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DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

MANAGEMENT’S DISCUSSION
AND ANALYSIS
SUMMARY OF THE MEDICARE-ELIGIBLE RETIREE HEALTH CARE SYSTEM

As of September 30, 2003

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the Fund). Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness, through the Office of the Assistant Secretary of Defense for Health Affairs (TRICARE Management Activity), has as one of its missions to oversee the operations of the Defense TRICARE Health Delivery System, including oversight of the Medicare-Eligible Retiree Health Care Fund (the Fund). In FY 2003, the Fund paid out approximately $4.4 billion in health care services to civilian providers ($3.2B), military medical treatment facilities ($0.8B) and Military Service Personnel Accounts ($0.4B) on behalf of Medicare eligible retirees, retiree dependents, and survivors. In addition to staff members of the TRICARE Management Activity, the Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund. The DoD Office of the Actuary is responsible for supporting the Board of Actuaries in the valuation of the Fund.

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 the Treasury to amortize the unfunded liability, and investment income. During FY 2003, the Fund received $8.2 billion in normal cost payments, a $14.4 billion initial unfunded liability amortization payment, and $196 million in investment income, net of premium/discount amortization. No accounts of the Fund have been excluded from the Fund’s financial statements.

Overview of Defense Health Program

The Defense Health Program is known as TRICARE. Covered beneficiaries include:
- Active duty Service members
- Dependents of active duty Service members.
- Military retirees.
- Dependents of military retirees
- Full-time reservists
- Dependents of full-time reservists
- Survivors of military retirees of those who died on active duty

The TRICARE program consists of a combination of military medical treatment facilities (MTFs) and regional networks of civilian providers that work together to provide care to eligible beneficiaries. The MTFs include 75 hospitals and 461 clinics in the United States and overseas. Those facilities provide care for eligible beneficiaries and also serve as a training ground for military medical personnel. Because the direct care health system’s capacity is not large enough to serve the health care needs of all eligible beneficiaries, DoD has ensured that active duty Service members receive top priority for care at the military facilities, while other beneficiaries
Management’s Discussion and Analysis

can receive direct care services on a “space-available” basis. If care is not available in MTFs, beneficiaries seek care from civilian providers paid through the TRICARE program via the Managed Care Support Contracts and the TRICARE for Life program.

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

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

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

- **TRICARE Extra** is similar to a civilian preferred provider organization. Beneficiaries pay lower co-payments than they would under TRICARE Standard if they seek care from a provider in the TRICARE network.

- **TRICARE Standard** is a fee-for-service plan that allows beneficiaries to seek care from any civilian provider and be reimbursed for a portion of the costs after paying co-payments and meeting deductibles.

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

Medicare-Eligible Retiree Health Care Plan of Benefits

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

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

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

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

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

Medicare-Eligible Retiree Health Care Fund (MERHCF)

The FY2001 NDAA also directed the establishment of the Medicare Eligible Retiree Health Care Fund to pay for Medicare-Eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-Eligible beneficiaries was financed through annual Congressional appropriations for space available care in MTFs. The Fund covers Medicare-Eligible beneficiaries, regardless of age.

Health Care Purchased From Civilian Providers

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

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

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

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TRICARE for Life/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management Division. By agreement with DFAS, disbursement transactions are provided by email the day prior to payment processing. DFAS uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The estimated purchased care cost for FY 2003 is approximately $3.5 billion.

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

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

The prospective payment amounts are based on costs reported by the MTF’s Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent fiscal year for which data is complete at the time the calculations are prepared. TMA develops, in coordination with the Military Departments and Office of the Undersecretary of Defense (Comptroller) (OUSD(C)), MTF-specific rates in accordance with DoDI 6070.2, July 19, 2002. MEPRS cost data are recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using standard OMB inflation rates applicable to those years. MEPRS data is recorded and maintained by the Military Departments in accordance with DoD 6010.13-M, “Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities,” November 21, 2000.

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

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

The estimated O&M expenditure for MTF provided care to Medicare-Eligible beneficiaries in FY 2003 is $0.8 billion. The estimated MILPERS expenditure for care provided in the MTFs to Medicare-Eligible beneficiaries in FY 2003 is $0.4 billion.
Management’s Discussion and Analysis

Performance Measures

FY 2003 is the first year of operation for the Fund.

There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2003, the Fund had net assets of $18.165 billion and an actuarial liability of $476.17 billion; the funded ratio was 3.81%. This ratio is expected to reach 100% once the initial unfunded liability is fully amortized. The 50-year amortization period is scheduled to end in FY 2052.

Improper Payments Information Act

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

In accordance with these provisions, the Department of Defense is reviewing all programs and activities and identifying those which are susceptible to significant improper payments. The Department will then estimate the amount of improper payments and establish goals to reduce the amount of these payments. Programs that meet the threshold criteria established in this guidance will be reported in next year’s report. Those not meeting the criteria will be tracked internally to ensure that all cost-effective measures are being taken to minimize the amount of improper payments.

For fiscal year 2003, the Office of Management and Budget Circular A-11 requires the Department of Defense to report improper payments for two programs, including the Defense Health Program, of which the Fund is a component. The information that follows relates to the overall Program, as no stand-alone information for the Fund has yet been developed.

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

One control is the claims edit system, which rebundles services that should be billed under a single comprehensive procedure code, but are broken out by medical service providers to increase reimbursement. This is a fraudulent practice condemned by national professional medical organizations.

A cost avoidance of $74 million was realized in fiscal year 2002 and a cost avoidance of $143 million is projected for fiscal year 2003 as a result of military health benefits program rebundling edits.

The Department identified $33.484 million of improper payments (underpayments and overpayments) for the Defense Health Program—purchased care program—in fiscal year 2003.
Management’s Discussion and Analysis

This represents an error rate of approximately 1.36% of the $3.9 billion in Defense Health Program payments made during fiscal year 2003.
DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

PRINCIPAL STATEMENTS
Principal Statements

Department of Defense
DoD Medicare-Eligible Retiree Health Care Fund
BALANCE SHEET
As of September 30, 2003
(In Thousands)

ASSETS

Intragovernmental:
  Fund Balances with Treasury (Note 3) $ 5,010
  Investments (Note 4)
Total Intragovernmental Assets (Note 2) $ 18,445,191

TOTAL ASSETS $ 18,450,201

LIABILITIES

Accounts Payable (Note 5) $ 105,961
Military Retirement Benefits and Other Employment-Related
  Actuarial Liabilities (Note 5 & 8) 476,170,267
  Other Liabilities (Notes 5 & 7) 254,912

TOTAL LIABILITIES $ 476,531,140

NET POSITION

Cumulative Results of Operations (458,080,939)

TOTAL NET POSITION $ (458,080,939)

TOTAL LIABILITIES AND NET POSITION $ 18,450,201

The accompanying notes are an integral part of these statements.
# Principal Statements

**Department of Defense**
**DoD Medicare-Eligible Retiree Health Care Fund**
**STATEMENT OF NET COST**
**For the Year Ended September 30, 2003**
**(In Thousands)**

## PROGRAM COSTS

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intragovernmental Gross Costs</td>
<td>$1,272,068</td>
</tr>
<tr>
<td>(Less: Intragovernmental Earned Revenue)</td>
<td>$(22,765,600)</td>
</tr>
<tr>
<td>Intragovernmental Net Costs</td>
<td>$(21,493,532)</td>
</tr>
<tr>
<td>Gross Costs With the Public</td>
<td>$67,375,671</td>
</tr>
<tr>
<td>Net Costs With the Public</td>
<td>$67,375,671</td>
</tr>
<tr>
<td>Total Net Cost</td>
<td>$45,882,139</td>
</tr>
<tr>
<td>Net Cost of Operations</td>
<td>$45,882,139</td>
</tr>
</tbody>
</table>

Additional information included in Note 9.

The accompanying notes are an integral part of these statements.
## Principal Statements

Department of Defense  
DoD Medicare-Eligible Retiree Health Care Fund  
STATEMENT OF CHANGE IN NET POSITION  
For the Year Ended September 30, 2003  
(In Thousands)

### CUMULATIVE RESULTS OF OPERATIONS

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balances</td>
<td>$</td>
</tr>
<tr>
<td>Other Financing Sources:</td>
<td>(412,198,800)</td>
</tr>
<tr>
<td>Transfers-in/out without reimbursement (Note 8)</td>
<td></td>
</tr>
<tr>
<td>Net Cost of Operations</td>
<td>45,882,139</td>
</tr>
<tr>
<td>Ending Balances</td>
<td>(458,080,939)</td>
</tr>
</tbody>
</table>

The accompanying notes are an integral part of these statements.
Principal Statements

Department of Defense
DoD Medicare-Eligible Retiree Health Care Fund
STATEMENT OF BUDGETARY RESOURCES
For the Year Ended September 30, 2003
(In Thousands)

BUDGETARY RESOURCES

Budget Authority:
  Appropriations received
  Total Budgetary Resources


STATUS OF BUDGETARY RESOURCES

Obligations incurred:
  Direct

Unobligated balance:
  Apportioned
  Unobligated balance not available
  Total Status of Budgetary Resources


RELATIONSHIP OF OBLIGATIONS TO OUTLAYS

Undelivered Orders

Obligated Balance, Net - end of period:
  Accounts payable

Outlays:
  Disbursements
  Less: Offsetting receipts
  Total Outlays


The accompanying notes are an integral part of these statements.
Principial Statements

Department of Defense
DoD Medicare-Eligible Retiree Health Care Fund
STATEMENT OF FINANCING
For the Year Ended September 30, 2003
(In Thousands)

<table>
<thead>
<tr>
<th>RESOURCES USED TO FINANCE ACTIVITIES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Budgetary Resources Obligated</td>
<td></td>
</tr>
<tr>
<td>Obligations incurred</td>
<td>$4,583,170</td>
</tr>
<tr>
<td>Less: Offsetting receipts</td>
<td>$(22,765,600)</td>
</tr>
<tr>
<td>Transfers in/out without reimbursement</td>
<td>$(412,198,800)</td>
</tr>
<tr>
<td><strong>Total resources used to finance activities</strong></td>
<td>$430,381,230</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Undelivered Orders</td>
<td>$(161,810)</td>
</tr>
<tr>
<td>Other</td>
<td>$412,198,800</td>
</tr>
<tr>
<td><strong>Total resources used to finance items not part of the net cost of operations</strong></td>
<td>$412,036,990</td>
</tr>
<tr>
<td><strong>Total resources used to finance the net cost of operations</strong></td>
<td>$18,344,240</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Components Requiring or Generating Resources in Future Periods:</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>$64,226,379</td>
</tr>
<tr>
<td><strong>Total components of net cost of operations that will not require or generate resources in the current period</strong></td>
<td>$64,226,379</td>
</tr>
<tr>
<td><strong>Net Cost of Operations</strong></td>
<td>$45,882,139</td>
</tr>
</tbody>
</table>

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.
DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE
FUND

FOOTNOTES
TO THE
PRINCIPAL STATEMENTS
NOTES TO THE DOD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND
PRINCIPAL STATEMENTS
FOR THE YEAR ENDED SEPTEMBER 30, 2003

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES


These financial statements report the financial position and results of operations of the Medicare-Eligible Retiree Health Care Fund. The Chief Financial Officers (CFO) Act of 1990 requires the preparation of these statements. This Act has subsequently been expanded by the Government Management Reform Act (GMRA) of 1994 and other appropriate legislation. The financial statements have been prepared from the books and records of the Fund maintained by the Trust Fund Accounting Division, Accounting Directorate, Defense Finance and Accounting Service (DFAS), in accordance with requirements of the Office of Management and Budget (OMB) Bulletin No. 01-09, “Form and Content of Agency Financial Statements,” and accounting principles generally accepted in the United States of America. DFAS prepares the Medicare-Eligible Retiree Health Care Fund financial statements, in addition to the financial reports, pursuant to OMB directives, which are used to monitor and control budgetary resources within the Fund.

More detailed explanations of these financial statement elements are discussed in applicable footnotes.

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

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

C. Appropriations and Funds. The Medicare-Eligible Retiree Health Care Fund was authorized by the Public Law 106-398, “Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001.” The purpose of this fund was to pay the costs of all uniformed services retiree health care programs for the benefit of members or former members of a participating service who are entitled to retired or retainer pay and are Medicare-eligible, their dependents who are Medicare-eligible, and their survivors who are Medicare-eligible.

The Medicare-Eligible Retiree Health Care Fund appropriations are designated special funds. These appropriations and funds are used to fund, and report how resources have been used in the course of executing, the Medicare-Eligible Retiree Health Care Fund’s mission.

The Medicare-Eligible Retiree Health Care Fund is classified as a special fund and uses both receipt and expenditure accounts. The Medicare-Eligible Retiree Health Care Fund symbol is 97X5472.

The account uses a budget activity level structure. Lower level accounts are established as necessary to meet reporting requirements.

D. Basis of Accounting. Under authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to the Secretary of the Treasury, the Director of OMB, and the Comptroller General, co-principals of the Joint Financial Management Improvement Program. The Director of OMB and the Comptroller General have issued Statements of Federal Financial Accounting Standards (SFFAS), some of which have deferred effective dates.
Footnotes

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

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

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

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

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

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance in the circumstances. When directed by OMB, through OMB Bulletin No. 01-09, generally accepted accounting principles in the United States of America serve as authoritative guidance for federal agencies in preparing reports that are addressed within OMB Bulletin No. 01-09.

E. Revenues and Other Financing Sources. Financing sources for the Medicare-Eligible Retiree Health Care Fund are provided primarily through an annual unfunded actuarial liability payment from Treasury, monthly contributions from the Military Services and Uniformed Services (United States Coast Guard, the National Oceanic and Atmospheric Administration, and the United States Public Health Service), and interest earned on investments. The monthly Military Service contributions are calculated by multiplying the monthly per capita rates (full time and part time) provided by the DoD Office of the Actuary times the reported end strength for the most recently reported month.

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

G. Accounting for Intragovernmental Activities. The Medicare-Eligible Retiree Health Care Fund purchases and redeems non-marketable market-based securities issued by the United States Treasury, Bureau of Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, and overnight certificates. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. Treasury notes have maturities of at least one-year, but not more than ten years, and are purchased at a discount or premium. Treasury bonds are long-term securities with maturity terms of ten years or more and are purchased at either a discount or premium.

The Medicare-Eligible Retiree Health Care Fund records investments at book value on the trial balance in USSGL 1600. Discounts and premiums are recorded on the Fund’s trial balances in SGL 1611 and 1612, respectively. The Fund calculates amortization of discounts and premiums using the effective interest method and records this amortization on the trial balance in USSGL 1613.

The Medicare-Eligible Retiree Health Care Fund receives interest on the value of its non-marketable market-based securities from Treasury on a semi-annual basis for U.S. Treasury bonds and notes.

H. Funds with the U.S. Treasury. The Medicare-Eligible Retiree Health Care Fund financial resources are maintained in U.S. Department of Treasury (Treasury) accounts. The Defense Finance and Accounting Service (DFAS)-Arlington processes all fund receipts and adjustments. DFAS-Arlington prepares monthly reports, which provide information to Treasury on transfers and deposits. In addition, DFAS-Arlington submits reports to Treasury, by appropriation, on collections received. Treasury then records this information in the appropriation Fund Balance with Treasury (FBWT) account maintained in the Treasury system. Differences between the recorded balance in the Medicare-Eligible Retiree Health Care Fund FBWT account and the Treasury FBWT are reconciled.
Footnotes

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

I. Investments in U.S. Department of Treasury Securities. Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. These securities are redeemable at market value exclusively through the Federal Investment Branch of Treasury. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 4.


K. Comparative Data. The Medicare-Eligible Retiree Health Care Fund was established on October 1, 2002. Therefore, no comparative data is available from the previous fiscal year.

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

M. Actuarial Information. The Medicare-Eligible Retiree Health Care Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year based on population information as of the beginning of the year and updated 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. ASSETS

<table>
<thead>
<tr>
<th>($ In Thousands)</th>
<th>FY03</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nonentity</td>
</tr>
<tr>
<td>1. Intragovernmental Assets:</td>
<td></td>
</tr>
<tr>
<td>a Fund Balance With Treasury</td>
<td>$0</td>
</tr>
<tr>
<td>b Investments</td>
<td>$0</td>
</tr>
<tr>
<td>c Total Intragovernmental Assets</td>
<td>$0</td>
</tr>
<tr>
<td>2. Nonfederal Assets</td>
<td></td>
</tr>
<tr>
<td>a Accounts Receivable</td>
<td>$0</td>
</tr>
<tr>
<td>b Total Nonfederal Assets</td>
<td>$0</td>
</tr>
<tr>
<td>3. Total Assets</td>
<td>$0</td>
</tr>
</tbody>
</table>

4. Other Information:

Asset accounts are categorized either as entity or nonentity. Entity accounts consist of resources that the agency has the authority to use, or when management is legally obligated to use funds to meet entity obligations. Nonentity assets are assets held by an entity, but not available for use in the operation of the entity. The $18,445,191 (in thousands) represents investments in non-marketable, market-based securities composed of Treasury overnight investments. The U.S. Department of Treasury allows the Fund to be fully invested.
### Footnotes

**NOTE 3. FUND BALANCES WITH TREASURY**

($ In Thousands)

1. Fund Balances:
   - **Fund Type**
   - a. Trust Funds: $5,010
   - b. Total: $5,010

2. Fund Balance Per Treasury Versus Agency:
   - a. Fund Balance Per Treasury: $5,010
   - b. Fund Balance Per Medicare-Eligible Retiree Health Care Fund: $5,010
   - c. Reconciling Amount: $0

**NOTE 4. INVESTMENTS**

($ In Thousands)

<table>
<thead>
<tr>
<th></th>
<th>FY 03</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost</strong></td>
<td>Amortization Method</td>
</tr>
<tr>
<td>Total Intragovernmental:</td>
<td></td>
</tr>
<tr>
<td>a. Non-Marketable, Market Based</td>
<td>$18,445,191</td>
</tr>
<tr>
<td>b. Subtotal</td>
<td>$18,445,191</td>
</tr>
<tr>
<td>c. Accrued Interest</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>$18,445,191</td>
</tr>
</tbody>
</table>

Line 1A, Investments. The investments listed above are presented at amortized cost and market value as of September 30, 2003. Listed below are the Par Value and Net Investment Values for the U.S. Department of Treasury Securities (in thousands):

<table>
<thead>
<tr>
<th></th>
<th>Par Value</th>
<th>Investments, Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Overnight</td>
<td>$18,445,191</td>
<td>$18,445,191</td>
</tr>
<tr>
<td>Total</td>
<td>$18,445,191</td>
<td>$18,445,191</td>
</tr>
</tbody>
</table>
NOTE 5. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES

($ In Thousands)

<table>
<thead>
<tr>
<th></th>
<th>Covered by Budgetary Resources</th>
<th>Not Covered by Budgetary Resources</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Intragovernmental Liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Other</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Total Intragovernmental Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2. Nonfederal Liabilities:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Accounts Payable</td>
<td>$105,961</td>
<td>$0</td>
<td>$105,961</td>
</tr>
<tr>
<td>b. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities</td>
<td>$18,182,430</td>
<td>$457,987,837</td>
<td>$476,170,267</td>
</tr>
<tr>
<td>c. Other Liabilities (Note 7)</td>
<td>$0</td>
<td>$254,912</td>
<td>$254,912</td>
</tr>
<tr>
<td>Total Nonfederal Liabilities</td>
<td>$18,288,391</td>
<td>$458,242,749</td>
<td>$476,531,140</td>
</tr>
<tr>
<td>3. Total Liabilities:</td>
<td>$18,288,391</td>
<td>$458,242,749</td>
<td>$476,531,140</td>
</tr>
</tbody>
</table>

Footnotes

Line 2. Military Retirement Benefits and Other Employment-Related Actuarial Liability. The amount displayed in the "Covered by Budgetary Resources" column represents the balances of USSGL account 4450, Unapportioned Authority, and USSGL account 4510, Apportionments.

NOTE 6. ACCOUNTS PAYABLE
($ In Thousands)

<table>
<thead>
<tr>
<th></th>
<th>FY 03</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Accounts Payable</td>
</tr>
<tr>
<td>1. Intra-governmental Payables</td>
<td>$0</td>
</tr>
<tr>
<td>2. Non-Federal Payables</td>
<td>$105,961</td>
</tr>
<tr>
<td>(to the Public)</td>
<td>$105,961</td>
</tr>
<tr>
<td>3. Total Accounts Payable</td>
<td>$105,961</td>
</tr>
</tbody>
</table>
NOTE 7. OTHER LIABILITIES

($ In Thousands)

1. Intragovernmental:
   a. Other Liabilities $0
      Total Intragovernmental Other Liabilities $0

2. Nonfederal:
   a. Accrued Funded Payroll and Benefits $254,912
      b. Total Nonfederal Other Liabilities $254,912

3. Total Other Liabilities $254,912

4. Other Information Pertaining to Other Liabilities:
   Line 2A., Accrued Funded Payroll and Benefits. The balance represents the actuarially-determined estimate of benefit claims incurred but not reported as of September 30, 2003 for covered services rendered prior to that date.

NOTE 8. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES

($ In Thousands)

<table>
<thead>
<tr>
<th>Major Program Activities</th>
<th>FY 03</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actuarial Present Value of Projected Plan Benefits</td>
</tr>
<tr>
<td>Medicare-Eligible Retiree Benefits</td>
<td>$476,170,267</td>
</tr>
<tr>
<td>Total:</td>
<td>$476,170,267</td>
</tr>
</tbody>
</table>

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

Assumptions: Interest Rate: 6.25%
Medical Trend:
Medicare Inpatient: 4.0% from 2002 to 2003, ultimate rate of 6.25% in 2027.
Medicare Outpatient: 5.5% from 2002 to 2003, ultimate rate of 6.25% in 2027.
Medical Prescriptions (Direct Care): 10.08% from 2002 to 2003, ultimate rate of 6.25% in 2027.
Medical Prescriptions (Purchased Care): 15.54% from 2002 to 2003, ultimate rate of 6.25% in 2027.

The medical cost-trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2003, by 32%, or approximately $152,374,485.

Market Value of Investments in Market-Based and Marketable Securities (in thousands): $18,445,191
Change in MERHCF Actuarial Liability

a. Actuarial Liability as of September 30, 2002 (DoD Medicare) $405,553,000
b. Transferred Actuarial Liability as of September 30, 2002 (non-DoD uniformed services Medicare) $6,645,800
c. Actuarial Liability as of September 30, 2002 (all uniformed services Medicare) $412,198,800
d. Expected Normal Cost $7,923,175
e. Expected Benefit Payments $5,584,055
f. Interest Cost $25,834,415
g. Estimated actuarial (gains)/losses on non-DoD uniformed services liabilities $2,347,317
h. Actuarial (gains)/losses due to other factors $25,680,437
i. Actuarial (gains)/losses due to changes in trend assumptions $7,770,178
j. Actuarial Liability as of September 30, 2003 (all uniformed services Medicare) $476,170,267
k. Change in Actuarial Liability $63,971,467

Each year the Accrued Liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of $28.2 billion in the Accrued Liability was expected during FY 2003 (line d minus line e plus line f). The September 30, 2003, Accrued Liability includes changes due to new assumptions and actuarial experience. The loss due to new medical trend assumptions is $7.8 billion (line i). The gains and losses are on the calculation of the non-DoD Uniformed Services liability ($2.3 billion, line g), new population data, other actuarial experience being different from assumed, and other actuarial assumption changes (net $25.7 billion, line h).

Prior to the establishment of the Medicare-Eligible Retiree Health Care Fund effective October 1, 2002, the actuarial liabilities for the covered benefits for the uniformed services were recorded in the financial statements of the participating employers, the DoD, the United States Coast Guard, the United States Public Health Service, and the National Oceanic and Atmospheric Administration (NOAA). During fiscal year 2003, the actuarial liabilities as of September 30, 2002 for the eligible beneficiaries of the Fund were transferred to the Fund by the participating employers, as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DoD</td>
<td>$405,553,000</td>
</tr>
<tr>
<td>Coast Guard</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Public Health Service</td>
<td>$1,547,000</td>
</tr>
<tr>
<td>NOAA</td>
<td>$98,800</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$6,645,800</strong></td>
</tr>
</tbody>
</table>

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout for the September 30, 2003 liability ($ thousands) is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DoD</td>
<td>$466,537,416</td>
</tr>
<tr>
<td>Coast Guard</td>
<td>$8,613,156</td>
</tr>
<tr>
<td>Public Health Service</td>
<td>$954,225</td>
</tr>
<tr>
<td>NOAA</td>
<td>$65,470</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$476,170,267</strong></td>
</tr>
</tbody>
</table>

FY 2003 Uniformed Services contributions to the MERHCF ($ thousands) is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DoD</td>
<td>$8,001,525</td>
</tr>
<tr>
<td>Coast Guard</td>
<td>$172,728</td>
</tr>
<tr>
<td>Public Health Service</td>
<td>$25,144</td>
</tr>
<tr>
<td>NOAA</td>
<td>$1,157</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$8,200,554</strong></td>
</tr>
</tbody>
</table>
Footnotes

MERHCF liabilities are valued at a lower cost basis for direct care than they are in the corresponding liabilities reported for the Military Retirement Health Benefits liability in the DoD Consolidated Financial Statements. Thus, the MERHCF liability is approximately $19.5 billion lower than the Medicare portion of the Military Retirement Health Benefits liability.

Estimated actuarial gains/losses on the non-DoD uniformed services liabilities reflect new assumptions in the calculation of their liabilities. Actuarial gains/losses due to other factors include new population data, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions.

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Claims cost assumptions for direct care were based on actual experience; assumptions for purchased care were developed from industry-based cost estimates adjusted to approximate the military retired population.

Projected revenues into the Medicare-Eligible Retiree Health Care Fund, authorized by Chapter 56 of Title 10, United States Code, come from three sources: Interest earnings on Fund assets, monthly Uniformed Services contributions, and annual contributions from the Treasury Department. The monthly contributions are determined as a per-capita amount (approved by the DoD Medicare Eligible-Retiree Health Care Board of Actuaries) multiplied by end strength. The contribution from Treasury is paid into the Fund at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines the Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

The actuarial liability reported above does not include $254,912 thousand in incurred but not reported liabilities as of September 30, 2003. These liabilities are disclosed in Note 5, Liabilities Not Covered and Covered by Budgetary Resources, and Note 7, Other Liabilities.

Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from prior year results. For purposes of the Fund’s financial reporting, this process is applied annually.

**NOTE 9. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENT OF NET COST**

<table>
<thead>
<tr>
<th>FY 03</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned Revenue for Program Costs: ($ In Thousands)</td>
<td></td>
</tr>
<tr>
<td>1. Service Contributions</td>
<td>$ 8,200,554</td>
</tr>
<tr>
<td>2. Annual Unfunded Liability Payment</td>
<td>14,369,000</td>
</tr>
<tr>
<td>3. Interest on Investments</td>
<td>196,046</td>
</tr>
<tr>
<td>4. Transfers</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$22,765,600</strong></td>
</tr>
</tbody>
</table>

Line 1, above, reflects total contributions from the Military Services plus the United States Public Health Service, the United States Coast Guard, and the National Oceanic Atmospheric Administration.
NOTE 9A: BENEFIT PROGRAM EXPENSE

<table>
<thead>
<tr>
<th></th>
<th>FY 03</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Service Cost</td>
<td>$7,923,175</td>
</tr>
<tr>
<td>2. Period Interest on the Benefit Liability</td>
<td>25,834,415</td>
</tr>
<tr>
<td>3. Prior (or past) Service Cost</td>
<td>0</td>
</tr>
<tr>
<td>4. Period Actuarial (Gains) or Losses</td>
<td>28,027,754</td>
</tr>
<tr>
<td>5. Gains/Losses Due to Changes in Medical Inflation Rate Assumption</td>
<td>7,770,178</td>
</tr>
<tr>
<td>6. Total Benefit Program Expense</td>
<td>$69,555,522</td>
</tr>
</tbody>
</table>

The benefit program expenses provide components of the change in the actuarial liability from September 30, 2002, to September 30, 2003. The September 30, 2003, actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during FY 2003. The September 30, 2003, actuarial liability is equal to the September 30, 2002, liability plus the total benefit program expenses minus the expected benefit payments.

NOTE 10: OTHER DISCLOSURES

The actuarial liability for Medicare-eligible retiree benefits as of October 1, 2002 and September 30, 2003 includes approximately $54 billion (13% of total) and $76 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by DoD - managed Military Treatment Facilities (MTFs) to eligible participants in the Fund. Additionally, the reported amounts of program revenues and costs for the year ended September 30, 2003, include approximately $3.5 billion and $1.3 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund’s actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to the extracted data, the MTFs do not have patient-level accounting systems and therefore cannot report the costs of an individual patient’s care.
DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

REQUIRED SUPPLEMENTARY INFORMATION
## Required Supplementary Information

**DoD**
**Medicare-Eligible Retiree Health Care Fund**
**Intragovernmental Transactions**
**For the Year Ended September 30, 2003**

($ In Thousands)

<table>
<thead>
<tr>
<th>Schedule, Part A</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Intragovernmental Asset Balances</td>
<td>Treasury Index</td>
<td>Fund Balance with Treasury</td>
<td>Investments</td>
</tr>
<tr>
<td>Which Reflect Entity Amount with Other Federal Agencies</td>
<td>20</td>
<td>$5,010</td>
<td>$18,445,191</td>
</tr>
<tr>
<td><strong>Department of the Treasury</strong></td>
<td></td>
<td>$5,010</td>
<td>$18,445,191</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Schedule, Part C DoD</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Intragovernmental Revenues and Related Costs with Other Federal Agencies</td>
<td>Treasury Index</td>
<td></td>
<td>Earned Revenue</td>
</tr>
<tr>
<td><strong>Department of the Treasury</strong></td>
<td>20</td>
<td></td>
<td>$196,046</td>
</tr>
<tr>
<td>Department of Commerce</td>
<td>13</td>
<td>$1,157</td>
<td></td>
</tr>
<tr>
<td>Department of Transportation</td>
<td>69</td>
<td>$114,553</td>
<td></td>
</tr>
<tr>
<td>Department of Health and Human Services</td>
<td>75</td>
<td>$25,144</td>
<td></td>
</tr>
<tr>
<td>Homeland Security</td>
<td>70</td>
<td>$58,175</td>
<td></td>
</tr>
<tr>
<td>Department of the Navy</td>
<td>17</td>
<td>$2,620,074</td>
<td></td>
</tr>
<tr>
<td>Department of the Army</td>
<td>21</td>
<td>$3,486,159</td>
<td></td>
</tr>
<tr>
<td>Department of the Air Force</td>
<td>57</td>
<td>$1,895,292</td>
<td></td>
</tr>
<tr>
<td>Other Defense Organizations</td>
<td>97</td>
<td>$14,369,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$22,765,600</td>
</tr>
</tbody>
</table>
DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

OTHER ACCOMPANYING INFORMATION
### TABLE 1

**MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND**

**ACTUARIAL STATUS INFORMATION**

**SEPTEMBER 30, 2003**

In Thousands

<table>
<thead>
<tr>
<th>Description</th>
<th>September 30, 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present value of future benefits</td>
<td></td>
</tr>
<tr>
<td>a. Current inactives</td>
<td>$289,244,138</td>
</tr>
<tr>
<td>b. Active duty personnel&lt;sup&gt;1&lt;/sup&gt;</td>
<td>$142,321,865</td>
</tr>
<tr>
<td>c. Non-retired reservists</td>
<td>$121,128,929</td>
</tr>
<tr>
<td>d. Total</td>
<td>$552,694,932</td>
</tr>
<tr>
<td>Present value of future normal cost contributions</td>
<td>$(76,524,665)</td>
</tr>
<tr>
<td>Actuarial accrued liability</td>
<td>$476,170,267</td>
</tr>
<tr>
<td>Assets&lt;sup&gt;2&lt;/sup&gt;</td>
<td>$(18,182,430)</td>
</tr>
<tr>
<td>Unfunded accrued liability&lt;sup&gt;3&lt;/sup&gt;</td>
<td>$457,987,837</td>
</tr>
</tbody>
</table>

---

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

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

<sup>3</sup> The unfunded accrued liability does not include $254,912 thousand for Incurred But Not Reported (IBNR) liabilities recorded as of September 30, 2003, as disclosed in Note 5 (Liabilities Not Covered and Covered By Budgetary Resources) and Note 7 (Other Liabilities) to the financial statements.
DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

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

SUBJECT: Endorsement of the Qualified Opinion on the FY 2003 DoD Medicare Eligible Retiree Health Care Fund Financial Statements
(Project No. D2003FJ-0117)


Qualified Audit Opinion. We concur with the Deloitte & Touche LLP qualified opinion dated December 8, 2003. Deloitte & Touche LLP opined that, except for problems regarding direct-care cost data, the FY 2003 Financial Statements and accompanying notes present fairly, in all material respects, the MERHCF financial position as of September 30, 2003, and its Net Cost, Changes in Net Position, Budgetary Resources, and reconciliation of budgetary resources to net cost for the year then ended. The Defense Finance and Accounting Service prepared the financial statements in conformity with accounting principles generally accepted in the United States.

We concur with the Deloitte & Touche LLP report on internal control over financial reporting in connection with the audit of the FY 2003 MERHCF Financial Statements. The report referred to matters involving the internal control over financial reporting that are considered to be reportable conditions.

The report concluded that the general controls over electronic data processing (EDP) at the computer processing locations that the MERHCF uses did not support the reliable processing of financial information within the related business cycles. The review disclosed deficiencies in the design or operation of controls related to EDP security policies, procedures, configurations, business continuity arrangements, and system software support activities that could adversely affect the Fund's ability to record, process, and summarize its financial information in accordance with all appropriate requirements.

This was a reportable condition that Deloitte & Touche LLP believed was not a material weakness. However, this condition could be considered significant in the context of a material weakness for DoD information security purposes.

A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time. –Constitution of the United States, Article I, Section 9

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As part of the audit, Deloitte and Touche LLP had to obtain reasonable assurance that the FY 2003 MERHCF Financial Statements were free of material misstatement. Deloitte & Touche LLP performed tests of the compliance of the administration of the MERHCF with certain provisions of laws and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000, requires that test results be reported if noncompliance with certain laws and regulations occurs. Specifically, the noncompliance concerns the following.

- MERHCF data is processed on electronic data processing systems that are not fully compliant with OMB Circular A-127, "Financial Management Systems."

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

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

To fulfill our oversight responsibilities for the contract with Deloitte and Touche LLP, we complied with Government auditing standards, OMB bulletin No. 01-02, and the General Accounting Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2001. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of the CPA firm; evaluated the key judgments; met with officials of the MERHCF; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. James L. Kornides (614) 751-1400, ext. 211 or Mr. Stuart D. Dunnett (614) 751-1400, ext. 214.

Paul Granette, CPA
Director
Defense Financial Auditing
Service

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*A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.* —Constitution of the United States, Article I, Section 9
INDEPENDENT AUDITORS’ REPORT

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheet of the Department of Defense ("DoD")
Medicare-Eligible Retiree Health Care Fund (the "Fund") as of September 30, 2003, and the
related statements of net cost, changes in net position, budgetary resources, and financing
for the year then ended. These financial statements are the responsibility of the management
of the Fund. Our responsibility is to express an opinion on these financial statements based
on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with
auditing standards generally accepted in the United States of America, the standards applicable
to financial audits contained in Government Auditing Standards, issued by the Comptroller
General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02,
Audit Requirements for Federal Financial Statements. Those standards require that we plan
and perform the audit to obtain reasonable assurance about whether the financial statements
are free of material misstatement. An audit includes examining, on a test basis, evidence
supporting the amounts and disclosures in the financial statements. An audit also includes
assessing the accounting principles used and significant estimates made by management, as
well as evaluating the overall financial statement presentation. We believe that our audit
provides a reasonable basis for our opinion.

We were unable to obtain patient – level information in support of allocated costs of direct care
provided by the DoD – managed Military Treatment Facilities (MTFs). As discussed in Note 10
to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of
October 1, 2002 and September 30, 2003 includes approximately $54 billion (13% of total) and
$76 billion (18% of total), respectively, of amounts reflecting the actuarial present value of the
projected direct – care costs of benefits to be provided by the MTFs to eligible participants in the
Fund. Additionally, the reported amounts of program revenues and costs for the year ended
September 30, 2003, include approximately $3.5 billion and $1.3 billion, respectively, of
amounts related to the direct – care costs. Such MTF-related amounts of direct – care costs are
estimated by the Fund’s actuaries using data extracted from various service-specific financial,
personnel and workload systems within DoD. With respect to the extracted data, the MTFs do
not have patient – level accounting systems and therefore cannot report the costs of an
individual patient’s care. While activity-based costing techniques have been used to apply total
program costs to individuals, there is insufficient evidence that adequate controls exist and have
been implemented to ensure the timeliness and accuracy of the medical record coding
processes at the MTFs, the primary basis of allocation. Additionally, the costs being allocated
cannot be related to specific appropriations, and there is insufficient evidence that adequate
controls exist and have been implemented to ensure the completeness, validity, recording and

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Audit • Tax • Consulting • Corporate Finance
To the Inspector General of the
Department of Defense

cut-off of the costs reported. We were not able to satisfy ourselves as to the direct—care
cost component of the reported amount of the actuarial liability for Medicare—eligible retiree benefits
by other auditing procedures.

In our opinion, except for the effects on the financial statements of the amounts related to the
Fund's direct—care costs, if any, as might have been determined to be necessary had we been
able to obtain sufficient evidence regarding the direct—care component of the actuarial liability
Medicare—eligible retiree benefits, the accompanying financial statements present fairly, in all
material respects, the financial position of the DoD Medicare-Eligible Retiree Health Care Fund
as of September 30, 2003, and its net cost, changes in net position, budgetary resources and
reconciliation of net cost to budgetary resources for the year then ended, in conformity with
accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated
December 8, 2003 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
grants. That report is an integral part of an audit performed in accordance with Government
Auditing Standards, and should be read in conjunction with this report in considering the results
of our audit.

Deloitte & Touche LLP

December 8, 2003
INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

To the Inspector General of the Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Medicare- Eligible Retiree Health Care Fund (the "Fund") as of and for the year ended September 30, 2003, and have issued our report thereon dated December 8, 2003. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, Audit Requirements for Federal Financial Statements.

Internal Control over Financial Reporting

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

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

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

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content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

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

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

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

1. The actuarial liability for Medicare-eligible retiree benefits as of October 1, 2002 and September 30, 2003 includes approximately $54 billion (13% of total) and $76 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct – care costs of benefits to be provided by DoD – managed Military Treatment Facilities (MTFs) to eligible participants in the Fund. Additionally, the reported amounts of program revenues and costs for the year ended September 30, 2003, include approximately $3.5 billion and $1.3 billion, respectively, of amounts related to the direct – care costs. Such MTF-related amounts of direct – care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD.

With respect to the extracted data, the MTFs do not have patient – level accounting systems and therefore cannot report the costs of an individual patient's care. While activity-based costing techniques have been used to apply total program costs to individuals, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, the primary basis of allocation. Additionally, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording and cut - off of the costs reported. The procedures in place to determine the allocated costs of direct care provided by the MTFs are not adequate to ensure presentation of the direct-care costs in conformity with accounting principles generally accepted in the United States of America.
To the Inspector General of the Department of Defense

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

The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the Services that have not been audited. The MTF – level data is based upon budget execution processes, rather than accrual - based accounting. There is insufficient evidence that appropriate cut-off of accounting activity occurred at the MTF - level. During 2003, the Fund had not yet established appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

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

During our procedures, we noted continuity of operations plans that were not periodically tested in a timely manner; lack of monitoring of performance levels of outsourced vendors and contractor personnel; inadequate tracking procedures to ensure effective backup processes; and backup tapes that were not adequately stored offsite. The information system assessment included the application systems implementation maintenance and support procedures in place. Our review noted weaknesses in the documentation of mainframe application changes, including lack of confirmation of system testing prior to implementation, and use of appropriate version control procedures. We also observed a lack of awareness of established change management processes, inadequate documentation of database administration and performance monitoring; database auditing features that were not enabled; and inadequate E-commerce system software change tracking procedures.

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

4. The general ledger system used by the Fund does not provide a fund structure that reflects complete classifications and consistency between financial activities of the Fund and its organizational structure. As discussed in the "Framework for Federal Financial Management Systems" issued by the Joint Financial Management Improvement Program (JFMIP), an agency's financial management system should include "the ability to ... facilitate the preparation of financial statements, and other financial reports in
accordance with federal accounting and reporting standards.” The responsibilities of agency level data stewardship exist at each level within the agency to insure that “the information contained within the systems is accurate, timely, consistent and useful.”

5. The DFAS Blue Book requires that general ledger systems provide for all transactions to record financial events, either individually or in summary, to the general ledger regardless of the origin of the transactions. Apparently, the system being used by the Fund was designed for accounting to the activity of other funds; therefore, a complete list of accounts supportive of the Fund’s activity was not established at the Fund’s inception. For example, we noted that no claims payable and claims incurred but not reported accounts were initially established on the trial balance, thus impacting on the reliability and completeness of the financial statements.

6. Budgetary accounting, as prescribed by the U.S. Standard General Ledger (SGL), is not being performed in support of budgetary reports prepared for the Fund. Existing budgetary accounts maintained by the Defense Finance and Accounting Service (DFAS) trial balance compilation system do not accurately reflect the Fund’s budgetary activity for each general ledger account. DFAS instead relies on information provided by Tricare Management Activity (TMA) for disbursements, known as proprietary information, and then proceeds to infer the other line items on the Report of Budget Execution (SF-133). The SF-133 is the basis for preparing the Statement of Budgetary Resources included in the principal statements. Therefore, budgetary accounts are not completely established in the general ledger environment used for reporting.

Additionally, we noted that TMA’s general ledger system properly includes budgetary accounts for the activities they manage; however, the budgetary amounts are not considered by DFAS in compiling budgetary reports for financial statement preparation purposes.

Our consideration of the Fund’s internal control would not necessarily disclose all matters in the Fund’s internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Of the reportable conditions noted above, the observations with respect to direct – care costs discussed at items 1. and 2. are, in our judgment, material weaknesses.

Compliance

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

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

2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger (SGL), it is not transaction based or derived from an integrated financial system.

3. The financial management systems utilized by the Fund do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A – 130, in that they do not fully, efficiently and effectively support the Fund’s efforts to:
   - Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;
   - Provide reliable and timely financial information for managing current operations;
   - Account for assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and
   - Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger

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

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

Distribution

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

December 8, 2003

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