FISCAL YEAR 2005

MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

AUDITED FINANCIAL STATEMENTS

November 7, 2005

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND FISCAL YEAR 2005 AUDITED FINANCIAL STATEMENTS

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DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND
MANAGEMENT'S DISCUSSION AND ANALYSIS

YEARS ENDED SEPTEMBER 30, 2005 AND 2004

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Medicare Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The FY2001 National Defense Authorization Act (NDAA) directed the establishment of the Medicare Eligible Retiree Health Care Fund to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for space available care in Military Treatment Facilities (MTFs). The Fund covers Medicare-eligible beneficiaries, regardless of age. (In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees, i.e., retirees themselves, dependents of retirees, and survivors.)

The NDAA also established an independent three-member DoD Medicare Eligible Retiree Health Care Board of Actuaries appointed by the Secretary of Defense. The Board is required to review the actuarial status of the Fund; to report annually to the Secretary of Defense, and to report to the President and the Congress on the status of the Fund at least every four years. The DoD Office of the Actuary provides all technical and administrative support to the Board.

Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness, through the Office of the Assistant Secretary of Defense for Health Affairs (TRICARE Management Activity [TMA]), has as one of its missions operational oversight of the Defense TRICARE Health Delivery System, including management of the Medicare Eligible Retiree Health Care Fund (the Fund). The Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund.

In Fiscal Year (FY) 2005, the Fund initially authorized approximately $5.3 billion in total health care services, civilian providers ($3.7B), military medical treatment facilities ($1.2B) and Military Service Personnel Accounts ($0.4B), on behalf of Medicare-eligible retirees, retiree dependents, and survivors. During FY 2005 budget execution, an additional purchased care requirement ($1.2B) was identified and approved by the Office of Management and Budget (OMB) in support of increased utilization, particularly pharmacy services, above projected demand.

Final Fiscal Year Requirements and Funding

Fiscal Year	Final (Billions)	Purchased Care (Billions)	Operating & Maintenance (Billions)	Military Personnel (Billions)
2005	$6.5	$4.9	$1.2	$.4
2004	$5.4	$4.0	$.9	$.5
2003	$4.6	$3.4	$.8	$.4

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's Service cost (this process will change starting in FY 2006 to a once-a-year Treasury payment at the beginning of the year based on budgeted force strengths), annual payments from the

Treasury to amortize the unfunded liability, and investment income. During the last two years of the Fund's operation, the income was received from the following sources:

MERHCF Funding Sources

Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) (Billions)	Normal Cost Contribution (Billions)	Interest on Investments (Billions)
2005	$15.7	$10.5	$2.2
2004	$16.3	$8.1	$.9
2003	$14.4	$8.2	$.2

No accounts of the Fund have been excluded from the Fund's financial statements.

Overview of the Defense Health Program (DHP)

The Defense Health Program is known as TRICARE. Covered beneficiaries include:

- Active duty Service members
- Dependents of active duty Service members
- Military retirees
- Dependents of military retirees
- Full-time reservists
- Dependents of full-time reservists
- Survivor dependents of military retirees and those who died on active duty

The TRICARE program consists of a combination of military medical treatment facilities (MTFs) and regional networks of civilian providers that work together to provide care to eligible beneficiaries. The MTFs include 70 inpatient facilities and 826 medical and dental clinics in the United States and overseas. Those facilities provide care for approximately 9.2 million beneficiaries and also serve as a training ground for military medical personnel. Because the direct care health system's capacity is not large enough to serve the health care needs of all eligible beneficiaries, DoD has ensured that active duty Service members receive top priority for care at the military facilities, while other beneficiaries can receive direct care services on a "space-available" basis. If care is not available in MTFs, beneficiaries seek care from civilian providers paid through the TRICARE program via the Managed Care Support Contracts and the TRICARE for Life (TFL) program.

Managed Health Care Plans (Non-Medicare-Eligible Beneficiaries)

Individuals have access to different levels and types of benefits depending on their beneficiary status. Active duty Service members generally obtain care from military medical treatment facilities. When necessary (MTF referrals for care not available in the MTF or emergency situations), active duty personnel may obtain care from civilian providers, at government expense. Family members of active duty personnel as well as military retirees and dependents who are not eligible for Medicare can choose from one of three main options:

- ***TRICARE Prime*** is similar to a civilian health maintenance organization (HMO). Beneficiaries are assigned to a primary care manager, who coordinates all aspects of their medical care. Enrolled beneficiaries may be assigned a MTF primary care manager or a civilian primary care manager.

- ***TRICARE Extra*** is similar to a civilian preferred provider organization. Beneficiaries pay lower co-payments than they would under TRICARE Standard if they seek care from a provider in the TRICARE network.
- ***TRICARE Standard*** is a fee-for-service plan that allows beneficiaries to seek care from any civilian provider and be reimbursed for a portion of the costs after paying co-payments and meeting deductibles.

Funding for MTF (direct) care services and civilian purchased care for non-Medicare eligible beneficiaries is provided through annual Congressional appropriations.

Medicare Eligible Retiree Health Care Plan of Benefits

The FY 2001 National Defense Authorization Act (NDAA) significantly expanded the DoD health care benefits for Medicare-eligible military retirees, their dependents and survivors. The NDAA established the TRICARE Senior Pharmacy Program that began on April 1, 2001, and the "TRICARE for Life" benefits that became effective on October 1, 2001.

The TRICARE Senior Pharmacy Program authorizes eligible beneficiaries to obtain low-cost prescription medications from the TRICARE Mail Order Pharmacy (TMOP) and TRICARE network and non-network civilian pharmacies. Beneficiaries may also continue to use military hospital and clinic pharmacies, at no charge. The pharmacy program is available to beneficiaries age 65 and over.

If beneficiaries age 65 and over cannot obtain care in a military medical treatment facility, they can receive essentially no charge civilian care through the TRICARE for Life program. With this program TRICARE serves as the final payer to Medicare and other health insurance for Medicare covered benefits, and first payer for TRICARE benefits that are not covered in the Medicare or other health insurance programs.

TRICARE for Life covers Medicare-eligible retirees 65 years of age or older, including retired guardsmen and reservists and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The Medicare-eligible retirees and family members of the non-DoD Uniformed Services (Coast Guard, Public Health Service, and National Oceanic and Atmospheric Administration) are also eligible for these benefits.

Finally, DoD beneficiaries, including Medicare-eligible beneficiaries, in specific locations where Uniformed Services Family Health Plan (USFHP) facilities are available, may enroll in these capitation rate plans. These plans include inpatient and outpatient services and a pharmacy benefit. The capitation rate is paid by DoD. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs as well as benefits under the TRICARE for Life and Senior Pharmacy programs.

Health Care Purchased From Civilian Providers

In accordance with Department of Defense Instruction (DoDI) 6070.2, dated July 19, 2002, the TRICARE Management Activity (TMA) reports each day obligations to the Fund for purchased care provided in the civilian sector. Daily claims are validated by the voucher edit procedures required by the TRICARE/CHAMPUS Automated Data Processing Manual 6010.50-M (ADP), May 1999, to ensure that only costs attributable to Medicare-eligible beneficiaries are included in payments drawn from the Fund.

At the end of each month, claims processing costs are reconciled against monthly distribution estimates and any over and/or under charged amounts are applied to the estimated requirement for the following

month. During the month of September, as fiscal year-end approaches, more frequent reconciliation between charged accounts and available funds may occur and processing can continue up to a predetermined cut-off date established by TMA in coordination with DFAS.

TMA reports obligations to the Fund for the estimated USFHP obligation amount based on the contract-specific capitation rates for Medicare-eligible beneficiaries enrolled for each USFHP hospital contract option period twice per year, upon the commitment of funds prior to the start of the option period. Each USFHP hospital's reported enrollment is used to reconcile contracted enrollment estimates for Medicare-eligible beneficiaries. At the end of each option period, total charges are reconciled against the estimate and any over and/or under charged amounts are applied to the estimated requirement for the following option period.

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TRICARE for Life/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management Division. By agreement with DFAS, disbursement transactions are provided by email the day prior to payment processing. DFAS uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The purchased care payments for FY 2005 were approximately $4.9 billion as compared to $4.0 billion in FY 2004 and $3.4 billion in FY 2003.

In the past, purchased care claims were processed by one of two Fiscal Intermediaries (FIs); Wisconsin Physician's Service (WPS) or Palmetto Government Business Administration (PGBA), depending on the managed care region in which the Medicare-Eligible beneficiary received care. Each region is managed by a different Primary Managed Care Contractor. The FIs serve as sub-contractors to the Managed Care Support Contractors for each of the managed care regions. The region in which care was received by the Medicare-eligible beneficiaries, then, determined which FI processed the TRICARE claim as a second payer to Medicare.

In April 2004, TMA awarded a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) to WPS. Dual eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. With the TDEFIC contract, WPS now processes all claims supported by the Fund, regardless of geographic region in which care was received.

Having a single FI to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. Under the old FI contracts, claims administrative costs averaged $1.40 for electronic claims and $5.98 for paper claims. The TDEFIC contract stipulates $1.31 for electronic claims and $3.93 for paper claims.

Payment For Health Care Provided In Military Medical Treatment Facilities (MTF)

TMA annually develops prospective payment amounts for care estimated to be provided in MTFs to Medicare-eligible beneficiaries. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and Defense Health Program (DHP) Operations and Maintenance (O&M) costs. TMA provides a memo to DFAS with the payment amounts by Service for MILPERS and DHP O&M that is reported on the Statement of Transactions (FMS 224) by DFAS.

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent fiscal year for which data is complete at the time the calculations are prepared. TMA develops, in coordination with the Military Departments and Office of the Undersecretary of Defense (Comptroller) (OUSD(C)), MTF-

specific rates in accordance with DoDI 6070.2, July 19, 2002. MEPRS cost data are recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using standard OMB inflation rates applicable to those years. MEPRS data is recorded and maintained by the Military Departments in accordance with DoD 6010.13-M, "Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities," November 21, 2000.

OUSD(C) distributes MTF prospective payment amounts based on the calculated annual total program amount to the Military Departments for MILPERS costs and to TMA for DHP O&M costs. TMA, in turn, distributes DHP funds to the Military Departments for execution. OUSD(C) includes financial authority in the DHP Expense Operating Budget to finance the annual financial plan requirement of the prospective payment.

When the year of execution is completed and the associated workload and cost data are available, TMA conducts an execution review in coordination with OUSD(C) and the Military Departments. A comparison of prospective payment amounts to actual workload and costs is accomplished in accordance with DoDI 6070.2, July 19, 2002.

The prospective payment for O&M for MTF provided care to Medicare-eligible beneficiaries in FY 2005 was $1.1 billion versus $0.9 billion in FY 2004. Increases in O&M expenditures are primarily due to increased drug costs and utilization of outpatient pharmacy services. While the cost of inpatient and outpatient services has risen slightly, the utilization of these services has remained fairly constant. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries in FY 2005 was $0.42 billion versus $0.47 billion in FY 2004. MILPERS costs have decreased primarily as a result of a decreasing inflation rate for Army personnel costs.

Performance Measures

There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2005, the Fund had net assets available to pay benefits of $60.7 billion and an actuarial liability of $537.4 billion; the funding ratio was 11.3%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

Types of Investments

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost (this process will change starting in FY 2006 to a once-a-year Treasury payment at the beginning of the year based on budgeted force strengths), annual payments from Treasury to amortize the unfunded liability, and investment income.

The Fund receives investment income from a variety of Treasury-based instruments such as bills, notes, bonds and overnight investment certificates. Treasury bills are short-term securities with maturities of less than one year issued at a discount. Treasury notes are intermediate securities with maturities of one to ten years. Treasury bonds are long-term debt instruments with maturities of greater than ten years. Overnight certificates are interest-based market securities purchased from the Treasury that mature the next business day and accrue interest based on the Federal Reserve Bank of New York survey of Reserve repurchase agreement rates.

The Fund also invests in Treasury Inflation Indexed Securities (TIIS) also known as Treasury Inflation Indexed Protected Securities (TIPS), which are indexed for inflation. TIIS/TIPS are fixed-rate instruments designed to protect against inflation, and the principal amount is indexed to the consumer price index (CPI) by adjusting the CPI at issuance to the current CPI ; as inflation increases, so does the principal amount and the coupon.

All of these instruments are debt obligations of the U.S Government and are backed by the "full faith and credit" of the government. Debt obligations of the U.S. Government have virtually no risk of nonpayment of principal and interest at the specified due date.

The Fund receives management oversight from the Department of Defense Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service, the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller) and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board met in FY 2005 and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. In April 2004, the Investment Board approved a new Investment Strategy. The previous strategy established a ladder of investment maturities over a period of 10 years. After reviewing current cash flow needs of the Fund and discussing investment opportunities with numerous Investment Advisors, the new strategy seeks to match the duration of the assets with the duration of the liability.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to report payments that should not have been made or that were made in an amount different than that required by law, regulation, or contract. The Office of Management and Budget Circular A-11, "Preparation, Submission, and Execution of the Budget," includes provisions implementing this Act.

In FY 2004, the Medical-Eligible Retiree Health Care Fund (MERHCF) and non-Medicare-eligible claims were co-mingled and reported as part of the overall audit results. Claims processing for the MERHCF purchased care transitioned to a separate TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) in April 2004. For FY 2005, separate error rates are being calculated. However, the FY 2005 results of the TDEFIC audit will not be available until mid-2006.

The Defense Health Program has numerous prepayment and post-payment controls built into the claims processing system to minimize improper payments.

One control is the claims edit system, which re-bundles services that should be billed under a single comprehensive procedure code, but are broken out by medical service providers to increase reimbursement. This is a fraudulent inflationary practice that, left unchecked, contributes to excessive health care costs. An example of this practice occurs when providers unbundle charges that should be included in a global surgical package. Some Current Procedural Terminology (CPT) surgical codes represent an all inclusive charge to include certain types of anesthesia, pre-op visits, post-op care in the recovery room, and typical follow-up visits after discharge for a 90-day period. Physicians who perform the entire global package should bill for their services with the single comprehensive surgical code. An example is:

Unbundled Billing

30520 – Repair of Nasal Septum	$547.60
00160 – Anesthesia, nose/sinus	$246.60
99214 – Pre-op Visit	$ 64.25
99231 – Subsequent Hospital Visit	$ 37.03
TOTAL:	$895.48

Re-bundled (Proper Billing)

30520:	$547.60

A cost avoidance of $110,674,822 was realized in FY 2004 as a result of the military health benefits program re-bundling edits. Anticipating that this trend will continue, the Department projects approximately a 10% increase in the amount of the cost avoidance for FY 2005.

Prepayment review is another control that enhances the accurate payment of claims. Prepayment review allows for a closer review of the services rendered and may require the provider to submit medical documentation to support the services billed. In calendar year 2004 prepay review resulted in a cost savings of $7.3 million.

The Department also mandates that each contractor have a fraudulent claims investigation or anti-fraud unit to identify and investigate any pattern of suspicious or potential fraudulent billings. Artificial intelligence software is a contract requirement to facilitate data mining to identify questionable billing practices. In calendar year 2004, there were $6 million in fraud judgments for TRICARE. Another $2.29 million was identified for administrative recoupment.

The Department projected a $100.1 million of improper payments for the military health benefits program (purchased care) in FY 2004. The final figure from completed audits is $99.6 million. This represents an error rate of 1.31% of the $7.6 billion in military health benefits program payments made during FY 2004.

The Department has established performance standards for claims processing with a zero tolerance for unallowable costs. The TDEFIC contractor is required to attempt to collect from providers/patients reimbursement for erroneous payments. If unable to collect reimbursement, the TDEFIC contractor will subtract balances owed the government from future claims. As a last alternative, unresolved erroneous claims are transferred to TMA General Counsel for collection efforts. In addition, the TDEFIC contractor is faced with a financial disincentive if the annual dollar amount of erroneous payments exceeds 2% of claims processed. This contractual design provides a built-in incentive for the contractors to continually perfect their claims processing system, to the extent that financial costs outweigh any benefits. This meets the desired premise for "continued improvement" required under the Improper Payment Improvement Act.

Claims Audit Sampling Methodology

For each audit quarter a sample of the claims with data processed within the specified audit quarter is selected for payment error auditing. Variable Sampling, using stratified Sampling with Optimum Allocation, is used to calculate the sample size for the Payment Errors. The sample size is determined with 90% confidence level and 1% precision. Only TRICARE Encounter Data (TED) records which pass batch header and TED edits are sampled.

Twelve different sample strata are used for the TDEFIC contract with government (contract) cost ranging from $0 to less than $25,000. Another stratum consists of all claims with government costs of $25,000 and over. Claims with government costs $0 - <$25,000 are broken down into the following 12 strata:

0	>=$25,000
01	$5,000 - <$25,000
02	$2,000 - <$ 5,000
03	$1,000 - <$ 2,000
04	$ 500 - <$ 1,000
05	$ 200 - <$ 500
06	$ 100 - <$ 200
07	$ 75 - <$ 100
08	$ 50 - <$ 75
09	$ 25 - <$ 50
10	$ 15 - <$ 25
11	$ 7.5 - <$ 15
12	$ > 0 - <$ 7.5

To calculate the sample size of each stratum, the formula below is applied:

$$n_i = \frac{N_i \sigma_i \sum(N_i \sigma_i)}{N^2((1/t)*S)^2 + \sum(N_i \sigma^2_i)}$$

where n_i is the sample size of each stratum, i = 1 to 12,

N_i is the universe size of each stratum,

σ_i is the standard deviation of the government cost for each stratum,

N is the universe size for all 12 strata,

t is 1.645 at 90% confidence level,

S is the product of 0.01 (precision level) and the mean of the government cost for all 12 strata combined.

A total of 12 n_i is calculated.

A finite population correction is applied to each stratum sample size using the formula below:

$$n_c = \frac{n}{1= (n-1)/N}$$

where n_c is corrected sample size for each stratum,

n is the uncorrected sample size for each stratum calculated previously as ni,
N is universe size for that stratum, which Ni in the previous calculation.

A final sample size is calculated by summing all the corrected stratum sample sizes.

Finite population correction is first applied on each stratum, before the summation of sample sizes of all strata. A minimum sample size of 30 is forced into each stratum. If the stratum universe count is less than 30, all the claims in that stratum are audited.

The sampling methodology for denied claims is similar to that of the non-denied claims. However, the stratification is based on billed amount instead of the government cost. For the TDEFIC contract, ten sample strata are used for denied claims with billed amounts $500,000 and over. Claims with billed amounts $0 - <$500,000 are broken down into the following 10 strata:

0	>=$500,000
01	$100,000 - <$500,000
02	$ 40,000 - <$100,000
03	$ 20,000 - <$ 40,000
04	$ 10,000 - <$ 20,000
05	$ 4,000 - <$ 10,000
06	$ 2,500 - <$ 4,000
07	$ 1,250 - <$ 2,500
08	$ 625 - <$ 1,250
09	$ 300 - <$ 625
10	$ >0 - <$ 300

Status of FY 2004 Audit Findings

Our independent auditors noted material weaknesses and other discrepancies during the conduct of the FY 2004 Financial Statement Audit. The material weaknesses center around two issues; the lack of a patient-level cost accounting system and insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs.

At issue with the lack of a patient-level cost accounting system is the fact that the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2005 and 2004 includes approximately $91 billion (17% of total) and $81 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, and for the year ended September 30, 2004, include approximately $3.9 billion and $1.4 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within

DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

True patient-level cost accounting systems are currently not available within TRICARE. In lieu of such a system, the DoD has developed the cost allocation tool, MEPRS. It enables our MTFs to allocate all costs associated with the daily operation of the facility into the inpatient, outpatient, dental, and ancillary service cost centers. Average costs per weighted workload unit can then be computed for various patient care activities.

These average costs per weighted workload unit can then be applied to specific care provided to specific patients by reviewing the Standard Inpatient Data Record (SIDR) and Standard Ambulatory Data Record (SADR) reported in the MHS Data Repository (MDR). The SIDRs and SADRs are prepared for each patient encounter and contain patient specific information, to include name, Social Security Number, sponsor or dependent status, and Medicare eligibility. Further, the SIDRs and SADRs reflect the diagnosis and any procedures that were performed on the patient for that specific encounter. The average costs per weighted workload unit computed in MEPRS is then applied against the specific data contained in the SIDRs and SADRs to determine an average cost for the specific care provided to a specific patient. Estimates of the weighted workload that will be provided to Medicare-eligible beneficiaries are calculated for each MTF based on historical experience. When the weighted workload costs are applied against the projected workload volume for each MTF, a prospective payment distribution plan can be computed for each MTF for the next fiscal year.

The prospective payments made to the MTFs are reconciled with actual workload activity after the close of the fiscal year. The results of the reconciliation are used to adjust projections of MTF workload levels and costs for the future prospective payment distribution plan. The results of the reconciliations will not be used to make adjustments to the current prospective payment distribution plan either during execution year activities or to a specific distribution subsequent to the close of the fiscal year's operation.

At issue with the prospective payment process are several applications; validation/reconciliation of financial data prior to its input into the MEPRS cost allocation process, archiving of MEPRS data at the close of each month, and timeliness of the reconciliation of the fiscal year prospective payment plan. Additionally, there may be several other issues, not classified as material weaknesses, which may require resolution.

To assist in resolving these discrepancies and in developing a detailed corrective action plan leading to an unqualified audit opinion on the MERHCF Financial Statements, TMA management has contracted with *BRADSON CORPORATION*. *BRADSON*, a local accounting consulting firm, has extensive experience in assisting other government agencies in making improvements in their financial reporting processes underlying their financial statements. They are coordinating TMA corrective action responsibilities with DFAS and other entities' responsibilities to ensure appropriate and complete corrective actions are taken to raise the financial management activities of each appropriate entity to a level that will lead to an unqualified opinion for the MERHCF Financial Statements.

To address the issue of validation/reconciliation of financial data prior to its input into MEPRS cost allocation process, *BRADSON* is working with TMA, each of the Services' Surgeon's General (SG) Offices, and DFAS to develop detailed, Service specific financial reconciliation processes. While they have visited all three Service SG Offices and selected Army, Navy, and Air Force MTFs, they have concentrated their initial efforts on Navy medical facility operations. In September 2005, they submitted a working draft report of their review of financial operations at Bethesda National Naval Medical Center. Reports involving the Naval Medical Centers in San Diego and Portsmouth should be submitted during

the first quarter of FY 2006. Reports involving Army and Air Force medical facilities are scheduled for later in FY 2006. Implementation of Service specific financial reporting reconciliation processes are scheduled for the Navy during second quarter FY 2006 and late in the fourth quarter FY 2006 for the Army and Air Force.

The other material weakness dealing with the controls over the timeliness and accuracy of the medical record coding processes at the MTFs is continually being addressed. Coding accuracy of inpatient records is approximately 90%. However, accuracy of coding outpatient and ambulatory surgery encounters is much less, 10% to 20%. Proper and accurate coding of medical records is essential for ensuring quality of care and to accurately document diagnosis and treatment procedures in the SIDRs and SADRs. Health Affairs (HA) has long since identified medical record coding as a deficiency requiring attention. HA/TMA has published both a DoD Directive for medical records retention and coding and a DoD Instruction on medical encounter and coding at MTFs. Realistic goals for medical records coding accuracy have been established and discussed with the Services' Surgeons General.

Additionally, the three Surgeons General are required to certify monthly data quality reports. In completing the data quality reports, the MTFs are required to randomly select inpatient, outpatient, and ambulatory surgery encounters for review to determine coding accuracy and, then, reflect the results in the monthly quality reports. Furthermore, Health Affairs has, for several years, contracted with AdvanceMed to conduct independent audits of a random sample of inpatient, outpatient, and ambulatory surgery records at MTFs to verify coding accuracy. The results of these independent audits are shared with the Service Surgeons General and the Tri-Service Data Quality Management Control committee.

To the extent the element of human error can be minimized, medical record coding will be positively affected. Therefore, included in the new clinical workload reporting system, Composite Health Care System II (CHCS II), is an enhanced provider coding capability. Deployment of CHCS II should improve medical record coding although improvement and maintenance are iterative processes that require continual attention.

The correction of medical record coding discrepancies is a current material weakness that, due to operational control, belongs to the Services' Medical Services. Health Affairs/TMA are committed to monitoring the Services' development of corrective action plans to improve medical record coding accuracy and to continue reviews of coding accuracy, to include independent audits.

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care for the Fund's beneficiaries relies on data files provided by TMA to the Office of the Actuary (OOA). Due to the lack of a fully integrated financial management system to support the Defense Health System, certain data is provided to OOA from health care operational sources, rather than from the accounting and financial records of claims payment activity. As a result, inconsistencies were noted in the FY 2004 accumulation of the data utilized for the IBNR estimation process as compared with the Fund's financial records. The variance was due primarily to improperly defining the population supported by the MERHCF when retrieving claims data for the IBNR calculation. Corrective action was taken to accurately identify the discrepancies and resolve the issue.

Further, the Contract Resource Management (CRM) Division in Aurora, Colorado, monitors claims processing activities performed by the TDEFIC fiscal intermediary, WPS, in support of purchased care activities for Medicare-eligible beneficiaries. During FY 2004, CRM transitioned to a new claims documenting data base which resulted in claims processing discrepancies that generated significant claims

adjudication backlogs in the last quarter of FY 2004 and the first quarter of FY 2005 (aggregating approximately $133 million). Consequently, an update to the IBNR calculation was not made for the first quarter of FY 2005. The backlog of claims has been corrected and updated calculations of IBNR were made for subsequent quarters of this fiscal year. However, we have not quantified the complete effects of the backlog on the MERHCF financial statements for FY 2004 and FY 2005.

Currently, there are no explicit provisions in the TDEFIC contract requiring the fiscal intermediary to provide, and certify to, incurred claims reserve amounts for a particular time period. The MERHCF Board of Actuaries has recommended such provisions be included in the contract as a means to insure all financial, actuarial, auditing, and management analyses are based on consistent and accurate data. Furthermore, computation of an IBNR reserve by the TDEFIC contractor would serve as a check and balance against the OOA/TMA calculated IBNR, and, in the event a future claims processing backlog, the contractor would be better positioned to produce a reliable IBNR estimate to be used for actuarial purposes and in the preparation of financial statements. The feasibility and estimated cost of modifying the TDEFIC contract to require such a calculation by the contractor is being investigated.

Coast Guard Issue

The determination of the amount of funds to be provided by the MERHCF to the Coast Guard for care provided in their clinics to Medicare-eligible beneficiaries remains an open issue. In FY 2004, Coast Guard representatives presented to the MERHCF Audit Committee an annual requirement of approximately $2.5 million. This estimate was based on historical budget reports and average costs for patients seen in their clinics and for prescribed medications from their pharmacies.

The Audit Committee questioned the rationale of the assumptions and computations used to project the annual requirement and asked the Coast Guard Inspector General (CGIG) to review and approve the cost estimate methodology and funds request. Further, the Audit Committee requested a formal written request for funds signed by a senior Coast Guard official once the methodology was reviewed and approved by the CGIG.

At the close of FY 2005, the Coast Guard and the CGIG were in the process of developing an acceptable methodology for the computation of MERHCF funding requirements to support Coast Guard MTF care given to Medicare dual-eligible beneficiaries. The MERHCF Audit Committee will not approve the release of MERHCF funds to Coast Guard clinics until a formal written request is submitted with CGIG approval.

Army Over-Payment of FY 2004 Monthly Normal Cost Contribution

The MERHCF receives revenue from the Treasury and the Uniformed Services. These intragovernmental earned revenues include the following:

1. Annual unfunded actuarial liability payment from the Treasury
2. Monthly contributions from the Uniformed Services (normal cost), and
3. Interest earned on investments from the Treasury

Each month, the Military Services' contributions process includes the following actions:

- The Military Services calculate their monthly normal cost contributions
    - Military Services prepare monthly end-strength reports

    - o Multiply monthly end-strength by the standard full-time (active duty) or part-time (Guard/Reserve) normal cost contribution rate provided by the Office of the Actuary (OOA)
- The Services provide the contribution information to the appropriate DFAS Center
- Each DFAS Center transfers the contribution to the MERHCF via the Intragovernmental Payment and Collection System (IPAC)

The DoD MERHCF Board of Actuaries approves all methods and assumptions used for determination of the normal cost contribution rates. OOA calculates the normal cost contribution rates each year based on an actuarial model that computes the amount needed to fund the current-year liability for a cohort of new entrants to the military. For FY 2003, the full-time rate was $353, and the part-time rate was $134. For FY 2004, the full-time rate was $381, and the part-time rate was $155.

On April 15, 2004, the Army verbally notified the MERHCF of a possible over-reporting of its personnel end-strength, resulting in a possible over-payment of the normal cost contributions to the Fund. At the time, the Army did not know the amount of the possible over-payment. The MERHCF disclosed information regarding this issue in Note 19A of MERHCF's Un-audited Financial Statements for the six months ended March 31, 2004.

Subsequently, the Army completed a schedule that compares actual payments made to payments calculated using its revised Army end-strength reports for active duty and ready reserve. The revisions resulted in calculated over-payments to the Fund of $394.6 million and $241.4 million in Fiscal Years 2003 and 2004, respectively.

For FY 2003 and FY 2004, the Army Reserve Budget Office calculated the MERHCF contribution using the monthly end-strength reports and the appropriate part-time rates. However, the Active Army Budget Office also calculated the MERHCF normal cost contribution for those same activated Reserves and made payment at the full-time rate from the Active Army funds. The Active Army Budget Office made these over-payments for the activated Reserves from October 2002 to February 2004.

In May 2004, the DoD General Counsel provided an opinion that the refund should be made to FY 2003 funds and FY 2004 funds in the same amounts as over-paid from those years.

Over-payments by the Army to the Fund were verified by the Chairman of the MERHCF Audit Committee.

Review of the impact on the FY 2003 and FY 2004 MERHCF financial statements revealed that the Balance Sheet for FY 2003 and the quarterly Balance Sheets for FY 2004 would have changed by the amount of the over-payments. The Army over-payment of normal cost contributions and the resulting over-statement of revenues do not affect the ending Actuarial Liability balance, and the amount of the change is less than 1% of the total Actuarial Liability. Therefore, we concluded that the $394.6 million change in FY 2003 and the $241.4 million over-statement of revenues in FY 2004 interim financial statements was not material and did not adversely affect the conclusions drawn by a reasonable reader, and represented a change in the previous estimates of required Army contributions.

Since the change in estimate was not material to the MERHCF financial statements for any period and would not adversely affect the conclusions drawn by a reasonable reader, we did not make any changes to previously issued FY 2003 and FY 2004 financial statements. We did adjust the un-audited financial statements for the nine months ended June 30, 2004 by the $394.6 million payable to Army, a $241.4 million prepaid revenue and a reduction in revenues for $636.0 million. The correction to the over-

payment is the recognition of the liability to the Army when it becomes probable and measurable as per Statements of Federal Financial Accounting Standard No. 5. Over-payments in FY 2004 were credited to future FY 2004 contributions. Therefore, the MERHCF applied the FY 2004 over-payment to required FY 2004 Army contributions. All corrective actions were taken prior to September 30, 2004. Appropriate disclosure of the change in estimate was made in the 3rd quarter and year-end FY 2004 MERHCF financial statements and footnotes.

DoD Inspector General Audit of Military Services' Monthly Normal Cost Contribution

As stated in the previous section, the Uniformed Services are one of the sources from which the MERHCF receives intragovernmental earned revenue (normal cost contribution) each year.

The DoD MERHCF Board of Actuaries approves all methods and assumptions used for determination of the normal cost contribution rates. OOA calculates the normal cost contribution rates each year based on an actuarial model that computes the amount needed to fund the current-year liability for a cohort of new entrants to the military. For FY 2004, the monthly full-time rate was $381, and the part-time rate was $155. The FY 2005 full-time and part-time rates increased to $447 and $261, respectively.

During FY 2005, the DODIG conducted an audit on the "Accuracy of the Contributions to the Medicare-Eligible Retiree Health Care Fund" (Project No. D2005-D2000FJ-0081.000). On July 12, 2005, the DODIG issued its findings and recommendations as follows:

FY 2005 DODIG Findings: The Military Departments did not always contribute the correct amounts to the Fund in the two quarters the DODIG reviewed. In the fourth quarter of FY 2004, the Navy overpaid the Fund by $602,175 and the Air Force underpaid the Fund by $393,235. Additionally, the Military Departments underpaid the Fund by $218.8 million in the first quarter of FY 2005. The Navy and the Air Force made adjusted payments to the Fund to correct FY 2005 underpayments identified during this audit. The Army's FY 2005 underpayment of $32.97 million was a result of the Army erroneously using the FY 2004 per capita normal cost contribution amount instead of the FY 2005 per capita amount in the first quarter of FY 2005. This underpayment had not been received into the Fund as of the close of FY 2005. Therefore, an intragovernmental receivable was booked in the fourth quarter of FY 2005 and will be recouped in the first quarter of FY 2006.

FY 2005 DODIG Recommendations:

1. The Under Secretary of Defense (Comptroller)/Chief Financial Officer should issue written guidance for implementing the legislative change requiring the Department of Treasury to make the annual normal cost contributions to the MERHCF on behalf of the Services starting in FY 2006. (see next section on "Legislative Proposals)
2. The Assistant Secretary of Defense (Health Affairs) should:
    i. Issue written guidance to the Military Departments outlining the criteria and schedule for making corrective payments or requesting corrective collections.
    ii. Disclose the Military Departments' contribution errors in the footnotes section of the FY 2005 Medicare-Eligible Retiree Health Care Fund Financial Statements.
    iii. Approve a credit to future Navy contributions for the amount of $602,175 because of the FY 2004 Marine Corps Reserve overpayment.
3. The Assistant Secretary of the Army (Financial Management and Comptroller), Assistant Secretary of the Navy (Financial Management and Comptroller), and the

Assistant Secretary of the Air Force (Financial Management and Comptroller) should establish written procedures for their respective contribution processes.

4. The Assistant Secretary of the Air Force (Financial Management and Comptroller) should:
    iv. Direct Air Force personnel to prepare the contributions to the Fund instead of delegating the responsibility to DFAS.
    v. Contribute $393,235 to the Fund because of the FY 2004 Air National Guard underpayment.

The Services' responses to the above recommendations are pending.

The Under Secretary of Defense (Comptroller) has agreed to place written guidance in the Financial Management Regulation (FMR) describing implementation of the legislative change requiring the Department of Treasury to start making annual normal cost contributions on behalf of the Services in FY 2006.

The Office of the Assistant Secretary of Defense (Health Affairs), in part, concurs with the audit recommendations. Also, revision to current DoD guidance on the operation of the MERHCF will be made in the first quarter of FY 2006. This guidance will include a description of the methodology for computing the normal cost contribution to be made by the Department of Treasury at the beginning of each fiscal year beginning in FY 2006.

However, since the guidance discusses the payment to be made by the Department of Treasury, it will not outline either criteria or a schedule for making corrective payments or requesting corrective collections. The Office of the Actuary and the DoD General Counsel have agreed that only one normal cost contribution payment will be made by the Department of Treasury at the beginning of the year, and it will be based on "expected average force strength". If actual force sizes throughout the fiscal year vary from the expected size, no retroactive adjustment will be made to the normal cost contribution. To the extent there is a difference, the normal actuarial process will adjust/fund through the actuarial gain/loss mechanism addressed in the current law (USC, Title 10, Chapter 56, (1115(c)(4)).

Finally, per a DoD General Counsel ruling, the Fund cannot comply with the recommendation to approve a $602,175 credit to future Navy contributions for the FY 2004 overpayment by the Marine Corps Reserve. A reimbursement can be made to the Navy to cover FY 2004 requirements, but a credit for future payments/requirements is not allowed. Action on this recommendation was not finalized during FY 2005 as the DODIG Audit Report on the Military Services' Monthly Normal Cost Contributions was not finally published.

Legislative Proposals

The 2005 National Defense Authorization Act (NDAA), Section 725, directs that at the beginning of each fiscal year (after September 30, 2005), the Treasury will pay into the Fund the normal cost contribution previously paid by the Services' MILPERS accounts. No impact is expected on Fund operations as a result of this action. The Department of Treasury will make one lump-sum normal cost contribution on behalf of the Services at the beginning of the fiscal year along with the unfunded accrued liability payment. Rather than the Services providing monthly payments into the Fund based on actual monthly personnel end-strengths, the Treasury will make one payment based on the expected average force strength (budgeted). As has been the case with the monthly payments made by the Services, the Treasury payment will be computed using the actuarially developed per capita rates.

Specifically, the DoD MERHCF Board of Actuaries will issue a letter each year approving the required amortization payment and the required normal cost contributions for DoD, U.S. Coast Guard, Public Health Service (PHS), and National Oceanic and Atmospheric Agency (NOAA). The normal cost per capita rates determined by the Board of Actuaries are multiplied by the expected average force strength for the fiscal year. The Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) then prepares a letter to the Secretary of the Treasury for the Secretary of Defense signature certifying the total amortization payment and the DoD normal cost contribution amounts. In addition, the letter requests the Treasury issue warrants at the start of the fiscal year to the MERHCF for the amortization payment and to the 10 new MERHCF contribution accounts set up by the Office of Management and Budget (OMB) for the DoD contributions. Each of these contribution accounts corresponds to one of the 10 military personnel accounts (Active, Reserve or National Guard). OUSD(C) also submits a letter apportionment request to OMB for the 10 MERHCF contribution accounts. Once the Treasury issues the warrants at the start of the fiscal year, the Services will, that same day, transfer all of the funding to the MERHCF. DoD contributions are then complete for the fiscal year. The Secretaries of Commerce, Department of Homeland Security, and Health and Human Services will need to separately certify and request warrants from the Treasury for their normal cost contributions.

Pharmaceutical Refunds for Retail Pharmacy Support

The Veterans Health Care Act (VHCA) of 1992, codified at 38 U.S.C., 126, established federal ceiling prices (FCP) of covered pharmaceuticals (requiring a minimum 24% discount off non-Federal average manufacturing prices (non-FAMP) – non-FAMP procured by the four designated agencies covered in the Act: Department of Veterans Affairs (VA), Department of Defense (DoD), Coast Guard, and the Public Health Service/Indian Health Service. VA administers the VHCA discount program on behalf of the four specified agencies. Under the Federal Supply Schedule (FSS) program (41 U.S.C., 259(b)(3)(A)), the General Services Administration (GSA) has authorized VA to award and manage schedule contracts with pharmaceutical companies. FSS contracts allow Federal agencies to obtain pharmaceuticals at prices associated with volume buying which, at times, may be lower than FCPs under VHCA. DoD currently has access to FCP and FSS prices for pharmaceuticals used in military treatment facilities (MTFs) and the TRICARE Mail Order Pharmacy (TMOP) program by either direct purchases or procurements through a Defense Supply Center Philadelphia (DSCP) Prime Vendor. Federal prices were not available to DoD through retail pharmacies under the previous at-risk TRICARE Managed Care Support Contracts (MCSCs) because VA had determined that the contracts were not structured to meet the VHCA statutory requirements for an agency-controlled centralized commodity management system. The VA's decision reflected concerns that pharmaceuticals would not be traceable to DoD, pharmaceutical payments were not made directly by DoD, and there was no assurance that DoD (vis-à-vis a contractor) would receive the benefit of federal pricing.

The new TRICARE Retail Pharmacy Program (TRRx) carved out retail pharmacy from the MCSCs, consolidated delivery of retail prescriptions under a single Pharmacy Benefits Manager (PBM) contract, and addressed VA's previous concerns under VHCA. The PBM contractor provides a retail pharmacy network and acts as fiscal intermediary, upon TMA authorization, to issue funds from a government account in payment for prescriptions dispensed to TRICARE beneficiaries. A government organization, the DoD Pharmacy Benefits Office (PBO), uses the reporting and audit capabilities of the Pharmacy Data Transaction Service (PDTS)* to verify beneficiary eligibility from the Defense Enrollment Eligibility Reporting System (DEERS), check for drug interactions, and authorize prescription payments. PDTS also identifies covered drugs eligible for federal pricing. The PBO, using industry standard reports from PDTS, will provide to manufacturers itemized data on covered drugs procured through TRICARE retail network pharmacies to obtain appropriate refunds on covered drugs subject to federal pricing. The PBM contractor has no role in DoD's process for obtaining refunds for the government based on FCPs already

established by the VA and DoD, in accordance with the VHCA. DoD's contract with and payments to the PBM contractor are not related, either directly or indirectly, to federal pricing of pharmaceuticals dispensed to TRICARE beneficiaries by network pharmacies.

*The PDTS, fully deployed since June 2001, creates a centralized data repository that records information about prescriptions filled for DoD beneficiaries at MTFs, the TRICARE Retail Pharmacy Network, and the TRICARE Mail Order Pharmacy Program. Transactions and messaging are based on National Council for Prescription Drug Program (NCPDP) standards, which is the Health Insurance Portability and Accountability Act (HIPAA) standard pharmacy transaction code set. The primary purpose of the PDTS is to improve the quality of prescription services and enhance patient safety by conducting on-line interactive screening of the patient's entire medication profile and alert notification prior to the dispensing of the prescription; thereby reducing the likelihood of drug-drug interactions, therapeutic overlaps, and duplicate treatments. PDTS also serves as the conduit for eligibility verification via the DEERS and transmission of TRICARE Encounter Data (TED) for financial accountability for the TRICARE Mail Order Pharmacy and TRICARE Retail Pharmacy contracts.

General Concept

▪ Apply Federal Pricing as the basis for refunds for overpayment on covered drugs DoD purchases through the TRICARE Retail Pharmacy Network under the TRICARE Retail Pharmacy Benefit Program.

▪ Transition to electronic virtual depot system for pharmaceutical commodity management with electronic accountability for TRICARE Retail Pharmacy Network.

▪ Pharmacy Benefit Office (PBO) as the Commodity Manager.

▪ PDTS provides robust audit trail and reporting process for accountability.

▪ FCP applies to TRRx purchases – at least 24% off non-FAMP.

▪ Other Federal Pricing not currently applicable unless specific language included for TRRx purchases:

a. Federal Supply Schedule (FSS) pricing
b. Incentive Agreements
c. Blanket Purchase Agreements (BPAs)
d. Temporary Price Reductions (TPRs)
e. VA/DoD Contracts

Claims Coverage

The refund process is only applicable to retail **network** claims, beginning October 1, 2004. The data file consists of only claim types included in the refund process. The PBO will ensure through the use of several types of flags that non-eligible claims are not included in the data file.

Claims ***excluded*** from the TRICARE Retail refund reports are:

- Dispensings that occurred at MTFs;
- Dispensings that occurred at TRICARE Mail Order Pharmacy (TMOP);
- Retail dispensings submitted for reimbursement by non-network pharmacies;
- Retail dispensings submitted for reimbursement by DoD beneficiaries;
- Retail dispensings submitted for reimbursement by state Medicaid agencies;
- Retail dispensings submitted for reimbursement by commercial payers (e.g., Coordination of Benefits (COB) claims);
- Retail dispensings submitted for reimbursement by aggregators/clearinghouses;
- Compounded prescriptions;
- Repackaged products (until such time as a correlation to the originator product can be achieved);
- Abbreviated New Drug Application (ANDA) Generics (Note: PDTS uses First Data Bank's Generic Name Indicator and other proprietary algorithms for filtering out "generics");
- Over-the-counter (OTCs) medications; and
- Obsolete items (i.e., over three years old).

Format
Data is at the transaction level, based on date of service with data elements pertaining to the drug, the pharmacy, and the beneficiary. The data in the reports only contains utilization data for prescriptions written for DoD beneficiaries, dispensed at network retail pharmacies, and paid for by DoD.

Claims adjudicated for Medicare-eligible DoD beneficiaries, which are paid from the MERHCF, are segregated by PDTS to enable refunds for these claims to be deposited back into the MERHCF for proper accountability. Separate reports are generated for claims paid for MERHCF beneficiaries and non-MERHCF beneficiaries.

Data
The level of detail for the reports is by prescription, and identifies the individual pharmacy by its NCPDP#, Pharmacy Name on file with NCPDP, zip code, and prescription number of the claim. The date on the utilization report for each prescription is the date the service was provided to the beneficiary by the network retail pharmacy.

The TRRx utilization reports identify all dispensing pharmacies by NCPDP#, and do not include purchases from any non-network pharmacies. Purchases from non-network pharmacies are not subject to refunds based on Federal pricing.

Report Generation and Delivery
The data file is compiled and available on the 15th of each month for the prior month's utilization. Monthly reporting is being offered to allow manufacturers the opportunity to review data early and gain experience with the program. Quarterly reports, on which refunds are calculated, are available on the 15th of the month following the end of each calendar quarter. The quarterly reports, not the monthly reports, are used to process all refunds. A separate report for MERHCF and non-MERHCF accounting is generated and provided to each manufacturer for the covered products.

Manufacturers' Non-Compliance with Retail Pharmacy Refund Program/Legal Status

The federal government believes that all pharmaceuticals purchased by DoD through the retail pharmacy network are subject to the federal ceiling prices, effective October 1, 2004, under the Veterans Health Care Act. These are the prices that have long applied to pharmaceuticals purchased by DoD and

dispensed through military facility pharmacies and the TRICARE Mail Order Pharmacy program. Most pharmaceutical companies have refused to comply with the legal requirements to honor federal pricing for the retail pharmacy network. A group of companies has initiated a legal challenge to the federal government's interpretation of the Veterans Health Care Act. This litigation is pending before the U.S. Court of Appeals for the Federal Circuit. The current status of the litigation is that briefs are being filed. Oral argument has not yet been scheduled, but may occur before year's end.

FY 2005 Receipts and Recording of Collections in the MERHCF Financial Statements

The FY 2005 MERHCF estimated retail pharmacy refunds from the pharmaceutical manufacturers, had they all complied with the Veterans Health Care Act, would have been approximately $179 million ($148 million from Federal Ceiling Prices and $31 million from Federal Supply Schedule). However, as of August 15, 2005, the MERHCF had received only $19.6 million. These collections have been recorded as a "contra expense" within the Gross Cost With the Public line item rather than Earned Revenue. Due to the pending litigation and the resultant uncertainty of future retail pharmacy refund collections, management decided not to establish an Account Receivable for the remaining estimated balance for this program in FY 2005.

Should the court ruling on this litigation be in the government's favor, we would then revisit the issue of establishing accounts receivable and developing an allowance for doubtful accounts for retail pharmacy refunds.

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the MERHCF pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the MERHCF in accordance with the formats prescribed by the Office of Management and Budget, the statements are different from the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization they are for a federal entity; unfunded liabilities reported in the financial statements can not be liquidated without the enactment of an appropriation; and the payment of all liabilities other than for contracts can be abrogated by DoD.

Comparative Financial Data

Comparatively, several line items on three of the financial statements have changed significantly from FY 2004 to FY 2005. The Balance Sheet, Statement of Net Costs, and Statement of Budgetary Resources each contain line items that show large changes from one fiscal year to the next.

The Balance Sheet reflects significant increases in "Total Assets," "Actuarial Liabilities," and "Benefits Due and Payable" (Incurred But Not Reported, IBNR). Total Assets increased from $38.6 billion in FY 2004 to $60.7 billion in FY 2005. The increase in FY 2005 is attributable primarily to Service normal cost contributions of $10.5 billion, Treasury annual unfunded actuarial liability payments of $15.7 billion in, and interest on investments of $2.2 billion. This phenomenon will continue into future years as the annual deposits/investments into the Fund exceed annual health care expenditures.

The Actuarial Liability has increased from $504.1 billion to $537.4 billion. The increase ($ in Thousands) tracked as follows:

Actuarial Liability as of September 20, 2004	$504,073,807
Expected Normal Cost for FY 2005	$ 10,613,753
Expected Benefit Payments for FY 2005	$ (6,546,888)
Interest Cost for FY 2005	$ 31,629,776
Actuarial (gains)/losses due to other factors	$ (14,902,660)
Actuarial (gains)/losses due to changes in trend assumptions	$ 12,529,304
Actuarial Liability as of September 30, 2005	$537,397,092
Change in Actuarial Liability	$ 33,323,285

Each year the Actuarial Liability is expected to increase with normal cost (+$10.6 billion), decrease with benefit payments (-$6.5 billion), and increase with the interest cost ($31.6). The actuarial loss due to new medical trend assumptions is $12.5 billion. The actuarial gains and losses due to other factors (net -$14.9 billion) includes new population data, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend assumptions.

Benefits Due and Payable on the Balance Sheet represent the purchased care claims reserve, also know as the Incurred But Not Reported (IBNR) liabilities. Current IBNR liabilities increased $270.8 million from fourth quarter FY 2004 to fourth quarter FY 2005. The increase is attributable to (in millions of dollars, and percent of overall increase) as follows:

1. $130.1 (49%) – an increase due to medical cost trends
2. -$33.0 (-13%) – a decrease due to replacing the overall administration load with loads by service type (e.g. inpatient, outpatient, and prescription) and updated administration load information
3. $163.4 (60%) – the effects of claim processing backlog and revised treatment of accounts payable
4. $10.3 (4%) – an increase due to prescription reconciliation of data used to calculate IBNR with accounting data

The Statement of Net Cost reflects a change in Net Cost of Operations from $5.2 billion in FY 2004 to $11.6 billion in FY 2005. The net increase of $6.4 billion is attributable to an increase in Gross Costs with the Public of $9.2 billion which is partially offset by an increase in Intragovernmental Earned Revenue of $3.1 billion. The $3.1 billion increase in Intragovernmental Earned Revenue consists of a decrease in U.S. Treasury Annual Unfunded Liability payment ($600 million), an increase in Service contributions ($2.4 billion), and an increase in interest on investments ($1.3 billion). The increase of $9.2 billion in Gross Costs with the Public is due to the following reasons:

1. An increase in payments to the daily purchased care operations of $979.0 million
2. An increase in the change of IBNR payables of $34.4 million
3. An increase in Allowance for Estimated Uncollectibles of $0.3 million
4. A decrease in Accounts Receivable of $4.4 million
5. The change in the estimate of the actuarial liability that resulted in an increase of expenses of $8.3 billion.

Within the Statement of Budgetary Resources significant changes from FY 2004 to FY 2005 are reflected in the "Unobligated Balance" ($18.2 billion in FY 2004 to $206 million in FY 2005), "Temporarily Not Available Pursuant to Public Law" ($0 in FY 2004 to $21.8 billion in FY 2005), and "Status of Budgetary Resources" ($43.3 billion in FY 2004 to $6.5 billion in FY 2005). These changes were driven by new guidance from the Office of Management and Budget (OMB). OMB advised that certain U.S. Standard

General Ledger accounts are inconsistent with the budget presentations for certain Special and Trust Fund Receipts. Consequently, the unobligated fund balance brought forward in FY 2005 had to be reclassified as receipts unavailable or precluded from obligation for the DoD Medicare-Eligible Retiree Health Care Fund. Beginning with September 30, 2005, year-end reporting, the unobligated unavailable balance is no longer visible on the Statement of Budgetary Resources.

More detailed comparisons between FY 2004 and FY 2005 line items can be found in all of the MERHCF's principal statements. Balances representing a 10 percent increase between fiscal years on any component of a line item are considered material and are discussed in the corresponding footnote.

Internal Controls Over Financial Reporting and on Compliance and Other Matters

During an independent audit of the Fund's financial statements, the auditor "identified deficiencies related to the internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of financial statements. Because of these deficiencies, the auditor believes the Fund's financial management system does not meet the requirements of an integrated financial management system as defined in OMB Circular A-127, with respect to consistent internal control over data entry, transaction processing and reporting. Further, the auditor believes the Fund is not in compliance with the system design requirements sufficient to comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data".

More detailed discussion of the auditors findings on internal controls can be found in the "Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based Upon the Audit Performed in Accordance with Government Auditing Standards".

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DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

PRINCIPAL STATEMENTS

Department of Defense
DoD Medicare Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30
(In Thousands)

	2005	2004
ASSETS		
Intragovernmental:		
Fund Balances with Treasury (Note 2)	$ 5,000	$ 5,000
Investments (Note 3)	60,691,679	38,585,158
Accounts Receivable, Net (Note 4)	32,970	0
Total Intragovernmental Assets	$ 60,729,649	$ 38,590,158
Accounts Receivable, Net (Note 4)	11,256	8,018
TOTAL ASSETS	$ 60,740,905	$ 38,598,176
LIABILITIES		
Accounts Payable	$ 241,705	$ 129,226
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Notes 5 & 6)	537,397,092	504,073,807
Benefits Due and Payable (Notes 5 & 6)	762,163	491,344
TOTAL LIABILITIES	$ 538,400,960	$ 504,694,377
NET POSITION		
Cumulative Results of Operations	$ (477,660,055)	$ (466,096,201)
TOTAL NET POSITION	$ (477,660,055)	$ (466,096,201)
TOTAL LIABILITIES AND NET POSITION	$ 60,740,905	$ 38,598,176

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Medicare Eligible Retiree Health Care Fund
STATEMENTS OF NET COST
For the Years Ended September 30
(In Thousands)

	2005	2004
PROGRAM COSTS		
Intragovernmental Gross Costs	$ 1,561,330	$ 1,380,721
(Less: Intragovernmental Earned Revenue) (Note 7)	(28,412,396)	(25,342,438)
Intragovernmental Net Costs	$ (26,851,066)	$ (23,961,717)
Gross Costs With the Public (Note 7)	38,414,920	29,133,679
Net Costs With the Public	$ 38,414,920	$ 29,133,679
Total Net Cost	$ 11,563,854	$ 5,171,962
Net Cost of Operations	$ 11,563,854	$ 5,171,962

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Medicare Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30
(In Thousands)

		2005		2004
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	$	(466,096,201)	$	(458,080,939)
Total Financing Sources		0		(2,843,300)
Net Cost of Operations (+/-)		11,563,854		5,171,962
Ending Balances	$	(477,660,055)	$	(466,096,201)

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Medicare Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30
(In Thousands)

		2005		2004
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations Received	$	28,128,834	$	25,100,279
Temporarily Not Available Pursuant to Public Law (Note 2)		(21,839,520)		0
Beginning of Period (Note 2)		206,625		18,182,430
Total Budgetary Resources	$	6,495,939	$	43,282,709
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Direct	$	6,398,727	$	5,196,769
Unobligated Balance:				
Apportioned		97,212		206,625
Unobligated Balance Not Available		0		37,879,315
Total Status of Budgetary Resources	$	6,495,939	$	43,282,709
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net - Beginning of Period	$	262,058	$	267,771
Obligated Balance, Net - End of Period:				
Undelivered Orders	$	146,176	$	132,833
Accounts Payable	$	241,705	$	129,225
Outlays:				
Disbursements	$	6,272,905	$	5,202,482
Less: Offsetting Receipts		(28,379,426)		(25,342,438)
Total Outlays	$	(22,106,521)	$	(20,139,956)

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Medicare Eligible Retiree Health Care Fund
STATEMENTS OF FINANCING
For the Years Ended September 30
(In Thousands)

		2005		2004
RESOURCES USED TO FINANCE ACTIVITIES				
Budgetary Resources Obligated				
Obligations Incurred	$	6,398,727	$	5,196,769
Less: Offsetting Receipts		(28,379,426)		(25,342,438)
Net Obligations		(21,980,699)		(20,145,669)
Other Resources				
Transfers In/Out Without Reimbursement	$	0	$	(2,843,300)
Total Resources Used to Finance Activities	$	(21,980,699)	$	(22,988,969)
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS				
Change in Budgetary Resources Obligated For Goods, Services and Benefits Ordered But Not Yet Provided:				
Undelivered Orders	$	(13,343)	$	28,977
Other		0		2,843,300
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	$	(13,343)	$	2,872,277
Total Resources Used to Finance the Net Cost of Operations	$	(21,994,042)	$	(20,116,692)
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Components Requiring or Generating Resources in Future Periods:				
Other	$	33,594,104	$	25,296,672
Components not Requiring or Generating Resources:				
Trust Fund Exchange Revenue		(32,970)		0
Other		(3,238)		(8,018)
Total Components of Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	$	33,557,896	$	25,288,654
Net Cost of Operations	$	11,563,854	$	5,171,962

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

NOTES TO THE PRINCIPAL STATEMENTS

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND
NOTES TO THE PRINCIPAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2005 AND 2004

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. The Department of Defense (DoD) Medicare Eligible Retiree Health Care Fund (the Fund or MERHCF) was authorized by Public Law (PL) 106-398 for the accumulation of funds to finance the liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. The Fund began operations effective October 1, 2002.

These financial statements report the financial position and results of operations for the Fund, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Trust Fund Accounting Division, Accounting Directorate, Defense Finance and Accounting Service (DFAS), in accordance with the requirements of Office of Management and Budget (OMB) Circular A-136 "Financial Reporting Requirements" and accounting principles generally accepted in the United States of America. The Fund's financial statements are prepared by DFAS in addition to the financial reports, pursuant to OMB directives, which are used to monitor and control budgetary resources within the Fund. More detailed explanations of these financial statement elements are discussed in applicable footnotes.

B. Mission of the Reporting Entity. The mission of the Fund is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries.

The asset accounts used to prepare the statements are categorized as either entity or non-entity assets, where applicable. Entity accounts consist of resources that the agency has the authority to use, or where management is legally obligated to use funds to meet entity obligations. Non-entity accounts are assets that are held by an entity but are not available for use in the operations of the entity.

C. Appropriations and Funds. The Fund was authorized by the "Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001." The purpose of the Fund is to pay the costs of all Military Service and uniformed services retiree health care programs for the benefit of members or former members of a participating service who are entitled to retired or retainer pay and are Medicare-eligible, their dependents who are Medicare-eligible, and their survivors who are Medicare-eligible.

The Fund's appropriations are designated special funds. These appropriations are used to fund the daily execution of the Fund's mission. The Fund is classified as a special fund and uses both receipt and expenditure accounts. The Fund's U.S. Treasury symbol is 97X5472.

D. Basis of Accounting. Under authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to its three principal members, the Secretary of the Treasury, the Director of the OMB, the Director of the Office of Personnel Management and the Comptroller General of the United States; who are co-principals of the Joint Financial Management Improvement Program (JFMIP). The Statements of Federal Financial Accounting Standards (SFFAS) have been issued by the FASAB, following procedures adopted by the FASAB principles. Some SFFAS have deferred effective dates.

In April 2000, the American Institute of Certified Public Accountants (AICPA), in its Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles (GAAP) in the Auditor's Report,* as amended by SAS No. 91, "Federal GAAP Hierarchy," established the following hierarchy of accounting principles for federal government entities.

(A) FASAB Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to Federal governmental entities by a FASAB Statement or Interpretation.

(B) FASAB Technical Bulletins and the following pronouncements, if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.

(C) AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins, if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB.

(D) Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government.

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance to the circumstance. When directed by OMB, through OMB Circular A-136, generally accepted accounting principles in the United States of America serve as authoritative guidance for federal agencies in preparing reports that are addressed within OMB Circular A-136.

E. Revenues and Other Financing Sources. Financing sources for the Fund are provided primarily through an annual unfunded actuarial liability payment from Treasury, monthly contributions from the Military Services and Uniformed Services (United States Coast Guard, the National Oceanic and Atmospheric Administration, and the United States Public Health Service), and interest earned on investments. The monthly contributions are calculated by multiplying the monthly per capita rates (full time and part time) provided by the DoD Office of the Actuary by the reported end strength for the most recently reported month. Contributions are recognized when due to the Fund. Starting in FY 2006, the beginning-of-fiscal-year Treasury contribution will also include the total normal cost amount for the year, determined based on Board-approved per capita normal cost rates and expected average force strengths for the Uniformed Services. Thus, starting in FY 2006 the Services will no longer make monthly contributions into the Fund. The FY 2005 Defense Authorization Act assigns Treasury, vice the Uniformed Services, the responsibility of paying normal cost contributions into the Fund, starting in FY 2006.

F. Recognition of Expenses. For financial reporting purposes, the Fund recognizes benefit expenses in the period incurred. During the interim quarters, prior to the last quarter, advances are made for the upcoming quarter's Military Treatment Facility (MTF) expenses. Those expenses are recognized at the outset of each quarter, and they are recorded as an advance to the MTFs. There is no advance recorded at September 30, 2005.

G. Accounting for Intragovernmental Activities. The Fund purchases and redeems non-marketable market-based securities issued by the United States Treasury, Bureau of Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS), and overnight certificates. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. Treasury notes have maturities of at least one-year, but not more than ten years, and are purchased at a discount or premium. Treasury bonds are long-term securities with maturity terms of ten years or more and are purchased at either a discount or premium. TIPS are floating-rate instruments designed to protect against inflation and the principal amount is indexed to the consumer price index (CPI) by adjusting the current CPI to the CPI at issuance; as inflation increases, so does the principal amount and the coupon.

The Fund records investments at book value, representing amortized cost. The Fund recognizes the amortization of discounts and premiums using the effective interest method. The Fund receives interest on the value of its non-marketable market-based securities from Treasury on a semi-annual basis for U.S. Treasury bonds and notes.

H. Funds with the U.S. Treasury. The U.S. Treasury allows the Fund to be fully invested. Therefore, the Fund Balance with Treasury (FBWT) may be zero during various quarters of the fiscal year.

The Fund's financial resources are maintained in U.S. Treasury Accounts. DFAS processes all Fund receipts and adjustments. DFAS prepares monthly reports, which provide information to the U.S. Treasury on transfers and deposits.

In addition, DFAS submits reports to Treasury, by appropriation, on collections received. Treasury then records this information to the FBWT account maintained in the Treasury system. Differences between the Fund recorded balance in the FBWT account and the Treasury FBWT are reconciled.

I. Accounts Receivable. As presented in the Balance Sheets, accounts receivable includes accounts, claims, and refunds receivable from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the Fund.

J. Investments in U.S. Department of Treasury Securities. Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. These securities are redeemable at market value exclusively through the Federal Investment Branch of Treasury. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 3.

K. Net Position. Net position consists of unexpended appropriations and cumulative results of operations.

L. Comparative Data. FY 2004 and FY 2005 financial statements are presented for comparative purposes. The Office of Management and Budget advised that certain U.S. Standard General Ledger accounts presented in the quarterly FACTS II are inconsistent with the budget presentations submitted with the budget Schedule N (Special and Trust Fund Receipts). Consequently, the unobligated fund balance brought forward in FY 2005 had to be reclassified as receipts unavailable or precluded from obligation for the DoD Medicare Eligible Retiree Health Care Fund. As a result, beginning with September 30, 2005, year-end reporting, the unobligated unavailable balance is no longer visible on the Standard Form (SF) 133, "Report on Budget Execution and Budgetary Resources."

M. Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and changes therein and the actuarial present value of accumulated plan benefits at the date of the financial statements. Actual results could differ from those estimates.

N. Actuarial Information. The Medicare Eligible Retiree Health Care Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year based on population information as of the beginning of the year and updated to the end of the year using accepted actuarial techniques. The "projected benefit obligation" method is used as required by SFFAS No. 5, "Accounting for Liabilities of the Federal Government."

NOTE 2. FUND BALANCES WITH TREASURY

($ In Thousands)	FY 2005	FY 2004
Fund Balances:		
Trust Funds	$5,000	$5,000
Status of Fund Balance with Treasury:		
Unobligated Balance		
Available	$97,212	$206,625
Unavailable	0	37,879,315
Obligated Balance not yet Disbursed	60,106,716	262,058
Non –Budgetary FBWT	(60,198,928)	(38,342,998)
Total	$5,000	$5,000

Fund Balances. Fund Balance with Treasury (FBWT) is maintained at approximately $5,000 to ensure that sufficient funds are available to cover estimated daily disbursements with the remaining funds invested in non-marketable market-based securities.

For FY 2004, FBWT was labeled Trust Funds as there was no disclosure provision made for Special Funds. For FY 2005, the FBWT was "Special Funds", as there is a new disclosure provision for Special Funds. Thus, the disclosure for September 30, 2005 is more defined.

Status of Fund Balance. The Office of Management and Budget advised that certain U.S. Standard General Ledger accounts are inconsistent with the budget presentations for certain Special and Trust Fund Receipts. Consequently, the unobligated fund balance brought forward in FY 2005 had to be reclassified as receipts unavailable or precluded from obligation for the DoD Medicare Eligible Retiree Health Care Fund. The amounts of Unobligated Balances, Obligated Balance not yet Disbursed, and Non-FBWT Budgetary Accounts were impacted by the OMB directed restatement for FY2005. Beginning with September 30, 2005, year-end reporting, the unobligated unavailable balance is no longer visible on the Statement of Budgetary Resources.

NOTE 3. INVESTMENTS

($ In Thousands)	FY 2005				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
Intragovernmental Securities:					
Non-Marketable, Market-Based	$60,873,720	Effective Interest	$ (684,873)	$60,188,847	$60,085,976
Subtotal	$60,873,720		$(684,873)	$60,188,847	$60,085,976
Interest Receivable	502,832		0	502,832	502,832
Total	$61,376,552		$(684,873)	$60,691,679	$60,588,808

	FY 2004				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
Intragovernmental Securities:					
Non-Marketable, Market-Based	$38,576,057	Effective Interest	$ (233,059)	$38,342,998	$38,971,708
Subtotal	$38,576,057		$ (233,059)	$38,342,998	$38,971,708
Interest Receivable	242,160		0	242,160	242,160
Total	$38,818,217		$(233,059)	$38,585,158	$39,213,868

Investments increased from $38,342,998 in FY 2004 to $60,188,848 in FY 2005 because of a cumulative positive cash flow. The investments listed above are presented at Amortized Cost and Market Value as of September 30, 2005 and 2004. Listed below are the Par Values of the U.S. Treasury Securities referenced above.

Par Value	FY 2005
Bonds	$2,000,000
Notes	22,384,102
Overnights	3,499,832
TIPS	24,989,166
Total	$52,873,100

Par Value	FY 2004
Bonds	$ 2,000,000
Notes	23,384,102
Overnights	2,205,928
TIPS	8,273,660
Total	$35,863,690

Note: Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, the recipient is paid the adjusted principal or original principal, whichever is greater.

NOTE 4. ACCOUNTS RECEIVABLE

($ In Thousands)	FY 2005		
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable Net
Intragovernmental Receivables:	$32,970	$0	$32,970
Nonfederal Receivables (From the Public)	$11,604	($348)	$11,256
Total Accounts Receivable	$44,574	($348)	$44,226

($ In Thousands)	FY 2004		
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable Net
Nonfederal Receivables (From the Public)	$8,018	($0)	$8,018

Other Information:

Intragovernmental

The $32,970 in Intragovernmental receivables as of September 30, 2005 was a result of the Army erroneously using the FY 2004 per capita amount instead of the FY 2005 per capita amount in the first quarter FY 2005. This underpayment was identified in the fourth quarter and will be recouped in first quarter FY 2006.

Non-Federal

Non-Federal Accounts Receivable, Net increased $3.2 million or (40%). The increase is primarily attributable to the transfer of health care processing to new contractors which, because of a new contractual provision, required additional review of the accounts receivable balance during the transition process. The new contractual provision requires the contractor making the payments to separately identify trust fund debt. The amount of the receivable identified in the fourth quarter of FY 2004 was an estimate.

Included in the balance is $1,700 mail order pharmacy debt. Patients are required to make a co-payment for each prescription obtained through the mail order pharmacy program. The co-payment is collected by the mail order pharmacy contractor and is to be returned to the Fund. This amount represents co-payments due during the fourth quarter FY 2005 that have been collected by the contractor but not yet returned to the Fund. This amount will be collected during the first quarter of FY 2006.

The remaining balance reflected in this note represents a combination of receivables that are:
1) less than 180 days old ($6,700) due from providers and beneficiaries for over payments.
2) $3,200 of accounts receivable that are individually less than $600 dollars and up to two years old and not forwarded to the TMA General Counsel/Treasury for collection, but are held by the contractor for continued collection efforts throughout the life of the fiscal intermediary contract.

The Allowance for Estimated Uncollectibles is calculated as a percentage (three percent) of receivables from all sources. The majority of the receivables are held by the TRICARE Dual-Eligible Fiscal Intermediary (TDEFIC). The allowance for uncollectible accounts is based on an analysis of the actual uncollectible amounts experienced during FY 2004 and the first three quarters of FY 2005.

NOTE 5. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES

	FY 2005		
($ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
Nonfederal Liabilities:			
a. Accounts Payable	$241,705	$0	$241,705
b. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 6)	$59,816,047	$477,581,045	$537,397,092
c. Benefits Due and Payable	$0	$762,163	$762,163
Total Liabilities:	$60,057,752	$478,343,208	$538,400,960

	FY 2004		
($ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
Nonfederal Liabilities:			
a. Accounts Payable	$129,226	$0	$129,226
b. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 6)	$38,085,939	$465,987,868	$504,073,807
c. Benefits Due and Payable	$0	$491,344	$491,344
Total Liabilities:	$38,215,165	$466,479,212	$504,694,377

Total Liabilities Covered by Budgetary Resources increased in FY2005 by $21,842,587 primarily due to increased assets of $22,142,729. The increased assets result from contributions exceeding beneficiary payments. Liabilities are considered covered by budgetary resources if they are to be funded by permanent indefinite appropriations, which have been enacted and signed into law as of the balance sheet date, provided that the resources may be apportioned by OMB without further action by the Congress and without a contingency having to be met first.

The $112,479 Non-Federal Accounts Payable increase is attributable to a new contract provision that requires the separate recording of Accounts Payable for the Fund rather than using estimates. The accounts payable represent payments due the TRICARE Dual-Eligible Fiscal Intermediary (TDEFIC) contractor (Wisconsin Physician Services) and the pharmacy fiscal intermediary (Express Scripts) for payments they made for health care and pharmaceuticals provided to Medicare-eligible beneficiaries. Accounts payable are processed within approximately 10 to 12 days with the exception of mail order pharmacy pharmaceutical supplies and non-network healthcare claims. Non-network claims are those claims for which beneficiaries have other health insurance. Final processing of these claims cannot be completed until all documentation showing the other insurance company's claims processing have been received.

The $762,163 and $491,344 for September 30, 2005 and 2004, respectively, in Benefits Due and Payable represents the recording of Incurred But Not Reported (IBNR) costs. Current IBNR liabilities increased $270,819 from FY 2004 to FY 2005. The increase can be attributed to (in millions of dollars, and percent of overall increase) the following:

1. ($130.10, 49%) – an expected increase due to medical cost trends
2. ($-33, -13%) – a decrease due to replacing the overall administration load with loads by service types (e.g., Inpatient, Outpatient, and Rx) and updated administration load information
3. ($163.4, 60%) – the effects of claim processing backlog and revised treatment of accounts payable
4. ($10.3, 4%) – an increase due to Rx reconciliation of data used to calculate IBNR with accounting data

NOTE 6. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES

($ In Thousands)	FY 2005			
Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Actuarial Liability
Medicare-Eligible Retiree Benefits	$537,397,092	6.25%	$(59,816,047)	$477,581,045
Total:	$537,397,092		$(59,816,047)	$477,581,045

($ In Thousands)	FY 2004			
Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Actuarial Liability
Medicare-Eligible Retiree Benefits	$504,073,807	6.25%	$(38,085,939)	$465,987,868
Total:	$504,073,807		$(38,085,939)	$465,987,868

Other Information Pertaining to Military Retirement Benefits and Other Employment-Related Actuarial Liabilities:

The actuarial liability reported above does not include $762,163 and $491,344 in incurred but not reported (IBNR) liabilities as of September 30, 2005 and 2004, respectively. These liabilities are disclosed in Note 5, Liabilities Not Covered and Covered by Budgetary Resources, as Benefits Due and Payable.

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Claims cost assumptions for direct care were based on actual experience; assumptions for purchased care were developed from industry-based cost estimates adjusted to approximate the military retired population. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. For purposes of the Fund's financial reporting, this process is applied annually.

Projected revenues into the Medicare Eligible Retiree Health Care Fund, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on Fund assets, monthly Uniformed Services “normal cost” contributions, and annual contributions from the Treasury Department. The monthly contributions are determined as a per-capita amount (approved by the DoD Medicare Eligible Retiree Health Care Board of Actuaries) times end strength. The contribution from Treasury is paid into the Fund at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed prior to October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines Treasury’s contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment. Starting in FY 2006, the beginning-of-fiscal-year Treasury contribution will also include the total normal cost amount for the year, determined based on Board-approved per capita normal cost rates and expected average force strengths for the Uniformed Services. Thus, starting in FY 2006 the Services will no longer make monthly contributions into the Fund.

FY 2005

Actuarial Cost Method Used for MERHCF Liability: Aggregate Entry-Age Normal

Assumptions in Calculation of MERHCF Liability: Interest Rate: 6.25%

Medical Trend:

Medicare Inpatient:	3.2% from FY04 to FY05, ultimate rate of 6.25% in 2029
Medicare Outpatient:	5.6% from FY04 to FY05, ultimate rate of 6.25% in 2029
Medicare Prescriptions (Direct Care):	10.0% from FY04 to FY05, ultimate rate of 6.25% in 2029
Medicare Prescriptions (Purchased Care):	15.2% from FY04 to FY05, ultimate rate of 6.25% in 2029

The medical cost trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2005, by 28%, or approximately $149.9 billion.

Market Value of Investments in Market-Based and Marketable Securities ($ in Thousands): $60,085,976

Change in MERHCF Actuarial Liability
($ in Thousands)

a. Actuarial Liability as of September 30, 2004 (all uniformed services Medicare)	$504,073,807
b. Expected Normal Cost for FY 2005	$10,613,753
c. Expected Benefit Payments for FY 2005	($6,546,888)
d. Interest Cost for FY 2005	$31,629,776
e. Actuarial (gains)/losses due to other factors	($14,902,660)
f. Actuarial (gains)/losses due to changes in trend assumptions	$12,529,304
g. Actuarial Liability as of September 30, 2005 (all uniformed services Medicare)	$537,397,092
h. Change in Actuarial Liability	$33,323,285

Each year the Actuarial Liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of $35,696,641 in the Actuarial Liability was expected during FY 2005 (line b plus line c plus line d). The September 30, 2005, Actuarial Liability includes changes due to new assumptions and actuarial experience. The actuarial loss due to new medical trend assumptions is $12,529,304 (line f). The actuarial gains and losses due to other factors (net -$14,902,660, line e) includes new population data, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend assumptions.

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2005 liability ($ in Thousands)

DoD	$526,082,475
Coast Guard	$10,176,676
Public Health Service	$1,066,976
NOAA	$70,965
Total	$537,397,092

FY 2005 Service contributions to the MERHCF ($ in Thousands) were:

DoD	$10,220,002
Coast Guard	$236,749
Public Health Service	$32,053
NOAA	$1,492
Total	$10,490,296

FY 2004
Actuarial Cost Method Used: Aggregate Entry-Age Normal Method.
Assumptions: Interest Rate: 6.25%
Medical Trend:

Medicare Inpatient:	5.1% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Outpatient:	6.8% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Prescriptions (Direct Care):	9.7% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Prescriptions (Purchased Care):	14.6% from FY03 to FY04, ultimate rate of 6.25% in 2028.

The medical cost-trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2004, by 28 percent, or approximately $141.3 billion.

Market Value of Investments in Market-Based and Marketable Securities ($ in thousands): $38,971,708 in FY04.

Change in MERHCF Actuarial Liability
($ in thousands)

a. Actuarial Liability as of September 30, 2003 (all uniformed services Medicare)	$476,170,267
b. Expected Normal Cost for FY 2004	10,187,814
c. Expected Benefit Payments for FY 2004	(5,911,780)
d. Interest Cost for FY 2004	29,892,243
e. Actuarial (gains)/losses due to other factors	(1,430,258)
f. Actuarial (gains)/losses due to changes in trend assumptions	(4,834,479)
g. Actuarial Liability as of September 30, 2004 (all uniformed services Medicare)	$504,073,807
h. Change in Actuarial Liability	$ 27,903,540

Each year the Actuarial Liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of $34,168,277 in the Actuarial Liability was expected during FY 2004 (line b plus line c plus line d). The September 30, 2004, Actuarial Liability includes changes due to new assumptions and actuarial experience. The gain due to new medical trend assumptions is -$4,834,479 (line f). The gains and losses due to other factors (net -$1,430,258, line e) include new population data, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions.

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2004, liability ($ in thousands) is:

.DoD	$493,716,990
Coast Guard	9,263,717
Public Health Service	1,024,851
NOAA	68,249
Total	$504,073,807

FY 2004 Service contributions to the MERHCF ($ in thousands) were:

DoD	$7,918,756
Coast Guard	192,332
Public Health Service	27,391
NOAA	1,210
Total	$8,139,689

NOTE 7. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

($ In Thousands)

Earned Revenue for Program Costs:		FY 2005	FY 2004
1.	Service Contributions	$10,523,266	$ 8,139,689
2.	Annual Unfunded Liability Payment	15,721,000	16,260,000
3	Interest on Investments	2,168,130	942,749
	Total	$28,412,396	$25,342,438

Line 1, above reflects the total contributions from the Military Services plus the U.S. Public Health Service, U.S. Coast Guard, and National Oceanic Atmospheric Administration. This figure also includes an accounts receivable for contributions owed by the Army, $32,970, as reflected in Note 4.

Service contributions increased $2,383,577 from FY 2004 to FY 2005. The change is due to an increase in normal cost contribution rates provided by the Board of Actuaries.

U.S. Treasury Annual Unfunded Liability Payment decreased from $16,260,000 in FY 2004 to $15,721,000 in FY 2005 based on the computation furnished by the Board of Actuaries.

Interest on investments increased $1,225,381 from FY 2004 to FY 2005. This is primarily due to a slight increase in Service contributions available for investment and with the compounding effect of higher rates of return.

Gross Costs with the Public increased from $29,133,679 in FY 2004 to $38,414,920 in FY 2005. The increase of $9,281,241 is due to the following:

1) An increase in payments to the daily Purchased Care Operations and Maintenance of $979,029.
2) An increase in the change of Incurred But Not Reported (IBNR) payables of $34,387. This represents the net difference increase in FY 2005 for IBNR change of $270,819.
3) An increase in Allowance for Estimated Uncollectables of $348
4) A decrease in the change in Accounts Receivables of $4,432.
5) The increase in the change in the estimate of the actuarial liability resulted in an increase of $8,263,045. This increase included the effect of a transfer of a U.S. Coast Guard actuarial liability of $2,843,300 during FY 2004.

Pharmaceutical Company Rebates for Retail Pharmacy Support:

The federal government believes all pharmaceuticals purchased by DoD through the retail pharmacy network are subject to the federal ceiling prices, effective October 1, 2004, under the Veterans Health Care Act. These are the same prices that have long applied to pharmaceuticals purchased by DoD and dispensed through military treatment facility pharmacies and the TRICARE Mail Order Pharmacy program. Most pharmaceutical companies have refused to comply with the legal requirements to honor federal pricing for the retail pharmacy network. A group of companies has initiated a legal challenge to the federal government's interpretation of the Veterans Health Care Act. This litigation is pending before the U.S. Court of Appeals for the Federal Circuit. Briefs have been filed in support of this litigation. Oral argument has not yet been scheduled but may occur before the end of calendar year 2005.

The FY 2005 MERHCF estimated retail pharmacy rebates from the pharmaceutical manufacturers, had they all complied with the Veterans Health Care Act, would have been approximately $179 million. However, as of the close of FY 2005, the MERHCF had received only $19.6 million. These collections have been recorded as a "contra expense" within the Gross Cost With the Public line item rather than as Earned Revenue. Due to the pending litigation and the resultant uncertainty of future retail pharmacy rebate collections, management decided not to establish an Account Receivable for the remaining estimated balance for this program for FY 2005.

NOTE 8. DISCLOSURES RELATED TO THE STATEMENT OF FINANCING:

($ In Thousands)

Other Components Not Requiring or Generating Resources of $(3,238) for FY 05 represents the change in the net Accounts Receivable from the Public, from over-payment of benefits made to military retirees and survivors, from the end of prior year (of $3,586), less the change in Allowance of Estimated Uncollectible Accounts Receivable of $348. The comparable amount of $(8,018) for FY 04 represents a $8,018 change in Accounts Receivable in FY 04.

NOTE 9. BENEFIT PROGRAM EXPENSE

($ In Thousands)

	FY 2005	FY 2004
1. Service Cost	$10,613,753	$10,187,814
2. Period Interest on the Benefit Liability	31,629,776	29,892,243
3. Prior (or past) Service Cost	0	0
4. Period Actuarial (Gains) or Losses	(14,902,660)	(1,430,258)
5. (Gains)/Losses Due to Changes in Medical Trend Assumption	12,529,304	(4,834,479)
6. Total	$39,870,173	$33,815,320

The benefit program expenses provide components of the change in the actuarial liability from the previous fiscal year to the current fiscal year. The actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during the fiscal year. The actuarial liability at the end of the fiscal year is equal to the liability at the end of the previous fiscal year plus the total benefit program expenses minus the expected benefit payments during the current fiscal year.

The benefit program expense (BPE) includes: normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments). BPE for FY 2005 was more than BPE for FY 2004 because of the net impact of several factors. New medical trend assumptions are adopted each year by the DoD Medicare Eligible Retiree Health Care Board of Actuaries (Board) relative to the prior year's valuation; the new assumptions increased liabilities in FY 2005 by $12,529,304 and decreased liabilities in FY 2004 by $4,834,479, as reflected in the "gains/losses due to changes in medical inflation rate assumption" line in the BPE note. However, every year there is also a "period actuarial gains or losses" component of BPE, which in FY 2005 decreased liabilities by $14,902,660 and included significant gains due to lowered assumptions regarding future administrative costs, as well as gains due to certain assumptions related to claims costs, offset by net losses in other assumptions and experience. For FY 2004, the net amount of the "period actuarial gains or losses" was a $1,430,258 decrease in liabilities. For FY 2005 compared to FY 2004, the net effect of the higher service cost, higher period interest, and higher medical trend loss offset by larger period actuarial gains, led to the higher total BPE.

The service cost components and interest cost components of the BPE are generally expected to increase each year. However, actuarial gains and losses always occur, and it is impossible to predict the effect of possible new assumptions in future years, the effect of gains and losses due to actuarial experience in future years, and the effect of possible benefit changes in future years, hence the BPE can vary by substantial amounts.

NOTE 10: OTHER DISCLOSURES

The FY 2005 Defense Authorization Act assigns Treasury, vice the Uniformed Services, the responsibility of paying normal cost contributions into the Fund, starting in FY 2006.

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2005 and 2004 includes approximately $91 billion (17% of total) and $81 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, and for the year ended September 30, 2004, include approximately $3.9 billion and $1.4 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and therefore cannot report the costs of an individual patient's care.

During the year ended September 30, 2005, a misstatement of approximately $133 million was identified in the amount of purchased care claims reported for the year ended September 30, 2004. Deficiencies in the controls over the systems used to process the purchased care claims existed prior to September 30, 2004, and were uncorrected at that date, resulting in an undetected backlog of unprocessed claims. The claims were re-submitted for processing during the year ended September 30, 2005. As a result, there is an uncorrected understatement of $133 million in claims expense and payable reported in 2004 and an uncorrected overstatement of $133 million in claims expense reported in 2005. The claims backlog was also inappropriately excluded from the data used in the actuarial estimate of claims incurred but not reported recorded as a liability as of September 30, 2004. The impact of the above misstatement on the estimate of claims incurred but not reported as of September 30, 2004 is estimated to be a $133 million understatement. There were insufficient details about the recorded transactions related to the claims backlog necessary to determine the complete budgetary and proprietary accounting impacts on the MERHCF financial statements for the years ended September 30, 2005 and 2004, beyond the $133 million understatements and overstatement identified above.

* * * * *

DoD
MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

REQUIRED SUPPLEMENTARY INFORMATION

DoD
MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND
INTRAGOVERNMENTAL TRANSACTIONS
FOR THE YEAR ENDED SEPTEMBER 30, 2005

($ In Thousands)

Schedule, Part A Intragovernmental Asset Balances Which Reflect Entity Amount with Other Federal Agencies	**Treasury Index**	**Fund Balance With Treasury**	**Accounts Receivable**	**Investments**
Department of Treasury	20	$5,000	$32,970	$60,691,679
Total		$5,000	$32,970	$60,691,679
Schedule, Part C DoD Intragovernmental Revenues & Related Costs with Other Federal Agencies	**Treasury Index**			**Earned Revenue**
Department of the Treasury	20			$2,168,130
Department of Commerce	13			$1,492
Department of Health & Human Services	75			$32,053
Homeland Security	70			$236,750
Department of the Navy	17			$3,333,405
Department of the Army	21			$4,363,617
Department of the Air Force	57			$2,555,949
Other Defense Organizations	97			$15,721,000
Total				$28,412,396
				Gross Cost
Department of the Navy	17			$125,788
Department of the Army	21			$113,180
Department of the Air Force	57			$181,752
Defense Health Program				$1,140,610
Total				$1,561,330

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

OTHER ACCOMPANYING INFORMATION

MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2005

($ In Thousands)

		September 30, 2005	September 30, 2004
1.	Present value of future benefits		
	a. Current inactives	$324,191,274	$301,185,333
	b. Active duty personnel [1]	$163,277,268	$154,360,137
	c. Non-retired reservists	$135,775,752	$129,930,550
	d. Total	$623,244,294	$585,476,020
2.	Present value of future normal cost contributions	$(85,847,202)	$(81,402,213)
3.	Actuarial accrued liability	$537,397,092	$504,073,807
4.	Assets [2]	$(59,816,047)	$(38,085,939)
5.	Unfunded accrued liability [3]	$477,581,045	$465,987,868

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[1] The future benefits of active duty personnel who are projected to retire as reservists are counted on line 1-c.

[2] The assets available to pay benefits are determined using the amortized cost method (book value) of valuation.

[3] The unfunded accrued liability does not include $762,163 and $491,344 for the estimated Incurred But Not Reported (IBNR) liabilities as of September 30, 2005 and 2004, respectively, as disclosed in the "Liabilities Not Covered and Covered By Budgetary Resources" note to the financial statements as Benefits Due and Payable.

DoD MEDICARE ELIGIBLE RETIREE HEALTH CARE FUND

INDEPENDENT AUDITORS' REPORTS

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202–4704

November 8, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)
\CHIEF FINANCIAL OFFICER
ASSISTANT SECRETARY OF DEFENSE FOR HEALTH AFFAIRS
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Endorsement of the Qualified Opinion on the FY 2005 DoD Medicare-Eligible Retiree Health Care Fund Financial Statements (Report No. D-2006-021)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, assigns the Department of Defense Inspector General responsibility for auditing the DoD Medicare-Eligible Retiree Health Care Fund Financial Statements. For FY 2005, we exercised an option with Deloitte & Touche LLP (Deloitte & Touche) to perform the audit.

Qualified Audit Opinion. We concur with the Deloitte & Touche's qualified opinion dated November 7, 2005. Deloitte & Touche opined that, except for amounts related to The Fund's direct care costs and a backlog of unprocessed purchased care transactions, the financial statements and accompanying notes present fairly, in all material respects, The Fund's financial position, net cost, changes in net position, budgetary resources, and financing, as of September 30, 2005 and 2004, were presented in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche qualified its opinion because it was unable to obtain patient-level data from transaction-based accounting systems that support the costs of direct care provided by DoD-managed Military Treatment Facilities. Deloitte & Touche also noted deficiencies in the controls over the systems used to process the purchased care claims. Deloitte & Touche also noted an uncorrected understatement of $133 million in claims expense and claims payable reported in 2004 and an uncorrected overstatement of $133 million in claims expense reported in 2005.

Report on Internal Controls. Deloitte & Touche concurrently issued a report on the internal control over financial reporting and compliance with laws and regulations as part of the audit of the Fund's FY 2005 financial statements. We concur with the Deloitte & Touche internal control report.

Financial Reporting. The Deloitte & Touche report on internal controls concluded that the Fund's financial management system did not meet the requirement of Office of Management and Budget Circular A-127, "Financial Management Systems," July 23, 1993, with respect to consistent internal control over data entry, transaction processing, and reporting. Deloitte & Touche reported the following conditions.

- The actuarial liability for Medicare-eligible retiree benefits includes the actuarial present value of projected direct care costs. The direct care costs are based on data extracted from various noncompliant systems that are not transaction-based and cannot accurately report the costs of an individual patient's care.

- There is insufficient policy or procedural documentation describing the methodology to collect and report Military Treatment Facility cost data, referred to as level of effort.

- The accuracy and completeness of the data files provided to the Office of the Actuary (the Actuary) for determining the funds incurred but not reported liability were impacted by a backlog of unprocessed purchased care claims with an aggregate value of $133 million as of September 30, 2004. The FY 2004 claims were processed in FY 2005 causing uncorrected misstatements of the FY 2004 and FY 2005 financial statements.

- There is a lack of a fully integrated financial management system. As a result, there is a data integrity risk that the incurred but not reported accumulation process may not be comparable to The Fund's financial records.

- The Fund's financial management improvement initiatives have not been planned and executed in a comprehensive, well thought-out manner, sufficient to ensure the desired results.

- Computer processing locations that support The Fund had inadequate controls over data processing to ensure reliable processing of financial information within the related business cycles. The audit disclosed deficiencies in the design and operation of controls related to data processing security policies, procedures, configurations, business continuity arrangements, and system software support activities that could adversely affect The Fund's ability to record, process, and summarize its financial information in accordance with all appropriate requirements.

Compliance with Laws and Regulations. Deloitte & Touche performed tests that disclosed noncompliance with certain provisions of the following laws and regulations.

- The Fund's data were processed on Electronic Data Processing systems that did not comply with Office of Management and Budget Circular A-127, "Financial Management Systems."

- Although the general ledger system complied with the U.S. Government Standard General Ledger, it was not transaction-based or derived from an integrated financial management system.

- The financial management system did not comply substantially with Office of Management and Budget Circular A-130, "Management of Federal Information Resources," November 20, 2000.

- Collectively the Fund did not fully comply with Office of Management and Budget Circulars A-123, "Management Accountability and Control," June 21, 1995, and A-127, "Financial Management Systems," and the Federal Managers' Financial Integrity Act.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000, requires that test results be reported if noncompliance with certain laws and regulations occurs.

Audit Responsibilities. We were responsible for obtaining reasonable assurance that the principal statements were presented fairly and free of material misstatement, in conformity with accounting principles generally accepted in the United States.

To fulfill our oversight responsibilities for the contract with Deloitte & Touche, we complied with government auditing standards, Office of Management and Budget Bulletin No. 01-02, and the "GAO/PCIE Financial Audit Manual," July 2004. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of Deloitte & Touche; evaluated the key judgments; met with officials of The Fund; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. James L. Kornides (614) 751-1400, extension 211 or Mr. Mark Starinsky (614) 751-1400, extension 231.

By direction of the Deputy Inspector General for Auditing:

Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

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INDEPENDENT AUDITORS' REPORT

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of September 30, 2005 and 2004, and the related statements of net cost, changes in net position, budgetary resources and financing for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We were unable to obtain patient-level data from compliant, transaction-based accounting systems in support of the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTFs). As discussed in Note 10 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2005 and 2004 includes approximately $91 billion (17% of total) and $81 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, and for the year ended September 30, 2004, include approximately $3.9 billion and $1.4 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and therefore cannot report the costs of an individual patient's care. While activity-based costing techniques have been used to apply total program costs to individuals, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and

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accuracy of the medical record coding processes at the MTFs, a significant factor in the allocation processes. Additionally, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording and cutoff of the costs reported. We were not able to satisfy ourselves as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

As discussed in Note 10 to the financial statements, during the year ended September 30, 2005, a misstatement of approximately $133 million was identified in the amount of purchased care claims reported for the year ended September 30, 2004. Deficiencies in the controls over the systems used to process the purchased care claims existed prior to September 30, 2004, and were uncorrected at that date, resulting in an undetected backlog of unprocessed claims. The claims were re-submitted for processing during the year ended September 30, 2005. As a result, there is an uncorrected understatement of $133 million in claims expense and payable reported in 2004 and an uncorrected overstatement of $133 million in claims expense reported in 2005. The claims backlog was also inappropriately excluded from the data used in the actuarial estimate of claims incurred but not reported recorded as a liability as of September 30, 2004. The impact of the above misstatement on the estimate of claims incurred but not reported as of September 30, 2004 is estimated to be a $133 million understatement. We were not able to obtain sufficient details about the recorded transactions related to the claims backlog necessary to determine the complete budgetary and proprietary accounting impacts on the MERHCF financial statements for the years ended September 30, 2005 and 2004, beyond the $133 million understatements and overstatement identified above, nor were we able to satisfy ourselves by means of other auditing procedures.

In our opinion, except for the effects on the financial statements of (1) the amounts related to the Fund's direct-care costs, if any, as might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct-care component of the actuarial liability for Medicare-eligible retiree benefits; and (2) the complete budgetary and proprietary accounting impacts of the claims backlog transactions; the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Medicare-Eligible Retiree Health Care Fund as of September 30, 2005 and 2004, and its net cost, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards,* we have also issued our report dated November 7, 2005 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

To the Inspector General of the
Department of Defense

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying required supplementary information included in the sections entitled "Management's Discussion & Analysis," "Required Supplementary Information," and "Other Accompanying Information," are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular A - 136, *Financial Reporting Requirements*, as amended, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

November 7, 2005

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

To the Inspector General of the
Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of and for the year ended September 30, 2005, and have issued our report thereon dated October 31, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements,* as amended.

Internal Control over Financial Reporting

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

Reportable conditions noted are described in the following paragraphs and include departures from certain requirements of OMB Circular A-127, *Financial Management Systems*, which incorporates by reference Circulars A-123, *Management's Responsibility for Internal Control*, and A-130, *Management of Federal Information Resources*, among other requirements.

During our audit of the Fund's financial statements, we identified deficiencies related to the internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of financial statements. Because of the deficiencies noted, we believe that the Fund's financial management system does not meet the requirements of an integrated financial management system as defined in OMB Circular A-127, with respect to "consistent internal control over data entry, transaction processing and reporting." We also believe that the Fund is not in compliance with the system design requirements sufficient to comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

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As defined in OMB Circular A – 127, "a financial management system encompasses automated and manual processes, procedures, controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions." Such financial management systems shall be designed to provide for effective and efficient interrelationship between software, hardware, personnel, procedures, controls, and data contained within the systems. These integrated systems shall have the following characteristics: (1) common data elements; (2) common transaction processing; (3) consistent internal control over data entry, transaction processing and reporting; and (4) efficient transaction entry.

With respect to system requirements in the area of financial reporting, OMB Circular A – 127 requires that an "agency financial management system shall be able to provide financial information in a timely and useful fashion to (1) support management's fiduciary role; (2) support the legal, regulatory and other special management requirements of the agency; (3) support budget formulation and execution functions; (4) support fiscal management of program delivery and program decision making; (5) comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury; and (6) monitor the financial management system to ensure integrity of financial data."

Our assessment is based upon various factors noted during our audit. For example, we noted that:

1. The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2005 and 2004, includes approximately $91 billion (17% of total) and $81 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the Medical Treatment Facilities ("MTFs"), managed by the Services, to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, and for the year ended September 30, 2004, include approximately $3.9 billion and $1.4 billion, respectively, of amounts related to the direct-care costs.

   Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries and others using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and therefore cannot report the costs of an individual patient's care. While activity-based costing techniques have been used to apply total program costs to individuals, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, a significant factor in the allocation processes. Additionally, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording and cut - off of the costs reported. The procedures in place to determine the allocated costs of direct care provided by the MTFs are not adequate to ensure presentation of the direct-care costs in conformity with accounting principles generally accepted in the United States of America.

2. The costs of health care provided directly by the DoD for Fund participants and beneficiaries represent significant input to the development of the actuarially determined health care liability of the Fund, as well to the determination of amounts contributed by the Services for their active duty participants. These costs are incurred in the multitude of Medical Treatment Facilities ("MTFs") managed by the Services in various locations. The Fund makes prospective payments to the Services based on estimates of these direct care costs in order to support the operations of the MTFs on an ongoing basis.

   The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the Services that have not been audited. The MTF – level data is based upon budget execution processes, rather than accrual - based accounting. There is insufficient evidence that appropriate cut-off of accounting activity occurred at the MTF - level. During 2005, the Fund had not yet established appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

   We did note that the Fund performs annual retrospective reconciliation reviews of the MTF level-of-effort data, for the purposes of comparing the prospective payments provided to the MTFs for care of the Fund's participants and beneficiaries, versus the results of the budget execution process. The results of the reconciliations are used in the determination of prospective budgetary requirements to support the MTFs' operations, as required by DoD Instructions. However, there is insufficient policy or procedure documentation describing the methodology (including processes, systems, files, queries, and assumptions) used to collect and report MTF cost data, referred to as the level of effort ("LOE"), to provide adequate internal control.

3. The actuarial determination of the Fund's liability for incurred but not reported ("IBNR") claims for purchased care for the Fund's participants and beneficiaries relies on data files provided by the TRICARE Management Activity ("TMA") of the Military Health System to the Office of the Actuary ("OOA"). During 2005, the accuracy and completeness of the data files provided to the OOA were impacted by a backlog of purchased care claims aggregating $133 million that existed as of September 30, 2004. The backlog of claims was identified subsequent to September 30, 2004, and resulted from claims that had been submitted by the claims contractor, but which were not processed by TMA on a timely basis. As a result, the claims were inappropriately omitted from the FY 2004 financial statements, not only with respect to the impact on the determination of the IBNR liability, but also as FY 2004 claims expense, cash payments to the contractor, or accounts payable as of September 30, 2004. Also as a result, uncorrected misstatements exist with respect to the FY 2004 and FY 2005 financial statements of the Fund.

   The claims backlog occurred due to computer processing issues arising from a systems conversion process at TMA related to the TRICARE Encounter Data System ("TEDS"), as well as deficiencies in internal control. The claims backlog transactions were resubmitted for processing during FY 2005 and the claims expense was recorded at that time, along with the effect of the additional claims on the actuarial estimate for the liabilities for claims incurred but not reported.

However, we were unable to obtain from TMA complete information for all transaction details for the claims backlog transactions necessary to assess the complete budgetary and proprietary accounting impacts on the FY 2004 and 2005 MERHCF financial statements from the identified misstatements. The batches for which details were not received aggregated $130,286,352. TMA indicated that they are not able to perform the necessary queries against the On-Line Data Source ("ODS") database to provide such transaction details, nor did they provide any manual journal entries regarding the affected batches. Additionally, from our inquiries with TMA, we received no indication that any analyses of the claims backlog transactions detail has been done by them for purposes of evaluating the full financial statement impacts, either at the time the backlog issue was identified, nor subsequently.

4. Because of the lack of a fully integrated financial management system to support the Military Health System and the Fund, certain data is provided to OOA from health care operational sources, rather than from the accounting and financial records of claims payment activity. As a result, inconsistencies and completeness issues can occur in the accumulation of the data utilized for the IBNR estimation process as compared with the Fund's financial records.

   TMA has finalized and coordinated with OOA standard agreed-upon procedures for collecting, transmitting, validating and documenting the workload and cost information transmitted to OOA for the annual valuation of the Fund. The process for the quarterly preparation of the IBNR-related claims triangle data has also been documented. However, we noted that these current management level control and reconciliation processes to ensure that the data files provided to the OOA are consistent with the information represented to be included therein, rely primarily on the comparison of amounts, rather than a full reconciliation process.

   For example, the agreed-upon procedures do not clearly discuss the process for collecting, transmitting, and documenting the workload and cost information for the actuarial estimates used for the Fund. The procedures also appear to be heavily focused on comparing the totals of detailed data in the MHS data repository with similar data in the MHS Management Analysis and Reporting Tool ("M2") system, a database that is a subset of the repository. This reconciliation of one system to a subsystem does not include any process for ensuring the integrity of the data in either system. While the comparison process does serve to help confirm that the data used in the actuarial estimate is the same data used in the application system, it does not eliminate the need to provide a clear audit trail from the data collection systems to the valuation and corresponding Fund financial reporting results.

5. During 2005, the Fund has undertaken a number of improvement initiatives in connection with the DoD Financial Improvement and Audit Readiness ("FIAR") process managed under the Office of the Under Secretary of Defense - Comptroller ("OUSD-C")." The initiatives are intended to address the necessary corrective actions with respect to the identified deficiencies in medical record coding and direct-care cost processes, as discussed above. Although the improvement initiatives have been in process since January 2005, we have not yet seen evidence that the initiatives have been planned and executed in a comprehensive, well-thought manner, sufficient to ensure the desired results. For example, we have not seen a detailed action plan with identified milestones and assigned responsibilities, nor is it clear that appropriate consideration has been

given to impact on data for the actuarial valuation processes, the most critical aspect of the direct care issue from a financial reporting perspective. From discussions with TMA and their support contractor, we understand that efforts have been undertaken to document certain direct-care related reconciliation processes at the MTF level. However, no documentation of the planned activities or of the status of ongoing efforts has been provided to us or presented to the Fund's Audit Committee in their oversight responsibilities.

6. Significant misstatements were identified in the calculation and reporting of the required contributions from the Services based on the Services' end-strength reporting and the per capita contribution rates as determined by the Office of the Actuary. In one case, a $33 million adjustment was identified related to the U.S. Army contributions, resulting from the incorrect per capita contribution rate used in the first quarter of FY 2005. The incorrect calculation in the U.S. Army required contributions was previously identified during an audit by the Office of the Inspector General, but was not corrected by the Army on a timely basis.

   The second identified misstatement, of approximately $43 million, also relates to the U.S. Army's required normal cost contributions, specifically for September 2005. The U.S. Army also did not remit their required September contributions for its Reserves component, nor did they report the matter to the Defense Finance and Accounting Service ("DFAS") Trust Fund Division, or to the Fund's management, so that the unpaid contributions could be recorded as an accounts receivable for year-end financial reporting. Similarly, the underpayments by the U.S. Army were not identified by DFAS or the Fund's management for resolution.

   We believe that improvements in the management level control and reconciliation processes at the Services, DFAS, and the Fund are required to improve the timeliness, accuracy, and completeness of the processes that support the determination and reporting of the Services' contributions.

7. Certain general electronic data processing ("EDP") controls at certain computer processing locations used by the Fund do not support the reliable processing of financial information within the related business cycles. Our review disclosed deficiencies in the design or operation of controls related to: (1) EDP security policies, procedures, and configurations, (2) business continuity arrangements; (3) application system implementation and maintenance activities; and (4) application control activities, that could adversely affect the Fund's ability to record, process, and summarize its financial information and protect sensitive data in accordance with all appropriate requirements.

   Because disclosure of detailed information about EDP weaknesses may further compromise controls, we are providing no further details here. Instead the specifics will be presented in a separate, limited distribution management letter.

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

Fund's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. Of the reportable conditions noted above, the observations with respect to direct – care costs discussed at items 1. and 2., and the observations with respect to the claims backlog at item 3. and related EDP controls item 7. (3), are, in our judgment, material weaknesses.

Compliance and Other Matters

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

1. The EDP systems utilized by the Fund are not compliant with OMB Circular A-127, *Financial Management Systems*. The Circular requires that federal financial systems provide complete, reliable, consistent and useful information on a timely basis. Our procedures identified deficiencies in the design and operation of certain EDP controls that may increase the risk of unauthorized access, modification, or loss of sensitive programs and data which could compromise the ability of the systems to provide reliable financial data.

2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger ("SGL"), it is not transaction-based nor is it derived from an integrated financial system.

3. The financial management systems utilized by the Fund do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A – 130, in that they do not fully, efficiently and effectively support the Fund's efforts to:

   ◊ Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;

   ◊ Provide reliable and timely financial information for managing current operations;

   ◊ Account for assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and

   ◊ Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger

   We believe these conditions, in the aggregate, result in significant departures from certain of the requirements of OMB Circulars A – 123, A – 127, and A – 130.

4. The reportable conditions identified above with respect to the internal control over financial reporting discussed above indicate that the Fund is not in full compliance with the requirements of OMB Circulars A – 123 and A – 127 and the FMFIA.

Distribution

This report is intended solely for the information and use of the Inspector General of the Department of Defense, the Audit Committee and management of the Fund, other Defense Organizations, the Office of Management and Budget, the Government Accountability Office, and the United States Congress and is not intended to be and should not be used by anyone other than these specified parties.

Deloitte & Touche LLP

November 7, 2005