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Report to the Chairman, Committee on Veterans Affairs, U.S. Senate

October 1991

FINANCIAL AUDIT

VA Housing Credit Assistance Program Financial Statements for Fiscal Years 1989 and 1988

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-244235

October 24, 1991

The Honorable Alan Cranston
Chairman, Committee on Veterans Affairs
United States Senate

Dear Mr. Chairman:

You requested that we audit various financial aspects of the Department of Veterans Affairs (VA) housing credit assistance program. This report covers our audit of the housing assistance program financial statements for the fiscal years ended September 30, 1989 and 1988. We plan to provide you with information on the program's accounting methods and calculations of its fiscal year 1990 loan loss liability separately.

VA prepared the housing assistance program financial statements as part of its consolidated financial statements, which combined financial information related to all of VA's programs and functions. Our November 1990 report, Financial Audit: Department of Veterans Affairs Financial Statements for Fiscal Years 1989 and 1988 (GAO/AFMD-91-6), discussed the results of our audit of VA's consolidated financial statements for those fiscal years.

As you requested, we are issuing this report to separately provide our opinion on VA's September 30, 1989 and 1988, financial statements for the housing assistance program, which, as of September 30, 1989, encompassed the Loan Guaranty Revolving Fund (LGRF) and the Direct Loan Revolving Fund (DLRF). This report adds to the financial data on VA's housing assistance program and expands upon the discussion and analysis of the program's financial position presented in our report on VA's consolidated financial statements. Reports on the housing assistance program's internal controls and VA's compliance with laws and regulations applicable to the program are also provided.

Results in Brief

VA's housing assistance program financial statements present fairly the program's financial position as of September 30, 1989 and 1988, and the results of its operations for the years then ended. (See appendix I.) VA's housing assistance program operations for fiscal year 1989 reported a net operating income of $200 million, as compared to a $1.8 billion loss the preceding year. This change was primarily caused by a refinement in the way VA estimates its liability for losses on loans currently guaranteed. Further refinement of the way VA approximates guaranteed loan losses would ensure that estimates continue to reasonably reflect actual losses and requirements of the Federal Credit Reform Act (Public Law 101-508) are met.

A decline in guaranteed home loan foreclosures also contributed to the change, as well as to a related change in the amount of VA's estimated liability for these losses. Cumulatively, operating losses for VA's housing assistance program totaled $3.9 billion between fiscal year 1986, when VA began estimating losses on its guaranteed loans, and fiscal year 1989.

As of September 30, 1989, the present value of VA's estimated liability for accrued loan losses payable in the future was $2.7 billion. Most of the actual loan loss payments will be made over the next 5 years and could amount to $3.6 billion. These payments will have to be funded primarily from appropriations since the fees VA charged on these loans were legislatively designed to cover only a small portion of the related losses.

Foreclosures on VA guaranteed loans grew between fiscal years 1986 and 1988 but declined in fiscal year 1989. Also, the number of home loans guaranteed by VA has been declining since fiscal year 1987. Continued reductions in these areas would reduce VA's liability for losses on guaranteed home loans to be paid in the future. However, recent increases in loan default rates, which are a leading indicator of loan foreclosure rates, suggest that future foreclosure rates could rise.

Other factors could affect the VA housing assistance program's financial position in the future. These include (1) the method of resolving the housing assistance program's $1.7 billion liability for borrowings from the Department of the Treasury, (2) elimination, in 1990, of most loan origination fees as a source of revenue for LGRF, which could increase the amount of appropriations needed to finance losses incurred by that fund, and (3) VA's response to recommendations previously made by GAO and by VA's Office of Inspector General to improve VA's housing assistance program operations, which could reduce the program's costs.

VA's self-assessments of its housing assistance program internal controls disclosed material weaknesses in several areas for which corrective actions are underway. In addition, we found that VA did not reconcile discrepancies in financial data contained in various systems which support the housing assistance program. Federal accounting requirements call for reconciliations to ensure the accuracy of the data contained in accounting systems and the reliability of financial reports. (See appendix II.) For the transactions we tested, VA complied with the laws and regulations applicable to its housing assistance program which could have materially affected its financial statements for the program. (See appendix III.)

Background

VA's housing assistance program (1) provides veterans with direct home loans and (2) guarantees home loans made to veterans by private sector mortgage lenders. Although initially established to provide mortgage funds to veterans in certain geographic areas where private mortgage funds were unavailable, VA's direct home loans have, since 1981, been restricted to severely disabled veterans requiring special housing. As a result, few new direct home loans are approved each year.

Most of VA's housing assistance involves guaranteed home loans for both nonmanufactured and manufactured (mobile) homes. VA guarantees lenders, such as banks or savings and loan institutions, against full financial losses not to exceed a maximum amount if the borrower stops paying the loan principal and interest and the loan is foreclosed. The guarantee increases on a sliding scale to a current maximum of $46,000 for loans greater than $144,000 on nonmanufactured homes.

VA had about $1.2 billion in outstanding direct and vendee[1] loans as of September 30, 1989, an increase of about $100 million from the previous fiscal year. As of September 30, 1989, home loans guaranteed by VA were valued at about $152 billion, of which about $60 billion was guaranteed by VA.

The Veterans' Home Loan Indemnity and Restructuring Act of 1989 (Public Law 101-237, Title III), enacted December 18, 1989, established the Guaranty and Indemnity Fund. On January 1, 1990, this fund, which became a component of the VA housing assistance program, began financing all new VA home loan guarantees, except those for manufactured homes. All home loans guaranteed by VA prior to January 1, 1990, continue to be accounted for through LGRF, which also continues to finance new guaranteed loans related to manufactured homes. VA's DLRF continues to account for all of VA's direct loans.

[1]Vendee loans are direct loans that are made under the LGRF on nonmanufactured homes acquired through foreclosure in the guaranteed claim settlement process and sold to veterans and the public on credit terms.

Loan origination fees for loans guaranteed before January 1, 1990, were revenue to LGRF. For loans guaranteed after that date, loan origination fees are revenue to the Guaranty and Indemnity Fund (except for the fees for manufactured homes). In addition, the act added a requirement that the Guaranty and Indemnity Fund be credited through the appropriation process with a portion of the government's subsidy for VA's home loan guarantees at the time a loan is guaranteed.

However, commencing on October 1, 1991, the accounting and financing activities relative to all three of VA's housing funds will change. Under the Federal Credit Reform Act of 1990, which will be effective beginning in fiscal year 1992, new and existing loans and guarantees will be accounted for differently. All financial transactions relative to direct loans and loan guarantee commitments outstanding as of September 30, 1991, will be recorded on a cash basis in three new accounts, referred to as liquidating accounts. These liquidating accounts will have permanent, indefinite budget authority, which VA can use to finance any insufficiencies in cash needs relating to the outstanding loans and loan guarantees.

For all new direct loans and loan guarantee commitments originating during fiscal year 1992 and beyond (including modifications of direct loans or guarantees that originated prior to fiscal year 1992), an amount equal to the present value of the entire estimated subsidy costs less the present value of estimated collections will be appropriated and recorded in new program and financing accounts for the year the loans or guarantees originate. Administrative expenses, currently not allocated to the housing assistance program, will also be recorded in these accounts.

Scope and Methodology

As requested by the Senate Veterans Affairs Committee, this report covers our audit of VA's housing assistance program financial statements for the fiscal years ended September 30, 1989 and 1988. The scope and methodology for our audit and reviews of the internal control structure and compliance with laws and regulations are contained in the opinion letter and respective reports. Our related discussion and analysis is based primarily on accounting data included in VA's audited financial statements for fiscal years 1986 through 1989. However, certain analyses required the use of statistical and financial data from other sources, such as VA's budget reports and program systems. Data from these sources were not subject to our audit and independent verification.

The views of responsible VA officials were sought during the course of our work and are incorporated where appropriate. These officials generally agreed with our findings and recommendations. Our work was performed between July and November 1990 at VA headquarters in Washington, D.C., and at six field offices. These offices were in Chicago, Ill.; Columbia, S.C.; Denver, Colo.; Indianapolis, Ind.; Muskogee, Okla.; and San Francisco, Calif.

Substantial Appropriations Will Be Needed to Cover Guaranteed Home Loan Losses

For fiscal years 1986 through 1989, VA's housing assistance program had a cumulative net operating loss of $3.9 billion, as shown in table 1.

Table 1: VA's Housing Assistance Program Net Operating Income (Loss) for Fiscal Years 1986 Through 1989

Dollars in billions

Fiscal year	Net income (loss)
1986	$(.7)
1987	(1.6)
1988	(1.8)
1989	.2
Total	**$(3.9)**

About $1.2 billion of the cumulative net operating loss for fiscal years 1986 through 1989 was financed by appropriations and receipts from other sources, such as loan sales. The remaining $2.7 billion represents the present value of VA's liability for the future payment of losses on home loan guarantees outstanding at September 30, 1989.

When paid, this $2.7 billion liability could reach $3.6 billion in actual outlays. However, it could be less if the number of actual foreclosures related to the housing assistance program is significantly lower than VA projected. This is unlikely in the near future given the current weak economy and housing market.

Future appropriations will be needed to finance most of the September 30, 1989, loan loss liability when it is paid. As in prior fiscal years, appropriations will have to be obtained to finance any loan loss liability in excess of program revenues and receipts from other sources.

VA projects that funds to pay the current liability for housing assistance program losses will be required principally through fiscal year 1995. However, changing economic conditions, revisions of VA's foreclosure policies, or other factors could affect the level of appropriations VA requests from year to year to fund those losses.

VA's Liability for Losses Changed Substantially From Preceding Year

VA's liability for losses on home loan guarantees was reduced by $1 billion from fiscal year 1988 to fiscal year 1989. We estimate that about 70 percent of this reduction resulted from a change in the method VA used to calculate the loss on its home loan guarantees. A 1989 decline in VA guaranteed home loan foreclosures led to the remainder of the reduction.

New Methodology Used to Compute Losses

Generally accepted accounting principles require that an entity's liability for losses be recognized in its financial statements. This liability is to be estimated each year using the best information available, such as historical experience. VA developed a method for estimating its liability for losses on home loans guaranteed each year and began using this methodology in fiscal year 1986. As a result of variances between actual and projected home loan guarantee losses VA experienced since that time, this methodology was revised for fiscal year 1989.

The estimated liability and related expense were determined through a statistical methodology based on historical foreclosure experience. In fiscal year 1989, VA refined this statistical methodology to reflect several years' actual experience. The change principally involved including historical foreclosure data for a greater number of years than before, thereby reducing distortions caused by short-term changes in economic conditions.

Had the revised methodology been used in prior years, the resulting net operating results for those years would have been reported differently. We determined, however, that on a cumulative basis, the overall net operating loss of $3.9 billion for the 4 years (fiscal years 1986 through 1989) in which VA calculated its liability on home loan losses would not change significantly.

While loan loss estimates are not expected to be exact, they should reasonably and consistently approximate actual loss experience. Under the best circumstances, there will generally be some fluctuation between projections and actual losses. If this occurs in a program as large as VA's, even a small percentage difference can have a significant financial statement impact. For instance, a one-half of 1 percent variance, either upward or downward, between the actual and estimated foreclosure rates would have resulted in VA's September 30, 1989, projected loan loss costs being $500 million higher or lower, respectively.

Overall, between fiscal years 1986 and 1989, the method used to determine VA's loan losses yielded reasonable results, as actual cash flows associated with loan losses that subsequently emerged in these years approximated those predicted. Also, the 1989 estimate of fiscal year 1990 foreclosures closely approximated the number of foreclosures actually encountered.

Nonetheless, the uncertainty surrounding loan loss estimates is magnified by the nation's current recession, which may cause increased foreclosures and losses on home loans guaranteed by VA in past years. In this regard, recent 1991 data show rising VA home loan defaults.

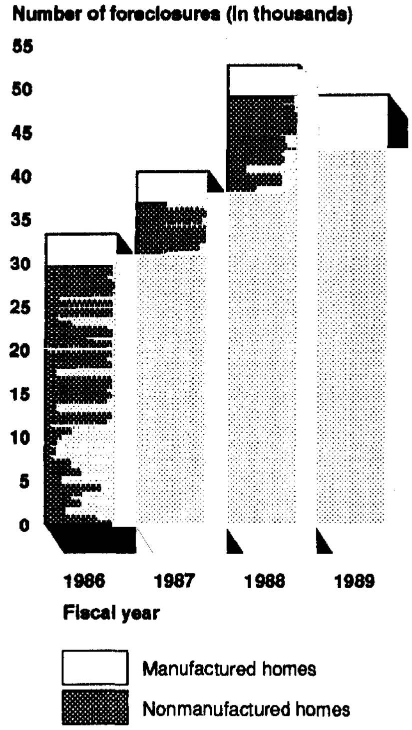
Looking to the future, and especially during times of highly uncertain economic conditions, VA could further improve the accuracy of its loss estimates by using economic modeling techniques as well as historical foreclosure experience. Under the Federal Credit Reform Act, the Office of Management and Budget is developing modeling techniques that incorporate economic factors. These techniques will be available to VA in fiscal year 1992 and can be used for estimating the loan losses shown in VA's future financial statements.

VA Guaranteed Home Loan Foreclosures Have Declined

In fiscal year 1989, VA's guaranteed home loan foreclosures declined for the first time since 1980. VA's nonmanufactured and manufactured home loan guarantee foreclosures for the past 4 fiscal years are shown in figure 1.

Future requirements for appropriations to cover guaranteed loan losses may be eased somewhat if the downward trend in the number of loans in default experienced in fiscal year 1989 continues. However, considering the present unfavorable state of the economy and, in particular, the housing market, this is improbable in the near future.

Figure 1: VA Guaranteed Home Loan Foreclosures for Fiscal Years 1986 Through 1989



Waiver of Debt to Treasury Would Improve VA Housing Assistance Program's Financial Condition

As shown in table 2, VA's housing assistance program did not have sufficient assets to meet its accrued obligations at the end of fiscal year 1989. At that time, the program's liabilities exceeded assets by about $2.3 billion. Most of this deficit consists of a $1.7 billion debt to Treasury for appropriations that were advanced to DLRF between 1951 and 1963 and subsequently transferred to and used for the operations of LGRF. Also, as a result of the creation of the Guaranty and Indemnity Fund, LGRF revenue will be restricted to that generated from manufactured home loan origination fees, which normally represents only a minor portion of the origination fees earned each year. For example, of the $141 million in revenues from loan origination fees earned during fiscal year 1989, VA estimates that less than 1 percent was applicable to manufactured home loans. Furthermore, the debt has no required repayment date and does not bear an interest charge. For these reasons, the debt could remain recorded as a liability and have a negative effect on these funds' financial position indefinitely. While the debt represents a receivable to Treasury, it has no value to Treasury. DLRF and LGRF do not have sufficient assets to repay the debt now, nor, in the future, are they expected to generate an operating surplus through improved operations sufficient to repay the borrowings.

Table 2: Assets and Liabilities of VA's Housing Assistance Program

Dollars in billions

	Fiscal year			
	1986	**1987**	**1988**	**1989**
Assets[a]				
Cash	$0.4	$0.1	$0.3	$0.2
Claims, loans receivable, and investments	1.3	1.3	1.2	1.3
Foreclosed property held for sale	0.8	0.9	0.8	0.7
Total Assets	**2.5**	**2.3**	**2.3**	**2.2**
Liabilities				
Losses on guaranteed loans	1.7	2.7	3.7	2.7
Debt to Treasury	1.7	1.7	1.7	1.7
Other liabilities	0.3	0.4	0.1	0.1
Total Liabilities	**3.7**	**4.8**	**5.5**	**4.5**
Deficit	**$(1.2)**	**$(2.5)**	**$(3.2)**	**$(2.3)**

[a]The total assets listed do not include the receivables from future financing sources (primarily appropriations) shown in the housing assistance program's statements of financial position for fiscal years 1986 through 1989. As stated in note 2.B to the financial statements, future financing sources represent receivables for accrued expenses for which funds will not be appropriated until the year payment is due.

Our audit report[2] on VA's consolidated financial statements for fiscal years 1988 and 1987 disclosed that DLRF did not have sufficient resources to repay the debt. Based on this disclosure, VA included a legislative proposal in its 1991 budget submission to waive the liability. However, as shown in note 6 to the 1989 financial statements, the Congress did not act on VA's proposal and VA did not follow up by including the request for waiver in its 1992 budget submission. Such a waiver would permit the housing assistance program to reclassify its accounting for the $1.7 billion from a liability to an equity account (that is, as an additional investment of appropriations by the federal government).

[2]Financial Audit: Veterans Administration's Financial Statements for Fiscal Years 1988 and 1987 (GAO/AFMD-89-69, September 15, 1989).

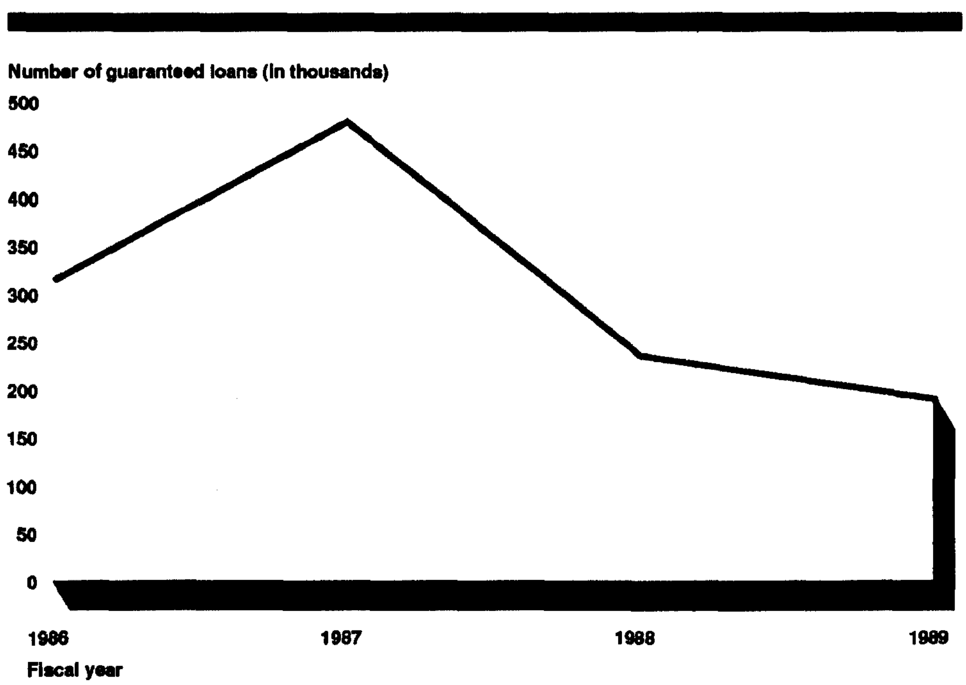
Factors That Could Affect Financial Position of VA's Housing Assistance Program

The financial position of VA's housing assistance program could be affected by many factors. These include

- any significant change in the number of home loans being guaranteed by VA;
- changes in the VA housing assistance program's foreclosure rate;
- the elimination of most future loan origination fees as a source of revenue for LGRF, which could increase the appropriations needed to pay for the fund's loan loss liability when it becomes due; and
- VA's response to GAO and Inspector General recommendations to improve housing assistance program operations.

A rise or decline in new home loans guaranteed each year could affect VA's financial position because new loan guarantees are used in determining the cost of and liability for VA's housing assistance losses. During fiscal year 1989, VA guaranteed about 189,700 loans valued at about $14.4 billion. This represents a significant decrease from recent years, as shown in figure 2.

Figure 2: VA Home Loans Guaranteed From Fiscal Years 1986 Through 1989



As discussed previously, fluctuations in VA's housing program foreclosure rate, which is a factor used in calculating the loan loss liability and related expense, can affect the program's financial position. Changes in the VA housing program's foreclosure rate, either upward or downward, would result in a corresponding increase or decrease in the program's loan loss liability and related expense. At September 30, 1989 and 1988, VA had outstanding guaranteed loans with a face amount of $152 billion and $150 billion, respectively. VA's potential maximum loan loss liability for these guarantees is about $60 billion, or about 40 percent of the face value of guaranteed loans outstanding.

Starting in 1990, LGRF will have only a nominal amount of loan origination fees on new guaranteed loans as a source of financing. These fees totaled $875 million during the 4 fiscal years from 1986 to 1989. As required by Public Law 101-237, loan origination fees received from new guaranteed loans on nonmanufactured homes are to be deposited in the Guaranty and Indemnity Fund and cannot be used to finance liabilities of LGRF. Accordingly, other sources of funding, primarily appropriations, would need to be available to help finance VA's liability for LGRF home loan losses when due.

VA could reduce the cost associated with home loan guarantee foreclosures by implementing the improvements to its housing assistance program that we and VA's Inspector General have recommended in previous audit reports. This would result in actual loan losses being lower than projected; therefore, the amount of appropriations needed to finance those losses would be lower than expected. Previous audits have identified significant problems in the management of VA's key home loan guarantee processes, including loan origination, servicing, processing and property acquisition, management, and sales. For instance, in a December 1989 report,[3] we recommended ways VA could use alternatives to foreclosure to reduce costs. We estimated the potential savings for fiscal year 1987 alone to be between $42 million and $94 million. In addition, VA's Inspector General has issued many audit reports recommending home loan guarantee program improvements, for which the Inspector General estimates potential savings of $287 million.

[3]Housing Programs: Increased Use of Alternatives to Foreclosure Could Reduce VA's Losses (GAO/RCED-90-4, December 20, 1989).

Recommendations

Until DLRF's $1.7 billion liability for borrowings from Treasury can be removed by an action such as a waiver of repayment, it will have a negative effect on its own as well as LGRF's reported financial position. Since this liability has remained outstanding for almost 30 years and has no prospect for repayment, a waiver would result in properly recognizing the $1.7 billion for what it has become—a government investment of appropriated funds. For this reason, we recommend that the Secretary of Veterans Affairs resubmit proposed legislation in VA's future budget submissions seeking a waiver of DLRF's $1.7 billion liability for appropriations advanced by Treasury.

Our report on internal control structure contains a recommendation to the Secretary of Veterans Affairs on another matter.

We are sending copies of this report to the Secretary of Veterans Affairs and to other interested parties. Copies will be made available to others upon request.

Sincerely yours,

Donald H. Chapin

Donald H. Chapin
Assistant Comptroller General

Contents

Abbreviations

DLRF	Direct Loan Revolving Fund
GAO	General Accounting Office
LGRF	Loan Guaranty Revolving Fund
VA	Department of Veterans Affairs

Opinion Letter

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial Management Division

B-244235

To the Secretary
Department of Veterans Affairs

We have audited the accompanying statements of financial position of the Department of Veterans Affairs' (VA) housing credit assistance program as of September 30, 1989 and 1988, and the related statements of operations and changes in financial position and reconciliations to budget for the fiscal years then ended. 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. Also, we reviewed VA's housing assistance program's internal control structure and its compliance with laws and regulations and are reporting separately on the results of these reviews.

The financial statements referred to above include only the financial activities of VA's housing credit assistance program, which, as of September 30, 1989, involved the activities of two revolving funds--the Loan Guaranty Revolving Fund and the Direct Loan Revolving Fund. The principal activities for the housing assistance program were carried out through the Loan Guaranty Revolving Fund. The financial activities of other VA programs are not included. Our November 1990 report, Financial Audit: Department of Veterans Affairs Financial Statements for Fiscal Years 1989 and 1988 (GAO/AFMD-91-6), discussed the results of our audit of VA's consolidated financial statements covering all component programs for fiscal years 1989 and 1988.

We conducted our audits in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Audits include examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Audits also include assessing the accounting principles used and significant estimates made by management, as well

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as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Department of Veterans Affairs' housing assistance program as of September 30, 1989 and 1988, the results of its operations, and the changes in its financial position and reconciliation to budget for the fiscal years then ended, in conformity with generally accepted accounting principles.

Donald H. Chapin
Assistant Comptroller General

February 12, 1991

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Report on Internal Control Structure

We have audited the financial statements of the Department of Veterans Affairs' housing assistance program for the fiscal years ended September 30, 1989 and 1988. We conducted our audit in accordance with generally accepted government auditing standards. As required by those auditing standards and as part of our audit, we obtained an understanding of and assessed the housing assistance program's internal control structure to the extent we considered necessary in planning and performing our audit. Our consideration of the internal control structure was made to determine our auditing procedures for the purpose of expressing an opinion on the housing assistance program's financial statements and not to provide assurance about the adequacy of the overall internal control structure. By itself, the consideration of an internal control structure for financial auditing planning purposes is not sufficient for expressing an overall opinion about the design and operation of an entity's internal control structure as a whole or of any specific elements, but such a consideration may disclose weaknesses in specific aspects of the control structure.

The purpose of this report is to describe VA's housing assistance program internal control structure that we considered and to communicate the results of our consideration and tests of the policies and procedures comprising the structure. This report pertains only to our consideration of VA's housing assistance program internal control structure for the year ended September 30, 1989. Our report on VA's overall internal accounting controls for the year ended September 30, 1988, is presented in GAO/AFMD-89-69, dated September 15, 1989.

VA's management is responsible for establishing and maintaining a system of internal administrative and accounting controls (in effect, an internal control structure) in accordance with the Accounting and Auditing Act of 1950 and the Federal Managers' Financial Integrity Act of 1982. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over agency assets. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, a lapse in the degree of adherence to the procedures, or a deterioration in the effectiveness of the design and operation of policies and procedures.

For purposes of this report, we have focused on the key activities of the loan guarantee cycle. Accordingly, we have classified the housing assistance program's significant internal control policies and procedures into the following categories:

- loan origination and approval,
- loan servicing,
- default servicing and property acquisition, and
- property management and sales.

For all the areas listed, we obtained an understanding of the design of relevant policies and procedures that comprise the control structure, determined whether they have been placed in operation, and assessed control risk. We performed limited tests of internal control procedures for all the categories. In addition, we performed audit tests to substantiate account balances associated with each control category. Such tests can serve to identify weaknesses in the internal control structure.

Management's Review of Internal Controls

VA has evaluated its internal control structure and has disclosed internal control and accounting system weaknesses in its reports under the Federal Managers' Financial Integrity Act. Weaknesses disclosed in VA's 1989 report relating to the housing assistance program are described below.

- VA's decentralized funding process for loan guarantee programs failed to provide VA's central office with adequate fund control over the $3.6 billion in program obligations. In its 1989 report, VA stated that its new Disbursing, Accounting, and Budgeting System would provide centralized fund control when implemented in 1991. However, VA officials advised us in July 1991 that VA now plans to use its new financial management system to provide centralized fund control. This new system is expected to be implemented by fiscal year 1993.
- VA's ability to detect duplicate payments is questionable. Controls over disbursements have been essentially manual and decentralized. In its

1989 report, VA stated that the implementation of the Disbursing, Accounting, and Budgeting System, in 1991, would correct this weakness. However, we were advised by VA officials in July 1991 that VA now plans to use its Automated Voucher Audit Payment System, which is to be implemented in late 1991, to reduce the potential for duplicate payments.

- Ineffective automated data processing support has resulted in loan servicing problems and excessive foreclosure rates. VA has begun the process of implementing new automated data processing application systems, as well as redesigning and replacing existing systems that support loan guaranty operations. VA does not expect these corrective actions to be completed until 1992.
- Internal monitoring of the private sector lenders who make the mortgage loans that VA guarantees could reduce early defaults and high foreclosure rates. To address this, VA initiated a lender monitoring unit during 1990 to review lender compliance with VA's policies and procedures.

GAO's Consideration of VA's Internal Controls

In making our risk assessment, we considered VA's Federal Managers' Financial Integrity Act reports, as well as our prior reports and VA Inspector General reports on financial matters and internal accounting control policies and procedures. Our consideration of the internal control structure, made for the limited purpose previously described, would not necessarily disclose all matters in the internal control structure that might be reportable conditions[1] and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses, as defined below. For this reason, we do not express an opinion on the VA housing assistance program's internal control structure taken as a whole or within the categories listed above.

No Material Weaknesses Identified

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities 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 structure

[1] A reportable condition involves a matter coming to our attention related to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect an entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

would not necessarily disclose all matters in the structure that might be material weaknesses. During our tests, we found no matter involving the internal control structure and its operation that we consider to be a material weakness. We did, however, identify one matter involving the internal control structure and its operation that we consider to be a reportable condition under generally accepted government auditing standards. This matter is discussed in the following section.

Data Reconciliations Inadequate

VA does not perform reconciliations of accounting data contained in systems that support the housing assistance program. GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2, specifies that reconciliations are part of an effective internal control structure. The purpose of such reconciliations is to (1) ensure the accuracy of the data contained in the accounting systems and the reliability of financial reports produced with such data and (2) assess whether controls need to be improved. Without reconciliations, VA cannot readily identify inaccuracies in the data, inadequacies in the structure or operation of systems, or adjustments that need to be made to bring reporting systems into agreement.

We found that VA did not regularly reconcile accounting data in a number of areas or make necessary adjustments promptly when discrepancies were identified. Examples include the following:

- Because of a system program problem at the Austin Finance Center, property account amounts in the Property Management System and general ledger differed. The differences had accumulated for over a year and had reached $19.2 million before being discovered and resolved. As a result, the amounts shown in the general ledger at the end of fiscal year 1989 were inaccurate and were subsequently adjusted during fiscal year 1990. We also found discrepancies between the Property Management System and general ledger with respect to specific expense accounts, such as an 11-percent difference for a selling expense account. Such differences mean that VA may not have had an accurate accounting of the assets, liabilities, and costs of its housing assistance program.
- The Property Management System report understated the number of properties sold during the current fiscal year while an Austin Data Processing Center report, which is used to account for the cost of property, showed the correct number. The discrepancy between the two reports involved only a small percentage of the total properties accounted for. However, because the Property Management System report's figure for properties sold is used in computing the provision for

loan losses, the estimated amount of losses (and the related liability) on guaranteed loans might have been understated.

Conclusions

VA is responsible for maintaining a system of internal controls and for evaluating its effectiveness. VA's assessment of its housing assistance program's internal controls has disclosed material weaknesses in several areas. Actions are underway to correct these weaknesses.

In addition to these problems, VA does not regularly reconcile its housing program property accounts to ensure that inaccuracies are identified and necessary adjustments are promptly made. As a result, some account balances used in computing estimates for other account balances may be inaccurate.

Recommendation

We recommend that the Secretary of Veterans Affairs direct the Assistant Secretary for Finance and Planning and the Chief Benefits Director to develop and implement policies and procedures to ensure that the Property Management System's property accounts and the records of other VA systems are reconciled regularly and that necessary adjustments are made promptly.

Report on Compliance With Laws and Regulations

We have audited the financial statements of the Department of Veterans Affairs' housing assistance program for the fiscal years ended September 30, 1989 and 1988, and have issued our opinion thereon. This report pertains only to our consideration of VA's compliance with laws and regulations applicable to housing assistance program activities for the year ended September 30, 1989. Our report on VA's overall compliance with laws and regulations for the year ended September 30, 1988, is presented in GAO/AFMD-89-69, dated September 15, 1989.

We conducted our audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Compliance with laws and regulations applicable to VA is the responsibility of VA's management. As part of obtaining reasonable assurance as to whether the financial statements were free of material misstatement, we performed tests of VA's compliance with certain provisions of the laws and regulations applicable to the housing assistance program that could have a material effect on the program's financial statements if not complied with. Since we only tested compliance with certain provisions of the selected laws and regulations, our objective was not to provide an opinion on overall compliance with these laws and regulations. The laws and regulations covered in our testing were the following:

- legislation authorizing the Loan Guaranty Revolving Fund (38 U.S.C. 1824);
- legislation authorizing direct loans (38 U.S.C. 1811);
- the Anti-Deficiency Act (31 U.S.C. 1341, 1342, and 1511-1519);
- legislation concerning recording obligations and balances available for obligation (31 U.S.C. 1501 and 1502) and related regulations;
- the Debt Collection Act of 1982 (31 U.S.C. 3302, 3711, and 3717), related regulations, and specific legislation related to collecting amounts owed to VA (38 U.S.C. 3114 and 3115); and
- the Prompt Payment Act (31 U.S.C. 3901-3906) and related regulations.

The results of our tests for fiscal year 1989 indicate that for the items tested, VA complied with those provisions of laws and regulations which could have a material effect on the financial statements. With respect to transactions not tested, nothing came to our attention that caused us to believe that VA had not complied, in all material respects, with those provisions.

Financial Statements

Statements of Financial Position

AS OF SEPTEMBER 30, 1989 AND 1988
(Dollars in Thousands)

	1989	1988
ASSETS:		
Cash with U.S. Treasury and on Hand	$ 219,028	$ 318,747
Advances, Accounts, Claims and Loans Receivable, Net (note 4)	993,419	1,015,793
Investments (notes 2F and 7)	316,948	150,682
Foreclosed Property Held for Sale (note 8)	679,343	818,833
Future Financing Sources (note 2B)	2,484,717	3,450,553
TOTAL ASSETS	$4,693,455	$5,754,608
LIABILITIES AND EQUITY:		
Liabilities:		
Accounts Payable, Principally to the Public	88,541	103,351
Other Liabilities	14,225	34,005
Liability for Losses on Guaranteed Loans (note 5)	2,672,857	3,663,488
Borrowings from Treasury (note 6)	1,730,078	1,730,078
TOTAL LIABILITIES	**$4,505,701**	**$5,530,922**
Equity of the U.S. Government:		
Unrealized Appropriations:		
Unobligated Balances	187,753	223,683
Undelivered Orders	1	3
TOTAL EQUITY OF THE U.S. GOVERNMENT	**$ 187,754**	**$ 223,686**
TOTAL LIABILITIES AND EQUITY	**$4,693,455**	**$5,754,608**

The accompanying notes are an integral part of this statement.

Statements of Operations and Financing Sources

FOR THE YEARS ENDED SEPTEMBER 30, 1989 AND 1988
(Dollars in Thousands)

	1989	1988
OPERATING EXPENSES:		
Expenses by Category:		
Property Sales Expense	$ 112,941	$ 95,393
Property Management Expense	64,066	69,867
Loss on Foreclosed Guaranteed Loans	962,165	788,862
Interest Expense, Trust Participation Certificates	0	21,547
Provision for Loan Losses (note 5)	(1,029,216)	1,055,868
TOTAL OPERATING EXPENSES	**$ 109,956**	**$2,031,537**
OPERATING REVENUE AND FINANCING SOURCES:		
Operating Revenues:		
Interest Income	$ 165,338	$ 168,143
Loan Origination Fees	141,057	135,118
Reimbursement and Other	6,486	(66,181)
Total Operating Revenue	312,881	237,080
Financing by Source:		
Appropriations Realized	762,911	940,194
Funds to be Provided by Future Financing Sources	(965,836)	854,263
Total Financing Sources	(202,925)	1,794,457
TOTAL OPERATING REVENUE AND FINANCING SOURCES	**$ 109,956**	**$2,031,537**

The accompanying notes are an integral part of this statement.

Statements of Changes in Financial Position and Reconciliation to Budget

FOR THE YEARS ENDED SEPTEMBER 30, 1989 AND 1988
(Dollars in Thousands)

	1989	1988
NET USE OF RESOURCES:		
Operations:		
Operating Expenses	$ 109,956	$2,031,537
Items Requiring (Providing) Funds:		
Decrease (Increase) in Future Liability Provisions	990,631	(944,590)
Increase (Decrease) in Accounts Receivable	(167,290)	(109,869)
Decrease (Increase) in Accounts Payable and Accruals	34,576	(136,871)
Revenues Accounted for as Offsetting Collections	(312,881)	(237,080)
Resources Used (Provided) by Operations	654,992	603,127
Non-Operating Uses:		
Purchase of Foreclosed Property Held for Sale	1,483,189	1,630,545
Issuance and Repurchase of Loans and Liens	1,073,002	1,080,064
Other, Net	(45,358)	(36,562)
Financing Activities:		
Sale of Foreclosed Property Held for Sale	(1,714,851)	(1,661,608)
Sale of Loans without Recourse	(433,331)	(296,683)
Loan and Lien Repayment Settlements	(139,824)	(179,845)
NET USE OF BUDGETARY RESOURCES (OUTLAYS)	**$ 877,819**	**$1,139,038**
SOURCES OF BUDGETARY RESOURCES PROVIDED:		
Intra-agency Transfers	0	178,270
Current Year Appropriation, Adjusted	778,100	916,400
Proceeds of Loan Sales With Recourse	0	389,259
Net Transfers, Reimbursements & Other	0	(146,046)
TOTAL RESOURCES PROVIDED	**$ 778,100**	**$1,337,883**
INCREASE (DECREASE) IN U.S. TREASURY AND IMPREST FUNDS	(99,719)	198,845
U.S. TREASURY AND IMPREST FUNDS:		
Beginning of Year	318,747	119,902
End of Year	$ 219,028	$ 318,747

The accompanying notes are an integral part of this statement.

Notes to Financial Statements

NOTE 1: THE ENTITY

The accompanying financial statements present only the financial activity of the Department of Veterans Affairs' (VA) housing credit assistance program, which, as of September 30, 1989, was comprised of two funds--LGRF and DLRF. The statements present only the direct program costs of the housing credit assistance program, referred to in the remaining sections of these notes as the housing assistance program. Administrative costs, which include items such as personnel, automated data processing, office space and travel, are not allocated from VA's overall departmental administrative function. Consolidated financial statements covering all of VA's activities (including Medical Care and Construction, Veterans Benefits, Housing Assistance, Life Insurance and Department Administration) are issued annually.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Accounting

The Statements of Financial Position, Statements of Operations and Financing Sources, and Statements of Changes in Financial Position are presented in accordance with generally accepted accounting principles as prescribed in Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies. These principles differ from budgetary reporting principles. The differences relate principally to the recognition of expenses on the accrual basis instead of on the cash basis of accounting and to the accrual and recognition of certain liabilities in the accompanying financial statements. Also, for financial statement purposes, appropriations are realized as a financing source as accrued expenses are recognized.

B. Future Financing Sources

For accrued expenses (e.g., losses on guaranteed loans), existing appropriations are not available under budgetary accounting to pay for the expenses. But, appropriations are customarily provided in the year payment of the expenses is required. An amount due from future financing sources is therefore recognized as a financing source in the statement of operations each year for that year's accrued amount of such expenses. The portion of the cumulative amount of the accrued expenses (e.g., loan losses) for which financing is not available until payment is due is reflected in the statement of financial position as an asset, receivables from future financing sources. The total amount of the future financing sources account is also reflected in the liability section of the statement of financial position as part of the liability for losses on guaranteed loans.

C. Recognition of Guaranteed Loan Losses and Related Liability for Payment

Activities under the housing credit assistance programs primarily involve the partial guarantee of home (manufactured and nonmanufactured) mortgage loans that eligible veterans or qualified survivors of veterans borrow from private lenders. Thus, VA provides a housing credit assistance benefit to veterans in the form of the substitution of the federal government's guaranty to the private lenders against full financial loss on the mortgage loans for the investment protection normally afforded under conventional mortgage terms by larger loan origination fees and downpayments. Guaranteed mortgage loans are originated by private lenders and are not recorded in the financial statements of VA. VA, however, does incur a cost for issuing guarantees, or providing this veteran benefit, and that is the cost (loan losses) VA will bear as loans already guaranteed go into default and are foreclosed in the future.

Under the housing assistance program, VA also sells foreclosed property on credit terms (called vendee loans), and originates direct loans to veterans through DLRF. VA also experiences losses on these loans when the borrowers fail to make mortgage payments and the loans are foreclosed.

Upon foreclosure of a guaranteed loan, when VA is called upon to honor its guarantee, it uses a methodology for establishing the fair market value of the property at the date of acquisition as contained in 38 U.S.C. 1832(c), and either pays the private lender for claim losses not to exceed VA's maximum guarantee or, for nonmanufactured home loans, purchases the property from the lender. In the latter case, VA not only incurs the expense in acquiring, managing and selling the property but also incurs a gain or loss from increases or decreases, respectively, in the value of the property from the date of acquisition to the date of sale. VA also incurs additional cost when the acquired properties that are sold on credit terms (i.e., vendee loans) also subsequently default. All of these cost factors comprise VA's "losses on guaranteed loans" and after deduction of revenues, the net cost of the annual housing benefits provided to veterans.

During each year, the amount actually paid relative to these guaranteed loan loss cost factors are recorded on the cash basis of accounting. However, this amount represents the payment of the loan losses previously accrued on loan guarantees made by VA during various previous years, not the loan guarantees made during the year covered in the financial statements. Accordingly, through a year-end accrual accounting process, an accounting adjustment is made that has the effect of converting the recorded loan loss payments from a cash basis of accounting to an accrual basis covering only the estimated loan losses for new loans guaranteed during the fiscal year. This year-end accrual process also results in the housing assistance program recording its liability for the future payments that will be required to cover loan losses on guaranteed loans outstanding at the end of each year (see note 5) and the establishment of the future financing sources discussed in note 2.B. above.

D. Operating Revenue

Loan origination fees, which during fiscal year 1989 were charged to non-disabled veterans at a rate of one percent of the loan principal, were recognized as revenues at the time of the guarantee or issuing of a loan.

E. Cash With the Department of the Treasury and On Hand

VA does not maintain cash in commercial bank accounts. Cash receipts and disbursements are processed by the Department of the Treasury. The balance in the Treasury represents the right to draw on the Treasury for allowable expenditures.

F. Method of Valuing Investments

Investments of the housing assistance program are comprised solely of subordinated certificates of securities, which were assigned to VA as partial proceeds from several non-recourse mortgage loan sales through a trust arrangement. (See note 6.) The investments are carried at cost, less an allowance for estimated foreclosures of the underlying mortgage loans (see note 5) because a market has not been established on the certificates to permit valuing them at fair market value.

G. Method of Valuing Property Held for Sale

For properties acquired after foreclosures of guaranteed, direct and vendee direct loans, VA holds the properties in inventory for sale to veterans and the general public. The properties are valued at acquisition cost, including any capital improvements, but less an allowance for estimated losses on the sale of the property.

NOTE 3: INTRAGOVERNMENTAL FINANCIAL ACTIVITIES

VA's financial activities, including housing credit assistance, interact with and are dependent upon those of the federal government as a whole. Thus, the VA housing assistance program's financial statements do not reflect the results of all financial decisions and activities applicable to the function, as if it were a stand-alone entity.

- The financial statements are not intended to report the Department's proportionate share of the federal deficit or of public borrowing, including interest thereon. Financing for budget appropriations reported on the statement of operations could derive from tax revenues or public borrowing or both; the ultimate source of this financing, whether it be tax revenues or public borrowing, has not been specifically allocated to VA.

- Financing for appropriations provided to the housing assistance program was obtained through budget appropriations. To the extent that this financing was derived from public borrowing, no interest has been capitalized because such borrowings are recorded in total by the Department of the Treasury and are not allocated to individual departments and agencies.

- Since the Department of the Treasury does not charge VA interest on borrowing from the Treasury, VA does not recognize interest costs related to foreclosed property in its financial records. In fiscal year 1989, VA held foreclosed properties for an estimated average of 6.5 months. Based on this estimate and the average interest rate for the public debt (9.0 percent), the holding costs associated with the foreclosed property held for sale were approximately $59 million in fiscal year 1989.

- The financial statements for the housing assistance program do not include the costs of management and personnel salaries and benefits, travel incurred by the personnel directly related to the origination and servicing of loans and the management and sale of VA owned property, and other services such as miscellaneous contractual services for appraisal reviews, loan examination and compliance inspections, etc. incident to the guaranteeing, insuring and making of loans. These costs were paid from funds appropriated for the general operating expenses of the VA, as follows (dollars in thousands).

Type	Fiscal Year 1989	1988
Personnel Services	$61,806	$60,239
Travel	663	517
Other Services	1,350	1,916
Total	$63,819	$62,672

The housing assistance program's statements also do not include costs for space, building repairs and maintenance, utilities, printing or computer services, which are also paid from funds appropriated for the general operating expenses of VA. While these amounts cannot be readily determined, they, along with the determinable amounts, are not considered material to the financial statements.

NOTE 4: RECEIVABLES

Advances

Advances principally represent amounts bid on properties being acquired through the foreclosed loans property acquisition process.

Accounts

Accounts receivable represent various miscellaneous receivables, such as late charges on vendee accounts and rent due from former tenants. Although VA is an active participant in Federal Debt Collection programs such as the IRS Income Tax Refund Offset, Federal Salary Offset, Litigation, Referral to Credit Reporting Agencies, and Referral to Private Collection Agencies, there are still a number of accounts where all possible collection actions will be unsuccessful. Based on VA's experience, an allowance for losses has been established at nearly 100 percent for the accounts receivables reported for individuals.

Claims

When VA pays a claim on a guaranteed loan under LGRF, federal regulations allow VA to establish a debt against the veteran for the amount of the claim paid. Claims receivable represent the established debts that have not been collected. The debt can include the following items: (1) unpaid principal balance, (2) past due interest, (3) accrued taxes, and (4) foreclosure costs, such as court costs, title search, and recording fees. Subtracted from the total debt is the net value of the property sold.

Very little of the claims debt VA establishes against the veteran is collected primarily because of the lower income of this category of veterans. Therefore, an allowance of nearly 100 percent has also been established for claim receivables.

Loans

Loans receivable are amounts due from direct and vendee loans outstanding that have not been sold. The current portion represents the amount of the home loans due within the next 12 months, and the long-term portion is the amount due beyond 12 months. Home loans have a firm repayment schedule over the life of the loans, which is generally 30 years; however, it is VA's practice to sell these home loans rather than hold them to maturity. (See note 6 for a complete explanation of VA's loan sales.)

An allowance for losses has been established on these receivables and is based on the provision for losses computation. (See note 5 for a full disclosure of the provision for loan loss computation.)

Home loans authorized but not closed amounted to $96,719,000 and $138,239,000 as of September 30, 1989, and September 30, 1988, respectively.

Receivable Balances and Related Allowances

The receivables as of September 30, 1989, consist of (dollars in thousands):

	Current	Long-Term	Total
Advances	$ 957	$ 0	$ 957
Accounts:			
Individuals/Corporations	224,821	0	224,821
Less: Allowance for Losses	(224,651)	0	(224,651)
Accounts Receivable, Net	170	0	170
Claims:			
Individuals	2,379,791	0	2,379,791
Less: Allowance for Losses	(2,377,411)	0	(2,377,411)
Claims, Net	2,380	0	2,380
Loans:			
Individuals	504,719	733,076	1,237,795
Less: Allowances for Losses	(145,207)	(102,676)	(247,883)
Loans, Net	359,512	630,400	989,912
Net Receivables	$ 362,062	$630,400	$ 993,419

The receivables as of September 30, 1988, consist of (dollars in thousands):

	Current	Long-Term	Total
Advances	$ 1,148	$ 0	$ 1,148
Accounts:			
Individuals/Corporations	201,971	0	201,971
Less: Allowance for Losses	(201,769)	0	(201,769)
Accounts Receivable, Net	202	0	202
Claims:			
Individuals	2,006,173	0	2,006,173
Less: Allowance for Losses	(2,004,167)	0	(2,004,167)
Claims, Net	2,006	0	2,006
Loans:			
Individuals	523,945	609,527	1,133,472
Less: Allowance for Losses	0	(121,035)	(121,035)
Loans, Net	523,945	488,492	1,012,437
Net Receivables	$ 526,153	$488,492	$1,015,793

The individual loans receivables as of September 30, 1989 and 1988, consisted of vendee loans (direct loans on guaranteed loan properties acquired through foreclosure and sold on credit terms) and direct loans under DLRF as follows (dollars in thousands):

	Loan principal balance September 30,	
Type of direct loan	1989	1988
Vendee loans	$1,177,452	$1,056,100
Direct loans	60,343	77,372
Total Direct Loans	$1,237,795	$1,133,472

NOTE 5: PROVISION FOR LOSSES ON GUARANTEED LOANS AND LIABILITY FOR FUTURE PAYMENT OF SUCH LOSSES

As stated in note 2.C., residential mortgage loans guaranteed by VA are originated by private lenders and are not recorded in the financial statements of VA. During each year, VA records its payments for settlements of claims received under outstanding guaranteed loan commitments as losses on foreclosed guaranteed loans. VA records payments related to the management and disposition of acquired property as property sales and management expenses. In addition, in fiscal year 1986, VA began to accrue a "provision for loan losses on guaranteed loans." To do this, VA estimates at year-end a provision for loan losses on its guaranteed loans and records increases or decreases in the estimate from one year to the next in its operating expenses. This process converts VA's accounting from a cash basis to an accrual basis and, in effect, recognizes the loan cost for the new loan guarantees made during the current fiscal year.

To accrue the loan loss provision, a methodology is used to estimate the amount of losses on guaranteed loans issued during the year. That is, for accounting purposes, a methodology is used to project the number of estimated foreclosures that VA will experience over the life of the loans guaranteed and to estimate the present value of the dollar amount of loan losses that VA will experience on the foreclosures. The projection of guaranteed loan foreclosures is based on VA's historical loan foreclosure rates in relation to loans guaranteed during the current and previous 11-year period, projected over the future 12-year period. [Note: VA's historical guaranteed loan foreclosure trend is a somewhat high rate in the early years (second through fifth year) of a mortgage loan, gradually declining to a nominal number of foreclosures commencing about the twelfth year of the generally 30 year loans.]

The average loss on foreclosed loans is then applied to the projected foreclosures to quantify the estimated dollar amount of loan losses. The projected loan loss is converted to present value basis to appropriately reflect the value of the loan losses, or cost of the new guarantees, in current year dollars for the year of issuance of the loan guarantees. The discount rate used in the present value computation was 8.9 percent for fiscal year 1989 and 8.8 percent for fiscal year 1988.

As of September 30, 1989 and 1988, respectively, the present value of the projected provision for loan losses amounted to (dollars in thousands):

September 30, 1989		September 30, 1988	
1990	$ 837,065	1989	$ 987,042
1991	639,024	1990	959,279
1992	485,247	1991	720,593
1993	351,027	1992	486,115
1994	251,600	1993	365,313
1995	171,041	1994	272,832
Subtotal	2,735,004		3,791,174
1996--2001	245,250	1995-1997	218,296
Total*	$2,980,254		$4,009,470

* The projected loan losses for fiscal year 1989 covered a 12-year period versus a 9-year period for 1988. See discussion below for explanation of this and other changes in methodology for estimating provision for loan losses during fiscal year 1989.

The provision for guaranteed loan losses and the accounting process used to record the loss result in increases or decreases in VA's operating expenses based on changes in the provision estimate from year to year--an increase in the provision balance from one year to the next increases expenses for the current year and a decrease in the provision decreases expenses. The significant decrease in the provision for losses from 1988 to 1989 (from $4 billion to $3 billion) resulted primarily from refinements that management made in the statistical methodology used to derive the estimated loan loss provision. An analysis of the effect of these refinements on the fiscal years 1988 and 1989 loan loss provisions shows that about $700 million (or 70 percent) of the 1989 reduction is due to the change in methodology, while about $300 million (or 30 percent) is attributable to a general improvement in the economy and better management of the housing assistance program during fiscal year 1989.

The refinements in the loan loss methodology are intended to result in a loan loss provision that more accurately reflects VA's historical experience and better predicts future foreclosures. The predicted foreclosures for the 3 years that the initial methodology had been used exceeded actual foreclosures to such a degree as to warrant refinement of the methodology. The utilization of the revised methodology, which primarily incorporated foreclosure rates experienced over a longer historical period, showed that a closer relationship between predicted and actual loan foreclosures would have been achieved with the revised methodology.

The recording of the provision for loan losses also results in the recognition of an allowance, or offset, against certain related assets to reflect the estimated value of those assets and the establishment of a liability for the portion of the future loan losses that will have to be financed with future cash resources as follows (dollars in thousands):

	Year ended September 30,	
	1989	1988
Offsets against loans receivable	$ 116,352	$ 156,077
Offsets against foreclosed property held for sale	100,407	144,081
Offset against investments	90,638	45,824
Liability for losses on guaranteed loans	2,672,857	3,663,488
Total Provision for Loan Losses	$2,980,254	$4,009,470

As of September 30, 1989 and 1988, there were about 3.9 million and 3.7 million of guaranteed loans outstanding, respectively. The face amount of the loans outstanding as of September 30, 1989 and September 30, 1988, was $152 billion and $150 billion, respectively. However, VA's guarantee of lenders losses on the loans amounted to only about 40 percent of the face amount of the loans, or about $60 billion for each year.

NOTE 6: BORROWINGS FROM TREASURY

The $1.7 billion liability for borrowings from the U.S. Treasury represents appropriated funds initially borrowed by DLRF between 1951 and 1963 and transferred to LGRF for cash flow deficiencies. The liability, which is owed by DLRF, does not bear an interest charge and has no required repayment date. Given the financial losses of LGRF and the financial position of both funds, management believes that repayment of this advance cannot be made by either fund. Accordingly, legislation was proposed in VA's fiscal year 1991 budget submission for a technical amendment to waive the liability. (However, the Congress did not act on VA's proposal and VA inadvertently did not include the request for waiver in its 1992 budget submission.)

NOTE 7: DIRECT (INCLUDES VENDEE) LOAN SALES AND INVESTMENTS IN SUBORDINATE CERTIFICATES

Recourse loan sales

During fiscal year 1988, VA sold approximately $379 million in loans with recourse marketing agreements for $365 million. Under the terms of the agreements, VA will repurchase the loans sold if default occurs. Any losses from defaults of repurchased loans are borne by VA, which has estimated the potential loss on the amount of such loans outstanding and has recorded this loss as a component of the provisions for loan losses. There were no recourse loan sales during fiscal year 1989.

Nonrecourse loan sales

During fiscal year 1989 and fiscal year 1988, VA conducted five nonrecourse loan sales through various trust arrangements or on the open market. The components of the sales are summarized as follows (dollars in thousands):

	FY 1988		FY 1989			
	American Housing Trust I	American Housing Trust II	American Housing Trust III	American Housing Trust IV	Whole Loans	Total
Loans receivable sold	$308,937	$234,346	$278,103	$364,670	$58,134	$1,244,190
Proceeds from Sale:						
Cash*	185,558	134,284	171,165	236,208	49,432	776,646
Investment in subordinate certificates of securities	105,059	91,391	94,557	116,695	0	407,702
	290,616	225,675	265,722	352,903	49,432	$1,184,348
Loss on loans receivable sold	$ 18,321	$ 8,671	$ 12,381	$ 11,767	$ 8,702	$ 59,842

*Information presented does not reflect the transaction expenses incurred to sell the loans.

Valuation of Investment in Subordinate Certificates of Securities

The four American Housing trust sales involved special sale arrangements whereby VA sold a specific amount of its vendee loans to various trusts, which, in turn, sold the loans as mortgage pass-through certificates. The mortgage pass-through certificates consisted of various classes of certificates that were offered to the public and subordinate certificates that were assigned to VA as partial proceeds from the sale of the loans.

The subordinate certificates were assigned to VA at the time of sale at specific face values. Principal and interest payments on the senior certificates are guaranteed by the American Loan Guarantee Association. Under the securities structure, principal and interest payments to VA are subordinate payments to the senior certificate holders.

The investments are carried at the face value of the underlying mortgage loans, or in effect cost to VA, less an allowance for estimated foreclosure losses on the underlying mortgage loans, because a market has not been established on the certificates to permit valuing at fair market value. The allowance has been recorded to reflect the estimated loss of principal as a result of the subordinated position. It is based upon historical loan foreclosures and was computed in connection with the annual provision for loan loss computation (see note 5). The net investment balances as of September 30, 1989, follows (dollars in thousands):

	American Housing Trust I	American Housing Trust II	American Housing Trust III	American Trust Trust IV	Total
Investment in subordinate certificates of securities	$104,887*	$91,391	$94,557	$116,695	$407,530
Allocation of loss provision	24,473	17,221	21,753	27,191	90,638
Net investment	$ 80,414	$74,170	$72,804	$ 89,504	$316,892

*The amount differs from the proceeds from sale amount for Trust I as shown in the preceding schedule because the proceeds from sale balance presented on that schedule represented the face amount, or principal owed, on the underlying loans at the time of sale. The September 30, 1989 amount reflects a decrease for loan principal payments made to VA and therefore a reduction in the face amount of the related loans since the date of sale.

NOTE 8: FORECLOSED PROPERTY HELD FOR SALE

The VA acquires property from homeowners who default on guaranteed or vendee loans. The properties are valued at acquisition cost and offset by an allowance for losses based on historical loan loss provision computation (see note 5), as follows (dollars in thousands):

	As of September 30,	
	1989	1988
Foreclosed property held for sale	$779,750	$962,914
Allowance for provision for losses	100,407	144,081
Net	$679,343	$818,833

NOTE 9: GUARANTEE COMMITMENTS

As of September 30, 1989, VA had outstanding commitments to guarantee various loans that will originate in fiscal year 1990.

The number 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.

NOTE 10: SUBSEQUENT EVENTS

A. Establishment of an additional Housing Credit Revolving Fund--the Guaranty and Indemnity Fund

On December 18, 1989, legislation was enacted (Public Law 101-237) which established a new fund (the Guaranty and Indemnity Fund) to finance the operation of VA's loan guaranty program for loans made on or after January 1, 1990, except manufactured (mobile) home loans and most administrative costs of operating the program. This legislation, which, among other things, increased the required loan origination fee in cases where there is no down payment on a loan and decreased the fee for guaranteed loans with a downpayment, will change the operating results and cash flow requirements of not only DLRF and LGRF, but also the overall loan guarantee program. This legislation will not change the unfunded loss (about $2.7 billion) incurred on the outstanding direct and guaranteed loans as of September 30, 1989. The legislation did, however, reduce the loan origination fees that will be available to finance the losses and other financial requirements of the Loan Guaranty and Direct Loan Revolving Funds (i.e., the majority of the origination fees collected on new loans will be available only for paying cash requirements of the new fund).

B. Credit Reform Act

The Federal Credit Reform Act of 1990 (Title V of the Congressional Budget Act of 1974, as amended by the Omnibus Budget Reconciliation Act of 1990) was enacted in part to institute a consistent and comparable basis of measuring the costs of cash and credit transactions so that proper budgetary decisions on the use of limited financial resources can be made. Currently, a direct loan is recorded in the budget as a cash outlay in full when it is disbursed. In contrast, the guarantee of a loan disbursed by a private lender is recorded in the federal budget only when cash outlays are made such as upon the default of the borrower. The difference in the budgetary treatment between direct loans and guaranteed loans creates a bias in favor of guarantees because their costs are deferred.

The Credit Reform Act states that "All funding for an agency's administration of a direct loan or loan guarantee program shall be displayed as distinct and separately-identified subaccounts within the same budget account as the program's costs." Accordingly, commencing in fiscal year 1992, accounting and financing activities relative to VA's three existing housing funds will change. Transactions relative to direct loans and loan guarantee commitments outstanding as of September 30, 1991, will be recorded in three liquidating accounts. All subsidy costs, including the administrative costs currently not allocated to the housing assistance program, arising from new direct loan obligations and loan guarantee commitments will be recorded in new program and financing accounts for the year in which the loans and guarantees originate.

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