



**FISCAL YEAR 2007**

**MILITARY RETIREMENT FUND**

**AUDITED FINANCIAL STATEMENTS**

**November 30, 2007**

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***DoD***  
***MILITARY RETIREMENT FUND***  
***FISCAL YEAR 2007***  
***AUDITED FINANCIAL***  
***STATEMENTS***

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*DoD*  
*MILITARY RETIREMENT*  
*FUND*

*MANAGEMENT'S DISCUSSION AND*  
*ANALYSIS*



### SUMMARY OF THE MILITARY RETIREMENT SYSTEM

For the Years Ended September 30, 2007 and 2006

#### Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund (MRF). The military retirement system provides benefits for retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The mission of the MRF 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.

Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness, the Office of the Under Secretary (Comptroller), and the Defense Finance and Accounting Service (DFAS) jointly oversee the operations of the Military Retirement System. DFAS is responsible for the accounting, investing, payment of benefits, and reporting of the Military Retirement Fund (the Fund). The DoD Office of the Actuary within the Office of the Under Secretary of Defense for Personnel and Readiness (OUSD (P&R)) calculates the actuarial liability of the Fund. The Office of Military Personnel Policy within OUSD (P&R) issues policy related to retirement benefits. While the Fund does not have a specified CFO, the OUSD(C) has oversight of the MRF's financial reporting processes.

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) 2007, the Fund paid out approximately \$44 billion in benefits to military retirees and survivors. In FY 2006, the Fund paid out approximately \$41 billion in benefits to military retirees and survivors. In addition to staff members of OUSD (P&R) and OUSD(C), 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 2007, the Fund received approximately \$14 billion in normal cost payments, a \$28.5 billion Treasury payment, and approximately \$10 billion in investment income, net of premium/discount amortization and accrued inflation compensation. During FY 2006, the Fund received approximately \$14 billion in normal cost payments, a \$26 billion Treasury payment, and approximately \$12 billion in investment income, net of premium/discount amortization and accrued inflation compensation.

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## Management's Discussion and Analysis

### 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.

There are three distinct nondisability benefit formulas related to three populations within the military retirement system. (1) *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. The National Defense Authorization Act for Fiscal Year 2007 (P.L. 109-364) lifted the 75 percent multiplier cap for personnel retiring after January 1, 2007. (2) *HI-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. (3) *CSB/Redux*: Members who first became a member of a uniformed service on or after August 1, 1986 and who elect to receive this option 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. Public Law 105-65 provided that Redux members have a choice of (a) receiving the HI-3 formula or (b) the Redux formula plus a lump-sum \$30,000 payment, called a Career Status Bonus (CSB). Members make their election during the fifteenth year of service. Those who choose the CSB 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 elect CSB/Redux, 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 CSB/Redux 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.

### Non Disability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of a uniformed service before September 8, 1980. It is equal to the average of the highest 36 months of

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## Management's Discussion and Analysis

basic pay for all other members. The multiplier is equal to (2.5 percent) times (years of service, rounded down to the nearest month). Members first entering a uniformed service on or after August 1, 1986, who elect CSB/Redux and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40 percent (50 percent minus 10 percent). At age 62, the retired pay is recomputed with the penalty removed.

As of September 30, 2007, there were approximately 1.46 million nondisability retirees from active duty receiving retired pay. In FY 2007, nondisability retirees were paid approximately \$35.78 billion. As of September 30, 2006, there were approximately 1.45 million nondisability retirees from active duty receiving retired pay. In FY 2006, nondisability retirees were paid approximately \$33.88 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. Public Law 108-375 extended the entitlement of disability retired pay to academy cadets and midshipmen.

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. 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, 2007, there were approximately 85,000 disability retirees receiving retired pay. In FY 2007, disability retirees were paid approximately \$1.27 billion. As of September 30, 2006, there were approximately 87,000 disability retirees receiving retired pay. In FY 2006, disability retirees were paid approximately \$1.29 billion.

### **Reserve Retirement**

Members of the reserves may retire after 20 qualifying years of creditable service, or after 15 if the member is unfit because of physical disability not incurred in the line of duty. 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

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## Management's Discussion and Analysis

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, 2007, there were approximately 313,000 reserve retirees receiving retired pay. In FY 2007, reserve retirees were paid approximately \$4.00 billion. As of September 30, 2006, there were approximately 292,000 reserve retirees receiving retired pay. In FY 2006, reserve retirees were paid approximately \$3.49 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 CSB/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. Effective April, 2008, the survivor benefit will be 55% of the member's elected base amount, with no reduction at age 62. Those whose annuities were reduced by a Social Security offset were grandfathered to get the better of the two formulas. Public Law 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. Public Law 109-163 allowed surviving spouses to transfer the SBP benefit to an eligible child



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## Management's Discussion and Analysis

without being subject to a Dependency and Indemnity Compensation (DIC) offset.

SBP annuities are reduced by any survivor benefits (DIC) received from the Department of Veterans Affairs (VA) 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 CSB/Redux 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. In addition, the Public Law 108-375 included a one-year Open Season from October 1, 2005, to September 30, 2006, during which retirees who had previously declined SBP coverage could enroll, or those already enrolled could increase their coverage.

As of September 30, 2007, there were approximately 286,000 survivors of military members receiving annuity payments. In FY 2007, survivors were paid approximately \$3.01 billion. As of September 30, 2006, there were approximately 285,000 survivors of military members receiving annuity payments. In FY 2006, survivors were paid approximately \$2.65 billion.

### **Temporary Early Retirement Authority (TERA)**

Public Law 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, 2007, there were approximately 58,000 TERA retirees receiving retired pay. In FY 2007, TERA retirees were paid approximately \$841 million. As of September 30, 2006, there were approximately 58,000 TERA retirees receiving retired pay. In FY 2006, TERA retirees were paid approximately \$769 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.

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## Management's Discussion and Analysis

The "full" COLA effective December 1 is computed by calculating the percentage increase in the average CPI of 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 most survivors) are increased annually with the full COLA, except for those first entering a uniformed service on or after August 1, 1986, who elect CSB/Redux. 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 a VA-rated disability. Public Law 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. Public Law 108-136 also expanded eligibility under the Combat Related Special Compensation program to include qualified retirees at any combined percentage rating for certain combat-related disabilities compensated by 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 10-year phase-out. Public Law 108-375 eliminated the phase-out of the offset to military retired pay for 20-year retirees with a 100% VA disability rating. Public Law 109-163 eliminated the phase-out of the offset on October 1, 2009, and thereafter, for 20-year retirees who are not rated 100% disabled by VA, but are paid at the 100% level as "Individual Unemployables".

VA benefits also overlap survivor benefits through the 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. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees).

### **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

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## Management's Discussion and Analysis

comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) 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. Public Law 109-364 allows members with greater than 30 years of service to retire with entitlements exceeding 75 percent of basic pay. 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. Under the 1983 Social Security amendments, the cost of the additional benefits resulting from the noncontributory wage credits for past service was met by a lump sum payment from general revenues, while the cost for future service will be met by payment of combined employer-employee tax on such credits as the service occurs. Payments for these wage credits ended in 2002.

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.

### **Significant Changes During FY 2007**

The following assumption changes during FY 2007 had significant effects on the Fund's actuarial liabilities: (1) updated rates and factors used to project Nondisability Retired Pay, (2) updated rates and factors used to project Survivor Annuities, (3) targeted pay increases for particular pay grades along with longevity increases between 28 and 40 years of service for senior members, and (4) refinements to the methodologies used to calculate survivor annuities for those members who die while serving on Active Duty.

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## Management's Discussion and Analysis

The most significant assumption change during FY 2007 was the adoption of the updated rates and factors used to project Nondisability Retired Pay. At the DoD Retirement Board of Actuaries August 2007 meeting, the Board approved the updated rates and factors.

The lone benefit change during FY 2007 was the elimination of the 75 percent retired pay multiplier cap for retirements exceeding 30 years of service.

Significant assumption changes during FY 2006 included: (1) a new long-term interest assumption, (2) a new Take-Rate assumption for those service personnel who elect Career Status Bonus (CSB), (3) an update to Temporary Disability rates, (4) an update to factors used to project Survivor Annuities, (5) a one-year open season for SBP, and (6) refinements to the methodologies used to calculate the Concurrent Receipt Phase-in amounts.

The most significant change during FY 2006 was the new long-term interest assumption. At the DoD Retirement Board of Actuaries August 2006 meeting, the Board lowered the long-term interest assumption from 6.25% to 6.00%.

### **Changes for FY 2008**

The possible foreseen benefit changes with respect to the Military Retirement Fund for FY 2008 include: (1) "Wounded Warrior Bills" which focus on combat-related severely injured members, (2) a reduction in the reserve retirement age below age 60, (3) SBP refinements, (4) Concurrent Receipt refinements, and (5) refinements to general retired pay.

### **Performance Measures**

During FY 2007 and 2006, the Fund made monthly disbursements to approximately 2.1 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, 2007 = .343
- b. September 30, 2006 = .328
- c. September 30, 2005 = .334
- d. September 30, 2004 = .338
- e. September 30, 2003 = .351
- f. September 30, 2002 = .378
- g. September 30, 2001 = .347
- h. September 30, 2000 = .354
- i. September 30, 1999 = .352
- j. September 30, 1998 = .331

The effective yield of the Fund during FY 2007 was approximately 4.69%.

## Management's Discussion and Analysis

### Projected Long-Term Financial Status of the Fund

The projected long-term financial status 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 increasing Fund assets.

Basic pay for FY 2007 was projected to be \$53.7 billion. Normal cost payments were projected to be \$16.2 billion. The unfunded liability amortization payment was projected to be \$26.0 billion. Investment income was projected to be \$13.3 billion. Fund disbursements for FY 2007 were projected to be \$43.6 billion. Actual amounts for FY 2007 were \$43.6 billion. 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's assets are projected to increase 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 Assets End of Year
2008	\$56.5	\$18.7 (0.331)	\$46.2 (0.818)	\$15.3 (0.271)	\$45.6 (0.807)	\$255.0 (4.513)
2009	\$59.4	\$19.7 (0.332)	\$47.9 (0.806)	\$17.4 (0.293)	\$47.5 (0.800)	\$292.6 (4.926)
2010	\$63.0	\$20.8 (0.330)	\$49.7 (0.789)	\$19.8 (0.314)	\$49.0 (0.778)	\$333.8 (5.298)
2011	\$66.8	\$22.1 (0.331)	\$51.6 (0.772)	\$22.4 (0.335)	\$50.4 (0.754)	\$379.5 (5.681)
2012	\$70.5	\$23.3 (0.330)	\$53.5 (0.759)	\$25.2 (0.357)	\$51.7 (0.733)	\$429.9 (6.098)
2013	\$74.1	\$24.5 (0.331)	\$55.5 (0.749)	\$28.4 (0.383)	\$53.0 (0.715)	\$485.4 (6.551)
2014	\$77.7	\$25.7 (0.331)	\$57.6 (0.741)	\$31.8 (0.409)	\$54.2 (0.698)	\$546.3 (7.031)
2015	\$81.5	\$27.0 (0.331)	\$59.8 (0.734)	\$35.6 (0.437)	\$55.5 (0.681)	\$613.2 (7.524)
2016	\$85.4	\$28.3 (0.331)	\$62.0 (0.726)	\$39.8 (0.466)	\$57.1 (0.669)	\$686.2 (8.035)
2017	\$89.5	\$29.7 (0.332)	\$64.3 (0.718)	\$44.3 (0.495)	\$58.8 (0.657)	\$765.7 (8.555)
2018	\$93.8	\$31.1 (0.332)	\$66.7 (0.711)	\$49.2 (0.525)	\$60.6 (0.646)	\$852.1 (9.084)
2019	\$98.2	\$32.6 (0.332)	\$69.2 (0.705)	\$54.5 (0.555)	\$62.5 (0.636)	\$946.0 (9.633)
2020	\$102.8	\$34.1 (0.332)	\$71.8 (0.698)	\$60.3 (0.587)	\$64.4 (0.626)	\$1,047.9 (10.194)
2021	\$107.7	\$35.8 (0.332)	\$74.5 (0.692)	\$66.6 (0.618)	\$66.4 (0.617)	\$1,158.3 (10.755)
2022	\$112.7	\$37.5 (0.333)	\$77.3 (0.686)	\$73.4 (0.651)	\$68.5 (0.608)	\$1,278.0 (11.340)
2023	\$118.0	\$39.2 (0.332)	\$80.2 (0.680)	\$80.7 (0.684)	\$70.7 (0.599)	\$1,407.5 (11.928)
2024	\$123.6	\$41.1 (0.333)	\$83.2 (0.673)	\$88.7 (0.718)	\$72.8 (0.589)	\$1,547.7 (12.522)
2025	\$129.6	\$43.1 (0.333)	\$120.0 (0.926)	\$99.3 (0.766)	\$75.0 (0.579)	\$1,735.1 (13.388)
2026	\$135.9	\$45.2 (0.333)	\$127.1 (0.935)	\$111.0 (0.817)	\$77.1 (0.567)	\$1,941.2 (14.284)
2027	\$142.3	\$47.4 (0.333)	\$8.1 (0.057)	\$116.2 (0.817)	\$79.5 (0.559)	\$2,033.4 (14.290)

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## Management's Discussion and Analysis

\*At its August, 2007, meeting, the Military Retirement Fund Board of Actuaries decided to shorten the amortization period of the initial unfunded liability such that it will be extinguished in 2026 rather than 2034. This led to an increase in the FY 2008 amortization payment amount of \$16 billion.

### **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.

### **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. The Investment Board approved a revised Investment Strategy that seeks to match the duration of the assets with the duration of the liability while ensuring the cash disbursement needs of the fund are met.

### **Expected Changes Between the Expected and Actual Investment Rate of Return**

Due to the current volatility in interest rates, the increasing deficit, the volatility in the markets with regard to energy prices, and the current state of international conflict 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

## Management's Discussion and Analysis

interest. An investment strategy has been developed to shift towards Treasury Inflation Protected Securities to hedge against any future inflation to increase the profitability of the Fund over time.

### Financial Data

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

### Military Retirement Fund Analysis of Financial Statements

For the Years Ended September 30, 2007 and 2006  
(\$ in Thousands)

<u>Statements of Net Assets</u>	<u>2007</u>	<u>2006</u>	<u>Difference</u> Increase/(Decrease)
Fund Balance with Treasury - Sufficiency of funds available to cover estimated disbursements	\$20,376	\$30,735	(\$10,359) 34%
Investments - Revenue from Treasury Payments Service Contribution, and Interest	\$218,084,995	\$208,392,113	\$9,692,882 5%
Account Receivable - Continued emphasis placed on collecting these amounts	\$143,116	\$23,259	\$119,857 515%
Other Liabilities - Custodial Liability due to Treasury	\$759	\$1,147	(\$388) 34%
Military Retirement Benefit Liabilities - Updated nondisability rates and factors	\$1,028,850,683	\$967,106,079	\$61,744,604 6%
Cumulative Results of Operations - Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by \$61.6 Billion and total assets increased by \$9.8 Billion.	(\$810,603,152)	(\$758,661,316)	\$51,941,836 7%
<b><u>Statements of Net Costs</u></b>			
Gross Cost of Operations - Lower Actuarial Liability in FY 07 due to updated nondisability rates and factors	\$105,253,018	\$112,821,696	(\$7,568,678) 7%
<b><u>Statements of Budgetary Resources</u></b>			
Distributed Offsetting Receipts - Unfunded liability amortization payment and concurrent receipt normal cost payment (FY 07 ) from Treasury	\$26,048,000	\$23,180,000	\$2,868,000 12%

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## Management's Discussion and Analysis

### **Management Assurances**

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of this Fund, DoD and not MRF represents the legislative definition of an Agency. Beginning with fiscal year 2006, as directed in OMB Circular A-123, *Management's Responsibility for Internal Control, Appendix A, Internal Control over Financial Reporting*, the 24 CFO Act agencies (including DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall Federal Managers Financial Integrity Act assurance statement. OUSD (C) issued guidelines to the Heads of DoD Components, including MRF, as to how to support this DoD reporting requirement. The three offices that comprise the management of the MRF are in the process of complying with the required guidelines for MRF. The MRF has been audited by DoDIG in conjunction with a private audit firm and no material weaknesses were reported during FY 2006. MRF management provided an assessment of management controls for MRF to OUSD(C).

Subsequent to management's assessment for FY 2007, a material weakness was identified during the preparation of the FY 2007 annual report. During the preparation of the Fund's year-end financial statements, the initial presentation of certain offsetting receipts accounts of the Fund for FY 2006 and FY 2007 was determined to be noncompliant with U.S. Treasury guidance, affecting the Statement of Budgetary Resources and the disclosure of financing activities. The change in U.S. Treasury guidance for offsetting receipts, which was effective for FY 2006, was not previously identified for the Fund's financial statement preparation process. In its FY 2006 Report of Treasury Receipts by Source, Treasury identified certain receipt accounts that should be identified as distributed offsetting receipts by the Fund and the DoD.

The correct classification of offsetting receipts is significant to the accurate reporting of intragovernmental activity for the DoD and U.S. Government financial statements. Therefore, the Fund made the correction in the FY 2007 financial statements and restated the FY 2006 financial statements and related disclosures.

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

The Improper Payments Information Act of 2002 (IPIA), as implemented by the Office of Management and Budget (OMB) Circular A-123, Appendix C, "Requirements for Effective Measurement and Remediation of Improper Payments," requires Federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments (i.e., programs with erroneous payments exceeding both \$10 million and 2.5% of program payments). The terms improper and erroneous are used interchangeably. An improper payment occurs when the funds go to the wrong recipient, the recipient receives the incorrect amount of funds, or the recipient receives payment for an ineligible service. Improper payments also include duplicate payments and payments for services not received.

The Department's risk assessments for Military Retirement addressed the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well as system weaknesses identified internally or by outside audit activities. While the Department's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments. The Department of Defense uses random sampling methods designed to meet or exceed the OMB requirement of annual estimates of improper payments with a 90% confidence interval of (plus or minus 2.5%).

Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. Based on FY 2007 reviews, the Department projected approximately \$49 million in improper payments for this program, with almost the entire amount paid to deceased retirees. This represents an overpayment rate of 0.13% of the estimated \$37 billion in annual military retirement payments. In



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## Management's Discussion and Analysis

certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in FY 2007 indicated that the Department recovered 93% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

The Department's control processes to prevent, identify, and reduce overpayments to deceased retirees include a series of periodic eligibility notifications, early detection data mining efforts, and partnerships with other Federal and state entities. The Department takes a proactive approach, routinely comparing retired and annuity payroll master file databases to Social Security Administration "deceased" records and periodically comparing records with the Office of Personnel Management deceased files. "Ad hoc" death match file comparisons are also conducted with the Department of Veterans Affairs' cemetery database files and with individual states (e.g., Texas, California, Florida) with sizable retiree and annuitant populations. Retirees identified as deceased in these comparisons must validate their continued eligibility, or the accounts are suspended.

Certifying officer legislation holds certifying and disbursing officers accountable for government funds. In accordance with section 2773a of title 10, United States Code, pecuniary liability attaches automatically when there is a fiscal irregularity, i.e., (1) a physical loss of cash, vouchers, negotiable instruments, or supporting documents, or (2) an improper payment. Efforts to recover from a recipient must be undertaken in accordance with the debt collection procedures in Volume V, Chapters 29 and 30, of the DoD Financial Management Regulation.

The Department has the information and infrastructure needed to reduce improper payments. The Department also is implementing a Business Activity Monitoring service which will employ the latest technology to increase the efficiency and effectiveness of improper payment detection efforts for commercial pay.

Military Retirement faces statutory or regulatory barriers limiting corrective actions. The barriers include: (1) the Retired and Annuitant Pay service contract and (2) the Federal Acquisition Regulation.

In January 2002, the Defense Finance and Accounting Service (DFAS) awarded the Retired and Annuitant Pay service operations to a contractor. Although most functions remained 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 Activity Office was formed to oversee this contract; 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 the change. The Federal Acquisition Regulation requires a contract modification for any scope change to the current contract.

The Department conducts monthly random reviews of both the confirmed deceased accounts and the overall population of retired and annuitant pay accounts. A monthly random sample of 135 accounts (1,620 annually) from an average monthly population of approximately 3,400 confirmed deceased retiree accounts is reviewed. Monthly random samples of 500 accounts (6,000 annually) also are reviewed from the retiree and annuitant pay files. All sampling plans are designed to produce annual estimates of improper payments with 95% probability (plus or minus 2.5% sampling precision).

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## Management's Discussion and Analysis

### **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 generally accepted accounting principles for Federal entities and formats prescribed by the Office of Management and Budget, the statements are in addition to 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 component of the U.S. Government, a sovereign 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.

*DoD*  
***MILITARY RETIREMENT  
FUND***

***PRINCIPAL STATEMENTS***

**Principal Statements** \_\_\_\_\_

**Department of Defense**  
**Military Retirement Fund**  
**BALANCE SHEETS**  
**For the Years Ended September 30, 2007 and 2006**  
**(In Thousands)**

	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 20,376	\$ 30,735
Investments (Note 4)	218,084,995	208,392,113
Accounts Receivable, Net (Note 5)	118,950	0
Total Intragovernmental Assets	\$ 218,224,321	\$ 208,422,848
Accounts Receivable, Net (Note 5)	24,166	23,259
<b>TOTAL ASSETS</b>	<b>\$ 218,248,487</b>	<b>\$ 208,446,107</b>
<b>LIABILITIES</b>		
Intragovernmental:		
Accounts Payable	\$ 0	\$ 0
Other Liabilities (Note 6)	759	1,147
Total Intragovernmental Liabilities	\$ 759	\$ 1,147
Military Retirement Benefit Liabilities (Note 6 & 7)	\$ 1,028,850,683	\$ 967,106,079
Other Liabilities (Note 6)	197	197
<b>TOTAL LIABILITIES</b>	<b>\$ 1,028,851,639</b>	<b>\$ 967,107,423</b>
<b>NET POSITION</b>		
Cumulative Results of Operations	\$ (810,603,152)	\$ (758,661,316)
<b>TOTAL NET POSITION</b>	<b>\$ (810,603,152)</b>	<b>\$ (758,661,316)</b>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<b>\$ 218,248,487</b>	<b>\$ 208,446,107</b>

The accompanying notes are an integral part of these statements.

## Principal Statements

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**Department of Defense**  
**Military Retirement Fund**  
**STATEMENTS OF NET COST**  
**For the Years Ended September 30, 2007 and 2006**  
**(In Thousands)**

	<u>2007</u>	<u>2006</u>
<b>PROGRAM COSTS</b>		
Gross Costs (Note 9)	\$ 105,253,018	\$ 112,821,696
Less: Earned Revenue (Note 8)	<u>(53,311,182)</u>	<u>(51,737,655)</u>
Net Program Costs	\$ <u>51,941,836</u>	\$ <u>61,084,041</u>
<b>NET COST OF OPERATIONS</b>	\$ <u><u>51,941,836</u></u>	\$ <u><u>61,084,041</u></u>

The accompanying notes are an integral part of these statements.

**Department of Defense  
Military Retirement Fund  
STATEMENTS OF CHANGES IN NET POSITION  
For the Years Ended September 30, 2007 and 2006  
(In Thousands)**

	<b>2007</b>	<b>2006</b>
<b>CUMULATIVE RESULTS OF OPERATIONS</b>		
<b>Beginning Balances</b>	\$ (758,661,316)	\$ (697,577,275)
<b>Net Cost of Operations (+/-)</b>	51,941,836	61,084,041
<b>Net Change</b>	\$ (51,941,836)	\$ (61,084,041)
<b>Cumulative Results of Operations</b>	\$ (810,603,152)	\$ (758,661,316)
<b>Net Position</b>	\$ (810,603,152)	\$ (758,661,316)

The accompanying notes are an integral part of these statements.

# Principal Statements

**Department of Defense**  
**Military Retirement Fund**  
**STATEMENTS OF BUDGETARY RESOURCES**  
**For the Years Ended September 30, 2007 and 2006**  
**(In Thousands)**

	<u>2007</u>	<u>2006</u> (As Restated)
<b>Budgetary Resources</b>		
Unobligated balance, brought forward, October 1	\$ 0	\$ 0
Budget authority:		
Appropriation	<u>53,452,702</u>	<u>52,126,503</u>
Subtotal	\$ <u>53,452,702</u>	\$ <u>52,126,503</u>
Temporarily not available pursuant to Public Law	<u>(9,822,597)</u>	<u>(10,893,014)</u>
<b>Total Budgetary Resources</b>	<u>\$ 43,630,105</u>	<u>\$ 41,233,489</u>
<b>Status of Budgetary Resources:</b>		
Obligations incurred:		
Direct	\$ <u>43,630,105</u>	\$ <u>41,233,489</u>
Subtotal	\$ <u>43,630,105</u>	\$ <u>41,233,489</u>
Unobligated balance:		
Exempt from apportionment	<u>0</u>	<u>0</u>
Subtotal	\$ <u>0</u>	\$ <u>0</u>
Unobligated balance not available	<u>0</u>	<u>0</u>
<b>Total status of budgetary resources</b>	<u>\$ 43,630,105</u>	<u>\$ 41,233,489</u>
<b>Change in Obligated Balance:</b>		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	\$ <u>3,409,801</u>	\$ <u>3,321,072</u>
Total unpaid obligated balance, net	<u>3,409,801</u>	<u>3,321,072</u>
Obligations incurred net (+/-)	\$ <u>43,630,105</u>	\$ <u>41,233,489</u>
Less: Gross outlays	\$ <u>(43,509,710)</u>	\$ <u>(41,144,759)</u>
Obligated balance, net, end of period		
Unpaid obligations	<u>3,530,196</u>	<u>3,409,802</u>
<b>Total, unpaid obligated balance, net, end of period</b>	<u>\$ 3,530,196</u>	<u>\$ 3,409,802</u>
<b>Net Outlays:</b>		
Gross outlays	\$ <u>43,509,710</u>	\$ <u>41,144,759</u>
Less: Distributed Offsetting receipts	<u>(26,048,000)</u>	<u>(23,180,000)</u>
<b>Total Outlays</b>	<u>\$ 17,461,710</u>	<u>\$ 17,964,759</u>

Additional information included in Notes 11 and 14.

**The accompanying notes are an integral part of these statements.**



*DoD*  
*MILITARY RETIREMENT*  
*FUND*

*NOTES*  
*TO THE*  
*PRINCIPAL STATEMENTS*



### DoD MILITARY RETIREMENT FUND NOTES TO THE PRINCIPAL STATEMENTS FOR THE YEARS ENDED SEPTEMBER 30 2007, AND 2006

#### **NOTE 1. SIGNIFICANT ACCOUNTING POLICIES**

A. **Basis of Presentation.** The Department of Defense (DoD) Military Retirement Fund (MRF, or the 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, Directorate for Agency Wide Financial Statements and Trust Funds Directorate for Corporate Accounting, Directorate for Standards and Compliance, Defense Finance and Accounting Services, in accordance with the requirements of the Office of Management and Budget (OMB) Circular A-136 "Financial Reporting Requirements," as revised, and accounting principles generally accepted in the United States of America. The Trust Fund Accounting Division prepares the financial statements of the MRF in addition to the financial reports required pursuant to OMB directives that are used to monitor and control the use of budgetary resources of the MRF. More detailed explanations of these financial statement elements are discussed in applicable footnotes. The financial statements account for all resources for which the MRF is responsible.

B. **Mission of the Reporting Entity.** The mission of the Department of Defense (DoD) MRF 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 military retirement program 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.

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 MRF is a pension program established in fiscal year (FY) 1984 by PL 98-94, which provided the MRF a permanent indefinite appropriation. This type of appropriation provides budget authority of an unspecified amount of money that is available as a result of previously enacted legislation and which does not require new legislation for the current year. Since 1st Quarter, FY 2006, all appropriations received are considered earmarked funds. Earmarked funds are financed by specifically identified revenues; required by statute to be used for designated activities, benefits, or purposes; and remain available over time. Earmarked funds are also required to account for and report on the receipt, use, and retention of revenues and other financing sources that distinguish earmarked funds from general revenues. The MRF uses these appropriations and funds for daily execution of the mission of the MRF and to report on resource usage.

The purpose of the MRF is to pay annuities and pensions to retired military personnel and their survivors. The DoD Retirement Board of Actuaries determines the contributions made to the MRF. The DoD contribution is a percentage of basic pay. The U.S. Department of Treasury makes payments from general revenues to amortize the unfunded liability, including any gains or losses that have arisen from changes in assumptions or benefits or from assumed experience differing from actual experience. The U.S. Department of Treasury's total contribution includes an additional amount to fund the normal cost for the Concurrent Receipt benefits. Excess funds from the contributions are invested and accrued interest revenue is used to cover future liabilities of the MRF.

## Notes to the Principal Statements

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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 the Secretary of the Treasury, the Director of the OMB, and the Comptroller General. The FASAB issues the Statements of Federal Financial Accounting Standards (SFFAS), following procedures adopted by the FASAB principles. Some SFFAS have deferred effective dates.

In April 2000, the American Institute of Certified Public Accountants (AICPA) through Statements on Auditing Standards (SAS) No. 69, "The Meaning of Present Fairly in Conformity with GAAP in the Auditor's Report," as amended by SAS No. 91, 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 Statement of Position;

(C) AICPA Accounting Standards Executive Committee 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 generally accepted accounting principles (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, GAAP in the United States of America serves as authoritative guidance for Federal agencies in preparing reports that are addressed within this Circular.

E. Revenues and Other Financing Sources. Financing sources for the MRF are provided primarily through monthly Military Service contributions as a percentage of base pay, a U.S. Department of Treasury payment to amortize the unfunded liability, including any gains or losses that have arisen from changes in assumptions or benefits or from assumed experience differing from actual experience, and interest earned on investments.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of operating expenses in the period incurred.

G. Accounting for Intragovernmental Activities. The MRF purchases and redeems non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of the Public Debt. Non-marketable market-based securities include U.S. Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS), and overnight certificates.

H. Funds with the U.S. Treasury. The financial resources of the MRF are maintained in U.S. Department of Treasury Accounts. The Defense Finance and Accounting Service (DFAS) processes all fund receipts and adjustments and prepares monthly reports that provide information to the U.S. Department of Treasury, by appropriation, on transfers, deposits and collections received. The Department of the Treasury records this information to the applicable Fund Balance with Treasury (FBWT) account maintained in the U.S. Department of Treasury system. Differences between the MRF's recorded balance and the balance in the U.S. Department of Treasury FBWT accounts are reconciled.

I. Accounts Receivable. As presented in the Balance Sheet, accounts receivable includes accounts, claims, and refunds receivable from other federal entities or from the public. The MRF calculates allowances for uncollectible accounts due from the public using the General Reserve Method. Under this method, a reserve is based on the age of debts and bad debt experience.

## Notes to the Principal Statements

J. Investments in U.S. Government Securities. The MRF reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts (book value). Premiums or discounts are amortized over the term of the investment using the effective interest rate method. The MRF's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The MRF invests in two types of non-marketable securities. The two types are par value and market-based intra-governmental securities. The Bureau of the Public Debt issues non-marketable par value intra-governmental securities. Non-marketable, market-based intra-governmental securities mimic marketable securities but are not publicly traded. Investments are recorded at amortized cost on the Balance Sheets. Material disclosures are provided at Note 4.

The MRF receives interest on the value of its non-marketable, market-based securities from U.S. Treasury on a semi-annual basis for U.S. Treasury bonds and notes.

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, but 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. Net Position consists of unexpended appropriations and cumulative results of operations.

Cumulative Results of Operations represent the net difference, since inception of an activity, between expenses and losses and financing sources (including appropriations, revenue, and gains). Beginning with FY 1998, the cumulative results also include donations and transfer in and out of assets without reimbursement.

M. Comparative Data. For comparative purposes, the financial statements display both FY 2006 and FY 2007 data. Certain FY 2006 amounts have been reclassified to conform to the FY 2007 presentation to reflect changes in presentation required in conjunction with the OMB Circular No. A-136 "Financial Reporting Requirements," updated and revised in June 2007.

As required by OMB Circular A-136, the reconciliation of budgetary obligations and non-budgetary resources available to the MRF with its net cost of operations information that was previously presented in a separate statement of financing is now presented in Note 12, Reconciliation of Net Cost of Operations to Budget, on a comparative basis.

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 MRF 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)	<u>FY 2007</u>	<u>FY 2006</u>
Accounts Receivable	\$ 759	\$ 1,147
Total Non-Entity Assets	\$ 759	\$ 1,147
 Total Entity Assets	 <u>218,247,728</u>	 <u>208,444,960</u>
Total Assets	<u>\$ 218,248,487</u>	<u>\$ 208,446,107</u>

## Notes to the Principal Statements

Accounts Receivable of \$759.0 and \$1,147.0 for FYs 2007 and 2006, respectively, represents "Penalties, Fines, and Administration Fees Receivable," net of an allowance for loss, which will be collected on behalf of the U.S. Treasury. This amount is also reflected in Note 6 as a custodial liability of \$759.0 and \$1,147.0 for FYs 2007 and 2006, respectively.

### NOTE 3. FUND BALANCE WITH TREASURY (FBWT)

(\$ In Thousands)	<u>FY 2007</u>	<u>FY 2006</u>
Fund Balance:		
Total Trust Funds	\$ <u>20,376</u>	\$ <u>30,735</u>
Status of Fund Balance with Treasury:		
Unobligated Balance -Unavailable	\$ 211,854,477	\$ 202,031,880
Obligated Balance not yet Disbursed	3,530,196	3,409,801
Non-Budgetary FBWT	<u>(215,364,297)</u>	<u>(205,410,946)</u>
Total	\$ <u>20,376</u>	\$ <u>30,735</u>

The FBWT has a normal fluctuation due to a timing difference between the receipt of the notification of the actual final payment and the required investment deadline at the U.S. Treasury. The MRF withholds \$20.0 million monthly and \$25.0 million quarterly in FBWT from overnight investments to ensure the availability of sufficient funds to cover disbursements made on the last business day of each month that cannot be captured in time to meet the month-end investment timeframe.

The Unobligated Balance represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. Certain unobligated balances are restricted for future use and are not apportioned for current use. These unobligated balances, which are segregated to show the available and unavailable amounts, are related to trust fund accounts which are restricted by the public laws that established the funds. These balances become available subsequently without appropriation actions. The MRF investment manager records the funds and invests the trust fund receipts with the U.S. Department of Treasury, Bureau of the Public Debt. These investments are redeemed as funds are needed.

### NOTE 4. INVESTMENTS

(\$ In Thousands)	<u>FY 2007</u>				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) / Discount</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities					
Non Marketable,	\$ 222,030,479	Effective	\$ (6,666,182)	\$ 215,364,297	\$ 212,242,566
Marketable Based		Interest			
Subtotal	<u>\$ 222,030,479</u>		<u>\$ (6,666,182)</u>	<u>\$ 215,364,297</u>	<u>\$ 212,242,566</u>
Accrued Interest	2,720,698			2,720,698	2,720,698
Total Investments	<u>\$ 224,751,177</u>		<u>\$ (6,666,182)</u>	<u>\$ 218,084,995</u>	<u>\$ 214,963,264</u>

## Notes to the Principal Statements

	FY 2006				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) / Discount</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities					
Non Marketable, Marketable Based	\$ 213,248,632	Effective Interest	\$ (7,889,863)	\$ 205,358,769	\$ 202,876,743
Subtotal	<u>\$ 213,248,632</u>		<u>\$ (7,889,863)</u>	<u>\$ 205,358,769</u>	<u>\$ 202,876,743</u>
Accrued Interest	3,033,344		3,033,344	3,033,344	3,033,344
Total Investments	<u>\$ 216,281,976</u>		<u>\$ (7,889,863)</u>	<u>\$ 208,392,113</u>	<u>\$ 205,910,087</u>

Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of the Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS), and overnight certificates.

The U.S. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at a discount or premium. The U.S. 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. The 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 MRF records investments at book value, representing amortized cost. The MRF recognizes the amortization of discounts and premiums using the effective interest method. The MRF receives interest on the value of its non-marketable market-based securities from the U.S. Treasury on a semi-annual basis for U.S. Treasury bonds and notes.

Investments, Net, increased \$9.7 billion (5%). This increase is the result of investing \$27.5 billion of the FY 2007 amortization payment for the unfunded liability; the increases of \$4.3 billion in inflation compensation, \$3.0 billion in overnight investments, and \$1.2 billion in premiums associated with new and matured securities; offset by \$26.4 billion in maturities throughout the year. The following tables display the Par Value of the U.S. Treasury Securities referenced above

(\$ In Thousands)

<u>SECURITIES</u>	<u>PAR VALUE</u> <u>FY 2007</u>	<u>PAR VALUE</u> <u>FY 2006</u>
Notes	\$ 49,437,658	\$ 49,437,658
Bonds	24,392,448	34,704,232
TIPS	110,482,056	94,730,199
Overnights	5,919,391	2,937,882
Totals	<u>\$ 190,231,553</u>	<u>\$ 181,809,971</u>

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited into the U.S. Department of Treasury, which uses the cash for general Government purposes. The U.S. Department of Treasury issues securities to the MRF as evidence of its receipts. The U.S. Treasury securities are an asset to the MRF and a liability to the U. S. Treasury. Because the MRF and the U.S. Department of Treasury are both parts of the Federal Government, these assets and liabilities offset each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the Federal Government-wide financial statements.

## Notes to the Principal Statements

The U.S. Treasury securities provide the MRF with authority to draw upon the U.S. Department of Treasury to make future benefit payments or other expenditures. When the MRF requires redemption of these securities to make expenditures, the Federal Government finances those expenditures out of accumulated cash balances by raising taxes or other receipts, by borrowing from the public, repaying less debt, or by curtailing other expenditures. This is the same way that the Federal Government finances all other expenditures.

### NOTE 5. ACCOUNTS RECEIVABLE

(\$ In Thousands)

	<u>FY 2007</u>		
	<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>
Entity Receivables:			
With the Public	\$ 29,197	\$ (5,031)	\$ 24,166
Intragovernmental	118,950	0	118,950
Total Receivables	<u>\$ 148,147</u>	<u>\$ (5,031)</u>	<u>\$ 143,116</u>

	<u>FY 2006</u>		
	<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>
Entity Receivables:			
With the Public	\$ 28,894	\$ (5,635)	\$ 23,259
Intragovernmental	0	0	0
Total Receivables	<u>\$ 28,894</u>	<u>\$ (5,635)</u>	<u>\$ 23,259</u>

The MRF uses the general reserve method to calculate a percentage for an allowance for estimated uncollectibles. This method, which is described in Volume 4, Chapter 3, of the DoD Financial Management Regulation, establishes a reserve based on age of the debts and bad debt experience. Accounts receivable includes amounts, claims, and refunds receivable from retirees and annuitants.

### NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

	<u>FY 2007</u>	<u>FY 2006</u>
(\$ in Thousands)		
Intragovernmental Liabilities:		
Other	\$ 759	\$ 1,147
Total Intragovernmental Liabilities	<u>\$ 759</u>	<u>\$ 1,147</u>
Non-Federal Liabilities:		
Military Retirement Benefits Liabilities (Note 7)	\$ 813,466,010	\$ 761,664,397
Other	197	197
Total Non-Federal Liabilities	<u>\$ 813,466,207</u>	<u>\$ 761,664,594</u>
Total Liabilities Not Covered by Budgetary Resources	\$ 813,466,966	\$ 761,665,741
Total Liabilities Covered by Budgetary Resources	<u>215,384,673</u>	<u>205,441,682</u>
Total Liabilities	<u>\$ 1,028,851,639</u>	<u>\$ 967,107,423</u>



## Notes to the Principal Statements

The Liabilities Not Covered by Budgetary Resources line, which represents MRF's actuarial liability, increased \$51.8 billion (7%). This change is attributable to an increase of \$61.7 billion in the actuarial liability offset by \$9.7 billion in the value of the assets (see Note 4). The reason for the change in the actuarial liability is discussed in Note 7. This line also represents a custodial liability and an amount recorded for benefits for which the DoD is contingently liable, both of which are discussed below.

For FY 2007 and FY 2006, Other Intragovernmental Liabilities of \$759.0 thousand and \$1,147.0 thousand, respectively, represent 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.

For both FY 2007 and FY 2006, Other Non-Federal Liabilities of \$197.0 thousand represent death payment liabilities payable by the DoD to certain disabled retirees receiving benefits from the Department of Veterans Affairs (DVA) also. The DVA benefits stop at the end of the month preceding death. The DoD records liabilities to cover the benefits payable to the exact date of death.

The liabilities not covered by budgetary resources represent the difference between the total actuarial liability as well as the custodial liability and the amount recorded for benefits for which the DoD is contingently liable and the current assets available to fund these liabilities. The total actuarial liability is the combination of the unamortized initial unfunded liability, being amortized over a 42-year period, subsequent gains and losses and changes based on methods and assumptions used to compute actuarial costs and liabilities. The initial unfunded liability of the program was being amortized over a 50-year period through the FY 2007 payment. At its August 2007 meeting, the Board decided to decrease the period over which the initial unfunded liability is fully amortized to 42 years. Therefore, starting with the FY 2008 payment, the initial unfunded liability will be paid over a 42-year period, with the last payment expected to be made October 1, 2025.

### **NOTE 7. MILITARY RETIREMENT BENEFIT LIABILITIES**

**(\$ In Thousands)**

<u>Major Program Activities</u>	<b>FY 2007</b>			
	<u>Present Value of Benefits</u>	<u>Assumed Interest Rate (%)</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Military Retirement Pensions Actuarial Liability	\$ 1,025,320,487	6.00%	\$ (211,854,477)	\$ 813,466,010
Benefits Due and Payable	<u>3,530,196</u>		<u>(3,530,196)</u>	<u>0</u>
Total:	<u>\$ 1,028,850,683</u>		<u>\$ (215,384,673)</u>	<u>\$ 813,466,010</u>
<u>Major Program Activities</u>	<b>FY 2006</b>			
	<u>Present Value of Benefits</u>	<u>Assumed Interest Rate (%)</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Military Retirement Pensions Actuarial Liability	\$ 963,696,277	6.00%	\$ (202,031,880)	\$ 761,664,397
Benefits Due and Payable	<u>3,409,802</u>		<u>(3,409,802)</u>	<u>0</u>
Total:	<u>\$ 967,106,079</u>		<u>\$ (205,441,682)</u>	<u>\$ 761,664,397</u>

## Notes to the Principal Statements

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The Total Present Value of Military Retirement Benefits increased \$61.7 billion (6%) due to the increase in the FY 2007 actuarial liability. This increase is (1) the FY 2007 normal cost liability, (2) interest cost, (3) benefit changes, and (4) assumption changes, all of which are offset by the benefit payments made in FY 2007. See Notes 9 and 13 for additional details.

For the determination of the Unfunded Liabilities, the Assets Available to Pay Benefits include the book value of investments, exclusive of accrued interest, plus Fund Balance with Treasury, and less Benefits Due and Payable.

Other Information Pertaining to Military Retirement Benefits Actuarial Liabilities:

### Actuarial Cost Method

Actuarial Cost Method Used: Aggregate entry-age normal method. As dictated by law, the Military Retirement System is funded using the aggregate entry-age normal method. This is a method whereby projected retirement costs are spread over the projected future salaries of a cohort at the point of entry.

### Projected Revenues

Projected revenues into MRF come from three sources: interest earnings on MRF assets, monthly DoD contributions, and an annual contribution from U.S. Treasury. The contribution from U.S. Treasury is paid into MRF at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed before October 1, 1984, as well as the amortization of subsequent actuarial gains and losses. Starting October 1, 2004, PL 108-136 requires U.S. 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 DoD Retirement Board of Actuaries (the Board) determines U.S. Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

### Assumptions

The Board sets the long-term economic assumptions for each valuation. The long-term assumptions for the FY 2006 valuation were 6.0% interest, 3.0% Consumer Price Index, and 3.75% salary increase. The same long-term economic assumptions were used in the FY 2007 valuation. The interest rate represents the long-term Fund yield. 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 from the prior year full valuation results as reported in DoD Office of Actuary Valuation of the Military Retirement System, published subsequent to September 30, 2006. Accepted actuarial methods are used for this roll-forward process, which is applied annually at September 30. Changes in the estimated rolled forward values from the prior to the current year are included in the determination of the actuarial gains and losses for the current period as presented in Note 9.

In calculating the FY 2007 roll-forward amount, the following assumptions were used:

	<u>Inflation</u>	<u>Salary</u>	<u>Interest</u>
Fiscal Year 2007	3.3 % (actual)	2.2 % (actual)	6.0 %
Fiscal Year 2008	2.3 % (estimated)	3.5 % (estimated)	6.0 %
Long-Term	3.0 %	3.75 %	6.0 %

Contributions to MRF are calculated so as to maintain MRF on an actuarially sound basis. An actuarially sound basis means that there will be sufficient funds to make all benefit payments to eligible recipients each year, and that MRF's balance is projected to eventually equal the actuarial liability, i.e., all unfunded liabilities are covered. In order to accomplish this process, 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 was being amortized over a 50-year period through the FY 2007 payment. At its August 2007 meeting, the Board decided to decrease the period over which the initial unfunded

## Notes to the Principal Statements

liability is fully amortized to 42 years. The Board's decision was made to ensure that, at a minimum, the amortization payment at least covered the interest on the unfunded actuarial liability. Therefore, starting with the FY 2008 payment, the initial unfunded liability will be paid over a 42-year period, with the last payment expected to be made October 1, 2025. All subsequent gains and losses experienced by the system are amortized over a 30-year period. As mandated by Chapter 74 of Title 10, United States Code, the Board must approve methods and assumptions used to (1) compute actuarial costs and liabilities, (2) amortize the initial unfunded liability, and (3) amortize all actuarial gains and losses. The Board is a Federal Advisory Committee appointed by the President.

### **NOTE 8. DISCLOSURES RELATED TO THE STATEMENTS OF NET COST**

**(\$ In Thousands)**

	<b><u>FY 2007</u></b>	<b><u>FY 2006</u></b>
Intragovernmental Costs	\$ 0	\$ 0
Public Costs	<u>105,253,018</u>	<u>112,821,696</u>
Total Costs	\$ <u>105,253,018</u>	\$ <u>112,821,696</u>
Intragovernmental Earned Revenue	\$ (53,311,182)	\$ (51,737,655)
Public Earned Revenue	<u>0</u>	<u>0</u>
Total Earned Revenue	\$ <u>(53,311,182)</u>	\$ <u>(51,737,655)</u>
Net Cost of Operations	\$ <u><u>51,941,836</u></u>	\$ <u><u>(61,084,041)</u></u>

The Statement of Net Cost is unique because its principles are driven on understanding the net cost of programs that the Federal Government supports through appropriations or other means. This statement provides gross and net cost information that can be related to the amount of output or outcome for a given program and/or organization administered by a responsible reporting entity.

Intragovernmental costs and revenues are related transactions made between two reporting entities with the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity. Discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

Intragovernmental Earned Revenue is comprised of the following amounts:

#### **Intragovernmental Earned Revenues for Program Costs**

<b>(\$ in Thousands)</b>	<b><u>FY 2007</u></b>	<b><u>FY 2006</u></b>
1. Military Service Contributions as a Percentage of Base Pay	\$ 14,483,714	\$ 13,895,849
2. Annual Treasury Unfunded Liability Payment	26,048,000	23,180,000
3. Annual Treasury Normal Cost Payment	2,452,000	2,344,000
4. Interest on Investments	<u>10,327,468</u>	<u>12,317,806</u>
<b>Total</b>	<b>\$ <u><u>\$53,311,182</u></u></b>	<b>\$ <u><u>\$51,737,655</u></u></b>

The primary financing sources for MRF are (1) monthly Military Service contributions as a percentage of base pay; (2) annual payments from the U.S Treasury for the unfunded liability and for the concurrent receipt provisions for certain disabled retirees; and (3) interest earned on investments. The Department of Defense Retirement Board of Actuaries calculates the annual payments amounts and percentages. The financing sources are the result of intra-governmental flows. Excess funds from the contributions are invested. The investments and associated accrued interest revenue are used to cover future liabilities of MRF.

The contributions from the Military Services increased by \$0.6 billion. The contributions are the product of basic pay and Normal Cost Percentages (NCPs) determined in accordance with methodology approved by the Board. Basic pay generally increases each year, and on January 1, 2007, there was a 2.2% across-the-board basic pay increase. The NCPs for FY 2007 are based on methods and assumptions approved by the Board at the August 2005 public meeting. These were promulgated by the Board in its August 2005 letter: 26.5% (full-time) and 17.5% (part-time). The NCPs for FY 2008 are based on methods and assumptions approved at the August 2006 public Board

## Notes to the Principal Statements

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meeting. The NCPs for FY 2008 promulgated in the August 2006 letter were amended by the October 2006 letter because of legislative changes in the FY 2007 National Defense Authorization Act (NDAA). The revised NCPs for FY 2008 are 29.0% (full-time) and 19.1% (part-time).

The October 1 contribution from U.S. Treasury, which is determined in accordance with methodology set by the Board, increased \$3.0 billion (from \$25.5 billion in FY 2006 to \$28.5 billion in FY 2007). The main reasons for the change include an expected increase of \$0.9 billion inherent in the Board's unfunded liability amortization methodology and additional increases of \$2.0 billion in the unfunded liability payment due to actuarial experience and assumption changes.

Interest on Investments decreased \$2.0 billion (16%) in FY 2007, principally due to the U.S. Treasury calling a security with a 10.375% interest rate. Treasury called this security in November 2006. The funds were reinvested at a much lower rate, 3.5%

### **NOTE 9. BENEFIT PROGRAM EXPENSE**

**(\$ In Thousands)**

	<b><u>FY 2007</u></b>	<b><u>FY 2006</u></b>
1. Service Cost	\$ 17,728,766	\$ 15,526,645
2. Period Interest on the Benefit Liability	57,059,086	54,988,681
3. Prior (or past) Service Cost	1,597,497	117,738
4. Period Actuarial (Gains) or Losses	28,766,450	41,441,989
5. Total Benefit Program Expense	<b><u>\$ 105,151,799</u></b>	<b><u>\$ 112,075,053</u></b>

The benefit program expenses provide components of the change in the actuarial liability from September 30, 2006, to September 30, 2007. The September 30, 2007, actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during FY 2007. The September 30, 2007, actuarial liability is equal to the September 30, 2006, liability plus the total benefit program expenses minus the expected benefit payments. The increase in Prior Service Cost (Line 3) is primarily due to the removal of the 75 percent retired pay multiplier cap used in calculation of retired pay for members eligible for non-disability retirement after January 1, 2007 as contained in the FY 2007 NDAA, whereas in FY 2006 the benefit change was a much smaller one primarily related to the Survivor Benefit Plan Open Season, which accounted for \$71,455 thousand of the loss. The decrease in Period Actuarial (Gains) or Losses (Line 4) is primarily due to the new non-disability rates approved by the DoD Retirement Board of Actuaries at the August 2007 meeting, whereas in FY 2006 the Actuarial (Gains) or Losses were higher primarily due to the Board lowering the long-term interest assumption to 6.0 percent at the August 2006 meeting.

### **NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION**

There was an amount of \$53.5 billion of Appropriations Received that was not reported on the Statement of Changes in Net Position and was reported as Appropriations Received on the Statement of Budgetary Resources. This difference is due to additional resources included in the Appropriations Received line on the Statement of Budgetary Resources. Refer to Note 11, Disclosures Related to the Statement of Budgetary Resources, for additional details.

### **NOTE 11. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES**

#### Apportionment Categories

Office of Management and Budget Circular No. A-136 specifically requires disclosure of the amount of direct and reimbursable obligations incurred against certain apportionment categories. The Military Retirement Fund (MRF) reported \$43.6 billion in obligations are exempt from apportionment.

### Intra-entity Transactions

The Statement of Budgetary Resources (SBR) includes intra-entity transactions because the statements are presented as combined and combining.

### Permanent Indefinite Appropriation

Title 10, United States Code 1461 established the Military Retirement Fund (MRF) to accumulate funds to finance, on an actuarially sound basis, the liabilities of the Department of Defense military retirement and survivor benefit programs. This statute provides a permanent indefinite appropriation with which to operate. These funds are only available to pay pensions and annuities to retired military personnel and their survivors, respectively. Amounts that are not needed to pay the current costs of the Fund may be invested in non-marketable market-based securities purchased through the Department of the Treasury.

### Reconciliation Differences

There was an amount of \$53.5 billion of Appropriations Received that was not reported on the Statement of Changes in Net Position (SCNP) and was reported as Appropriations Received on the SBR. Non-revolving trust funds receipts, immediately available for obligation, are reported as exchange revenue and included in the cost of operations on the SCNP. The MRF current receipts total \$53.5 billion.

### Use of Unobligated Balances of Budget Authority

The MRF's unobligated balances of budget authority represent the portion of trust fund receipts collected in the current fiscal year that (1) exceed the amount needed to pay benefits or other valid obligations and (2) exceed receipts temporarily precluded from obligation by law due to a benefit formula or other limitation. The receipts, however, are assets of the MRF and are available for obligation as needed in the future.

## Notes to the Principal Statements

### NOTE 12. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

(\$ In Thousands)

	<u>FY 2007</u>	<u>FY 2006</u> (As Restated) (Note 14)
<b>RESOURCES USED TO FINANCE ACTIVITIES</b>		
Budgetary Resources Obligated		
Obligations incurred	\$ 43,630,105	\$ 41,233,489
Less: Offsetting receipts (-)	(26,048,000)	(23,180,000)
Net obligations	<u>\$ 17,582,105</u>	<u>\$ 18,053,489</u>
Other Resources:	\$ 0	\$ 0
	<u>0</u>	<u>0</u>
<b>Total resources used to finance activities</b>	<u>\$ 17,582,105</u>	<u>\$ 18,053,489</u>
<b>RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS:</b>		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders (-)	\$ 0	\$ 0
	<u>0</u>	<u>0</u>
<b>Total resources used to finance items not part of the Net Cost of Operations</b>	<u>\$ 0</u>	<u>\$ 0</u>
<b>Total resources used to finance the Net Cost of Operations</b>	<u>\$ 17,582,105</u>	<u>\$ 18,053,489</u>
<b>COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD:</b>		
Components Requiring or Generating Resources in Future Period: Other	<u>\$ 61,624,209</u>	<u>\$ 71,584,638</u>
Total components of Net Cost of Operations that will Require or Generate Resources in future periods	<u>\$ 61,624,209</u>	<u>\$ 71,584,638</u>
Components not Requiring or Generating Resources: Other		
Trust Fund Exchange Revenue	\$ (27,263,182)	\$ (28,557,655)
Other	<u>(1,296)</u>	<u>3,569</u>
Total Components of Net Cost of Operations that will not Require or Generate Resources	<u>\$ (27,264,478)</u>	<u>\$ (28,554,086)</u>
<b>Total components of Net Cost of Operations that will not Require or Generate Resources in the current period</b>	<u>\$ 34,359,731</u>	<u>\$ 43,030,552</u>
<b>Net Cost of Operations</b>	<u>\$ 51,941,836</u>	<u>\$ 61,084,041</u>

For FY 2007, the information previously presented on the Statement of Financing (SOF) is being disclosed as a note in accordance with the Office of Management and Budget Circular A-136 guidance as updated and revised in June 2007. Comparative information for FY 2006 has been conformed to the current year presentation.

The previous note schedule lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated: obligations incurred; obligations net of offsetting collections and recoveries; less: offsetting receipts; and net obligations.

## Notes to the Principal Statements

Components not Requiring or Generating Resources – Other displays the change in accounts receivables during FY 2006 and FY 2007. These amounts represent refunds receivable for erroneous payments to military retirees and their survivors. These refunds receivable are recorded as an offset to expenses.

Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods report unfunded expenses that were incurred during FY 2007. The cumulative total of unfunded expenses from all fiscal years is reported as “Liabilities Not Covered by Budgetary Resources” in Note 6. The Military Retirement Fund (MRF) has a difference of \$9.96 billion between these two lines. The MRF had \$61.7 billion in unfunded expenses in FY 2007, which represents the current year change in the actuarial liabilities. The amounts in Note 7 represent actuarial liabilities that eventually must be funded. As additional assets become available in MRF, the unfunded portion of the actuarial liability will decrease.

### **NOTE 13. OTHER DISCLOSURES**

#### **FY 2007 Change in MRF Actuarial Liability**

The net pension expense for the change in the actuarial accrued liability from September 30, 2006, to September 30, 2007, is developed in Table 1 below:

**Table 1: Change in Actuarial Liability**

<b>(\$ In Thousands)</b>	<b>FY 2007</b>	<b>FY 2006</b>
A. Beginning of Year Accrued Liability	\$ 963,696,277	\$ 892,111,601
B. Normal Cost Liability	17,728,766	15,526,645
C. Plan Amendment Liability	1,597,497	117,738
D. Assumption Change Liability	26,530,870	35,383,261
E. Benefit Outlays	(43,527,589)	(40,490,377)
F. Interest on Pension Liability	57,059,086	54,988,681
G. Actuarial Loss (Gain)	2,235,579	6,058,728
H. End-of-Year Accrued Liability (A+B+C+D+E+F+G)	\$ 1,025,320,486	\$ 963,696,277
I. Net Change in Actuarial Liabilities (B+C+D+E+F+G)	\$ 61,624,209	\$ 71,584,676

Each year the accrued liability is expected to increase with the normal cost, decrease with benefit outlays, and increase with the interest cost resulting in an expected increase of \$31.3 billion in the accrued liability during FY 2007.

The September 30, 2007, accrued liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include updated non-disability retiree and survivor rates, updated retired pay factors, refinements to the death on active model, refinement to first year projection of benefit payments, and modeling the effect on future pay increases due to the April 1, 2007, new pay table. The net effect of these new assumptions is an increase in the September 30, 2007, accrued liability of \$26.5 billion, shown on Line D in Table 1, above (\$24.1 billion of this increase is due to the updated non-disability retiree rates).

The changes in retirement benefits for FY 2007 include the removal of the 75% cap used in the calculation of retired pay, which increases the limit on base pay for retirees with over 30 years service, a provision in the FY 2007 NDAA. The effect of this benefit change is \$1.6 billion shown on Line C in Table 1, above. The increase in Accrued Liability due to the net experience loss of \$2.2 billion, shown on line G, above, reflects the new population on which the September 30, 2006, roll-forward is based, as well as other economic experience being different from that assumed.

#### **Treasury Contributions**

The October 1 contribution from U.S. Treasury, which is determined in accordance with methodology set by the Board, increased \$3.0 billion (from \$25.5 billion in FY 2006 to \$28.5 billion in FY 2007). The main reasons for the change include an expected increase of \$0.9 billion inherent in the Board's unfunded liability amortization

## Notes to the Principal Statements

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methodology and additional increases of \$2.0 billion in the unfunded liability payment due to actuarial experience and assumption changes.

### **Military Services Contributions**

The contributions from the Military Services are the product of basic pay and Normal Cost Percentages (NCPs) determined in accordance with methodology approved by the Board. Basic pay generally increases each year, and on January 1, 2007, there was a 2.2% across-the-board basic pay increase. The NCPs for FY 2007 are based on methods and assumptions approved by the Board at the August 2005 public meeting. These were promulgated by the Board in its August 2005 letter: 26.5% (full-time) and 17.5% (part-time). The NCPs for FY 2008 are based on methods and assumptions approved at the August 2006 public Board meeting. The NCPs for FY 2008 promulgated in the August 2006 letter were amended by the October 2006 letter because of legislative changes in the FY 2007 NDAA. The revised NCPs for FY 2008 are 29.0% (full-time) and 19.1% (part-time).

### **Market Value of Investments**

Market Value of Investments in Market-Based and Marketable Securities: \$215.0 billion

### **NOTE 14. RESTATEMENT**

In accordance with FASAB guidance, the OMB and the U. S. Treasury are responsible for issuing budgetary reporting guidance for Federal entities to use in the preparation of the Statement of Budgetary Resources and the Reconciliation of Net Cost of Operations to Budget. During the preparation of the FY 2007 year-end financial statements, the DoD's Audited Financial Statement (AFS) Division advised that, under the OMB and U. S. Treasury guidance, certain MRF offsetting receipts previously considered as distributed to DoD should be considered undistributed receipts for purposes of the appropriate presentation of budgetary balances at the DoD and government-wide levels. As the issuance of the FY 2007 financial statements was imminent, the MRF corrected the classification of the offsetting receipts for the FY 2007 financial statements and disclosures and has corrected the presentation of the FY 2006 comparative statements and disclosures as discussed in the subsequent paragraph.

For the FY 2006 statements, the classification of intragovernmental receipt amounts of approximately \$2.3 billion was corrected from distributed to undistributed, reducing the amount of previously reported offsetting receipts in the FY 2006 Statement of Budgetary Resources and in Note 12, and increasing the amount of previously reported Trust Fund Exchange Revenue in Note 12 by the same amount. There was no impact on the MRF's net position or net cost of operations for FY 2006.

Details of the effects of the FY 2006 restatement are displayed in the following table.



## Notes to the Principal Statements

### FY 2006

#### Effects of Restatement (\$ in Thousands)

	<u>As Restated</u>	<u>As Originally Reported</u>	<u>Effect of Change</u>
<b>Statement of Budgetary Resources</b>			
Distributed Offsetting Receipts	<u>\$(23,180,000)</u>	<u>\$(25,524,000)</u>	<u>\$ 2,344,000</u>
Total Net Outlays	<u>\$ 17,964,759</u>	<u>\$ 15,620,759</u>	<u>\$ 2,344,000</u>
<b>Reconciliation of Net Cost of Operations to Budget</b>			
Less: Offsetting receipts	<u>\$(23,180,000)</u>	<u>\$(25,524,000)</u>	<u>\$ 2,344,000</u>
Net Obligations	<u>\$ 18,053,489</u>	<u>\$ 15,709,489</u>	<u>\$ 2,344,000</u>
Total resources used to finance activities	<u>\$ 18,053,489</u>	<u>\$ 15,709,489</u>	<u>\$ 2,344,000</u>
Total Resources used to Finance the Net Cost of Operations	<u>\$ 18,053,489</u>	<u>\$ 15,709,489</u>	<u>\$ 2,344,000</u>
Trust Fund Exchange Revenue	<u>\$(28,557,655)</u>	<u>\$(26,213,655)</u>	<u>\$(2,344,000)</u>
Total components of Net Cost of Operations that will not require or generate resources in the current period	<u>\$ 43,030,552</u>	<u>\$ 45,374,552</u>	<u>\$(2,344,000)</u>



***DoD***  
***MILITARY RETIREMENT***  
***FUND***

***OTHER ACCOMPANYING***  
***INFORMATION***

## Other Accompanying Information

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### MILITARY RETIREMENT SYSTEM ACTUARIAL STATUS INFORMATION SEPTEMBER 30, 2007 AND 2006

(\$ in Thousands)

	<u>FY 2007</u> <sup>1</sup>	<u>FY 2006</u>
1 Present value of future benefits		
a. Annuitants now on roll	\$ 637,166,322	\$ 603,133,141
b. Non-retired reservists	128,186,214	119,079,488
c. Active duty personnel <sup>2</sup>	<u>408,865,072</u>	<u>378,230,841</u>
d. Total	\$1,174,217,608	\$1,100,443,470
2 Present value of future normal cost contributions	<u>\$ 148,897,122</u>	<u>\$ 136,747,193</u>
3 Actuarial accrued liability	\$1,025,320,487	\$ 963,696,277
4 Assets <sup>3</sup>	<u>\$ 211,854,477</u>	<u>\$ 202,031,880</u>
5 Unfunded accrued liability	<u>\$ 813,466,010</u>	<u>\$ 761,664,397</u>

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<sup>1</sup> Rolled forward from September 30, 2006.

<sup>2</sup> The future benefits of active duty personnel who are projected to retire as reservists are counted on line 1-b.

<sup>3</sup> The assets available to pay benefits are determined using the amortized cost method (book value) of valuation.

*DoD*  
*MILITARY RETIREMENT*  
*FUND*

*INDEPENDENT AUDITORS'*  
*REPORTS*





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

DEC 13 2007

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 2007 DoD Military Retirement Fund Financial Statements (Report No. D-2008-018)

The requirement for audited Federal Government financial statements was established by the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). The Office of Management and Budget Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 2007, requires audited financial statements for the DoD Military Retirement Fund. As allowed by the Chief Financial Officers Act, we contracted with Deloitte & Touche LLP (Deloitte & Touche) to perform the Fund's FY 2007 audit.

**Unqualified Audit Opinion.** We concur with the Deloitte & Touche unqualified opinion dated November 30, 2007. Deloitte & Touche opined that the Fund's FY 2007 financial statements and accompanying notes present fairly, in all material respects, the Fund's financial position as of September 30, 2007 and 2006, and its net cost of operations, changes in net position, and budgetary resources for the years then ended.

The Fund has restated its FY 2006 financial statements to correct an error in the originally issued financial statements. The restatement is discussed in Note 14 to the Fund's FY 2007 financial statements. As a result of the material misstatement, Deloitte & Touche advised that their audit opinion report dated November 1, 2006, should no longer be relied upon. It is replaced by their updated FY 2006 opinion report submitted with their FY 2007 report. Accordingly, we withdraw our endorsement of the original FY 2006 Deloitte & Touche opinion report (DoD IG Report No. D-2007-019) and replace it with this report.

**Report on Internal Control.** We further concur with the Deloitte & Touche report on internal control over financial reporting and compliance with laws and regulations as part of the audit of the Fund's FY 2007 financial statements. In addition to the material weakness reported as a result of the material misstatement cited above, the report identified two other significant deficiencies.

**Contributions to the Fund.** The Fund is impacted by control deficiencies identified within the Services regarding the calculation, authorization, and payment of required contributions (Retired Pay Accrual) to the Fund. There is insufficient documentation provided to the Defense Finance and Accounting Service Trust Fund Division for Service Contributions processed by the Defense Finance and Accounting Service payroll offices on behalf of the Services. The insufficient documentation does not allow for the appropriate level of review for accuracy and completeness of the calculation that supports the determination of the Services' contribution payment amounts. In addition, the payroll offices may not have been provided the necessary information to support the amounts contributed by the Services. This limits both the

Defense Finance and Accounting Service payroll offices and the Trust Fund Division's abilities to determine and review, respectively, that the amounts of the contributions are appropriate, accurate, and complete.

We recommend that the Under Secretary of Defense for Personnel and Readiness work with the Services' Manpower Offices to ensure that certified basic payroll reports are provided to the Defense Finance and Accounting Service to support the amounts contributed to the Fund, and that the processes used to determine the required contribution amounts are applied on a consistent basis among the Services. We recommend that the Defense Finance and Accounting Service payroll offices and Trust Fund Division develop and implement improved validation and reconciliation processes for Service contributions.

**Data Processing for the Fund.** Certain general electronic data processing controls at certain computer processing locations used by the Fund may not support the reliable processing of financial information within the related business cycles. The review disclosed deficiencies in the design and operation of controls related to electronic data processing security configurations, business continuity arrangements, and system network 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 electronic data processing weaknesses may further compromise controls, Deloitte & Touche provided no additional details here. Instead, the specifics will be presented in a separate, limited distribution report concerning other control deficiencies involving the Fund's internal control over financial reporting and other matters that Deloitte & Touche identified during its audit.

**Compliance with Laws and Regulations.** As part of the audit, Deloitte & Touche needed to obtain reasonable assurance that the Fund's FY 2007 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 with these laws and regulations that could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget Bulletin No. 07-04 requires that test results be reported if there are instances of noncompliance with certain other laws and regulations. Deloitte & Touche noted the following instances of noncompliance.

- The electronic data processing systems used by the Fund are not compliant with Office of Management and Budget Circular A-127, "Financial Management Systems," July 1993. The Circular requires that Federal financial systems provide complete, reliable, consistent, and useful information on a timely basis. Deloitte & Touche's procedures identified deficiencies in the design and operation of certain electronic data processing 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.
- The general ledger system used by the Fund is not transaction based and it is not derived from an integrated financial system.

**Audit Responsibilities.** We are responsible for obtaining reasonable assurance that the basic financial statements are fairly presented and free of material misstatement, according to accounting principles generally accepted in the United States of America.

To fulfill our oversight responsibilities for the contract with Deloitte & Touche, we complied with government auditing standards; Office of Management and Budget Bulletin No. 07-04; 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; reviewed documentation prepared by Deloitte & Touche; 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) 601-5960 or Mr. Thomas J. Winter at (703) 601-5918.



Paul G. Granetto, CPA  
Assistant Inspector General and Director  
Defense Financial Auditing Service







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## INDEPENDENT AUDITORS' REPORT

To:

The Inspector General of the Department of Defense,  
The Deputy Under Secretary of Defense for Program Integration, Department of Defense, and  
The Audit Committee of the Department of Defense  
Military Retirement Fund

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Military Retirement Fund (the "Fund") as of September 30, 2007 and 2006, and the related statements of net cost, changes in net position, and budgetary resources 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 the requirements of Office of Management and Budget ("OMB") Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. 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. An audit includes 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.

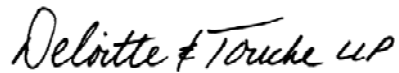
In our opinion, such financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2007 and 2006, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 14 to the financial statements, the accompanying 2006 financial statements have been restated. The restatement was for the correction of an error in the originally issued financial statements, on which we issued our report dated November 1, 2006. Such report should no longer be relied upon as a result of the material misstatement in the previously-issued FY 2006 financial statements and is withdrawn and replaced by this updated report on the restated financial statements.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying "Management's Discussion & Analysis" 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*, 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 supplementary information. However, such information have not been subjected to the auditing procedures applied in our audits of the basic financial statements and accordingly, we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2007 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 considered in assessing the results of our audits.

A handwritten signature in cursive script that reads "Deloitte & Touche LLP".

November 30, 2007



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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,  
The Deputy Under Secretary of Defense for Program Integration, Department of Defense, and  
The Audit Committee of the Department of Defense  
Military Retirement Fund

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, 2007, and have issued our report thereon dated November 30, 2007. 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 the requirements of Office of Management and Budget ("OMB") Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

### **Internal Control over Financial Reporting**

In planning and performing our audit, we considered the Fund's 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 do not express an opinion on the Fund's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we have identified certain matters involving the Fund's internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Fund's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Fund's financial statements that is more than inconsequential will not be

prevented or detected by the Fund's internal control over financial reporting. We considered the matters discussed in the following paragraphs to be significant deficiencies.

1. The Fund is impacted by control deficiencies identified within the Services regarding the calculation, authorization and payment of required contributions (Retired Pay Accrual) to the Fund. There is insufficient documentation provided to the Defense Finance and Accounting Service ("DFAS") Trust Fund Division for Service Contributions (based on base pay) processed by the DFAS payroll offices on behalf of the Services for the appropriate level of review for accuracy and completeness of the calculation that supports the determination of the Services' contribution payment amounts. Furthermore, we also noted that the DFAS payroll offices themselves may not have been provided the necessary information to support the amounts contributed by the Services. This limits both the DFAS payroll offices and the Trust Fund Division's abilities to determine and review, respectively, that the amounts of the contributions are appropriate, accurate, and complete.

We recommend that the Under Secretary of Defense for Personnel and Readiness ("P&R") work with the Services' Manpower Offices to ensure that certified basic payroll reports are provided to DFAS to support the amounts contributed to the Fund, and that the processes and controls used in the determination of required contribution amounts are applied on a consistent basis among the Services. We recommend that DFAS payroll offices and Trust Fund Division develop and implement improved validation and reconciliation processes for Service contributions.

2. 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 and network 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, as requested by the Office of Inspector General, the specifics will be presented in a separate, limited distribution report concerning other control deficiencies involving the Fund's internal control over financial reporting and other matters that we identified during our audit.
3. During the preparation of the Fund's year-end financial statements, the DoD Trust Fund Accounting Division ("TFAD") was notified by the DoD's Audited Financial Statement ("AFS") Division, part of the Office of the Under Secretary of Defense – Comptroller ("OUSD-C"), that based on the reconciliation of DoD budgetary accounts with Treasury, certain offsetting receipt accounts of the Fund for FY 2006 and FY 2007 should be reclassified. The change in the U.S. Treasury guidance for offsetting receipts, which was effective for FY 2006, affected both the Statement of Budgetary Resources and the disclosure of financing activities. The correct classification of offsetting receipts is significant to the accurate reporting of intragovernmental activity for the DoD and U.S. Government financial statements. Therefore the Fund has restated the FY 2006 financial statements and related disclosures to correct the presentation error.

While the DoD utilizes certain standardized processes to facilitate the preparation of financial statements and budgetary reports in conformity with the United States Standard General Ledger ("SGL") accounts and standard attributes, it appears that certain of the

Fund's account attributes were not updated for the change in U.S. Treasury guidance for offsetting receipts in FY 2006 or FY 2007. There were insufficient controls in place within AFS and TFAD in order to identify and implement changes in financial and budgetary reporting guidance on a timely basis. There were insufficient management review processes in place within the Fund's management oversight processes in order to detect the incorrect financial statement presentation.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider the observation regarding the Fund's offsetting receipts at item 3. to be a material weakness.

With respect to internal control relevant to data that support reported performance measures on page 10 of Management's Discussion and Analysis accompanying the financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on the internal control over reported performance measures and, accordingly, we do not express an opinion on such control.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed 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. 07-04. 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 the requirements of OMB Bulletin No. 07-04, 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.



## **Views of Responsible Officials**

We provided a draft of this report to representatives of the Inspector General of the Department of Defense, the Audit Committee, and the management of the Fund, who then provided us with technical comments, which we incorporated as appropriate. The Audit Committee and the management of the Fund expressed their continuing commitment to address the deficiencies identified in this report.

## **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 30, 2007