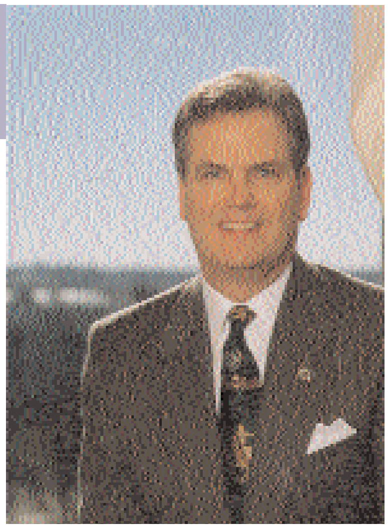


Edward A. Powell, Jr.
Chief Financial Officer

Management Discussion and Analysis

Introduction

This Annual Accountability Report documents the Department of Veterans Affairs' accomplishments in providing high-quality, timely benefits and services to the men and women who have served our country in the armed forces. This report identifies the achievements VA recorded during FY 1998 that contribute to the attainment of the goals and objectives in the VA Strategic Plan and Annual Performance Plan. In so doing, we are providing detailed information to Congress, OMB, veterans service organizations, and the general public that spells out not only what we do but, more importantly, *how well we are doing* in meeting our commitment to the Nation's veterans and their families.

Mission

"To administer the laws providing benefits and other services to veterans and their dependents and the beneficiaries of veterans" (38 U.S.C. §301(b), 1997).

In recognition of their service to the Nation, VA serves America's veterans and their families with profound respect and compassion; is their principal advocate in promoting the health, welfare, and dignity of all veterans; and ensures they receive medical care, benefits, social support, and lasting memorials.

Vision

As the Department of Veterans Affairs heads into the 21st century, we will continue striving to meet the needs of the Nation's veterans.

We are a customer-focused organization, functioning as "One VA" and delivering seamless service to veterans and their families. We benchmark the quality and delivery of our service with the best in business, using innovative means and high technology to deliver world-class customer service. We foster partnerships with our customers and stakeholders, making them part of the decisionmaking process. We cultivate a dedicated workforce of highly skilled employees who understand, believe in, and take pride in our vitally important mission.

Background

VA directly touches the lives of millions of veterans every day through its healthcare, benefits, and burial programs. The Department accomplishes its mission through partnerships among the Veterans Health Administration (VHA), the Veterans Benefits Administration (VBA), the National Cemetery Administration (NCA), the Board of Veterans' Appeals (BVA), and the Departmental staff organizations by integrating the related activities and functions of the following programs:

Medical Care

VA meets the healthcare needs of America's veterans by providing primary care, specialized care, and related medical and social support services.

Medical Education

VA's healthcare education and training programs help to assure an adequate supply of clinical care providers for veterans and the Nation.

Medical Research

The medical research program contributes to the Nation's knowledge about disease and disability.

Compensation

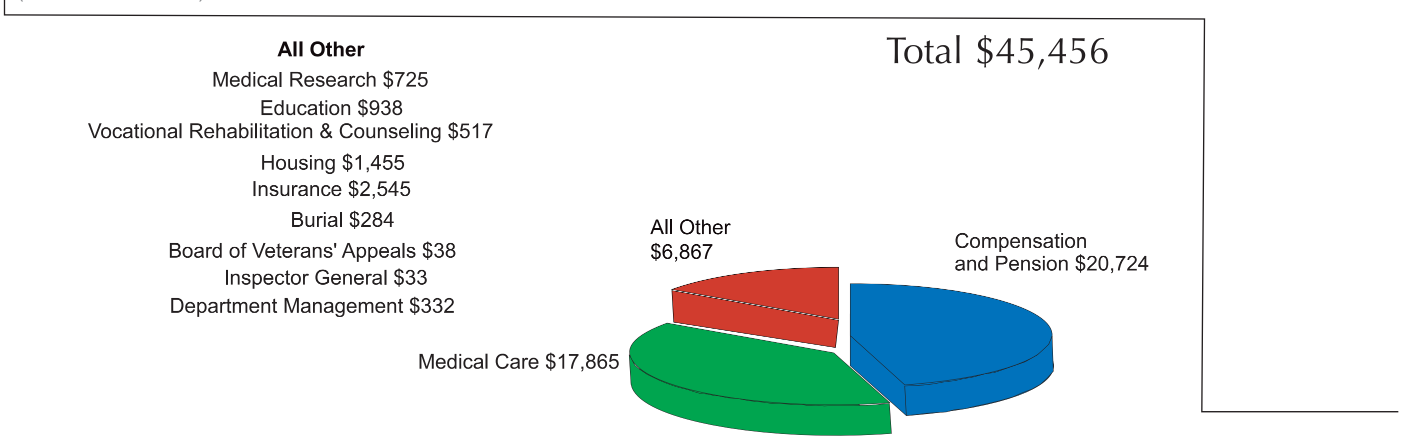
The compensation program provides monthly payments and ancillary benefits to veterans, in accordance with rates specified by law, in recognition of the average potential loss of earning capacity caused by a disability, disease, or injuries incurred in, or aggravated during, active military service. This program also provides monthly payments, as specified by law, to surviving spouses, dependent children, and dependent parents, in recognition of the economic loss caused by the veteran's death during active military service or, subsequent to discharge from military service, as a result of a service-connected disability.

Pension

The pension program provides monthly payments, as specified by law, to needy wartime veterans or survivors who are permanently and totally disabled or who die as a result of a disability not related to military service. This program also provides monthly payments, as specified by law, to needy surviving spouses and dependent children of deceased wartime veterans.

VA making good on America's promise to our veterans.

Obligations for VA Programs, FY 1998
(dollars in millions)



Number of Veterans and Family Members Participating in VA Programs, FY 1998

Medical Care	
Unique Patients	3,431,400
Compensation	
Veterans	2,269,700
Survivors/children	304,500
Pension	
Veterans	396,600
Survivors	299,500
Education	
Veterans and Servicepersons	294,800
Reservists	74,000
Survivors/dependents	42,300
Vocational Rehabilitation	
Veterans receiving services	53,400
Housing	
Loans Guaranteed	344,000
Insurance	
Administered policies in force	2,408,700
Supervised policies in force	2,383,000
Burial	
Interments	76,700
Graves maintained	2,261,100
Headstones and markers ordered	346,000

Education

The education program assists veterans and eligible dependents to achieve their educational or vocational goals as a means of honoring and rewarding them for their sacrifices in service to our Nation.

Vocational Rehabilitation and Counseling

The vocational rehabilitation and counseling program assists veterans with service-connected disabilities to achieve functional independence in daily activities. It provides all services and assistance necessary to enable service-disabled veterans to become employable and to obtain and maintain suitable employment. The performance objective of the vocational rehabilitation program is to place service-disabled veterans in suitable employment or to gain independence in daily living.

Housing

The housing program helps veterans and active duty personnel purchase and retain homes.

Insurance

This program provides life insurance benefits, which are not available from the commercial life insurance industry, due to lost or impaired insurability resulting from military service, to veterans and servicemembers.

Burial

Largely through the National Cemetery Administration (NCA), VA honors veterans with a final resting place and lasting memorials to commemorate their service to our Nation.

Priorities Set by the Secretary of Veterans Affairs

- Improve the accuracy and timeliness of compensation and pension claims processing;
- Continue to maintain and improve a high level of veterans' healthcare quality;
- Maintain our national cemeteries as national shrines;
- Deliver goods and services to the Nation's veterans as "One VA."

Timeliness of compensation and pension claims processing continues to be a major problem. The Department fell short of achieving our claims processing timeliness goals during FY 1998.

A recent performance audit completed by the Office of the Inspector General (IG) revealed that actual timeliness was well above reported timeliness (refer to "Data Verification and Validation" on page 54). The Under Secretary for Benefits has responded by taking aggressive steps to make sure performance data covering VA's benefits programs are reported accurately by all regional offices. The Under Secretary issued specific guidance pertaining to data validation and verification; reviews were initiated and communicated to field offices. Unacceptable practices were identified. The involvement of top leadership led to immediate change. The reported timeliness data on processing original compensation claims jumped from 139 days in December 1997 to 175 days in January 1998. While these data show claims processing timeliness is actually worse than previously reported, the Department has vastly improved its data quality.

During FY 1998, VA made substantial progress in transitioning to a patient-centered, community-based healthcare system–a system designed to find more and better ways to enhance quality, increase access, reduce costs, and otherwise improve performance.

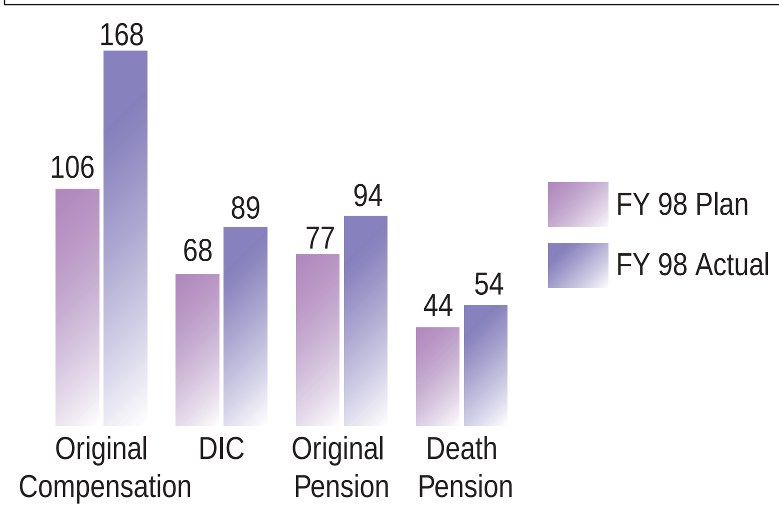
VA's efforts are geared specifically toward the business of healthcare, not hospital care. As such, veterans and stakeholders are recognizing VA's ability to deliver quality care, provided locally, and performed on an outpatient basis. In order to achieve good value in its healthcare delivery, VA has developed goals and objectives encompassing five domains of value: technical quality, customer satisfaction, improved patient functional status, access, and cost.

Maintaining good value requires: continuous monitoring and restructuring of the delivery system; success in such efforts as implementing and using a new enrollment system to manage healthcare delivery; and Congressional support for necessary legislative initiatives.

Just as important will be the continued achievement of cost reductions through reengineering of the system by shifting healthcare resources from inpatient to outpatient care.

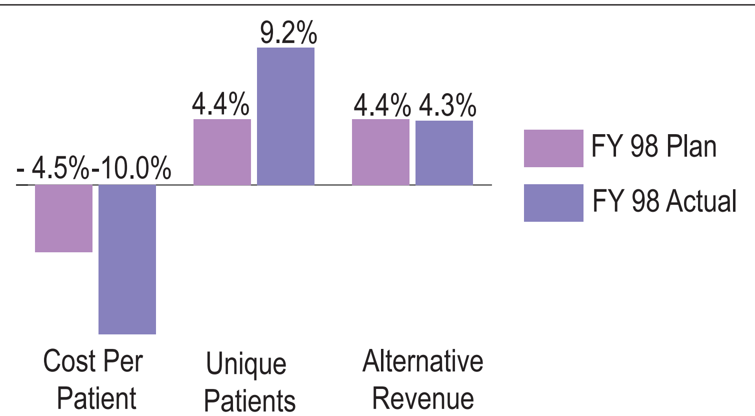
The strategic direction for VA's healthcare system is set by achievement of major objectives known as "10 for 2002." Of these, three are referred to as "30-20-10." Between FY 1997 and FY 2002, VA intends to reduce per patient costs by 30%, increase unique patients treated by 20%, and increase the share

Average Days to Process Compensation and Pension Claims



While actual timeliness was well above reported timeliness, the Department vastly improved its data quality.

VA's Progress Toward Achievement of 30-20-10 Goals



By 2002, VA plans to reduce per patient cost by *30%*, increase unique patients by *20%*, and increase the share of the medical care operating budget coming from alternative revenue streams to *10%*.

of the medical care operating budget coming from alternative revenue streams to 10%.

The delivery of goods and services as "One VA" means that the Department will function as a unified organization, delivering seamless service to veterans, with a focus on providing world-class customer service. VA uses surveys and other forms of feedback to assess the degree to which we measure up to our customers' expectations.

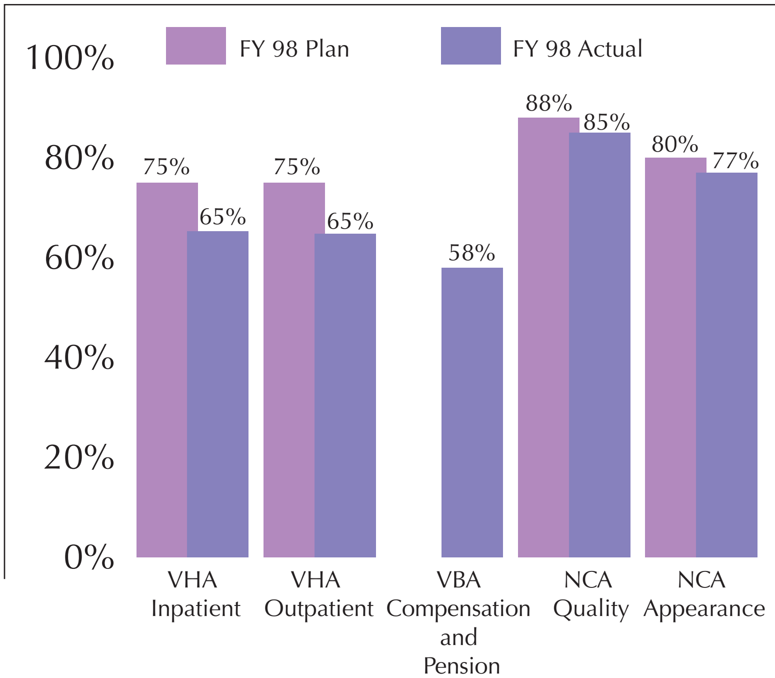
Performance Summary Scorecard

During FY 1998, VA's leaders identified goals and associated performance measures considered critical to the success of the Department. These goals and measures provide the focal point of the performance section of this Accountability Report. Some deal with program outcomes; others pertain to the management of our programs. We will discuss these with our primary stakeholders in Congress, OMB, and veterans service organizations, obtain their views on which are most important, and strive to reach consensus. Some of these are newly developed outcome goals for which we do not yet have performance data. We will use program evaluations as one vehicle through which to fill the existing data gap.

The scorecard presents FY 1998 actual versus planned performance for key measures, some of which were developed during FY 1998. As a result, no performance goals are available for these measures (shown as N/A). The Department achieved three of the performance goals established at the beginning of the fiscal year. Of the remaining 16, there were several instances in which program performance during FY 1998 recorded significant improvement over our performance during FY 1997, even though the performance target may not have been reached.

One of the driving forces behind VA's improvements is the executive level focus on, commitment to, and accountability for achieving specified levels of

One VA Customer Satisfaction
(in percentages)



Note: There was no FY 1998 plan for VBA Compensation and Pension.

FY 1998 Performance Scorecard Summary

Note: FY 1998 data are not currently available for the following key measures: compensation program outcomes, pension program outcomes, and insurance program outcomes.

N/A = Not Available

↑ = Improvement over FY 1997 performance

General Goal	Performance Measure	Was the Goal Achieved?		Performance	
		Yes	No	Plan	Actual
Improve the overall heathcare of veterans	Number of unique patients	✔		3,279,000	3,431,400
	Chronic disease care index		✔↑	90%	85%
	Prevention index		✔↑	85%	79%
VA medical research programs meet the needs of the veteran population and contribute to the Nation's knowledge about disease and disability	Percent of research projects relevant to VA's healthcare mission	✔		99%	99%
Eligible veterans will be assisted in their readjustment to civilian life as a result of educational services provided by VA	Montgomery GI Bill usage rate			N/A	54%
Enable service-connected disabled veterans to become employable and to obtain and maintain suitable employement	Vocational rehabilitation and counseling rehabilitation rate			N/A	42%
Assure the burial needs of veterans are met	Percent of veterans served by a burial option		✔↑	69.2%	68.6%
A veteran, beneficiary, or representative will be able to access VA in the fastest possible time, by the easiest possible means, and receive one-stop service	Community-based outpatient clinics		✔↑	430	362
	Abandoned call rate			N/A	13%
	Blocked call rate			N/A	52%
Service will meet or exceed veteran expectations	Percent of patients who rate VA healthcare service as very good or excellent:				
	Inpatient		✔↑	75%	65%
	Outpatient		✔↑	75%	65%
	Percent of C&P claimants who are satisfied with the handling of their claims			N/A	58%
	Customers who rate quality of NCA service as excellent		✔	88%	85%
	Customers who rate appearance of national cemeteries as excellent		✔	80%	77%
Do it right the first time	National accuracy rate for core rating work			N/A	64%
Timeliness of service delivery will meet or exceed customer expectations and will be analyzed against the best in business	Average days to complete:				
	Original compensation claims		✔	106	168
	Original pension claims		✔	77	94
	Dependency indemnity compensation claims		✔	68	89
	Death pension claims		✔	44	54
	Core rating actions			N/A	128
	Original education claims		✔	19	25
	Supplemental education claims		✔	11	16
	Appeals resolution time			N/A	686
Reduce costs and improve the revenue stream for the healthcare system	Average cost (obligations) per patient	✔		$5,230	$4,897
	Percent of medical care budget from alternative revenue streams		✔↑	4.4%	4.3%
Reduce benefit delivery costs and improve productivity	Foreclosure avoidance through servicing ratio		✔	40	36.7

Management Discussion and Analysis

Financial Reporting

Prompt Payment Act

In FY 1998, over 94% of VA invoices were paid on time. VA processed more than 4 million invoices representing over $7 billion, subject to the Prompt Payment Act. The 94% on-time rate represents a 3% increase over the 91% on-time rate in the previous year. Electronic commerce increased our electronic vendor payments to over $3.3 billion for FY 1998, compared to $2.9 billion for FY 1997. Interest penalty dollars paid have decreased by $84,782, or 4%, from FY 1997.

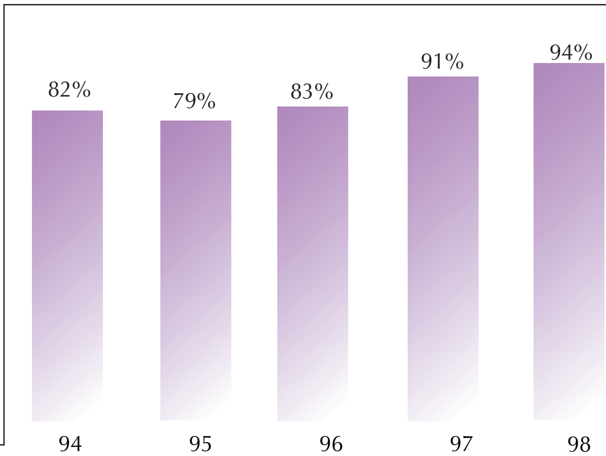
The Department aggressively used the governmentwide commercial purchase card program. Our purchase card disbursement for FY 1998 was nearly $1.1 billion, covering 1.9 million transactions and earning the Department rebates from Rocky Mountain National Bank of North Carolina, totaling over $7.4 million.

To improve payment performance, we emphasized the following efforts:

- VA was the first Federal agency to award its Purchase Card task order under the new General Services Administration SmartPay contract to Citibank. This brings us closer to a single integrated payment solution for purchase, travel, and fleet card services. VA's size and technology created an opportunity to obtain the most favorable rebates and fees for purchase card services, and to use all the purchase technologies offered by Citibank. Extensive pilot testing at four VA medical centers ensured the credit card processing interface to VA's core financial system was fully operational prior to implementation of the new card program. VA plans to implement innovative ways to further automate purchasing activities, while capturing financial and performance information and reducing administrative costs.

- VA's Travel Management Centers (TMC), which serve veterans and employees who travel frequently, began operations in January 1998. The billings are transmitted electronically from each TMC, and payment is sent through the Department of the Treasury's Electronic Certification System daily. The Travel Management program processed more

Prompt Payment on-time percentage rate.



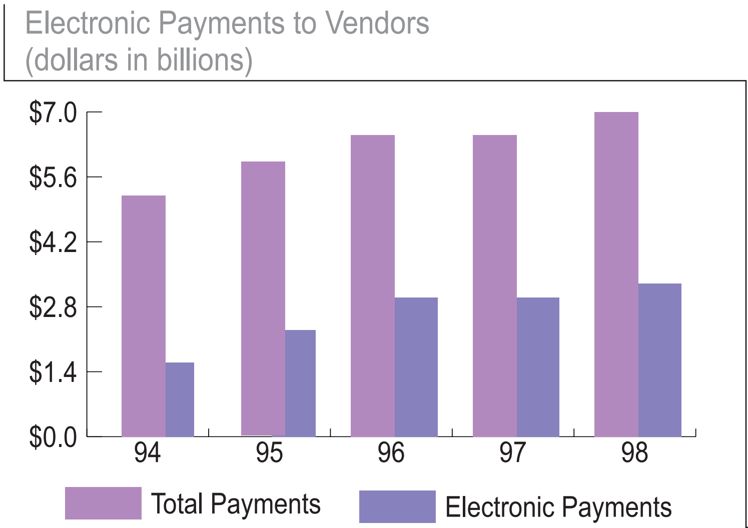
Over 94% of VA's 4 million invoices were paid on time.

than 46,000 transactions and disbursed about $11 million, which earned VA $367,219 in rebates.

- VA implemented a Prime Vendor Payment System, which automates payments under a nationwide prime vendor centralized purchasing contract. For FY 1998, VA converted 122 VA medical centers to our Prime Vendor System, with 188,000 transactions processed electronically, totaling more than $825 million.

- VA's Financial Services Center (FSC) staff developed an application to provide vendor payment history on the Internet. The application stores 90 days of information on invoices. Currently, 366 vendors are using the Vendor Inquiry System internet download procedures to assist them with payment identification.

- As of September 30, 1998, 61 VA field stations converted to the fast pay procedures for certified invoices under $1,000. The VA FSC has continued its statistical sampling FastPay program for payment of invoices under $2,500 and has encouraged field stations to forward all invoices to our Austin payment center.



FY 1998 electronic vendor payments increased to over $3.3 billion compared to $2.9 billion in FY 1997.

Debt Management

VA has long been regarded as a leader in the federal debt management community. Our Debt Management Center (DMC) is largely responsible for VA's attainment of this leadership position. Focusing on the prevention as well as the collection of debt, the DMC oversees a centralized, automated collection system that employs every collection tool available to federal agencies.

The DMC has established a record as an efficient and cost-effective operation. In FY 1998, the cost of operating the DMC totaled $5.4 million (including IT support from the Austin Automation Center and support provided by the St. Paul Regional Office), while DMC cash collections (excluding offsets) totaled more than $74 million. This resulted in a ratio of $13.70 in cash collections for every dollar spent. Total DMC collections (including offsets) exceeded $267 million, resulting in a ratio of $49 dollars collected for every dollar spent.

In order to maintain VA's leadership position in the federal debt collection community, over the past year we have continued to explore the possibility of consolidating all significant VA debt programs into one centralized, automated collection system. Historically, the management of VA's major debt programs has been divided into two categories: first-party medical care cost recovery and the collection of VA benefit debts. Most benefit debts have been maintained in an automated system and managed by the DMC since the 1970s. VHA medical care debts, conversely, have been managed in a decentralized and less automated system, with each medical center responsible for account management activity.

During the previous fiscal year, we succeeded in automating the billing process for first-party medical debt at our Austin

Automation Center as a first step toward centralizing and automating the medical debt management process. This centralized billing function is now generating substantial savings in postage costs. Although we have encountered some delays in automating collection processing for these receivables at a lockbox administered by a private contractor, the automation of these functions will free VHA resources from time-consuming clerical tasks.

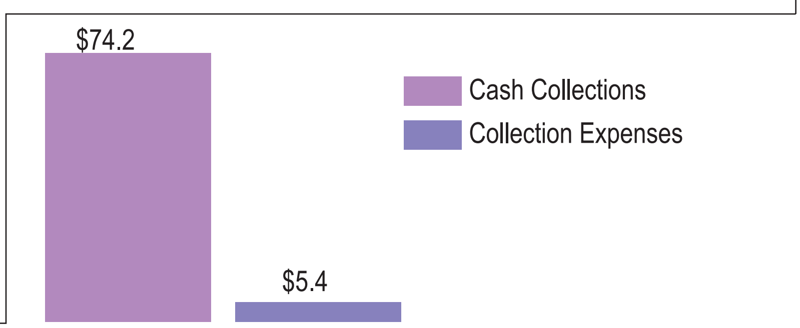
This year, we completed the referral to the DMC of medical care debts that are more than 90 days delinquent. While these debts are not yet subject to the full array of DMC collection management tools, the DMC will be able to collect these debts by offsetting payments to VA beneficiaries. This referral, which helps to implement a recommendation by the National Partnership for Reinventing Government, is consistent with the Department's strategy of achieving maximum debt consolidation. We will continue to work toward the referral of all first-party debt to the DMC and seek renewed support for this goal from VA upper management.

Such centralization would not only increase the collection rate, but would also significantly lower the cost of collection, because the centralized operation at the DMC is more efficient than having each medical center manage the collection of its bills. We have completed the development of the data and process models for a system to allow the DMC to manage all first-party medical care receivables (including non-delinquent receivables) and to subject these debts to all collection tools at our disposal. We have also completed a business case analysis that indicates unqualified support for building this system.

After reviewing all of its regulations governing the management of benefit and medical care debt, VA has drafted new regulations to reduce the volume in this area of 38 C.F.R. by more than 50%. These revised regulations have yet to be published, pending the release of the revised Federal Claims Collection Standards by the Treasury Department. We expect Treasury to publish the standards in FY 1999; VA's regulations will be published shortly thereafter.

We have been working with Treasury 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. In FY 1998, we referred more than $260 million worth of the eligible amount for the Treasury offset program. This amount represents approximately 95% of the agency debt eligible for referral. During the coming fiscal year, all eligible debt housed at the DMC and all eligible first-party medical debt will again be referred to Treasury. Referral of the remaining 5% will depend on implementing the centralization of all debt outlined above.

Debt Management Center
Collection Activity and Operating Expenses
(dollars in millions)



$13.70 in cash collections for every dollar spent.

Civil Monetary Penalties Report To Treasury

In accordance with Public Law 101-410, the Department of the Treasury's Financial Management Service requests that agencies complete an annual report on the status of civil monetary penalty assessments and receivables for each fiscal year. 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. No penalties were assessed under either statute in FY 1998.

VBA Loan Guaranty Service and the Office of Inspector General provided input for this report. The Federal Reports Elimination Act of 1998 (Public Law 105-362, November 10, 1998) terminated the requirement for future Civil Monetary Penalties Reports.

Inspector General Amendments Act of 1988 - Management Report on Final Action

The VA was successful in collecting more that $28.3 million in disallowed costs from VA contracted suppliers.

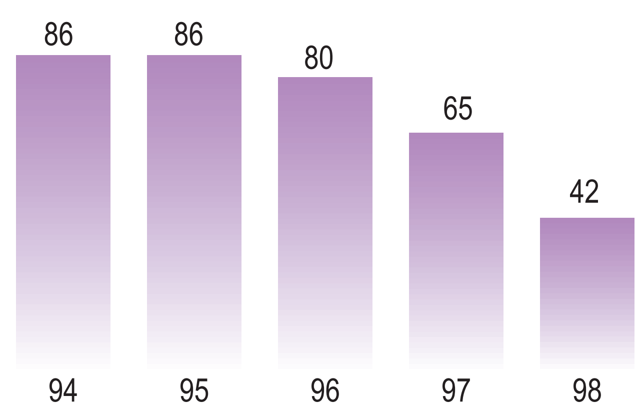
Departmentwide, 42 unique reports with at least 1 unimplemented recommendation have been pending final action for over 1 year. This is a significant reduction from past fiscal years when delays were caused by system changes, collection and/or write-off activities, development and implementation of new regulations or directives, federally mandated training initiatives, recent legislation, GPRA validation concerns, implementation of cost accounting system development work and scarce financial resources.

Perpetual Inventory
Management Final Action on IG Audit Recommendations
Disallowed Costs and Funds to Be Put to Better Use
Reporting Period October 1, 1997 - September 30, 1998
(dollars in millions)

	Reports	Disallowed Costs	Reports	Funds to be Put to Better Use
Balance as 10/01/97	19	$12.3	8	$102.6
New Reports	22	21.0	18	456.8
Total	41	$33.3	26	$559.4
Completed	33	28.3	13	79.9
Balance as 09/30/98	8	$ 5.0	13	$479.5

VA collected more than $28 million audit-related receivables in FY 1998.

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



Management efforts in FY 1998 resulted in a significant reduction in pending reports.

Management Discussion and Analysis

Systems and Controls

Secretary of Veterans Affairs

Statement of Written Assurance

A review and evaluation of senior administrative and program managers' annual assessments provides significant assurance that VA's management controls and financial systems adhere to the requirements of the Federal Managers' Financial Integrity Act. Full compliance of VA's financial systems will depend on the completion of the Veterans Benefits Administration's systems modernization efforts.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)

During FY 1998, VA closed one material weakness - Aging, Antiquated, and Obsolete Hardware and Software Systems. VBA completely replaced its obsolete hardware and software systems, which were first identified for replacement in 1983. The old system lacked adequate controls to prevent substantial losses (e.g., overpayments) and made it impossible to take advantage of new technology. The current systems will support benefits delivery well into the next century. This is designated as a mission-critical management problem.

Progress continues on the remaining material weaknesses, but six targeted correction dates slipped during the last fiscal year:

- Lack of Adequate Contingency Plans - VA is in the process of developing IT contingency plans in the event of a catastrophic occurrence at one or more of our Data Processing Centers. The lack of adequate contingency planning, a mission-critical management problem, has been a continuing concern. VA offices and facilities need to develop and thoroughly test comprehensive written contingency plans to back up and store critical files. The Office of Information and Technology is tracking contingency planning within the Department. Site visits, conducted by Chief Information Officer representatives, continue to be made to validate reported progress. Site-by-site information will be used to compare and verify compliance. The targeted completion date has slipped to FY 2000.

- Compensation and Pension (C&P) System: Lack of Adaptability and Documentation - The C&P system is outdated and needs to be replaced. The plan for correcting this weakness is to implement the Veterans Service Network (VETSNET) C&P application. VETSNET will be deployed in scheduled increments, in response to customer feedback, reengineering initiatives, management recommendations, and enhancements identified during development. The targeted correction date has slipped to FY 2001.

- Loan Guaranty Financial Modernization (formerly the Loan Guaranty System: effective interfaces) - The loan guaranty system lacks up-to-date interfaces between manual and automated components. There are three major needs for a modernized loan guaranty system: (1) credit reform requirements, including cohort year accounting; (2) interface of loan guaranty systems to FMS; (3) loan guaranty program modernization projects, including a new payment system to identify duplicate payments automatically. Automatic interfacing of payments cannot be accomplished before VA implements the modernized loan guaranty systems. The targeted completion date is to be determined.

- Loan Guaranty - Loan Service and Claims - The VBA loan service and claims component of the loan guaranty program lacks the capability to manage supplemental servicing of GI loans. .Additional time and funds are needed to complete the loan service and claims system project, because of changes in the VBA corporate system architecture and system development tools. This completion date has slipped to FY 2000.

- Inadequate Controls Over Addictive Drugs - A 1991 GAO report concluded that VA's controls over a large number of prescription drugs were inadequate. Too many employees had access to pharmacy drug stocks, and the stocks were inspected infrequently. VHA issued a directive, "Increased Accountability for Drugs," which required medical centers to maintain a perpetual inventory of all bulk supplies of controlled substances. New procedures for screening prospective employees were also established.

In 1992, VA and the Drug Enforcement Agency conducted a seminar for all

VA identified one new material weakness in FY 1998

FMFIA Material Weaknesses and Mission-Critical Management Issues

Issues	Reported	FY 1998 Planned Correction	Target Correction
Aging, Antiquated, and Obsolete Hardware and Software Systems	1983	1998	N/A
Lack of Adequate Contingency Plans	1984	1998	2000
Compensation and Pension System	1985	1999	2001
Loan Guaranty			
Financial Modernization	1986	TBD	TBD
Loan Service and Claims	1989	1999	2000
Inadequate Controls over Addictive Drugs	1991	1999	2000
PAID System-Mission Performance	1993	2000	2001
Education System-Chapter 1606	1993	1998	2001
Credit Reform	1995	1999	1999
Loan Sale Program Management	1996	TBD	1999
Information Systems Security	1998	N/A	TBD

TBD =To Be Determined

Chiefs of Pharmacy on drug accountability and security. VA issued documents in 1993 relating to drug accountability, physical access, and electronic access to security systems for controlled substances. We expanded the prime vendor delivery systems for pharmaceuticals to reduce inventories and provide direct delivery of controlled substances to VA pharmacies. VA also recovered controlled substances for all Acquisition and Materiel Management warehouses and depots, and procured bar code equipment to inventory controlled substances.

In FY 1998, VA decided to move forward with plans to bar code blood transfusions and medical administration. After determining information system needs in early 1999, equipment acquisition is expected to begin in August. The information system needs will be determined in early 1999, and equipment acquisition is expected to begin in August 1999. The correction date has slipped to FY 2000.

- PAID - VA's central payroll and personnel system, PAID, lacks the ability to expand, a critical VA mission need. HR LINK$, the Department's initiative to replace PAID with a modern human resources and payroll system, became the basis for correcting the weakness in lieu of investing in expensive modifications to existing systems. HR LINK$ labor distribution module will be tested in VA's pilot of the new payroll system. The targeted completion date is still FY 2001.

- Education System: Chapter 1606 Mission Performance – The system to support the Montgomery GI Bill (MGIB) selected reserve payments is outdated. Payment delays are frequent occurrences because the system relies heavily on human input. This weakness will be resolved by installing an enhanced MGIB - Selected Reserve system, patterned after the MGIB-Active System. The targeted correction date has slipped to FY 2001, the system redesign scheduled completion date.

- Credit Reform - We need to improve the integration of VBA's systems and procedures to support credit reform initiatives affecting loan programs. The forced reliance on the manual accumulation of data to prepare major financial reports has resulted in untimely reports to Treasury and OMB. In FY 1998, much progress was made toward correcting this material weakness. VBA's staff used the cohort year general ledgers to prepare the end-of-FY 1998 budget executive reports (SF 133s). We will be requesting closure of this material weakness in FY 1999.

- Loan Sale Program Management - Under the Loan Sale or Vinnie Mac program, VA sells its current portfolio loans to investors, with a guarantee of prompt monthly payments and reimbursements for losses on foreclosed loans, including foreclosed loan costs. Currently, mechanisms to account for loans sold (after they leave VA) are not in place. VA needs to develop systems to account for losses on loans, to track cash reserves, and to establish individual reserves, in accordance with credit reform requirements. The Department's budget staff is working with Treasury to coordinate the establishment of these new funds. A contract was let to perform credit reform accounting and budgeting for the loan sales and loans sold program. The targeted completion date is FY 1999.

- Information Systems Security - One new material weakness was identified for FY 1998. The Department's assets and financial data are vulnerable to error or fraud because of weaknesses in information security management, access to controls and monitoring, and physical access controls. A milestone chart with a targeted correction plan will be prepared in FY 1999.

Management Discussion and Analysis

Financial Position Overview

Analysis of Financial Statements

VA's Financial Statements have a new look this year resulting from full implementation of OMB Bulletin No. 97-01 (Form and Content of Agency Financial Statements). The chart below illustrates the end result of the new Statement of Net Costs.

The current emphasis on performance measurement is supported with net cost data for the 10 programs contained in VA's Strategic Plan:

- Medical Care
- Medical Education
- Medical Research
- Compensation
- Pension
- Education
- Vocational Rehabilitation and Counseling
- Housing
- Insurance
- Burial

Some programs, such as burial, receive support from all three Administrations. While NCA operates the national cemeteries, VHA provides administrative support for personnel, procurement, and finance functions, and VBA funds headstones, gravemarkers, graveliners, and burial benefits to the next of kin of service-connected veterans.

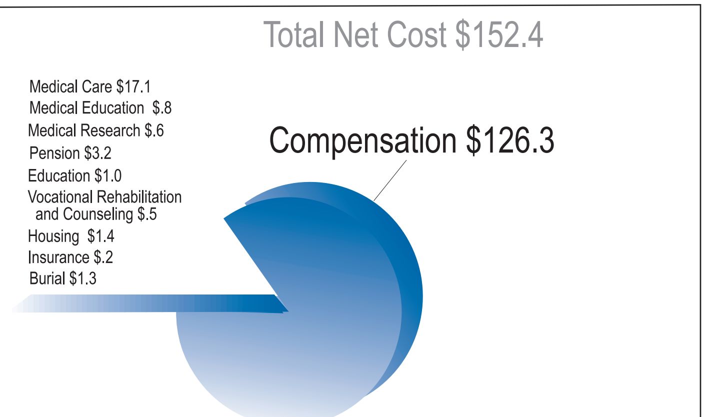
Examining the assets on VA's balance sheet reveals very little change over the years. The chart "VA's Assets" trends four of the major components of VA assets.

Fund Balance with Treasury is principally composed of unliquidated appropriations, a third of which result from up-front funding of loan guarantees as required by the Credit Reform Act. Investments are principally in non-marketable U.S. Treasury special bonds owned by VA's life insurance programs. VA's housing credit program includes an investment of $239 million in American Housing Trust I-V certificates. These subordinated certificates are pledged as collateral to support loans sold with recourse under American Housing Trust VI through XI and the "Vinnie Mac" programs. Veterans benefit programs, principally home loans and veterans' life insurance policy loans, dominate receivables. Also, since the early 1990s, medical care cost recovery programs have caused a dramatic rise in patient and third-party insurers' medical debts. Receivables are shown net of an Allowance for Doubtful Accounts of $1.2 billion at September 30, 1998. VA referred $260 million to the Treasury Offset Program during FY 1998. Net Property, Plant, and Equipment reflect growth due to the capitalization of improvements over the years.

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

FY 1998 Net Cost by Program
(dollars in billions)



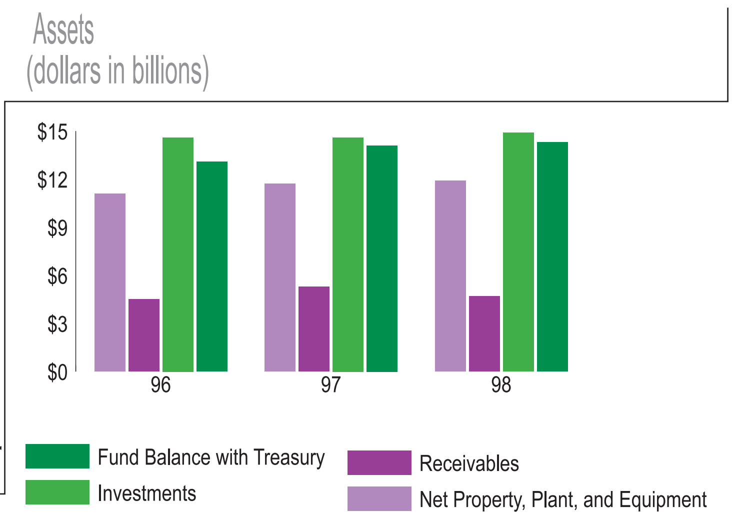
funding for all federal loan programs. Insurance policy reserves represents the maturing of the life insurance contracts. Borrowing from Treasury totally relates to the Housing Credit Assistance program. The increased borrowing from Treasury in FY 1997 was only temporary. The Housing Credit Financing (HCF) Accounts repaid $1.6 billion during October 1997.

Unfunded liabilities have been very volatile in recent years. The chart "VA Unfunded Liabilities" trends two of the major components of VA Unfunded Liabilities.

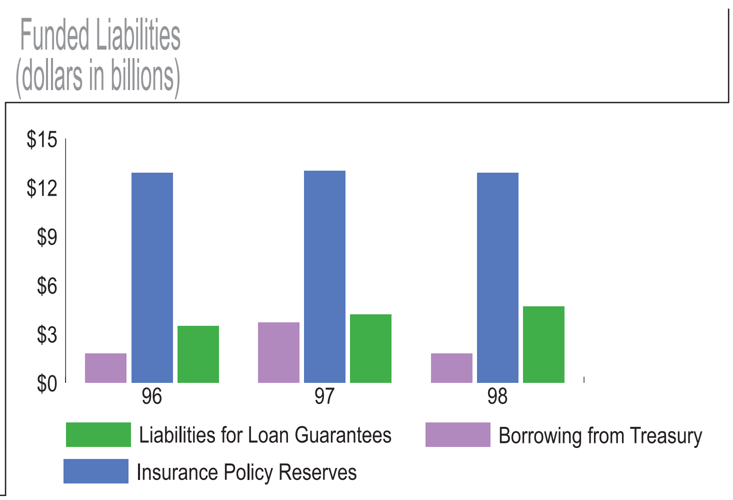
Federal Employees Compensation Act liability represents an actuarial estimate of future years' payments for VA cases currently on the rolls. After increasing for many years, this liability has come down lately due to the diligent efforts of VHA to manage the costs of this program by returning employees to light duty and similar efforts.

The big fluctuation in VA's balance sheet over the past 3 years is attributable to the unfunded liability for veterans' compensation and burial benefits.

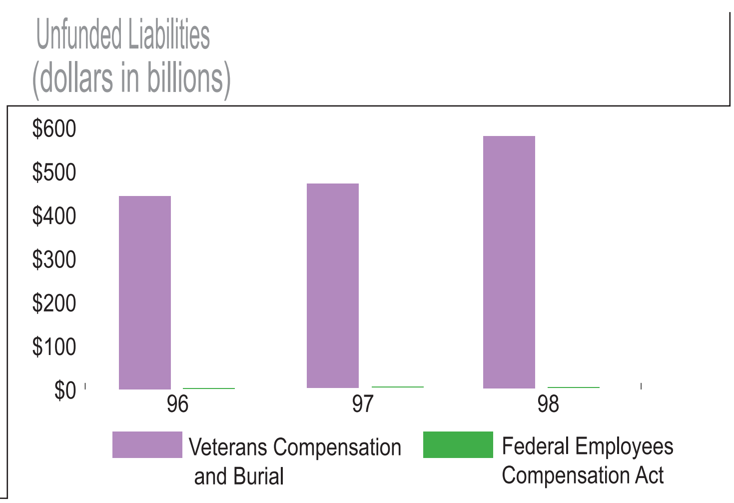
During FY 1998, changes were made to the actuarial assumptions used in determining the estimate of future compensation, pension and burial claims from the prior year. Specifically, estimates were made to consider future claims pertaining to active military persons who are not yet considered vet-



Three of VA's major components.



Three of VA's major components.



Two of VA's major components.

erans but will be upon discharge from service, and their future survivors. This change had the effect of increasing the total liability as of September 30, 1998 by about $6 billion. However, the most significant factor increasing the liability over last year's estimate was decreasing interest rates. The interest rate as of September 30, 1998 was the lowest rate for the most recent 3 years. The lower interest rates increased the present value of the projected liability by about $73 billion. Other differences in assumptions made, and changes in the beneficiary population resulted in an increase of about $31 billion.

VA does not fund post-retirement benefits such as the Federal Employees Health Benefits Program and the Federal Employees Group Life Insurance Program. VA also is not required to fully fund the Civil Service Retirement System 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 $694 million for FY 1998 and is included in the Statement of Changes in Net Position.

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 for Federal Tort Claims Act cases) 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 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 $67 million for FY 1998 and is included on the Balance Sheet under "Other Liabilities Not Covered by Budgetary Resources."

From FY 1992 through FY 1997, 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 not related to 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 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.

In FY 1998, the MCCR program was replaced by the Medical Care Collection Fund (MCCF). MCCF collections now are transferred to the VA Medical Care appropriation and remain available until expended. These funds are authorized for any purpose for which the Medical Care appropriation can be used. The authority to transfer these collections was effective July 1, 1997. Collections for the final quarter of FY 1997 of $140 million were transferred through MCCF to the Medical Care appropriation in November 1997.

During FY 1998, an additional $560 million was collected and deposited to the MCCF. In accordance with VA's FY 1998 Appropriation Bill, the Secretary determined the total amount recovered ($560 million) was less than the amount contained in the Congressional Budget Office baseline estimate ($604 million); therefore, Treasury deposited the amount of the shortfall in excess of $25 million into MCCF. This amounted to an additional $19 million.

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 has recorded unfunded cleanup costs in the amount of $139.3 million for FY 1998. The majority of the unfunded liability involves asbestos removal, lead abatement, replacement of underground oil and gasoline tanks, decommissioning of waste incinerators, and costs associated with decontamination of equipment prior to disposal.

VA has medical centers and national cemeteries that meet the criteria for a heritage asset. Fifty of VA's hospital properties are of architectural significance. Eleven are former National Homes for Disabled Volunteer Soldiers, established by Congress after the Civil War in 1866 to care for disabled veterans and those with no homes. Still others are former Military Posts that have been turned over to VA. Many of the national cemeteries had their beginnings after the Civil War; 22 of the cemeteries have superintendent's lodges that were designed by Brigadier General Montgomery C. Meigs, Quartermaster of the Army from 1861 - 1862.

Deferred Maintenance is classified as not performed when it should have been, or scheduled and delayed for a future period. It is VA policy to assure 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. VHA reported estimated deferred maintenance of $622 million and NCA reported $1 million.

Results of FY 1998 Financial Statement Audit

The Department received a qualified opinion from the Office of the Inspector General (IG). The IG was unable to verify the recorded balances for loan guarantee receivables, liabilities, and resources payable to Treasury as of September 30, 1998, and related items on the Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing because of the inadequacy of accounting records. The inaccurate balances resulted from VA accounting procedures not being consistently followed and/or internal controls not operating effectively. The effect of the resulting errors on the reported balances could not reasonably be determined.

The IG Report on Internal Control Structure discusses two material weaknesses concerning VA-wide information system security controls and Housing Credit Assistance (HCA) program accounting, and a reportable condition regarding medical facility accounts receivable. These internal control weaknesses expose VA to significant risks and vulnerabilities. The Department reported the information systems security controls and the HCA program accounting issues as material weaknesses in its FMFIA report for 1998.

The IG Report on Compliance with Laws and Regulations discusses three findings. One noncompliance dealt with the Department not complying with Federal Financial Management Improvement Act requirements concerning HCA program financial management information systems, information system security, and cost accounting standards. Except for this noncompliance, the report concludes that for the items tested, VA complied with those laws and regulations materially effecting the financial statements. IG also identified noncompliance with two laws that while not material to the financial statements, warrant disclosure. One concerns the requirements for charging interest and administrative costs on compensation and pension accounts receivable. The other concerns the requirement that agents of the government receiving money for the government shall deposit the funds with Treasury as soon as practical.

VA financial managers concurred with the audit findings and recommendations. Detailed action plans are being implemented to address the areas of qualification and noncompliance.

Clarifying VA Program Financial Data
"Obligations with Cost"

READER'S NOTE:
The chart below is intended to clarify VA program financial data.
The GPRA Section of this report used Budgetary "Obligations" as a yardstick of the magnitude of each program.
The Financial Statements reported "Costs" for VA programs. The chart contrasts "Obligations" with "Costs".

(dollars in millions)

	Performance Measurement	Statement of Net Costs		
Program	**Resources (Obligations)**	**Gross Costs (Note 1)**	**Offsetting Revenues**	**Net Cost**
Medical Care (Note 2)	$17,865	$18,067	$891	$17,176
Medical Education (Note 3)		$833		$833
Medical Research (Note 4)	$725	$627	$52	$575
Compensation (Note 5)	$17,651	$126,267		$126,267
Pension	$3,073	$3,243	$15	$3,228
Education	$938	$1,135	$171	$964
Vocational Rehabilitation and Counseling	$517	$502		$502
Housing	$1,455	$1,847	$469	$1,378
Insurance	$2,545	$2,141	$1,961	$180
Burial (Note 6)	$284	$1,314		$1,314
Departmental Management (Note 7)	$403			
Non-VA Program Cost & Eliminations		$129	$102	$27
Total VA	$45,456	$156,105	$3,661	$152,444

Note 1 - Statement of Net Costs includes charges for unfunded expenses not captured under obligations such as post retirement benefits funded by OPM and outyear annual leave, worker's compensation and environmental clean-up costs which will be funded by future VA appropriations.

Note 2 - Offsetting revenues includes (in millions) $578 for MCCF, $234 for Canteen Sales, $41 for Special Therapeutic & Rehabilitation Activities, and $ 38 for Sharing Agreements.

Note 3 - For Performance Measurement Purposes, Medical Education was included under Medical Care.

Note 4 - Budgetary Resources include $415 million in grants directly to VA Researchers which were not included in the entity "VA" for the purposes of the Statement of Net Costs.

Note 5 - Gross Costs include $108,712 million attributable to the FY 98 increase in the unfunded outyear liability for Veterans Compensation Benefits.

Note 6 - Gross Costs include $1,084 million attributable to the FY 98 increase in the unfunded outyear liability for Veterans Burial Benefits.

Note 7 - Obligations include the Board of Veterans' Appeals, Staff Offices, and the Inspector General. The cost of these offices were allocated to VA programs in the Statement of Net Cost.