FISCAL YEAR 2005

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

November 2, 2005

DoD MILITARY RETIREMENT FUND FISCAL YEAR 2005 AUDITED FINANCIAL STATEMENTS

Table of Contents

DoD MILITARY RETIREMENT FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

For the Years Ended September 30, 2005 and 2004

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund. Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness has as one of its missions to oversee the operations of the Military Retirement System, including the accounting, investing, and reporting of the Military Retirement Fund (the Fund). The Fund was established by Public Law 98-94 (currently Chapter 74 of Title 10, U.S.C.). This law also established an independent three-member DoD Retirement Board of Actuaries appointed by the President. The Board is required to review valuations of the military retirement system; to determine the method of amortizing unfunded liabilities; 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.

In Fiscal Year (FY) 2005, the Fund paid out approximately $39 billion in benefits to military retirees and survivors. In FY 2004, the Fund paid out approximately $37 billion in benefits to military retirees and survivors. In addition to staff members of the reporting entity and the DoD Office of the Actuary, hundreds of individuals at the DFAS Cleveland and Denver Pay Centers are involved in making the benefit payments. However, the discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt per the National Defense Authorization Act (NDAA) of 2004; and investment income. During FY 2005, the Fund received approximately $15 billion in normal cost payments, a $23 billion Treasury payment, and approximately $11 billion in investment income, net of premium/discount amortization and accrued inflation compensation. During FY 2004, the Fund received approximately $14 billion in normal cost payments, a $18 billion Treasury payment, and approximately $10 billion in investment income, net of premium/discount amortization and accrued inflation compensation. No accounts of the Fund have been excluded from the Fund's financial statements.

Summary

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Homeland Security), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of

Commerce). Only those members in plans administered by the Department of Defense (DoD) are included in this report.

The system is a funded, noncontributory defined benefit plan that includes nondisability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs, and special compensation programs for certain disabled retirees. The Service Secretaries may approve immediate nondisability retired pay at any age with credit of at least 20 years of active duty service. Reserve retirees must be at least 60 years old and have at least 20 qualified years of service before retired pay commences. There is no vesting before retirement.

Significant Changes During FY 2005

Changes during FY 2005 included: (1) updated retiree divorce rates, and (2) enhancements to the part-time valuation to better reflect the accumulation of years of active service over a reservist's career.

The most significant change in FY 2004 was the implementation of the concurrent receipt provision in the FY 2004 National Defense Authorization Act (NDAA) (P.L. 108-136) (hereafter referred to as NDAA 2004 Concurrent Receipt). Through December 31, 2003, retired pay earned from DoD for military service was offset by any payment received from the Department of Veterans Affairs (VA) for a VA-rated disability. NDAA 2004 Concurrent Receipt provides a phase-out of the offset to military retired pay due to receipt of VA disability compensation for members whose combined disability rating is 50% or greater. Members retired under disability provisions must have at least 20 years of service. P.L. 108-136 also expands eligibility under the Combat Related Special Compensation program to include qualified retirees at any combined percentage rating for certain combat-related disabilities compensated by the VA. Certain retirees who meet the 50% criteria specified by the statute will have their offset phased out over a ten-year period beginning in 2004 and ending in 2013. During calendar year 2004, the maximum monthly amount that a VA offset to retired pay is reduced is $750 for a qualified retiree with 100% VA disability rating, grading down to $100 for a member with a 50% rating. Some retirees who receive other special payments, such as Combat Related Special Compensation, may not be subject to the ten-year offset phase-out.

Other changes during FY 2004 included: (1) updating retiree VA offset factors which reflect the increasing VA offsets to the DoD military retired pay for new and continuing retirees; (2) updating the Career Status Bonus (CSB) take-rate parameter which measures the percentage of service members first entering the armed services after August 1, 1986 who elect to receive the $30,000 Career Status Bonus; and (3) the introduction of the new January 1, 2004, pay table which continues the annual military pay adjustments to bridge the gap between military and civilian pay.

Type 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; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt; 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-Protected Securities (TIPS), which are indexed for inflation. 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 revised 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 revised strategy seeks to match the duration of the assets with the duration of the liability.

Non Disability Retirement From Active Service

There are three distinct nondisability benefit formulas related to three populations within the military retirement system. *Final pay*: Military personnel who first became members of a uniformed service before September 8, 1980, have retired pay equal to final basic pay times a multiplier. The multiplier is equal to 2.5 percent times years of service and is limited to 75 percent. *High-3:* If the retiree first became a member of a uniformed service on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of final basic pay. *Redux:* Members who first became a member of a uniformed service on or after August 1, 1986 and who elect to receive the Career Status Bonus outlined below are subject to a multiplier penalty if they retire with less than 30 years of service; however, at age 62, their retired pay is recomputed without the penalty. They also have retired pay computed on a base of the average of their highest 36 months of basic pay. The FY 2000 Defense Authorization Act provided that

Redux members have a choice of (a) receiving High-3 benefits or (b) staying under the Redux formula and receiving a lump-sum $30,000 payment, called a Career Status Bonus. Members make their election during the fifteenth year of service. Those who choose the lump-sum payment must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the $30,000.

Retired pay and survivor annuity benefits are automatically adjusted annually to protect the purchasing power of initial retired pay. The benefits associated with members first entering a uniformed service before August 1, 1986, or those entering on or after that date who do not take the bonus, have their benefits adjusted annually by the percentage increase in the average Consumer Price Index (CPI). This is commonly referred to as full CPI protection. Benefits associated with members entering on or after August 1, 1986, who elect the $30,000 bonus payment are annually increased by the percentage change in the CPI minus 1 percent, but at the military member's age 62, or when the member would have been age 62 for a survivor annuity, the benefits are restored to the amount that would have been payable had full CPI protection been in effect. This restoral is in combination with that described in the previous paragraph. However, after this restoral, partial indexing (CPI minus 1 percent) continues for future retired pay and survivor annuity payments.

As of September 30, 2005, there were approximately 1.44 million nondisability retirees from active duty receiving retired pay. In FY 2005, nondisability retirees were paid approximately $32.40 billion. As of September 30, 2004, there were approximately 1.38 million nondisability retirees from active duty receiving retired pay. In FY 2004, nondisability retirees were paid approximately $29.93 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the member has at least 20 years of service or the disability is at least 30 percent (under a standard schedule of rating disabilities by the Veterans Administration) and either (1) the member has at least eight years of service; (2) the disability results from active duty; or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

In disability retirement, the member receives retired pay equal to the larger of (1) the accrued nondisability retirement benefit regardless of eligibility to retire or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75 percent of base pay. Only the excess of (1) over (2) is subject to federal income taxes if the member had service on or before September 24, 1975. If not a member of a uniformed service on September 24, 1975, disability retired pay is tax-exempt only for those disabilities that are combat or hazardous duty related. Base pay is equal to final basic pay if the retiree first became a member of a uniformed service before September 8, 1980; otherwise, base pay is equal to the average of the highest 36 months of basic pay.

Members whose disabilities may not be permanent are placed on a temporary-disability retired list and receive disability retirement pay just as if they were permanently disabled. However, they must be physically examined every 18 months for any change in disability. A final determination must be made within five years. The temporary disability pay is calculated like the permanent disability retired pay, except that it can be no less than 50 percent of base pay.

As of September 30, 2005, there were approximately 89,000 disability retirees receiving retired pay. In FY 2005, disability retirees were paid approximately $1.25 billion. As of September 30, 2004, there were approximately 87,000 disability retirees receiving retired pay. In FY 2004, disability retirees were paid approximately $1.14 billion.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service, the last six of which must be in a reserve component. However, reserve retired pay is not payable until age 60. Retired pay is computed as base pay times 2.5 percent times years of service. If the reservist was first a member of a uniformed service before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of a uniformed service on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on active duty for the 36 months immediately preceding age 60. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, a point is awarded for a day of service or drill attendance, with 15 points being awarded for a year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation. Non-active duty points are limited in any year to no more than 90. Lesser limitations have applied in the past.

As of September 30, 2005, there were approximately 280,000 reserve retirees receiving retired pay. In FY 2005, reserve retirees were paid approximately $3.31 billion. As of September 30, 2004, there were approximately 271,000 reserve retirees receiving retired pay. In FY 2004, reserve retirees were paid approximately $3.01 billion.

Survivor Benefits

Legislation originating in 1953 provided optional survivor benefits. It was later referred to as the Retired Servicemen's Family Protection Plan (RSFPP). The plan proved to be expensive and inadequate since the survivor annuities were never adjusted for inflation and could not be more than 50 percent of retired pay. RSFPP was designed to be self-supporting in the sense that the present value of the reductions to retired pay equaled the present value of the survivor annuities.

On September 21, 1972, RSFPP was replaced by the Survivor Benefit Plan (SBP) for new retirees. RSFPP still covers those servicemen retired before 1972 who did not convert to the new plan or who retained RSFPP in conjunction with SBP. RSFPP continues to pay survivor annuities.

Retired pay is reduced, before taxes, for the member's cost of SBP. Total SBP costs are shared by the Government and the retiree, so the reductions in retired pay are only a portion of the total cost of the SBP program.

The SBP survivor annuity is initially 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than $300 or more than the member's full retired pay. If the member elects the Career Status Bonus with REDUX and is subject to a penalty for service under 30 years in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty.

When the plan started in 1972, survivor benefits for those annuitants 62 and over were reduced to reflect the availability of Social Security. In 1985, that reduction formula was changed so all annuitants 62 and over received 35% of the member's base. Those whose annuities were reduced by a Social Security offset were grandfathered to get the better of the two formulas. The National Defense Authorization Act for FY 2005 (P.L.108-375) phased out the reduction in the survivor benefit that occurs at age 62 by April 1, 2008 for all current and future survivors.

During FY 1987, the SBP program's treatment of survivor remarriages changed. Prior to the change, a surviving spouse remarrying before age 60 had the survivor annuity suspended. The change lowered the age to 55. If the remarriage ends in divorce or death, the annuity is reinstated.

Members who die on active duty are assumed to have retired with full disability on the day they died and to have elected full SBP coverage for spouses, former spouses, and/or children. Insurable interest elections may be applicable in some cases. These benefits have been improved and expanded over the history of the program.

SBP annuities are reduced by any Veterans Administration (VA) survivor benefits (Dependency and Indemnity Compensation (DIC)) and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities and premiums are annually increased with cost-of-living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the Career Status Bonus dies before age 62, the survivor is subject to partial COLAs and his/her annuity is increased on what would have been the member's 62nd birthday to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. A second set of optional reductions, under the Reserve Component Survivor Benefit Plan (RCSBP), provides annuities to survivors of reservists who die before age 60, but after attaining 20 years of qualified service. The added cost of this coverage is borne completely by reservists through deductions from retired pay and survivor annuities.

A paid-up provision eliminating the reduction in retired pay for premiums for SBP and RSFPP coverage will be effective October 1, 2008, for participants age 70 or older whose retired pay has been reduced for 30 years or more.

As of September 30, 2005, there were approximately 279,000 survivors of military members receiving annuity payments. In FY 2005, survivors were paid approximately $2.25 billion. As of September 30, 2004, there were approximately 274,000 survivors of military members receiving annuity payments. In FY 2004, survivors were paid approximately $2.16 billion.

Temporary Early Retirement Authority (TERA)

The National Defense Authorization Act for FY 1993 (P.L. 102-484) granted temporary authority for the military services to offer early retirements to members with more than 15 but less than 20 years of service. The retired pay was calculated in the usual way except that there was a reduction of 1 percent for every year below 20 years of service. Part or all of this reduction can be restored at age 62 if the retired member works in a qualified public service job during the period from the date of retirement to the date on which the retiree would have completed 20 years of service. Unlike members who leave military service before 20 years with voluntary separation incentives or special separation benefits, these early retirees are generally treated like regular military retirees for the purposes of other retirement benefits. This authority expired on September 1, 2002.

As of September 30, 2005, there were approximately 58,000 TERA retirees receiving retired pay. In FY 2005, TERA retirees were paid approximately $769 million. As of September 30, 2004, there were approximately 55,000 TERA retirees receiving retired pay. In FY 2004, TERA retirees were paid approximately $725 million.

Cost-of-Living Increase

All nondisability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. Cost-of-living adjustments (COLAs) are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January. The "full" COLA effective December 1 is computed by calculating the percentage increase in the average CPI from the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W) and is rounded to the nearest tenth of one percent.

The benefits of retirees (and their survivors) are increased annually with the full COLA, except for those first entering a uniformed service on or after August 1, 1986, who elect the $30,000 Career Status Bonus. Their benefits are increased annually with a partial COLA equal to the full COLA minus 1 percent. A one-time restoral is given to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, retired pay (or the survivor benefit if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with Department of Veterans Affairs (VA) Benefits

The Department of Veterans Affairs (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of or in combination with DoD retired pay, but through December 31, 2003 were not fully additive. Since VA benefits are exempt from federal income taxes, it is often to the advantage of a member to elect them. Through 2003, retired pay earned from DoD for military service was offset by any payment received from Veterans Affairs for a VA-rated disability. The National Defense Authorization Act of 2004 (P.L. 108-136) provided a phase-out of the offset to military retired pay due to receipt of VA disability compensation for members whose combined disability rating is 50% or greater. Members retired under disability provisions must have at least 20 years of service. P.L. 108-136 also expands eligibility under the Combat Related Special Compensation program to include qualified retirees at any combined percentage rating for certain combat-related disabilities compensated by the VA. Certain retirees who meet the 50% criteria specified by the statute will have their offset phased out over a ten-year period beginning in 2004 and ending in 2013. Some retirees who receive other special payments, such as Combat Related Special Compensation, may not be subject to the ten-year offset phase-out. The National Defense Authorization Act of 2005 (P.L. 108-375) eliminated the phase-out of the offset to military retired pay for 20-year retirees with a 100% VA disability rating.

Veterans Administration benefits also overlap survivor benefits through the Dependency and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefit are returned to the survivor.

Interrelationship with Other Federal Service

For retirement purposes, no credit is given for other federal service, except where cross-service transferability is allowed. Military service is generally creditable toward the federal civilian retirement systems if military retired pay is waived.

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is based and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative, for comparative purposes, of salary levels in the public and private sectors. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) cash or in-kind allowances (the housing allowance, which varies by grade, location, and dependency status, and a subsistence allowance) and (3) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 70 percent of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 67 percent of RMC. Consequently, a 20-year retiree may be entitled to 50 percent of basic pay, but only 34 percent of RMC. For a 30-year retiree, the corresponding entitlements are 75 percent of basic pay, but only 54 percent of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

Many military members and their families receive monthly benefits indexed to the CPI from Social Security. As full participants in the Social Security system, military personnel are in general entitled to the same benefits and are subject to the same eligibility criteria and rules as other employees. Details concerning the benefits are covered in other publications.

Beginning in 1946, Congress enacted a series of amendments to the Social Security Act that extended some benefits to military personnel and their survivors. These "gratuitous" benefits were reimbursed out of the general fund of the U.S. Treasury. The Servicemen's and Veterans' Survivor Benefits Act brought members of the military into the contributory Social Security system effective January 1, 1957.

For the Old Age, Survivors, and Disability Insurance (OASDI) program, military members must contribute the employee portion of the OASDI payroll tax, with the federal government contributing the matching employer contribution. Only the basic pay of a military member constitutes wages for social security purposes. One feature of OASDI unique to military personnel grants a noncontributory wage credit of (i) $300 for each quarter between 1956 and 1978 in which such personnel received military wages and (ii) up to $1,200 per year after 1977 ($100 of credit for each $300 of wages up to a maximum credit of $1,200). The purpose of this credit is to take into account elements of compensation such as quarters and subsistence not included in wages for Social Security benefit calculation purposes.

Members of the military are also required to pay the Hospital Insurance (HI) payroll tax, with the federal government contributing the matching employer contribution. Medicare eligibility occurs at age 65, or earlier if the employee is disabled.

Performance Measures

During FY 2005 and 2004, the Fund made monthly disbursements to approximately two million retirees and annuitants.

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for annuitants on the roll is commonly used. Here is what this ratio has been for the last ten years:

a. September 30, 2005 = .359
b. September 30, 2004 = .338
c. September 30, 2003 = .351
d. September 30, 2002 = .378
e. September 30, 2001 = .347
f. September 30, 2000 = .354
g. September 30, 1999 = .352
h. September 30, 1998 = .331
i. September 30, 1997 = .322
j. September 30, 1996 = .313

The effective yield of the Fund during FY 2005 was approximately 5.54%.

Core Performance Measures

No operating costs are calculated for the Fund.

Changes for FY 2006

There are no foreseen benefit changes with respect to the Military Retirement Fund for FY 2006.

NDAA 2005 implemented a one-year Open Season for participation in SBP beginning October 1, 2005. The liability for the new participants will be calculated as they appear in the system.
On August 1, 2005, the Office of Management and Budget (OMB) issued a memorandum to all Chief Financial Officers concerning implementation plans for OMB Circular A-123, Appendix A. As a result of the memorandum, OSD(C) has prepared draft guidance for implementation of the Statement of Assurance on Internal Control over Financial Reporting. An annual report on the effectiveness of internal control over financial reporting for the MRF is scheduled to begin with the FY 2006 financial statements.

Projected Long-Term Health of the Fund

The projected long-term health of the fund is good due to the fact that it has three different sources of funding. The first two are appropriated funds—one is annual payments from Treasury to amortize the unfunded liability and pay the normal cost of the concurrent receipt benefits, and one is monthly normal cost payments from the Services to pay for the current year's service cost.

Both of these can be considered secure sources of funding backed by the "full faith and credit" of the U.S. Government. The investment portion will most likely be an increasing contribution to the Fund as the return on investments increases due to expected increases in interest rates.

The table below presents a projection of contributions to and disbursements from the Fund. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-year projection period.

MILITARY RETIREMENT SYSTEM
PAST AND PROJECTED FLOW OF PLAN ASSETS
(In Billions of Dollars and as a Proportion of Payroll)

Fiscal Year	Basic Payroll	Normal Cost Payments		Amortization of Unfunded Liability		Investment Income		Fund Disbursements		Fund Balance End of Year	
2006	$50.9	$15.3	(0.301)	$23.2	(0.456)	$13.0	(0.256)	$40.5	(0.796)	$208.8	(4.102)
2007	$51.2	$15.3	(0.299)	$24.0	(0.470)	$13.7	(0.268)	$42.2	(0.824)	$219.7	(4.290)
2008	$51.7	$15.4	(0.299)	$25.0	(0.483)	$14.4	(0.279)	$43.9	(0.850)	$230.5	(4.461)
2009	$52.3	$15.6	(0.298)	$25.9	(0.495)	$15.1	(0.288)	$45.7	(0.874)	$241.4	(4.612)
2010	$53.1	$15.8	(0.298)	$26.9	(0.505)	$15.8	(0.297)	$47.2	(0.887)	$252.7	(4.755)
2011	$54.1	$16.1	(0.298)	$27.9	(0.515)	$16.5	(0.305)	$48.5	(0.896)	$264.7	(4.894)
2012	$55.1	$16.4	(0.297)	$28.9	(0.525)	$17.3	(0.314)	$49.8	(0.903)	$277.6	(5.038)
2013	$56.1	$16.7	(0.297)	$30.0	(0.534)	$18.2	(0.323)	$51.0	(0.909)	$291.4	(5.191)
2014	$57.2	$17.0	(0.297)	$31.1	(0.544)	$19.0	(0.333)	$52.5	(0.917)	$306.1	(5.349)
2015	$59.1	$17.6	(0.297)	$32.3	(0.546)	$20.0	(0.339)	$53.9	(0.912)	$322.0	(5.449)
2016	$61.0	$18.1	(0.297)	$33.5	(0.549)	$21.1	(0.345)	$55.4	(0.908)	$339.3	(5.557)
2017	$63.0	$18.7	(0.297)	$34.8	(0.551)	$22.2	(0.352)	$57.0	(0.904)	$357.9	(5.678)
2018	$65.1	$19.3	(0.297)	$36.1	(0.554)	$23.4	(0.360)	$58.6	(0.901)	$378.1	(5.812)
2019	$67.1	$19.9	(0.297)	$37.4	(0.557)	$24.7	(0.368)	$60.2	(0.897)	$399.9	(5.957)
2020	$69.2	$20.5	(0.296)	$38.8	(0.560)	$26.1	(0.377)	$62.0	(0.895)	$423.4	(6.114)
2021	$71.4	$21.2	(0.296)	$40.3	(0.564)	$27.6	(0.387)	$63.7	(0.892)	$448.7	(6.283)
2022	$73.7	$21.8	(0.296)	$41.8	(0.567)	$29.3	(0.397)	$65.5	(0.889)	$476.1	(6.460)
2023	$76.1	$22.5	(0.296)	$43.3	(0.569)	$31.1	(0.408)	$67.4	(0.885)	$505.7	(6.644)
2024	$78.6	$23.3	(0.296)	$86.6	(1.101)	$35.6	(0.452)	$69.2	(0.880)	$582.0	(7.400)
2025	$81.3	$24.1	(0.296)	$110.1	(1.353)	$41.8	(0.514)	$71.0	(0.873)	$686.9	(8.445)

Expected Problems

There are no foreseen major problems with respect to the Military Retirement Fund that would require disclosure in the Management's Discussion and Analysis.

Expected Changes Between the Expected and Actual Investment Rate of Return

Due to the currently increasing trend in interest rates, the increasing deficit, the volatility in the markets with regard to energy prices, and the current state of international conflict, along with the newly passed tax cuts, one might expect the U.S. budget deficit to increase. This will necessitate increased borrowing by the U.S. Government for the foreseeable future and therefore there may be a greater opportunity to purchase treasury market securities at higher rates of interest. A redistribution of the funds portfolio toward TIPS-type investments might serve as a hedge against any future inflation impact and could increase the profitability of the Fund over time.

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund 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 Military Retirement Fund 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.

Financial Data

The table below presents comparative financial statement information for the MRF.

Military Retirement Fund
Analysis of Financial Statements

for the period ending September 30, 2005 and 2004
($ in 000s)

Balance Sheet	2005	2004	Difference (Increase/Decrease)
Fund Balance with Treasury (See Note 3) - Ensured sufficient funds were available to cover estimated disbursements	22,896	20,677	2,219 10.73%
Investments (See Note 4) - Revenue from Treasury Payments, Service Contribution, and Interest	197,807,057	187,962,462	9,844,595 5.24%
Account Receivable (See Note 5) - Continued emphasis placed on collecting these amounts	26,738	25,257	1,481 5.86%
Other Liabilities (See Note 15) - Custodial Liability due to Treasury	1,058	905	153 16.91%
Military Retirement Benefits and Other Employment Related Actuarial Liabilities - NDAA 05 SBP benefit increase	892,111,601	834,582,098	57,529,503 6.89%
Cumulative Results of Operations - Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by $57.5 Billion and total assets increased by $9.8 Billion.	(697,577,275)	(649,695,061)	(47,882,214) 7.37%
Consolidated Statement of Net Cost Net Costs With the Public - Higher increase in Actuarial Liability in FY 04 due to concurrent receipt benefits	96,694,416	135,662,860	(38,968,444) -28.72%
Combined Statement of Budgetary Resources Offsetting Receipts - Unfunded liability amortization payment and concurrent receipt normal cost payment (FY 05 only) from Treasury	22,897,000	18,189,000	4,708,000 25.88%
Combined Statement of Financing Net Cost of Operations - Decrease in excess of revenue over expenses due to concurrent receipt benefits	47,882,214	93,278,356	(45,396,142) -48.67%

Improper Payments Information Act of 2002 (Public Law No. 107-300)

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review annually all programs and activities and identify those that may be susceptible to significant erroneous payments. The DoD's FY 2005 survey did not identify any programs or activities where payments met the Office of Management and Budget's criteria for "significant" erroneous payments. The DoD reports to both the President and the Congress its progress in reducing erroneous payments. The Department conducts various types of prepayment and postpayment reviews for military retirement payments.

In FY 2004, the Military Retired and Annuitant Pay began monthly random reviews of confirmed deceased retiree accounts, in addition to monthly random reviews from the overall population of retired and annuity pay accounts. Both of these sampling plans were designed to produce annual estimates of improper payments, with probability of 95 percent and sample precisions of plus or minus 2.5 percent. DoD targeted the review of confirmed deceased accounts as a subset of the population highly at risk for improper payments. A monthly sample of accounts (approximately 138) is selected from the population of confirmed deceased accounts. Each account is audited to determine if the member was overpaid after the member's death was reported to Military Retired and Annuitant Pay. Statistics collected from the review include the number of accounts reviewed, number with overpayments, dollar amount of the overpayment, amount of correct pay (what the payment should have been), and the dollar amount collected back from the member's account/estate within the first 60 days after notification. These sample statistics are projected to the population of deceased retirees to then determine an improper payment rate population estimate for deceased accounts. Population estimates from the deceased account reviews are then added to any improper payments identified through other than retired pay random audits, to then determine an overall improper payments population estimate for retired pay.

Military Retirement and Annuitant Pay places great emphasis on methods to reduce the dollar value of improper payments to deceased retirees. It fully recognizes that a certain number of retirees will be paid after death, simply by virtue of the inability to predict death and the fact that families have more pressing issues to address immediately following death than to notify the Military Retired and Annuitant Pay customer contact center. To minimize the impact of a delay in death notification, it has substantially improved its internal processing methods as well as streamlining and automating listings and data mining techniques with the Social Security Administration. This process allows DoD to receive death notice information through an automated system match on military retirees. In many cases, this death notification process will prevent the payment system from generating an improper payment. Preliminary assessment of the FY 2005 estimates suggests that these death match process improvement initiatives are contributing to a reduction of improper payments to deceased personnel. FY 2004 improper payments to deceased retirees were estimated at $51.8 million (the initial estimate of $26.2 million was incorrect and raised subsequently to $51.8 million). For FY 2005, the Department projected $49.3 million of improper payments for this program, with most of that ($46.7 million) going to deceased retirees. This represents an error rate of 0.1381 percent of the $35.6 billion in military retirement payments. In addition, results from random review of the first 8 months of FY 2005 indicate that 95.81 percent of the overpaid dollars to deceased retirees is recovered within the first

60 days after notification. As such, DoD can project that more than $47.2 million of the $49.3 million in overpayments, nearly 96 percent, were recovered within 60 days of notification.

Two barriers impede the agency's ability to take corrective actions in reducing improper payments, the Federal Acquisition Regulation and the Retired and Annuitant Pay service contract. On January 28, 2002, the servicing of Retired and Annuitant Pay came under the purview of a government contractor. Although most functions remain unchanged from when the government performed these functions, there are now contractual limits to the government's involvement in the day-to-day operations of Retired and Annuitant Pay. The Continuing Government Activities office was formed to oversee the Retired and Annuitant Pay contract, to ensure the contractual requirements are followed; however, the government can no longer direct how the work is accomplished. To bring about an operational change, both the government and the contractor must agree on how to effect and fund a change. Any deviation from the current contract requires a contract modification, which is detailed in the Federal Acquisition Regulation.

DoD MILITARY RETIREMENT FUND

PRINCIPAL STATEMENTS

Principal Statements

Department of Defense
DoD Military Retirement Fund
BALANCE SHEETS
As of September 30
(In Thousands)

		2005		2004
ASSETS				
Intragovernmental:				
Fund Balances with Treasury (Note 3)	$	22,896	$	20,677
Investments (Note 4)		197,807,057		187,962,462
Total Intragovernmental Assets	$	197,829,953	$	187,983,139
Accounts Receivable (Note 5)		26,738		25,257
TOTAL ASSETS	$	197,856,691	$	188,008,396
LIABILITIES				
Intragovernmental:				
Other Liabilities (Note 6)	$	1,058	$	905
Total Intragovernmental Liabilities	$	1,058	$	905
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 6 & 7)		892,111,601		834,582,098
Benefits Due and Payable (Note 6)		3,321,307		3,120,454
TOTAL LIABILITIES	$	895,433,966	$	837,703,457
NET POSITION				
Cumulative Results of Operations	$	(697,577,275)	$	(649,695,061)
TOTAL NET POSITION	$	(697,577,275)	$	(649,695,061)
TOTAL LIABILITIES AND NET POSITION	$	197,856,691	$	188,008,396

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF NET COST
For the Years Ended September 30
(In Thousands)

	2005	2004
PROGRAM COSTS		
(Less: Intragovernmental Earned Revenue) (Note 8)	$ (48,812,202)	$ (42,384,504)
Intragovernmental Net Costs	$ (48,812,202)	$ (42,384,504)
Gross Costs With the Public (Note 9)	96,694,416	135,662,860
Net Costs With the Public	$ 96,694,416	$ 135,662,860
TOTAL NET COST	$ 47,882,214	93,278,356
NET COST OF OPERATIONS	$ 47,882,214	$ 93,278,356

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30
(In Thousands)

		2005		2004
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	**$**	(649,695,061)	$	(556,416,705)
Net Cost of Operations		47,882,214		93,278,356
ENDING BALANCES	$	(697,577,275)	$	(649,695,061)

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30
(In Thousands)

		2005		2004
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	$	49,171,963	$	42,256,826
Other				
Unobligated Balance:				
Beginning of period (Note 3)		0		176,028,930
Temporarily Not Available Pursuant to Public Law (Note 3)		(10,005,741)		0
Total Budgetary Resources	$	39,166,222	$	218,285,756
STATUS OF BUDGETARY RESOURCES				
Obligations Incurred:				
Direct	$	39,166,222	$	37,152,632
Unobligated Balance:				
Exempt From Apportionment		0		181,133,124
Total Status of Budgetary Resources	$	39,166,222	$	218,285,756
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net - Beginning of Period	$	3,120,239	$	2,963,018
Obligated Balance, Net - End of Period:				
Accounts Payable	$	3,321,072	$	3,120,239
Outlays:				
Disbursements	$	38,965,389	$	36,995,411
Less: Offsetting Receipts		(22,897,000)		(18,189,000)
Total Outlays	$	16,068,389	$	18,806,411

The accompanying notes are an integral part of these statements.

DoD Military Retirement Fund
STATEMENTS OF FINANCING
For the Years Ended September 30
(In Thousands)

		2005		2004
RESOURCES USED TO FINANCE ACTIVITES				
Budgetary Resources Obligated				
Obligations Incurred	$	39,166,222	$	37,152,632
Less: Offsetting Receipts		(22,897,000)		(18,189,000)
Total Resources Used to Finance Activities	$	16,269,222	$	18,963,632
Total Resources Used to Finance the Net Cost of Operations	$	16,269,222	$	18,963,632
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	$	57,529,523	$	98,520,513
Components not Requiring or Generating Resources (Note 10):				
Trust Fund Exchange Revenue		(25,915,202)		(24,195,504)
Other		(1,329)		(10,285)
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	$	31,612,992	$	74,314,724
Net Cost of Operations	$	47,882,214	$	93,278,356

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

Principal Statements

DoD MILITARY RETIREMENT FUND

FOOTNOTES TO THE PRINCIPAL STATEMENTS

Footnotes

DoD MILITARY RETIREMENT 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) Military Retirement Fund was authorized by Public Law (PL) 98-94 for the accumulation of funds to finance the liabilities of the DoD under military retirement and survivor benefit programs.

These financial statements have been prepared to report the financial position and results of operations of the Military Retirement 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, in accordance with the requirements of the Office of Management and Budget (OMB) Circular A-136 "Financial Reporting Requirements" and accounting principles generally accepted in the United States of America. The Military Retirement Fund financial statements are prepared by the Military Retirement Fund in addition to the financial reports required pursuant to OMB directives that are used to monitor and control the Military Retirement Fund's use of budgetary resources.

A more detailed explanation of these financial statement elements are discussed in the applicable footnote.

B. Mission of the Reporting Entity. The mission of the DoD Military Retirement Fund is to accumulate funds in order to finance on an actuarially sound basis the liabilities of the DoD under military retirement and survivor benefit programs.

The asset accounts used to prepare the statements are categorized as either entity or nonentity 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. Nonentity 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 Military Retirement Fund is a pension program established in Fiscal Year (FY) 1984 by PL 98-94, for the payment of annuities and pensions to retired military personnel and their survivors. The DoD Retirement Board of Actuaries determines the contributions made to the Military Retirement Fund. The DoD contribution is a percentage of basic pay. The Department of Treasury contribution is the annual unfunded amortization payment. Excess funds from the contributions are invested and accrued interest revenue is used to cover future liabilities of the Fund.

D. Basis of Accounting. Under the authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to its three principle members, the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB) and the Comptroller General of the United States. 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) Federal Accounting Standards Advisory Board (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; and (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 in the circumstances. When directed by OMB, through OMB Circular A-136, generally accepted accounting principles in the United States of America serve as authoritative.

E. Revenues and Other Financing Source. Financing sources for the Military Retirement Fund are provided primarily through monthly Military Service contributions as a percentage of base pay, an annual unfunded liability payment from the U.S. Department of Treasury, and interest earned on investments.

F. Recognition of Expenses. For financial reporting purposes, the Fund recognizes benefit expenses in the period incurred.

G. Accounting for Intragovernmental Activities. The Military Retirement Fund purchases and redeems non-marketable market based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS), and over-night certificates. Treasury bills are short-term securities with maturity of one year or less and are purchased at a discount. Treasury notes have a maturity of at least one-year, but not more than ten, 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. Treasury TIPS are securities with maturities of five to twenty years and are purchased at a discount or premium. TIPS provide protection against inflation. The principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. At maturity the recipient is paid the adjusted principal or original principal, whichever is greater.

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 Military Retirement Fund's financial resources are maintained in U.S. Department of Treasury Accounts. The Defense Finance and Accounting Service (DFAS) processes all fund receipts and adjustments. DFAS prepares monthly reports, which provide information to the U.S. Department of Treasury, by appropriation, on transfers, deposits, and collections received. The U.S. Department of Treasury then records this information to the appropriation Fund Balance with Treasury (FBWT) account maintained in the U.S. Department of Treasury system. Differences between the Military Retirement Fund's recorded balance in the FBWT account and the U.S. Department of 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. Government Securities. Intra-governmental 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 U.S. Department of Treasury, Bureau of Public Debt. 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 Sheets. Material disclosures are provided at Note 4.

K. Contingencies and Other Liabilities. Contingencies occur when DoD Military Retired Pay is offset by Department of Veterans Affairs (DVA) payments. DoD entitlements are payable to the exact date of death and DVA entitlements end in the month preceding death. The contingency becomes payable by DoD to cover retiree benefits not paid by DVA during the month of death.

L. Net Position. Changes in Net Position reflect changes in net cost of operations.

M. Comparative Data. FY 2004 and FY 2005 Fourth Quarter 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 Military Retirement 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."

N. 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, disclosure of contingent assets and liabilities, and the actuarial present value of accumulated plan benefits at the date of the financial statements. Actual results could differ from those estimates.

O. Actuarial Information. The DoD Military Retirement 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 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. NON-ENTITY ASSETS:

($ In Thousands)	**FY 2005**	**FY 2004**
1. Intragovernmental Assets:		
a Fund Balance With Treasury	$0	$0
b Investments	$0	$0
c Total Intragovernmental Assets	$0	$0
2. Nonfederal Assets		
a Accounts Receivable	$1,058	$905
b Total Nonfederal Assets	$1,058	$905
3. Total Assets	$1,058	$905

4. Line 2.b, Accounts Receivable of $1,058 and $905 for 2005 and 2004, respectively, represents "Penalties, Fines, and Administration Fees Receivable, net of an allowance for loss which will be collected on behalf of U.S. Department of Treasury. This amount is also reflected in Notes 6 and 7 as a custodial liability of $1,058 and $905 for 2005 and 2004, respectively.

NOTE 3. FUND BALANCE WITH TREASURY (FBWT):

($ In Thousands)		**FY 2005**	**FY2004**
1.	Fund Balance		
	Fund Type		
	a. Trust Funds	$22,896	$20,677
	b. Total	$22,896	$20,677
2.	Status of Fund Balance with Treasury:		
	a. Unobligated Balance - Available	$ 0	$ 181,133,124
	b. Obligated Balance not yet Disbursed	194,459,938	3,120,239
	c. Non-Budgetary FBWT	0	0
	d. Non-FBWT Budgetary Accounts	(194,437,042)	(184,232,686)
	e. Total	$ 22,896	$ 20,677

The FBWT is maintained to ensure that sufficient funds are available to cover disbursements for the last business day of the fiscal year.

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 Military Retirement 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.”

NOTE 4. INVESTMENTS:

($ In Thousands)

	FY 2005				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
1. Intra-Governmental Securities:					
a. Non-Marketable, Market-Based	$208,140,459	Effective Interest	$(13,750,290)	$194,390,169	$197,354,456
b. Subtotal	$208,140,459		$(13,750,290)	$194,390,169	$197,354,456
c. Accrued Interest	3,416,888			3,416,888	3,416,888
Total	$211,557,347		$(13,750,290)	$197,807,057	$200,771,344
Total Intra-governmental:	$211,557,347		$(13,750,290)	$197,807,057	$200,771,344

	FY 2004				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
1. Intra-Governmental Securities:					
a. Non-Marketable, Market-Based	$199,372,589	Effective Interest	$ (15,139,903)	$184,232,686	$195,469,245
b. Subtotal	$199,372,589		$ (15,139,903)	$184,232,686	$195,469,245
c. Accrued Interest	3,729,776			3,729,776	3,729,776
Total	$203,102,365		$ (15,139,903)	$187,962,462	$199,199,021
Total Intra-governmental:	$203,102,365		$ (15,139,903)	$187,962,462	$199,199,021

Investments increased from $187,962,462 in FY 04 to $197,807,057 in FY 05 because of cumulative positive cash flow. The cumulative positive cash flow occurred due to Earned Revenue for Program Costs being greater than Benefit Outlays (Note 10). The investments listed above are presented at Amortized Cost and Market Value as of September 30, 2005 and 2004. Listed below is Par Value of the U.S. Treasury Securities referenced above.

	FY 2005 PAR VALUE	**FY 2004 PAR VALUE**
Bonds	$ 53,999,882	$ 64,897,911
Notes	49,437,658	79,875,820
TIPS	55,041,460	16,547,320
Overnights	18,802,622	15,959,284
Total	$ 177,281,622	$177,280,335

Footnotes

NOTE 5. ACCOUNTS RECEIVABLE:

($ In Thousands)

	FY 2005		
	Gross Amount Due	(Allowance for Estimated Uncollectibles)	Net Amount Due
1. Entity Receivables: With the Public	$32,665	$ (5,927)	$26,738

	FY 2004		
	Gross Amount Due	(Allowance for Estimated Uncollectibles)	Net Amount Due
1. Entity Receivables: With the Public	$30,421	$ (5,164)	$25,257

The General Reserve Method, under which a reserve is based on age of debts and bad debt experience, is used as stated in Volume 4, Chapter 3, Annex 1 (3) of the DoD Financial Management Regulation to calculate an allowance percentage. Accounts receivable includes amounts, claims and refunds receivable from members.

NOTE 6. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES:

	FY 2005		
($ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	$0	$1,058	$1,058
Total Intragovernmental Liabilities	$0	$1,058	$1,058
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 7)	$191,138,866	$700,972,735	$892,111,601
b. Benefits Due and Payable	$3,321,072	$235	$3,321,307
Total Nonfederal Liabilities	$194,459,938	$700,972,970	$895,432,908
3. Total Liabilities:	$194,459,938	$700,974,028	$895,433,966

	FY 2004		
($ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	$0	$905	$905
Total Intragovernmental Liabilities	$0	$905	$905
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 7)	$181,133,124	$653,448,974	$834,582,098
b. Benefits Due and Payable	$3,120,240	$214	$3,120,454
Total Nonfederal Liabilities	$184,253,364	$653,449,188	$837,702,552
3. Total Liabilities:	$184,253,364	$653,450,093	$837,703,457

For FY 2005 and FY 2004, Line 1.a., Other Intra-governmental liability of $1,058 and $905, respectively, represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2. to the U.S. Department of Treasury. The nonentity asset replaces the budgetary resource to cover the liability. The change in other intragovernmental liabilities and other non-federal liabilities are explained in further details in Note 7.

NOTE 7. 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
Military Retirement Pensions	$892,111,601	6.25%	$ (191,138,866)	$700,972,735
Total:	$892,111,601		$ (191,138,866)	$700,972,735
	FY 2004			
Military Retirement Pensions:	$834,582,098	6.25%	$181,133,124	$653,448,974
Total:	$834,582,098		$181,133,124	$653,448,974

1. Other Information Pertaining to Military Retirement Benefits and Other Employment-Related Actuarial Liabilities:
   a. Actuarial Cost Method Used: Aggregate entry-age normal method.

   b. The Military Retirement System is a single-employer, defined benefit plan. Administrative costs of the Fund are not ascertainable. Projected revenues into the Fund, authorized by PL 98-94, come from three sources: interest earnings on Fund assets, monthly DoD contributions, and annual contributions from the Treasury Department. The monthly DoD contributions are determined as a percentage (approved by the DoD Retirement Board of Actuaries) of basic pay. 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, 1984, as well as the amortization of actuarial gains and losses that have arisen since then. Starting October 1, 2004, Public Law 108-136 requires the Treasury to contribute the normal cost amount for the concurrent receipt provisions under Sections 1413, 1413a, and 1414 in addition to the unfunded liability amortization payment. The Board determines Treasury's contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

The long-term economic assumptions for the FY 2004 valuation were 6.25 percent interest, 3.0 percent Consumer Price Index, and 3.75 percent salary increase. For fiscal years 2005 and 2006, the inflation rates of 2.7 percent (actual) and 4.1 percent (actual), salary increases of 3.5 percent (actual) and 3.1 percent (estimated) were used, respectively. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. 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 valuation results as reported in the DoD Office of Actuary Valuation of the Military Retirement System. For purposes of the Fund's financial reporting, this process is applied annually.

Contributions to the Military Retirement Fund (Fund) are calculated so as to maintain the Fund on an actuarially sound basis. This means that there will be sufficient funds to make all benefit payments to eligible recipients each year, and that the Fund balance is projected to eventually equal the actuarial liability, i.e., all unfunded liabilities are liquidated. In order to accomplish this, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded) and any emerging actuarial gains or losses. The initial unfunded liability of the program is being amortized over a 50-year period. All subsequent gains and losses experienced by the system are amortized over a 30-year period. Methods and assumptions used to compute actuarial costs and liabilities, and to amortize the initial unfunded liability as well as all actuarial gains and losses, must be approved by the Department of Defense Retirement Board of Actuaries, as required by Chapter 74 of Title 10, United States Code. The Board is a Federal Advisory Committee appointed by the President.

NOTE 8. DISCLOSURES RELATED TO THE STATEMENT OF NET COST:

Earned Revenues for Program Costs:
($ in thousands)

	FY 2005	FY 2004
1. Service Contributions as a Percentage of Base Pay	$15,015,443	$14,070,799
2. Annual Treasury Unfunded Liability Payment	21,358,000	18,189,000
3. Annual Treasury Normal Cost Payment	1,539,000	0
4. Interest on Investments	10,899,759	10,124,705
Total	$ 48,812,202	$42,384,504

Interest on investments increased from $10,124,705 in FY 04 to $10,899,759 in FY 05 principally due to the increase in the Annual Treasury Payments and increased service contributions. Beginning with FY 05, the Annual Treasury Payments include in addition to the Unfunded Liability payment, the normal cost for the concurrent receipt benefits enacted in the FY 04 National Defense Authorization Act.

Gross Costs with the Public decreased from $135,662,860 in FY 04 to $96,694,416 in FY 05. The decrease was principally due to a smaller increase in actuarial liability in FY 05 of $57,529,503 compared to FY 04's increase of $98,520,497. Due to the change in the actuarial liability, the Net Cost of operations also decreased respectively.

NOTE 9. BENEFIT PROGRAM EXPENSE:

($ In Thousands)

	FY 2005	FY 2004
1. Service Cost	$14,857,208	$12,857,181
2. Period Interest on the Benefit Liability	51,427,451	45,272,408
3. Prior (or past) Service Cost	25,835,945	81,062,746
4. Period Actuarial (Gains) or Losses	(4,113,278)	(4,048,320)
6. Total Benefit Program Expense	$96,233,882	$135,144,015

The benefit program expenses provide components of the change in the actuarial liability from September 30, 2004 to September 30, 2005. The September 30, 2005 actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during FY 2005. The September 30, 2005 actuarial liability is equal to the September 30, 2004 liability plus the total benefit program expenses minus the expected benefit payments. The large decrease in Prior Service Cost (Line 3.) is primarily due to the concurrent receipt legislation contained in the 2004 National Defense Authorization Act, which contributed significantly to the amount reported in FY 2004. In FY 2005, benefit changes included primarily enhancements to the Survivor Benefit Program, but the impact on the actuarial liability was smaller in magnitude.

NOTE 10. DICLOSURES RELATED TO THE STATEMENT OF FINANCING:

($ In Thousands)

Other Components Not Requiring or Generating Resources of $(1,329) for FY 05 represents the change in the net Accounts Receivable, from over-payment of benefits made to military retirees and survivors, from the end of prior year (of $2,040), less the change in Allowance of Estimated Uncollectible Accounts Receivable of $771. The comparable amount of $10,285 for FY 04 represents a $9,488 change in Accounts Receivable and change in Allowance for Estimated Uncollectibles of $797. The calculation for the allowance for estimated uncollectibles is disclosed in Note 5.

NOTE 11. OTHER DISCLOSURES:

Net Pension Expense: The net pension expense for the change in the actuarial accrued liability is developed in the table below.

($ In Thousands)	FY 2005	FY 2004
A. Beginning of Year Accrued Liability	$834,582,098	$736,061,601
B. Normal Cost Liability	14,857,208	12,857,181
C. Plan Amendment Liability	25,835,945	81,062,746
D. Assumption Change Liability	4,904,136	(32,540)
E. Benefit Outlays	(38,704,379)	(36,623,518)
F. Interest on Pension Liability	51,427,451	45,272,408
G. Actuarial Loss (Gain)	(790,858)	(4,015,780)
H. End-of-Year Accrued Liability (A+B+C+D+E+F+G)	$892,111,601	$834,582,098
I. Net Change in Actuarial Liabilities (B+C+D+E+F+G)	$57,529,503	$98,520,497

Other Information:

Each year the Accrued Liability is expected to increase with the normal cost, decrease with benefit outlays, and increase with the interest cost. In the absence of (1) actuarial gains and losses, (2) plan benefit changes, and (3) assumption changes, an increase of $27,580,280 in the Accrued Liability was expected during FY 2005.

The September 30, 2005, Accrued Liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include an updated set of retiree divorce rates and refinements in the methodology used to project drilling reservists, the net effect of which is an increase in the September 30, 2005, accrued liability of $4,904,136, shown on Line D. The change in retirement benefits for FY 2005 includes accelerated phase-in of concurrent receipt benefits for certain retirees, and an increase in Survivor Benefit Plan (SBP) benefits in the 2005 National Defense Authorization Act. The September 30, 2004, reported Accrued Liability included an updated set of retiree offset factors and updated assumptions pertaining to members' choice of Redux Career Status Bonus, the net effect of which was a decrease in the September 30, 2004, Accrued Liability of $32,540, shown on Line D. The change in retirement benefits for FY 2004 includes the new concurrent receipt benefits and the reform of basic pay rates in the 2004 National Defense Authorization Act.

The combined effect of these benefit changes is an increase in the September 30, 2005 Accrued Liability of $25,835,945, and September 30, 2004 Accrued Liability of $81,062,746, shown on Line C. The FY 2005 and FY 2004 decreases in Accrued Liability due to the net experience gain of $790,858 and $4,015,780, respectively, shown on line G, reflects the new population on which the September 30, 2004 and 2003, respectively, roll-forward is based, as well as other economic experience being different than assumed.

DoD MILITARY RETIREMENT FUND

REQUIRED SUPPLEMENTARY INFORMATION

Required Supplementary Information

DoD
Military Retirement Fund
Intragovermental 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	Investments
Department of the Treasury	20	$22,896	$197,807,057
Total		$22,896	$197,807,057

Schedule, Part B Intragovernmental Liability Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index	Other
Department of the Treasury	20	$1,058
Total		$1,058

Schedule, Part C DoD Intragovernmental Revenues and Related Costs with Other Federal Agencies	Treasury Index	Earned Revenue
Department of the Treasury	20	$10,899,759
Department of the Navy	17	4,731,825
Department of the Army	21	6,482,147
Department of the Air Force	57	3,801,471
Other Defense Organizations	97	22,897,000
Total		$48,812,202

Required Supplementary Information

DoD MILITARY RETIREMENT FUND

OTHER ACCOMPANYING INFORMATION

Other Information

MILITARY RETIREMENT FUND
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2005 AND 2004

($ in Thousands)

	September 30, 2005 [1]	September 30, 2004
1 Present value of future benefits		
a. Annuitants now on roll	$561,003,879	$510,443,224
b. Non-retired reservists	$109,916,312	$102,298,810
c. Active duty personnel [2]	$342,389,456	$336,894,654
d. Total	$1,013,309,647	$949,636,688
2 Present value of future normal cost contributions	$121,198,047	$115,054,590
3 Actuarial accrued liability	$892,111,601	$834,582,098
4 Assets [3]	$191,138,866	$181,133,124
5 Unfunded accrued liability	$700,972,735	$653,448,974

[1] Rolled forward from September 30, 2004

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

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

Other Information

DoD MILITARY RETIREMENT FUND

INDEPENDENT AUDITORS' REPORTS

Independent Auditors' Reports

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

November 4, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/
CHIEF FINANCIAL OFFICER
UNDER SECRETARY OF DEFENSE (PERSONNEL AND READINESS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2005 Military Retirement Fund Financial Statements (Report No. D-2006-023)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires Federal agency Inspectors General appointed under the Inspector General Act of 1978, as amended, to audit the financial statements of the Federal agency or determine that "an independent external auditor" should conduct such audits. For FY 2005, we determined that Deloitte & Touche, LLP (Deloitte & Touche) should perform the audit of the Department of Defense Military Retirement Fund (The Fund) Financial Statements.

Unqualified Audit Opinion. We concur with the Deloitte & Touche unqualified opinion dated November 2, 2005. Deloitte & Touche opined that The Fund's FY 2005 financial statements and accompanying notes present fairly, in all material respects, The Fund's financial position as of September 30, 2005 and 2004, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary resources to net cost for the years then ended. The Defense Finance and Accounting Service prepared the financial statements in conformity with accounting principles generally accepted in the United States.

Report on Internal Controls. We further concur with the Deloitte & Touche report on internal control over financial reporting in connection with the audit of The Fund's FY 2005 financial statements. The report concluded that certain general data processing controls at certain computer processing locations The Fund uses may not support reliable processing of financial information within the related business cycles. The review disclosed deficiencies in the design or operation of controls related to data processing security configurations, business continuity arrangements, and system software change management 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. The deficiencies comprise a reportable condition; however, Deloitte & Touche stated it was not material for financial statement purposes. Other auditors could consider this condition to be significant in the context of a material weakness for DoD information security purposes.

Compliance with Laws and Regulations. As part of the audit, Deloitte & Touche had to obtain reasonable assurance that The Fund's FY 2005 financial statements are free of material misstatement. Deloitte & Touche performed tests to determine whether The Fund was administered in compliance with certain provisions of laws and regulations, and the tests disclosed instances of noncompliance. 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," requires that test results be reported if there are instances of noncompliance with certain other laws and regulations.

- The Fund's data are processed on data processing systems that do not fully comply with Office of Management and Budget Circular A-127, "Financial Management Systems."

- The Fund uses a general ledger system that is not transaction-based or derived from an integrated financial system.

Audit Responsibilities. We are responsible for obtaining reasonable assurance that the principal statements are fairly presented and free of material misstatement, according to 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 to the circumstances. Deloitte & Touche formed their opinion on the basic financial statements taken as a whole. Because the required supplementary information is not part of the basic financial statements, Deloitte & Touche did not audit that information and did not express an opinion on it.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. Douglas P. Neville at (703) 428-1061 (DSN 328-1061) or Mr. Thomas J. Winter at (703) 428-1082 (DSN 328-1082).

By Direction of the Deputy Inspector General for Auditing:

Paul J. Granetto

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

Deloitte.

Deloitte & Touche LLP
Suite 800
1750 Tysons Boulevard
McLean, VA 22102-4219
USA

Tel: 703-251-1000
Fax: 703-251-3400
www.us.deloitte.com

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") Military Retirement 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.

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 and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2005 and 2004, and its net cost of operations, 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 2, 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 audits.

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.

Deloitte & Touche LLP

November 2, 2005

Deloitte & Touche LLP
Suite 800
1750 Tysons Boulevard
McLean, VA 22102-4219
USA

Tel: 703-251-1000
Fax: 703-251-3400
www.us.deloitte.com

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") Military Retirement Fund (the "Fund") as of and for the year ended September 30, 2005, and have issued our report thereon dated November 2, 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 a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. 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. The reportable condition we noted is described in the following paragraph.

Certain general electronic data processing (EDP) controls at certain computer processing locations used by the Fund may 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 EDP security configurations, business continuity arrangements, and system software change management 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 internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

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, 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 which are summarized in the following paragraphs:

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 and protect sensitive 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.

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 2, 2005