



FISCAL YEAR 2010

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

November 5, 2010

DoD
MILITARY RETIREMENT FUND
FISCAL YEAR 2010
AUDITED FINANCIAL
STATEMENTS

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***DoD
MILITARY RETIREMENT
FUND***

***MANAGEMENT'S DISCUSSION AND
ANALYSIS***

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

For the Years Ended September 30, 2010 and 2009

REPORTING ENTITY

The reporting entity is the Department of Defense (DoD) Military Retirement Fund (MRF). The military retirement system provides benefits for retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The mission of the MRF is to accumulate funds in order to finance, on an actuarially sound basis, the liabilities of DoD under military retirement and survivor benefit programs. Statutorily, military retirees are entitled to either 'retired pay' or 'retainer pay' as opposed to a 'pension.' For purposes of these statements, however, the terms can be used interchangeably.

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

The Fund was established by Public Law 98-94 (currently Chapter 74 of Title 10, U.S.C.). This law also established an independent three-member DoD Retirement Board of Actuaries appointed by the President. Public Law 110-181 eliminated the Retirement Board and the Education Benefits Board, and created the DoD Board of Actuaries. The members of the DoD Board of Actuaries are appointed by the Secretary of Defense. Board duties with respect to the Retirement and Education Benefits Funds are the same, and the most recent law expanded the Board's responsibilities to include oversight of any other fund the Secretary of Defense deems necessary. The Board is required to review valuations of the military retirement system to determine the method of amortizing unfunded liabilities, to report annually to the Secretary of Defense and to report to the President and the Congress on the status of the Fund at least every four years. The DoD Office of the Actuary provides all technical and administrative support to the Board.

In Fiscal Year (FY) 2010, the Fund paid out approximately \$50.58 billion in benefits to military retirees and survivors. In FY 2009, the Fund paid out approximately \$49.96 billion in such benefits. In addition to staff members of OUSD (C) and OUSD (P&R), hundreds of individuals at the DFAS Pay Centers are involved in making the benefit payments. Administrative costs of supporting the Fund's activities are not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the normal cost due to Concurrent Receipt per Public Law 108-136; and investment income. During FY 2010, the Fund received approximately \$20.41 billion in normal cost payments, a \$63.14 billion Treasury payment, and approximately \$10.42 billion in investment income, net of premium/discount amortization and accrued inflation compensation. During FY 2009, the Fund received approximately \$17.54 billion in normal cost payments, a \$54.87 billion Treasury payment, and approximately \$2.86 billion in investment income, net of premium/discount amortization and accrued inflation compensation (see the Financial Performance Overview section for an explanation of the change in investment income).

THE FUND

General Benefit Information

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

The system is a funded, noncontributory, defined-benefit plan that includes non-disability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs, and special compensation programs for certain disabled retirees. The Service Secretaries may approve immediate non-disability retired pay at any age with credit of at least 20 years of active duty service. Reserve retirees generally must be at least 60 years old and have at least 20 qualifying years of service before retired pay commences; in some cases the age can be less than 60 if the reservist performs certain types of active service. Public Law 110-181 allows a 90-day reduction in the reserve retirement age from age 60 for every 3 months of certain active duty service served within a fiscal year, for service after January 28, 2008 (not to exceed ten years). There is no vesting before retirement.

There are three distinct non-disability benefit formulas related to three populations within the military retirement system. 1) *Final Pay*: Military personnel who first became members of a uniformed service before September 8, 1980, have retired pay equal to final basic pay times a multiplier. The multiplier is equal to 2.5% times years of service. 2) *High-3*: If the retiree first became a member of a uniformed service on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of final basic pay. 3) *Career Status Bonus (CSB)/Redux*: Members who first became a member of a uniformed service on or after August 1, 1986, may choose between a High-3 and CSB/Redux retirement. Those who elect CSB/Redux receive the Career Status Bonus outlined below, also have retired pay computed on a base of the average of their highest 36 months of basic pay, but are subject to a multiplier penalty if they retire with less than 30 years of service; however, at age 62, their retired pay is recomputed without the penalty. Members make their election during the fifteenth year of service and may receive the Career Status Bonus of \$30,000 in either a lump-sum or installments. Those who elect CSB/Redux must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the \$30,000.

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

Management's Discussion and Analysis

Non-Disability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to Service Secretary approval. The military retiree immediately receives retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of a uniformed service before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5%) times (years of service, rounded down to the nearest month). Members first entering a uniformed service on or after August 1, 1986, who elect CSB/Redux and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40% (50% minus 10%, where 50% equals 20 years multiplied by 2.5%). At age 62, the retired pay is recomputed with the penalty removed.

As of September 30, 2010, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2010, non-disability retirees were paid approximately \$40.26 billion. As of September 30, 2009, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2009, non-disability retirees were paid approximately \$39.95 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the disability is not the result of the member's intentional misconduct or willful neglect, was not incurred during a period of unauthorized absence, and either: (1) the member has at least 20 years of service; or (2) at the time of determination, the disability is at least 30% (under a standard schedule of rating disabilities by the Veterans Administration) and one of three additional conditions is met:

- *1st additional condition.* If the disability was incurred:

- (a) prior to January 28, 2008, it must have been incurred after the member had 8 years of active service; or
- (b) between January 28, 2008 and October 13, 2008, it must have been incurred after the member had 6 months or more of active military service and the disability must not have been noted at the time of the member's entrance on active duty (unless compelling evidence or medical judgment is such to warrant a finding that the disability existed before the member's entrance on active duty); or
- (c) effective October 14, 2008, it must have been incurred after the member's entrance on active duty and the disability must not have been noted at the time of the member's entrance on active duty (unless clear and unmistakable evidence demonstrates that the disability existed before the member's entrance on active duty and was not aggravated by active military service).

- *2nd additional condition.* The disability results from active duty.

- *3rd additional condition.* The disability occurred in the line of duty during a time of war or national emergency or after September 14, 1978.

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

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

Members who elected the CSB/Redux retirement option, but who retire for disability, are not subject to the reduced CSB/Redux retired pay multiplier and are awarded retired pay based on the disability retired rules outlined above. However, such members continue to be subject to the reduced CPI (with age 62 restoral) as Career Status Bonus recipients.

As of September 30, 2010, there were approximately 93,000 disability retirees receiving retired pay. In FY 2010, disability retirees were paid approximately \$1.37 billion. As of September 30, 2009, there were approximately 91,000 disability retirees receiving retired pay. In FY 2009, disability retirees were paid approximately \$1.39 billion.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service. However, reserve retired pay is not payable until age 60 unless the member performs certain types of active duty or active service specified in the National Defense Authorization Act for FY 2008 (P.L. 110-181), in which case the age is reduced below 60 by 3 months for every 90 days of such service within a fiscal year. However, the age cannot go below 50 and eligibility for retiree health benefits remains at age 60 even if the eligibility age for retired pay is reduced. Retired pay is computed as base pay times 2.5% times years of service. If the reservist was first a member of a uniformed service before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on active duty for the entire period preceding retired pay commencement. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, one point is awarded for one day of active duty service (e.g. active duty training) or one inactive duty training drill attendance. Reservists often perform two IDT periods in one day, thereby receiving 2 retirement points per day. In addition, 15 points are awarded for completion of one year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member generally cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation. Beginning with years of service that include October 30, 2007, non-active duty points are limited in any year to no more than 130. Lesser limitations have applied in the past.

As of September 30, 2010, there were approximately 355,000 reserve retirees receiving retired pay. In FY 2010, reserve retirees were paid approximately \$4.96 billion. As of September 30, 2009, there were approximately 341,000 reserve retirees receiving retired pay. In FY 2009, reserve retirees were paid approximately \$4.75 billion.

Survivor Benefits

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

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

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

The SBP survivor annuity is 55% of the member's base amount. The base amount is elected by the member, but cannot be less than \$300 or more than the member's full gross monthly retired pay. If the member elects CSB/Redux and is subject to a penalty for service under 30 years in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty. However, the annuity for a survivor of a CSB/Redux retiree is subject to the reduced CPI.

When the plan started in 1972, benefits for those 62 and older were reduced by the constructed amount of Social Security for which the survivor would be eligible based on the member's military pay. In 1985, that reduction formula was changed so all annuitants 62 and over received a reduced flat rate of 35% of the member's base. Beginning October 1, 2005, the age 62 reduced rate was phased out in 5% increments. On April 1, 2008, the survivor benefit reduction at age 62 was fully eliminated and the rate of 55% of the member's elected base became standard for all survivors, regardless of age.

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

Members who died on active duty in the line of duty on or after September 11, 2001, are assumed to have retired with full disability on the day they died and to have elected full SBP coverage for spouses, former spouses, and/or children. Insurable interest elections may be applicable in some cases. These benefits have been improved and expanded over the history of the program.

The surviving spouse (or dependent children if there is no surviving spouse or the spouse subsequently dies) of a reservist with fewer than 20 qualifying years of service who dies while performing inactive duty is entitled to a survivor annuity under the Reserve Component Survivor Benefit Program.

SBP spousal annuities are reduced by any Veterans Affairs survivor benefits (Dependency and Indemnity Compensation (DIC)) and all premiums relating to the reductions are returned to the survivor. The 2008 National Defense Authorization Act enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary Special Survivor Indemnity Allowance that pays a monthly amount (\$50 in FY 2009 grading up to \$310 in FY 2017) to survivors with a DIC offset. The authority for the allowance ends in 2017.

As with retired pay, SBP annuities and premiums are annually increased with cost-of-living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the CSB/Redux retirement option dies before age 62, the survivor is subject to partial COLAs and his/her annuity is increased on what would have been the member's 62nd birthday to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. The Reserve Component Survivor Benefit Plan provides annuities to survivors of reservists who die before age 60, provided they attained 20 years of qualified

service. The added cost of this coverage is borne completely by reservists through deductions from future retired pay and/or survivor annuities.

Beginning October 1, 2008, a paid-up provision eliminated the reduction in retired pay for premiums for SBP and RSFPP coverage for participants age 70 or older whose retired pay has been reduced for at least 360 months.

The offset relationship between SBP and DIC has been the subject of litigation in the U.S. Court of Appeals. The rulings are being monitored for their potential impacts.

As of September 30, 2010, there were approximately 294,000 survivors of military members receiving annuity payments. In FY 2010, survivors were paid approximately \$3.62 billion. As of September 30, 2009, there were approximately 291,000 survivors of military members receiving annuity payments. In FY 2009, survivors were paid approximately \$3.58 billion.

Temporary Early Retirement Authority (TERA)

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

As of September 30, 2010, there were approximately 57,000 TERA retirees receiving retired pay. In FY 2010, TERA retirees were paid approximately \$903 million. As of September 30, 2009, there were approximately 57,000 TERA retirees receiving retired pay. In FY 2009, TERA retirees were paid approximately \$897 million.

Cost-of-Living Increase

All non-disability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. COLAs are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January.

The "full" COLA effective December 1 is computed by calculating the percentage increase in the average CPI over the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index and is rounded to the nearest tenth of one percent.

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

FUND RELATIONSHIPS

Department of Veterans Affairs Benefits

The Department of Veterans Affairs (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of or in combination with DoD retired pay, but through December 31, 2003, were not fully additive. Since VA benefits are exempt from federal income taxes, it is often to the advantage of a member to elect them. Through 2003, retired pay earned from DoD for military service was offset by any payment received from VA for a VA-rated disability. Beginning with the National Defense Authorization Act for FY 2004 (P.L. 108-136), a series of legislation has been enacted that increasingly reduces or eliminates the offset to military retired pay due to receipt of VA disability compensation. Members with a combined VA disability rating of 50% or greater who have at least 20 years of service will have their offset eliminated under the Concurrent Retirement and Disability Pay (CRDP) program. The CRDP program has a ten-year phase-in schedule that began in 2004; however, the offset is already fully eliminated for members whose disabilities are rated total or make the individual unemployable. Members whose disability meets certain combat-related criteria can elect to receive payments against the offset under the Combat Related Special Compensation (CRSC) program. Under CRSC, members are not subject to a phase-in schedule, are not required to have at least 20 years of service, and are not required to have at least a 50% VA disability rating. Although CRSC amounts are calculated based on retired pay lost due to offset and are paid from the Military Retirement Fund, CRSC is not technically considered retired pay. CRSC payments are tax exempt. A member may not participate in both the CRDP and CRSC programs simultaneously, but may change from one to the other during an annual "open season."

VA benefits also overlap survivor benefits through the DIC program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefits are returned to the survivor. The 2008 National Defense Authorization Act enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary Special Survivor Indemnity Allowance that pays a monthly amount (\$50 in FY 2009 grading up to \$310 in FY 2017) to survivors with a DIC offset; the authority for the allowance ends in 2017. The offset relationship between SBP and DIC has been the subject of litigation in the U.S. Court of Appeals. The rulings are being monitored for their potential impacts.

Other Federal Service

For military retirement purposes, no credit is given for other federal service, except for TERA and where cross-service transferability is allowed. Military service is generally creditable toward the federal civilian retirement systems if military retired pay is waived. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement and Disability Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees). Military retirees may qualify separately for Civil Service retirement and receive concurrent pay from both systems.

Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which non-disability retired pay is based and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative of salary levels in the public and private sectors for comparative purposes. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) the housing allowance, which varies by grade, location, and dependency status,

(3) the subsistence allowance and, (4) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 69% of RMC for all retirement eligible members. For the 20-year retiree, basic pay is approximately 67% of RMC. Consequently, a member retired with 20-years of service and entitled to 50% of basic pay only receives 34% of RMC. For a 30-year retiree, basic pay is approximately 73% of RMC and such member would be entitled to 75% of basic pay or 55% of RMC. Public Law 109-364 allows members, who retire after January 1, 2007, with greater than 30 years of service, to retire with entitlements exceeding 75% of basic pay. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

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

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

For the Old Age, Survivors, and Disability Insurance (OASDI) program, military members must contribute the employee portion of the OASDI payroll tax, with the federal government contributing the matching employer contribution. Only the basic pay of a military member constitutes wages for Social Security purposes. One feature of OASDI unique to military personnel grants a noncontributory wage credit of (i) \$300 for each quarter between 1956 and 1978 in which such personnel received military wages and (ii) up to \$1,200 per year after 1977 (\$100 of credit for each \$300 of wages up to a maximum credit of \$1,200). The purpose of this credit is to take into account elements of compensation such as quarters and subsistence not included in wages for Social Security benefit calculation purposes. Under the 1983 Social Security amendments, the cost of the additional benefits resulting from the noncontributory wage credits for past service was met by a lump sum payment from general revenues, while the cost for future service will be met by payment of combined employer-employee tax on such credits as the service occurs. Payments for these wage credits ended in 2002.

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

SIGNIFICANT CHANGES

During FY 2010 and FY 2009

Changes during FY 2010 included: (1) new economic assumptions due to implementation of the Federal Accounting Standards Advisory Board (FASAB) financial reporting Statement of Federal Financial Accounting Standards 33 (SFFAS 33), discussed further in Note 9, Military Retirement Benefit Liabilities; (2) new non-disabled retirement rates; and (3) new Active Duty decrement rates. Of these, the implementation of SFFAS 33, which provides standards for selecting discount rate assumptions and the valuation date for measuring pension liabilities, was the most significant. SFFAS 33 requires the use of a yield curve based on marketable Treasury securities to determine the interest rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable Treasury securities. The DoD Board of Actuaries approved items (2) and (3) at

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their July 2010 meeting. Item (1) is prescribed per standard and the resulting economic assumptions will be different than those assumed by the DoD Board of Actuaries for funding calculations.

There were no legislative benefit changes during FY 2010 which impacted the valuation.

Changes during FY 2009 included: (1) lowering of the CSB Take Rate election assumption from 25% to 15%; (2) new permanent disabled retirement rates; and (3) updates to various rates and factors used to project survivor pay. All items (1) – (3) are classified as assumption changes to the actuarial valuation. Of these, the lower CSB election assumption (item 1) was the most significant. The DoD Board of Actuaries approved these assumptions at their August 2009 meeting.

Changes for FY 2011

The possible benefit changes with respect to the Military Retirement Fund for FY 2011 include: (1) "Wounded Warrior" legislation targeting refinements to the disability retirement systems; (2) SBP/DIC enhancements; (3) Concurrent Receipt enhancements; (4) enhancements to general retired pay; and (5) refinements to the Active and Reserve Duty systems.

PERFORMANCE MEASURES

During FY 2010 and 2009, the Fund made monthly disbursements to approximately 2.2 million retirees and annuitants.

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

- a. September 30, 2010 = .431
- b. September 30, 2009 = .380
- c. September 30, 2008 = .354
- d. September 30, 2007 = .343
- e. September 30, 2006 = .328
- f. September 30, 2005 = .334
- g. September 30, 2004 = .338
- h. September 30, 2003 = .351
- i. September 30, 2002 = .378
- j. September 30, 2001 = .347

The effective yield of the Fund during FY 2010 was approximately 3.2%.

PROJECTED LONG-TERM HEALTH OF THE FUND

The projected long-term health of the Fund is good due to the fact that it has three different sources of funding. The first two are appropriated funds—annual payments from Treasury to amortize the unfunded liability and pay the normal cost of the concurrent receipt benefits and monthly normal cost payments from the Services to pay for the current year's service cost. Both of these can be considered secure sources of funding backed by the "full faith and credit" of the U.S. Government. The investment portion is projected to be an increasing contribution to the Fund as the return on investments increases due to an increasing Fund balance.

Basic pay for FY 2010 was projected to be \$58.9 billion. Normal cost payments were projected to be \$23.0 billion. The unfunded liability amortization payment was projected to be \$58.6 billion. Investment income

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was projected to be \$19.4 billion. Fund disbursements for FY 2010 were projected to be \$50.4 billion. Table 1, below, presents a projection of contributions to and disbursements from the Fund. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-year projection period.

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

Fiscal Year	Basic Payroll	Normal Cost Payments		Amortization of Unfunded Liability		Investment Income		Fund Disbursements		Fund Balance End of Year	
2011	\$60.8	\$24.1	(0.396)	\$61.4	(1.010)	\$21.8	(0.359)	\$50.8	(0.836)	\$385.4	(6.339)
2012	\$61.7	\$24.4	(0.395)	\$63.7	(1.032)	\$25.2	(0.408)	\$51.5	(0.835)	\$447.2	(7.248)
2013	\$63.1	\$25.0	(0.396)	\$66.1	(1.048)	\$28.9	(0.458)	\$52.8	(0.837)	\$514.3	(8.151)
2014	\$64.9	\$25.7	(0.396)	\$68.6	(1.057)	\$32.8	(0.505)	\$54.3	(0.837)	\$587.1	(9.046)
2015	\$66.8	\$26.4	(0.395)	\$71.1	(1.064)	\$37.2	(0.557)	\$55.6	(0.832)	\$666.2	(9.973)
2016	\$68.8	\$27.2	(0.395)	\$73.8	(1.073)	\$41.8	(0.608)	\$57.1	(0.830)	\$751.9	(10.929)
2017	\$70.9	\$28.0	(0.395)	\$76.6	(1.080)	\$46.9	(0.661)	\$58.6	(0.827)	\$844.8	(11.915)
2018	\$73.0	\$28.8	(0.395)	\$79.5	(1.089)	\$52.4	(0.718)	\$60.0	(0.822)	\$945.5	(12.952)
2019	\$75.2	\$29.7	(0.395)	\$82.4	(1.096)	\$58.3	(0.775)	\$62.0	(0.824)	\$1,054.0	(14.016)
2020	\$77.7	\$30.7	(0.395)	\$85.5	(1.100)	\$64.7	(0.833)	\$64.2	(0.826)	\$1,170.7	(15.067)
2021	\$80.3	\$31.7	(0.395)	\$88.7	(1.105)	\$71.6	(0.892)	\$66.5	(0.828)	\$1,296.2	(16.142)
2022	\$83.0	\$32.8	(0.395)	\$92.1	(1.110)	\$79.0	(0.952)	\$68.9	(0.830)	\$1,431.1	(17.242)
2023	\$85.8	\$33.9	(0.395)	\$95.5	(1.113)	\$86.9	(1.013)	\$71.5	(0.833)	\$1,576.0	(18.368)
2024	\$88.6	\$35.0	(0.395)	\$99.1	(1.119)	\$95.4	(1.077)	\$74.1	(0.836)	\$1,731.4	(19.542)
2025	\$91.5	\$36.1	(0.395)	\$102.8	(1.123)	\$104.5	(1.142)	\$76.7	(0.838)	\$1,898.1	(20.744)
2026	\$94.6	\$37.3	(0.394)	\$127.2	(1.345)	\$115.4	(1.220)	\$79.5	(0.840)	\$2,098.6	(22.184)
2027	\$97.8	\$38.6	(0.395)	\$11.5	(0.118)	\$120.3	(1.230)	\$82.2	(0.840)	\$2,186.7	(22.359)
2028	\$101.2	\$39.9	(0.394)	\$11.9	(0.118)	\$125.3	(1.238)	\$85.3	(0.843)	\$2,278.5	(22.515)
2029	\$104.8	\$41.4	(0.395)	\$12.3	(0.117)	\$130.6	(1.246)	\$88.4	(0.844)	\$2,374.5	(22.657)
2030	\$108.6	\$42.8	(0.394)	\$12.8	(0.118)	\$136.1	(1.253)	\$91.3	(0.841)	\$2,474.9	(22.789)

Table 1

NOTES:

- The above projections assume a long-term 5.75% interest rate each year.
- The projections will vary in the short-term depending on the actual economic experience.
- The table is also presented in the September 30, 2009, 'Valuation of the Military Retirement System.'

Expected Problems

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

Management's Discussion and Analysis _____

INVESTMENTS

Management Oversight

The Fund receives management oversight from the DoD Investment Board established in September 2003. The members of the Investment Board are the Director, DFAS; the Deputy CFO, OUSD(C); and a senior military member, currently the Director, Army Budget. The Investment Board meets twice each fiscal year to consider investment objectives, policies, performance, and strategies with the goal of maximizing the Fund's investment income. The Investment Board reviews the Fund's law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. At the September 14, 2010, meeting, the Investment Board approved an Investment Policy Statement that incorporated all previously approved strategies into one document. This includes a ladder approach for investments and the "hold to maturity" policy.

Anticipated Changes Between the Expected and Actual Investment Rate of Return

The recent volatility in interest rates, the volatility in equity markets, the increasing deficit, the volatility in the markets with regard to energy prices, the state of international conflict, increasing sovereign debt, and the economic downturn indicate that there might be strong U.S. fiscal control and monetary policy in the future. This would necessitate increased borrowing by the U.S. Government for the foreseeable future and there may therefore be a greater opportunity to purchase treasury market securities at higher rates of interest. Conversely, uneasy equity markets tend to push participants toward government securities causing downward pressure on the interest rates. Modern corporate financial theory also suggests that non-federal government firms may tend to increase pension plan investments in government securities. An investment strategy has been developed to shift toward TIPS to hedge against any future inflation to maximize the return of the Fund over time.

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

The Fund also invests in Treasury Inflation-Protected Securities (TIPS), which are indexed for inflation. TIPS are fixed-rate instruments designed to protect against inflation and the principal amount is indexed to the consumer price index (CPI) by adjusting the CPI at issuance to the current CPI; as inflation increases, so does the principal amount and the coupon. Figure 1 depicts the book value (par plus premium/discount less amortization of premium/discount) of investment holdings as of September 30 2010.

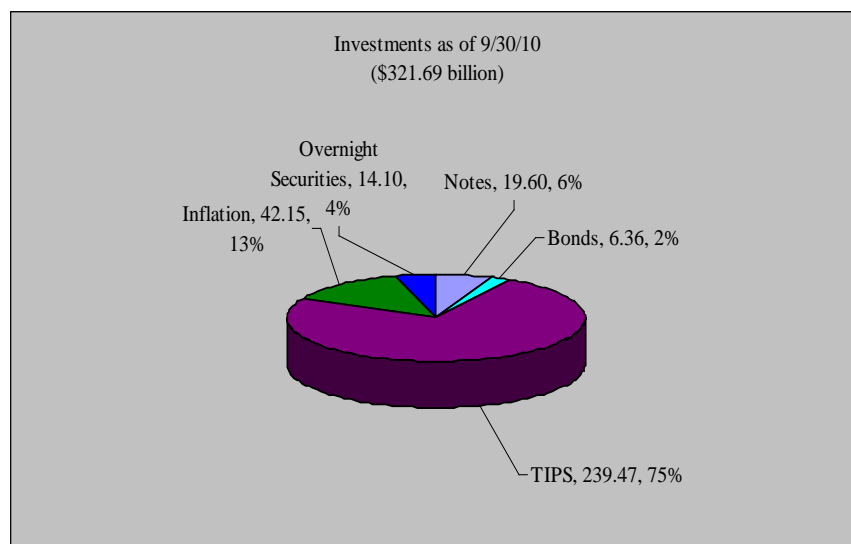


Figure 1

Management's Discussion and Analysis _____

FINANCIAL PERFORMANCE OVERVIEW

Financial Data

Table 2, below, presents comparative financial statement information for the MRF.

Military Retirement Fund **Analysis of Financial Statements** For the Years Ended September 30, 2010 and 2009 (\$ in Thousands)

<u>Balance Sheet</u>	<u>2010</u>	<u>2009</u>	<u>Difference Increase/ (Decrease)</u>	<u>% Change</u>
Fund Balance with Treasury				
- Sufficiency of funds available to cover estimated disbursements	\$25,383	\$20,488	\$4,895	24%
Investments				
- Intragovernmental Securities plus Accrued Interest	\$321,686,840	\$278,346,954	\$43,339,887	16%
Account Receivable, Net amounts, including both inter- and intra-governmental				
- Continued emphasis placed on collecting these amounts	\$37,043	\$31,897	\$5,143	16%
Other Liabilities				
- Custodial Liability due to Treasury	\$1,819	\$1,714	\$105	6%
Military Retirement Benefit Liabilities				
- Implementation of SFFAS 33	\$1,262,672,927	\$1,177,154,851	\$85,518,076	7%
Cumulative Results of Operations				
- Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by \$85.0 billion and total assets increased by \$43.3 billion.	(\$940,925,661)	(\$898,757,412)	(42,168,249)	5%
<u>Statement of Net Costs</u>				
Gross Cost of Operations				
- Higher Actuarial Liability in FY 10 due to the application of SFFAS 33	\$136,097,972	\$73,003,916	\$63,094,056	86%
<u>Statements of Budgetary Resources</u>				
Distributed Offsetting Receipts				
- Unfunded liability amortization payment (FY 10) from Treasury	\$58,619,000	\$51,125,000	\$7,494,000	1%

Table 2

Assets

Assets of \$321.7 billion included in Table 2 and shown in Figure 2, represent amounts that the MRF owns and manages. Assets increased \$43.34 billion, 15%, at the end of FY 2010. This increase is largely attributable to purchasing new investments of \$43.34 billion with funds received from the U.S. Treasury payments, Service contributions, and interest received. The net increase in investments is related to expected normal growth to cover unfunded portions of future military retirement benefits. Funds not needed to pay current benefits are held in separate trust and special funds and invested in U.S. Treasury securities.

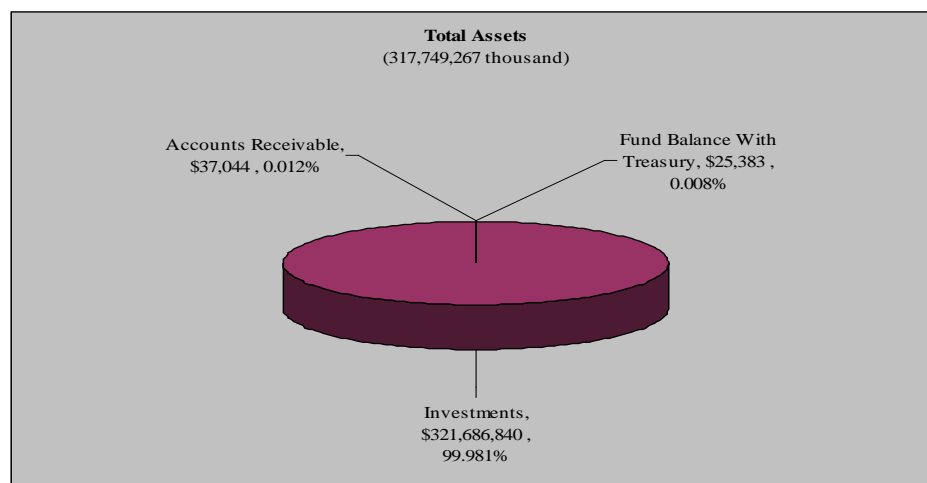


Figure 2

Liabilities

Liabilities of \$1.26 trillion included in Table 2 and shown in Figure 3 represent liabilities related to military retirement pension benefits. Nearly all of the liabilities are the actuarial liability of the Fund. Liabilities increased \$85.52 billion, 7%, at the end of FY 2010. This increase is largely attributable to the increase in the actuarial liability calculation as a result of applying the newly implemented SFFAS 33.

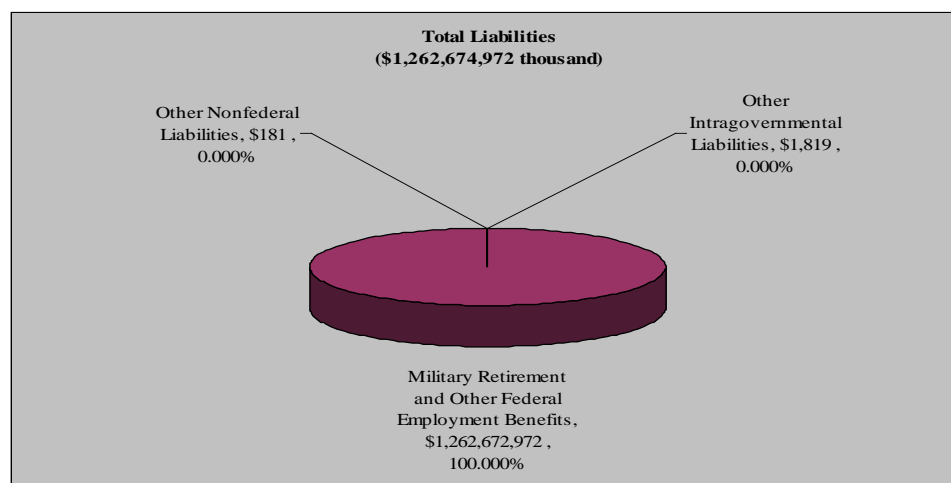


Figure 3

Management's Discussion and Analysis

The Fund is confident in its ability to meet its financial obligations. Of the \$1.26 trillion in liabilities, approximately \$314 billion (25%) is covered primarily by investments in U.S. Treasury securities (Figure 4). While the liability presents a negative financial position, the majority of the unfunded portion will come from annual appropriations external to DoD ensuring benefits are paid regardless of available assets. The initial unfunded actuarial liability, \$529 billion in 1984, is being amortized over 42 years and is expected to be fully funded through U.S. Treasury contributions by FY 2026. The current investments, the interest received on the investments, and the amortization of the initial liability will provide sufficient funds to cover the financial obligations of the MRF

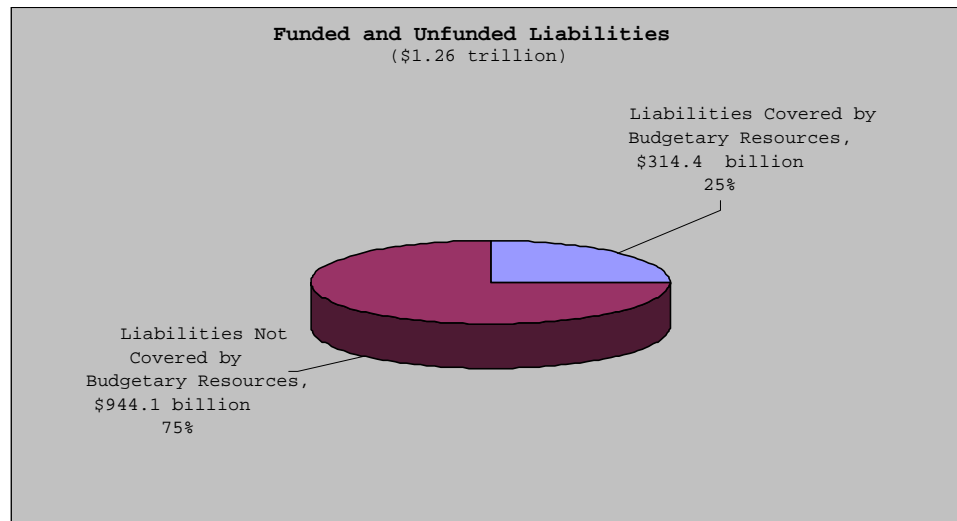


Figure 4

MANAGEMENT ASSURANCES

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of the MRF Management's Discussion and Analysis, DoD, and not MRF, represents the legislative definition of an Agency. Beginning with FY 2006, as directed in Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, *Internal Control over Financial Reporting*, the 24 CFO Act agencies (including DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall Federal Managers Financial Integrity Act (FMFIA) assurance statement.

In FY 2010, MRF management determined that the MRF has effective internal controls to support effective and efficient programmatic operations and reliable financial reporting. In FY 2009, the MRF management implemented corrective actions to become substantially compliant with applicable laws and regulations (FMFIA § 2). The current financial management systems conforms to financial systems requirements as of year end and is substantially FMFIA compliant.

The MRF management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the FMFIA. The MRF conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation, the MRF can provide reasonable assurance that its internal controls over the effectiveness and efficiency of operations and compliance with

applicable laws and regulations for FY 2010 were operating effectively and no material weaknesses were found in the design or operation of the internal controls.

In addition, MRF conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. Based on the results of this evaluation, the MRF can provide reasonable assurance that its internal control over financial reporting as of June 30, 2010 was operating effectively and no material weaknesses were found in the design or operation of the internal control over financial reporting.

IMPROPER PAYMENTS INFORMATION ACT OF 2002 (PUBLIC LAW NO. 107-300)

The MRF accounts receivable, \$37.04 million, consists mostly of improper payments to deceased retirees and survivors. This is less than 0.02% of the total assets and less than 0.08% of the annual benefit outlays. In comparison, on the FY 2009 Government-Wide Financial statements, that same figure was about 4%.

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

The Fund's risk assessments address the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well as system weaknesses identified internally or by outside audit activities. While the Fund's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. In certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in FY 2008 indicated that the Department recovered 96% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

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

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

LIMITATIONS OF THE FINANCIAL STATEMENTS

These financial statements have been prepared to report the financial position and results of operations for the MRF pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the Fund in accordance with the generally accepted accounting principles for Federal entities and formats prescribed by the OMB, the statements are in addition to the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization they are for a component of the U.S. Government, a sovereign entity. Unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation.

DoD
MILITARY RETIREMENT
FUND

PRINCIPAL STATEMENTS

Principal Statements

Department of Defense
Military Retirement Fund
CONSOLIDATED BALANCE SHEETS
As of September 30, 2010 and 2009
(\$ In Thousands)

	<u>2010</u>	<u>2009</u>
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 25,383	\$ 20,488
Investments (Note 4)	<u>321,686,840</u>	<u>278,346,954</u>
Total Intragovernmental Assets	321,712,223	278,367,442
Accounts Receivable, Net (Note 5)	<u>37,043</u>	<u>31,897</u>
TOTAL ASSETS	\$ <u>321,749,266</u>	\$ <u>278,399,339</u>
LIABILITIES		
Intragovernmental:		
Other Liabilities (Notes 6 & 7)	<u>1,819</u>	<u>1,714</u>
Total Intragovernmental Liabilities	1,819	1,714
Military Retirement Benefit Liabilities (Notes 6 & 9)	1,262,672,927	<u>1,177,154,851</u>
Other Liabilities (Notes 6 & 7)	<u>181</u>	<u>186</u>
TOTAL LIABILITIES	\$ 1,262,674,927	\$ 1,177,156,751
NET POSITION		
Cumulative Results of Operations - Earmarked Funds	<u>(940,925,661)</u>	<u>(898,757,412)</u>
TOTAL NET POSITION	\$ <u>(940,925,661)</u>	\$ <u>(898,757,412)</u>
TOTAL LIABILITIES AND NET POSITION	\$ <u>321,749,266</u>	\$ <u>278,399,339</u>

The accompanying notes are an integral part of these statements.

Department of Defense
Military Retirement Fund
CONSOLIDATED STATEMENTS OF NET COST
For the Years Ended September 30, 2010 and 2009
(\$ In Thousands)

	<u>2010</u>	<u>2009</u>
Program Costs		
Gross Costs (Note 10)	\$ 51,091,079	\$ 50,296,665
(Less: Earned Revenue) (Note 10)	<u>(93,929,724)</u>	<u>(75,267,766)</u>
Net Cost before Losses/(Gains) from Actuarial Assumption		
Changes for Military Retirement Benefits	(42,838,645)	(24,971,101)
Losses/(Gains) from Actuarial Assumption Changes for		
Military Retirement Benefits	<u>85,006,894</u>	<u>22,707,251</u>
Net Cost of Operations	\$ <u>42,168,249</u>	\$ <u>(2,263,850)</u>

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2010 and 2009
(\$ In Thousands)

	<u>2010</u>	<u>2009</u>
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (898,757,412)	\$ (901,021,262)
Net Cost of Operations (+/-)	<u>42,168,249</u>	<u>(2,263,850)</u>
Net Change	<u>(42,168,249)</u>	<u>2,263,850</u>
Cumulative Results of Operations	<u>(940,925,661)</u>	<u>(898,757,412)</u>
Net Position (Note 12)	\$ <u>(940,925,661)</u>	\$ <u>(898,757,412)</u>

The accompanying notes are an integral part of these statements.

Department of Defense
Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2010 and 2009
(\$ In Thousands)

	<u>2010</u>		<u>2009</u>
Budgetary Resources (Note 13)			
Unobligated balance, brought forward, October 1	\$ 0	\$	0
Budget authority			
Appropriation	<u>93,678,557</u>		<u>75,145,332</u>
Subtotal	93,678,557		75,145,332
Temporarily not available pursuant to Public Law	<u>(42,582,432)</u>		<u>(24,841,369)</u>
Total Budgetary Resources	\$ <u>51,096,125</u>	\$	<u>50,303,963</u>
 Status of Budgetary Resources			
Obligations incurred:			
Direct	\$ <u>51,096,125</u>	\$	<u>50,303,963</u>
Subtotal	51,096,125		50,303,963
 Total status of budgetary resources	\$ <u>51,096,125</u>	\$	<u>50,303,963</u>
 Change in Obligated Balance:			
Obligated balance, net			
Unpaid obligations, brought forward, October 1	\$ <u>3,698,756</u>	\$	<u>3,359,247</u>
Total unpaid obligated balance	3,698,756		3,359,247
Obligations incurred net (+/-)	51,096,125		50,303,963
Less: Gross outlays	<u>(50,584,943)</u>		<u>(49,964,454)</u>
Obligated balance, net, end of period			
Unpaid obligations	<u>4,209,938</u>		<u>3,698,756</u>
Total, unpaid obligated balance, net, end of period	\$ <u>4,209,938</u>	\$	<u>3,698,756</u>
 Net Outlays:			
Gross outlays	\$ 50,584,943	\$	49,964,454
Less: Distributed Offsetting receipts	<u>(58,619,000)</u>		<u>(51,125,000)</u>
Net Outlays	\$ <u>(8,034,057)</u>	\$	<u>(1,160,546)</u>

The accompanying notes are an integral part of these statements.

DoD
MILITARY RETIREMENT
FUND

NOTES TO THE PRINCIPAL
STATEMENTS

DoD MILITARY RETIREMENT FUND

NOTES TO THE PRINCIPAL STATEMENTS

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 Military Retirement Fund (MRF), 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 from the books and records of MRF in accordance with, to the extent possible, U.S. generally accepted accounting principles (U.S. GAAP) promulgated by the Federal Accounting Standards Advisory Board; the Office of Management and Budget Circular No. A-136, Financial Reporting Requirements; and the Department of Defense (DoD) Financial Management Regulation. The accompanying financial statements account for all resources for which MRF is responsible unless otherwise noted.

B. Mission of the Reporting Entity. The mission of MRF is to accumulate funds to finance, on an actuarially sound basis, the liabilities of DoD military retirement and survivor benefit programs. The MRF is a program for the payment of pensions to retired military personnel, annuities to eligible survivors, and special compensation for certain disabled retirees.

C. Appropriations and Funds. Public Law 98-94, *The Defense Authorization Act of 1984*, authorized the MRF 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 MRF is a non-revolving trust fund. Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

The MRF 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 MRF 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 MRF's financial management systems meet all full accrual accounting requirements. The MRF's accounting systems record transactions based on the U.S. Standard General Ledger (USSGL). Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with U.S. GAAP.

The financial statements and supporting trial balances are compiled from the underlying financial data and trial balances. The underlying data for MRF 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 and pension 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 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 approved by DoD Board of Actuaries, DoD Office of the Actuary determines the amount of the contributions made to the MRF. The Military Services make a monthly contribution, which is a percentage of basic pay, to cover accruing costs for currently active military members. The MRF also receives a U. S. Treasury warrant at the beginning of each fiscal year (1) to amortize unfunded liability and (2) to cover accruing costs for

Notes to the Principal Statements

concurrent receipts (certain beneficiaries with combat-related injuries who are receiving payments from the Department of Veterans Affairs (VA)). In addition, interest is earned on investments. Funds from the 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 MRF.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of benefit expenses for the period incurred. The current financial management systems for MRF collect and record on full accrual accounting basis for liabilities and expenses of the MRF.

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 MRF 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's financial statements do not report any portion of the public debt, interest or source of public financing whether from issuance of debt or tax revenues.

H. Funds with the U.S. Treasury. The MRF's monetary resources are maintained in U.S. Treasury accounts. The disbursing offices of Defense Finance and Accounting Service (DFAS) process MRF'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 by appropriation to the U.S. Treasury 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 MRF reconciles monthly with the U.S. Treasury account with no outstanding discrepancies.

The U.S. Treasury allows MRF 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 from 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 MRF during the previous three years. 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>.

J. Investments in U.S. Government Securities. The MRF reports investments in the U.S. Treasury securities at cost, net of amortized premiums or discounts (book value). Premiums or discounts are amortized over the term of the investment using the effective interest rate method. The MRF's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities.

The MRF invests in non-marketable, 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 MRF 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 MRF 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. The MRF reports death payment contingencies that result from DoD's responsibility to cover retiree benefits not paid by U.S. Department of Veteran Affairs during the month of death.

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.

M. 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 systems and those reported by the U.S. Treasury. The MRF has no undistributed disbursements or collections.

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

O. Actuarial Information. The DoD MRF financial statements present the unfunded actuarial liability determined as of the end of the fiscal year based on population information as of the beginning of the year and updated using accepted actuarial techniques. The "projected benefit obligation" method is used as required by SFFAS No. 5, *Accounting for Liabilities of the Federal Government*.

NOTE 2. NON-ENTITY ASSETS

(\$ In Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
Accounts Receivable	\$ 1,819	\$ 1,714
Total Non-Entity Assets	1,819	1,714
 Total Entity Assets	 321,747,447	 278,397,625
Total Assets	\$ 321,749,266	\$ 278,399,339

Non-entity assets are assets for which MRF maintains stewardship accountability and reporting responsibility, but are not available for MRF's operations.

Nonfederal Assets, Accounts Receivable, represent the amounts of interest, penalties, and administrative charges that are collected by MRF on behalf of the U.S. Treasury. Once collected, these amounts are transferred to the appropriate U.S. Treasury receipt account. This amount is offset by a corresponding liability reported in Note 7, Other Liabilities.

Notes to the Principal Statements

NOTE 3. FUND BALANCE WITH TREASURY (FBWT)

(\$ In Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
Fund Balance		
Total Trust Fund Balance	\$ <u>25,383</u>	\$ <u>20,488</u>
Status of Fund Balance with Treasury		
Unobligated Balance-Unavailable	\$ 314,380,513	\$ 271,798,080
Obligated Balance not yet Disbursed	4,209,938	3,698,756
NonFBWT Budgetary Accounts	<u>(318,565,068)</u>	<u>(275,476,348)</u>
Total	\$ <u>25,383</u>	\$ <u>20,488</u>

The Status of Fund Balance with Treasury reflects the budgetary resources to support 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.

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. The balance becomes available subsequently without further congressional action.

Obligated Balance not yet Disbursed represents the amount of earned and accrued pension and annuity payments. The MRF balance represents benefits payable on October 1, 2010.

NonFBWT Budgetary Accounts reduce the Status of FBWT. The MRF balance represents investment accounts.

NOTE 4. INVESTMENTS

(\$ In Thousands)	<u>FY 2010</u>				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) /Discount</u>	<u>Investments Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities					
Nonmarketable, Market-Based	\$ <u>325,124,664</u>	Effective Interest	\$ <u>(6,559,596)</u>	\$ <u>318,565,068</u>	\$ <u>351,050,659</u>
Subtotal	325,124,664		(6,559,596)	318,565,068	351,050,659
Accrued Interest	<u>3,121,772</u>			<u>3,121,772</u>	<u>3,121,772</u>
Total Investments	\$ <u>328,246,436</u>		\$ <u>(6,559,596)</u>	\$ <u>321,686,840</u>	\$ <u>354,172,431</u>

Notes to the Principal Statements

(\$ In Thousands)

FY 2009

	<u>Cost</u>	<u>Amortization Method</u>		<u>Investments Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities					
Nonmarketable, Market-Based	\$ 281,250,305	Effective Interest	\$ (5,773,956)	\$ 275,476,349	\$ 283,292,576
Subtotal	281,250,305		(5,773,956)	275,476,349	283,292,576
Accrued Interest	2,870,605			2,870,605	2,870,605
Total Investments	\$ 284,120,910		\$ (5,773,956)	\$ 278,346,954	\$ 286,163,181

Total Intragovernmental Securities, Net Investments increased \$43.3 billion (16%). This increase is primarily the result of investing annual contributions from the U.S. Treasury, net of current disbursements for benefits paid. The increase in the annual investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover future benefits. The MRF purchased \$40.8 billion in long-term securities during FY 2010.

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 MRF and a liability to the U.S. Treasury. Since MRF and 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 MRF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When MRF requires redemption of these securities to make expenditures, the Government finances the securities out of accumulated cash balances by raising taxes or other receipts, borrowing from the public, repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

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

(\$ In Thousands)

	FY 2010 COST	FY 2009 COST
Notes	\$ 31,347,154	\$ 41,635,067
Bonds	6,427,250	2,805,625
TIPS	273,248,935	225,032,819
Overnights	14,101,325	11,776,794
Total Cost	<u>\$325,124,664</u>	<u>\$281,250,305</u>

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

At the semiannual meetings, DoD Investment Board approves the strategy for the type of securities purchased by MRF. These securities can include U.S. Treasury bills, notes, bonds, inflation-protected

Notes to the Principal Statements

securities, and overnight certificates. The U.S. Treasury bills are short-term securities with maturities of 1 year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least 1 year, but not more than 10 years, and are purchased at either a discount or premium. The U.S. Treasury bonds are long-term securities with maturities of 10 years or more and are purchased at either a discount or premium. The TIPS provide protection against inflation and are purchased at either a discount or premium. The TIPS principal increases with inflation and decreases with deflation, as measured by the CPI. When TIPS mature, 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 securities. 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.

NOTE 5. ACCOUNTS RECEIVABLE

(\$ In Thousands)

FY 2010

	<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>
Entity Receivables:			
With the Public	\$ 38,921	\$ (1,878)	\$ 37,043
Total Receivable	\$ 38,921	\$ (1,878)	\$ 37,043

(\$ In Thousands)

FY 2009

	<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>
Entity Receivables:			
With the Public	\$ 33,441	\$ (1,544)	\$ 31,897
Total Receivable	\$ 33,441	\$ (1,544)	\$ 31,897

Nonfederal Accounts Receivable increased by \$5.1 million (16%). The increase is partially attributable to an increase in annuity pay accounts receivable related to the Sharp project, which began in April 2010. Historically, survivor benefit payments (SBP) were reduced by amounts received from the VA. Annuitants were allowed an additional stipend known as the Special Survivor Indemnity Allowance (SSIA). Refunds of premiums were made to the annuitants due to the non-receipt of Survivor Benefit Plan (SBP). On August 26, 2009, a court ruling determined that annuitants are allowed to receive the full amount of SBP in addition to DVA payments but would no longer be allowed the SSIA. The SHARP project was established to put accounts in a posture to stop the offset and to return the annuity to a fully paying status. In order to do so, debts were created for any overpayment of SSIA payments dating back to 2008 and to any SBP returns previously refunded to the annuitants. The amount related to the SHARP project and explanations regarding additional fluctuations cannot be determined, due to system limitations on the monthly accounts receivable reports that are produced out of the Defense Retired and Annuitant System.

Notes to the Principal Statements

The accounts receivable represent the MRF's claim for payment from military retirees or their survivors for erroneous amounts previously paid. The MRF only recognizes an allowance for uncollectible amounts from the public. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

(\$ In Thousands)

	<u>FY 2010</u>	<u>FY 2009</u>
Nonfederal Liabilities		
Military Retirement Benefits Liability (Note 9)	\$ 944,082,476	\$ 901,658,014
Other Liabilities		
	<u>181</u>	<u>186</u>
Total Nonfederal Liabilities	<u>944,082,657</u>	<u>901,658,200</u>
Total Liabilities Not Covered by Budgetary Resources	<u>944,082,657</u>	<u>901,658,200</u>
Total Liabilities Covered by Budgetary Resources	<u>318,592,270</u>	<u>275,498,551</u>
Total Liabilities	\$ <u>1,262,674,927</u>	\$ <u>1,177,156,751</u>

The Military Retirement Fund Liabilities Not Covered by Budgetary Resources amount represents actuarial liabilities for pension benefits for which assets are not yet available. Refer to Note 9, Military Retirement Benefit Liabilities, for additional details and disclosures.

Nonfederal Other Liabilities represent contingent liabilities payable by the DoD for estimated death payments. These liabilities cover the retiree benefits not paid by the VA during the month of death. This amount is also reported on Note 7, Other Liabilities, and Note 8, Commitments and Contingencies.

NOTE 7. OTHER LIABILITIES

(\$ In Thousands)

	<u>FY 2010</u>	<u>FY 2009</u>
Intragovernmental		
Custodial Liabilities	\$ <u>1,819</u>	\$ <u>1,714</u>
Total Intragovernmental Other Liabilities	\$ <u>1,819</u>	\$ <u>1,714</u>
Nonfederal		
Contingent Liabilities	<u>181</u>	<u>186</u>
Total Nonfederal Other Liabilities	\$ <u>181</u>	\$ <u>186</u>
Total Other Liabilities	\$ <u>2,000</u>	\$ <u>1,900</u>

Intragovernmental Custodial Liabilities are comprised of interest, penalties, and administrative charges to be collected on behalf of U.S. Treasury. This amount is also reported as a nonfederal accounts receivable on Note 2, Non-entity Assets.

Nonfederal Other Liabilities represent contingent liabilities payable by the DoD for estimated death payments. These liabilities cover the retiree benefits not paid by the VA during the month of death. This amount is also reported on Note 6, Liabilities Not Covered by Budgetary Resources, and on Note 8, Commitments and Contingencies.

Notes to the Principal Statements

NOTE 8. COMMITMENTS AND CONTINGENCIES

Currently there are no known contingent liabilities pending legal action.

The MRF has an estimated contingent liability of \$181.1 thousand that is measurable and probable and, therefore, has been recorded in the accounting records. These liabilities cover the retiree benefits not paid by the VA during the month of death. This amount is also reported on Note 7, Other Liabilities.

NOTE 9. MILITARY RETIREMENT BENEFIT LIABILITIES

(\$ In Thousands)

FY 2010

<u>Major Program</u> <u>Activities</u>	<u>Liabilities</u>	<u>Assumed</u> <u>Interest Rate</u> <u>(%)</u>	<u>(Less: Assets</u> <u>Available to Pay</u> <u>Benefits</u>	<u>Unfunded</u> <u>Liabilities</u>
Military Retirement Pension Actuarial Liability	\$ 1,258,462,989	5.00%	\$ (314,380,513)	\$ 944,082,476
Other	<u>4,209,938</u>		<u>(4,209,938)</u>	<u>0</u>
Total:	\$ <u>1,262,672,927</u>		\$ <u>(318,590,451)</u>	\$ <u>944,082,476</u>

(\$ In Thousands)

FY 2009

<u>Major Program</u> <u>Activities</u>	<u>Liabilities</u>	<u>Assumed</u> <u>Interest Rate</u> <u>(%)</u>	<u>(Less: Assets</u> <u>Available to Pay</u> <u>Benefits</u>	<u>Unfunded</u> <u>Liabilities</u>
Military Retirement Pension Actuarial Liability	\$ 1,173,456,095	5.75%	\$ (271,798,080)	\$ 901,658,015
Other	<u>3,698,756</u>		<u>(3,698,756)</u>	<u>0</u>
Total:	\$ <u>1,177,154,851</u>		\$ <u>(275,496,836)</u>	\$ <u>901,658,015</u>

The Total Military Retirement Benefit Liabilities increased \$85.5 billion (7%) primarily due to the increase in the actuarial liability. This increase resulted from the expected increase of \$40.5 billion and an increase of \$66.6 billion due to changes in key assumptions offset by \$22.1 billion decrease in actuarial experience from military pay and cost of living adjustments.

The MRF accumulates funds used to pay pensions to retired military personnel and annuities to their survivors. The Military Retirement System is a single-employer, defined benefit plan.

The schedules above reflect two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled "Military Retirement Pension Actuarial Liability" represents actuarial liability for future pension benefits not yet incurred. The line entitled "Other" represents retirement benefits that are due and payable on the first day of the next reporting period.

Effective FY 2010, MRF implemented requirements of SFFAS 33 which directs the interest rate, underlying inflation rates, and other economic assumptions should be consistent with one another. A change in the interest rate may cause other assumptions to change as well. For the September 30, 2010, financial statement valuations, the implementation of the SFFAS equivalent rate required DoD Office of

the Actuary (OACT) to change the long-term inflation and salary increase assumptions to be consistent with the underlying Treasury spot rates used in the valuation.

The MRF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2010, balance represents the September 30, 2010, amount.

Actuarial Cost Method

As dictated by law, the MRF is funded using the Aggregate Entry-Age Normal Cost method. This is a method whereby projected retirement costs are spread over the projected future salaries of a new-entrant cohort.

Projected Revenues

The MRF receives projected revenues from three sources: interest earnings on MRF assets, monthly contributions from the Military Services, and an annual contribution from the U.S. Treasury. The contribution from the U.S. Treasury is applied to MRF at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed before October 1, 1984, as well as the amortization of subsequent actuarial gains and losses. Starting October 1, 2004, Public Law (P.L.) 108-136 requires a contribution for the normal cost amount for the concurrent receipt provisions under Sections 1413a and 1414 in addition to the unfunded liability amortization payment. The DoD Board of Actuaries (the Board) approves methods and assumptions used to determine the amount for the U.S. Treasury warrant, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

Assumptions

The Board sets the long-term economic assumptions for each valuation performed for funding purposes. Prior to FY 2010, the same long-term assumptions were used for the financial-statement valuations. The distinction between the two different valuations is discussed further below. The long-term assumptions for the FY 2009 valuations were 5.75% interest, 3.0% CPI, and 3.75% salary increase. For the FY 2010 funding valuation, the long-term assumptions did not change. For the FY 2010 financial-statement valuation, the long-term assumptions were 5.0% interest, 2.4% CPI, and 3.6% salary increase. The change in the long-term assumptions is due to implementation of the SFFAS 33. The standard is discussed further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward from the prior year valuation results as reported in the OACT 'Valuation of the Military Retirement System' using accepted actuarial methods. Adjustments are made as necessary to put liabilities on a financial-statement basis. In the selection of the valuation date, SFFAS 33 allows for actuarial liabilities to be rolled forward from the prior year valuation results. The effects of changes during the year for major factors such as pay raises and cost of living adjustments have been incorporated in the roll-forward adjustment. In calculating the FY 2010 roll-forward amount, the following assumptions were used:

	<u>Inflation</u>	<u>Salary</u>	<u>Interest</u>
Fiscal Year 2010	0.0 % (actual)	3.4 % (actual)	5.0 %
Fiscal Year 2011	0.0 % (actual)	1.4 % (estimated)	5.0 %
Long-Term	2.4 %	3.6 %	5.0 %

For purposes of the MRF's financial reporting, this roll-forward process is applied annually.

Contributions to MRF are calculated so as to maintain the MRF on an actuarially sound basis. This means that there will be sufficient funds to make all benefit payments to eligible recipients each year, and

Notes to the Principal Statements

that the asset balance is projected to eventually equal the actuarial liability; i.e., all unfunded liabilities are liquidated. In order to accomplish this, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded liability) and any emerging actuarial gains or losses.

The initial unfunded liability of the program was amortized over a 50-year period through the FY 2007 payment. At its August 2007 meeting, the Board decided to decrease the period over which the initial unfunded liability is fully amortized by eight years. Their decision was made to ensure that, at a minimum, the amortization payment covered the interest on the unfunded actuarial liability. Therefore, starting with the FY 2009 payment, the initial unfunded liability is being amortized over a 42-year period, with the last payment expected to be made October 1, 2025. All subsequent gains and losses experienced by the system are amortized over a 30-year period. Methods and assumptions used to compute actuarial costs and liabilities, amortize the initial unfunded liability, and amortize all actuarial gains and losses must be approved by the Board, as required by Chapter 74 of Title 10, U.S.C. The Board is a Federal Advisory Committee appointed by the Secretary of Defense.

SFFAS 33, as published on October 14, 2008 by the Federal Accounting Standards Advisory Board (FASAB) requires the use of a yield curve based on marketable Treasury securities to determine the interest rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable Treasury securities.

The statement is effective for periods beginning after September 30, 2009, and applies to information provided in general purpose federal financial statements. It does not affect statutory or other special-purpose reports, such as pension or Other Retirement Benefit reports. It requires a minimum of five periodic rates for the yield curve input and a consistency in the number of historical rates used from period to period. It permits the use of a single average interest rate if the resulting present value is not materially different from what would be obtained using the yield curve.

OACT annually performs two MRF valuations. The primary valuation is for funding purposes which is governed by Chapter 74 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other is for financial statement purposes and is governed by FASAB standards. For the September 30, 2010 financial statement valuation, the OACT used quarterly zero coupon Treasury spot rates (as published by the Office of Thrift Supervision) from June 30, 2000 to March 31, 2010 (40 quarterly interest rates) to determine an SFFAS equivalent interest rate of 5.0%. In the summer of 2010, the Board approved an interest rate of 5.75% for the September 30, 2010 funding valuation, which differs from the SFFAS equivalent rate by 75 basis points. Using the SFFAS 33 long-term economic assumptions increases the MRF actuarial liability by 4%.

Military Services Contributions

The contributions from the Military Services are the product of basic pay and normal cost percentages (NCPs) determined in accordance with the methods and assumptions approved by the Board. Basic pay generally increases each year, and on January 1, 2010, there was a 3.4% across-the-board basic pay increase. The NCPs for FY 2010 were set by the Board in their August 2008 Board Letter: 32.3% (full-time) and 24.5% (part-time). The NCPs for FY 2011 were set by the Board in their August 2009 Board Letter: 32.7% (full-time) and 24.4% (part-time). The above NCPs are based on the Board's funding valuation, not the financial-statement valuation (SFFAS 33).

Market Value of Investments

The market value of MRF's nonmarketable market-based securities totaled \$354.2 billion as of September 30, 2010 and \$286.2 billion as of September 30, 2009, as reflected in Note 4, Investments and Related Interest.

NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

(\$ In Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
Public Costs	\$ <u>136,097,973</u>	\$ <u>73,003,916</u>
Total Costs	<u>136,097,973</u>	<u>73,003,916</u>
Intragovernmental Earned Revenue	<u>(93,929,724)</u>	<u>(75,267,766)</u>
Total Earned Revenue	<u>(93,929,724)</u>	<u>(75,267,766)</u>
Net Cost of Operations	\$ <u>42,168,249</u>	\$ <u>(2,263,850)</u>

Net Cost of Operations increased \$44.4 billion primarily due to an increase in the actuarial liability for Military Retirement Benefits in the amount of \$62.3 billion. Factors impacting the change are discussed in Note 9, Military Retirement Benefits and Other Federal Employment Benefits. This is offset by an increase in earned revenue. The earned revenue change is primarily due to the increases in interest earnings of \$7.6 billion, the annual Treasury contribution of \$7.5 billion, and the employing agency (Military Services) contributions of \$2.8 billion.

The Statement of Net Cost (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 or organization administered by a responsible reporting entity.

Intragovernmental costs and revenue are related to 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. Public costs also include actuarial gains and losses on assumption changes for pensions.

Intragovernmental earned revenue is comprised primarily of the following:

Intragovernmental Earned Revenues for Program Costs

(\$ in Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
1. Military Service Contributions as a Percentage of Base Pay	\$ 20,376,688	\$ 17,542,736
2. Annual Treasury Unfunded Liability Payment	58,619,000	51,125,000
3. Annual Treasury Normal Cost Payment	4,516,000	3,745,000
4. Interest on Investments	<u>10,418,036</u>	<u>2,855,030</u>
Total	\$ <u>93,929,724</u>	\$ <u>75,267,766</u>

Notes to the Principal Statements

NOTE 11. BENEFIT PROGRAM EXPENSE

Benefit Expenses

(\$ in Thousands)		<u>FY 2010</u>		<u>FY 2009</u>
1. Service Cost	\$	23,932,659	\$	22,505,083
2. Period Interest on the Benefit Liability		66,965,791		65,608,846
3. Prior (or Past) Service Cost		0		332,088
4. Period Actuarial (Gains) or Losses		<u>44,525,019</u>		<u>(15,236,158)</u>
Total	\$	<u>135,423,469</u>	\$	<u>73,209,859</u>

The benefit program expense provides components of the change in the actuarial liability from September 30, 2009, to September 30, 2010. The September 30, 2010, actuarial liability is calculated using the components of benefit program expense as well as the expected benefit payments during FY 2010. The September 30, 2010, actuarial liability is equal to the September 30, 2009, liability plus the total benefit program expense minus the expected benefit payments. For FY 2010, there was no Prior Service Cost (Line 3), whereas for FY 2009 it is primarily due to the increase in the Dependency and Indemnity Coverage allowance for survivors enacted in Public Law 111-31. The FY 2010 Period Actuarial (Gains) or Losses (Line 4) is positively impacted by a lower rate of interest due to the application of Statement of Federal Financial Accounting Standards 33, and negatively impacted by a lower than expected cost of living adjustment anticipated in January 2011, whereas in FY 2009 it was largely impacted by a lower cost of living adjustment in January 2010.

NOTE 12. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION

There was a difference of \$93.7 billion between Appropriations Received on the Statement of Changes in Net Position and Appropriations Received on the Statement of Budgetary Resources (SBR). This difference is due to Trust Fund Receipts included in the Appropriations Received line of the SBR but excluded from the Statement of Changes in Net Position. Refer to Note 13, Disclosures Related to the Statement of Budgetary Resources, for additional details.

NOTE 13. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES

Net Outlays decreased \$6.9 billion (592%) due to a \$7.5 billion increase in the U.S. Treasury contribution for the amortization of the unfunded liability offset by a \$0.6 billion increase in disbursements. The amortization payment is based on the unfunded liability amortization schedule established by the DoD Board of Actuaries.

The MRF reported \$51.1 billion of direct obligations that are exempt from apportionment.

The SBR includes intraentity transactions because the statements are presented as combined.

The MRF's unobligated balances of budget authority represent the portion of trust fund receipts collected in the current fiscal year (1) that exceed the amount needed to pay benefits or other valid obligations and (2) that exceed the receipts temporarily precluded from obligation by law. The MRF's unobligated balances of budget authority represent the portion of trust fund receipts collected in the current fiscal year that exceed the amount needed to pay benefits or other valid obligations. Outstanding balances become

temporarily precluded from obligation by law at the end of the reporting period, thus resulting in zero unobligated balances. The receipts, however, are assets of the MRF and are available for obligation, as needed, in the future.

There was a difference of \$93.7 billion between appropriations on the Statement of Changes in Net Position (SCNP) and appropriations received on the SBR. This difference represents current receipts, immediately available for obligation, reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR.

NOTE 14. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

(\$ In Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
Resources Used to Finance Activities:		
Budgetary Resources Obligated:		
Obligations incurred	\$ 51,096,125	\$ 50,303,963
Less: Offsetting receipts (-)	<u>(58,619,000)</u>	<u>(51,125,000)</u>
Net obligations	\$ <u>(7,522,875)</u>	\$ <u>(821,037)</u>
Resources that fund expenses recognized in prior period	(5)	(6)
Total resources used to finance the Net Cost of Operations	\$ <u>(7,522,880)</u>	\$ <u>(821,043)</u>
Components of the Net Cost of Operations that will not		
Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future	<u>85,006,894</u>	<u>22,707,250</u>
Period - Other		
Components not Requiring or Generating Resources:	<u>85,006,894</u>	\$ <u>22,707,250</u>
Other (+/-)		
Trust Fund Exchange Revenue	(35,310,724)	(24,142,766)
Other	<u>(5,041)</u>	<u>(7,291)</u>
Total Components of Net Cost of Operations that will not	(35,315,765)	(24,150,057)
Require or Generate Resources		
Total components of Net Cost of Operations that will not	<u>49,691,129</u>	\$ <u>(1,442,807)</u>
Require or Generate Resources in the current period		
Net Cost of Operations	<u>42,168,249</u>	\$ <u>(2,263,850)</u>

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

Components Requiring or Generating Resources in Future Period – Other displays the change in the actuarial liability of \$85.0 billion for FY 2010 and \$22.7 billion for FY 2009. Refer to Note 9, Military Retirement Benefit Liabilities, for additional details and disclosures regarding the FY 2010 change.

Components not Requiring or Generating Resources – Other displays the change in accounts receivable since the beginning of both FY 2010 and FY 2009. These amounts represent refunds receivable and changes in bad debt for erroneous payments to military retirees or their survivors.

Notes to the Principal Statements

NOTE 15. EARMARKED FUNDS

	<u>2010</u>	<u>2009</u>
<u>BALANCE SHEET</u>		
<u>ASSETS</u>		
Fund balance with Treasury	\$ 25,383	\$ 20,488
Investments	321,686,840	278,346,954
Accounts and Interest Receivable	<u>37,043</u>	<u>31,897</u>
Total Assets	<u>\$ 321,749,266</u>	<u>\$ 278,399,339</u>
<u>LIABILITIES and NET POSITION</u>		
Military Retirement Benefits and Other Federal Employment Benefits	\$ 1,262,672,927	\$ 1,177,154,851
Other Liabilities	<u>2,000</u>	<u>1,900</u>
Total Liabilities	\$ 1,262,674,927	\$ 1,177,156,751
Cumulative Results of Operations	<u>(940,925,661)</u>	<u>(898,757,412)</u>
Total Liabilities and Net Position	<u>\$ 321,749,266</u>	<u>\$ 278,399,339</u>
<u>STATEMENT OF NET COST</u>		
Program Costs	\$ 136,097,973	\$ 73,003,916
Less Earned Revenue	(93,929,724)	(75,267,766)
Net Program Costs	<u>\$ 42,168,249</u>	<u>\$ (2,263,850)</u>
Net Cost of Operations	<u>\$ 42,168,249</u>	<u>\$ (2,263,850)</u>
<u>STATEMENT OF CHANGES IN NET POSITION</u>		
Net Position Beginning of the Period	\$ (898,757,412)	\$ (901,021,262)
Net Cost of Operations	<u>42,168,249</u>	<u>(2,263,850)</u>
Change in Net Position	<u>\$ (42,168,249)</u>	<u>\$ 2,263,850</u>
Net Position End of the Period	<u>\$ (940,925,661)</u>	<u>\$ (898,757,412)</u>

Public Law 98-94, *The Defense Authorization Act of 1984*, established the MRF as a pension program for the payment of pensions to retired military personnel, annuities to eligible survivors, and special compensation for certain disabled retirees. The MRF accumulates funds to finance, on an actuarially sound basis, liabilities of the DoD retirement program. The MRF receives its funding as an earmarked trust fund and uses these resources to execute its mission.

The primary financing sources for MRF are (1) monthly Military Service contributions as a percentage of base pay; (2) an annual warrant from the U.S. Treasury for the unfunded liability and for the concurrent receipt provisions for certain disabled retirees; and (3) interest earned on investments. Using methods and assumptions approved by the DoD Board of Actuaries, the DoD Office of the Actuary calculates the annual payment amounts and percentages. The financing sources are the result of intragovernmental flows. Contributions in excess of the projected current year retiree and annuitant benefits are invested. The investments and associated interest revenue are used to cover future liabilities of MRF.

NOTE 16. OTHER DISCLOSURES

FY 2010 Change in the MRF Actuarial Liability

The net pension expense for the change in the actuarial accrued liability from September 30, 2009 to September 30, 2010 is developed in the following table.

Table 1: Change in Actuarial Liability

(\$ In Thousands)	<u>FY 2010</u>	<u>FY 2009</u>
Beginning Actuarial Liability	\$ 1,173,456,095	\$ 1,150,748,844
Normal Cost Liability	23,932,659	22,505,083
Plan Amendment Liability	0	332,088
Assumption Change Liability	66,642,583	7,821,688
Benefit Outlays	(50,416,577)	(50,502,608)
Interest Cost	66,965,791	65,608,846
Actuarial (gains)/losses due to changes in experience	<u>(22,117,562)</u>	<u>(23,057,846)</u>
Ending Actuarial Liability	\$ 1,258,462,989	\$ 1,173,456,095
Change in Actuarial Liability	\$ <u>85,006,894</u>	\$ <u>22,707,251</u>

The September 30, 2010, accrued liability includes changes due to (1) assumptions, and (2) experience. The new assumptions include updated nondisabled retiree death and other loss rates, new active duty rates, and a lower single equivalent interest rate under the SFFAS 33 of 5.0%. The net effect of these new assumptions is an increase in the September 30, 2010, accrued liability of \$66.6 billion (\$44.0 billion of this increase is due to the lower SFFAS 33 interest rate and associated changes in the long-term salary increase and inflation assumptions, \$20.6 billion is due to the updated nondisability retiree rates, and \$2.0 billion is due to the new active duty rates). The change in the accrued liability due to the net experience gain of \$22.1 billion reflects the new population on which the September 30, 2010, roll-forward is based, as well as other economic experience being different from that assumed (\$32.1 billion of this change is due to a lower than expected cost of living adjustment and across-the-board salary increase for January 2011).

NOTE 17. SUBSEQUENT EVENT

No material events or transactions have occurred subsequent to September 30, 2010, that have not been properly recorded in the financial statements or disclosed in the notes. Also, there have been no changes to internal control subsequent to September 30, 2010, or other factors that might significantly affect the effectiveness of internal control.

DoD
MILITARY RETIREMENT
FUND

OTHER ACCOMPANYING
INFORMATION

Other Accompanying Information

MILITARY RETIREMENT SYSTEM ACTUARIAL STATUS INFORMATION SEPTEMBER 30, 2010 AND 2009

(\$ In Thousands)

	<u>FY 2010 ¹</u>	<u>FY 2009</u>
1 Present value of future benefits		
a. Annuitants now on roll	\$ 746,080,160	\$ 719,698,159
b. Non-retired reservists	195,376,103	162,345,352
c. Active duty personnel ²	<u>562,074,329</u>	<u>480,769,055</u>
d. Total	\$ 1,503,530,592	\$ 1,362,812,566
2 Present value of future normal cost contributions	\$ <u>245,067,603</u>	\$ <u>189,356,471</u>
3 Actuarial accrued liability	\$ 1,258,462,989	\$ 1,173,456,095
4 Assets ³	\$ <u>314,380,513</u>	\$ <u>271,798,080</u>
5 Unfunded accrued liability	\$ <u><u>944,082,476</u></u>	\$ <u><u>901,658,015</u></u>

¹ Rolled forward from September 30, 2009.

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

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

DoD
MILITARY RETIREMENT
FUND

INDEPENDENT AUDITORS’
REPORTS



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

November 9, 2010

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

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2010 DOD Military Retirement
Fund Basic Financial Statements (Report No. D-2011-010)

The requirement for audited Federal Government financial statements was established by the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). The Office of Management and Budget (OMB) Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,* requires audited financial statements for the DOD Military Retirement Fund. We contracted with Acuity Consulting, Inc. (Acuity Consulting), to perform the FY 2010 Military Retirement Fund audit. Acuity Consulting's Independent Auditor's Report is attached.

Unqualified Audit Opinion

We endorse the Acuity Consulting unqualified opinion dated November 5, 2010. Acuity Consulting reported that the Military Retirement Fund's Basic Financial Statements as of and for the years ended September 30, 2010 and 2009, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP).

Reports on Internal Control and Compliance and Other Matters

We agree with the Acuity Consulting Report on Internal Control Over Financial Reporting. Acuity Consulting, in planning and performing its audit, considered the Military Retirement Fund's internal control over financial reporting as a basis for designing audit procedures, but not for expressing an opinion on its effectiveness. In the Report on Internal Control, Acuity Consulting cites one significant deficiency relating to the Military Retirement Fund internal control over financial reporting.

We also agree with the Acuity Consulting Report on Compliance and Other Matters. Acuity Consulting performed tests to determine whether management administered the Military Retirement Fund in compliance with certain provisions of laws and regulations. Acuity Consulting cited no instances of noncompliance in its report.

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

Independent Auditors' Reports

Noncompliance with the laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 07-04, as amended, requires that auditors report test results if they identify noncompliance with certain provisions of laws and regulations.


Audit Responsibilities

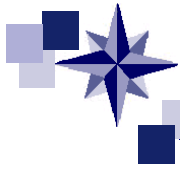
We were responsible for obtaining reasonable assurance that the basic financial statements of the Military Retirement Fund were presented fairly and free of material misstatement, in conformity with U.S. GAAP.

To fulfill our responsibilities for oversight of the Acuity Consulting audit work, we complied with the following: the U.S. Government Accountability Office (GAO), "Government Auditing Standards," OMB Bulletin 07-04, and "GAO/PCIE [President's Council on Integrity and Efficiency] Financial Audit Manual," July 2008. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; reviewed documentation prepared by Acuity Consulting; met with Acuity Consulting partners and staff members; reviewed the key judgments; met with officials of the Military Retirement Fund; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

Acuity Consulting formed its opinion on the basic financial statements taken as a whole. Acuity Consulting did not audit the Required Supplementary Information and did not express an opinion on it because that information is not part of the basic financial statements.

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


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



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INDEPENDENT AUDITORS' REPORT

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

INTRODUCTION

We have audited the balance sheets of the Department of Defense (DoD) Military Retirement Fund (the Fund) as of September 30, 2010 and 2009, as well as the related statements of net cost, changes in net position, and budgetary resources (the financial statements) for the years then ended. The objective of our audit was to express an opinion on the fair presentation of the financial statements as of September 30, 2010 and 2009. In connection with our audits, we also considered the Fund's internal controls over financial reporting and tested the Fund's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion of the financial statements, we found that the Fund's financial statements as of and for the years ended September 30, 2010 and 2009, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal controls would not necessarily disclose all significant deficiencies in the internal control over financial reporting that might be significant deficiencies under standards issued by the American Institute of Certified Public Accountants (AICPA) and Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. In September 2009, a new general ledger accounting system, the Trust Fund Reporting System (TFRS), was implemented to address compliance with the Federal Financial Management Improvement Act (FFMIA) in future years. Our audit disclosed no instances in which the Fund's systems did not substantially comply with FFMIA. The results of our tests of compliance with certain provisions of laws and regulations did not disclose any instances of noncompliance required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States and OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

The following sections discuss in more detail our report on the Fund's financial statements, our consideration of the internal control over financial reporting, and our tests of the Fund's compliance with certain provisions of applicable laws and regulations.

INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the DoD Fund as of September 30, 2010 and 2009, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. Those standards and the OMB Bulletin require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2010 and 2009, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 9 and 16 to the financial statements, the Fund changed its method of computing the actuarial liability in 2010. The adoption of the new Statement of Federal Financial Accounting Standards Number 33 required new economic assumptions to be implemented for periods beginning after September 30, 2009.

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, but are supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular A - 136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, such information has not been subjected to the auditing procedures applied in our audit of the basic financial statements and accordingly, we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 5, 2010 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

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

We have audited the financial statements of the DoD Fund as of and for the years ended September 30, 2010 and 2009, and have issued our report thereon dated November 5, 2010. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. With respect to internal control over financial reporting, we obtained an understanding of the design effectiveness of internal controls, determined whether they have been placed in operation, assessed control risk, and performed tests of the Fund's internal controls.

In planning and performing our audit, we considered the Fund's internal control over financial reporting as a basis for designing audit procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we do not express an opinion on the Fund's internal control over financial reporting.

A *deficiency in internal control* 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 and correct misstatements on a timely basis.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A *significant deficiency* is a deficiency or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a deficiency in internal control over financial reporting, described below that we consider to be a significant deficiency in internal control over financial reporting.

We considered the following matter to be a *significant deficiency*:

- Our audit procedures identified continued instances where benefits for retirees were not properly calculated. One of these erroneous calculations involved the use of the High-3 method. The High-3 method, for calculating retirement benefits, is used for all personnel who entered the service after September 8, 1980 and will become the predominant method used for retirement benefit calculations in the future. DFAS-CL should develop and implement a plan to validate the initial High-3 calculation for members receiving benefit payments, identifying and correcting the pay for any members who are receiving improper payments. This condition was reported externally in the prior year's report.

Other internal control deficiencies we did not consider to be significant, either individually or collectively, are to be reported to management separately in a management letter to be dated November 30, 2010.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no reportable instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and the requirements of OMB Bulletin No. 07-04.

VIEWS OF RESPONSIBLE OFFICIALS

We provided a draft of this report to the Audit Committee and the management of the Fund, who then provided us with comments, which we incorporated as appropriate. The Audit Committee and the management of the Fund expressed their continuing commitment to address the deficiencies identified in this report. Management's planned corrective actions provide reasonable assurance the reported conditions will be corrected in the future and provided an estimated completion date of March 1, 2011.

DISTRIBUTION

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

Acuity Consulting, Inc.

November 5, 2010