets Against Foreclosed Property Held for Sale	58	10
Total Provision for Loss	$ 58	$ 10

Subsidy Expense for Post-1991 Direct Loans

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

Direct Loan Subsidy Expense for the years ended September 30,	2005	2004
Interest Differential	$ (33)	$ (6)
Defaults*	5	3
Fees**	(3)	-
Other***	21	4
Subtotal	(10)	1
Interest Rate Reestimates	(31)	473
Technical Reestimates	(49)	922
Total Direct Loans	$ (90)	$ 1,396

* Includes approximately $50 thousand in defaults and other expenses for the Vocational Rehabilitation Program in both FY 2005 and 2004.
** "Fees" expense for direct loans includes estimated down payments and other fees collected when homes are sold with vendee financing.
*** The "Other" expense for direct loans includes the estimated loss of scheduled principal and interest when vendee loans are sold.

Subsidy Rates for Direct Loans by Component

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

Subsidy rates for direct loans	
Interest Differential	(21.11%)
Defaults	2.75%
Fees	(1.88%)
Other	14.01%

Allowance for Subsidy for Direct Loans (Post-1991)

VA reports the allowance for subsidy for direct loans, subject to Credit Reform requirements. For these loans, the allowance for subsidy represents the present value of the estimated net cash flows to be paid by VA as a result of a disbursed direct loan. VA disburses a direct loan and receives an allowance for subsidy along with borrowing from Treasury. For FY 2005 OMB instructed VA to use a combination of the balances approach re-estimates (1992-2000 cohorts) and traditional re-estimates (2001-2004 cohorts) to be included in the FY 2006 President's Budget. The change of methodology for cohorts 2001-2004 required a $74.4 increase to the re-estimates initially calculated using only the balances approach re-estimates. For FY 2005, the subsidy rate for October through September is (5.12%) for Veterans Housing Direct and (7.75%) for Native American Direct. In FY 2004, the subsidy rate for October through December was (11.16%) and the subsidy rate for January through September was (2.48%). The allowance for subsidy as of September 30, 2005 and 2004 is $27 and $166, respectively.

Schedule for Reconciling Subsidy Cost Allowance Balances

Beginning Balance, Changes and Ending Balance	FY 2005	FY 2004
Beginning balance of the allowance	$ 166	$ (1,136)
Subsidy expense for direct loans disbursed during the reporting years by component:		
Interest subsidy costs	(33)	(6)
Default costs (net of recoveries)	5	3
Fees and other collections	(3)	-
Other subsidy costs	21	4
Total of the above subsidy expense components	(10)	1
Adjustments:		
Fees received	3	1
Foreclosed property acquired	(31)	(21)
Loans written off	(5)	(9)
Subsidy allowance amortization	(16)	(65)
Ending balance of the allowance before reestimates	107	(1,229)
Subsidy reestimates by component		
Interest rate reestimate	(31)	473
Technical/default reestimate	(49)	922
Total of the above reestimate components	(80)	1,395
Ending balance of the allowance	$ 27	$ 166

Loan Guarantees

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

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

2005	Loans Receivable Gross	Interest Receivable	Allowance for Loan Losses	Foreclosed Property	Value of Assets Related to Loans
Defaulted Guaranteed Loans Pre-1992 Guarantees	102	1	(94)	18	27
Defaulted Guaranteed Loans Post-1991	-	-	-	553	553
Total Loans Receivable and Related Foreclosed Property from Loan Guarantees					$ 580

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

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

Total Loans Receivable and Related Foreclosed Property, Net for the years ended September 30,

	2005	2004
Total Direct Loans	$ 1,740	$ 1,829
Total Guaranteed Loans	580	1,125
Total Loans Receivable and Related Foreclosed Property, Net	$ 2,320	$ 2,954

Foreclosed Property

Prior to the foreclosure of property secured by a VA loan, VA obtains an independent appraisal of the property. This appraisal is reviewed by VA staff to make a determination of the fair market value. To determine the net value of the property, VA expenses such as costs for acquisition, management, and disposition of the property, as well as estimated losses on property resale, are subtracted from the estimated fair market value. As of September 30, 2005 and 2004, the estimated number of residential properties in VA's inventory was 7,288 and 15,539, respectively. For FY 2005 and FY 2004, the average holding period from the date properties were conveyed to VA until the properties were sold was estimated to be 14.1 months and 10.1 months, respectively. The number of properties for which foreclosure proceedings are in process is estimated to be 6,567 and 10,355 as of September 30, 2005, and 2004, respectively.

Guaranteed Loans as of September 30,		**2005**		**2004**
Guaranteed Loans Outstanding:				
Outstanding Principal Guaranteed Loans, Face Value	$	202,073	$	207,374
Amount of Outstanding Guarantee		62,114		64,683
New Guaranteed Loans Disbursed:				
Outstanding Principal Guaranteed Loans, Face Value	$	24,901	$	44,130
Amount of Outstanding Guarantee		6,808		12,643
Liabilities for Loan Guarantees Post 1991 (Present Value)	$	3,465	$	4,740

Guaranty Commitments

As of September 30, 2005, VA had outstanding commitments to guarantee loans that will originate in FY 2006. The number and amount of commitments could not be determined, as VA has granted authority to various lenders to originate VA loans that meet established criteria without prior VA approval. Nearly 99 percent of VA's guaranteed loans originate under this authority.

Subsidy Expense for Post-1991 Loan Guarantees

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

Guaranteed Loan Subsidy Expenses
for the years ended September 30,

	2005	2004
Defaults	$ 343	$ 652
Fees*	(417)	(470)
Subtotal	(74)	182
Interest Rate Reestimates	(421)	(241)
Technical Reestimates	(1,025)	(542)
Total Guaranteed Loan Subsidy Expense**	$ (1,520)	$ (601)

* The "Fees" expense includes estimated up-front fees collected when the loans are guaranteed and the present value of estimated annual fees from loan assumptions.
** A negative subsidy rate indicates cash inflows from interest and fees are greater than disbursements.

Loan Sale-Guaranteed Loan Subsidy Expense
for the years ended September 30,

	2005	2004
Defaults	$ -	$ 19
Other	-	(2)
Subtotal	-	17
Interest Rate Reestimates	(25)	102
Technical Reestimates	(42)	80
Total Loan Sale-Guaranteed Subsidy Expense	$ (67)	$ 199

Total Subsidy Expense
for the years ended September 30,

	2005	2004
Total Direct Loans	$ (90)	$ 1,396
Total Guaranteed Loans	(1,520)	(601)
Total Sale Loans	(67)	199
Total Subsidy Expense	$ (1,677)	$ 994

Subsidy Rates for Loan Guarantees by Component

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

Subsidy Rates for Loan Guarantees	
Defaults	(1.52%)
Fees	(1.85%)

Loan Sales

VA continues to have vendee loan sales to reduce the administrative burden of servicing vendee loans. During the period FY 1992 through FY 2005, the total loans sold amounted to $13.8 billion. Under the sale of vendee loans, certificates are issued pursuant to the Pooling and Servicing Agreement (the Agreement) among VA, the Master Servicer, and the Trustee. On the closing date of the certificates, VA transfers its entire interest in the related loans to the Trustee for the benefit of the related certificate holders pursuant to the Agreement. Under the Agreement, the Trust will issue certificates backed by mortgage loans and installment contracts. The Trust owns the mortgage loans and other property described in the offering and the Trust makes elections to treat certain of its assets as one or more Real Estate Mortgage Investment Conduits (REMIC) for U.S. federal income tax purposes. The certificates represent interests in the assets of the Trust and are paid from the Trust's assets. The certificates are issued as part of a designated series that may include one or more classes. VA guarantees that the investor will receive full and timely distributions of the principal and interest on the certificates and that guaranty is backed by the full faith and credit of the federal government.

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

The Agreement requires the mortgage loans to be serviced generally in compliance with Fannie Mae and Freddie Mac standards and consistent with prudent residential mortgage loan servicing standards generally accepted in the servicing industry. For mortgage loans sold during FY 2005, servicing was performed by Countrywide Home Loans, Inc. (Master Servicer). The Master Servicer is responsible for the performance of all of the servicing functions under the Agreement. The Master Servicer is entitled to be compensated by receiving (1) a service fee of 0.2075 percent per annum payable monthly and calculated by multiplying the interest payment received by a fraction, the numerator of which is 0.2075 percent and the denominator of which is the mortgage interest rate on such loan; (2) earnings on investment of funds in the certificate account; and (3) all incidental fees and other charges paid by the borrowers and a portion of the liquidation proceeds in connection with the liquidated loans.

VA did not complete any sales during FY 2005, and only one transaction was completed in FY 2004. The FY 2004 sale totaled $298. The components of the vendee sales are summarized in the tables below:

Loan Sales **Years ended September 30,**	**2005**	**2004**
Loans Receivable Sold	$ -	$ 298
Net Proceeds From Sale	(2)*	308
Loss (Gain) on Receivables Sold	$ (2)	$ (10)

* Misc. Proceeds from the Old Reserve Account

Outstanding Balance of Loan Sale Guarantees

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

Guaranteed Loans Sold **as of September 30,**	**2005**	**2004**
Outstanding Balance Guaranteed Loans Sold, Start of Year	$ 4,188	$ 5,569
Sold to the Public	-	298
Payments, Repayments, and Terminations	(1,176)	(1,679)
Outstanding Balance Guaranteed Loans Sold, End of Year	$ 3,012	$ 4,188

Liability for Loan Sale Guarantees (Post-1991)

VA reports the liability on the guarantee of loans sold under the Vendee Mortgage Trust and American Housing Trust programs, subject to Credit Reform requirements. For these loans, the guaranteed loan sale liability represents the present value of the estimated net cash flows to be paid by VA as a result of the guarantee. These sales contain two types of guarantees for which VA pays net cash flow. VA guarantees that the principal and interest payment due on a loan sold will be paid by the 15th of each month. If not paid by the borrower, VA allows the loan servicer to take funds from cash reserve accounts for the deficient amount. VA also guarantees the loan against loss at foreclosure. VA will not buy back the loans but will pay off the loan loss and foreclosure expenses. The subsidy rate for FY 2005 is 3.69 percent. For FY 2004 the subsidy rate was 5.65 percent. The liability for loan sale guarantees as of September 30, 2005, and 2004, is $188 and $255, respectively.

Schedule for Reconciling Loan Sale Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance	FY 2005	FY 2004
Beginning balance of the liability	$ 255	$ 77
Subsidy expense for guaranteed loans disbursed during the reporting years by component:		
Default costs (net of recoveries)	-	19
Other subsidy costs	-	(2)
Total of the above subsidy expense components	-	17
Adjustments:		
Claim payments to lenders	(10)	(36)
Interest accumulation on the liability balance	8	6
Other	2	9
Ending balance of the liability before reestimates	255	73
Subsidy reestimates by component		
Interest rate reestimate	(25)	102
Technical/default reestimate	(42)	80
Total of the above reestimate components	(67)	182
Ending balance of the liability	$ 188	$ 255

Liability for Loan Guarantees (Post-1991)

VA reports the liability on the guarantee of loans, subject to Credit Reform requirements. For these loans, the guaranteed loan liability represents the present value of the estimated net cash flows to be paid by VA as a result of a defaulted loan guarantee. VA guarantees the loan against loss at foreclosure for which VA pays net cash flow up to a legally specified maximum based on the value of individual loans. VA will pay the lender the guarantee and foreclosure expenses. If an agreement can be made with the veteran, VA may acquire the loan by refunding the lender for the loan. The FY 2005 and FY 2004 subsidy rates are (0.32) percent and 0.52 percent, respectively. The liability for loan guarantees as of September 30, 2005, and 2004, is $3,277 and $4,485, respectively.

Schedule for Reconciling Loan Guarantee Liability Balances

Beginning Balance, Changes and Ending Balance	FY 2005	FY 2004
Beginning balance of the liability	$ 4,485	$ 4,679
Subsidy expense for guaranteed loans disbursed during the reporting years by component:		
Default costs (net of recoveries)	343	652
Fees and other collections	(417)	(469)
Total of the above subsidy expense components	(74)	183
Adjustments:		
Fees received	411	482
Foreclosed property and loans acquired	23	67
Claim payments to lenders	(340)	(406)
Interest accumulation on the liability balance	218	263
Ending balance of the liability before reestimates	4,723	5,268
Subsidy reestimates by component		
Interest rate reestimate	(421)	(241)
Technical/default reestimate	(1,025)	(542)
Total of the above reestimate components	(1,446)	(783)
Ending balance of the liability	$ 3,277	$ 4,485

Administrative Expense

Administrative expense on direct and guaranteed loans for each of the years ended September 30, 2005 and 2004 was $154.

8. Inventories

Inventories as of September 30,	2005	2004
Held for Current Sale	$ 66	$ 65
Other	10	4
Total Inventories	$ 76	$ 69

9. General Property, Plant and Equipment

Depreciation and amortization expense totaled $812 and $805 in FY 2005 and FY 2004, respectively.

General Property, Plant and Equipment as of September 30, 2005

	Cost	Accumulated Depreciation	Net Book Value
Land and Improvements	$ 323	$ (17)	$ 306
Buildings	15,457	(7,523)	7,934
Equipment	3,174	(1,889)	1,285
Other	1,923	(1,160)	763
Work in Progress	944	-	944
Total Property, Plant, and Equipment	$ 21,821	$ (10,589)	$ 11,232

Hurricane damage to the Gulfport VAMC resulted in a $19 reduction in the Net Book Value of Property Plant and Equipment.

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

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

10. Liabilities Not Covered By Budgetary Resources

The total amount of VA liabilities not covered by budgetary resources was $1,127.5 billion and $929.5 billion as of September 30, 2005, and 2004, respectively, as shown in the following table.

Components of Unfunded Liabilities as of September 30,

	2005	2004
Workers' Compensation*	$ 2,133	$ 2,112
Annual Leave	1,216	1,173
Judgment Fund	522	501
Environmental and Disposal	376	339
Accounts Payable – Canceled Appropriations	6	6
Veterans Compensation and Burial	1,122,600	924,800
Insurance	666	568
Total	$ 1,127,519	$ 929,499

The actuarial estimate for workers' compensation provided by DOL was computed using interest rates of 4.53 percent for FY 2005 and 4.88 percent for FY 2004.

11. Federal Employee and Veterans Benefits

Federal Employee Benefits

Imputed Expenses-Employee Benefits years ended September 30,

	2005	2004
Civil Service Retirement System	$ 356	$ 366
Federal Employees Health Benefits	874	788
Federal Employees Group Life Insurance	2	2
Total Imputed Expenses-Employee Benefits	$ 1,232	$ 1,156

Veterans Benefits

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

Federal Employee and Veterans Benefits Liabilities as of September 30,	**2005**	**2004**
FECA	$ 1,776	$ 1,753
Compensation	1,118,800	921,500
Burial	3,800	3,300
Total Federal Employee and Veterans Benefits Liabilities	$ 1,124,376	$ 926,553

VA provides certain veterans and/or their dependents with pension benefits, based on annual eligibility reviews, if the veteran died or was disabled from nonservice-related causes. The actuarial present value of the future liability for pension benefits is a non-exchange transaction and is not required to be recorded on the balance sheet. The projected amount of future payments for pension benefits (presented for informational purposes only) as of September 30, 2005 and 2004 was $96.8 billion and $102.2 billion, respectively.

Assumptions Used to Calculate the Veterans Benefits Liability

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

All future benefits were discounted. Discount rates were based on rates for securities issued by Treasury on September 30, 2005, ranging from 4.11 to 4.74 percent, and on September 30, 2004, ranging from 2 to 5.23 percent. Beginning in FY 2004, the discount rates used were based on U.S. Treasury's spot rates rather than corresponding constant maturity rate, which were used in previous years. Benefit payments were assumed to occur at the midpoint of the fiscal year.

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

Life expectancies of beneficiaries collecting benefits from the Compensation and Pension programs were based upon studies of mortality experience of those beneficiaries between 2002 and 2005. Life expectancies of veterans not yet collecting these benefits used in the calculation of the liability for future beneficiaries are based on mortality derived from the 2002 U.S. Life Table. Applying mortality improvements at a rate that varies by age of between 0.85 and 1.00 percent per annum brought both sets of mortality rates forward. In addition, rates of benefit termination of beneficiaries due to reasons other than mortality are also reflected.

The amount of benefits by beneficiary category and age were based on current amounts being paid, future cost of living adjustments (COLAs) to determine the average benefits per veteran for each future time period, and changes in other factors that affect benefits. A COLA of 4.1 percent was applied for FY 2006. For fiscal years after 2006, COLAs have been determined from OMB's estimates prepared in conjunction with the Administration's annual budget. Expected changes in benefits due to other reasons were also reflected.

Expected benefit payments have been explicitly modeled for the next 75 years. This period is the same as that used by the Office of the Chief Actuary of the Social Security Administration (SSA). However, unlike Social Security, (1) estimates of expected benefit payments after this 75-year period were incorporated in the liability based on extrapolations reflecting expected aggregate experience by beneficiary category between the years 70 and 75 and (2) SSA uses an open population model, while the C&P projections only reflect benefits associated with military service through September 30, 2005.

12. Environmental and Disposal Liabilities

VA had unfunded environmental and disposal liabilities in the amount of $376 and $339 as of September 30, 2005, and 2004, respectively. The majority of the unfunded liabilities involve asbestos removal, lead abatement, replacement of underground oil and gasoline tanks, decommissioning of waste incinerators, and decontamination of equipment prior to disposal.

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

13. Other Liabilities

Other liabilities are liabilities not reported elsewhere. They consist of Funded and Unfunded Liabilities. Funded liabilities are generally considered to be current liabilities. Unfunded liabilities are generally considered to be non-current liabilities.

Other Intragovernmental Funded Liabilities as of September 30,	**2005**	**2004**
Deposit and Clearing Account Liabilities	$ 8	$ (61)
Accrued Expenses - Federal	123	149
Deferred Revenue	166	283
Resources Payable to Treasury	299	350
Custodial Liabilities*	1,631	1,022
General Fund Receipts Liability	32	29
Accrued VA Contributions for Employee Benefits	3	3
Total Other Intragovernmental Funded Liabilities	$ 2,262	$ 1,775

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

Other Intragovernmental Unfunded Liabilities as of September 30,

		2005		2004
Accrued FECA Liability	$	357	$	359
Total Other Intragovernmental Unfunded Liabilities	$	357	$	359

Other Public Funded Liabilities as of September 30,

		2005		2004
Accrued Funded Annual Leave	$	11	$	11
Accrued Expenses		2,466		2,482
Accrued Salaries and Benefits		548		583
Contract Holdbacks		11		12
Deferred Revenue		1		1
Unredeemed Coupons		1		1
Deposit and Clearing Account Liability		47		46
Unearned Premiums		102		111
Insurance Dividends Left on Deposit and Related Interest Payable*		1,725		1,677
Dividend Payable to Policyholders		203		225
Amounts due to non-federal trusts		-		1
Capital Lease Liability		31		30
Total Other Public Funded Liabilities	$	5,146	$	5,180

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

Other Public Unfunded Liabilities as of September 30,

		2005		2004
Annual Leave*	$	1,216	$	1,172
Accounts Payable from Cancelled Appropriation		6		6
Amounts due to non-federal trust		187		188
Judgment Fund-Unfunded**		522		501
Total Other Public Unfunded Liabilities	$	1,931	$	1,867

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

14. Leases

VA has both capital and operating leases. The capital lease liability is $31 and $30 as of September 30, 2005 and 2004, respectively. Real property leases reflect those that VA has committed to as of September 30, 2005. Due to the number of equipment operating leases and the decentralization of records, the future commitment for equipment operating leases is projected assuming annual increases between 4.2 and 4.4 percent. VA's FY 2005 operating lease costs were $248 for real property rentals and $85 for equipment rentals. The FY 2004 operating lease costs consisted of $243 for real property rentals and $79 for equipment rental. The following chart represents VA's operating lease commitments or costs for the next 5 years.

Leases:

YEAR	REAL PROPERTY	PERCENTAGE	EQUIPMENT
2006	$ 245	4.4	$ 89
2007	225	4.2	93
2008	214	4.2	97
2009	198	4.2	101
2010	188	4.2	105

15. Insurance Programs

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

Administered Programs

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

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

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

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

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

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

Supervised Insurance Programs

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

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

Public Insurance Carriers

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

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

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

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

Reserve Liabilities

The insurance reserves for administered programs are reported as liabilities covered by budgetary resources, while part of the S-DVI and Veterans Insurance and Indemnities (VI&I) reserves are reported as liabilities not covered by budgetary resources. Reserves for SGLI and VGLI are maintained in Prudential's financial records since the risk of loss is assumed by Prudential. Actuarial reserve liabilities for the administered life insurance programs are based on the mortality and interest assumptions at time of issue. These assumptions vary by fund, type of policy, and type of benefit. The interest assumptions range from 2.25 to 5 percent. The mortality assumptions include the American Experience Table, the 1941 Commissioners Standard Ordinary (CSO) Table, the 1958 CSO Basic Table, and the 1980 CSO Basic Table.

Insurance Liability (Reserve) Balances

Insurance Liability (Reserve) Balances As of September 30, 2005

Program	Insurance Death Benefits	Death Benefit Annuities	Disability Income & Waiver	Reserve Totals
NSLI	$9,031	$156	$126	$9,313
USGLI	26	4	-	30
VSLI	1,535	10	28	1,573
S-DVI	313	2	329	644
VRI	359	2	4	365
VI&I	89	-	-	89
Subtotal	$11,353	$174	$487	$12,014
Less Liability not Covered by Budgetary Resources				(666)
Liability Covered by Budgetary Resources				$11,348

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

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

Insurance In-Force

The amount of insurance in-force is the total face amount of life insurance coverage provided by each administered and supervised program as of the end of the fiscal year. It includes any paid-up additional coverage provided under these policies. Prudential and its reinsurers provided coverage to 5,964,000 and 5,946,231 insured for a face value of $1,137.4 billion and $737.9 billion as of September 30, 2005, and 2004, respectively. The face value of the insurance provided by Prudential and its reinsurers represents 98.4 percent and 97.5 percent of the total insurance in-force as of September 30, 2005, and 2004, respectively. The number of policies represents the number of active policies remaining in the program as of the end of each fiscal year.

	2005 Policies	2004 Policies	2005 Face Value	2004 Face Value
Supervised Programs				
SGLI Active Duty	1,530,000	1,545,000	$612,000	$371,135
SGLI Ready Reservists	826,500	783,500	325,650	176,493
SGLI Post Separation	126,000	120,000	35,428	28,351
SGLI Family - Spouse	988,000	990,000	96,956	97,198
SGLI Family - Children	2,076,000	2,100,000	20,760	21,000
VGLI	417,500	407,731	46,600	43,767
Total Supervised	5,964,000	5,946,231	$1,137,394	$737,944
Administered Programs				
NSLI	1,202,065	1,300,404	$13,198	$14,013
VSLI	206,501	213,545	2,490	2,525
S-DVI	175,200	165,651	1,728	1,614
VRI	52,881	57,757	488	523
USGLI	9,034	10,390	28	33
VMLI	2,514	2,625	167	170
Total Administered	1,648,195	1,750,372	$18,099	$18,878
Total Supervised and Administered Programs	7,612,195	7,696,603	$1,155,493	$756,822

Policy Dividends

The Secretary of VA determines annually the excess funds available for dividend payment. Dividends are based on an actuarial analysis of the individual programs at the end of the preceding calendar year. Dividends are declared on a calendar year basis and paid on policy anniversary dates. Policyholders can elect to: (1) receive a cash payment; (2) prepay premiums; (3) repay loans; (4) purchase paid-up insurance; or (5) deposit the amount in an interest-bearing account. A provision for dividends is charged to operations, and an insurance dividend is established when gains to operations are realized in excess of those essential to maintain solvency of the insurance programs. Policy dividends for fiscal years 2005 and 2004 were $439 and $497, respectively.

Sale of Prudential Stock

On December 18, 2001, Prudential completed its conversion from a mutual company to a stock company. As policyholder of the SGLI and VGLI programs, VA received 369,177 shares of Prudential stock. VA liquidated these shares in six sales over a 3-year period, which started in 2003. In 2005, VA liquidated the remaining 123,177 shares in two sales. In March 61,500 shares were sold and 61,177 shares were sold in September. Total proceeds over the 3-year period of $17.3 were deposited into the SGLI Contingency Reserve, which is held for VA by Prudential in an interest-bearing account. This guarantees that the monies will be used for the benefit of the service members and veterans who are the intended recipients of these life insurance programs.

16. Contingencies

VA is a party in various administrative proceedings, legal actions, and tort claims arising from various sources including: disputes with contractors, challenges to compensation and education award decisions, loan guaranty indemnity debt cases, and allegations of medical malpractice. Certain legal matters to which VA may be a named party are administered and, in some instances, litigated by the Department of Justice. Generally, amounts (more than $2.5 thousand for Federal Tort Claims Act cases) to be paid under any decision, settlement, or award are funded from the Judgment Fund, which is maintained by Treasury. Of the amounts paid from the Judgment Fund, malpractice cases claimed 69 percent in FY 2005 and 85 percent in FY 2004. Contract dispute payments for FY 2005 and FY 2004 were $18.8 and $9.4, respectively. The "No Fear" payments for FY 2005 were $1.1 and $1.4 for FY 2004.

VA uses accepted actuarial methods to estimate the liability resulting from medical malpractice and other tort claim exposure. VA discounted future estimated payments using U.S. Treasury spot rates as of September 30, 2005 and 2004. Had these payments not been discounted, the associated liability would have been an additional $62 and $41, respectively.

VA has recorded a liability for pending legal claims that are estimated to be paid by the Judgment Fund. This liability is established for all pending claims whether reimbursement is required or not. This liability was $522 for FY 2005 and $501 for FY 2004. There were 13 contract and personnel law cases with claimed amounts totaling $62.1 where there was at least a reasonable possibility that a loss may occur. VA is also required to record an operating expense and imputed financing source for the Judgment Fund's pending claims and settlements. Judgment Fund accounting is shown below:

Judgment Fund
For the Years Ended September 30,

	2005	2004
Fiscal Year Settlement Payments	$ 110	$ 108
Less Contract Dispute and "No Fear" Payments	(20)	(11)
Imputed Financing-Paid by Other Entities	90	97
Increase (Decrease) in Liability for Claims	(21)	(27)
Operating Expense (Revenue)	$ 69	$ 70

It is the opinion of VA's management that resolution of pending legal actions as of September 30, 2005 will not materially affect VA's operations or financial position when consideration is given to the availability of the Judgment Fund appropriation to pay some court-settled legal cases. Fiscal year 2005 settlement payments were $90.

The amount of unobligated and obligated authority relating to appropriations cancelled on September 30, 2005 and 2004 was $25.1 and $16.9, respectively. Any payments due that may arise relating to cancelled appropriations will be paid out of the current year's appropriations in accordance with the provisions of the Expired Funds Control Act of 1990.

VA provides medical care to veterans on an "as available" basis, subject to the limits of the annual appropriations. In accordance with 38 CFR 17.36 (c), VA's Secretary makes an annual enrollment decision that defines the veterans, by priority, who will be treated for that fiscal year subject to change based on funds appropriated, estimated collections, usage, the severity index of enrolled veterans, and changes in cost. While VA expects to continue to provide medical care to veterans in future years, an estimate of this amount cannot be reasonably made. Accordingly, VA recognizes the medical care expenses in the period the medical care services are provided. For the fiscal years 2001-2005, the average medical care cost per year was $24.1 billion.

The Medical facility in New Orleans was significantly damaged by Hurricane Katrina. The facility was closed pending assessments of damages and operational feasibility. The losses have not yet been determined, but management believes they will not materially impact VA operations.

17. Exchange Transactions

Exchange Revenues

Although VA recognizes full cost per SFFAS No. 4, VHA has legislated exceptions to the requirement to recover the full cost to the federal government of providing services, resources, or goods for sale. Under "enhanced sharing authority," VHA facilities may enter into arrangements that are in the best interest of the federal government. In FY 2005, randomly selected VA medical centers were reviewed by the Financial and Systems Quality Assurance Service to determine the facility's compliance with Statement of Federal Financial Accounting Standards No. 7 and the Chief Financial Officers Act of 1990.

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

NCA leases lodges at 11 cemeteries to not-for-profit groups for no fee. The not-for-profit groups are required to provide the upkeep on the lodges and pay the costs for utilities, insurance, minor repairs and maintenance, and any other costs associated with the lodges, and NCA pays for major repairs at these facilities. NCA also has four agricultural leases with private companies/individuals. NCA leases land for growing crops and, on certain leases, receives various services in exchange from the lessee, such as brush cutting and removal services, backfilling and grading of roads, and welding services. In addition, NCA received fees for motion picture filming performed at three cemeteries.

Exchange Transactions with Public

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

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

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

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

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

VA's Loan Guaranty Program collects certain fees that are set by law. The loan guarantee funding fees collected for FY 2005 were $407 and for FY 2004 were $478.9. The loan guarantee lender participation fees collected for FY 2005 were $1.7. The lender participation fees collected for FY 2004 were $1.9.

Intragovernmental Exchange Transactions

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

VA and Department of Defense (DoD) have authority to enter into agreements and contracts for the mutual use or exchange of use of hospital and domiciliary facilities and other resources. The providing agency shall be reimbursed for the cost of the health care resources based on the methodology agreed to by VA and DoD. Facility directors have the flexibility to consider local conditions and needs and the actual costs of providing the services. VA's General Counsel has determined that full cost recovery is not mandated. VHA captures the total amount of reimbursements received under DoD sharing agreements, but the total amount billed below full cost is not readily available. VHA is in the process of developing mechanisms to report this information in the future. VBA collects funding from DoD in order to administer certain education programs. DoD transferred $295.3 during FY 2005 for the Post-Vietnam Era Education Assistance Program, Reinstated Entitlements Program for Survivors, and the New GI Bill for Veterans.

VA reports intragovernmental trading partner information to Treasury's Intragovernmental Reporting and Analysis System. VA and our trading partners are not able to reconcile the activity and balances between themselves due to several factors including transaction volumes, recognition timing issues, and system limitations.

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

18. Net Cost of Veterans Affairs Programs

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

Schedule of Net Program Cost

For the Year Ended September 30, 2005 (Dollars in Millions)	Medical Care	Medical Education	Medical Research	Compensation	Pension	Education	Vocational Rehab	Loan Guaranty	Insurance	Burial	Non-Program	Total
Production Costs												
Intragovernmental Costs	$ 1,241	$ 2	$ 17	$ 60	$ 5	$ 3	$ 2	$ 235	$ 2	$ 12	$ 67	$ 1,646
Less Earned Revenues	(95)	-	(31)	-	(8)	(286)	-	(664)	(840)	-	(1,280)	(3,204)
Net Intragovernmental Production Costs	1,146	2	(14)	60	(3)	(283)	2	(429)	(838)	12	(1,213)	(1,558)
Public Costs	29,804	540	688	226,836	3,630	2,683	698	(947)	1,540	820	2,121	268,413
Less Earned Revenues	(2,551)	-	(15)	-	-	(198)	-	(56)	(554)	-	(49)	(3,423)
Net Public Production Costs	27,253	540	673	226,836	3,630	2,485	698	(1,003)	986	820	2,072	264,990
Total Net Cost of Operations	$ 28,399	$ 542	$ 659	$ 226,896	$ 3,627	$ 2,202	$ 700	$ (1,432)	$ 148	$ 832	$ 859	$ 263,432

Schedule of Net Program Cost

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

19. Disclosures Related to the Statements of Budgetary Resources

Apportionment categories of obligations incurred
Obligations

Years Ended September 30,	**2005**	**2004**
Category A, Direct	$ 31,691	$ 31,972
Category B, Direct	41,934	37,398
Reimbursable	5,625	4,657
Exempt from Apportionment	348	394
Total Obligations	$ 79,598	$ 74,421

Borrowing Authority

Loan Guaranty had borrowing authority of $1.8 billion and $1.1 billion as of September 30, 2005, and 2004, respectively. The Vocational Rehabilitation Program had borrowing authority of $3.7 and $4.1 as of September 30, 2005, and 2004, for making direct loans. Loan Guaranty borrowing is repaid to Treasury through the proceeds of portfolio loan collections, funding fees, and the sale of loans to Vinnie MAC trusts. The Vocational Rehabilitation loans generally had duration of 1 year, and repayment was made from offsetting collections.

Adjustments to Budgetary Resources

During the reporting period, adjustments to budgetary resources available at the beginning of the year included VA appropriations that were subjected to a rescission that totaled $247. Additionally, unobligated balances of prior year recoveries of $20 were rescinded. Various VA program accounts received a cut in discretionary budget authority.

Permanent Indefinite Appropriations

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

Use of Unobligated Balances of Budget Authority

Available unobligated balances on the Statement of Budgetary Resources are composed of current fiscal year apportioned funds for annual, multi-year, and no-year appropriations from Congress as well as revolving and trust funds. Other balances not available are composed of expired appropriation unobligated amounts, which generally are not available for new obligations, but can be used to increase existing obligations under certain circumstances. This amount also includes unobligated funds that were not apportioned by OMB for FY 2005 use.

Unobligated VA funds are available for uses defined in VA's FY 2005 Appropriation Law (P.L. 108-447). These purposes include: veterans medical care, research, education, construction and maintenance of VA buildings, veterans and dependents benefits, veterans life insurance, loan guaranty programs, veterans burial benefits, and administrative functions. Various obligation limitations are imposed on individual VA appropriations. Examples include travel obligation limitations and limitation of the use of medical care multi-year funds to object classes for equipment, structures, and land.

Explanation of Differences Between Statement of Budgetary Resources and the Budget

As a result of an analysis of aged obligations, obligations were reduced by $79 for FY 2005 and $90 for FY 2004 on the Statements of Budgetary Resources for both FY 2005 and FY 2004. These adjustments were not reflected in the FACTS II data used to prepare the President's Budget. No other differences were identified as of the preparation date of the financial statements.

Contributed Capital

The amount of contributed capital received during FY 2005 consisted of donations in the amount of $41.0 to the General Post Fund and $0.2 to the National Cemetery Gift Fund.

20. Disclosures Related to the Statements of Financing

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

21. Dedicated Collections

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

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

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

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

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

For the year ended September 30, 2005 Fund Symbol Assets:	**5287**	**5358**	**6020**	**8132**	**8133**	**8150**	**8455**	**8180**	**Total**
Fund balance with Treasury	$ 158	$ -	$ 46	$ 9	$ 72	$ -	$ 1	$ 4	$ 290
Investments with Treasury	-	-	-	10,758	-	45	1,963	65	12,831
Other Assets	589	-	-	505	1	2	106	19	1,222
Total Assets	747	-	46	11,272	73	47	2,070	88	14,343
Liabilities:									
Payables to Beneficiaries	-	-	-	142	1	2	10	1	156
Other Liabilities	-	-	46	10,846	-	44	1,993	2	12,931
Total Liabilities	-	-	46	10,988	1	46	2,003	3	13,087
Net Position:									
Cumulative Results	747	-	-	284	72	1	67	85	1,256
Total Liabilities & Net Position	$ 747	$ -	$ 46	$ 11,272	$ 73	$ 47	$ 2,070	$ 88	$ 14,343

For the year ended September 30, 2005

Fund Symbol	5287	5358	8132	8133	8150	8455	8180	Total
Revenues:								
Exchange - Federal	$ (62)	$ -	$ 670	$ -	$ 3	$ 140	$ -	$ 751
Exchange - Public	2,177	(1)	413	1	-	68	3	2,661
Total Revenues	2,115	(1)	1,083	1	3	208	3	3,412
Expenses:								
Program Expenses	207	4	1,081	3	3	207	43	1,548
Total Expenses	207	4	1,081	3	3	207	43	1,548
Net Change from Operations								
Beginning Net Position	732	5	281	74	1	66	83	1,242
Total Financing Sources	(1,895)	-	1	-	-	-	42	(1,852)
Net Cost of Operations	1,910	(5)	2	(2)	-	1	(40)	1,866
Ending Equity	$ 747	$ -	$ 284	$ 72	$ 1	$ 67	$ 85	$ 1,256

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

Reclassification of FY 2004 Consolidated Statements of Financing

Approximately $1.25 billion was reclassified from line item - "Increase in Exchange Revenue Receivable from the Public" to line item - "Others" under the section Costs That Do Not Require Resources in the Current Period. The total amount reported under this section did not change nor did this change impact any other financial statements being reported. The change is summarized below:

	As Previously Reported	As Reclassified
Costs That Do Not Require Resources in the Current Period		
Increase in Exchange Revenue Receivable from the Public	$952	($295)
Other	($1,430)	($183)

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 2005 AND 2004

Report No. 05–01096-21 **November 15, 2005**

VA Office of Inspector General
Washington, DC 20420

DEPARTMENT OF VETERANS AFFAIRS
Office of Inspector General
Washington DC 20420

Memorandum to the Secretary

Report of Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2005 and 2004

1. Attached is the Report of Audit of the Department of Veterans Affairs (VA) Consolidated Financial Statements (CFS) for Fiscal Years (FY) 2005 and 2004, as required by the Chief Financial Officers Act of 1990. The Office of Inspector General contracted with the independent public accounting firm, Deloitte & Touche LLP, to perform the audit of VA's FY 2005 CFS.

2. The independent auditors' report by Deloitte & Touche LLP provides an unqualified opinion on VA's FYs 2005 and 2004 CFS. The report on internal control identifies three reportable conditions, of which all are material weaknesses. The three material weaknesses are (i) information technology security controls, (ii) integrated financial management system, and (iii) operational oversight. During FY 2005, VA management took corrective action to eliminate the judgments and claims reportable condition reported in the FY 2004 audit report.

3. The report on compliance with laws and regulations continues to show that VA is not in substantial compliance with the financial management system requirements of the Federal Financial Management Improvement Act of 1996. The internal control issues concerning an integrated financial system and information technology security controls indicate noncompliance with the requirements of Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," which incorporates by reference OMB Circulars A-123, "Management Accountability and Control," and A-130, "Management of Federal Information Resources."

4. The auditors' unqualified opinion was achieved through the extensive efforts of program and financial management staff, as well as the auditors, to overcome material weaknesses in internal control to produce auditable information. The risk of materially misstating financial information remains high using the existing non-integrated financial management systems.

5. The independent auditors will follow up on these internal control findings and evaluate the adequacy of corrective actions taken during the audit of the VA's FY 2006 CFS.

MICHAEL L. STALEY
Assistant Inspector General for Auditing

Attachment

Deloitte.

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INDEPENDENT AUDITORS' REPORT

Secretary
Department of Veterans Affairs

We have audited the accompanying consolidated balance sheets of the Department of Veterans Affairs (VA) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, financing and the combined statements of budgetary resources for the years then ended which collectively comprise VA's basic financial statements. These financial statements are the responsibility of VA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and the requirements of Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of VA's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of VA as of September 30, 2005 and 2004, and the respective net costs, changes in net position, financing and budgetary resources thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 14, 2005, on our consideration of VA's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

Deloitte & Touche LLP

November 14, 2005

Member of
Deloitte Touche Tohmatsu

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

Secretary
Department of Veterans Affairs

We have audited the basic financial statements of the Department of Veterans Affairs (VA), as of and for the year ended September 30, 2005, and have issued our report thereon dated November 11, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the requirements of the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended.

Internal Control Over Financial Reporting

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

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

We identified the following matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions that we identified in our prior year report dated November 4, 2004 are identified as repeat conditions.

Member of
Deloitte Touche Tohmatsu

Secretary
Department of Veterans Affairs
Page 2

Three 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 three reportable conditions identified as "Information Technology (IT) Security Controls," "Integrated Financial Management System" and "Operational Oversight" are also material weaknesses. Certain conditions existed in Fiscal Year (FY) 2005 that resulted in the "Operational Oversight" reportable condition being elevated to a material weakness in the current year.

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

VA continued to make IT security controls improvements through the implementation of improved controls over VA financial management systems. Data centers and financial management system program offices have taken corrective actions to remediate elements of IT control weaknesses reported in our prior year report. However, VA's program and financial data continue to be at risk due to serious weaknesses related to: 1) inadequate implementation and enforcement of access controls over access to financial management systems and data; 2) improper segregation of key duties and responsibilities of employees in operating and maintaining key systems; 3) underdeveloped IT service continuity planning; and 4) inconsistent development and implementation of system change controls. 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. Our testing of key controls over the general computer systems at the VA's primary computer centers and selected medical facilities, selected financial management systems, as well as external and internal network vulnerability assessment of the VA's network infrastructure, identified the following control weaknesses:

Access Control

- Strong access authentication mechanisms and administration of user access have not been consistently implemented and enforced at the data centers, medical centers, and regional offices;

- Access privileges were not restricted based on needs due to non-restrictive system access profiles for users and programming staff. There were ineffective monitoring and review of user access profiles; and

- Intrusion detection mechanisms, and coordination and communication between Central Incident Response group and local security functions were not operating promptly and effectively to detect and resolve potential security violations from internal sources. There were also system configuration management and password issues identified in the current and previous year.

Secretary
Department of Veterans Affairs
Page 3

Segregation of Duties

- Legacy systems have not been configured to support proper implementation of system segregation of duties in financial management systems such as Veterans Health Information Systems and Technology Architecture accounts receivables and procurement modules and certain personnel and payroll functions.

- Prior years' segregation of duties issues for the Integrated Funds Distribution Control Point Activity, Accounting and Procurement (IFCAP) system and the Automated Engineering Management System/Medical Equipment Reporting System (AEMS/MERS) remained uncorrected in FY 2005.

Service Continuity

- A business continuity plan at the departmental level has not been fully developed to provide overall guidance, direction, and coordination for IT service continuity;

- The "*Bull*" operating system, supporting Veteran's Benefit Administration (VBA) applications such as compensation, pension and education programs, loan guarantee, and the property management systems' data, has not been tested for the service continuity purpose because the backup hardware does not have adequate memory and processing capacity; and

- Testing of the Continuity of Operations Plan for financial management systems at certain medical facilities and data centers has not been consistently scheduled and adequately performed.

Change Control

- Change control policy at the departmental level does not provide uniformed application development and change guidance for a wide-range of new and legacy applications to facilitate consistent implementation and effective monitoring of system change controls for mission critical systems.

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

Recommendations

VA senior leadership should continue to pursue a more centralized approach, apply appropriate resources, and establish a clear chain of command and accountability structure to implement and enforce IT internal controls. In addition, VA needs to plan and implement corrective actions and remediate identified deficiencies within a reasonable timeframe. The VA Chief Information Officer (CIO) should perform proactive oversight of compliance with established IT internal control policies and procedures. VA should continue its entity-wide effort to accomplish the following key tasks:

Secretary
Department of Veterans Affairs
Page 4

1. Improve access control policies and procedures to provide actionable steps for configuring security settings on operating systems, improving administration of user access, and detection and resolution of potential access violations. Access privileges need to be assigned based on the user's level of responsibility and position.

2. Evaluate user functional access needs and system access privileges to support proper segregation of duties within financial applications. Assign, communicate, and coordinate responsibility for enforcing and monitoring such controls in a consistent fashion throughout VA.

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

4. Develop a change control framework and, within that framework, implement application specific change control procedures for mission critical systems.

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

- Reconciliations of property records in the loan guaranty programs continue to identify significant differences from non-interfaced systems;

- Within the compensation, pension and education programs, there are a number of programs that do not directly interface with the general ledger or they interface at various intervals. As a result, numerous adjusting entries resulting from timing differences are necessary to reconcile balances with the general ledger to ensure that amounts are properly stated; and

- In the life insurance programs, the lack of system interface with the VA's general ledger creates the need for a significant amount of adjusting entries. We observed that some journal entries were not posted to the general ledger nor were reconciling items identified and posted timely.

Recommendation

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

Operational Oversight – Material Weakness
(Repeat Condition)

With more than 150 medical centers nationwide, management oversight at the medical centers is essential to ensure compliance with VA's established policies and procedures. To assess the effectiveness of internal controls at the medical center level, we conducted tests at selected medical centers to (1) determine whether staffs were aware of key internal controls, (2) review evidence to determine whether internal controls were functioning as intended and (3) assess the effectiveness of the internal controls.

During the current year testing, exceptions identified in previous years continued to exist. In addition, in one medical center, financial data was manipulated in a manner that circumvented financial monitoring controls and internal financial performance metrics producing improved financial indicators for that medical center.

We continued to find a number of previously reported instances where key internal controls and reconciliation processes were not performed consistently or completely. The Veterans Health Administration (VHA), Office of the CFO, has implemented a monthly reconciliation monitoring process.

VHA also conducted training designed specifically for medical center accountants and developed performance measures for the Veterans Integrated Service Networks (VISN) scorecard to monitor medical centers' progress in complying with VA policies and procedures. Although there has been improvement, our testing at the medical centers showed continued noncompliance with certain established policies and procedures. Among the control exceptions found at the medical centers were:

- Certain medical accounts receivable and/or other account receivable balances had not been reconciled in a timely manner. Furthermore, supervisory reviews of medical accounts receivable reconciliations were not completed in accordance with procedures;

- Completed construction or upgrade projects were not capitalized in a timely manner;
- Non-expendable equipment inventories were not completed or were not completed in accordance with certain VA policies and procedures;
- Accounts receivable collections were not properly completed or were not completed in a timely manner;
- Inadequate reviews of undelivered orders and/or accrued service payable transactions increased in FY 2005;
- Estimated environmental clean-up costs were not reported in a timely manner;
- Deferred maintenance costs were not recorded or were incorrectly recorded in the general ledger; and
- Accounts records were modified without approval.

Recommendations

6. The VHA CFO should enhance monitoring controls over medical center financial and performance metrics reporting and investigate unusual activity or financial variances on a monthly basis. The VHA CFO should also continue training programs in areas where noncompliance continues to exist, and use the VISN scorecards to measure compliance with VA policies and procedures to improve internal controls over financial reporting.

7. The VHA CFO should consider financial training for medical center directors and other supervisory personnel highlighting the importance of accurate financial reporting and promoting timely and thorough follow up on aged accounts balances. The VHA CFO should also review and enhance controls related to approving write-off transactions.

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

Follow-up on Previous Report

In our *Independent Auditors' Report On Internal Control Over Financial Reporting And On Compliance Based Upon the Audit Performed in Accordance with Government Auditing Standards* dated November 4, 2004, we reported four reportable conditions (with two material weaknesses) in the areas of (1) Information Technology (IT) Security Controls, (2) Integrated Financial Management System, (3) Operational Oversight and (4) Judgment and Claims. In FY 2005, the material weaknesses repeated are items (1) and (2). Item (3) has been elevated to a material weakness. Item (4) is no longer a reportable condition.

* * * * * *

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

In addition, we considered VA's internal control over Supplementary Information by obtaining an understanding of VA's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02, as amended. Our procedures were not designed to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

Compliance and Other Matters

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

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

The material weaknesses in internal control over financial reporting discussed above and identified as "Information Technology (IT) Security Controls" and "Integrated Financial Management System" and "Operational Oversight" indicate that VA is not in compliance with the requirements of OMB Circulars A–123, A–127, and A-130. As discussed above, we found material weaknesses in (1) the effectiveness of the information technology controls; and (2) the design and operation of internal controls over financial reporting, particularly with effectiveness of the control monitoring and reconciliation processes in support of the preparation of the VA's consolidated financial statements and (3) circumvention of 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 FFMIA.

Secretary
Department of Veterans Affairs
Page 8

In addition, we noted other matters involving the internal control and compliance over financial reporting that we have reported to the VA, in a separate letter dated November 14, 2005.

Distribution

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

Deloitte & Touche LLP

November 14, 2005

Department of Veterans Affairs

Memorandum

Date: NOV 15 2005

From: General Counsel (02) and Former Chief Management Officer (004)

Subj: Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for Fiscal Years 2005 and 2004

To: Assistant Inspector General for Auditing (52)

1. We have reviewed the Report of the Audit of the Department of Veterans Affairs Consolidated Financial Statements for fiscal years 2005 and 2004, and are pleased with receipt of an unqualified opinion. We are especially proud that we were able to meet the FY 2005 timeframe requirements established by the Office of Management and Budget. Please extend to your staff and the staff of Deloitte & Touche, LLP, our appreciation for their detailed planning, hard work, and cooperation during this year's audit.

2. 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 VHA, VBA, and NCA and with other VA staff and program managers. We will continue to provide you with updates on our progress to correct the two material weaknesses, Integrated Financial Management System and Information Technology Security Controls, as well as develop and implement a plan to correct the material weakness, Operational Oversight, first reported this year.

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

Tim S. McClain

Tim S. McClain

Required Supplementary Stewardship Information (Unaudited)

1. Heritage Assets

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

Heritage Assets in Units

As of September 30,	**2005**	**2004**
Art Collections	29	33
Buildings and Structures	1,815	1,817
Monuments/Historic Flag Poles	732	724
Other Non-Structure Items	186	76
Archaeological	11	11
Cemeteries	157	157
Total Heritage Assets in Units	2,930	2,818

2. Non-Federal Physical Property

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

Grant Program Costs

Years Ended September 30,	**2005**	**2004**
State Extended Care Facilities	$ 183	$ 66
State Veterans Cemeteries	36	34
Total Grant Program Costs	$ 219	$ 100

The Extended Care Facilities Grant Program assists states in acquiring facilities to provide domiciliary, nursing home, and other day health care for veterans, and to expand, remodel, or alter existing buildings to provide domiciliary, nursing home, hospital, and day health care for veterans in state homes. VA participates in two grant-in-aid programs for states. VA may participate in up to 65 percent of the cost of construction or acquisition of state nursing homes or domiciliaries or in renovations of existing state homes. Over the last 5 fiscal years, the State Home Construction Grant Program has awarded grants in excess of $587 million. VA also provides per diem payment for the care of eligible veterans in state homes.

Since the cemetery program was established in 1980, VA has awarded grants totaling more than $244.7 million to 34 states and the Commonwealths of Guam and the Northern Marianas. The program provides up to 100 percent of the cost to establish, expand, or improve state veterans' cemeteries. States provide the land and agree to operate the cemeteries.

3. Human Capital

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

Veterans and Dependents Education Years ended September 30,	**2005**	**2004**	**2003**	**2002**	**2001**
Program Expenses					
Education and Training-Dependents of Veterans	$ 405	$ 320	$ 266	$ 234	$ 175
Vocational Rehabilitation and Education Assistance	2,779	2,517	2,309	1,894	1,644
Administrative Program Costs	226	230	288	229	172
Total Program Expenses	$ 3,410	$ 3,067	$ 2,863	$ 2,357	$ 1,991
Program Outputs (Participants)					
Dependent Education	75,072	67,420	64,582	53,888	46,917
Veterans Rehabilitation	71,956	75,409	71,549	69,634	64,235
Veterans Education	444,359	409,695	400,289	375,013	372,054

Program Outcomes

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

4. Health Professions Education

Health Professions Education Years Ended September 30,	**2005**	**2004**
Program Expenses		
Physician Residents and Fellows	$ 438	$ 420
Associated Health Residents and Students	63	62
Instructional and Administrative Support	430	401
Total Program Expenses	$ 931	$ 883
Program Outputs		
Health Professions Rotating Through VA:		
Physician Residents and Fellows	30,903	29,179
Medical Students	16,750	16,740
Nursing Students	22,675	20,275
Associated Health Residents and Students	16,862	16,921
Total Program Outcomes	87,190	83,115

Program Outcomes

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

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

5. Research and Development (R&D)

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

Program Expense
Year ended September 30, 2005

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

Program Expense
Year ended September 30, 2004

	Basic	Applied	Development	Total
Medical Research Service	$ 172.9	$ 81.8	$ -	$ 254.7
Rehabilitative Research and Development	3.5	27.9	17.0	48.4
Health Services Research and Development	-	61.8	-	61.8
Cooperative Studies Research Service	-	27.7	-	27.7
Medical Research Support	-	452.0	-	452.0
Prosthetic Research Support	-	4.8	-	4.8
Total Program Expenses	$ 176.4	$ 656.0	$ 17.0	$ 849.4

In addition, VHA researchers received grants from the National Institutes of Health in the amount of $545 million and $274 million in other grants during FY 2005. These grants went directly to researchers and are not considered part of the VA entity. They are being disclosed here but are not accounted for in the financial statements.

Program Outputs/Outcomes

For FY 2005, VA's R&D general goal related to stewardship was to ensure that VA medical research programs met the needs of the veteran population and contributed to the Nation's knowledge about disease and disability. Target levels were established for the (1) percent of funded research projects relevant to VA's health-care mission in designated research areas, and (2) number of research and development projects. Strategies were developed in order to ensure that performance targets would be achieved.

Research and Development Measures-Actual Year ended September 30,	2005	2004
Percent of Funded Research Projects Relevant to VA's Health-Care Mission	94.3%	97.1%
Number of Research and Development Projects	2,107	2,165

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

Required Supplementary Information (Unaudited)

1. Deferred Maintenance

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

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

Deferred Maintenance as of September 30,	**2005**	**2004**
General PP&E	$ 1,976	$ 1,649
Heritage Assets	42	34
Total Deferred Maintenance	$ 2,018	$ 1,683

2. Balances with Other Federal Entities

Intragovernmental Assets
as of September 30, 2005

Trading Partners	Fund Balance with Treasury	Investments	Accounts Receivable	Other Assets
Treasury	$ 17,087	$ 13,286	$ -	$ 4
DoD - Defense Agencies	-	-	49	-
All Other	-	-	23	36
Total Intragovernmental Assets	$ 17,087	$ 13,286	$ 72	$ 40

Intragovernmental Liabilities
as of September 30, 2005

Trading Partners	Accounts Payable	Debt	Other
Treasury	$ 19	$ 2,193	$ 1,942
Other	47	-	677
Total Intragovernmental Liabilities	$ 66	$ 2,193	$ 2,619

Intragovernmental Earned Revenue and Related Cost (trade activity)
Year Ended September 30, 2005

Trading Partner	Earned Revenue
DoD - Defense Agencies	$ 1,064
Health & Human Services	510
Justice	46
All Other	89
Total Earned Revenue	$ 1,709
Related Cost	$ 1,658

Intragovernmental Non-Exchange Revenue
Year Ended September 30, 2005

Trading Partner	Transfers-Out
Treasury	$ 1,507

3. Schedule of Budgetary Activity

Schedule of Budgetary Activity
Year Ended September 30, 2005

	Total Budgetary Resources	Obligations Incurred	Spending Authority from Offsetting Collections and Adjustments	Obligated Balance net, Oct. 1	Obligated Balance net, Sept. 30	Total Outlays
VHA						
0152 Medical Admin	4,518	4,400	45	656	840	4,171
0160 Medical Care	24,111	23,081	168	2,401	2,711	22,603
0161 Medical & Prosthetic Research	525	467	60	123	140	390
0162 Medical Facilities	3,414	3,303	25	658	921	3,015
All Other	2,568	1,142	248	737	1,133	498
Total	35,136	32,393	546	4,575	5,745	30,677
VBA						
0102 Compensation, Pension, & Burial Benefits	33,422	32,340	-	2,441	87	34,694
0137 Readjustment Benefits	3,334	3,176	285	82	37	2,936
4025 Housing Credit Liquidating	57	25	102	2	2	(77)
4127 Direct Loan Financing	1,923	649	2,147	71	69	(1,496)
4129 Guaranteed Loan Financing	6,228	2,059	2,034	22	12	35
8132 National Service Life Insurance Fund	10,651	1,518	307	1,467	1,472	1,206
All Other	5,511	3,138	1,226	419	433	1,898
Total	61,126	42,905	6,101	4,504	2,112	39,196
NCA						
0129 National Cemetery Adm.	152	145	-	33	29	149
All Other	36	36	-	31	46	21
Total	188	181	-	64	75	170
ADM						
0151 General Operating Expenses	2,068	1,951	542	308	432	1,285
All Other	2,922	2,168	2,495	676	(57)	406
Total	4,990	4,119	3,037	984	375	1,691
Total of all Business Lines	101,440	79,598	9,684	10,127	8,307	71,734

4. Segment Information

Segment Information

Condensed Balance Sheet as of September 30	Supply Fund 2005	Supply Fund 2004	Franchise Fund 2005	Franchise Fund 2004
Assets				
Fund Balance with Treasury	$ 564	$ 921	$ 111	$ 96
Accounts Receivable, Net	93	133	55	28
General Property, Plant and Equipment	7	4	21	22
Other Assets Including Inventory	28	27	7	6
Total Assets	$ 692	$ 1,085	$ 194	$ 152
Liabilities and Net Position				
Accounts Payable	$ 55	$ 67	$ 3	$ 4
Deferred Revenues	146	338	-	-
Other Liabilities	337	524	92	57
Total Liabilities	538	929	95	61
Cumulative Results of Operations	154	156	99	91
Total Liabilities and Net Position	$ 692	$ 1,085	$ 194	$ 152
Condensed Net Cost Information				
Total Program Costs	$ 1,898	$ 1,829	$ 247	$ 230
Earned Revenues				
Intra-Departmental	(610)	(573)	(157)	(143)
Other Federal Entities	(1,249)	(1,225)	(94)	(66)
Non-Federal	(34)	(27)	-	-
Total Earned Revenues	$ (1,893)	$ (1,825)	$ (251)	$ (209)
Net Program Costs (Revenue)	$ 5	$ 4	$ (4)	$ 21

5. Franchise Fund Services

Created by Congress in 1996, as one of six Franchise Fund pilots operating within the Executive Branch of Government, the Department of Veterans Affairs' (VA) Franchise Fund supports VA's mission by supplying common administrative services at competitive prices. By law, the business lines within the Fund can only sell to federal entities. This organization accounted for its funds in six activity centers (VA Enterprise Centers) and in one administrative organization: Austin Automation Center, Debt Management Center, Financial Services Center, Law Enforcement Training Center, Security and Investigations Center, VA Records Center and Vault, and the Enterprise Fund Office.

For more information, visit http://www.va.gov/fund/reports.

6. Supply Fund Services

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