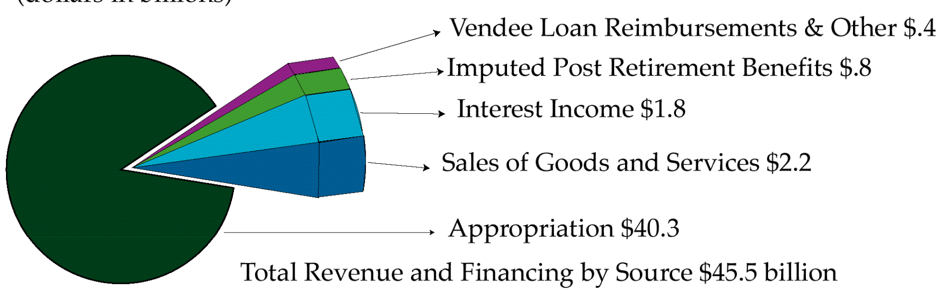
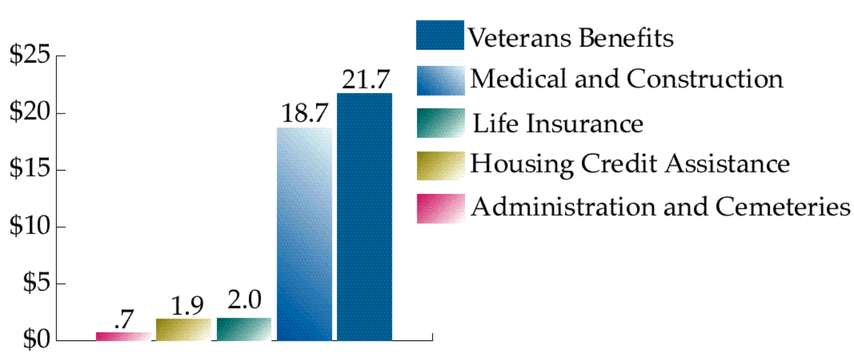
Financial Highlights

(dollars in billions)	FY 1997	FY 1996
Assets		
Fund Balance with Treasury	14.1	13.1
Investments	14.6	14.6
Net Receivables	5.3	4.5
Net Property, Plant, and Equipment	11.7	11.1
Funded Liabilities		
Liabilities for Loan Guarantees	4.2	3.5
Insurance Policy Reserves	13.0	12.9
Borrowing from Treasury	3.7	1.8
Unfunded Liabilities		
Federal Employee Compensation Act	1.7	1.7
Veterans' Compensation / Burial	468.4	442.3
Veterans' Pension	73.4*	68.7*

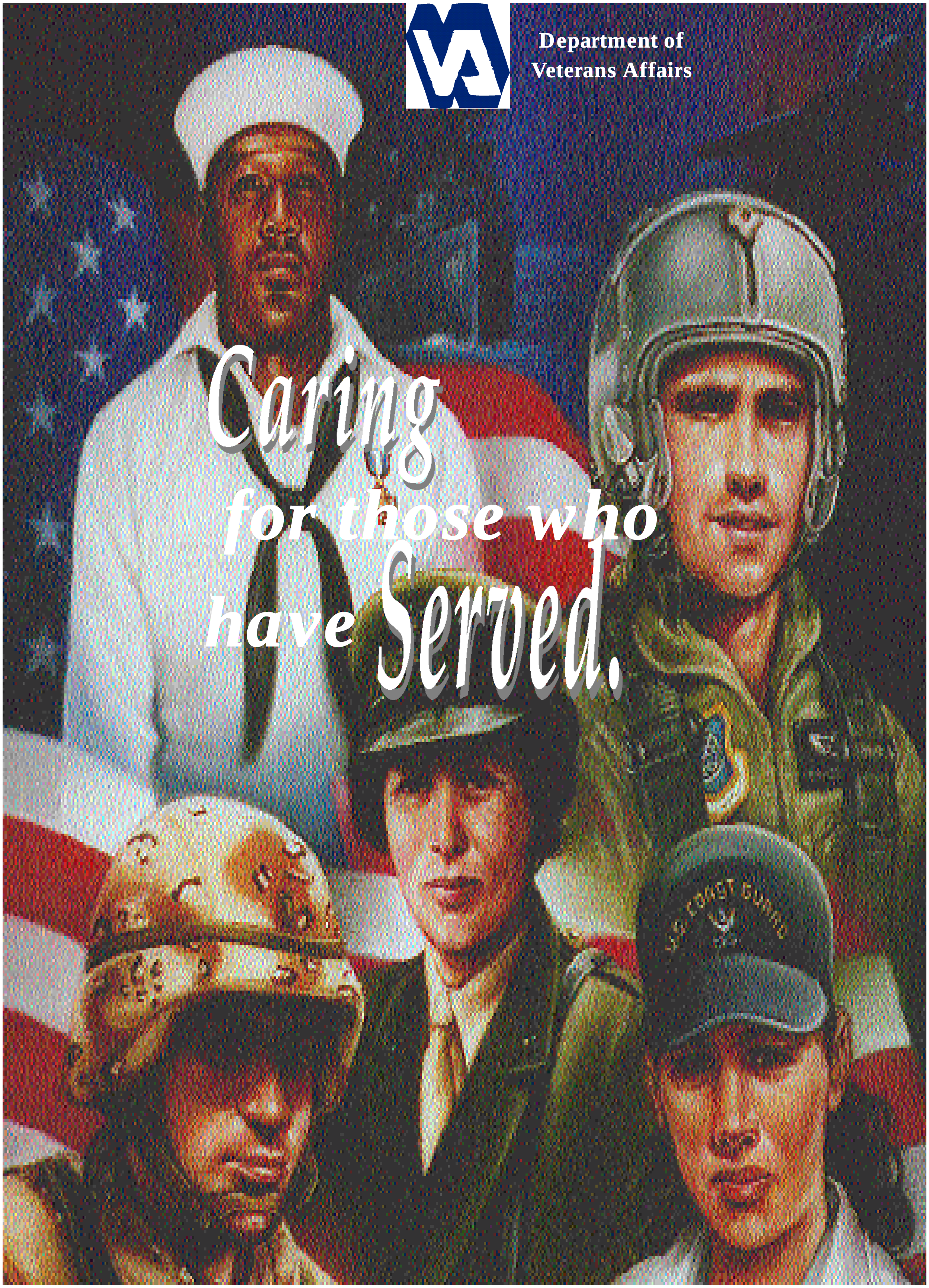
FY 1997 Revenue and Financing by Source
(dollars in billions)



Expenses by Program
(dollars in billions)



* Disclosure Only


Department of
Veterans Affairs
Caring
for those who
have Served.

Message from the Secretary of Veterans Affairs

The Department of Veterans Affairs Fiscal Year 1997 Accountability Report is the third to be issued under OMB's pilot program for streamlining government reporting. Included as items of interest to the President, Members of Congress, VA managers and customers are overviews of the performance of VA's mission, accomplishments of the Government Performance and Results Act (GPRA), the audited financial statements, and the status of management controls. The report also contains—for the first time—a summary of the Inspector General's findings during the fiscal year.

The information in the Accountability Report is derived from officially recognized financial and management systems. A review of senior administrative and program managers' annual assessments provides significant assurance that VA's management controls and financial systems adhere to governmentwide standards and requirements. Full compliance of VA's financial systems will depend on the completion of the Veterans Benefits Administration's systems modernization efforts.

To keep the promises made by America to its veterans and their dependents, VA will continue to raise the bar of expectations—searching for ways to improve the quality of medical care, the delivery of services, and the appropriate memorialization for those who have served their country with courage and honor.

Togo D. West,

Management Discussion and Analysis

As VA's Acting Chie Financial Officer and Chief Information Officer, my vision is for the Department to be recognized for excellence in financial and information management, by providing quality and innovative solutions and services in full partnership with our customers, to enhance service delivery in support of the VA's mission. The Management Discussion and Analysis (commonly referred to as MD&A) section gives me the opportunity to provide you with the Department's performance and financial highlights, its annual reporting and a summary of our financial condition.

D Mark Catlett

PERFORMANCE HIGHLIGHTS

- The Secretary published the VA strategic plan on September 30, 1997, based on the requirements of the Government Performance and Results Act, known popularly as the Results Act. VA's plan is organized around two major themes: *honor, care and compensate veterans in recognition of their sacrifices for America,* which include strategic goals for VA programs through which benefits and services are provided; and *management strategies that will help VA operate as "One VA."*

- The Department's first performance plan under the Results Act was sent to Congress as part of VA's FY 1999 Budget. The plan serves as a bridge between the Department's strategic plan and the individual volumes of the FY 1999 Budget.

- Executive performance agreements linked to organizational goals, specific management strategies, and cross-cutting activities with outside entities contributed to VA's success in improving the overall health care of veterans. Among the most noteworthy performance achievements were:

Quality of Care

- Chronic disease and prevention interventions for veterans significantly improved.
- End-of-life planning was provided to about two-thirds of terminally ill veterans.
- Investigations by the Medical Inspector's office resulted in identification of potential opportunities and improvements in the delivery of care, such as ways to avoid delays in diagnoses of conditions of women veterans; more consistent medical record documentation; closer supervision of residents in training; and a more intensive evaluation of the process leading to Sentinel Events (isolated, unexpected, serious).

Access

- The number of unique patients rose to over 3.1 million.
- Operations began in Hines, Illinois for the Consolidated Mail Outpatient Pharmacy (CMOP), an automated service that provides 500,000 prescriptions weekly, dramatically cutting the turnaround time for prescriptions and reducing overall operating expenses.
- A National Formulary was established that enhances equal access to pharmaceuticals for veterans, regardless of where they live.

Cost

- Acute bed days of care per 1,000 unique patients dropped 29 percent from 2,525 days to 1,782 days.
- Total operating beds declined 21 percent to some 52,700.
- More surgeries and procedures (69 percent) were performed in an ambulatory setting.

Customer Satisfaction

- Inpatient and outpatient satisfaction improved slightly, although spinal cord injury dysfunction patient satisfaction results were lower than expected.

◆ On April 1, 1997, VA implemented the Veterans Equitable Resource Allocation (VERA) system to allot its $17 billion medical care budget to its 22 Networks. VERA was developed because previous funding allocation systems perpetuated funding inequities across the country that resulted in sub-optimal utilization of taxpayers' dollars and unequal veteran access to health care. Based on the VERA model, VA began a three-year plan to shift $500 million to facilities that have been historically underfunded. As a result, VA will spend these funds more efficiently and veterans will have improved access to health care.

◆ VA worked closely with other Federal departments and agencies pursuing scientific investigations to learn more about the health problems of Gulf War veterans. The Persian Gulf Veterans Coordinating Board, chaired by the Secretaries of Veterans Affairs, Defense, and Health and Human Services, revised its comprehensive research strategy to ensure that Federal research efforts are designed to answer the varied concerns about Gulf War veterans' illnesses. The Board also developed an outreach and education plan for Gulf War veterans, and a Force Health Protection Program for future deployments.

◆ Satisfaction surveys were conducted with program participants for the compensation and pension programs, the insurance program, and the loan guaranty program. Taken as a whole, veterans were more satisfied than dissatisfied with VA performance. Nationally, 59 percent of all surveyed veterans were satisfied with the way VA handled their claims. Ninety percent of veterans who evaluated the insurance program gave VA a high rating, and only five percent gave VA a low rating. Lenders, under the loan guaranty program, expressed a high degree of satisfaction (90 percent) with their overall interaction with VA.

- VA improved the timeliness for all its major work products in the compensation and pension programs. During FY 1997, original compensation claims were completed in an average of l33 days, down from 144 days during the previous year. Other end products had similar improvements. However, the Department met its annual goal for only one measure, timeliness of dependency and indemnity compensation.

- Timeliness of education claims processing far exceeded the annual goal, completing claims in an average of 12 days compared with the plan of 24 days. This is an improvement of eight days from the FY 1996 level of performance.

- The number and percentage of veterans who successfully completed a program of vocational rehabilitation exceeded the annual plan. Approximately 88 percent of all program participants who ended a program were deemed to have been effectively rehabilitated. This means they found suitable employment and held their job for at least six months.

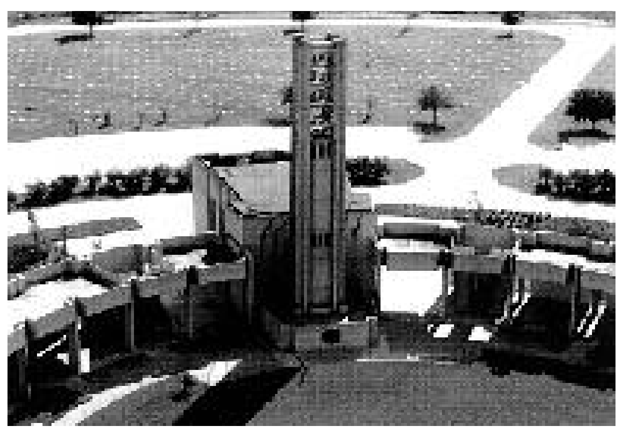
- Tahoma National Cemetery, the 115th VA national cemetery and the first in the State of Washington, opened in September 1997. The first phase of construction, covering 43 acres of the 160-acre site, will allow for more than 10,000 gravesites and 4,000 niches for cremated remains. With more than 600,000 veterans living in Washington State, including 400,000 in the Puget Sound area, it is anticipated that Tahoma will quickly become one of VA's busiest national cemeteries.

- The Department expanded its second inscription program to 38 national cemeteries. Instead of replacing the headstone with one that includes the added information, now the information is added to the original headstone. In August 1997, the cost savings realized by this program passed the $1 million mark.

- In addition to improving timeliness by 44 percent, VA's Board of Veterans' Appeals issued 43,347 decisions, the highest total since FY 1991.

- The VA Franchise Fund completed the first year of operations with revenue of $59.2 million.

- A veteran-focused information technology (IT) architecture project was initiated to ensure that VA uses technology to provide better service to veterans and other customers and program management support services, to include development of an IT vision and identification of critical issues and major decision points and time frames.

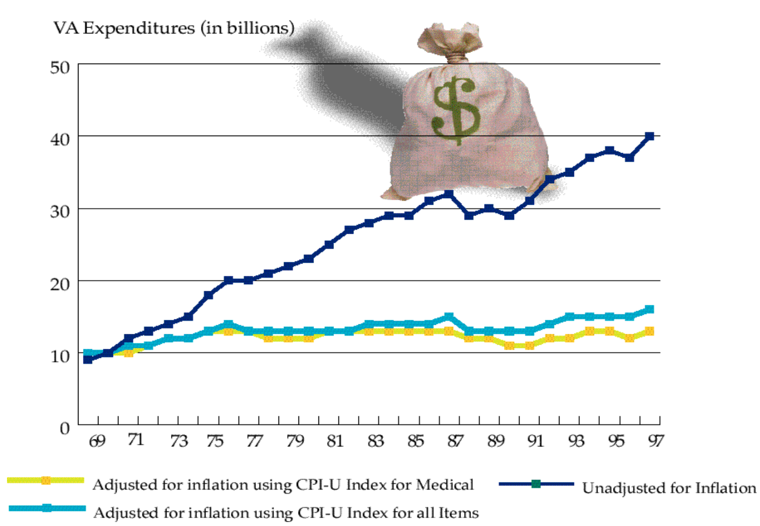


Houston National Cemetery includes a unique structure called a hemi-cycle, the only one of its kind in the National Cemetery System.

FINANCIAL MANAGEMENT HIGHLIGHTS

VA Employment and Expenditures

The Department of Veterans Affairs full time equivalent (FTE) employment dropped by 10,348, or 4.7 percent, during FY 1997. Since 1993, FTE has declined by 22,690 or 9.7 percent. The Department's outlays for the fiscal year were $39.3 billion. After adjusting outlays to account for inflation, using 1969 as the base year, VA expenditures have experienced an 8.4 percent increase during the last four years.



VA and Treasury Pilot – Smart Cards

In partnership with the Treasury Department, FMS, VISA, and NationsBank, VA implemented two pilot programs, one at the Bronx VAMC and the other at the Tampa VAMC. The pilot programs will place VISA Cash in the hands of patients, physicians, visitors, volunteers, and employees.

The Smart Card is aimed at improving services, reducing government costs, and streamlining federal operations. During the pilot, VA will test the Smart Card in a variety of applications: integrated cash registers and terminals, vending machines, and cashless ATMs that transfer cash value onto reloadable cards. Participants will use the cards to make purchases at food courts, retail stores, and vending machines at the two medical centers.

Payroll Electronic Payments

In FY 1997, the Department achieved its goal of 95 percent participation for employee salary payment via Direct Deposit/Electronic Funds Transfer (DD/EFT), up 5 percent over the prior two years.

Governmentwide Commercial Purchase Card Program

The IMPAC/Purchase Card Program continued to show unprecedented growth in FY 1997. Some 34,000 cardholders placed over 1.5 million electronic transactions on their IMPAC Purchase Cards. This represents over $797 million in purchased goods and services.

The Department achieved its goal of making 90 percent of its micro-purchases with the IMPAC card. VA's Credit Card System (CCS) was instrumental in achieving this goal. The CCS provides the

Financial Services Center in Austin, TX, with the capability to download transaction files from the contract bank as a single invoice; process payments daily through Electronic Funds Transfer (EFT); and post the transactions automatically to the VA's field station accounts via the integrated FMS accounting system.

All VAfacilities can now easily access the CCS and make accounting changes, with the system automatically doing expenditure transfers. The system's reengineering has enabled VA to take maximum advantage of rebates offered under the IMPAC contract. During FY 1997, VA earned a rebate in excess of $5.1 million which is projected to grow to more than $5.5 million in FY 1998.

Prime Vendor

Prime Vendor – a multi-billion dollar procurement program – provides VA medical centers with a simple, efficient, and cost effective way to order recurring goods and supplies, typically in the pharmaceutical, subsistence, and medical/surgical areas. Prime Vendor offers VA a variety of goods from numerous manufacturers at low, negotiated contract prices.

A payment system, modeled on VA's immensely successful IMPAC Credit Card System, was implemented to facilitate the electronic processing of prime vendor invoices. VA accepts a daily transaction file for prime vendor invoices from First Bank Systems (FBS)/Rocky Mountain Bankcard System (RMBCS), then posts those transactions to VA's integrated accounting system, and remits an electronic payment to FBS/RMBCS.

Implemented in September 1996 at the Philadelphia Medical Center, the program expansion is now fully operational. During FY 1997, the 98 participating VA medical centers placed over 88,850 transactions for over $231 million in goods and services. Through the first quarter of FY 1998, 108 facilities processed 47,975 transactions, totaling over $149 million for a single pharmaceutical prime vendor. Approval has been given to include additional Prime Vendors in the program.

The payment program provides a number of substantial benefits to all participants: the prime vendor is assured of timely payment; the contract bank gains the opportunity to process business not normally captured in its credit card market; and VA quickly initiates a full electronic business cycle, dramatically reducing the processing time. VA's Prime Vendor Payment Program is an excellent example of an innovative partnership between the public and the private sectors.

ANNUAL REPORTS

Prompt Pay

In FY 1997, VA processed more than 4 million invoices representing over $6.5 billion, subject to the Prompt Payment Act. Over 91 percent of these invoices were paid on time, an 8 percent increase over the 83 percent on-time rate in FY 1996. The continuing development and extensive use of our Electronic Commerce initiatives increased our electronic vendor payments to nearly $3 billion for FY 1997, as compared to $2.7 billion for FY

1996. Additionally, the Department undertook an aggressive approach in implementing the Governmentwide commercial purchase card program. Our purchase card disbursement for over 1.5 million transactions in FY 1997 was $797 million.

The Department has placed special emphasis on Prompt Payment and has initiated the following efforts to improve payment performance:

- Implemented a new Prime Vendor Payment System (PVPS) – The PVPS is an electronic payment program that works through VA's existing Credit Card System, disbursing payments to vendors for subsistence and pharmacy purchase orders.

- Successfully implemented the piloted fast pay procedures for certified invoices under $1,000 at fifty-seven field stations. Further, the VA's Financial Services Center has undertaken a statistical sampling fast pay program for invoices under $2,500. Fast pay procedures increased the timeliness of payments by allowing post payment certification (in accordance with the U.S. General Accounting Office Manual for Guidance of Federal Agencies, Title 7) while reducing interest penalties and lost discount payments. FY 1997 interest penalties totaled $2.1 million, a decrease of $1.3 million, or 39 percent, as compared to $3.4 million in FY1996.

An application was developed to provide vendors direct access to our vendor inquiry system through the Internet. This World Wide Web application stores 90 days of payment status information. As of September 30, 1997, 63 vendors are using the Vendor Inquiry System Internet Download Procedures.

Invoices and Payments Paid Under the Prompt Pay Act

	Total		Electronic Commerce	
Fiscal Year	**Payments**	**Invoices**	**Payments**	**Invoices**
1993	**$5.0b**	**3.6m**	**$1.2b**	**1.1m**
1994	**$5.2b**	**3.8m**	**$1.6b**	**1.3m**
1995	**$5.9b**	**4.1m**	**$2.3b**	**1.3m**
1996	**$6.3b**	**4.0m**	**$2.7b**	**1.1m**
1997	**$6.5b**	**4.0m**	**$3.0b**	**1.8m**

b= billions
m=millions

Over 91 percent of VA's invoices were paid on time, an 8 percent increase over FY 1996

Debt Management

VA has long been regarded as a leader in the federal debt management community. VA's Debt Management Center (DMC) oversees a centralized, automated collection system that employs every collection tool available to federal agencies. This is an efficient, cost-effective operation that emphasizes both the prevention and the collection of debt. In FY 1997, the cost of operating the DMC totaled $5.65 million (including ADP support provided by other offices), while DMC cash collections (excluding offsets) totaled over $82 million, resulting in a ratio of $14.53 in cash collections for every dollar spent. Total DMC collections exceeded

$317 million, resulting in a total cost to collection ratio of $56 collected for every dollar spent.

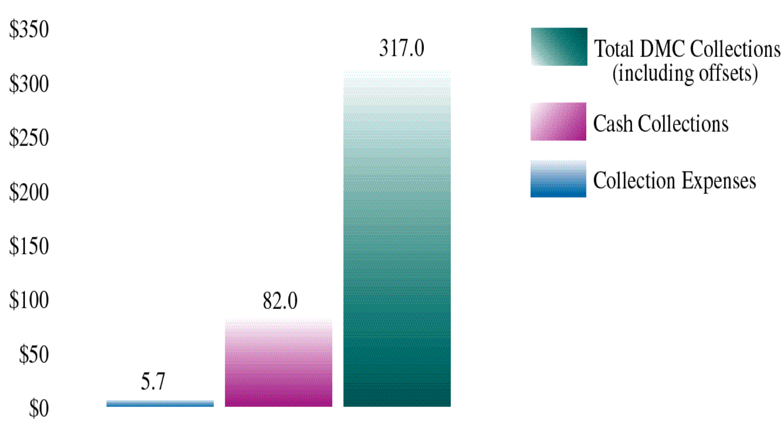
In order to maintain VA's leadership position in the federal debt collection community, the Department has moved closer to its goal of consolidating all significant VA debt programs into one centralized, automated collection system. Historically, the management of VA's major debt programs was divided into two categories: first-party medical care cost recovery (MCCR) and the recovery of VA benefit debts. Most benefit debts have been housed in an automated system and managed by the DMC for many years. During FY 1997, billing processes for first-party medical debt were automated at VA's Automation Center in Austin, Texas. Significant progress was made toward automating payment processing for these receivables at a lockbox administered by a private contractor. The automation of these functions will save on postage costs and will free MCCR resources from time-consuming clerical tasks.

In 1998, the referral of delinquent medical care debts (those that are more than 90 days old) to the DMC for limited collection management activity will be completed. This referral, which will help implement a recommendation by the National Performance Review, is consistent with the Department's strategy of achieving maximum consolidation of debt. VA continues to work toward the referral of all first-party debt to the DMC for the management of all collection activity. Such centralization should not only increase the collection rate, but should also significantly lower the cost of collection. The centralized operation at the DMC is more efficient than requiring each medical center to manage the collection of its bills. During 1998, VA will continue to develop and modify the systems that allow the DMC to manage all first-party medical care receivables (including nondelinquent receivables).

After reviewing all of its regulations governing the management of VA benefit and medical care debt, the Department has drafted new regulations which will reduce the volume in this area by more than 50 percent. These revised regulations have yet to be published, pending the release of the revised Federal Claims Collection Standards by the Treasury Department. Treasury is expected to publish these standards in FY 1998; VA's regulations will be published shortly thereafter.

VA has been working with the Treasury Department to implement the requirements of the Debt Collection Improvement Act of 1996 (DCIA) and to take advantage of the expanded debt collection authority under this law. VA recently reached agreement with Treasury on the

VA Debt Management Center
FY 1997 (dollars in millions)



appropriate amount of debt eligible for referral to Treasury for offset ($334 million) and for cross-servicing ($699 million). Over $261 million worth of the eligible amount has been referred to Treasury's offset program. During fiscal year 1998, it is expected that all eligible debt housed at the DMC and all eligible first-party medical debt (which comprise over 80 percent of eligible VA debt) will be referred to Treasury. Veterans Benefits Administration (VBA) and Veterans Health Administration (VHA) are currently developing plans to achieve referral of the remaining debt.

OMB recently approved the DMC's application to operate as a franchise fund. In April 1997, the DMC applied for designation as a federal collection center, under the provisions of the DCIA, and is awaiting a decision from Treasury. The DMC has already begun making changes to its automated system that will allow for the servicing of other agency debt, should its application be approved.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)

In FY1997, VA closed two material weaknesses: (1) Insurance System– Lack of Adaptability and Documentation; (2) Controls Over Prescriptions for Patients Treated at More Than One Facility.

- **Insurance System** – The system was completely redesigned. All obsolete insurance computer programs were rewritten. The mainframe computer supporting the processing of insurance payments was replaced with a larger and more modern machine. All insurance central processing is now done on a single mainframe.

- **Controls Over Prescriptions for Patients Treated At More Than One Facility** – VHA incorporated the Pharmacy Practices Software into the Clinical Information Resources Network (CIRN). The CIRN will monitor and prevent the distribution of duplicate prescriptions.

Progress continues on the remaining material weaknesses, four of which required adjusted completion dates.

- **Aging, Antiquated and Obsolete Hardware and Software Systems** – All planned actions have been competed. The effectiveness of these changes is being evaluated. Closure will be requested in FY 1998.

- **Lack of Adequate Contingency Planning** – The Austin Automation and Financial Services Centers tested and completed their contingency planning efforts before

FMFIA Corrective Action Plan	Identified	Targeted Correction
Aging, Antiquated, and Proprietary Hardware and Software Systems	1983	1998
Lack of Adequate Contingency Plans	1984	1998
Education System-Chapter 1606	1993	1998
Compensation and Pension System	1985	1999
Loan Guaranty Systems Modernization	1986	TBD*
Credit Reform	1995	1998
Loan Guaranty-Loan Service and Claims	1989	1999
Inadequate Controls Over Addictive Drugs	1991	1999
PAID System-Mission Performance	1993	2000
Loan Sale Program Management	1996	TBD*

**To be determined*

conducting a survey of the state of contingency planning in all VA facilities. Completion of the material weakness, however, hinges on testing the contingency plans at VA's Hines and Philadelphia data centers.

- **Mission Performance of the Education Processing System, Chapter 1606, Reserve Educational Assistance Program** – The current ADP system prevents implementation of monthly certification, and causes significant overpayment errors and delays in payment. Funds were recently re-programmed to accelerate development of a redesigned system.

- **Lack of Adaptability and Documentation in the Compensation and Pension System** – The planned VETSNET system solution has been delayed by three months, pushing its scheduled completion into FY 1999.

VA is reporting no new material weaknesses in FY 1997 and it has no specific GAO High Risk Area.

In FY1997, VAalso closed one Internal High Priority (IHP) Area, VHA Resource Allocation, by implementing the Veterans Equitable Resource Allocation (VERA) system. VERA ensures that eligible veterans with similar economic status have equal access to medical care, regardless of where they live in the United States.

VA identified three new IHPs: Accounting of Entitlement Accounts, Portfolio Loan Accounting, and Toll-Free Telephone Service for Education Claims. In addition, the following IHPs were carried into FY 1998: Integration of VBA's Small PC Applications with FMS, Portfolio Loan Accounting, Security of VA Internet Gateways, Space Acquisition Process, Year 2000 Computer Compliance, Workers' Compensation Program, Real Property and Personal Property Accounting and Veterans Claims and Appeals Processing.

Noteworthy progress was made on the Veterans Claims and Appeals Processing IHP. The Board of Veterans Appeals (BVA) made significant improvements in productivity and timeliness. BVA issued 43,347 decisions, a 27.7 percent increase over FY 1996. Average response time was 334 days, a reduction of 43.9 percent from the 595 days recorded at the end of FY 1996. The Board also put greater emphasis on streamlining the appeal process by providing overtime funds, training, conferences, and satellite broadcasts to reduce the backlog of cases awaiting certification for BVA call-up as well as remands. This

Internal High Priority Areas

- **Accounting of Entitlement Accounts**
- **Toll-Free Telephone Service for Education Claims**
- **Integration of VBA's Small PC Applications with FMS**
- **Portfolio Loan Accounting**
- **Security of VA Internet Gateways**
- **Space Acquisition Process**
- **Year 2000 Computer Compliance**
- **Workers'Compensation Program**
- **Real Property Accounting**
- **Personal Property Accounting**
- **Veterans Claims and Appeals Processing**

resulted in a reduction of cases in pre-certified status by some 24,500.

IG Amendments Act of 1988 Management Report on Final Action

The VA was successful in collecting more than $32.8 million in disallowed costs from VA contracted suppliers.

Departmentwide, 65 reports with at least one unimplemented recommendation have been pending final action for over one year. This is a significant reduction from past fiscal years when automated data system changes, collection and/or write-off activities, development and implementation of new regulations or directives, federally mandated training initiatives, recent legislation, and scarce financial resources have contributed to delays.

Civil Monetary Penalties Report to Treasury

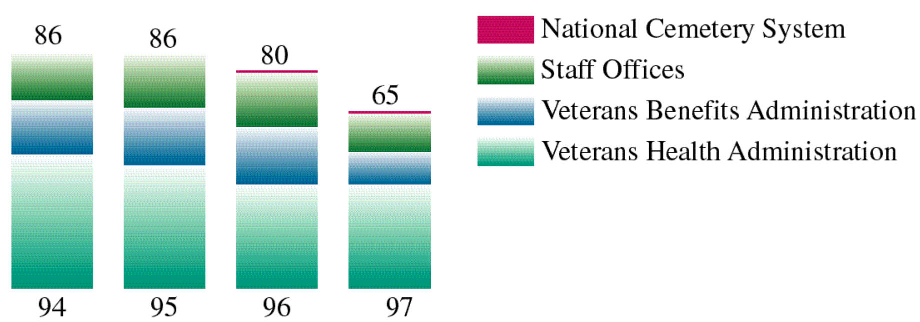
VA pursues the assessment of such penalties under two statutes: 38 U.S.C. 3710, for false housing loan certification, and 31 U.S.C. 3801-3812, the Program Fraud Civil Remedies Act of 1986. The VBA Loan Guaranty Service and the Office of Inspector General have advised us that no penalties were assessed under either statute in FY 1997.

Perpetual Inventory
Management Final Action on IG Audit Recommendations
Disallowed Costs and Funds to be Put to Better Use

Reporting period October 1, 1996 - September 30, 1997

	Disallowed Costs		Funds to be Put to Better Use	
	Reports	Dollar Value	Reports	Dollar Value
Balance as of 10/01/96	30	$ 8.5m	13	$118.0m
New Reports	24	39.5m	23	66.8m
Total	54	48.0m	36	184.8m
Completed	(35)	(35.7m)	(20)	(82.2m)
Balance as of 9/30/97	19	$12.3m	16	$102.6m

OIG Reports Pending Final Action One Year After Management Decisions Have Been Made



ANALYSIS OF FINANCIAL CONDITION

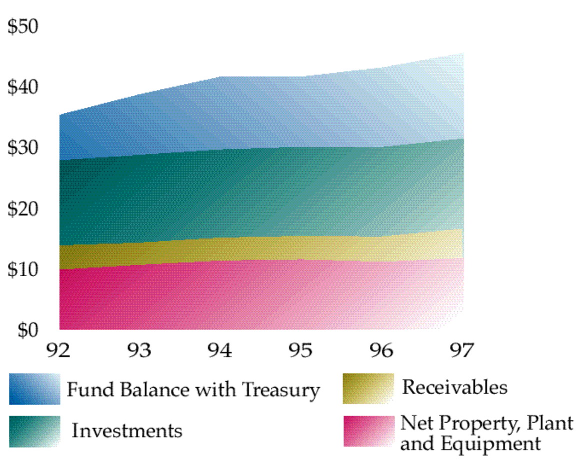
The *assets* on VA's Statement of Financial Position have remained very stable over the past ten years. The chart, VA Assets, trends four of the major components of VA assets.

Fund Balance with Treasury has grown since 1992 when the Credit Reform Act required up-front funding of loan guarantees. *Investments* are principally in non-marketable U.S. Treasury special bonds owned by VA's life insurance programs. Veterans benefit programs, principally home loans and veterans life insurance policy loans, dominate *Receivables*. Also, since the early nineties, Medical Care Cost Recovery Programs have caused a dramatic rise in patient and third-party insurers' medical debts. As of September 30, 1997, receivables are shown net of an Allowance for Doubtful Accounts of $1.3 billion. VA Receivables Delinquent over 180 days at September 30, 1997, were $1.3 billion. VA referred $.2 billion to the Treasury Offset Program during FY 1997. It also wrote off $.7 billion in non-judicial foreclosure debt during FY 1997. *Net Property, Plant, and Equipment* reflects growth due to the capitalization of improvements over the years. An addition during this fiscal year was the capitalization of $163 million to the buildings account for the main hospital and administration buildings at the VA Palo Alto Medical Center damaged in the 1989 earthquake.

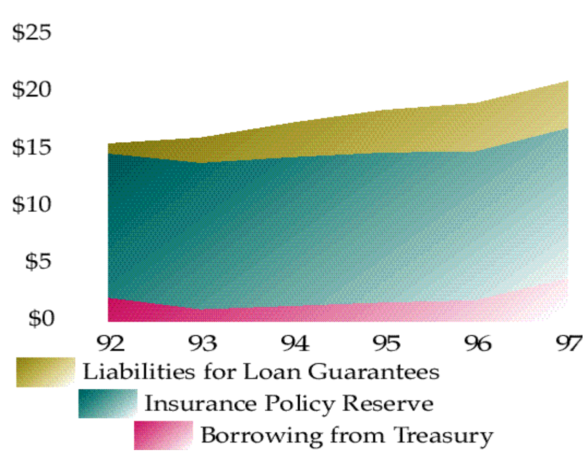
Funded Liabilities have also remained stable over the years. The chart, VA Funded Liabilities, trends three of the major components of VA Funded Liabilities.

Liabilities for Loan Guarantees have grown since the Credit Reform Act required up-front funding for all federal loan programs. The steady increase in *Insurance Policy Reserves* represents the maturing of the life insurance contracts. *Borrowing from Treasury* totally relates to the Housing Credit Assistance Program. The increased Borrowing from Treasury in FY 1997 was only temporary. The Housing Credit Financing Accounts repaid $1.6 billion during October 1997.

VA Assets (dollars in billions)



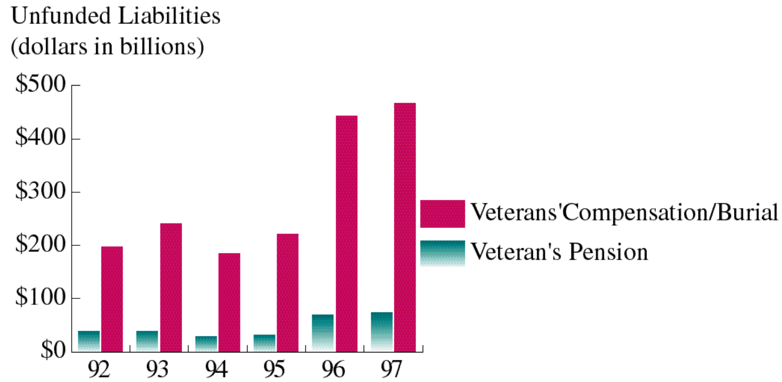
VA Funded Liabilities (dollars in billions)



Unfunded Liabilities have been very volatile in recent years. The chart, Unfunded Liabilities, trends four of the major components of VA Unfunded Liabilities.

Federal Employees Compensation Act Liability represents an actuarial estimate of future years' payments for VA cases currently on the roles. After increasing for many years, this liability has come down lately, due to the diligent efforts of VHA to manage the costs of this program by returning employees to light duty and similar efforts. The unfunded liability *Reserve for Losses on Guaranteed Loans* has declined in recent years due to the Credit Reform requirement to fund guarantees up front.

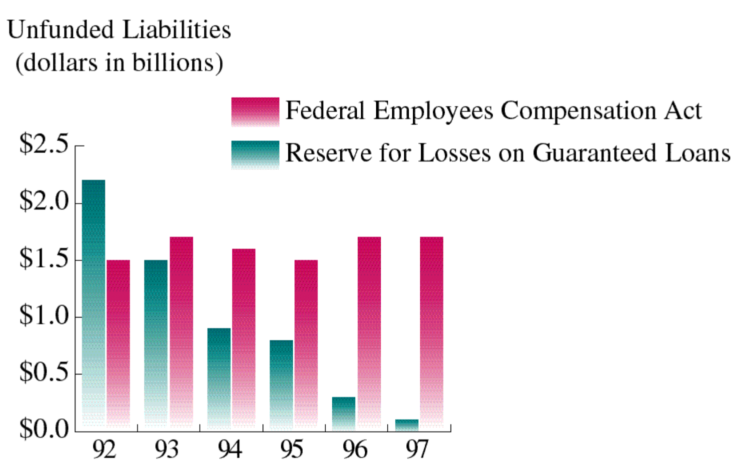
The big fluctuation in VA's Statement of Financial Position over the past five years is attributable to the unfunded liability for *Veterans' Compensation, Burial and Pension Benefits.* This actuarial estimate of future years' payments is very susceptible to changes in the discount rate used to make the present value computation.



Also, during FY 1997, VA changed its method of accounting for pension benefits by disclosing it in a Statement Note, but not recording it as a liability on the Statement of Financial Position. This accounting change was made in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 5, "Accounting for Liabilities of the Federal Government."

The Pension Program is needs-based where the beneficiaries are subject to income limitations. Many pension payments are made to survivors of deceased veterans. The Pension Program payments are non-exchange transactions since the payments are not based solely on prior military service. The accounting for this liability is similar to accounting for social insurance programs (e.g. Food Stamps) where the recognized liability equals any unpaid amounts due as of the reporting date.

The liability for Compensation and Burial Benefits is



recognized (shown as a liability) on the Statement of Financial Position since it is viewed as an exchange transaction where the liability is recognized because the veteran has earned it through military service.

In accordance with SFFAS No. 5, the actuarial model used to compute future veterans' Compensation, Burial, and Pension benefits was modified retroactive to FY 1996. The signficiant increase is attributable to the fact that the old methodology only reflected the liability associated with those currently receiving benefits and ignored future retroactive benefits and changes in benefit levels for reasons other than cost of living adjustments.

VA does not fund post-retirement benefits such as the Federal Employees Health Benefit (FEHB) Program and the Federal Employees Group Life Insurance (FEGLI) Program. VA also is not required to fully fund the CSRS pension liability. However, SFFAS No. 4, "Managerial Cost Accounting Concepts and Standards," requires recognition of Full Costs in agency financial statements. Therefore, VA has recognized an expense and imputed a financing source for the future cost of these benefits and pensions while its employees are still working. This expense was $771 million for FY 1997 and $769 million for FY 1996 and is included in the Statement of Operations and Changes in Net Position (Deficit).

Certain legal matters to which VA may be a named party are administered and, in some instances, litigated and paid by other Federal agencies. These primarily relate to allegations of medical malpractice, but also include other tort claims and contract disputes. Generally, amounts more than $2,500 to be paid under any decision, settlement, or award pertaining to litigation are funded from a special appropriation called the Judgment Fund, which is maintained by the Department of the Treasury.

Contract dispute payments require reimbursement to the Judgment Fund by VA. In accordance with OMB Interpretation Number 2 of SFFAS Nos. 4 & 5, VA has included a liability, imputed financing, and recognized an expense for pending legal claims that will probably be paid by the Judgment Fund. This liability is established for all pending claims whether reimbursement is required or not. This liability was $23 million for FY 1997 and $14 million for FY 1996.

Beginning in FY 1992, a separate fund was activated at the Treasury Department, *Medical Care Cost Recovery (MCCR),* to track the cost recovery of medical care furnished to insured veterans who have no service-connected disabilities. The fund provided a method for recording collection of funds owed to VA while also showing the costs for recovery of those funds. Under the Medical Care Cost Recovery program, VA was authorized to retain enough of the recovered monies to fund expenses incurred in the collection activities nationwide.

Collections in excess of program costs were transferred to the Treasury's general fund in the early part of each succeeding fiscal year. The MCCR collections transferred to Treasury amounted to $365,334,669 and $421,162,309 for FY 1997 (through June 30, 1997) and FY 1996, respectively.

In FY 1998 the MCCR program is being replaced by the Medical Care Collection Fund (MCCF). MCCF collections will be transferred to the VA

Medical Care appropriation and remain available until expended. These funds are authorized for any purpose that the Medical Care appropriation can be used. The authority to transfer these collections was effective as of July 1, 1997. Collections for the final quarter of FY 1997 of $139,520,655 were transferred through MCCF to the Medical Care appropriation in November 1997.

If the Secretary determines that the total amount to be recovered in FY1998 will be less than the amount contained in the Congressional Budget Office baseline estimate ($604 million), the Treasury will deposit the amount of the shortfall in excess of $25 million into MCCF.

The preparation of financial statements in conformity with generally accepted accounting principles for federal entities requires management to make estimates and assumptions that affect the amounts reported in the financial statements and footnotes thereto. This is particularly applicable to the amounts reported for unfunded liabilities. Actual results could differ from management's estimates.

VA's General Counsel has determined that under current law, service connection of a disability or death may be established if injury or disease resulted from tobacco use in the active military service. VA already has received and begun to adjudicate tobacco related disability and death claims. OMB requested that VBA's FY 1999 budget submission include an estimated cost of providing compensation for disabilities attributable to tobacco usage.

The FY 1999 budget proposes legislation to disallow benefits for those disabilities acquired after military service and based on nicotine dependence beginning in the military. This proposal would prohibit service connection of disabilities acquired after service and based solely on it being attributable, in whole or in part, to use of tobacco products during service. It would not preclude establishing service connection based on a finding that a disease or injury became manifest or was aggravated during active service, or became manifest to the requisite degree of disability during any applicable statutory presumptive period. The savings from this proposal in FY 1999 are estimated to be $741 million, with a projection of approximately $17 billion in savings over 5 years.

Results of FY 1997 Financial Statement Audit

The Department received a qualified opinion from the Office of Inspector General (IG). The IG was unable to verify the recorded balances for receivables, liabilities for loan guarantees, and credit reform resources payable to Teasury as of September 30, 1997, due to the inadequacy of VA's accounting records. These resulted from accounting procedural errors and / or ineffective internal controls. Their effect on the reported balances could not be reasonably determined.

In the report on the Department's Internal Conrol Structure, five matters were reported as material weaknesses: (1) VA-wide information systems security controls, (2) Housing Credit Assistance (HCA) Program financial reporting (3) HCA Program direct loan portfolio, (4) Guaranteed sales of vendee loans, and (5) Accuracy of medical receivable balances.

VA Financial Managers concurred with the audit findings and recommendations. Detailed action plans are being implemented to address the qualifications and noncompliance.