



**FISCAL YEAR 2007**

**MEDICARE-ELIGIBLE RETIREE  
HEALTH CARE FUND**

**AUDITED FINANCIAL STATEMENTS**

**November 30, 2007**

***DoD***  
***MEDICARE-ELIGIBLE RETIREE***  
***HEALTH CARE FUND***  
***FISCAL YEAR 2007***  
***AUDITED FINANCIAL STATEMENTS***

*Table of Contents*

Management's Discussion and Analysis.....	1
Principal Statements.....	25
Notes to the Principal Statements.....	30
Other Accompanying Information.....	51
Independent Auditors' Reports.....	53

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

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

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## Management's Discussion and Analysis

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

YEARS ENDED SEPTEMBER 30, 2007 AND 2006

#### Description of the Reporting Entity

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

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

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

In Fiscal Year (FY) 2007, the Fund initially authorized approximately \$7.7 billion (B) in total health care services, civilian providers (\$5.9B), military medical treatment facilities (\$1.4B), and Military Service Personnel Accounts (\$0.4B), on behalf of Medicare eligible retirees, retiree dependents, and survivors. Subsequently, approval was obtained from the Office of Management and Budget (OMB) to increase FY 2007 apportionment authority by an additional \$30 million (M) for projected increased purchased health care services and \$650 thousand for the mandatory mailing of letters to Medicare-eligible beneficiaries explaining the availability and features of the Medicare Part D, Voluntary Pharmacy

## Management's Discussion and Analysis

Benefit Program. In FY 2006, the Fund initially authorized approximately \$7.2B in total health care services, civilian providers (\$5.5B), military medical treatment facilities (\$1.3B) and Military Service Personnel Accounts (\$0.4B), on behalf of Medicare eligible retirees, retiree dependents, and survivors. An additional purchased care requirement of \$150M was identified and approved by OMB in early September 2006 in support of increased utilization, particularly pharmacy services, above projected demand.

### Final Fiscal Year Requirements and Funding Plan

Fiscal Year	Purchased Care (Billions)	Operations & Maintenance (Billions)	Military Personnel (Billions)	Final (Billions)
2007	\$5.9	\$1.4	\$.4	\$7.7
2006	\$5.5	\$1.3	\$.4	\$7.2

The Fund receives income from three sources:

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

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

### MERHCF Funding Sources

Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment (Billions)	Normal Cost Contribution (Billions)	Interest on Investments (Billions)
2007	\$15.6	\$11.5	\$4.4
2006	\$16.6	\$11.1	\$4.1

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

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

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

TFL covers Medicare-eligible retirees 65 years of age or older, including retired guardsmen and reservists and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The

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## Management's Discussion and Analysis

Medicare-eligible retirees and family members of the non-DoD Uniformed Services (Coast Guard, Public Health Service, and National Oceanic and Atmospheric Administration) are also eligible for these benefits.

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

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

### **Health Care Purchased From Civilian Providers**

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

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

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 and 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.

At the beginning of each Fiscal Year, a new Funding Authorization Document for the TFL/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management (CRM) Division. By agreement with DFAS,

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## Management's Discussion and Analysis

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 purchased care payments planned for FY 2007 were approximately \$5.9B as compared to \$5.3B in FY 2006.

TMA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services (WPS) for purposes of processing all claims supported by the Fund, regardless of geographic region in which care was received. Dual eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single Fiscal Intermediary (FI) to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. The TDEFIC contract stipulates a cost of \$1.31 per unit for electronic claims and \$3.93 for paper claims.

### **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-Indianapolis (DFAS-IN) with the payment amounts by Service for MILPERS and DHP O&M that is reported on the Standard Form 1081, Voucher and Schedule of Withdrawals and Credits by DFAS-IN.

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

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## Management's Discussion and Analysis

Military Departments. A comparison of prospective payment amounts to actual workload and costs is accomplished in accordance with DoDI 6070.2, dated July 19, 2002.

The prospective payment for O&M for MTF provided care to Medicare-eligible beneficiaries in FY 2007 was \$1.4B versus \$1.3B in FY 2006. The increases in O&M expenditures were primarily due to increased drug costs and higher utilization of outpatient pharmacy services. While the cost of inpatient and outpatient services has risen slightly, the utilization of these services has declined slightly. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries in FY 2007 was \$0.42B versus \$0.43B in FY 2006.

### **Performance Measures**

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2007, the Fund had net assets available to pay benefits of \$107.5B and an actuarial liability of \$516.5B; the funding ratio was 20.9%. As of September 30, 2006, the Fund had net assets available to pay benefits of \$83.7B and an actuarial liability of \$538B; the funding ratio was 15.6%.

Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

### **Types of Investments**

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

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

All of these instruments are debt obligations of the U.S Government and are backed by the "full faith and credit" of the federal government. Debt obligations of the U.S.

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## Management's Discussion and Analysis

Government have virtually no risk of nonpayment of principal and interest at the specified due date.

The Fund receives management oversight from the Department of Defense Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service; the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller); and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board met in FY 2007 and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. The Board reviews current cash flow needs of the Fund and invests excess funds to match the duration of the assets with the duration of the liability.

### **Improper Payments Information Act**

The Improper Payments Information Act of 2002, as implemented by the Office of Management and Budget, requires federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments.

The Department of Defense reports its progress in reducing erroneous payments to both the President and the Congress. The Department's FY 2006 review did not identify any programs or activities at risk for "significant erroneous payments" in accordance with the Office of Management and Budget's criteria (i.e., programs with erroneous payments exceeding both \$10 million and 2.5 percent of program payments). For FY 2006, the Department reports on three high risk programs: military health benefits, military retirement, and military pay.

### *Risk Assessment*

The Department reviewed all of its programs and activities and determined that six programs/activities were susceptible to improper payments: Military Retirement, Travel Pay, Military Health Benefits, Military Pay, Civilian Pay, and Commercial Pay. These programs represent approximately 86 percent of the Department's total payments. The Department of Defense performed risk assessments for each of these programs/activities that addressed the strength of the internal controls in place to prevent improper payments (such as prepayment reviews), system weaknesses identified internally or by outside audit activities, voluntary returns of overpayments by vendors, etc.

### *Statistical Sampling*

Military Health Benefits, TRICARE is a triple option health benefit plan available for active duty family members, retirees and their family member and family members of deceased service members. To determine the statistically valid estimate of the annual amount of improper payments, the Department uses the following sampling methodology to pull encounter data records for the annual target health care cost audits of the managed care support services contracts.

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## Management's Discussion and Analysis

For each contract option period, statistically valid samples of claims with care end dates within the specified option period are selected for payment error auditing. Payment samples are stratified at multiple levels within the \$100 to \$100,000 range variable sampling using stratified sampling with optimum allocation to calculate the sample size for the payment errors.

To determine the statistically valid estimate of improper payments for quarterly claim audits, the Department pulls TRICARE encounter data records for claims processed by the managed care support contractors and the Medicare dual eligible contractor. Claims with a cost less than \$100 are not sampled (except for Medicare dual eligibility claims). One sample category includes all claims \$100,000 and more. Claims with a cost of greater than \$100 but less than \$100,000 are broken down into 12 sample categories. A formula is applied to calculate the sample size for each sample category. If the sample category universe count is less than 30, all the claims in that category are audited. The percentage of overpayments for the sample is applied to all the payments to determine the improper payment amounts.

### *Corrective Action Plans*

For many years, the Department has maintained contracts with payment performance standards for military health benefit claims processing. Zero tolerance is tied to the annual audit in that any overpayment found in the audit process is projected to the audit universe, and the managed care support contractor is liable. Zero tolerance is also tied to the quarterly audits in that any overpayment found in the audit process is the responsibility of the TDEFIC and managed care support contractors, both of whom are responsible for any overpayments. This contractual design provides a built-in incentive for contractors to continually perfect their claims processing system, up to the point where financial costs outweigh the benefits. Quarterly performance audits are also conducted wherein the contractor is required to meet the 2 percent performance standard. If that standard is exceeded, a monetary performance withhold is assessed.

Quarterly, the Department audits statistically valid samples that over the years have consistently produced an error rate of less than the 2 percent performance standard contained in the TRICARE contracts. Errors in health care claims processing can be potentially related to improperly submitted claims by the provider community, as well as a minimal degree of human error expected with handling a large volume of claims under the tight time parameters established by the prompt payment regulation and the claims processing timeliness performance standard. Based on the projected FY 2007 survey, the FY 2007 improper payment rate for the military health benefits is projected to be \$156.0 million or 2.0 percent.

Numerous prepayment and post-payment controls are built into the military health benefits' claims processing system to minimize improper payments. Every TRICARE claim is adjudicated against this system of checks and balances. The managed care support contractors are required to utilize specialized software containing specific auditing logic designed to ensure appropriate coding on professional service claims and

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## Management's Discussion and Analysis

eliminate overpayments. The software does not set coverage/benefit policy; it merely audits claims for appropriate code combinations. For calendar year 2006, the prepayment automated software used by managed care contractors accounted for approximately \$268 million in cost avoidance for the TRICARE program (MERHCF subset data is not available).

Another control is the prepayment review required under the TRICARE contracts. The contractors use this strategy to prevent payment for questionable billing practices. Prepayment review allows for a closer examination of the services rendered and may require the provider to submit medical documentation to support the services billed. In calendar year 2006, prepayment review resulted in a cost savings of \$10.1 million (MERHCF subset data is not available).

In Calendar Year 2006, fraud judgments for TRICARE based on intervention by Department of Justice were ordered for \$36.7 million. This included a large settlement with Tenet Healthcare Corporation for over \$20 million. In addition, the Department requires each contractor to have a fraudulent claims investigation or anti-fraud unit to identify and investigate any pattern of suspicious or potential fraudulent billings. Recoupments resulting from cases identified, combined with proactive case work by TRICARE, has resulted in another \$5.3 million being identified for administrative recoupment. These judgments and recoveries are benefit dollars returned to the program (MERHCF subset data is not available).

For FY 2006, the error rate for the MERHCF and the TDEFIC contract was 1.98%, under the 2% contract standard and in compliance with the IPIA.

### **Status of FY 2006 Audit Findings**

Our independent auditors noted material weaknesses and other discrepancies during the conduct of the FY 2006 Financial Statement Audit. The material weaknesses center around three issues:

1. The lack of a patient-level cost accounting system
2. Insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, and
3. Inadequate systems integration testing of TRICARE Encounter Data System ("TEDS") implementation, resulting in a Purchased Care Claims backlog

At issue with the lack of a patient-level cost accounting system is the fact that the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2007 and 2006 includes approximately \$75B (14% of total) and \$83B (15% 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 cost for the year ended September 30, 2007, include approximately \$3.7B and \$1.8B, respectively, and for the year ended September 30, 2006, include approximately \$4.0B and \$1.7B, respectively, of amounts

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## Management's Discussion and Analysis

related to direct care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

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

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

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for actuarial liability. The reconciliation tasks performed by TMA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service (PDTS), data to support both the prospective payment and calculation of the actuarial liability. DoD Pharmacy Program Office and TMA management are in the process of developing an RxCOTS pharmacy system as part of the Armed Forces Health Longitudinal Technology Application. The RxCOTS will interface both with the Defense Medical Logistic Standard Support (DMLSS) system and PDTS. The RxCOTS patient-level interfaces will improve PDTS accuracy of the ingredient costs of pharmaceuticals issued at MTF outpatient pharmacies.

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

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## Management's Discussion and Analysis

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

### **Actions Taken**

Since FY 2003, when the Fund was established, MERHCF management has attempted to resolve the auditor-identified material weaknesses through the development of key milestone initiatives. These initiatives were established and managed by TMA leadership and intended to serve as work-arounds to address the Military Services' financial systems' deficiencies. The material weaknesses are associated with computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs. Disappointingly, the milestone initiatives have not produced the desired results in the projected time frame. Clearly, each of the Military Services must become more actively involved in the resolution of the identified weaknesses. We have initiated coordination with the DoD Comptroller Financial Improvement and Audit Readiness (FIAR) Office to engage the Military Services in better defining their required corrective actions and assuming more direct responsibility in resolving the material weaknesses. Each of the Military Services will incorporate into their existing FIAR plans key milestones to correct the auditor-identified deficiencies associated with coding of medical records and the accurate documentation of costs to support the delivery of health care to Medicare-eligible beneficiaries in MTFs.

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

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

The Contract Resource Management (CRM) Division in Aurora, Colorado, monitors claims processing activities performed by the TDEFIC fiscal intermediary, WPS, in support of purchased care activities for Medicare-eligible beneficiaries. During FY 2004, CRM transitioned to a new claims documenting database. The transition process resulted in claims processing discrepancies that generated significant claims processing backlogs in the last quarter of FY 2004 and the first quarter of FY 2005 (aggregating approximately \$133M). Consequently, the IBNR calculation as of September 30, 2004, was understated due to the missing claims data, and no update to the IBNR calculation for the first quarter of FY 2005 could be made. Estimates for the remainder of FY 2005 included a substantial margin of conservatism due to the concerns about the accuracy and completeness of the underlying claims data. The backlog of claims has been subsequently resolved, and all appropriate claims data has been included in the

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## Management's Discussion and Analysis

calculations of IBNR as of September 30, 2006. However, we were not able to quantify the complete budgetary and proprietary accounting effects of the backlog on the MERHCF financial statements for FY 2004, FY 2005, and FY 2006, respectively.

To better monitor purchased care claims processing and mitigate the potential for an undetected large increase in claims backlogs occurring in the future, MERHCF management has developed a purchased care claims backlog metric to report quarterly to OUSD(C).

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

By their nature, IBNR calculations need regular or typical data. The data does not necessarily have to be 100 percent complete, but the data must have a large percentage of claims included, and most importantly, the degree of incompleteness should remain relatively constant over time. The IBNR metric guards against the very large, unpredictable backlogs that DoD experienced in FY 2004 and early FY 2005.

The goal is to ensure the IBNR calculation is based upon no less than 85% of the liability contained on all processed and backlogged claims. It is anticipated that 8% to 12% of available monthly claims will not be included in the IBNR calculation due to the cutoff of processed claims by 10:00 am on the last business day of the month. The cutoff was established to ensure IBNR calculations could be completed in time to meet reporting requirements. For the close of FY 2006 and again in FY 2007, the IBNR calculation included 100% of available monthly claims.

### **Coast Guard Issue**

The determination of the amount of funds to be provided by the MERHCF to the Coast Guard for care provided in their clinics to Medicare-eligible beneficiaries remains an open issue. In FY 2004, Coast Guard representatives presented to the MERHCF Audit Committee an annual requirement of approximately \$2.5M. This estimate was based on historical budget reports and average costs for MERHCF patients seen in their clinics and for prescribed medications from their pharmacies.

The MERHCF Audit Committee questioned the rationale of the assumptions and computations used to project the annual requirement and asked the Coast Guard Inspector General (CGIG) to review and approve the cost estimate methodology and funds request. Further, the MERHCF Audit Committee requested a formal written request for funds signed by a senior Coast Guard official once the methodology was reviewed and approved by the CGIG.

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## Management's Discussion and Analysis

Through FY 2006 and FY 2007, the Coast Guard and the CGIG were in the process of developing an acceptable methodology for the computation of MERHCF funding requirements to support Coast Guard MTF care given to Medicare dual-eligible beneficiaries. The MERHCF Audit Committee will not approve the release of MERHCF funds to Coast Guard clinics until a formal written request is submitted with CGIG approval.

### **Legislative Proposals**

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

Section 708(b) of the 2007 NDAA Conference Report directed the Secretary of Defense to transfer \$186M from the un-obligated balances of the National Defense Stockpile Transaction Fund to the DoD Medicare-Eligible Retiree Health Care Fund.

### **Pharmaceutical Refunds for Retail Pharmacy Support**

The Veterans Health Care Act (VHCA) of 1992, codified at 38 U.S.C., 126, established federal ceiling prices (FCP) of covered pharmaceuticals (requiring a minimum 24% discount off non-Federal average manufacturing prices (non-FAMP) – non-FAMP procured by the four designated agencies covered in the Act: Department of Veterans Affairs (VA), DoD, Coast Guard, and the Public Health Service/Indian Health Service. VA administers the VHCA discount program on behalf of the four specified agencies. Under the Federal Supply Schedule (FSS) program (41 U.S.C., 259(b)(3)(A)), the General Services Administration (GSA) has authorized VA to award and manage schedule contracts with pharmaceutical companies. FSS contracts allow Federal agencies to obtain pharmaceuticals at prices associated with volume buying which, at times, may be lower than FCPs under VHCA. DoD currently has access to FCP and FSS prices for pharmaceuticals used in MTFs and the TRICARE Mail Order Pharmacy (TMOP) program by either direct purchases or procurements through a Defense Supply Center Philadelphia Prime Vendor. Federal prices were not available to DoD through retail pharmacies under the previous at-risk TRICARE Managed Care Support Contracts (MCSCs) because the VA had determined the contracts were not structured to meet the VHCA statutory requirements for an agency-controlled centralized commodity management system.

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## Management's Discussion and Analysis

The new TRICARE Retail Pharmacy Program carved out retail pharmacy from the MCSCs, consolidated delivery of retail prescriptions under a single Pharmacy Benefits Manager (PBM) contract, and addressed VA's previous concerns under VHCA. The PBM contractor provides a retail pharmacy network and acts as fiscal intermediary, upon TMA authorization, to issue funds from a government account in payment for prescriptions dispensed to TRICARE beneficiaries.

### Discussion

In May, 2004, the VHCA was applied to the TRICARE Pharmacy Benefits Program, specifically, for beneficiaries obtaining covered pharmaceuticals from retail pharmacies. The retail pharmacies obtain the drugs they dispense at non-discounted prices. The mechanism for payment involved a "Dear Manufacturer" letter sent to the pharmaceutical manufacturers. The letter required that these manufacturers calculate a discount rate and pay refunds to DoD for covered drugs purchased at network pharmacies. The letter demanded refunds as of September 30, 2004.

The Coalition for Common Sense in Government Procurement requested legal review of that letter, and the VA agreed to postpone enforcement pending judicial review. While enforcement was stayed during judicial review, some manufacturers made voluntary refunds to DoD during this time period. As of August 31, 2006, the MERHCF had received \$23.6M in FY 2005 and \$30.2M in FY 2006. These refunds are identified by fiscal year and specific pharmaceutical manufacturer.

By decision dated September 11, 2006, the Court of Appeals for the Federal Circuit set aside the "Dear Manufacturer" letter and, on procedural grounds, ruled against the government's position in the federal drug pricing litigation. The Court held that the action taken by the VA in determining the revised TRICARE Retail Pharmacy program qualified for federal ceiling prices was in the nature of a substantive regulation and that it, therefore, should have been issued for public comment before it was adopted. The Court, thus, set it aside and remanded the matter to the VA for further consideration. The Court did not rule on the major substantive issue of whether the TRICARE Retail Pharmacy program should be considered as covered by the current law. Thus, the VA could reassert its current interpretation of the law through a notice-and-comment rulemaking procedure.

As a result of the Court decision, TMA was advised by TMA General Counsel to suspend indefinitely the quarterly refund invoicing to manufacturers involving network retail pharmacy drugs. The VA General Counsel has requested the Department of Justice not to seek rehearing of the Court's decision. Therefore, TMA General Counsel advised the MERHCF to reimburse any refunds received in FY 2005 and FY 2006. A nonfederal accounts payable to the public of \$53.8M was established as of September 30, 2006 to reimburse affected pharmaceutical manufacturers during the 1<sup>st</sup> Quarter, FY 2007. In accordance with 10 U.S.C. 1113(c)(2), transfers from the MERHCF must be made no later than September 30, 2007 for FY 2005 refunds and no later than September 30, 2008 for FY 2006 refunds. The pharmaceutical manufacturing companies were notified of the

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## Management's Discussion and Analysis

requirement to reimburse them for the involuntary drug refunds and ask to submit individual claims for reimbursement. As of September 30, 2007 all but \$32.7 thousand had been reimbursed to the pharmaceutical companies. The \$32,652 (\$19,419 from FY 2005 and \$13,233 from FY 2006) represents monies for which 5 drug companies have not requested reimbursement.

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

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

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

As of September 30, 2007, the MERHCF invoiced a total of \$15.908M and had received \$15.854M in pharmacy retail network rebates under both VARR programs.

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

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

## Management's Discussion and Analysis

### Comparative Financial Data

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

**Medicare-Eligible Retiree Health Care Fund**  
**Analysis of Financial Statements**  
for the years ended September 30, 2007 and 2006  
(\$ in Thousands)

<u>Consolidated Balance Sheet</u>	<u>2007</u>	<u>2006</u>	<u>Difference</u> Increase/ (Decrease)
Fund Balance with Treasury - Army payment of FY 2005 normal cost contribution was not received until last day of FY 2006 – could not be invested by close of FY 2006	\$5,000	\$37,855	(\$32,855) (87%)
Investments (Intra-Governmental Securities) - Revenue from Treasury Payments, Service Contribution, and Interest	\$109,549,060	\$85,394,986	\$24,154,074 28%
Account Receivable (Non-Federal) - Increase from increased purchased care inpatient/outpatient workload, increased TMOP workload, decreased allowance for uncollectibles	\$10,393	\$8,803	\$1,590 18%
Accounts Payable (Intra-Governmental) - Increased due to increased use of TMOP and cost of pharmaceuticals	\$70,276	\$49,109	\$21,167 43%
Accounts Payable (Non-Federal) Decreased - Decreased due to payment of \$53.8M refunds to pharmaceutical manufacturers - Increased use of retail pharmacies, USFHP & TFL by MERHCF beneficiaries ~\$16.9M	\$186,361	\$223,265	(\$36,904) (17%)
Military Retirement and Other Federal Employment Benefits - Actuarial liability decreased for reasons stated below	\$516,479,229	\$538,032,547	(\$21,553,318) (4%)
Benefits Due and Payable - IBNR increased only \$20.8M (3.4%) from FY 2006 to FY 2007	\$625,418	\$604,664	\$20,754 3.4%
<b><u>Statement of Net Cost</u></b>			
Public costs decreased primarily due to changes in the computation of the health care liability discussed in the "Military Retirement and Other Federal Employment Benefits" section	(\$16,344,340)	\$5,329,733	(\$21,674,073) (407%)
<b><u>Statement of Changes In Net Position</u></b>			
Transfers-in/out Without Reimbursement increased due to a one-time transfer of funds from the National Defense Stockpile Transaction Fund in 1 <sup>st</sup> Quarter, FY 2007. Transfer was made per the requirements of section 708(b) of the FY 2007 National Defense Authorization Act Conference Report	\$186,000	-0-	\$186,000 100%
<b><u>Statement of Budgetary Resources</u></b>			
Non-Expenditure Transfers, Net, Anticipated and Actual increased \$186M due to the Transfer described previously in the Statement of Changes in Net Position Section	\$186,000	-0-	\$186,000 100%

### **Fund Balance with Treasury (FBWT)**

The FBWT decreased \$32.9M (87%). The MERHCF has a normal fluctuation of FBWT due to a timing difference between the receipt of the notification of the final payment or contribution and the required investment deadline at Treasury. The MERHCF withholds \$5.0M in FBWT from overnight investments to ensure the availability of sufficient funds to cover disbursements made on the last day of the quarter that cannot be captured in time to meet the month-end investment timeframe. The \$5.0M total in FBWT as of September 30, 2007 is the normal holdback. The \$37.9M total in FBWT as of September 30, 2006 was the sum of the holdback plus a \$32.4M collection from the Army Reserve for a correction of the FY 2005 contribution.

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

Investments, Net increased \$24.2B (28%). This increase is primarily the result of investing \$21.3B of the \$27.2B in Treasury, Military Service, and other Uniformed Service annual contributions. The remainder was used for current operations of the MERHCF.

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

Primarily, three activities generate the MERHCF accounts receivable (public). The majority of receivables result from purchased health care delivery claims processing activities conducted by the TRICARE Dual Eligible Fiscal Intermediary Contractor (TDEFIC). The MERHCF also establishes accounts receivable with the TRICARE Mail Order Pharmacy (TMOP) contractor to recoup the patient co-payments made for each prescription issued through the TMOP program. Finally, the MERHCF establishes an account receivable for voluntary refunds received from pharmaceutical manufacturers for including their prescription drugs in the DoD pharmacy formulary.

The TDEFIC holds accounts receivable up to 150 days in accordance with contract requirements to attempt collection. Once the accounts age to 150 days, TDEFIC transfers the larger debts, totaling at least \$600, to the TMA General Counsel (GC) for review, further appropriate collection action, and ultimate transfer to U.S. Treasury. Since the TDEFIC does not transfer debts less than \$600, these debts age well beyond 150 days.

The debts held by the contractor and the debts held by the TMA/GC are each considered in total to be separate age groups because, generally, debts held by the GC are older than debts held by the contractor, and collections are less certain. TMA, in September each year, calculates the actual write-offs for each of the two debt categories for the previous year.

In FY 2007, Non-Federal Receivables, Net, increased \$1.6M (18%) due to increases in the purchased care claims processing, (\$0.7M), increased volume of TMOP issued prescriptions which increased the volume of patient co-payment recoupment (\$0.7M), and reduction in the computation of the "Allowance for Doubtful Accounts" (\$0.2M).

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## Management's Discussion and Analysis

The increase in contractor held claims is directly attributable to increased usage of purchased care providers. The increase in TMOP co-payment reimbursements is related to the increased utilization of TMOP benefits. The reduction in the Allowance for Doubtful Accounts is impacted by a significant reduction in debt write-offs in FY 2007 due to the cross servicing of claims through the U.S. Treasury; approximately \$0.6M were collected by Treasury in FY 2007 through cross servicing of MERHCF delinquent accounts receivable. The bad debt allowance percentages, which significantly influence the computation of the allowance for doubtful accounts declined as follows from FY 2006 to FY 2007:

GC administered debts:	FY 2006	20.11%
	FY 2007	3.32%
Contractor held debts:	FY 2006	1.85%
	FY 2007	0.54%

### Accounts Payable (Intra-Governmental)

Intra-Governmental Payables increased \$21.2M (43%) due to both the increased use of the mail order pharmacy by DoD Medicare-eligible beneficiaries and the increased cost of pharmaceuticals. These payables are to the Defense Logistics Agency for replenishment of the TMOP contractor's drug inventory back to the initial level established at the beginning of the TMOP program.

### Accounts Payable (Non-Federal)

Non-Federal Payables (to the Public) decreased \$36.9M (17%) due primarily to the payment in FY 2007 of the \$53.8M accounts payable that existed at the close of FY 2006 for refunds to pharmaceutical manufacturers. The elimination of the \$53.8M accounts payable was offset by increased payables of \$16.9M associated with increased demand for retail pharmacy services, USFHP enrollments, and TFL utilization.

### Military Retirement and Other Federal Employment Benefits

The Actuarial Liability has decreased from \$538.0B to \$516.5B. The decrease (\$ in Thousands) tracked as follows:

a. Actuarial Liability as of 9/30/06	\$538,032,547
b. Expected Normal Cost for FY 2007	\$ 10,801,492
c. Expected Benefit Payments for FY 2007	\$ (8,494,519)
d. Interest Cost for FY 2007	\$ 34,040,697
e. Actuarial (gains)/losses due to other factors	\$ (4,783,551)
f. Actuarial (gains)/losses due to changes in trend assumptions	<u>\$ (53,117,437)</u>
g. Actuarial Liability as of 9/30/07	<u>\$516,479,229</u>
h. Change in Actuarial Liability	<u>\$ (21,553,318)</u>

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## Management's Discussion and Analysis

Each year the Actuarial 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 \$36,347,670 thousand in the Actuarial Liability was expected during FY 2007 (line b plus line c plus line d). The September 30, 2007, Actuarial Liability includes changes due to new assumptions and actuarial experience. The actuarial gain due to new medical trend assumptions is -\$53,117,437 thousand (line f). The actuarial gains and losses due to other factors (net -\$4,783,551 thousand, line e) includes new population data, a 0.25% decrease in the discount rate, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend and discount rates.

### Statements of Net Cost

Public Costs for MERHCF decreased \$21.7B (407%) primarily due to the change in the computation of the health care liability discussed in the Military Retirement and Other Federal Employment Benefits Section.

### Statements of Changes In Net Position

Transfers-in/out Without Reimbursement increased \$186M due to a transfer of funds from the National Defense Stockpile Transaction Fund in 1<sup>st</sup> Quarter, FY 2007. This transfer was made in accordance with the requirements of section 708(b) of the FY 2007 National Defense Authorization Act Conference Report.

### Statements of Budgetary Resources

Non-Expenditure Transfers, Net, Anticipated and Actual increased \$186M due to the transfer described previously in the Statement of Changes in Net Position Section.

### Reconciliation of Net Cost of Operations to Budget

Undelivered Orders decreased \$8.7M (41%) primarily due to a decrease of \$10.0M in orders for medical/surgical inpatient and outpatient care that were overstated in FY 2006.

Components Requiring or Generating Resources in Future Periods – Other decreased \$22.0B primarily due to the change in the FY 2007 actuarial liability. This change was primarily caused by a revision of two key economic assumptions: the valuation discount rate and medical trend rates.

### 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 MERHCF Management Discussion and Analysis, DoD, and not MERHCF, represents the legislative definition of an Agency. Beginning with FY 2006, as directed in OMB Circular A-123, *Management's*

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## Management's Discussion and Analysis

*Responsibility for Internal Control, Appendix A, Internal Control Over Financial Reporting*, the 24 CFO Act agencies (includes DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall Federal Managers Financial Integrity Act (FMFIA) assurance statement. OUSD(C) issued guidelines to the leadership of DoD Components, including MERHCF, as to how to support this DoD reporting requirement. TMA management complied with the required guidelines for MERHCF.

In its FY 2007 assessments, TMA management assessed that, except for direct care-related material weaknesses addressed above, the MERCHF (as an OMB designated Financial Statement Reporting Entity (FSRE)) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2); while the current financial management systems do not currently conform to financial systems requirements (FMFIA § 4) TMA management is working with DFAS to implement corrective actions for purchased care operations to comply with (FMFIA § 4). MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Services have implemented financial systems that comply with (FMFIA § 4). The OUSD (C ) published Financial Improvement and Audit Readiness Report as of September 30, 2007, indicates a FY 2017 timeline for the Services to achieve (FMFIA § 4) compliance.

TMA management previously reported that, except for the direct care - related material weakness discussed above, and documented in its *Annual Statement Required Under the FMFIA, dated July 3, 2007*, and its non-compliance with OMB Circular A-127, the MERHCF had effective internal controls over financial reporting. However, subsequent to the assessment process, an additional material weakness was identified during FY 2007. During the preparation of the Fund's year-end financial statements, the initial presentation of certain offsetting receipts accounts of the MERHCF for FY 2006 and FY 2007 was determined to be noncompliant with U.S. Treasury guidance, affecting the Statement of Budgetary Resources and the disclosure of financing activities. The change in U.S. Treasury guidance for offsetting receipts, which was effective for FY 2006, was not previously identified for the MERHCF's financial statement preparation process. In its FY 2006 Report of Treasury Receipts by Source, Treasury identified certain receipt accounts that should be identified as distributed offsetting receipts by the MERHCF and the DoD.

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

The Status of FY 2006 Audit Findings and Actions Taken above include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weaknesses and non-conformances.

## Management's Discussion and Analysis

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

Audit Opinion	Qualified				
Restatement	Yes				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	1	0	0	0	1
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	0	0	1
Purchased Care Claims Backlog (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	1	0	0
Presentation of Distributed Offsetting Receipts	0	1	0		1
<i>Total Material Weaknesses</i>	3	1	1	0	3

**Table 2.**  
Summary of Management Assurances

<b>Effectiveness of Internal Controls over Financial Reporting (FMFIA § 2)</b>						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	1	0	0	0	0	1
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	0	0	0	1
Purchased Care Claims Backlog (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	1	0	0	0
Presentation of Distributed Offsetting Receipts	0	1	0		0	1
<i>Total Material Weaknesses</i>	3	1	1	0	0	3

## Management's Discussion and Analysis

<b>Effectiveness of Internal Controls over Operations (FMFIA § 2);</b>						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	1	0	0	0	0	1
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	0	0	0	1
Purchased Care Claims Backlog (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	1	0	0	0
<i>Total Material Weaknesses</i>	3	0	1	0	0	2

## Management's Discussion and Analysis

<b>Conformance with financial management system requirements (FMFIA § 4)</b>						
Statement of Assurance	Except for the Trust Fund Accounting System (TFAS) used by DFAS-IN, Purchased Care systems conform to financial management systems requirements; Direct Care Cost systems do not comply with financial management systems requirements					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	1	0	0	0	0	1
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	0	0	0	1
Purchased Care Claims Backlog (Carried Forward and Updated Finding from Fiscal Year FY2005)	1	0	1	0	0	0
<b>Total non-conformances</b>	<b>3</b>	<b>0</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>2</b>

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

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

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

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## **Management's Discussion and Analysis**

requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

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

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

*PRINCIPAL STATEMENTS*

# Principal Statements

**Department of Defense  
DoD Medicare-Eligible Health Care Fund  
BALANCE SHEETS  
For the Years Ended September 30  
(In Thousands)**

	<u>2007</u>	<u>2006</u>
<b>ASSETS</b>		
Intragovernmental:		
Fund Balances with Treasury (Note 2)	\$ 5,000	\$ 37,855
Investments (Note 3)	<u>109,549,060</u>	<u>85,394,986</u>
Total Intragovernmental Assets	\$ <u>109,554,060</u>	\$ <u>85,432,841</u>
Accounts Receivable, Net (Note 4)	<u>10,393</u>	<u>8,803</u>
<b>TOTAL ASSETS</b>	<u>\$ <u>109,564,453</u></u>	<u>\$ <u>85,441,644</u></u>
 <b>LIABILITIES</b>		
Intragovernmental:		
Accounts Payable (Note 6)	\$ <u>70,276</u>	\$ <u>49,109</u>
Total Intragovernmental Liabilities	\$ <u>70,276</u>	\$ <u>49,109</u>
Accounts Payable (Note 6)	186,361	223,265
Military Retirement Benefits and Other		
Employment Benefits (Notes 5 and 7)	516,479,229	538,032,547
Benefits Due and Payable (Notes 5 and 7)	<u>625,418</u>	<u>604,664</u>
<b>TOTAL LIABILITIES</b>	\$ <u>517,361,284</u>	\$ <u>538,909,585</u>
 <b>NET POSITION</b>		
Cumulative Results of Operations	<u>(407,796,831)</u>	<u>(453,467,941)</u>
<b>TOTAL NET POSITION</b>	<u>\$ <u>(407,796,831)</u></u>	<u>\$ <u>(453,467,941)</u></u>
 <b>TOTAL LIABILITIES AND NET POSITION</b>	 <u>\$ <u>109,564,453</u></u>	 <u>\$ <u>85,441,644</u></u>

The accompanying notes are an integral part of these statements.

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

	<u>2007</u>	<u>2006</u>
<b>PROGRAM COSTS</b>		
Gross Costs	\$ (13,945,803)	\$ 7,610,604
(Less: Earned Revenue)	<u>(31,539,307)</u>	<u>(31,802,718)</u>
Net Program Costs	\$ (45,485,110)	\$ (24,192,114)
<b>Net Cost of Operations</b>	<u>\$ (45,485,110)</u>	<u>\$ (24,192,114)</u>

Additional information included in Note 8.

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

# Principal Statements

**Department of Defense  
DoD Medicare-Eligible Retiree Health Care Fund  
STATEMENTS OF CHANGES IN NET POSITION  
For the Years Ended September 30  
(In Thousands)**

	<u>2007</u>	<u>2006</u>
<b>CUMULATIVE RESULTS OF OPERATIONS</b>		
Beginning Balances	\$ (453,467,941)	\$ (477,660,055)
Budgetary Financing Sources:		
Transfers-in without reimbursement	\$ 186,000	\$ 0
Other Financing Sources	0	0
Total Financing Sources	\$ 186,000	\$ 0
Net Cost of Operations (+/-)	\$ (45,485,110)	\$ (24,192,114)
Net Change	\$ 45,671,110	\$ 24,192,114
Cumulative Results of Operations	\$ (407,796,831)	\$ (453,467,941)
Unexpended Appropriations, Beginning Balance	\$ 0	\$ 0
Budgetary Financing Sources	0	0
Total Unexpended Appropriations	\$ 0	\$ 0
<b>Net Position</b>	<b>\$ (407,796,831)</b>	<b>\$ (453,467,941)</b>

The accompanying notes are an integral part of these statements.

# Principal Statements

**Department of Defense  
DoD Medicare-Eligible Retiree Health Care Fund  
STATEMENTS OF BUDGETARY RESOURCES  
For the Years Ended September 30  
(In Thousands)**

	<u>2007</u>	<u>2006</u> (As Restated)
<b>BUDGETARY RESOURCES</b>		
<b>Unobligated balance, brought forward, October 1:</b>	\$ 0	\$ 97,212
Budget Authority:		
Appropriation	31,200,621	31,528,510
Subtotal	\$ 31,200,621	\$ 31,625,722
Nonexpenditure transfers, net, anticipated and actual	186,000	0
Temporarily not available pursuant to Public Law	(23,810,932)	(24,549,875)
<b>Total Budgetary Resources</b>	<u>\$ 7,575,689</u>	<u>\$ 7,075,847</u>
<b>STATUS OF BUDGETARY RESOURCES</b>		
Obligations incurred:		
Direct	\$ 7,575,689	\$ 7,075,847
Subtotal	\$ 7,575,689	\$ 7,075,847
Unobligated balance:		
Apportioned	0	0
Subtotal	\$ 0	\$ 0
Unobligated Balance Not Available	\$ 0	\$ 0
<b>Total Status of Budgetary Resources</b>	<u>\$ 7,575,689</u>	<u>\$ 7,075,847</u>
<b>CHANGE IN OBLIGATED BALANCE</b>		
Obligated Balance, net		
Unpaid obligations, brought forward October 1	\$ 397,172	\$ 387,881
Total unpaid obligated balance, net	\$ 397,172	\$ 387,881
Obligations incurred net (+/-)	7,575,689	7,075,847
Gross Outlays	(7,604,088)	(7,066,556)
Obligated Balance, Net - end of period		
Unpaid Obligations	368,773	397,172
<b>Total unpaid obligated balance, net, end of period</b>	<u>\$ 368,773</u>	<u>\$ 397,172</u>
<b>NET OUTLAYS</b>		
Net Outlays:		
Gross Outlays	\$ 7,604,088	\$ 7,066,556
Distributed Offsetting Receipts	(19,653,179)	(20,390,638)
<b>Total Outlays</b>	<u>\$ (12,049,091)</u>	<u>\$ (13,324,082)</u>

Additional information included in Notes 9 and 13.

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

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

***NOTES***  
***TO THE***  
***PRINCIPAL STATEMENTS***

# Notes to the Principal Statements

## DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND NOTES TO THE PRINCIPAL STATEMENTS FOR THE YEARS ENDED SEPTEMBER 30, 2007 AND 2006

### NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. The Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the Fund or MERHCF) was authorized by Public Law (PL) 106-398 for the accumulation of funds to finance the liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. The Fund began operations effective October 1, 2002.

These financial statements report the financial position and results of operations for the Fund, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Trust Fund Accounting Division, Directorate for Agency Wide Financial Statements and Trust Funds Directorate for Corporate Accounting, Directorate for Standards and Compliance, Defense Finance and Accounting Service (DFAS), in accordance with the requirements of Office of Management and Budget (OMB) Circular A-136, "Financial Reporting Requirements," as revised, and accounting principles generally accepted in the United States of America. The Fund's financial statements are prepared by DFAS 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. The financial statements account for all resources for which the Fund is responsible, unless otherwise noted.

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

C. Appropriations and Funds. The Fund was authorized by the "Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001." The purpose of the Fund is to pay the costs of all Military Service and 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.

Since 1<sup>st</sup> Quarter, FY 2006, all appropriations received are considered earmarked funds. Earmarked funds are financed by specifically identified revenues; required by statute to be used for designated activities, benefits, or purposes; and remain available over time. Earmarked funds are also required to account for and report on the receipt, use and retention of revenues and other financing sources that distinguish them from general revenues. The MERHCF receives its appropriations and funds as earmarked funds. The MERHCF uses these appropriations and funds for daily execution of its mission and to report subsequently on resource usage. The MERHCF's U.S. Treasury symbol is 97X5472.

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 its three principal members, the Secretary of the Treasury, the Director of the OMB, and the Comptroller General of the United States. The Statements of Federal Financial Accounting Standards (SFFAS) have been issued by the FASAB, following procedures adopted by the FASAB principles. Some SFFAS have deferred effective dates.

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

## Notes to the Principal Statements

- (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 to the circumstance. When directed by OMB, through OMB Circular A-136, 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 Circular A-136.

E. Revenues and Other Financing Sources. The FY 2005 Defense Authorization Act assigned Treasury, vice the Uniformed Services, the responsibility of paying normal cost contributions into the Fund, starting in FY 2006. In FY 2006, the beginning of fiscal year Treasury contribution also included the total normal cost amount for the year. This contribution is determined based on per-capita normal cost rates approved by the DoD MERHCF Board of Actuaries times the expected average force strength for the Uniformed Services. Thus, the Uniformed Services no longer make monthly contributions into the Fund. Contributions are recognized when due to the Fund.

F. Recognition of Expenses. For financial reporting purposes, the Fund recognizes benefit expenses in the period incurred. However, because MERHCF's financial feeder systems were not designed to collect and record financial information on the full accrual basis, accrual adjustments are made for major items such as accounts receivable and accounts payable. As of the 3<sup>rd</sup> Quarter, FY 2006, payments are now made in the quarter that the Military Treatment Facility (MTF) expenses will be incurred. Previously, during the interim quarters, prior to the last quarter, advances were made for the MTF expenses for the upcoming quarters. Those expenses were recognized at the outset of each quarter and recorded as an advance to the MTFs. There were no advances recorded at September 30, 2007 or September 30, 2006, and there will be no advances recorded in any future quarter.

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

H. Funds with the U.S. Treasury. 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.

The Fund's financial resources are maintained in U.S. Treasury Accounts. The DFAS processes all Fund receipts and adjustments. The DFAS prepares monthly reports, which provide information to the U.S. Treasury on transfers and deposits.

In addition, DFAS submits reports to Treasury, by appropriation, on collections received. Treasury then records this information to the FBWT account maintained in the Treasury system. Differences between the Fund-recorded balance in the FBWT account and the Treasury FBWT are reconciled.

I. Accounts Receivable. As presented in the Balance Sheets, accounts receivable includes accounts, claims, and refunds receivable from the public as well as intragovernmental receivables due from the Uniformed Services. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the

## Notes to the Principal Statements

Fund. The Fund does not recognize an allowance for estimated uncollectible amounts due from intragovernmental receivables.

J. 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 the 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. The MERHCF's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities. The MERHCF receives interest semiannually on the value of its marketable, market-based securities from the U.S. Treasury. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 3.

K. Net Position. Net position consists of cumulative results of operations and unexpended appropriations. Cumulative results of operations represent the net difference, since the inception of an activity, between the net cost of operations and financing sources. Effective FY 2002, when the Fund began operations, the cumulative results also include transfers in and out of assets without reimbursement.

Unexpended Appropriations represent the amounts of authority that are unobligated and have not been rescinded or withdrawn. Unexpended appropriations also represent amounts obligated for which legal liabilities for payments have not been incurred. The MERHCF does not report unexpended appropriations because these amounts are not applicable.

L. Comparative Data. For comparative purposes, the financial statements display both FY 2006 and 2007 data. Certain FY 2006 balances have been reclassified to conform to the FY 2007 presentation to reflect changes required in conjunction with the OMB Circular A-136, "Financial Reporting Requirements," updated and revised in June 2007.

As required by OMB Circular A-136, the reconciliation of budgetary obligations and non-budgetary resources available to the MERHCF with its net cost of operations information that was previously presented in a separate statement of financing is now presented in Note 10, Reconciliation of Net Cost of Operations to Budget, on a comparative basis.

M. 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.

N. Actuarial Information. The MERHCF 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 to the end of the year using accepted actuarial techniques. The "projected benefit obligation" method is used as required by SFFAS No. 5, "Accounting for Liabilities of the Federal Government."

## Notes to the Principal Statements

### NOTE 2. FUND BALANCES WITH TREASURY (FBWT)

(\$ in Thousands)	FY 2007	FY 2006
Fund Balances:		
Trust Funds	\$ <u>5,000</u>	\$ <u>37,855</u>
Status of Fund Balance with Treasury:		
Unobligated Balance		
Available	\$ 0	\$ 0
Unavailable	108,079,641	84,268,709
Obligated Balance not yet Disbursed	368,773	397,173
Non-FBWT Budgetary Accounts	(108,443,414)	(84,628,027)
Total	\$ <u>5,000</u>	\$ <u>37,855</u>

The FBWT decreased \$32.9 million (87%) because a collection was processed late on the last business day of September 2006 and was not available to invest before the end of the fiscal year. This collection represented an underpayment of the Army Reserves' FY 2005 contribution. There were no similar late collections in September 2007.

**Fund Balances.** Generally, the FBWT is maintained at approximately \$5.0 million to ensure that sufficient funds are available to cover estimated daily disbursements with the remaining funds invested in non-marketable market-based securities.

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

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

**Non-FBWT Budgetary Accounts.** These amounts represent adjustments to budgetary accounts that do not affect FBWT, such as contract authority, borrowing authority, and investment accounts. This category reduces the Status of FBWT. The MERCHF balance represents investment accounts.

## Notes to the Principal Statements

### NOTE 3. INVESTMENTS

		<b>FY 2007</b>				
(\$ in Thousands)		Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities:						
Non-Marketable, Market-Based		\$ 110,206,344	Effective Interest	\$ (1,762,930)	\$ 108,443,414	\$ 106,692,773
Subtotal		\$ 110,206,344		\$ (1,762,930)	\$ 108,443,414	\$ 106,692,773
Interest Receivable		1,105,646		0	1,105,646	1,105,646
Total		<u>\$ 111,311,990</u>		<u>\$ (1,762,930)</u>	<u>\$ 109,549,060</u>	<u>\$ 107,798,419</u>

		<b>FY 2006</b>				
		Cost	Amortization Method	Amortized (Premium)/ Discount	Investments, Net	Market Value Disclosure
Intragovernmental Securities:						
Non-Marketable, Market-Based		\$ 85,730,555	Effective Interest	\$ (1,123,332)	\$ 84,607,223	\$ 82,962,706
Subtotal		\$ 85,730,555		\$ (1,123,332)	\$ 84,607,223	\$ 82,962,706
Accrued Interest		787,763		0	787,763	787,763
Total		<u>\$ 86,518,318</u>		<u>\$ (1,123,332)</u>	<u>\$ 85,394,986</u>	<u>\$ 83,750,469</u>

Investments, Net increased from \$85.4 billion in FY 2006 to \$109.5 billion in FY 2007 because of a cumulative positive cash flow. The investments are presented at Amortized Cost in the accompanying balance sheets. The components of the net Amortized Cost and the Market Value of the investments are displayed in the table above as of September 30, 2007 and 2006. The table below displays the par value of the U.S. Treasury Securities held by the Fund:

<u>Par Value</u>	<u>FY 2007</u>	<u>Par Value</u>	<u>FY 2006</u>
(\$ in Thousands)		(\$ in Thousands)	
Bonds	\$ 2,000,000	Bonds	\$ 2,000,000
Notes	16,486,564	Notes	19,384,102
Overnights	4,606,470	Overnights	4,841,189
TIPS	69,098,361	TIPS	46,514,635
Total	<u>\$ 92,191,395</u>	Total	<u>\$ 72,739,926</u>

## Notes to the Principal Statements

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

The U.S. Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at a discount or premium. The U.S. Treasury bonds are long-term securities with maturity terms of ten years or more and are purchased at either a discount or premium. The 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 current CPI to the CPI at issuance; as inflation increases, so does the principal amount and the coupon. When a TIPS matures, the U.S. Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the shares. Overnight securities are short-term securities that mature the next business day and earn interest at the daily Federal Reserve repurchase agreement rate.

The Fund records investments at book value, representing amortized cost. The Fund recognizes the amortization of discounts and premiums using the effective interest method. The Fund receives interest on the value of its non-marketable market-based securities from the U.S. Treasury on a semi-annual basis for U.S. Treasury bonds and notes.

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

## Notes to the Principal Statements

### NOTE 4. ACCOUNTS RECEIVABLE

		<b>FY 2007</b>		
<b>(\$ in Thousands)</b>				
		Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	\$	0	\$ 0	\$ 0
Non-Federal Receivables (from the Public)		10,450	(57)	10,393
<b>Total Accounts Receivable</b>	<b>\$</b>	<b>10,450</b>	<b>\$ (57)</b>	<b>\$ 10,393</b>

		<b>FY 2006</b>		
<b>(\$ in Thousands)</b>				
		Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	\$	0	\$ 0	\$ 0
Non-Federal Receivables (from the Public)		9,016	(213)	8,803
	\$	9,016	\$ (213)	\$ 8,803

Other Information (\$ in Thousands, unless otherwise noted)

#### Non-Federal

Non-Federal Accounts Receivable, Net, increased from \$8,803 to \$10,393 (18%) due to increases in Medicare cross-over claim recoupments and TRICARE Mail Order Pharmacy (TMOP) program usage.

The recoupments for Medicare cross-over claims, which are first adjudicated by Medicare and subsequently adjudicated by the TRICARE Dual Eligible Fiscal Intermediary Contractor, increased \$0.7 million. These claims are associated with increased utilization of purchased care inpatient and outpatient services.

The reimbursements for TMOP co-payments increased \$0.7 million. This change is related to the increased utilization of TMOP benefits.

The Allowance for Estimated Uncollectibles is calculated by using the actual percentage of write-off activity experienced for the past 11 months for two categories of debt: Debts held by the contractor on behalf of the Government and those administered by the TRICARE Management Activity (TMA) Office of General Counsel. Debts owed to the TMA by contractors are considered fully collectible.

In FY 2007, TMA experienced a significant reduction in debt write-offs (\$610 thousand) due to the cross servicing of claims through Treasury. Consequently, the bad debt allowance percentages, which significantly impact the computation of the Allowance for Estimated Uncollectibles, declined. The Office of General Counsel administered debt decreased from 20.11% in FY2006 to 3.32% in 2007. The Contractor held debt decreased from 1.85% in FY 2006 to 0.54% in FY 2007.

## Notes to the Principal Statements

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

(\$ in Thousands)	<u>FY 2007</u>	<u>FY 2006</u>
Non-Federal Liabilities:		
Military Retirement Benefits and Other Federal Employment Benefits (Note 7)	\$ 409,025,006	\$ 454,368,502
Total Non-Federal Liabilities	<u>\$ 409,025,006</u>	<u>\$ 454,368,502</u>
Total Liabilities Not Covered by Budgetary Resources	\$ 409,025,006	\$ 454,368,502
Total Liabilities Covered by Budgetary Resources	<u>\$ 108,336,278</u>	<u>\$ 84,541,083</u>
Total Liabilities	<u><u>\$ 517,361,284</u></u>	<u><u>\$ 538,909,585</u></u>

Total Liabilities Not Covered by Budgetary Resources, which represent an actuarial liability, decreased \$44.7 billion (10%). This change is primarily attributable to an increase of \$23.2 billion in the assets available to pay benefits plus a decrease of \$21.6 billion in the actuarial liability amount. The change in available assets is due to the receipt of annual contributions and transfer of funds from the National Defense Stockpile Transaction Fund that were invested in non-marketable securities. The reasons for the change in the actuarial liability are discussed in Note 7.

The Military Retirement Benefits and Other Federal Employment Benefits not covered by budgetary resources represent actuarial liabilities for the DoD and other Uniformed Services health care programs for specific Medicare-eligible beneficiaries for FY 2007 and FY 2006. There are no assets available to pay benefits at this time; but these liabilities are not due and payable during the current fiscal year.

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

(\$ in Thousands)	<u>FY 2007</u>	<u>FY 2006</u>
Intragovernmental Payables	\$ 70,276	\$ 49,109
Non-Federal Payables (to the Public)	<u>186,361</u>	<u>223,265</u>
Total Accounts Payable	<u><u>\$ 256,637</u></u>	<u><u>\$ 272,374</u></u>

Intragovernmental payables increased from \$49.1 million in FY 2006 to \$70.3 million in FY 2007. These payables increased due to both the increased use of the mail order pharmacy by DoD Medicare-eligible beneficiaries and the increased cost of pharmaceuticals. These payables are associated with the replenishment, by the Defense Logistics Agency, of the TRICARE Mail Order Pharmacy (TMOP) contractor's drug inventory that was initially established at the beginning of the TMOP Program.

Non-Federal Accounts Payable (to the Public) decreased from \$223.3 million in FY 2006 to \$186.4 million in FY 2007. This decrease is due primarily to the payment in FY 2007 of the \$53.8 million accounts payable that existed at the close of FY 2006 for refunds to pharmaceutical manufacturers. See Note 12, Other Disclosures, for additional details. The elimination of the \$53.8 million accounts payable was offset by increased payables of \$10.6 million to retail pharmacies, \$3.5 million to U.S. Family Health Plans (USFHP), and \$2.8 million for TRICARE for Life (TFL) utilization. The increase in payables for retail pharmacy support was due to increased

## Notes to the Principal Statements

demand for retail pharmacy services. The increase in USFHP and TFL payables is attributable to increased use of these health care benefits.

### **NOTE 7. MILITARY RETIREMENT AND OTHER FEDERAL EMPLOYMENT BENEFITS**

<b>FY 2007</b>				
<b>(\$ in Thousands)</b>	<b>Present</b>	<b>Assumed</b>	<b>(Less: Assets</b>	<b>Unfunded</b>
<b>Major Program Activities</b>	<b>Value</b>	<b>Interest</b>	<b>Available to</b>	<b>Liability</b>
<b>Major Program Activities</b>	<b>of Benefits</b>	<b>Rate (%)</b>	<b>Pay Benefits)</b>	<b>Liability</b>
Medicare-Eligible Retiree Benefits	\$ <u>516,479,229</u>	6.00%	\$ <u>(107,454,223)</u>	\$ <u>409,025,006</u>
Total	\$ <u>516,479,229</u>		\$ <u>(107,454,223)</u>	\$ <u>409,025,006</u>
Benefits Due and Payable	<u>625,418</u>		<u>(625,418)</u>	<u>0</u>
Total Military Retirement and Benefits Due and Payable	\$ <u><u>517,104,647</u></u>		\$ <u><u>(108,079,641)</u></u>	\$ <u><u>409,025,006</u></u>

<b>FY 2006</b>				
<b>(\$ in Thousands)</b>	<b>Present</b>	<b>Assumed</b>	<b>(Less: Assets</b>	<b>Unfunded</b>
<b>Major Program Activities</b>	<b>Value</b>	<b>Interest</b>	<b>Available to</b>	<b>Liability</b>
<b>Major Program Activities</b>	<b>of Benefits</b>	<b>Rate (%)</b>	<b>Pay Benefits)</b>	<b>Liability</b>
Medicare-Eligible Retiree Benefits	\$ <u>538,032,547</u>	6.25%	\$ <u>(83,664,045)</u>	\$ <u>454,368,502</u>
Total	\$ <u>538,032,547</u>		\$ <u>(83,664,045)</u>	\$ <u>454,368,502</u>
Benefits Due and Payable	<u>604,664</u>		<u>(604,664)</u>	<u>0</u>
Total Military Retirement and Benefits Due and Payable	\$ <u><u>538,637,211</u></u>		\$ <u><u>(84,268,709)</u></u>	\$ <u><u>454,368,502</u></u>

## Notes to the Principal Statements

The Medicare-Eligible Retiree Benefits, which represent an actuarial liability, decreased \$21.6 billion (4%) from FY 2006 to FY 2007. This change was caused by a revision of two key economic assumptions: the valuation discount rate and medical trend rates. The discount rate was decreased by 0.25% (resulting in a \$31.8 billion increase). The medical trend rates were updated to reflect recent medical claims experience and current industry forecasts, medical trend assumptions from the 2007 Medicare Trustee Report, and incorporating federal drug pricing formulas (resulting in a \$53.1 billion decrease). In addition, the net effect of the expected actuarial liability change, changes due to experience, and non-economic assumptions reduced the liability by \$0.2 billion. The Benefits Due and Payable represent an actuarially determined estimate of incurred liabilities for already-provided covered medical services for which a health care claim had not been received before the end of the 4<sup>th</sup> Quarters for both FY 2006 and FY 2007.

### **Projected Revenues**

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, annual “normal cost” contributions (paid by the U.S. Treasury at the beginning of the fiscal year), and annual unfunded liability amortization contributions (paid by the U.S. Treasury at the beginning of the fiscal year). The “normal cost” contributions are determined as per-capita amounts (approved by the DoD Medicare-Eligible Retiree Health Care Board of Actuaries) times expected average force strength. The unfunded liability amortization contribution 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 unfunded liability amortization contribution.

### **Computation of Liability**

The DoD Office of the Actuaries computes MERHCF benefits liability. The estimated actuarial liability is updated only at the close of each fiscal year at September 30. The MERHCF accumulates funds to finance the liabilities of the DoD and the Uniformed Services health care programs. Beneficiaries of these programs include Medicare-eligible members of the Military and other Uniformed Services who are entitled to retired or retainer pay and their dependents and survivors who are Medicare-eligible.

### **Actuarial Cost Method**

Actuarial cost method used for MERHCF liability: Aggregate Entry-Age Normal. As dictated by law, MERHCF is funded using the aggregate entry-age normal method. This is a method whereby projected retirement costs are spread over the projected future service of a cohort at the point of entry.

### **Assumptions**

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Claims cost assumptions for direct care were based on actual experience in FY 2006. Assumptions for purchased care were developed from actual experience incurred during FY 2004 through FY 2006. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year’s results. The FY 2007 change in the actuarial liability is displayed below. In calculating the FY 2007 roll-forward amount, the following medical trend assumptions were used:

<b><u>Medical Trend</u></b>	<b><u>FY 2006 - FY 2007</u></b>	<b><u>Ultimate Rate 2031</u></b>
Medicare Inpatient	6.74%	6.25%
Medicare Outpatient	6.54%	6.25%
Medicare Prescriptions (Direct Care)	6.25%	6.25%
Medicare Prescriptions (Purchased Care)	10.95%	6.25%

## Notes to the Principal Statements

The medical cost trend rate assumptions have a significant effect on the amounts reported. For example, if the FY 2007 assumed rates had increased by one percentage point, the actuarial present value of projected plan benefits would have increased by 28%, or approximately \$144.1 billion.

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

(\$ in Thousands)

a	Actuarial Liability as of September 30, 2006 (all Uniformed Services Medicare)	\$ 538,032,547
b	Expected Normal Cost for FY 2007	10,801,492
c	Expected Benefit Payments for FY 2007	(8,494,519)
d	Interest Cost for FY 2007	34,040,697
e	Actuarial (Gains)/Losses Due to Other Factors	(4,783,551)
f	Actuarial (Gains)/Losses Due to Changes in Trend Assumptions	<u>(53,117,437)</u>
g	Actuarial Liability as of September 30, 2007 (all Uniformed Services Medicare)	\$ <u>516,479,229</u>
h	Change in Actuarial Liability (line g-line a)	<u><u>\$ (21,553,318)</u></u>

Each year the actuarial liability is expected to increase with normal (or service) cost, decrease with benefit payments, and increase with interest cost (interest on the liability during the period), resulting in an expected increase of \$36.3 billion in the FY 2007 actuarial liability (line b plus line c plus line d). The September 30, 2007, actuarial liability includes changes due to new assumptions and actuarial experience. The actuarial gain due to new medical trend assumptions decreased the liability by \$53.1 billion (line f). The Actuarial Gains and Losses Due to Other Factors, line e, decreased the liability by an additional \$4.8 billion. These other factors (line e) also included a 0.25% decrease in the discount rate (\$31.8 billion loss), claim-related changes (\$31.0 billion gain), changes in assumed plan participation rates (\$14.2 billion gain) and other actuarial assumption and experience changes (\$8.6 billion loss).

### **FY 2007 Actuarial Liability for the Uniformed Services**

The MERHCF liability included Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2007, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$ 505,103,001
Coast Guard	10,216,768
Public Health Service	1,086,666
National Oceanic and Atmospheric Administration	<u>72,794</u>
Total	<u><u>\$ 516,479,229</u></u>

### **FY 2007 Military Service and Other Uniformed Service Contributions**

The FY 2007 Military Service and other Uniformed Service contributions to MERHCF (\$ in thousands) were as follows:

DoD	\$ 11,230,630
Coast Guard	278,704
Public Health Service	36,288
National Oceanic and Atmospheric Administration	<u>1,820</u>
Total	<u><u>\$ 11,547,442</u></u>

# Notes to the Principal Statements

## Market Value of Securities for the MERHCF

The market value of the non-marketable market-based securities as of September 30, 2007, totaled \$107,798,419 thousand.

## FY 2006

### Actuarial Cost Method

Actuarial cost method used for the MERHCF liability: Aggregate Entry-Age Normal. As dictated by law, MERHCF is funded using the aggregate entry-age normal method. This is a method whereby projected retirement costs are spread over the projected future service of a cohort at the point of entry.

<u>Medical Trend</u>	<u>FY 2005 - FY 2006</u>	<u>Ultimate Rate 2030</u>
Medicare Inpatient	5.6%	6.25%
Medicare Outpatient	7.8%	6.25%
Medicare Prescriptions (Direct Care)	8.1%	6.25%
Medicare Prescriptions (Purchased Care)	11.2%	6.25%

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, 2006, by 28%, or approximately \$148.7 billion.

### FY 2006 Change in MERHCF Actuarial Liability

**(\$ in Thousands)**

a. Actuarial Liability as of 09/30/05 (all Uniformed Services Medicare)	\$ 537,397,092
b. Expected Normal Cost for FY 2006	11,043,720
c. Expected Benefit Payments for FY 2006	(7,461,017)
d. Interest Cost for FY 2006	34,047,927
e. Actuarial (Gains)/Losses Due to Other Factors	42,129,764
f. Actuarial (Gains)/Losses Due to Changes in Trend Assumptions	(79,124,939)
g. Actuarial Liability as of 09/30/06 (all Uniformed Services Medicare)	\$ <u>538,032,547</u>
h. Change in Actuarial Liability (line g – line a)	\$ <u><u>635,455</u></u>

Each year the actuarial 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 \$37,630,630 in the actuarial liability was expected during FY 2006 (line b plus line c plus line d). The September 30, 2006, actuarial liability includes changes due to new assumptions and actuarial experience. The actuarial gain due to new medical trend assumptions is \$(79,124,939) (line f). The Actuarial Gains and Losses Due to Other Factors (net \$42,129,764, line e) include new population data, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend assumptions.

## Notes to the Principal Statements

### **FY 2006 Actuarial Liability for the Uniformed Services.**

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The September 30, 2006, liability (\$ in thousands) is broken out between DoD and the other Uniformed Services in the table below.

DoD	\$	526,295,514
Coast Guard		10,545,121
Public Health Service		1,118,244
NOAA		73,668
Total	\$	<u><u>538,032,547</u></u>

### **FY 2006 Military Service and Other Uniformed Services Contributions**

The FY 2006 Military Service and other Uniformed Services contributions to the MERHCF (\$ in thousands) were as follows:

DoD	\$	10,841,216
Coast Guard		260,533
Public Health Service		34,477
NOAA		1,645
Total	\$	<u><u>11,137,871</u></u>

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

#### **Intragovernmental Costs and Exchange Revenue (\$ in Thousands)**

	<u>FY 2007</u>	<u>FY 2006</u>
Intragovernmental Costs	\$ 2,398,537	\$ 2,280,871
Public Costs	<u>(16,344,340)</u>	<u>5,329,733</u>
Total Costs	\$ <u>(13,945,803)</u>	\$ <u>7,610,604</u>
Intragovernmental Earned Revenue	\$ (31,539,307)	\$ (31,802,718)
Public Earned Revenue	<u>0</u>	<u>0</u>
Total Earned Revenue	\$ <u>(31,539,307)</u>	\$ <u>(31,802,718)</u>
Net Cost of Operations	\$ <u><u>(45,485,110)</u></u>	\$ <u><u>(24,192,114)</u></u>

## Notes to the Principal Statements

The abnormal balance on the Statement of Net Cost, a negative \$13.9 billion, was due to a significant decrease in the actuarial liability of the MERHCF. This liability is updated annually each September. The \$21.6 billion decrease in the actuarial liability was caused by changes in the actuarial assumptions related to participation trend rates, medical trend rates, and the assumed discount rate and was offset by \$5.2 billion in normal benefit expenses. The decrease in the actuarial liability was also the primary reason for the \$21.7 billion decrease in the Public Costs.

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

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

<u>Earned Revenue for Program Costs</u>	<u>FY 2007</u>	<u>FY 2006</u>
(\$ in Thousands)		
1 Uniformed Services Contributions	\$ 11,547,442	\$ 11,137,871
2 Annual Treasury Unfunded Liability	15,608,000	16,612,000
3 Interest on Investments	<u>4,383,865</u>	<u>4,052,847</u>
Total	<u>\$ 31,539,307</u>	<u>\$ 31,802,718</u>

Line 1. Uniformed Services Contributions represent the amount contributed by Treasury on behalf of the Uniformed Services (Military Services, U.S. Public Health Service, U.S. Coast Guard, and the National Oceanic and Atmospheric Administration) at the beginning of each fiscal year. The contribution rates, which are determined by the DoD Retirement Board of Actuaries, are based on Board-approved per capita normal cost rates and expected average strengths for the Uniformed Services.

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

Line 3. Interest on Investments represents the interest income received by the MERHCF for FYs 2007 and 2006.

### **NOTE 9. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES**

**Apportionment Categories.** The Office of Management and Budget Circular No. A-136 specifically requires disclosure of the amount of direct and reimbursable obligations incurred against amounts apportioned under categories A (related to a specific period of time); B (related to a specific program or project); and exempt from apportionment. As of September 30, 2007, the MERHCF reported \$7.6 billion in direct, category B obligations. As of September 30, 2006, the MERHCF reported \$1.5 billion in category B apportionment obligations and \$6.3 billion in exempt from apportionment obligations.

**Permanent Indefinite Appropriation.** Title 10, U.S. Code 1111 provides the MERHCF a permanent indefinite appropriation with which to finance, on an actuarially sound basis, the liabilities of DoD's uniformed services retiree health care programs for Medicare-eligible beneficiaries. These funds are only available to pay for the costs of the retiree health care program for all eligible beneficiaries of the MERHCF. Amounts that are not needed to pay the current costs of the Fund may be invested in non-marketable market-based securities purchased through the

## Notes to the Principal Statements

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Department of the Treasury. A permanent indefinite appropriation provides budget authority of an unspecified amount of money that is available as a result of previously enacted legislation and which does not require new legislation for the current year.

**Use of Unobligated Balances of Budget Authority.** The unobligated balances of budget authority for the MERHCF 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 receipts temporarily precluded from obligation by law due to a benefit formula or other limitation. The receipts, however, are assets of the MERHCF and are available for obligations as needed in the future.

**Intraentity Transactions.** Intraentity transactions have not been eliminated because the statements are presented as combined and combining.

**Reconciliation Differences.** There was a difference of \$31.2 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations Received on the Statement of Budgetary Resources. Nonrevolving trust fund receipts, immediately available for obligation, are reported as exchange revenue and included in the cost of operations on the SCNP. For the MERHCF, current receipts total \$31.2 billion. As of September 30, 2006, the difference between the MERHCF's two statements was \$31.5 billion.

The U.S. Treasury issues annual warrants that pay amortized payments for the unfunded actuarial liabilities of the Fund. The Fund's annual warrant for FY 2007 totaled \$15.6 billion. The Other Defense Organizations General Fund credits, and subsequently expends, this amount to the MERHCF in accordance with OMB guidance. The OMB is aware, and approves, of this duplicate reporting. As a result, \$15.6 billion is duplicated on the DoD Agency-wide Statement of Budgetary Resources (SBR). As of September 30, 2006, the Fund's annual warrant was \$16.6 billion, which was duplicated on the DoD Agency-wide SBR for FY 2006.

In addition, the Fund reports Appropriations Received for contributions that the Army, Navy, and Air Force pay. The Military Departments also include these amounts in their respective Appropriations Received. For FY 2007, the Fund reported a total of \$11.2 billion for the Military Departments, which is duplicated on the DoD Agency-wide SBR. As of September 30, 2006, the Fund reported \$10.8 billion in contributions from the Military Departments, which was duplicated on the DoD Agency-wide SBR for FY 2006.

## Notes to the Principal Statements

### NOTE 10. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

(\$ In Thousands)

	<u>FY 2007</u>	<u>FY 2006</u> (As Restated) (Note 13)
<b>RESOURCES USED TO FINANCE ACTIVITIES</b>		
Budgetary Resources Obligated		
Obligations incurred	\$ 7,575,689	\$ 7,075,847
Less: Offsetting receipts	<u>(19,653,179)</u>	<u>(20,390,638)</u>
Net Obligations	\$ (12,077,490)	\$ (13,314,791)
Other Resources	<u>0</u>	<u>0</u>
<b>Total resources used to finance activities</b>	<u>\$ (12,077,490)</u>	<u>\$ (13,314,791)</u>
<b>RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS</b>		
Change in budgetary resources obligated for goods, services, and benefits ordered but not yet provided:		
Undelivered Orders	\$ 12,662	\$ 21,378
Resources that fund expenses recognized in prior periods	<u>(21,532,564)</u>	<u>0</u>
<b>Total resources used to finance items not part of the Net Cost of Operations</b>	<u>\$ (21,519,902)</u>	<u>\$ 21,378</u>
<b>Total resources used to finance the net cost of operations</b>	<u>\$ (33,597,392)</u>	<u>\$ (13,293,413)</u>
<b>COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL REQUIRE OR GENERATE RESOURCES IN FUTURE PERIODS</b>		
Components Requiring or Generating Resources in Future Periods:		
Other	\$ <u>0</u>	\$ <u>477,956</u>
Total components of Net Cost of Operations that will require or generate resources in future periods	\$ 0	\$ 477,956
Components not Requiring or Generating Resources:		
Other (+)		
Trust Fund Exchange Revenue	\$ (11,886,128)	\$ (11,412,081)
Other	<u>(1,590)</u>	<u>35,424</u>
<b>Total components of net cost of operations that will not require or generate resources in the current period</b>	<u>\$ (11,887,718)</u>	<u>\$ (10,898,701)</u>
<b>Net Cost of Operations</b>	<u>\$ (45,485,110)</u>	<u>\$ (24,192,114)</u>

## Notes to the Principal Statements

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

Undelivered orders decreased from \$21.4 million to \$12.7 million primarily due to the elimination of a \$10.0 million over-booking of orders for medical/surgical inpatient and outpatient care offset by a \$1.3 million increase in pharmacy mail orders during FY 2007.

In FY 2007, the Resources That Fund Expenses Recognized in Prior Periods line decreased \$22 billion primarily due to the decrease in the FY 2007 estimated actuarial liability. This change was primarily caused by a revision of two key economic assumptions: the valuation discount rate and medical trend rates. The discount rate was decreased by 0.25% (resulting in a \$31.8 billion increase). The medical trend rates were updated to reflect recent medical claims experience and current industry forecasts, medical trend assumptions from the 2007 Medicare Trustee Report, and incorporating federal drug pricing formulas (resulting in a \$53.1 billion decrease). In addition, the net effect of the expected actuarial liability change, changes due to experience, and non-economic assumptions reduced the liability by \$0.2 billion. In FY 2006, the actuarial liability reflected a slight increase as reflected in the Components Requiring or Generating Resources in Future Periods –Other line, that was offset by a small decrease in the incurred-but-not-reported (IBNR) amounts. The IBNR amounts represent an actuarially determined estimate of incurred liabilities for already-provided covered medical services for which a health care claim had not been received before the end of the current and prior fiscal year quarters.

Components not Requiring or Generating Resources – Other displays the change in accounts receivable for FY 2007. These amounts represent refund receivables for duplicate or other erroneous MERHCF payments made to contractors for care of the beneficiaries and for co-payments from MERHCF beneficiaries for prescriptions. This line also displays the change in bad debts for FY 2006, and FY 2007. These bad debts occurred because of erroneous payments made to MERHCF beneficiaries or to nonfederal service providers.

Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods report unfunded expenses that were incurred during FY 2007. The cumulative total of unfunded expenses from all fiscal years is reported as “Liabilities Not Covered by Budgetary Resources” in Note 5. The Fund has a difference of \$45.3 billion between these two lines. The MERHCF had no unfunded expenses in the current year. The amounts in Note 5 represent actuarial liabilities that eventually must be funded. As additional assets become available in the MERHCF, the unfunded portion of the actuarial liability will decrease.

### **NOTE 11. BENEFIT PROGRAM EXPENSE**

**(\$ in Thousands)**

	<b>FY 2007</b>	<b>FY 2006</b>
1 Service Cost	\$ 10,801,492	\$ 11,043,720
2 Period Interest on the Benefit Liability	34,040,697	34,047,927
3 Prior (or Past) Service Cost	0	0
4 Period Actuarial (Gains) or Losses	(4,783,551)	42,129,764
5 (Gains)/Losses Due to Changes in Medical Trend Assumptions	<u>(53,117,437)</u>	<u>(79,124,939)</u>
6 Total	<u>\$ (13,058,799)</u>	<u>\$ 8,096,472</u>

The benefit program expenses provide components of the change in the actuarial liability from the previous fiscal year to the current fiscal year. The actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during the fiscal year. The actuarial liability at the end of the fiscal year is equal to the liability at the end of the previous fiscal year plus the total benefit program expenses minus the expected benefit payments during the current fiscal year.

## Notes to the Principal Statements

The benefit program expense (BPE) includes normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments). The BPE for FY 2007 was less than the BPE for FY 2006, largely because the new plan participation assumptions decreased liabilities in FY 2007; whereas the new plan participation assumptions increased liabilities in FY 2006 (line 4). Every year, there is also a “period actuarial gains or losses” component of BPE (line 4), which in FY 2007 contributed a net gain (liability decrease), reflecting the net of losses primarily due to a lower rate discount rate and revisions to various demographic assumptions, offset by gains primarily due to new plan participation rates and baseline (2006) claim levels. In FY 2006, this component reflected a net loss (liability increase), reflecting increases mainly due to new plan participation assumptions and other assumptions and experience, offset by reductions due to new administrative cost assumptions and claims experience.

In FY 2007, new medical trend rates (line 5) reflected in a gain (liability decrease); however, the new medical trend rates used in FY 2006 produced a larger gain.

The service cost components and interest cost components of the BPE are generally expected to increase each year. However, actuarial gains and losses always occur; new assumptions are usually adopted each year; and benefit changes are possible every year; hence, the BPE can vary by substantial amounts from year to year.

### **NOTE 12. OTHER DISCLOSURES**

The FY 2005 Defense Authorization Act assigns Treasury, vice the Uniformed Services, the responsibility of paying normal cost contributions into the Fund, starting in FY 2006.

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2007, and 2006 includes approximately \$75.0 billion (14% of total) and \$83.0 billion (15% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the military treatment facilities (MTFs) to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 billion, respectively, and for the year ended September 30, 2006, include approximately \$4.0 billion and \$1.7 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund’s actuaries using data extracted from various Military Service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient’s care.

During the year ended September 30, 2005, a misstatement of approximately \$133 million was identified in the amount of purchased care claims reported for the year ended September 30, 2004. Deficiencies in the controls over the systems used to process the purchased care claims existed prior to September 30, 2004, and were uncorrected at that date, resulting in an undetected backlog of unprocessed claims. The identified claims, aggregating \$133 million, were re-submitted for processing during the year ended September 30, 2005, resulting in an overstatement of 2005 reported claims. The claims backlog was also inappropriately excluded from the data used in the actuarial estimate of claims incurred but not reported recorded as a liability as of September 30, 2004. The impact of the above misstatement on the estimate of Benefits Due and Payable as of September 30, 2004 was estimated to be a \$133 million understatement.

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## Notes to the Principal Statements

However, uncertainties continued to exist during the year ended September 30, 2005, about the completeness of the population of the aggregate unprocessed claims as of September 30, 2004, and the extent and timing of subsequent reprocessing. Due to these data integrity concerns, the actuarial estimate of Benefits Due and Payable as of September 30, 2005, included a margin of conservatism. Analyses of claims information performed during the year ended September 30, 2006, indicate it is probable that, through the passage of time, all claims that may have been part of the backlog as of September 30, 2004, have been reprocessed. A retrospective analysis indicates that the actuarial estimate of Benefits Due and Payable as of September 30, 2005 was overstated by approximately \$215 million, with related understatement on recorded claims expense included in Gross Program Costs for the year ended September 30, 2006.

### **Pharmaceutical Company Rebates for Retail Pharmacy Support**

The Veterans Health Care Act (VHCA) of 1992, codified at 38 U.S.C. 126, established federal ceiling prices of covered pharmaceuticals. In May 2004, the VHCA was applied to the TRICARE Pharmacy Benefits Program, specifically, for beneficiaries obtaining covered pharmaceuticals from retail pharmacies. The retail pharmacies obtain the drugs they dispense at non-discounted prices. The mechanism for payment involved a “Dear Manufacturer” letter sent to the pharmaceutical manufacturers. The letter required that these manufacturers calculate a discount rate and pay refunds to DoD for covered drugs purchased at network pharmacies. The letter demanded refunds as of September 30, 2004.

The Coalition for Common Sense in Government Procurement requested legal review of that letter, and the Department of Veterans Affairs (DVA) agreed to postpone enforcement pending judicial review. While enforcement was stayed during judicial review, some manufacturers made voluntary refunds to DoD during this time period. As of August 31, 2006, the MERHCF had received \$23.6 million in FY 2005 and \$30.2 million in FY 2006. These refunds are identified by fiscal year and specific pharmaceutical manufacturer.

By decision dated September 11, 2006, the Court of Appeals for the Federal Circuit set aside the “Dear Manufacturer” letter and, on procedural grounds, ruled against the government’s position in the federal drug pricing litigation. As a result of the Court decision, the TRICARE Management Activity (TMA) was advised by counsel to suspend indefinitely the quarterly refund invoicing to manufacturers involving network retail pharmacy drugs. The VA General Counsel requested the Department of Justice not to seek rehearing of the Court’s decision. Therefore, TMA General Counsel advised the MERHCF to reimburse any refunds received in FY 2005 and FY 2006. A nonfederal payable to the public of \$53.8 million was established 4<sup>th</sup> Quarter, FY 2006. Full reimbursements were made to the affected pharmaceutical manufacturers during FY 2007.

### **NOTE 13. RESTATEMENT**

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

For the FY 2006 statements, the classification of intragovernmental receipt amounts of approximately \$11.4 billion was corrected from distributed to undistributed, reducing the amount of previously reported offsetting receipts in the FY 2006 Statement of Budgetary Resources and in Note 10, and increasing the amount of previously reported Trust Fund Exchange Revenue in Note 10 by the same amount. There was no impact on the MERHCF’s net position or net cost of operations for FY 2006.

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

## Notes to the Principal Statements

**FY 2006**

**Effects of Restatement**

**(\$ in Thousands)**

	As Restated	As Originally Reported	Effect of Change
<b>Statement of Budgetary Resources</b>			
Distributed Offsetting Receipts	<u>\$(20,390,638)</u>	<u>\$(31,802,719)</u>	<u>\$ 11,412,081</u>
Total Net Outlays	<u>\$(13,324,082)</u>	<u>\$(24,736,163)</u>	<u>\$ 11,412,081</u>
<b>Reconciliation of Net Cost of Operations to Budget</b>			
Less: Offsetting receipts	<u>\$(20,390,638)</u>	<u>\$(31,802,719)</u>	<u>\$ 11,412,081</u>
Net Obligations	<u>\$(13,314,791)</u>	<u>\$(24,726,872)</u>	<u>\$ 11,412,081</u>
Total resources used to finance activities	<u>\$(13,314,791)</u>	<u>\$(24,726,872)</u>	<u>\$ 11,412,081</u>
Total Resources used to Finance the Net Cost of Operations	<u>\$(13,293,413)</u>	<u>\$(24,705,494)</u>	<u>\$ 11,412,081</u>
Trust Fund Exchange Revenue	<u>\$(11,412,081)</u>	<u>\$ 0</u>	<u>\$(11,412,081)</u>
Total components of Net Cost of Operations that will not require or generate resources in the current period	<u>\$(10,898,701)</u>	<u>\$ 513,380</u>	<u>\$(11,412,081)</u>

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

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

## Other Accompanying Information

**TABLE 1**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
ACTUARIAL STATUS INFORMATION  
SEPTEMBER 30, 2007

(\$ In Thousands)

	September 30, 2007	September 30, 2006
1. Present value of future benefits		
a. Current inactive	\$ 316,898,580	\$ 330,842,715
b. Active duty personnel <sup>1</sup>	156,849,172	160,999,865
c. Non-retired reservists	121,155,895	128,420,451
d. Total	\$ 594,903,647	\$ 620,263,031
2. Present value of future normal cost contributions	(78,424,418)	(82,230,484)
3. Actuarial accrued liability (Note 7)	\$ 516,479,229	\$ 538,032,547
4. Assets <sup>2</sup>	107,454,223	83,664,045
5. Unfunded accrued actuarial liability <sup>3</sup>	\$ 409,025,006	\$ 454,368,502

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<sup>1</sup> The future benefits of active duty personnel who are projected to retire as reservists are counted on line 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 \$625.4 million and \$604.7 million for the estimated Incurred But Not Reported (IBNR) liabilities as of September 30, 2007, and 2006, respectively, as presented in the Balance Sheets as "Benefits Due and Payable," and as discussed in Note 7, "Military Retirement and Other Federal Employment Benefits."

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

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



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

December 13, 2007

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

SUBJECT: Endorsement of the Qualified Opinions on the Fiscal Year 2007 and 2006 (Restated)  
DoD Medicare-Eligible Retiree Health Care Fund Financial Statements  
(Report No. D-2008-035)

The Medicare-Eligible Retiree Health Care Fund (the Fund) was established by Public Law No. 106-398 (The National Defense Authorization Act for FY 2001). In accordance with the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act (Public Law 103-356) of 1994, agencies are required to submit financial statements for each revolving fund and trust fund. We contracted with Deloitte & Touche LLP (Deloitte & Touche) to perform the Fund's FY 2007 audit.

**Qualified Audit Opinion.** We concur with the Deloitte & Touche qualified opinion dated November 30, 2007. Deloitte & Touche opined that, except for amounts related to the Fund's direct care costs and the impact of a September 30, 2004, backlog of unprocessed purchased care transactions, the financial statements and accompanying notes present fairly, in all material respects, the Fund's financial position, net cost, changes in net position, and budgetary resources as of September 30, 2007 and 2006. Deloitte & Touche also opined that, other than the effects of the matters identified above, the statements were presented in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche qualified its opinion because it was unable to obtain sufficient, appropriate audit evidence from compliant transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. Deloitte & Touche also noted deficiencies in the controls over the systems used to process the purchased care claims as of September 30, 2004. Additionally, Deloitte & Touche indicated that the actuarial estimate of claims incurred but not reported (that is, medical claims the Fund expects to pay) as of September 30, 2005, was overstated by approximately \$215 million, with related impacts on recorded claims expenses for the year ended September 30, 2006.

The Fund restated its FY 2006 financial statements to correct an error in the originally issued financial statements. The restatement is discussed in Note 13 to the Fund financial statements. As a result of the material misstatement, Deloitte & Touche advised that their audit opinion report on the Fund's FY 2006 financial statements dated November 1, 2006, should no longer be relied upon and is replaced by their FY 2007 report. Accordingly, we withdraw our endorsement of the FY 2006 Deloitte & Touche opinion report dated November 8, 2006, (DoD IG Report No. D-2007-017) and replace it with this report.

**Report on Internal Control.** Deloitte & Touche concurrently issued a report on the internal control over financial reporting and compliance with laws and regulations as part of the

audit of the Fund's FY 2007 financial statements. We concur with the Deloitte & Touche internal control report.

**Financial Reporting.** The Deloitte & Touche report on internal controls concluded that the Fund's financial management system did not meet the requirements of Office of Management and Budget Circular A-127, "Financial Management Systems," July 23, 1993, with respect to maintaining consistent internal control over data entry, transaction processing, and reporting. Deloitte & Touche reported the following significant deficiencies, of which the first three are considered to be material weaknesses.

- The actuarial liability for Medicare-eligible retiree benefits includes the projected value of direct care costs for benefits provided at Military Treatment Facilities. The direct care costs are based on data extracted from various systems that are noncompliant and are not transaction based.
- The Military Treatment Facility-level health care cost data are based on budget execution processes rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the Military Treatment Facility level. As a result, some transactions may not be recorded in the correct accounting period.
- The DoD Trust Fund Accounting Division did not have sufficient controls in place to identify and implement changes in U.S. Treasury guidance for offsetting receipts on a timely basis. Additionally, Health Affairs /Tricare Management Activity did not have sufficient management review processes to detect the incorrect financial statement presentation that resulted. Fund management did not detect the FY 2006 presentation error until the FY 2007 financial statements were being prepared.
- The accuracy and completeness of the data files provided to the Office of the Actuary for determining the funds incurred but not reported were impacted by a backlog of unprocessed purchased care claims as of September 30, 2004. However, uncertainties exist about the completeness of the population of the aggregate unprocessed claims as of September 30, 2004, and the extent and timing of subsequent reprocessing of the claims. A retrospective analysis indicated that the actuarial estimate of claims incurred but not reported as of September 30, 2005, was overstated by approximately \$215 million. The Fund's management was unable to provide Deloitte & Touche complete information to identify a complete population of the claims transactions backlog as of September 30, 2004, and all transaction details necessary to assess the complete budgetary and proprietary accounting impacts on the FY 2004, 2005, and 2006 financial statements.
- The Fund's financial management improvement initiatives have not been finalized for all Services and implemented at all Military Treatment Facilities.
- Computer processing locations that support the Fund had inadequate controls over data processing to ensure reliable processing of financial information within the related business cycles. The audit disclosed deficiencies in the design or operation of data processing controls related to security policies, procedures, configurations, business continuity arrangements, and network and database change management locations. These deficiencies could adversely affect the Fund's ability to record, process, and summarize the Fund's financial information in accordance with all appropriate requirements.

**Compliance with Laws and Regulations.** Deloitte & Touche performed tests that disclosed noncompliance with certain provisions of the following laws and regulations.

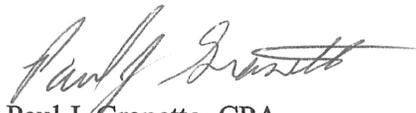
- The Fund's data were processed on electronic data processing systems that did not comply with Office of Management and Budget Circular A-127.
- Although the general ledger system complied with the U.S. Government Standard General Ledger, it was not transaction based or derived from an integrated financial system.
- The financial management system did not comply substantially with Office of Management and Budget Circular A-130, "Management of Federal Information Resources," November 28, 2000.
- Collectively, the Fund did not fully comply with Office of Management and Budget Circulars A-123, "Management's Responsibility for Internal Control," December 21, 2004, and A-127, and the Federal Managers' Financial Integrity Act.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 4, 2007, requires that test results be reported if noncompliance with certain laws and regulations occurs.

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

To fulfill our oversight responsibilities for the contract with Deloitte & Touche, we complied with government auditing standards, Office of Management and Budget Bulletin No. 07-04, and the "GAO/PCIE Financial Audit Manual," July 2004. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of Deloitte & Touche; reviewed the key judgments; met with officials of the Fund; 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. Mark Starinsky (614) 751-1400 ext. 231.



Paul J. Granetto, CPA  
Assistant Inspector General and Director  
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## INDEPENDENT AUDITORS' REPORT

To:

The Inspector General of the Department of Defense,  
The Deputy Under Secretary of Defense for Program Integration,  
The Acting Deputy Assistant Secretary of Defense, Health Budgets and Financial Policy, and  
The Audit Committee of the Department of Defense  
Medicare-Eligible Retiree Health Care Fund

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of September 30, 2007 and 2006, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We were unable to obtain sufficient, appropriate audit evidence from compliant, transaction-based accounting systems in support of the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTFs). As discussed in Note 12 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2007 and 2006 includes approximately \$75 billion (14% of total) and \$83 billion (15% 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 cost for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 billion, respectively, and for the year ended September 30, 2006, include

November 30, 2007

approximately \$4.0 billion and \$1.7 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems. While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and 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. Additionally, 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, a significant factor in the allocation processes. We were not able to satisfy ourselves as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

As discussed in Note 12 to the financial statements, during the year ended September 30, 2005, a misstatement was identified in the amount of purchased care claims reported for the year ended September 30, 2004. Deficiencies in the controls over the systems used to process the purchased care claims existed prior to September 30, 2004, and were uncorrected at that date, resulting in an undetected backlog of unprocessed claims. The identified claims were re-submitted for processing during the year ended September 30, 2005, resulting in an overstatement of 2005 reported claims. The claims backlog was also inappropriately excluded from the data used in the actuarial estimate of claims incurred but not reported recorded as a liability as of September 30, 2004.

However, uncertainties continued to exist during the year ended September 30, 2005, about the completeness of the population of the aggregate unprocessed claims as of September 30, 2004, and the extent and timing of subsequent reprocessing. Due to these uncertainties, the actuarial estimate of claims incurred but not reported as of September 30, 2005, included a margin of conservatism. Analyses of claims information performed during the year ended September 30, 2006, indicated it was probable that, through the passage of time, all claims that may have been part of the backlog as of September 30, 2004, had been reprocessed. A retrospective analysis indicated that the actuarial estimate of claims incurred but not reported as of September 30, 2005 was overstated by approximately \$215 million, with related impacts on recorded claims expense for the year ended September 30, 2006.

We were not able to obtain sufficient details about the recorded transactions related to the claims backlog necessary to determine the complete budgetary and proprietary accounting impacts on the MERHCF financial statements for the year ended September 30, 2006, beyond the estimated understatements and overstatements identified above, nor were we able to satisfy ourselves by means of other auditing procedures.

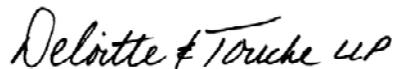
In our opinion, except for the effects on the financial statements of (1) the amounts related to the Fund's direct-care costs, if any, as might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct-care component of the actuarial liability for Medicare-eligible retiree benefits; and (2) the complete population, and budgetary and proprietary accounting impacts, of the claims backlog transactions existing as of September 30, 2004 and subsequently reprocessed; such financial statements present fairly, in all material respects, the financial position of the DoD Medicare-Eligible Retiree Health Care Fund as of September 30, 2007 and 2006, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

November 30, 2007

As discussed in Note 13 to the financial statements, the accompanying 2006 financial statements have been restated. The restatement was for the correction of an error in the originally issued financial statements, on which we issued our report dated November 1, 2006. Such report should no longer be relied upon as a result of the material misstatement in the previously-issued FY 2006 financial statements and is withdrawn and replaced by this updated report on the restated financial statements.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying "Management's Discussion & Analysis" and "Other Accompanying Information," are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular A - 136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, such information have not been subjected to the auditing procedures applied in our audits of the basic financial statements and accordingly, we do not express an opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 30, 2007 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

The image shows a handwritten signature in cursive script that reads "Deloitte & Touche LLP". The signature is written in black ink and is positioned above the date "November 30, 2007".

November 30, 2007



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## **INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

To:

The Inspector General of the Department of Defense,  
The Deputy Under Secretary of Defense for Program Integration,  
The Acting Deputy Assistant Secretary of Defense, Health Budgets and Financial Policy, and  
The Audit Committee of the Department of Defense  
Medicare-Eligible Retiree Health Care Fund

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, 2007, and have issued our report thereon dated November 30, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of Office of Management and Budget ("OMB") Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

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

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

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

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

matters discussed in the following paragraphs to be significant deficiencies.

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 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 September 30, 2007 and 2006, includes approximately \$75 billion (14% of total) and \$83 billion (15% of total), respectively, of amounts reflecting the actuarial present value of the projected direct care costs of benefits to be provided by the Military Treatment Facilities ("MTFs"), managed by the Services, to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 billion, respectively, and for the year ended September 30, 2006, include approximately \$4.0 billion and \$1.7 billion, respectively, of amounts related to the direct care costs.

Such MTF-related amounts of direct care costs are estimated by the Fund's actuaries and others using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems, applying common and consistent business rules, in a manner envisioned by the DoD's planned Standard

Financial Information Structure (“SFIS”). While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and 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. Additionally, 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, a significant factor in the allocation processes.

Therefore, 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.

We continue to recommend the implementation of the necessary management control and reconciliation processes with respect to direct care, as well as the design of improved financial management information systems as part of the overall DoD business transformation efforts.

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 liabilities 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 Military 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 and consistent cut-off of accounting activity occurs at the MTF-level. During 2007, the Fund had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

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

We continue to recommend the implementation of the necessary management control and reconciliation processes with respect to direct care, as well as the design of improved financial management information systems as part of the overall DoD business transformation efforts.

3. Since 2005, the Fund has undertaken a number of improvement initiatives in connection with the DoD Financial Improvement and Audit Readiness (“FIAR”) process managed

under the Office of the Under Secretary of Defense - Comptroller ("OUSD-C"). The initiatives are intended to address the necessary corrective actions with respect to the identified deficiencies in the direct care cost processes and medical record coding, as discussed above. From discussions with TMA and their support contractor, we understand that efforts have been undertaken to document and test certain direct care related reconciliation processes from the MTF level through to the financial statement level for the Services. However, as of September 30, 2007, the process and procedures have not yet been finalized for all Services nor deployed to all MTFs.

We continue to recommend the implementation of the necessary management control and reconciliation processes with respect to direct care, as well as the design of improved financial management information systems as part of the overall DoD business transformation efforts.

4. Certain general and application 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: (1) EDP security policies, procedures, and configurations, (2) business continuity arrangements; and (3) network and database change management activities, that could adversely affect the Fund's ability to record, process, and summarize its financial information and protect sensitive data in accordance with all appropriate requirements.

Because disclosure of detailed information about EDP weaknesses may further compromise controls, we are providing no further details here. Instead, as requested by the Office of Inspector General, the specifics will be presented in a separate, limited distribution report concerning other control deficiencies involving the Fund's internal control over financial reporting and other matters that we identified during our audit.

5. During the preparation of the Fund's year-end financial statements, the DoD Trust Fund Accounting Division ("TFAD") was notified by the DoD's Audited Financial Statement ("AFS") Division, part of the DoD's Office of the Under Secretary of Defense – Comptroller ("OUSD-C") that, based on the reconciliation of DoD budgetary accounts with Treasury, certain offsetting receipt accounts of the Fund for FY 2006 and FY 2007 should be reclassified. The change in the U.S. Treasury guidance for offsetting receipts, which was effective for FY 2006, affected both the Statement of Budgetary Resources and the disclosure of financing activities. The correct classification of offsetting receipts is significant to the accurate reporting of intragovernmental activity for the DoD and U.S. Government financial statements. Therefore, the Fund has restated the FY 2006 financial statements and related disclosures to correct the presentation error.

While the DoD utilizes certain standardized processes to facilitate the preparation of financial statements and budgetary reports in conformity with the United States Standard General Ledger ("SGL") accounts and standard attributes, it appears that certain of the Fund's account attributes were not updated for the change in U.S. Treasury guidance for offsetting receipts in FY 2006 or FY 2007. There were insufficient controls in place within TFAD in order to identify and implement changes in financial and budgetary reporting guidance on a timely basis. There were insufficient management review processes in place within HA/TMA in order to detect the incorrect financial statement presentation.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies noted above, we consider the observations with respect to direct-care costs discussed at items 1., and 2., and the observation with respect to offsetting receipt accounts at item 5., to be material weaknesses.

With respect to internal control relevant to data that support reported performance measures on page 6 of Management's Discussion and Analysis accompanying the financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on the internal control over reported performance measures and, accordingly, we do not express an opinion on such control.

### **Compliance and Other Matters**

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

1. The EDP systems utilized by the Fund are not compliant with OMB Circular A-127, *Financial Management Systems*. The Circular requires that federal financial systems provide complete, reliable, consistent and useful information on a timely basis. Our procedures identified deficiencies in the design and operation of certain EDP controls that may increase the risk of unauthorized access, modification, or loss of sensitive programs and data which could compromise the ability of the systems to provide reliable financial data.
2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger ("SGL"), it is not transaction-based nor is it derived from an integrated financial system.
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;

November 30, 2007

- ◇ 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 the requirements of OMB Circulars A-123, A-127, and A-130.

The significant deficiencies and material weaknesses 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.

### **Views of Responsible Officials**

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

### **Distribution**

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

*Deloitte & Touche LLP*

November 30, 2007

\* \* \* \* \*