



**FISCAL YEAR 2009**

**MEDICARE-ELIGIBLE RETIREE  
HEALTH CARE FUND**

**AUDITED FINANCIAL STATEMENTS**

**November 6, 2009**

*DoD*

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HEALTH CARE FUND  
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***MEDICARE-ELIGIBLE RETIREE  
HEALTH CARE FUND***

***MANAGEMENT DISCUSSION AND  
ANALYSIS***

# Management's Discussion And Analysis

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

YEARS ENDED SEPTEMBER 30, 2009, AND 2008

### Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The Fiscal Year (FY) 2001 National Defense Authorization Act (NDAA) directed the establishment of the Medicare-Eligible Retiree Health Care Fund to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for space available care in Military Treatment Facilities (MTFs). The Fund covers Medicare-eligible beneficiaries, regardless of age. In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees (i.e., retirees themselves, dependents of retirees, and survivors).

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

Within DoD, the Office of the Under Secretary of Defense (OUSD) for Personnel and Readiness (P&R), through the Office of the Assistant Secretary of Defense (OASD) for Health Affairs (HA) TRICARE Management Activity (TMA), has as one of its missions operational oversight of the Defense TRICARE Health Delivery System, including management of the Fund. TMA management responsibilities include accounting for, documenting, and projecting annual budget distribution requirements (both purchased care claims demands and MTF prospective payments for anticipated care provided in the direct care system), oversight of claims processors, monitoring/management of the Improper Payments Information Act, and preparation of financial statements and footnotes. The Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund.

In FY 2009, the Fund authorized approximately \$8.7 billion (B) in total health care services, civilian providers (\$7.0B), military medical treatment facilities (\$1.3B), and Military Service Personnel Accounts (\$0.4B), on behalf of Medicare eligible retirees, retiree dependents, and survivors.

In FY 2008, the Fund initially authorized approximately \$8.4B in total health care services, civilian providers (\$6.7B), military medical treatment facilities (\$1.3B) and Military Service Personnel Accounts (\$0.4B), on behalf of Medicare eligible retirees, their dependents, and survivors.

### **Final Fiscal Year Requirements and Funding Plan**

Fiscal Year	Purchased Care (Billions)	Operations & Maintenance (Billions)	Military Personnel (Billions)	Final (Billions)
2009	\$7.0	\$1.3	\$0.4	\$8.7
2008	\$6.7	\$1.3	\$0.4	\$8.4

The Fund receives income from three sources:

1. An annual Treasury payment made on behalf of the Services at the beginning of the year based on average budgeted force strengths
2. Annual payments from the Treasury to amortize the unfunded liability, and
3. Investment income

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During the last two years of the Fund's operation, income was received from the following sources:

### MERHCF Funding Sources

Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment (Billions)	Normal Cost Contribution (Billions)	Interest on Investments (Billions)
2009	\$10.7	\$10.6	\$1.2
2008	\$12.9	\$11.5	\$8.2

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

### Medicare-Eligible Retiree Health Care Plan of Benefits

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

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

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

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

### Health Care Purchased From Civilian Providers

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

At the end of each month, claims processing costs are reconciled against monthly distribution estimates and any over and/or under charged amounts are applied to the estimated requirement for the following month. During the month of September, as fiscal year-end approaches, more frequent reconciliation between charged accounts and available funds may occur and processing can continue up to a predetermined cut-off date established by TMA in coordination with DFAS-Indianapolis (DFAS-IN).

TMA reports obligations to the Fund for the estimated DPP obligation amount based on the contract-specific capitation rates for Medicare-eligible beneficiaries enrolled for each DPP hospital contract option period twice per year, upon the commitment of funds and prior to the start of the option period. Each DPP hospital's reported enrollment is used to reconcile contracted enrollment estimates for Medicare-eligible beneficiaries. At the end of

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each option period, total charges are reconciled against the estimate and any over and/or under charged amounts are applied to the estimated requirement for the following option period.

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TFL/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management (CRM) Division. By agreement with DFAS-IN, disbursement transactions are provided by email the day prior to payment processing. DFAS-IN uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The final purchased care payments estimated for FY 2009 are approximately \$7.0B as compared to \$6.7B in FY 2008.

TMA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services (WPS) for purposes of processing all claims supported by the Fund, regardless of the geographic region in which care was received. Dual-eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single Fiscal Intermediary (FI) to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. The TDEFIC contract stipulates a payment of \$0.71 per unit for electronic claims and \$3.67 for paper claims.

### **Payment For Health Care Provided In MTFs**

TMA annually develops prospective payment amounts for care estimated to be provided in MTFs to Medicare-eligible beneficiaries. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and Defense Health Program (DHP) Operations and Maintenance (O&M) costs. TMA provides a memo to DFAS-IN with the payment amounts by Service for MILPERS and DHP O&M that is reported on the Standard Form 1081, Voucher and Schedule of Withdrawals and Credits by DFAS-IN.

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent fiscal year for which data is complete at the time the calculations are prepared. TMA develops, in coordination with the Military Departments and Office of the Under Secretary of Defense Comptroller (OUSDC), MTF-specific rates in accordance with DoDI 6070.2, dated July 19, 2002. MEPRS cost data are recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using Service-provided budget data, and standard OMB inflation rates listed in the President's Budget applicable to those years. MEPRS data are recorded and maintained by the Services in accordance with DoD 6010.13-M, "Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities," dated April, 2007.

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

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

The prospective O&M payment for MTF-provided care to Medicare-eligible beneficiaries in FY 2009 was \$1.3B and also approximately \$1.3B in FY 2008. While the unit costs of inpatient and outpatient services have risen slightly, utilization of these services has continued to decline at a greater rate. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries remained the same in FY 2009 (\$0.40B).

### **Performance Measures**

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a

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commonly used fund ratio. As of September 30, 2009, the Fund had net assets available to pay benefits of \$148.8B and an actuarial liability of \$509.5B; the funding ratio was 29.2%. As of September 30, 2008, the Fund had net assets available to pay benefits of \$134.3B and an actuarial liability of \$500.2B; the funding ratio was 26.8%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the DoD Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

### **Types of Investments**

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

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

All of these instruments are debt obligations of the U.S Government and are backed by the "full faith and credit" of the federal 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 Board reviews the Fund's law and Department of Treasury guidelines to ensure compliance with broad policy guidance and public law.

The Investment Board met in September 2009 and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income and holding investments to maturity. The Board continues to push the new investment strategy which includes:

a.) Eliminate the "duration matching strategy" (matching assets to the duration of the liability), since it is not feasible. The duration of the unfunded actuarial liability is 40+ years while the duration of the securities available to invest is 24 years, at most.

b.) Cash Flow

- Current year cash flow needs maintained in overnights and bills
- Use a ladder approach for long-term securities
  - Ninety percent (90%) in TIPS
    - Start with a six-year ladder (coming back from 2032)
    - Expand as appropriate for future years
- Ten percent (10%) in conventional/overnights

In FY 2009, 80% of MERHCF investments were in TIPS, with the remaining investments in one day securities (7%), notes (10%), and bonds (3%). Projections for FY 2010 are 85% in TIPS, 88% in TIPS for FY 2011, and 90% in TIPS by 2012. As of the close of FY 2009, approximately 29 percent of the total health care liability was funded.

### **Status of FY 2008 Audit Findings**

The MERHCF independent auditors noted material weaknesses and other discrepancies during the FY 2008 Financial Statement Audit. The material weaknesses center around two issues:

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1. The lack of a patient-level cost accounting system
2. Insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs

At issue with the lack of a patient-level cost accounting system is the fact the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2009 and 2008 includes approximately \$72.1B (14% of total) and \$71.0B (14% of total), respectively, which reflects the actuarial present value of the projected direct-care costs of benefits to be provided by MTFs to MERHCF beneficiaries.

Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2009, include approximately \$2.9B and \$1.7B, respectively, and for the year ended September 30, 2008, include approximately \$3.3B and \$1.7B, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not have Federal Accounting Standard Advisory Board (FASAB) compliant, transaction-based accounting systems and cannot report the costs of an individual patient's care.

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

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

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for the actuarial liability. The reconciliation tasks performed by TMA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service (PDTs), data to support both the prospective payment and calculation of the actuarial liability.

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

Issues with the prospective payment process include validating/reconciling financial data prior to its input into the MEPRS cost allocation process, archiving MEPRS data at the close of each month, and reconciling in a timely manner the fiscal year prospective payment plan.



### **Actions Taken**

Since FY 2003, when the Fund was established, MERHCF management has attempted to resolve auditor-identified material weaknesses through the development of key milestone initiatives. These initiatives were established and managed by TMA leadership and intended to serve as work-arounds to address the Services' financial systems' deficiencies. The material weaknesses are associated with the computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs.

Unfortunately, the milestone initiatives have not produced the desired results in the projected time frame. To mitigate risks associated with these weaknesses, and to affect appropriate corrective actions, we have developed a revised financial improvement plan with key milestones to incorporate a methodology to use per capita rates to prospectively compensate the Services each year for health care provided to Medicare-eligible beneficiaries in DoD MTFs. This methodology will also be used by the Office of the Actuary to compute the MERHCF health care liability. The use of per capita rates will enable the MERHCF to eliminate the need to rely on MTFs for auditable financial information and accurate coding of medical records and, thus, move to an unqualified audit opinion independent of the Services' receipt of unqualified audit opinions on their financial statements.

Creating a new model is very complex and resource intensive. The model must comply with actuarial laws and requirements as well as satisfy accounting, GAO, and Congressional standards. Data on which the new model will be developed must be collected over time for several fiscal years with appropriate adjustments, as trends dictate. The initial data collected from the Center for Medicare and Medicaid Services (CMS) by the DoD Office of the Actuary contained 2.2 million records on Medicare-eligible retirees and dependents. Additional time will be required to collect industry benchmark data, analyze the data, and develop and test the model. After testing, modifications may also be required, therefore, the time table for implementation of the per capita rate methodology is for the close of FY 2013.

Direct care costs developed under this proposed method will still retain the current plan design wherein Medicare does not reimburse DoD for care received in MTFs.

### **Computation of Incurred Claims Reserve**

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care for the Fund's beneficiaries relies on data files provided by TMA to the DoD Office of the Actuary (OOA). Due to the lack of a fully integrated financial management system to support the Defense Health System, certain data are provided to the OOA from health care operational sources, rather than from the accounting and financial records of claims payment activity.

The Contract Resource Management (CRM) Division in Aurora, Colorado, monitors claims processing activities performed by the TDEFIC fiscal intermediary, WPS, in support of purchased care activities for Medicare-eligible beneficiaries. To better monitor purchased care claims processing and mitigate the potential for an undetected large increase in claims backlogs occurring in the future, MERHCF management has developed a quarterly purchased care claims backlog metric to report to OUSD(C).

Each quarter MERHCF estimates the IBNR purchased care claims liability. IBNR represents health care received by Medicare-eligible beneficiaries for which DoD has not yet received a claim. The purchased care claims processing metric monitors the completeness of the data used for the IBNR liability calculation. The metric is calculated by dividing the liability from claims on hand that is actually used in the IBNR calculation (without any backlogged claims) by the liability that includes any claims backlogged at the time of the IBNR calculation.

By their nature, IBNR calculations need regular and normally distributed data. The data does not have to be 100 percent complete, but must include a percentage of claims large enough to represent the normal claims universe, and most importantly, the degree of claims completeness should remain relatively constant over time.

The goal is to ensure the IBNR calculation is based upon no less than 85% of the liability contained on all processed and backlogged claims. It is anticipated that 8% to 12% of available monthly claims will not be included in the IBNR calculation due to the cutoff of processed claims by 10:00 am EST on the last business day of the month. The

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cutoff was established to ensure IBNR calculations could be completed in time to meet reporting requirements. For FY 2008 and again in FY 2009, the IBNR calculation included 100% of available monthly claims.

### **Legislative Proposals**

The 2007 National Defense Authorization Act (NDAA) included several relevant sections concerning the MERHCF. Section 592 of the Conference Report, "Revision in Government Contributions to Medicare-Eligible Retiree Health Care Fund," excluded from the term "members of the uniformed services on active duty" cadets at the United States Military Academy, the United States Air Force Academy, or the Coast Guard Academy or Midshipmen at the United States Naval Academy. This change (with other things being equal), will reduce the Board of Actuaries annually calculated normal cost contribution and the health care liability. The elimination of cadets and midshipmen from the calculation of the active duty portion of the normal cost contribution and the health care liability took effect beginning in FY 2008.

Section 703 of the 2008 NDAA states any prescription filled on or after January 28, 2008 through the TRICARE Retail Pharmacy Network shall be treated as an element of the DoD for purposes of procurement of drugs by Federal agencies. The Veterans Health Care Act of 1992, established the Federal Ceiling Prices (FCPs) of covered pharmaceuticals requiring a minimum 24% discount off non-federal average manufacturing prices. Since the beginning of the FCP program, outpatient pharmaceuticals provided by DoD through MTF pharmacies have been subject to FCPs, as have those under the TMOP program since it began. This legislation addresses the disparity with the retail pharmacy program.

The effect of this law is that for all prescriptions filled on or after January 28, 2008, all covered drug TRICARE Retail Pharmacy Network prescriptions are subject to FCPs. After a period for public comments under the rule making process of the Administrative Procedure Act, DoD implemented this law through the promulgation of a Final Rule (32C.F.R. § 199.21(q), 74 Federal Register 11,279), published March 17, 2009, and effective May 26, 2009. The two primary provisions of the Final Rule are as follows:

- Pharmaceutical manufacturers are required to sign a written agreement to honor FCPs as a condition of eligibility for preferred approved brand name drug status (Tier 2) on the Uniform Formulary (UF) and unrestricted access through retail network pharmacies. Consistent with standard commercial practice in the retail pharmacy sector and the established TRICARE program of voluntary retail refunds, FCPs are implemented through refunds of the amount above FCPs the manufacturer was paid when the drugs entered the commercial stream, typically through a sale to a distributor.

- For prescriptions not covered by a UF pricing agreement, FCPs still apply under the statute, but collection of the refund is subject to waiver or compromise, including a potential waiver of all collections if the manufacturer withdraws its drug from the TRICARE pharmacy benefits program. Waiver and compromise requests are considered based on the established TRICARE procedures under the Federal Debt Collection Act (32 C.F.R. § 199.11), which generally include Justice Department approval to waive or compromise a significant amount.

### **Status of Implementation of Statute and Final Rule.**

Since the effective date of the Final Rule, the status of implementation on the primary provisions is as follows:

- Agreements with manufacturers have now been signed prospectively covering more than 90% of the dollar value of all potential FCP-based refunds. Additional agreements are expected in the coming weeks, which should raise the amount covered well above 90%. The effective dates of these prospective agreements are generally dates in June or July 2009.

- For prescriptions not covered by these agreements, particularly prescriptions filled between January 28, 2008, and the May 26, 2009, effective date of the Final Rule, most pharmaceutical manufacturers have requested waiver of any refunds. No company has requested removal of any of its drugs from TRICARE Pharmacy Benefits Program coverage. The waiver requests that have been submitted are pending review.

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### Litigation Pending

Pending is litigation initiated by pharmaceutical manufacturers, acting through an association called The Coalition for Common Sense in Government Procurement. This litigation seeks to invalidate the Final Rule and obtain a Court order prohibiting DoD from collecting any refunds. The Government's position in the litigation is to defend all provisions of the Final Rule. This case is pending in the United States District Court for the District of Columbia. A decision from the Court is expected before the end of the calendar year 2009 (although appeals or other circumstances could defer a conclusive resolution).

- Prescriptions filled from January 28, 2008, through March 17, 2009, occurred prior to the publication of the DoD Final Rule and before the signing of pricing agreements with the pharmaceutical manufacturers now required by the Final Rule. Again, the Final Rule was issued on March 17, 2009, with an effective date of May 26, 2009. The majority of drug companies requested a waiver of refunds for these prescriptions on the grounds the pharmaceutical manufacturers do not believe DoD has legal authority to require collection. The manufacturers believe DoD's attempt to require refunds for this period is an impermissible retroactive regulation. The Government disagrees, which is a major issue in the pending lawsuit. Due to the pendency of the waiver requests and lawsuit, the DoD and TMA General Counsels recommended TMA not issue demand letters (invoices) nor establish accounts receivable for the refunds during the period January 28, 2008, through March 31, 2009.

- Refunds were requested for prescriptions filled from April 1, 2009, through June 30, 2009, in the form of computer files by manufacturer. The Final Rule did not take effect until May 26, 2009, and the Government spent much of June negotiating pricing agreements. Consequently, most of the utilization during this quarter was not under pricing agreements. Refunds for this quarter are not due until October 10, 2009. Demand letters (invoices) were not issued with the utilization data sent to the drug manufacturers in July 2009. However, it is the General Counsels' recommendation that TMA record accounts receivable for the refund amounts reflected in the flat files sent to each of the pharmaceutical manufacturers for the 3<sup>rd</sup> Quarter, FY 2009.

- The issuing of invoices starts the clock for the accrual of interest on the debt. However, an agency always has authority to waive interest payments. It is the view of the DoD and TMA General Counsels that the pending litigation provides a basis to defer the start date of interest. Additionally, the General Counsel is concerned if DoD had to return refunds collected based on a final court ruling, DoD would not pay interest for the period DoD held the money. Therefore, DoD's demand for interest payment before the Court decides the issue might appear to the Court to be unfair.

- For prescriptions filled during the 4<sup>th</sup> Quarter, FY 2009, TMA will issue invoices with the utilization data submitted to the pharmaceutical manufacturers. These invoices will be submitted in the latter part of October 2009, with payment due 70 days later – roughly the close of calendar year 2009. A Court ruling should be rendered by then; so DoD can react with any adjustments as necessary. At the time invoices are sent to the pharmaceutical manufacturers, the DoD and TMA General Counsels recommend TMA record a like amount as accounts receivable.

- The collectability of the refunds for the 3<sup>rd</sup> and 4<sup>th</sup> Quarters, FY 2009, is almost certain once the legal issues are resolved. Minor changes may be required due to adjustments in the calculation of the receivable amount due from various manufacturers and/or the financial viability of some manufacturers. As such, an allowance for doubtful accounts will be assessed at 10% for each of the last two quarters of FY 2009. TMA expects to modify this allowance once historical evidence becomes available from which to base a calculation on actual collections as the program matures.

- It is DoD's position regarding the pending lawsuit involving Federal Ceiling Price drug refunds that the agency's actions are legally supportable, and our legal arguments should prevail. However, as with any litigation, there are risks the Court may rule against the Government. If that occurs, and one of the remedies ordered by the Court involves setting aside the TRICARE regulation on federal pricing refunds, the Government could face the issue of refunding those collections related to the mandatory pricing agreements (\$38.1 million). Given that possibility, the TMA General Counsel believes it is prudent and has recommended TMA consider disclosing a possible contingent liability of \$38.1 million in the footnotes to the MERHCF financial statements.

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• Given the DoD Final Rule had not been published in FY 2008, and that further litigation was possible, the MERHCF Board of Actuaries decided at the July 2008 Board meeting to apply only half the estimated savings to the MERHCF actuarial liability assumptions to the FY 2008 calculation of the liability. As a result, the conservative impact of this legislation was a change in the actuarial assumption of \$35.3 billion on the MERHCF actuarial health care liability. Since the Final Rule was published in FY 2009 and approximately 93% of the pricing agreements with the pharmaceutical manufacturers have been signed, the Board of Actuaries did not allow the potential of legal outcomes to influence their actuarial assumptions. Consequently, of all the actuarial assumptions used in the calculation of the FY 2009 actuarial health care liability, \$24.8 billion were associated with the retail pharmacy Federal Ceiling Price refund.

### **Voluntary Agreements for TRICARE Retail Network Rebates (VARRs)**

TMA initiated a new retail pharmacy rebate program during the 2<sup>nd</sup> Quarter, FY 2007, Voluntary Agreements for TRICARE Retail Network Rebates (VARRs). Manufacturers may offer rebates to the DoD for pharmaceutical agents dispensed through the TRICARE Retail pharmacy network. There are two types of VARRs.

1. The **Uniform Formulary VARR (UF-VARR)** is contingent upon pharmaceutical agents being included on the 1<sup>st</sup> (generic drugs) or 2<sup>nd</sup> (formulary brand drugs) tiers of the DoD Uniform Formulary.
2. The **Utilization VARR (VARR (Utilization))** is based solely on utilization of the pharmaceutical agent(s) dispensed through the TRICARE Retail Pharmacy Network. There is no association between formulary placement and an offer of a rebate. The rebates will apply to all prescriptions dispensed for the National Drug Class (NDC) listed on an accepted VARR to a DoD beneficiary through the TRICARE Retail Pharmacy Network.

As of September 30, 2008, the MERHCF received a total of \$110.5M in pharmacy retail network rebates under both VARR programs. In FY 2009, receipts from both VARR programs were \$132.9M.

### **Limitations of the Financial Statements**

The principal financial statements have been prepared to report the financial position and results of operations for the MERHCF pursuant to the requirements of the Chief Financial Officers (CFO) Act of 1990. While the statements have been prepared from the books and records of the MERHCF in accordance with the Generally Accepted Accounting Principles (GAAP) for Federal entities and the formats prescribed by OMB, these statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization they are for a component of the U.S. Government, a sovereign entity.

### **Comparative Financial Data**

The following table presents comparative financial statement information for the MERHCF.

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<b>Medicare-Eligible Retiree Health Care Fund</b>			
<b>Analysis of Financial Statements</b>			
for the years ended September 30, 2009, and 2008			
(\$ In Thousands)			
<b><u>Consolidated Balance Sheet</u></b>	<b><u>2009</u></b>	<b><u>2008</u></b>	<b><u>Difference</u></b> Increase/ (Decrease)
Investments (Intra-Governmental Securities) - Revenue from Treasury payments and Service contributions excess to current year health care benefit payments is invested in Treasury securities	\$148,403,475	\$134,291,659	\$14,111,816 11%
Liabilities Not Covered by Budgetary Resources - Represents difference between actuarial liability for future benefit payments and current assets	\$363,616,192	\$368,254,642	(\$4,638,450) 1%
Accounts Receivable (A/R), Public A/R associated with Mandatory Agreement Retail Refund (MARR) pharmacy program	\$424,686	\$12,486	\$412,200 3,302%
Accounts Payable (Non-Federal)	\$60,081	\$138,429	(\$78,348) (57%)
Military Retirement and Other Federal Employment Benefits - Represents actuarial liability of future health care benefit and incurred-but-not-reported (IBNR) liability	\$510,286,785	\$500,819,180	\$9,467,605 2%
<b><u>Statement of Net Cost</u></b>			
Net costs of operation - Changes in computation of actuarial health care liability are the major contributor to changes in net costs of operation	\$5,133,333	\$41,086,980	(\$35,953,647) (88%)
<b><u>Statement of Budgetary Resources</u></b>			
Undelivered orders	\$50,298	\$40,286	\$10,012 25%
Net Outlays	(\$3,394,795)	(\$12,860,266)	\$9,465,471 74%

### **Investments – Intra-Governmental Securities**

Total Intra-governmental Securities, Net Investments, for MERHCF increased \$14.1 billion, 11%. This increase is primarily the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. Public Health Service, National Oceanographic and Atmospheric Administration, and the U.S. Coast Guard) net of current disbursements for benefits paid. Investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover the unfunded portions of future benefits. The MERHCF purchased \$15.3 billion in long-term securities during FY 2009.

### **Liabilities Not Covered by Budgetary Resources**

Total Liabilities Not Covered by Budgetary Resources decreased \$4.6 billion (1%). This change is primarily attributable to an increase of \$14.1 billion in investments offset by an increase in the actuarial liability of \$9.3 billion.

### **Accounts Receivable, Public**

Accounts Receivable, Public, increased \$412.2 million. This increase was primarily due to the implementation of the Mandatory Agreement Retail Refund (MARR) Pharmacy Program. MARR receivables (\$402.6 million) were recorded as of September 30, 2009: 3<sup>rd</sup> Quarter, FY 2009, totaled \$200.1 million, and 4<sup>th</sup> Quarter, FY 2009, totaled \$202.5 million.

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## Management's Discussion And Analysis

On March 17, 2009, the Department of Defense (DoD) published a Final Rule (32 C.F.R. § 199.21 (q), 74 Federal Register 11,279) implementing Section 703 of the National Defense Authorization Act (NDAA) for FY 2008 with respect to the TRICARE Retail Pharmacy program. According to the Final Rule, the refunds are to be collected retroactively to the date of the NDAA enactment – January 28, 2008.

Shortly after publishing the Final Rule, a coalition of members from the pharmaceutical industry took legal action to invalidate the Final Rule and obtain a Court order prohibiting DoD from collecting any refunds whatsoever. The coalition also argued that if the Final Rule is valid, it should not be effective retroactively to January 2008. This legal action is currently being reviewed in a Federal Court, with a decision anticipated before the end of the current calendar year.

Prescriptions filled from January 28, 2008, through March 17, 2009, occurred prior to the publication of the DoD Final Rule and before the signing of pricing agreements with the pharmaceutical manufacturers now required by the Final Rule. The majority of drug companies requested a waiver of refunds for prescriptions filled during this time frame on the grounds they do not believe DoD has legal authority to require them. The DoD disagrees, which is a major issue in the pending lawsuit. Due to the pendency of the waiver requests and lawsuit, the DoD and TMA General Counsels recommend that DoD delay issuing invoices and establishing accounts receivable for the refunds during the period January 28, 2008, through March 31, 2009, until after the Court's ruling.

The TMA believes the government is in a favorable position to prevail on the legal actions. As such, the collectability of these refunds is almost certain once the legal issues are resolved. There may be some changes in the calculation of the amount receivable raised by the manufacturers which will require adjustment of the amount receivable. As such, an allowance for doubtful accounts has been estimated (at 10% (\$40.3 million)) and recorded. The TMA expects to modify this allowance once this program matures and there is a historical basis from which to project actual collections.

### **Accounts Payable (Non-Federal)**

Non-federal Payables (to the Public) decreased \$78.3 million (57%). This decrease is primarily due to the normal fluctuations in the billings by Express Scripts, the pharmacy contractor, for furnishing the pharmaceuticals associated with the TRICARE Mail Order Program (TMOP) and the claims paid by the TRICARE Dual-Eligible Fiscal Intermediary Contractor for purchased inpatient and outpatient care.

### **Military Retirement and Other Federal Employment Benefits**

The total Military Retirement and Other Federal Employment Benefits increased \$9.5 billion, (2%) primarily due to the increase in the FY 2009 actuarial liability. This increase is primarily due to a net gain from changes in key assumptions that were partially offset by the expected increase in the actuarial liability of \$31.1 billion (growth due to service and interest, and liability released through benefit payments). The actuarial gains and losses due to other factors decreased the liability by \$18.6 billion. Key factors contributing to these "Other Factors" include updated assumptions to reflect mandated federal ceiling prices for retail prescription drugs and revised mortality improvement factors. The actuarial gain due to changes in medical trend assumptions decreased the liability by \$3.2 billion.

### **Statements of Net Cost**

The Net Cost of Operations decreased \$36.0 billion, (88%). This change is due to a \$25.8 billion decrease in Total Costs and a \$10.2 billion decrease in Earned Revenue. The change in Total Costs is primarily attributable to the difference between the FY 2008 (\$16.2 billion decrease) and FY 2009 (\$9.5 billion increase) changes in the actuarial liability. The change in Earned Revenue is primarily due to a decrease of \$7.1 billion in interest revenue combined with a decrease of \$3.1 billion in contributions from the U.S. Treasury and Uniformed Services. The decrease in interest revenue is the result of a decrease in inflation compensation which, in turn, is directly related to the current economic conditions. Contribution amounts calculated by the DoD Office of the Actuary decreased due to assumptions used by the DoD Board of Actuaries.

### **Statements of Budgetary Resources**

The Net Amount of Budgetary Resources Obligated for Undelivered Orders increased \$10.0 million (25%). Of this amount, \$11.4 million was directly related to TMOP. These changes in TMOP are associated with the increased cost of drugs and the increased number of beneficiaries using the program.

Net Outlays increased \$9.5 billion (74%) primarily due to a decrease in the U.S. Treasury contributions of \$2.3 billion and a decrease of \$7.1 billion in interest revenue. The U.S. Treasury has classified its contribution and the interest revenue as distributed offsetting receipts. The decrease in contributions is directly related to the payment computations made by the DoD Office of the Actuary. The decrease in interest revenue is the result of the current economic conditions.

### **Internal Controls Over Financial Reporting and on Compliance with Other Matters**

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

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

*DoD*

***MEDICARE-ELIGIBLE RETIREE  
HEALTH CARE FUND***

***PRINCIPAL STATEMENTS***

The accompanying notes are an integral part of these statements



## Principal Statements

**Department of Defense**  
**Medicare-Eligible Retiree Health Care Fund**  
**BALANCE SHEETS**  
**For the Years Ended September 30, 2009, and 2008**  
**(\$ In Thousands)**

	<u>2009</u>	<u>2008</u>
<b>ASSETS</b>		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$ 5,000	\$ 5,000
Investments (Note 3)	148,403,475	134,291,659
Total Intragovernmental Assets	<u>148,408,475</u>	<u>134,296,659</u>
Accounts Receivable, Net (Note 4)	424,686	12,486
<b>TOTAL ASSETS</b>	<u>\$ 148,833,161</u>	<u>\$ 134,309,145</u>
<b>LIABILITIES</b>		
Intragovernmental:		
Accounts Payable (Note 6)	\$ 62,813	\$ 61,387
Total Intragovernmental Liabilities	<u>62,813</u>	<u>61,387</u>
Accounts Payable (Note 6)	60,081	138,429
Military Retirement Benefit Liabilities (Notes 5 and 8)	509,466,419	500,195,710
Benefits Due and Payable (Note 8)	820,366	623,470
<b>TOTAL LIABILITIES</b>	<u>\$ 510,409,679</u>	<u>\$ 501,018,996</u>
<b>NET POSITION</b>		
Cumulative Results of Operations – Earmarked Funds	\$ (361,576,518)	\$ (366,709,851)
<b>TOTAL NET POSITION</b>	<u>(361,576,518)</u>	<u>(366,709,851)</u>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<u>\$ 148,833,161</u>	<u>\$ 134,309,145</u>

The accompanying notes are an integral part of these statements

**Department of Defense  
Medicare-Eligible Retiree Health Care Fund  
STATEMENTS OF NET COST  
For the Years Ended September 30, 2009, and 2008  
(\$ In Thousands)**

	<u>2009</u>	<u>2008</u>
<b>PROGRAM COSTS</b>		
Gross Costs	\$ 17,336,042	\$ (8,429,788)
Less: Earned Revenue	<u>(22,469,375)</u>	<u>(32,657,192)</u>
Net Program Costs	(5,133,333)	(41,086,980)
<b>NET COST OF OPERATIONS</b>	\$ <u>(5,133,333)</u>	\$ <u>(41,086,980)</u>

Additional information included in Note 9.

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

## Principal Statements

**Department of Defense**  
**Medicare-Eligible Retiree Health Care Fund**  
**STATEMENTS OF CHANGES IN NET POSITION**  
**For the Years Ended September 30, 2009, and 2008**  
**(\$ In Thousands)**

	<u>2009</u>	<u>2008</u>
<b>CUMULATIVE RESULTS OF OPERATIONS</b>		
Beginning Balances	\$ (366,709,851)	\$ (407,796,831)
Budgetary Financing Sources	0	0
Other Financing Sources	<u>0</u>	<u>0</u>
Total Financing Sources	\$ 0	\$ 0
Net Cost of Operations (+/-)	<u>(5,133,133)</u>	<u>(41,086,980)</u>
Net Change	<u>5,133,133</u>	<u>41,086,980</u>
Cumulative Results of Operations	\$ (361,576,518)	\$ (366,709,851)
Unexpended Appropriations, Beginning Balance	0	0
Budgetary Financing Sources	<u>0</u>	<u>0</u>
Total Unexpended Appropriations	<u>0</u>	<u>0</u>
<b>Net Position</b>	<u>\$ (361,576,518)</u>	<u>\$ (366,709,851)</u>

The accompanying notes are an integral part of these statements

**Department of Defense  
Medicare-Eligible Retiree Health Care Fund  
STATEMENTS OF BUDGETARY RESOURCES  
For the Years Ended September 30, 2009, and 2008  
(\$ In Thousands)**

	<b>2009</b>	<b>2008</b>
<b>BUDGETARY RESOURCES</b>		
Unobligated balance, brought forward, October 1	\$ 0	\$ 0
Budget authority		
Appropriation	22,396,704	32,270,819
Subtotal	22,396,704	32,270,819
Nonexpenditure transfers, net, anticipated and actual	0	0
Temporarily not available pursuant to Public Law	(14,106,055)	(24,484,897)
<b>Total Budgetary Resources</b>	<b>\$ 8,290,649</b>	<b>\$ 7,785,922</b>
<b>STATUS OF BUDGETARY RESOURCES</b>		
Obligations incurred:		
Direct	\$ 8,290,649	\$ 7,785,922
Subtotal	8,290,649	7,785,922
Unobligated balance:		
Apportioned	0	0
Subtotal	0	0
Unobligated balance not available	0	0
<b>Total status of budgetary resources</b>	<b>\$ 8,290,649</b>	<b>\$ 7,785,922</b>
<b>CHANGE IN OBLIGATED BALANCE</b>		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	\$ 240,101	\$ 368,773
Total unpaid obligated balance, net	240,101	368,773
Obligations incurred net (+/-)	8,290,649	7,785,922
Less: Gross outlays	(8,357,559)	(7,914,594)
Obligated balance, net, end of period		
Unpaid obligations	173,192	240,101
<b>Total unpaid obligated balance, net, end of period</b>	<b>\$ 173,192</b>	<b>\$ 240,101</b>
<b>NET OUTLAYS</b>		
Net Outlays		
Gross Outlays	\$ 8,357,559	\$ 7,914,594
Less: Distributed Offsetting Receipts	(11,752,354)	(20,774,860)
<b>Total Outlays</b>	<b>\$ (3,394,795)</b>	<b>\$ (12,860,266)</b>

Additional information included in Note 11.

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

*DoD*

***MEDICARE-ELIGIBLE RETIREE  
HEALTH CARE FUND  
FUND***

***NOTES TO THE  
PRINCIPAL STATEMENTS***

**DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
NOTES TO THE PRINCIPAL STATEMENTS  
FOR THE YEARS ENDED SEPTEMBER 30, 2009, AND 2008**

**NOTE 1. SIGNIFICANT ACCOUNTING POLICIES**

A. Basis of Presentation. These financial statements have been prepared to report the financial position and results of operations for the Medicare-Eligible Retiree Health Care Fund (MERHCF), as required by the *Chief Financial Officers Act of 1990*, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared using the books and records of MERHCF in accordance with U.S. generally accepted accounting principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board; the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*; and the *Department of Defense (DoD) Financial Management Regulation*. The accompanying financial statements account for all resources for which the MERHCF is responsible unless otherwise noted.

The MERHCF currently has two auditor-identified financial statement material weaknesses: (1) The DoD-managed Military Treatment Facilities (MTFs) do not have compliant, transaction-based accounting systems that support the costs of direct care provided to MERHCF beneficiaries and (2) The MTF-level health care cost data is based on budget execution processes rather than accrual-based accounting.

B. Mission of the Reporting Entity. The mission of the MERHCF is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of health care programs for DoD Military Services and other Uniformed Services. The MERHCF provides benefits for a Medicare-eligible member of a participating Military Service or other Uniformed Service entitled to retired or retainer pay and such member's Medicare-eligible dependents or survivors.

C. Appropriations and Funds. Public Law 106-398, *The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001*, authorized MERHCF and provided a permanent, indefinite appropriation. Permanent authority becomes available based upon standing provisions of law without any further legislative action by the Congress after transmittal of the budget for each year. The law does not specify an amount of budget authority for the indefinite appropriation; however, the law does specify a variable factor that determines the amount available until expended.

The MERHCF is a special fund. Special fund accounts are used to record government receipts reserved for a specific purpose. Accordingly, the funds in MERHCF are used, in compliance with the law, to provide benefits for the Medicare-eligible beneficiaries listed in paragraph 1B.

The MERHCF funds are designated as earmarked funds. Earmarked funds are financed by specifically identified revenues; are required by statute to be used for designated activities, benefits, or purposes; and remain available over time. The MERHCF is required to separately account for and report on the receipt, use, and retention of revenues and other financing sources for earmarked funds.

D. Basis of Accounting. The MERHCF's financial management systems record and report on the accrual basis. Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with USGAAP.

The financial statements and supporting trial balances are compiled from the underlying financial data and trial balances. The underlying data for the MERHCF is largely derived from budgetary (obligations, disbursements, and collections) and proprietary transactions (assets and liabilities) and accruals made for major items such as accounts receivable, accounts payable, and health care liabilities. Some of the lower level trial balances may reflect known abnormal balances resulting largely from business and system processes. At the consolidated level, these abnormal balances may not be evident. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident at the consolidated level.

E. Revenues and Other Financing Sources. Using methods and assumptions provided by the DoD MERHCF Board of Actuaries, the DoD Office of the Actuary determines the amount of the contribution to MERHCF. The contribution consists of two parts: A U.S. Treasury warrant for the amortization payment of the original unfunded liability and an annual contribution from each Uniformed Service: Army, Navy, Air Force, Marine Corps, U.S. Coast Guard, Public Health Service, and National Oceanic and Atmospheric Administration. Funds from the

## Notes to the Principal Statements

contributions that exceed the amounts required to pay current year expenses are invested in long-term securities. These investments and their associated interest revenues will be used to cover future liabilities of MERHCF.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of benefit expenses in the period incurred. The current financial feeder system was not designed to collect and record financial information on the full accrual accounting basis. Accruals are made for major items such as accounts receivable and accounts payable.

G. Accounting for Intragovernmental Activities. The U.S. Treasury's *Federal Intragovernmental Transactions Accounting Policy Guide* and the *Treasury Financial Manual*, Part 2 – Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government*, provide guidance for reporting and reconciling intragovernmental balances. The MERHCF is able to reconcile balances pertaining to investments in federal securities.

The DoD's proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DoD financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenues.

H. Funds with the U.S. Treasury. The MERHCF's monetary resources are maintained in U.S. Treasury accounts. The disbursing offices of the Defense Finance and Accounting Service (DFAS) and other DoD Agency financial service centers process the majority of MERHCF's cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites submit reports to the U.S. Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account. The MERHCF reconciles monthly with the U.S. Treasury account with no outstanding discrepancies.

The U.S. Treasury allows MERHCF to be fully invested. Therefore, FBWT may be zero at various times during the fiscal year including the end of a quarter or a fiscal year; however, precautions are taken to prevent abnormal balances at the U.S. Treasury.

I. Accounts Receivable. Accounts receivable from other federal entities or the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by MERHCF during the previous 11 months. The DoD does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the *Intragovernmental Business Rules* published in the *Treasury Financial Manual* at <http://www.fms.treas.gov/tfm/vol1/07-03.pdf>.

Since the beginning of the Federal Ceiling Price (FCP) Program, outpatient pharmaceuticals purchased by DoD for medical treatment facility pharmacies have been subject to FCPs, as have those under the TRICARE Retail Pharmacy Program. The MERHCF implemented FCP for the TRICARE Retail Pharmacy Program in compliance with the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 2008, section 703. The Final Rule was published March 17, 2009, with an effective date of May 26, 2009. The MERHCF applied this rule to all retail prescriptions filled subsequent to January 28, 2008, unless the TRICARE Management Activity granted a waiver to a particular manufacturer. Compliance is mandatory and the advantage to the manufacturers is that their drugs will be included on the DoD Uniform Formulary (list of available prescription drugs). The MERHCF recorded accounts receivable upon receipt of the calculation from the TRICARE Pharmacy Operations Directorate subject to pending litigation and will post the collections from the manufacturers to the fiscal year of receipt pursuant to Title 10, U.S. Code, section 1079a.

J. Investments in U.S. Treasury Securities. The MERHCF 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 method. The MERHCF's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities.

## Notes to the Principal Statements

The MERHCF invests in nonmarketable, market-based U.S. Treasury securities which are issued to federal agencies by the U.S. Treasury, Bureau of the Public Debt. These securities mirror marketable securities, but are not publicly traded. The MERHCF receives interest semiannually from the U.S. Treasury on the value of these securities.

K. Contingencies and Other Liabilities. The Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The MERHCF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses.

L. Net Position. Net position consists of cumulative results of operations. Cumulative results of operations represent the net of expenses, losses, and financing sources (including appropriations, revenue, and gains) since inception. The cumulative results also include donations and transfers in and out of assets that were not reimbursed.

M. Unexpended Obligations. The MERHCF obligates funds to provide goods and services; some of which are not yet delivered. The financial statements do not reflect this liability, for payment for goods and services not yet delivered, unless title passes. Unexpended obligations include (1) obligations for which goods and services have been delivered (title passed) and a liability recognized and (2) obligations for which no delivery has occurred and no liability recognized. The balance of unexpended obligations appears immediately before net outlays in the Statement of Budgetary Resources and is referred to as "Total unpaid obligated balances, net, end of period."

N. Undistributed Disbursements and Collections. Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to a specific obligation, payable, or receivable in the source system and those reported by the U.S. Treasury. The MERHCF has no undistributed disbursements or collections.

### **NOTE 2. FUND BALANCES WITH TREASURY**

(\$ In Thousands)	2009	2008
Fund Balance		
Total Special Funds	\$ 5,000	\$ 5,000
Status of Fund Balance with Treasury		
Unobligated Balance - Unavailable	\$ 146,670,593	\$ 132,564,539
Obligated Balance not yet Disbursed	173,192	240,101
Non-FBWT Budgetary Accounts	(146,838,785)	(132,799,640)
Total	\$ 5,000	\$ 5,000

During the FY 2009 audit, the auditors discovered that estimated disbursements for the MERHCF were being reported to the U.S. Treasury each month and any differences between the actual and estimated amounts were reported as disbursements of the Contract Resource Management (CRM) Division in the TRICARE Management Activity (TMA). This process, which has been in place since the beginning of MERHCF in FY 2003, was implemented to prevent the over-investment of funds which would result in a negative FBWT. Any differences were then corrected in the subsequent month. As a result of this process, both the FBWT and net position were overstated and gross costs were understated in the amount of \$22.8 million. The MERHCF and TMA are addressing this issue and will develop a resolution by the next reporting period.



## Notes to the Principal Statements

The Status of FBWT reflects the budgetary resources to support the FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

The Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. The unavailable balance, which consists primarily of funds that are temporarily precluded from obligation by law, is invested in U.S. Treasury securities. Certain MERHCF unobligated balances are restricted for future use and are not apportioned for current use. These MERHCF balances relate to special fund accounts which are treated similarly to a trust fund and are restricted by the public laws that established the fund. These balances become available subsequently without further congressional action.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods and services not received and those received but not paid. The MERHCF balance represents amounts payable to the Defense Logistics Agency (DLA) for purchases of pharmaceuticals, to private contractors waiting for DLA to replenish the pharmaceutical supply, and to private hospitals for medical services rendered.

Non-FBWT Budgetary Accounts reduces the Status of FBWT. The MERHCF balance represents investment accounts.

### NOTE 3. INVESTMENTS

(\$ In Thousands)	2009				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
Intragovernmental Securities:					
Non Marketable, Market-Based	\$ 150,184,308	Effective Interest	\$ (3,345,523)	\$ 146,838,785	\$ 150,820,636
Subtotal	150,184,308		(3,345,523)	146,838,785	150,820,636
Interest Receivable	1,564,690		0	1,564,690	1,564,690
Total Investments	<u>\$ 151,748,998</u>		<u>\$ (3,345,523)</u>	<u>\$ 148,403,475</u>	<u>\$ 152,385,326</u>

(\$ In Thousands)	2008				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities:					
Non Marketable, Market-Based	\$ 135,483,350	Effective Interest	\$ (2,683,711)	\$ 132,799,639	\$ 127,002,399
Subtotal	135,483,350		(2,683,711)	132,799,639	127,002,399
Interest Receivable	1,492,020		0	1,492,020	1,492,020
Total Investments	<u>\$ 136,975,370</u>		<u>\$ (2,683,711)</u>	<u>\$ 134,291,659</u>	<u>\$ 128,494,419</u>

Investments, Net, increased \$14.1 billion (11%). This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services net of current disbursements for benefits paid. Investment of these

## Notes to the Principal Statements

funds has a cumulative effect with an expectation that invested balances will continue growing to cover the unfunded portions of future benefits. The MERHCF purchased \$15.3 billion in long-term securities during FY 2009.

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash generated from earmarked funds is deposited in the U.S. Treasury, which uses the cash for general government purposes. The U.S. Treasury securities are issued to the earmarked funds as evidence of its receipts and are an asset to the MERHCF and a liability to the U.S. Treasury. Since the MERHCF and the U.S. 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 U.S. Government-wide financial statements. The U.S. Treasury securities provide the MERHCF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the MERHCF requires redemption of these securities to make expenditures, the Federal Government finances the securities out of accumulated cash balances by raising taxes or other receipts, borrowing from the public or repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

The following table displays the cost of the U.S. Treasury Securities.

(\$ In Thousands)	<u>COST 2009</u>		<u>COST 2008</u>
Notes	\$ 11,237,504	Notes	\$ 14,313,315
Bonds	4,957,957	Bonds	3,203,750
TIPS	127,272,130	TIPS	115,980,754
Overnights	<u>6,716,717</u>	Overnights	<u>1,985,531</u>
<b>Total Cost</b>	<b><u>\$150,184,308</u></b>	<b>Total Cost</b>	<b><u>\$135,483,350</u></b>

The MERHCF purchases and redeems nonmarketable, market-based securities that fluctuate in tandem with the current selling price of the equivalent marketable securities on the open market. The MERHCF purchases securities with the intent to hold until maturity; therefore, balances are not adjusted to market value.

At the semiannual meetings, the DoD Investment Board approves the strategy for the type of securities purchased by MERHCF. These securities may include U.S. Treasury bills, notes, bonds, inflation-protected securities, 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 either a discount or premium. The U.S. Treasury bonds are long-term securities with maturities of ten years or more and are purchased at either a discount or premium. The U.S. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The TIPS principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, the U.S. Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the shares. Overnight securities are short-term securities, purchased at face value, that mature the next business day and earn interest at the daily Federal Reserve repurchase agreement rate.

## Notes to the Principal Statements

### NOTE 4. ACCOUNTS RECEIVABLE

(\$ In Thousands)

	2009		
	Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	\$ 0	\$ N/A	\$ 0
Nonfederal Receivables from the Public	464,995	(40,309)	424,686
Total Accounts Receivables	\$ 464,995	\$ (40,309)	\$ 424,486

(\$ In Thousands)

	2008		
	Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intra-governmental Receivables	\$ 0	\$ N/A	\$ 0
Nonfederal Receivables from the Public	12,537	(51)	12,486
Total Accounts Receivables	\$ 12,537	\$ (51)	\$ 12,486

Accounts Receivable, Public, increased \$412.2 million. This increase is primarily due to the implementation of the FCP Program for the TRICARE Retail Pharmacy Program as required by the FY 2008 NDAA.

The receivables for the Mandatory Agreement Retail Pharmacy Refunds (MARR) Program were recorded as of September 30, 2009: 3<sup>rd</sup> Quarter, FY 2009, totaled \$200.1 million and 4<sup>th</sup> Quarter, FY 2009, estimates totaled \$202.5 million.

On March 17, 2009, the DoD published a Final Rule (32 C.F.R. § 199.21 (q), 74 Federal Register 11,279) implementing Section 703 of the NDAA for FY 2008 with respect to the TRICARE Retail Pharmacy program.

According to the Final Rule, the refunds are to be collected retroactively to the date of the NDAA enactment – January 28, 2008.

Shortly after the publishing of the Final Rule, a coalition of members from the pharmaceutical industry took legal action to invalidate the Final Rule and obtain a Court order prohibiting DoD from collecting any refunds whatsoever. The coalition also argued that if the Final Rule is valid, it should not be effective retroactively to January 2008. This legal action is currently being reviewed in a Federal Court, with a decision anticipated before the end of the current calendar year.

Prescriptions filled from January 28, 2008, through March 17, 2009, occurred prior to the publication of the DoD Final Rule and before the signing of pricing agreements with the pharmaceutical manufacturers now required by the Final Rule. Almost all drug companies requested a waiver of refunds for prescriptions filled during this time frame on the grounds they do not believe DoD has legal authority to require them. The DoD disagrees, and that is a major issue in the pending lawsuit. Due to the pendency of the waiver requests and lawsuit, the DoD and TMA General Counsels recommend that DoD delay issuing invoices and establishing accounts receivable for the refunds during the period January 28, 2008, through March 31, 2009, until after the Court's ruling.

Refunds were requested for prescriptions filled from April 1, 2009, through June 30, 2009, in the form of computer files by manufacturer. Neither demand letters nor invoices were sent to the manufacturers with the prescription files. However, it is the General Counsels' recommendation that DoD record accounts receivable for the refund amounts for the 3<sup>rd</sup> Quarter, FY 2009, reflected in the flat files sent to each of the pharmaceutical manufacturers.

## Notes to the Principal Statements

For prescriptions filled during the 4th Quarter, FY 2009, DoD will issue invoices with the utilization data submitted to the pharmaceutical manufacturers. These invoices will be submitted in the latter part of October 2009, with payment due 70 days thereafter – roughly the close of calendar year 2009. A Court ruling should be rendered by then; so DoD can react with adjustments as necessary. An estimate of the 4th Quarter, FY 2009, refunds has been recorded as an accounts receivable along with the 3<sup>rd</sup> Quarter accounts receivable for a total MARR Program gross receivable of \$402.6 million.

The TMA believes the government is in a favorable position to prevail on the legal actions. As such, the collectability of these refunds is almost certain once the legal issues are resolved. There may be some changes in the calculation of the amount receivable which will be raised by the manufacturers which will require adjustment of the amounts receivable. The financial viability of some of the manufacturers may also affect their ability to pay these refunds. As such, an allowance for doubtful accounts has been estimated (at 10% (\$40.3 million)) and recorded. The TMA expects to modify this allowance once this program matures and there is a historical basis from which to project actual collections.

### **NOTE 5. LIABILITIES COVERED AND NOT COVERED BY BUDGETARY RESOURCES**

(\$ In Thousands)	<u>2009</u>	<u>2008</u>
Non-Federal Liabilities:		
Military Retirement Benefits Liabilities (Note 7)	\$ 363,616,192	\$ 368,254,642
Total Non-Federal Liabilities	\$ <u>363,616,192</u>	\$ <u>368,254,642</u>
Total Liabilities Not Covered by Budgetary Resources	\$ 363,616,192	\$ 368,254,642
Total Liabilities Covered by Budgetary Resources	<u>146,793,487</u>	<u>132,764,354</u>
Total Liabilities	\$ <u>510,409,679</u>	\$ <u>501,018,996</u>

The Total Liabilities Not Covered by Budgetary Resources decreased \$4.6 billion (1%). This change is primarily attributable to an increase of \$14.1 billion in investments offset by an increase in the actuarial liability of \$9.3 billion. The increase in assets was largely attributable to the receipt of annual contributions from the U.S. Treasury and Uniformed Services during the 1<sup>st</sup> Quarter, FY 2009. The increase in the actuarial liability was primarily due to a net gain from changes in key assumptions.

The MERHCF liabilities not covered by budgetary resources represent the difference between the actuarial liability for future benefit payments and the current assets of the MERHCF.

The Military Retirement and Other Federal Employment Benefits not covered by budgetary resources represent health benefit liabilities. Refer to Note 8, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

### **NOTE 6. ACCOUNTS PAYABLE**

(\$ In Thousands)	<u>2009</u>	<u>2008</u>
Intragovernmental Payables	\$ 62,813	\$ 61,387
Nonfederal Payables (to the Public)	<u>60,081</u>	<u>138,429</u>
Total Accounts Payable	\$ <u>122,894</u>	\$ <u>199,816</u>

## Notes to the Principal Statements

Nonfederal Payables (to the Public) decreased \$78.3 million (57%). This decrease is primarily due to the normal fluctuations in the billings by Express Scripts, the pharmacy contractor, for furnishing the pharmaceuticals associated with the TMOP and the claims paid by the TRICARE Dual-Eligible Fiscal Intermediary Contractor for purchased inpatient and outpatient care.

Accounts payable include amounts owed to federal and nonfederal entities for goods and services received by the MERHCF. The MERHCF's system does not track intra-governmental transactions by customer at the transaction level. Buyer-side balances are adjusted to agree with internal seller-side accounts receivable. The accounts payable were adjusted by reclassifying between federal and nonfederal accounts payable.

### **NOTE 7. COMMITMENTS AND CONTINGENCIES**

The SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss.

Section 703 of the NDAA for FY 2008 enacted 10 U.S.C. 1074g(f) which provides for the following:

(f) Procurement of Pharmaceuticals by TRICARE Retail Pharmacy Program. With respect to any prescription filled on or after the date of the enactment of the National Defense Authorization Act for FY 2008 [January 28, 2008], the TRICARE Retail Pharmacy Program shall be treated as an element of the Department of Defense [DoD] for purposes of the procurement of drugs by Federal agencies under section 8126 of title 38 to the extent necessary to ensure that pharmaceuticals paid for by the Department of Defense [DoD] that are provided by pharmacies under the program to eligible covered beneficiaries under this section are subject to the pricing standards in such section 8126.

The effect of this law is that for all prescriptions filled on or after January 28, 2008, all covered TRICARE Retail Pharmacy Network drug prescriptions are subject to FCPs. The DoD implemented this law through the promulgation of a Final Rule (32 C.F.R., section 199.21(q), 74 Federal Register 11,279), published March 17, 2009, and effective May 26, 2009. The two primary provisions of the Final Rule are as follows:

- Pharmaceutical manufacturers are required to sign a written agreement to honor FCPs as a condition of eligibility for preferred Tier 2 status on the Uniform Formulary (UF) and unrestricted access through retail network pharmacies. Consistent with standard commercial practice in the retail pharmacy sector and the established TRICARE program of voluntary retail refunds, FCPs are implemented through refunds of the amount above FCPs the manufacturer was paid when the drugs entered the commercial stream, typically through a sale to a distributor.
- For prescriptions not covered by a UF pricing agreement, FCPs still apply under the statute, but collection of the refund is subject to waiver or compromise, including a potential waiver of all collections if the manufacturer withdraws its drug from the TRICARE pharmacy benefits program. Waiver and compromise requests are considered based on the established TRICARE procedures under the Federal Debt Collection Act (32 C.F.R., section 199.11), which generally include Department of Justice approval to waive or compromise a significant amount.

Litigation, which is pending, was initiated by pharmaceutical manufacturers acting through an association called the Coalition for Common Sense in Government Procurement. This litigation seeks to invalidate the Final Rule and obtain a court order prohibiting the DoD from collecting any refunds whatsoever. It is the DoD's position that the agency's actions are fully supportable. The DoD will defend all provisions of the Final Rule. This case is pending in the Federal Court for the District of Columbia. A decision from the Court is expected before the end of the calendar year (although appeals or other circumstances could defer a conclusive resolution).

However, as with any litigation, there are risks that the Court may rule against the government. If that happens and one of the remedies ordered by the Court involves setting aside the TRICARE regulation on federal pricing refunds, the government could face the issue of refunding those collections not related to a voluntary pricing agreement.

## Notes to the Principal Statements

Given this possibility, it is prudent to disclose a contingent liability in the footnotes to the MERHCF financial statements equal to the refunds collected to-date as of September 30, 2009, in the amount of \$38.1 million.

### **NOTE 8. MILITARY RETIREMENT BENEFIT LIABILITIES**

(\$ In Thousands)

<b><u>Major Program Activities</u></b>	<b>2009</b>			
	<b>Liabilities</b>	<b>Assumed Interest Rate</b>	<b>(Less: Assets Available to Pay Benefits)</b>	<b>Unfunded Liability</b>
Medicare-Eligible Retiree Benefits	\$ 509,466,419	5.75%	\$ (145,850,227)	\$ 363,616,192
Total	<u>\$ 509,466,419</u>		<u>\$ (145,850,227)</u>	<u>\$ 363,616,192</u>
Benefits Due and Payable	820,366		(820,366)	0
Total Military Retirement and Benefits Due and Payable	<u>\$ 510,286,785</u>		<u>\$ (146,670,593)</u>	<u>\$ 363,616,192</u>

(\$ In Thousands)

<b><u>Major Program Activities</u></b>	<b>2008</b>			
	<b>Liabilities</b>	<b>Assumed Interest Rate</b>	<b>(Less: Assets Available to Pay Benefits)</b>	<b>Unfunded Liability</b>
Medicare-Eligible Retiree Benefits	\$ 500,195,710	5.75%	\$ (131,941,068)	\$ 368,254,642
Total	<u>\$ 500,195,710</u>		<u>\$ (131,941,068)</u>	<u>\$ 368,254,642</u>
Benefits Due and Payable	623,470		(623,470)	0
Total Military Retirement and Benefits Due and Payable	<u>\$ 500,819,180</u>		<u>\$ (132,564,538)</u>	<u>\$ 368,254,642</u>

The Total Military Retirement and Benefits Due and Payable increased \$9.5 billion (2%) primarily due to the increase in the FY 2009 actuarial liability. This increase is primarily due to a net gain from changes in key assumptions that were partially offset by the expected increase in the actuarial liability of \$31.1 billion (growth due to service and interest, and liability released through benefit payments). The actuarial gains and losses due to other factors decreased the liability by \$18.6 billion. Key factors contributing to these "Other Factors" include updated assumptions to reflect mandated federal ceiling prices for retail prescription drugs and revised mortality improvement factors. The actuarial gain due to changes in medical trend assumptions decreased the liability by \$3.2 billion.

The above table displays two distinct types of liabilities that are related to Military Retirement and Other Federal Employment Benefits. This table presents the actuarial liability for health care benefits which are not yet incurred on the line titled "Medicare-Eligible Retiree Benefits." It also displays the incurred-but-not-reported (IBNR) reserve amount that represents an estimate of benefits already incurred but not yet reported to the DoD on the line titled "Benefits Due and Payable."

## Notes to the Principal Statements

### Projected Revenues

The MERHCF receives projected revenues from three sources: interest earnings on MERHCF assets, annual Uniformed Services normal cost contributions, and an annual U.S. Treasury contribution. The normal cost contributions are paid annually at the beginning of the fiscal year by the U.S. Treasury from the amounts appropriated to the Military Services and are calculated at the approved full-time and part-time per capita rates times the budgeted full-time and part-time force strengths. The contribution from the U.S. Treasury is also paid into MERHCF at the beginning of each fiscal year and represents the amortization of the unfunded liability for services performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses. The DoD MERHCF Board of Actuaries approves the per capita normal cost rates and the U.S. Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payments.

### FY 2009

#### Actuarial Cost Method

As dictated by law, the MERHCF 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.

#### Assumptions

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. The discount rate used was 5.75% and represents the expected long-term rate of return on U.S. Treasuries. Incurred cost assumptions for inpatient and outpatient care (for both direct care and purchased care) were based on FY 2005 through FY 2007 experience. Assumptions for prescription drug costs (both purchased care and direct care) and US Family Health Plan (USFHP) premiums were developed from FY 2007 and FY 2008 experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. The FY 2009 change in the actuarial liability is displayed below. In calculating the actuarial liabilities, the following medical trend assumptions were used:

<u>Medical Trend</u>	<u>FY 2008 - FY 2009</u>	<u>Ultimate Rate 2033</u>
Medicare Inpatient (Direct Care)	5.13%	6.25%
Medicare Inpatient (Purchased Care)	6.13%	6.25%
Medicare Outpatient (Direct Care)	4.13%	6.25%
Medicare Outpatient (Purchased Care)	5.13%	6.25%
Medicare Prescriptions (Direct Care)	3.00%	6.25%
Medicare Prescriptions (Purchased Care)	8.44%	6.25%
USFHP (Purchased Care)	9.00%	6.25%

The medical cost trends assumptions have a significant effect on the amounts reported. For example, if each of the assumed trend rates had increased by one percentage point, the actuarial present value of project plan benefits would have increased 28.6%, or approximately \$145.7 billion.

## Notes to the Principal Statements

### FY 2009 Change in MERHCF Actuarial Liability

#### (\$ In Thousands)

A. Actuarial Liability as of September 30, 2008 (all Uniformed Services Medicare)	\$ 500,195,710
B. Expected Normal Cost for FY 2009	10,373,852
C. Expected Benefit Payments for FY 2009	(8,429,211)
D. Interest Cost for FY 2009	29,118,797
E. Actuarial (Gains)/Losses Due to Other Factors	(18,604,305)
F. Actuarial (Gains)/Losses Due to Changes in Trend Assumptions	(3,188,424)
G. Actuarial Liability as of September 30, 2009 (all Uniformed Services Medicare)	<u>509,466,419</u>
H. Change in Actuarial Liability (Line G-Line A)	<u>\$ 9,270,709</u>

Each year the actuarial liability is expected to increase with normal (or service) cost (Line B), decrease with benefit payments (Line C), and increase with interest cost (interest on the liability during the period) (Line D), resulting in an expected increase of \$31.1 billion in the FY 2009 actuarial liability (Line B + Line C + Line D). The September 30, 2009, actuarial liability incorporates changes in assumptions, new assumptions, and actuarial experience. The Actuarial Gains and Losses Due to Other Factors (Line E) decreased the liability by an additional \$18.6 billion. Key factors contributing to these "Other Factors" include updated assumptions to reflect mandated federal ceiling prices for retail prescription drugs, revised mortality improvement factors, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions. The actuarial gain due to changes in medical trend assumptions (Line F) decreased the liability by \$3.2 billion.

The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4<sup>th</sup> Quarter, FY 2009, balance represents the September 30, 2009, amount.

### FY 2009 Actuarial Liability for the Uniformed Services

The MERHCF liability included Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2009, Medicare liability for all Uniformed Services is as follows:

#### (\$ In Thousands)

DoD	\$ 498,077,834
Coast Guard	10,215,732
Public Health Service	1,100,526
National Oceanic and Atmospheric Administration	<u>72,327</u>
Total	<u>\$ 509,466,419</u>

### FY 2009 Uniformed Service Contributions

The FY 2009 Uniformed Service contributions to the MERHCF were as follows:

#### (\$ In Thousands)

DoD	\$ 10,350,593
Coast Guard	257,305
Public Health Service	34,778
National Oceanic and Atmospheric Administration	<u>1,674</u>
Total	<u>\$ 10,644,350</u>

### Market Value of Securities for the MERHCF

The market value of the non-marketable, market based securities as of September 30, 2009, totaled \$152.4 billion.



**FY 2008**

**Actuarial Cost Method**

As dictated by law, the MERHCF 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.

**Assumptions**

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. The discount rate used was 5.75% and represents the expected long-term rate of return on U.S. Treasuries. The discount rate was reduced 0.25% from the prior actuarial valuation. Incurred cost assumptions for direct were based on actual experience in FY 2007. Assumptions for purchased care were developed from actual experience incurred during FY 2005 through FY 2007. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. The FY 2008 change in the actuarial liability is displayed below. In calculating the actuarial liabilities, the following medical trend assumptions were used:

<b><u>Medical Trend</u></b>	<b><u>FY 2007 - FY 2008</u></b>	<b><u>Ultimate Rate 2032</u></b>
Medicare Inpatient (Direct Care)	5.65%	6.25%
Medicare Inpatient (Purchased Care)	6.65%	6.25%
Medical Outpatient (Direct Care)	3.33%	6.25%
Medicare Outpatient (Purchased Care)	4.33%	6.25%
Medicare Prescriptions (Direct Care)	3.00%	6.25%
Medicare Prescriptions (Purchased Care)	8.55%	6.25%
USFHP (Purchased Care)	10.00%	6.25%

Beginning with the actuarial liability determined for the September 30, 2008, MERHCF financial statements, separate medical trend rates were used for direct care and purchased care costs to incorporate the assumption that purchased care medical trends will be higher than direct care medical trends. In addition, a new set of trends was introduced for the U.S. Family Health Plan (USFHP) costs. The USFHP costs are now valued as a separate benefit in order to more accurately reflect that portion of the liability.

The medical cost trends assumptions have a significant effect on the amounts reported. For example, if the FY 2008 assumed rates had increased by one percentage point, the actuarial present value of projected plan benefits would have increased by 28.6%, or approximately \$143.0 billion.

**FY 2008 Change in MERHCF Actuarial Liability**

**(\$ In Thousands)**

A. Actuarial Liability as of September 30, 2007 (all Uniformed Services Medicare)	\$ 516,479,229
B. Expected Normal Cost for FY 2007	10,070,293
C. Expected Benefit Payments for FY 2007	(8,545,983)
D. Interest Cost for FY 2007	31,340,326
E. Actuarial (Gains)/Losses Due to Other Factors	(5,248,219)
F. Actuarial (Gains)/Losses Due to Changes in Trend Assumptions	<u>(43,899,936)</u>
G. Actuarial Liability as of September 30, 2007 (all Uniformed Services Medicare)	\$ <u>500,195,710</u>
H. Change in Actuarial Liability (Line G-Line A)	\$ <u>(16,283,519)</u>

Each year the actuarial liability is expected to increase with normal (or service) cost (Line B), decrease with benefit payments (Line C), and increase with interest cost (interest on the liability during the period) (Line D), resulting in an expected increase of \$32.9 billion in the FY 2008 actuarial liability (Line B + Line C + Line D). The September 30, 2008, actuarial liability incorporates changes in assumptions, new assumptions, and actuarial

## Notes to the Principal Statements

experience. The Actuarial Gains and Losses Due to Other Factors (Line E) decreased the liability by an additional \$5.2 billion. Key factors contributing to these “Other Factors” include a 0.25% decrease in the discount rate, adding an assumption to reflect mandated federal ceiling prices for retail prescription drugs, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions and discount rate. The actuarial gain due to changes in medical trend assumptions (and the introduction of new trend rates for USFHP) (Line F) decreased the liability by \$43.9 billion.

### **FY 2008 Actuarial Liability for the Uniformed Services**

The MERHCF liability included Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2008, Medicare liability for all Uniformed Services is as follows:

**(\$ In Thousands)**

DoD	\$ 489,038,340
Coast Guard	10,015,552
Public Health Service	1,070,835
National Oceanic and Atmospheric Administration	<u>70,983</u>
Total	<u>\$ 500,195,710</u>

### **FY 2008 Uniformed Service Contributions**

The FY 2008 Uniformed Service contributions to MERHCF were as follows:

**(\$ In Thousands)**

DoD	\$ 11,185,399
Coast Guard	272,111
Public Health Service	36,647
National Oceanic and Atmospheric Administration	<u>1,802</u>
Total	<u>\$ 11,495,959</u>

### **Market Value of Securities for the MERHCF**

The market value of the non-marketable, market based securities as of September 30, 2008, totaled \$128.5 billion.

### **NOTE 9. GENERAL DISCLOSURES RELATED TO THE STATEMENTS OF NET COST**

**(\$ In Thousands)**

	<u>2009</u>	<u>2008</u>
Intragovernmental Costs	\$ 2,459,487	\$ 2,365,012
Public Costs	<u>14,876,555</u>	<u>(10,794,800)</u>
Total Costs	<u>\$ 17,336,042</u>	<u>\$ (8,429,788)</u>
Intragovernmental Earned Revenue	\$ (22,469,375)	\$ (32,657,192)
Public Earned Revenue	<u>0</u>	<u>0</u>
Total Earned Revenue	<u>\$ (22,469,375)</u>	<u>\$ (32,657,192)</u>
Net Cost of Operations	<u>\$ (5,133,333)</u>	<u>\$ (41,086,980)</u>

## Notes to the Principal Statements

The Net Cost of Operations decreased \$36.0 billion (88%). This change is primarily due to a \$25.8 billion decrease in Total Costs and a \$10.2 billion decrease in Earned Revenue. The change in Total Costs is primarily attributable to the difference between the FY 2008 (\$16.2 billion decrease) and FY 2009 (\$9.5 billion increase) changes in the actuarial liability. Factors impacting the changes in the actuarial liability are discussed in Note 8, Military Retirement Benefits Liabilities. The change in Earned Revenue is primarily due to a decrease of \$7.1 billion in interest revenue combined with a decrease of \$3.1 billion in contributions from the U. S. Treasury and Uniformed Services. The decrease in interest revenue is the result of a decrease in inflation compensation which, in turn, is directly related to the current economic conditions. Contribution amounts calculated by the DoD Office of the Actuary decreased due to assumptions used by the DoD Board of Actuaries.

During the FY 2009 audit, the auditors discovered that estimated disbursements for the MERHCF were being reported to the U.S. Treasury each month and any differences between the actual and estimated amounts were reported as disbursements of the Contract Resource Management Division in the TMA. As a result of this process, the MERHCF total costs were understated by \$22.8 million. Refer to Note 2, Fund Balances with Treasury, for additional details.

The FY 2008 abnormal balance on the Statement of Net Cost (SNC), a negative \$8.4 billion, is due to a \$16.3 billion decrease in the MERHCF actuarial liability which was updated September 30, 2008. This decrease was caused by changes in the actuarial assumptions, new assumptions, experience, and assumed discount rate and was offset by \$7.9 billion in normal benefit expenses.

The SNC represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program organization administered by a responsible reporting entity. The DoD's current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act. The DoD is in the process of reviewing available data and developing a cost reporting methodology as required by the SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, as amended by SFFAS No. 30, *Inter-entity Cost Implementation*.

Intragovernmental costs and revenue are related transactions made between two reporting entities within the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity.

The MERHCF's system does not track intragovernmental transactions by customer at the transaction level. Buyer-side expenses are adjusted to agree with internal seller-side expenses. Expenses are adjusted by reclassifying amounts between federal and nonfederal expenses.

Intragovernmental Earned Revenue is comprised of the following amounts:

### Intragovernmental Earned Revenues for Program Costs

(\$ In Thousands)	2009	2008
1. Uniformed Service Contributions	\$ 10,644,350	\$ 11,495,959
2. Annual Treasury Unfunded Liability Payment	10,660,000	12,930,000
3. Interest on Investments	1,165,025	8,231,233
4. Total Intragovernmental Revenue	\$ 22,469,375	\$ 32,657,192

## Notes to the Principal Statements

Line 1. Uniformed Services Contributions represent the amount contributed by Treasury on behalf of the Uniformed Services at the beginning of each fiscal year. The contribution rates, which are determined by the DoD Retirement Board of Actuaries, are based on Board-approved per capita normal cost rates and expected average strengths for the Uniformed Services.

Line 2. Annual Treasury Unfunded Liability Payment. This payment represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses.

Line 3. Interest on Investments represents the interest income received by the MERHCF for FYs 2009 and 2008.

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

During the FY 2009 audit, the auditors discovered that estimated disbursements for the MERHCF were being reported to the U.S. Treasury each month and any differences between the actual and estimated amounts were reported as disbursements of the CRM Division in TMA. As a result of this process, the MERHCF net position was overstated by \$22.8 million. Refer to Note 2, Fund Balances with the Treasury.

There was a difference of \$22.4 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations Received on the Statement of Budgetary Resources (SBR). This difference is due to additional resources included in the Appropriations Received line on the SBR. Refer to Note 11, Disclosures Related to the Statements of Budgetary Resources. As of September 30, 2008, the difference between the MERHCF's two statements was \$32.3 billion.

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

(\$ In Thousands)

	<u>2009</u>	<u>2008</u>
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ <u>50,298</u>	\$ <u>40,286</u>

Net Outlays increased \$9.5 billion (74%) primarily due to a decrease in the U. S. Treasury contribution of \$2.3 billion and a decrease of \$7.1 billion in interest revenue. The U. S. Treasury has classified its contribution and the interest revenue as distributed offsetting receipts. The decrease in contributions is directly related to the payment computations made by the DoD Office of the Actuary. The decrease in interest revenue is the result of the current economic conditions. See Note 9, General Disclosures Related to the Statements of Net Cost, for additional information regarding these decreases.

The Net Amount of Budgetary Resources Obligated for Undelivered Orders increased \$10.0 million (25%). Of this amount, \$11.4 million was directly related to TMOP. The increases in the undelivered orders for TMOP are associated with the increased cost of pharmaceutical drugs and the increased number of beneficiaries using the program.

The MERHCF reported \$8.3 billion in direct, Category B obligations. Category B obligations are apportioned funds that relate to a specific project or program. As of September 30, 2008, the MERHCF reported \$7.8 billion in direct, Category B obligations.

The MERHCF'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 MERHCF and are available for obligation as needed in the future.

There was a difference of \$22.4 billion between appropriations on the SCNP and appropriations on the SBR. This difference represents current receipts reported as exchange revenue on the SNC, as appropriations on the SBR, and as a part of the Net Cost of Operations on the SCNP.

## Notes to the Principal Statements

The U.S. Treasury issues annual warrants that pay amortized payments for the unfunded actuarial liabilities of the Fund. The Fund's annual warrant for FY 2009 totaled \$10.7 billion. The Other Defense Organizations General Fund credits, and subsequently expends, this amount to the MERHCF in accordance with OMB guidance. The OMB is aware, and approves, of this duplicate reporting. As a result, \$10.7 billion is duplicated on the DoD Agency-wide SBR. As of September 30, 2008, the Fund's annual warrant was \$12.9 billion, which was duplicated on the DoD Agency-wide SBR for FY 2008.

In addition, the Fund reports Appropriations Received for contributions that the Army, Navy, and Air Force pay. The Military Departments also include these amounts in their respective Appropriations Received. For FY 2009, the Fund reported a total of \$10.4 billion for the Military Departments, which is duplicated on the DoD Agencywide SBR. As of September 30, 2008, the Fund also reported \$11.2 billion in contributions from the Military Departments, which was duplicated on the DoD Agency-wide SBR for FY 2008.

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

**(\$ In Thousands)**

#### **RESOURCES USED TO FINANCE ACTIVITIES**

	<b>2009</b>	<b>2008</b>
Budgetary Resources Obligated		
Obligations incurred	\$ 8,290,649	\$ 7,785,922
Less: Offsetting receipts (-)	(11,752,354)	(20,774,860)
Net obligations	(3,461,705)	(12,988,938)
<b>Total resources used to finance activities</b>	<b>\$ (3,461,705)</b>	<b>\$ (12,988,938)</b>
<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 (-)	\$ (10,012)	\$ 71,850
Resources that fund expenses recognized in prior periods	0	(16,285,468)
<b>Total resources used to finance items not part of the Net Cost of Operations</b>	<b>(10,012)</b>	<b>(16,213,618)</b>
<b>Total resources used to finance the Net Cost of Operations</b>	<b>\$ (3,471,717)</b>	<b>\$ (29,202,556)</b>
<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	\$ 9,467,605	\$ 0
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	(10,717,021)	(11,882,332)
Other	(412,200)	(2,092)
<b>Total components of Net Cost of Operations that will not require or generate resources in the current period</b>	<b>\$ (1,661,616)</b>	<b>\$ (11,884,424)</b>
<b>Net Cost of Operations</b>	<b>\$ (5,133,333)</b>	<b>\$ (41,086,980)</b>

The following note schedule lines are presented as combined instead of consolidated due to intraagency budgetary transactions not being eliminated: Obligations Incurred; Obligations Net of Offsetting Collections and Recoveries; Less: Offsetting Receipts; Net Obligations; and Undelivered Orders.

Components Requiring or Generating Resources in Future Period – Other displays the change in the FY 2009 actuarial liability and the FY 2009 IBNR reserve amount. The actuarial liability amount represents health care liabilities that are not covered by budgetary resources. The IBNR amount represents an estimate of medical benefits already incurred by not yet reported to the Department of Defense.

## Notes to the Principal Statements

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables since the beginning of both FY 2008 and FY 2009. These changes represent refunds receivable for (1) amounts due from drug manufacturers as required by the FCP Program, (2) duplicate or other erroneous MERHCF payments made to contractors for care of the beneficiaries, and (3) copayments from MERHCF beneficiaries for mail order prescriptions. These refunds receivable are recorded as an offset to expenses. This line also displays the changes in bad debts for both FY 2008 and FY 2009. These bad debts occurred because erroneous payments made to the MERHCF beneficiaries or to nonfederal providers of medical services were not repaid.

The MERHCF reported \$363.6 billion in health care liabilities not covered by budgetary resources. These liabilities represent amounts for which the MERHCF has no assets available, nor are these liabilities due and payable, in the current fiscal year. Refer to Note 8, Military Retirement Benefit Liabilities, for additional details and disclosures.

### **NOTE 13. BENEFIT PROGRAM EXPENSE**

The benefit program expenses (BPE) for FY 2009 and FY 2008 are displayed below. Details about these expenses are provided in the following paragraphs:

#### **Benefit Program Expenses**

<b>(\$ In Thousands)</b>	<b>2009</b>	<b>2008</b>
A. Service Cost	\$ 10,373,852	\$ 10,070,293
B. Period Interest on the Benefit Liability	29,118,797	31,340,326
C. Prior (or Past) Service Cost	0	0
D. Period Actuarial (Gains) or Losses	(18,604,305)	(5,248,219)
E. Actuarial (Gains)/Losses Due to Changes in Medical Trend Assumptions	<u>(3,188,424)</u>	<u>(43,899,936)</u>
F. Total	\$ <u>17,699,920</u>	\$ <u>(7,737,536)</u>

The BPE provide components of the change in the actuarial liability from September 30, 2008, to September 30, 2009. The September 30, 2009, actuarial liability is calculated using the components of BPEs as well as the expected benefit payments during the fiscal year. See Note 8, Military Retirement Benefit Liabilities, for further details about the change in the actuarial liability. The September 30, 2009, actuarial liability is equal to the September 30, 2008, liability plus the total BPEs minus the expected benefit payments. The BPE includes normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments).

In FY 2009, the Period Actuarial (Gains) or Losses component of BPE (Line D) contributed a net gain (liability decrease) reflecting the net of various gains and losses resulting from experience and changes in assumptions. The (Gains)/Losses Due to Changes in Medical Trend Assumption component of BPE (Line E) also produced a gain in FY 2009; however, the new medical trend rate assumptions used in FY 2008 produced a larger gain. Each year, the MERHCF Board of Actuaries approves the assumption changes.

The Service Cost (Line A) and Interest Cost components of the BPE (Line B) are generally expected to increase each year. However, actuarial gains and losses always occur as a result of changes in assumptions, new assumptions, new assumptions, actuarial experience, and/or benefit changes.

## Notes to the Principal Statements

### NOTE 14. EARMARKED FUNDS

#### BALANCE SHEET

##### Assets

	<b>2009</b>	<b>2008</b>
Fund balance with Treasury	\$ 5,000	\$ 5,000
Investments	148,403,475	134,291,659
Accounts and Interest Receivable	<u>424,686</u>	<u>12,486</u>
<b>Total Assets</b>	<b>\$ <u>148,833,161</u></b>	<b>\$ <u>134,309,145</u></b>

##### Liabilities And Net Position

Military Retirement Benefits and Other Federal Employment Benefits	\$ 510,286,785	\$ 500,819,180
Other Liabilities	<u>122,894</u>	<u>199,816</u>
Total Liabilities	510,409,679	501,018,996
Cumulative Results of Operations	<u>(361,576,518)</u>	<u>(366,709,851)</u>
<b>Total Liabilities And Net Position</b>	<b>\$ <u>148,833,161</u></b>	<b>\$ <u>134,309,145</u></b>

#### STATEMENT OF NET COST

Program Costs	\$ 17,336,042	\$ (8,429,788)
Less Earned Revenue	(22,469,375)	(32,657,192)
Net Program Costs	<u>(5,133,333)</u>	<u>(41,086,980)</u>
<b>Net Cost of Operations</b>	<b>\$ <u>(5,133,333)</u></b>	<b>\$ <u>(41,086,980)</u></b>

#### STATEMENT OF CHANGES IN NET POSITION

Net Position Beginning of the Period	\$ (366,709,851)	\$ (407,796,831)
Net Cost of Operations	(5,133,333)	(41,086,980)
Budgetary Financing Sources	<u>0</u>	<u>0</u>
Change in Net Position	\$ 5,133,333	\$ 41,086,980
<b>Net Position End of Period</b>	<b>\$ <u>(361,576,518)</u></b>	<b>\$ <u>(366,709,851)</u></b>

Public Law 106-398, *The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001*, authorized the establishment of the MERHCF. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the DoD and the Uniformed Services health care programs for specific Medicare-eligible beneficiaries. The MERHCF receives its appropriations and funds as an earmarked special fund and uses these resources to execute its mission and report on resource usage.

The primary financing sources for MERHCF are (1) an annual unfunded actuarial liability payment from the U.S. Treasury, (2) annual contributions from the Military Services and other Uniformed Services, and (3) interest earned on investments. Using methods and assumptions approved by the DoD Board of Actuaries, the DoD Office of the Actuary calculates the annual unfunded liability amount, the annual Military Services payment amounts, and the rates for the other Uniformed Services. These financing sources are the result of intragovernmental flows. Contributions in excess of the projected current year health care benefits are invested. These investments and associated revenue are used to cover future liabilities of MERHCF.

**NOTE 15. OTHER DISCLOSURES**

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2009, and 2008 includes approximately \$72.1 billion (14% of total) and \$71.0 billion (14% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2009, include approximately \$2.9 billion and \$1.7 billion, respectively, and for the year ended September 30, 2008, include approximately \$3.3 billion and \$1.7 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various Military Service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.



***DoD***  
***MEDICARE-ELIGIBLE RETIREE***  
***HEALTH CARE FUND***

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

**EXHIBIT 1**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
ACTUARIAL STATUS INFORMATION  
SEPTEMBER 30, 2009, AND 2008

(\$ In Thousands)

	<u>September 30, 2009</u>	<u>September 30, 2008</u>
1 Present value of future benefits		
a. Current inactives	\$313,966,215	\$307,149,821
b. Active duty personnel <sup>1</sup>	\$158,897,873	\$156,814,830
c. Nonretired reservists	<u>\$119,939,882</u>	<u>\$116,763,813</u>
d. Total	\$592,803,970	\$580,728,464
2 Present value of future normal cost contributions	<u>\$ (83,337,551)</u>	<u>\$ (80,532,754)</u>
3 Actuarial accrued liability	\$509,466,419	\$500,195,710
4 Assets <sup>2</sup> (funded accrued liability)	<u>\$145,850,227</u>	<u>\$131,941,068</u>
5 Unfunded accrued liability <sup>3</sup>	<u>\$363,616,192</u>	<u>\$368,254,642</u>

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

<sup>2</sup> The assets available to pay benefits are determined using the amortized cost method (book value) of valuation.

<sup>3</sup> The unfunded accrued liability does not include \$820.4 million and \$623.5 million for the estimated incurred-but-not-reported liabilities as of September 30, 2009, and 2008, respectively, as presented in the Balance Sheet as "Benefits Due and Payable" and as discussed in Note 8, "Military Retirement Benefit Liabilities."

**EXHIBIT 2**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
SUMMARY OF FINANCIAL STATEMENT AUDIT AND MANAGEMENT ASSURANCES  
SEPTEMBER 30, 2009

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 the MERHCF Management Discussion and Analysis, DoD, and not MERHCF, represents the legislative definition of an Agency. Beginning with FY 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 (includes 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 (FMFIA) assurance statement. OUSD(C) issued guidelines to the leadership of DoD Components, including MERHCF, as to how to support this DoD reporting requirement. TMA management complied with the required guidelines for MERHCF.

In its FY 2009 assessments, TMA management assessed that, except for direct care related material weaknesses addressed above, the MERCHF (as an OMB designated Financial Statement Reporting Entity (FSRE)) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Services have implemented financial systems that comply with (FMFIA § 4). The OUSD (C ) published Financial Improvement and Audit Readiness Report as of September 2008, indicates a FY 2017 timeline for the Services to achieve (FMFIA § 4) compliance.

Except for the direct care-related material weakness discussed above, and documented in TMA's *Annual Statement Required Under the FMFIA, dated July 7, 2009*, and TMA's non-compliance with OMB Circular A-127, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2009 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weaknesses and non-conformances.

**Table 1.**  
Summary of Financial Statement Audit

Audit Opinion	Qualified				
Restatement	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	✓				✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓				✓
<i>Total Material Weaknesses</i>	2	0	0	0	2

## Other Accompanying Information

**Table 2.**  
Summary of Management Assurances

<b>Effectiveness of Internal Controls over Financial Reporting (FMFIA § 2)</b>						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant U.S. Standard General Ledger transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. (Carried Forward and Updated Finding from Fiscal Year (“FY”) 2005)	✓					✓
<i>Total Material Weaknesses</i>	1	0	0	0	0	1

<b>Effectiveness of Internal Controls over Operations (FMFIA § 2)</b>						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant U.S. Standard General Ledger transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. (Carried Forward and Updated Finding from Fiscal Year (“FY”) 2005)	✓					✓
<i>Total Material Weaknesses</i>	1	0	0	0	0	1

## Other Accompanying Information

<b>Conformance with financial management system requirements (FMFIA § 4)</b>						
Statement of Assurance	Purchased Care systems conform to financial management systems requirements; Direct Care Cost systems do not comply with financial management systems requirements					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant U.S. Standard General Ledger transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. (Carried Forward and Updated Finding from Fiscal Year (“FY”) 2005)	✓					✓
Total non-conformances	1	0	0	0	0	1

<b>Compliance with Federal Financial Management Improvement Act (FFMIA)</b>		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. Systems Requirements	Yes for Purchased Care; - No for Direct Care	
2. Accounting Standards	Yes for Purchased Care; - No for Direct Care	
3. USSGL at Transaction Level	Yes for Purchased Care; - No for Direct Care	

Note: The above uncorrected weakness combines the two reported material weaknesses identified by the independent auditor in the audit of the FY 2009 MERHCF financial statements. Identification and implementation of appropriate corrective actions to resolve this one material weakness will result in successful correction of the two material uncorrected weaknesses identified in the FY 2009 MERHCF audit.

**EXHIBIT 3**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
IPIA REPORTING DETAILS  
SEPTEMBER 30, 2009

**IMPROPER PAYMENTS INFORMATION ACT REPORTING**

The Improper Payments Information Act (IPIA) of 2002, as implemented by the 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. The Department's FY 2008 review did not identify any programs at risk of significant erroneous payments in accordance with OMB criteria (programs with erroneous payments exceeding both \$10 million and 2.5% of program payments).

**RISK ASSESSMENT**

The Department's risk assessment for Military Health Benefits addressed the effectiveness of internal controls for preventing 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 low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

On a quarterly basis, the Department audits statistically valid samples of health care claims. Over the years, these audits consistently have produced an error rate of less than the 2% performance standard contained in TRICARE contracts. Errors in health care claims processing potentially can be related to improperly submitted claims by providers, as well as a minimal degree of human error expected with handling a large volume of claims under the tight time parameters established by the Prompt Payment Act regulations and the claims processing timeliness performance standard. The FY 2008 improper payment rate for military health benefits was estimated to be \$178 million or 2%. The actual performance was significantly less: 0.44% or \$45.8 million. The 2009 improper payment rate for military health benefits is estimated to be \$240 million or 2%.

Numerous prepayment and post-payment controls are built into the military health benefits' claims processing system to minimize improper payments. Every claim is adjudicated against this system of checks and balances. One control is the prepayment review required under the contract. The contractor uses this strategy to prevent payment for questionable billing practices. Prepayment review allows for a closer examination of the services rendered and may require the provider to submit medical documentation to support the services billed. In addition, the Department of Defense requires the contractor to have an anti-fraud unit to identify and investigate any pattern of suspicious or potential fraudulent billings. Recoupment from cases identified, combined with proactive case work are additional benefit dollars returned to the Fund.

**STATISTICAL SAMPLING PROCESS**

To determine an estimate of the annual amount of improper payments, the Department of Defense uses a statistically valid method of sampling for the managed care support services contracts and the Medicare dual-eligibility contractor.

The Department samples data records for review for claims processed by the Medicare dual eligible contractor quarterly. There are two kinds of payment samples, one for non-denied claims and one for denied claims. For the Medicare dual eligible contract, the non-denied payment sample will be drawn from all records with government payments of \$1 to \$25,000. All records with a government payment of \$25,000 and over will be audited. The denied payment sample will be drawn from all records with a billed amount of \$1 to \$500,000. All records with billed amounts of \$500,000 and over will be audited. The non-denied sample will be stratified at multiple levels within the \$1 to \$25,000 range, and the denied payment sample will be stratified at multiple levels within the \$1 to \$500,000 range.

**CORRECTIVE ACTION PLAN**

The Department’s contracts have had payment performance standards for military health benefit claims processing in place for many years. The estimate of 2 percent is based on the contract performance standard. However, actual results have been consistently less than 2 percent. FY 2008 results reflect an improper payment rate of 0.44%. Contractors exceeding the 2% performance standard are subjected to a financial disincentive for erroneous claims payments. In addition, the contractors are financially liable for payment of non-allowable claims. This contractual design, combined with numerous prepayment and post-payment controls, effectively minimizes improper payments and ensures the Government’s risk for improper payments in military health benefits is minimized.

**MILITARY HEALTH BENEFITS PROGRAM IMPROPER PAYMENT REPORTING**

FY 2008			FY 2009			FY 2010 Estimated			FY 2011 Estimated			FY 2012 Estimated		
Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)
\$10.4	0.44	\$45.8	\$12.0	2	\$240	\$12.7	2	\$254	\$14.0	2	\$280	\$15.2	2	\$304

1. The final payment error rate for FY 2008 is 0.44%, which is less than the contract performance standard of 2% used in the FY 2008 AFR calculation. The error rate in FY 2008 and beyond is a conservative estimate based on the 2% contract performance standard.

2. The FY 2008 outlays include all benefit dollars subject to the audit process. Fee-for-service claims are considered susceptible to improper payments as payment is made based upon an individual claim submitted by a provider or beneficiary certifying services were provided as billed. Administrative or change order costs are not included, as those costs do not fall into the definition of areas susceptible to improper payments.

3. The FY 2008 outlays do not include:

a) The Designated Providers (U.S. Family Health Plan) contracts, through which a set amount is paid for each patient’s care on a per member per month basis. The contractor is 100% responsible for improper payments; there is no shared risk with the Government. The Defense Contract Audit Agency conducts reconciliations to validate correct capitated payments for the enrolled population. Government liability is limited to the amount paid to the contractor regardless of the cost of health care services.

b) Pharmacy claims. The Department is developing an audit process.

c) Foreign claims. The Department is developing an audit process.

*DoD*  
***MEDICARE-ELIGIBLE RETIREE***  
***HEALTH CARE FUND***

***INDEPENDENT AUDITORS’***  
***REPORTS***





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

November 10, 2009

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

SUBJECT: Independent Auditor's Report on the Medicare-Eligible Retiree Health Care Fund,  
FY 2009 and FY 2008 Basic Financial Statements (Report No. D-2010-019)

We are providing the subject report to be published in the FY 2009 Agency Financial Report in conjunction with the Medicare-Eligible Retiree Health Care Fund, FY 2009 and FY 2008 Basic Financial Statements provided to us in draft on October 19, 2009. The report includes our qualified opinion on the financial statements as well as our required Report on Internal Control and Compliance with Laws and Regulations. We are issuing our qualified opinion to accompany the Medicare-Eligible Retiree Health Care Fund, FY 2009 and FY 2008 Basic Financial Statements, and therefore, this audit report should not be disseminated separately from those statements.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5868 (DSN 329-5868).

*Patricia A. Marsh*  
Patricia A. Marsh, CPA  
Assistant Inspector General  
Defense Business Operations



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

November 10, 2009

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

SUBJECT: Independent Auditor's Report on the Medicare-Eligible Retiree Health Care Fund,  
FY 2009 and FY 2008 Basic Financial Statements (Report No. D-2010-019)

The Medicare-Eligible Retiree Health Care Fund (MERHCF) was established by the National Defense Authorization Act for FY 2001 (Public Law 106-398). In accordance with 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), agencies are required to submit financial statements for each revolving fund and trust fund. The Under Secretary of Defense (Comptroller) requires that MERHCF prepare audited financial statements in accordance with the DOD Financial Management Regulation.

We audited the accompanying Consolidated Balance Sheets of MERHCF as of September 30, 2009 and 2008, and Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, and related notes for the fiscal years then ended. The financial statements are the responsibility of MERHCF management. MERHCF management is also responsible for implementing effective internal control and for complying with laws and regulations. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraphs, we conducted our audit in accordance with auditing standards generally accepted in the United States of America (U.S. GAAP), the U.S. Government Accountability Office, "Government Auditing Standards," and the requirements of Office of Management and Budget (OMB) Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended.<sup>1</sup> Those standards 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and assessing the internal control over financial reporting and compliance with laws and regulations. We believe that our audit provides a reasonable basis for our opinion.

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<sup>1</sup> OMB Memorandum M-09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 23, 2009.

We were unable to obtain sufficient, appropriate audit evidence to support the costs of direct-care provided by the DOD-managed Military Treatment Facilities (MTFs). The actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2009 and 2008, includes approximately \$72.1 billion (14 percent of total actuarial liability) and \$71 billion (14 percent of total actuarial liability), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2009, include approximately \$2.9 billion and \$1.7 billion, respectively, and for the year ended September 30, 2008, include approximately \$3.3 billion and \$1.7 billion, respectively, of amounts related to the direct-care costs.

MTF-related amounts of direct-care costs are estimated by MERHCF's actuaries using data extracted from various Service-specific financial, personnel, and workload systems within DOD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems. Although activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and MERHCF lacked adequate controls to ensure the completeness, validity, recording, and cutoff of the costs reported.

Additionally, we were unable to apply adequate audit procedures to obtain sufficient, appropriate audit evidence related to Accounts Receivable for refunds related to the TRICARE Retail Pharmacy Program activity for FY 2009. There is uncertainty surrounding the refund program Accounts Receivable balance because of pending litigation from various pharmaceutical manufacturers. Therefore, MERHCF was unable to provide sufficient supporting documentation that Accounts Receivable was fairly stated in all material respects.

In our opinion, except for the effects on the financial statements of the amounts related to MERHCF's direct-care costs and Account Receivable amounts related to refunds for the TRICARE Retail Pharmacy Program, such financial statements present fairly, in all material respects, the financial position of MERHCF as of September 30, 2009 and 2008, and the Net Cost of Operations, Changes in Net Position, and Budgetary Resources for the years then ended in conformity with U.S. GAAP and the requirements of OMB Circular A-136, "Financial Reporting Requirements," June 10, 2009.

### **Controls Over Other Accompanying Information**

Our audit was 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. Rather, these are considered supplementary information required by U.S. GAAP, OMB Circular A-136, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of MERHCF 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 has not been

subjected to the procedures applied in our audits of the Basic Financial Statements. Accordingly, we do not express an opinion on it.

## Summary of Internal Control

In planning and performing our audit, we considered MERHCF's internal control over financial reporting as a basis for designing auditing procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of MERHCF's internal control over financial reporting. Accordingly, we do not express an opinion on MERHCF's internal control over financial reporting. However, two previously identified significant deficiencies, both of which are material, continued to exist in the following areas:

- MTF-related amounts of direct-care costs are estimated by the MERHCF actuaries and others using data extracted from various Service-specific financial, personnel, and workload systems within DOD. The MTFs do not currently have compliant, U.S. Government Standard General Ledger transaction-based accounting systems, and they do not apply common and consistent business rules in a manner envisioned by the DOD planners. Thus, inadequate controls exist over this data to ensure the timeliness and accuracy of the medical record coding processes at the MTFs.
- MERHCF bases the MTF-level health care cost data on budget execution processes rather than accrual-based accounting. MERHCF did not implement appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of data required for its financial reporting and actuarial valuation processes. As a result, MERHCF lacked appropriate and consistent accounting cutoff procedures at the MTF level.

A material weakness is a significant deficiency, or a combination of significant deficiencies, resulting in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.<sup>2</sup> 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.

The Attachment offers additional details on the above deficiencies, both of which we consider to be material internal control weaknesses.

## Summary of Compliance With Laws and Regulations

As part of obtaining reasonable assurance about whether the MERHCF FY 2009 and FY 2008 financial statements were free of material misstatements, we performed tests for compliance with certain provisions of laws and regulations, including those specified in OMB Bulletin No. 07-04. We did not determine whether MERHCF complied with all applicable laws and regulations related to financial reporting. Providing an opinion on compliance with certain provisions of

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<sup>2</sup> The term "remote" is defined as when the chance of a future event or events occurring is slight. Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

laws and regulations was not an objective of our audit, and accordingly, we do not express such an opinion. However, we noted MERHCF did not comply with certain provisions of the following laws and regulations.

- MERHCF had five instances of noncompliance with the Prompt Payment Act (Title 31 U.S.C., Chapter 39, "Prompt Payment"). However, MERHCF management acknowledged a noncompliance and paid interest penalties in four instances.
- The MERHCF data were processed on electronic data processing systems that did not comply with OMB Circular A-127, "Financial Management Systems," October 1, 2009.
- Although the general ledger system complied with the U.S. Government Standard General Ledger, it was not transaction-based or derived from an integrated financial system.
- MERHCF did not fully comply with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004; OMB Circular A-127; the Federal Managers' Financial Integrity Act; and the Federal Financial Management Improvement Act.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 07-04 requires that auditors report test results if the financial statements do not comply with certain laws and regulations. See the Attachment for additional details on compliance with laws and regulations.

## **Management's Responsibilities**

Management is responsible for:

- preparing the financial statements in conformity with U.S. GAAP;
- selecting and applying appropriate accounting policies;
- safeguarding U.S. Government assets related to the entities' operations;
- designing and implementing programs and controls to prevent and detect fraud;
- establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met;

- complying with applicable laws and regulations; and
- informing us about all known or suspected fraud affecting MERHCF.

MERHCF management is also responsible for making all financial records and related information available to us to conduct the audit and for the accuracy and completeness of that information. MERHCF management is responsible for adjusting the financial statements to correct material misstatements and to represent to us that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We provided a draft of this report to the Assistant Secretary of Defense for Health Affairs and Director, Defense Finance and Accounting Service, who provided technical comments that we incorporated into the report as appropriate.



Patricia A. Marsh, CPA  
Assistant Inspector General  
Defense Business Operations

Attachment:  
As stated

# Report on Internal Control and Compliance With Laws and Regulations

## Internal Control

Management is responsible for implementing and maintaining effective internal control and for providing reasonable assurance that accounting data are accumulated, recorded, and reported properly; that the requirements of applicable laws and regulations are met; and that assets are safeguarded against misappropriation and abuse. Our purpose was not to, and we do not, express an opinion on 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 Medicare-Eligible Retiree Health Care Fund's (MERHCF's) internal control over financial reporting that we consider to be material weaknesses.

During our audit of MERHCF's financial statements, we identified deficiencies related to internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of financial statements. Because of the deficiencies noted, we believe MERHCF's financial management system does not meet the requirements of an integrated financial management system as defined in Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," October 1, 2009. We also believe that MERHCF is not in compliance with the system design requirements necessary to comply with internal and external reporting requirements. These include the requirements for financial statements to be prepared in accordance with the form and content rules prescribed by OMB and reporting requirements prescribed by the Department of the Treasury and for agencies to monitor the financial management system to ensure the integrity of the financial data.

As defined in OMB Circular A-127:

[a] financial management system includes the core financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, and controls, data, hardware, software, and support personnel dedicated to the operation and maintenance of system functions.

Such financial management systems are to be designed so that:

... financial events shall be recorded applying the requirements of the U.S. Government Standard General Ledger (USSGL). Application of the USSGL at the transaction level means that each time an approved transaction is recorded in the system, it will generate appropriate general ledger accounts for posting the transaction according to the rules defined in the USSGL guidance.

## ***Previously Identified Material Weaknesses***

Management acknowledged that previously identified significant deficiencies, both of which are material, continued to exist in the following areas.

### **Transaction-Based Accounting System**

The MTFs do not currently have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by the DOD's planned Standard Financial Information Structure. MTF-related direct-care costs are estimated by MERHCF's actuaries and others using data extracted from various Service-specific financial, personnel, and workload systems within DOD. Although activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and MERHCF lacked adequate controls to ensure the completeness, validity, recording, and cutoff of the costs reported. Additionally, MERHCF lacked adequate controls to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the direct-care costs allocation processes.

### **Adequacy and Completeness of Health Care Cost Data**

The costs of health care provided directly by DOD for MERHCF participants and beneficiaries represent significant input to the development of the actuarially-determined health care liabilities of MERHCF as well as to the determination of amounts contributed by the Services for their active duty participants. These costs are incurred in the MTFs managed by the Services in various locations. MERHCF makes prospective payments to the Services based on estimates of these direct-care costs in order to support the operations of the MTFs on an ongoing basis.

The health care cost data from the MTFs provided for the estimation process are aggregated or derived from information in both financial and nonfinancial systems within the Services that have not been audited. The MTF-level data are based on budget execution processes, rather than accrual-based accounting. MERHCF lacked adequate controls to ensure consistent cutoff of accounting activity at the MTF-level. During FY 2009, MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

We did note that MERHCF performs annual retrospective reconciliation reviews of the MTF level-of-effort data for the purpose of comparing the results of the budget execution process to the prospective payments provided to the MTFs for care of MERHCF's participants and beneficiaries. The results of the reconciliations are used in the determination of prospective budgetary requirements to support MTF operations, as required by DOD guidance.

Our consideration of the internal control over financial reporting would not necessarily disclose all internal control matters that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered material weaknesses. However, we consider the two significant deficiencies noted above to be material weaknesses.



## **Compliance With Laws and Regulations**

Management is responsible for complying with existing laws and regulations related to financial reporting. The purpose of our work is to determine compliance with the applicable laws and regulations in order to obtain reasonable assurance about whether the MERHCF FY 2009 Basic Financial Statements were free of material misstatements. We performed tests for compliance with certain provisions of laws and regulations that could have a direct and material effect on determining financial statement amounts as well as with other relevant laws and regulations specified in OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended.<sup>1</sup> However, we did not determine whether MERHCF complied with selected provisions of all applicable laws and regulations related to financial reporting. Our objective was not to, and we do not, express an opinion on compliance with applicable laws and regulations.

The results of our audit tests disclosed instances of noncompliance or other matters that the U.S. Government Accountability Office, "Government Auditing Standards," and OMB Bulletin No. 07-04 required agencies to report.

### ***Prompt Payment Act***

In our audit, we examined 98 payments for compliance with the Prompt Payment Act (Title 31 U.S.C., Chapter 39, "Prompt Payment"), which requires Federal agencies to make payments in a timely manner. If a payment to a contractor is late, an interest payment also is due to the contractor and should be made without a contractor having to request the interest payment. The Prompt Payment Act regulations are specified at 5 Code of Federal Regulations Part 1315, which are implemented by the Federal Acquisition Regulation Subpart 32.9, "Prompt Payment." We documented five instances of Prompt Payment Act noncompliance. However, MERHCF management acknowledged a noncompliance and paid interest penalties in four instances.

### ***Federal Financial Management Improvement Act of 1996***

MERHCF did not comply with U.S. Government Standard General Ledger transaction guidance as required by the Federal Financial Management Improvement Act of 1996. The general ledger system used by MERHCF was compliant with the U.S. Government Standard General Ledger, but it was not transaction-based or derived from an integrated financial system.

The material weaknesses identified above, with respect to internal control over financial reporting, indicate that MERHCF is not fully compliant with the requirements of OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004; OMB Circular A-127; the Federal Managers' Financial Integrity Act; and the Federal Financial Management Improvement Act.

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<sup>1</sup> OMB Memorandum M-09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 23, 2009.

## **Audit Disclosures**

We will provide the recommendations for corrective actions associated with MERHCF's material internal control weaknesses, other significant deficiencies, and noncompliance with laws and regulations addressed in this report to MERHCF management in a separate letter.