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**FY 2008 Change in MERHCF Actuarial Liability**

The benefit program expenses (BPE) for FY 2008 and FY 2007 are displayed in the Table 1. Details about these expenses are provided below:

**Table 1. Benefit Program Expenses**

**(\$ In Thousands)**

	<b>FY 2008</b>	<b>FY 2007</b>
A. Service Cost	\$ 10,070,293	\$ 10,801,492
B. Period Interest on the Benefit Liability	31,340,326	34,040,697
C. Prior (or Past) Service Cost	0	0
D. Period Actuarial (Gains) or Losses	(5,248,219)	(4,783,551)
E. Actuarial (Gains)/Losses Due to Changes in Medical Trend Assumptions	<u>(43,899,936)</u>	<u>(53,117,437)</u>
F. Total	<u>\$ (7,737,536)</u>	<u>\$(13,058,799)</u>

The BPE provide components of the change in the actuarial liability from September 30, 2007, to September 30, 2008. The September 30, 2008, actuarial liability is calculated using the components of BPE as well as the expected benefit payments during the fiscal year. See Note 7, Military Retirement Benefit Liabilities, for further details about the change in the actuarial liability. The September 30, 2008, actuarial liability is equal to the September 30, 2007, liability plus the total BPE minus the expected benefit payments. The BPE includes normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments).

In FY 2008, the Period Actuarial (Gains) or Losses component of BPE (Line D) contributed a net gain (liability decrease) reflecting the net of various gains and losses resulting from experience and changes in assumptions. The (Gains)/Losses Due to Changes in Medical Trend Assumption component of BPE (Line E) also produced a gain in FY 2008; however, the new medical trend rate assumptions used in FY 2007 produced a larger gain. Each year, the MERHCF Board of Actuaries approves the assumption changes.

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

## Notes to the Principal Statements

### NOTE 13 EARMARKED FUNDS

#### BALANCE SHEET

	2008	2007
<b><u>Assets</u></b>		
Fund balance with Treasury	\$ 5,000	\$ 5,000
Investments	134,291,659	109,549,060
Accounts and Interest Receivable	12,486	10,393
<b>Total Assets</b>	<b><u>\$ 134,309,145</u></b>	<b><u>\$ 109,564,453</u></b>
<b><u>Liabilities And Net Position</u></b>		
Military Retirement Benefits and Other Federal Employment Benefits	\$ 500,819,180	\$ 517,104,647
Other Liabilities	199,816	256,637
Total Liabilities	<u>\$ 501,018,996</u>	<u>\$ 517,361,284</u>
Cumulative Results of Operations	(366,709,851)	(407,796,831)
<b>Total Liabilities And Net Position</b>	<b><u>\$ 134,309,145</u></b>	<b><u>\$ 109,564,453</u></b>

#### STATEMENT OF NET COST

Program Costs	\$ (8,429,788)	\$ (13,945,803)
Less Earned Revenue	(32,657,192)	(31,539,307)
Net Program Costs	<u>\$ (41,086,980)</u>	<u>\$ (45,485,110)</u>
<b>Net Cost of Operations</b>	<b><u>\$ (41,086,980)</u></b>	<b><u>\$ (45,485,110)</u></b>

#### STATEMENT OF CHANGES IN NET POSITION

Net Position Beginning of the Period	\$ (407,796,831)	\$ (453,467,941)
Net Cost of Operations	(41,086,980)	(45,485,110)
Budgetary Financing Sources	0	186,000
Change in Net Position	<u>\$ 41,086,980</u>	<u>\$ 45,671,110</u>
<b>Net Position End of Period</b>	<b><u>\$ (366,709,851)</u></b>	<b><u>\$ (407,796,831)</u></b>

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

The primary financing sources for MERHCF are (1) an annual unfunded actuarial liability payment from the U.S. Treasury; (2) annual contributions from the Military Services and other Uniformed Services (U.S. Coast Guard, the National Oceanic and Atmospheric Administration, and U.S. Public Health Service); and (3) interest earned on investments. These financing sources are the result of intra-governmental flows. Contributions in excess of the projected current year health care benefits are invested. These investments and associated revenue are used to cover future liabilities of MERHCF.

**NOTE 14. OTHER DISCLOSURES.** The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2008, and 2007 includes approximately \$71.0 billion (14% of total) and \$75.0 billion (14% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the 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, 2008, include approximately \$3.3 billion and \$1.7 billion, respectively, and for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various Military Service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

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

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

**EXHIBIT 1**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
ACTUARIAL STATUS INFORMATION  
SEPTEMBER 30, 2008, AND 2007

(\$ in Thousands)

	<u>September 30, 2008</u>	<u>September 30, 2007</u>
1 Present value of future benefits		
a. Current inactives	\$307,149,821	\$316,898,580
b. Active duty personnel <sup>1</sup>	\$156,814,830	\$156,849,172
c. Nonretired reservists	<u>\$116,763,813</u>	<u>\$121,155,895</u>
d. Total	\$580,728,464	\$594,903,647
2 Present value of future normal cost contributions	<u>\$ (80,532,754)</u>	<u>\$ (78,424,418)</u>
3 Actuarial accrued liability	\$500,195,710	\$516,479,229
4 Assets <sup>2</sup> (funded accrued liability)	<u>\$131,941,068</u>	<u>\$107,454,223</u>
5 Unfunded accrued liability <sup>3</sup>	<u>\$368,254,642</u>	<u>\$409,025,006</u>

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

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

<sup>3</sup> The unfunded accrued liability does not include \$623.5 million and \$625.4 million for the estimated incurred-but-not-reported liabilities as of September 30, 2008, and 2007, respectively, as presented in the Balance Sheet as "Benefits Due and Payable" and as discussed in Note 7, "Military Retirement Benefit Liabilities."

### EXHIBIT 2

#### MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND SUMMARY OF FINANCIAL STATEMENT AUDIT AND MANAGEMENT ASSURANCES SEPTEMBER 30, 2008

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of the MERHCF Management Discussion and Analysis, DoD, and not MERHCF, represents the legislative definition of an Agency. Beginning with FY 2006, as directed in OMB Circular A-123, *Management's Responsibility for Internal Control, Appendix A, Internal Control Over Financial Reporting*, the 24 CFO Act agencies (includes DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall Federal Managers Financial Integrity Act (FMFIA) assurance statement. The Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) issued guidelines to the leadership of the 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 2008 assessments, TMA management assessed that, except for direct care related material weaknesses addressed below, the MERHCF (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). The MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Military Services have implemented financial systems that comply with (FMFIA § 4). The OUSD (C)-published Financial Improvement and Audit Readiness Report as of March 2008, indicates a FY 2017 timeline for the Military Services to achieve (FMFIA § 4) compliance.

TMA management previously reported that, except for the direct care-related material weakness discussed below, 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 financial 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 2008 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4) and summary of corrective actions to resolve the material weaknesses and non-conformances.



## Other Accompanying Information

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

Audit Opinion	Qualified				
Restatement	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year (“FY”) 2005)	✓				✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓				✓
Presentation of Distributed Offsetting Receipts	✓		✓		
<i>Total Material Weaknesses</i>	3	0	1	0	2

**Table 2. Summary of Management Assurances**

Effectiveness of Internal Controls over Financial Reporting (FMFIA § 2)						
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)	✓					✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓					✓
Presentation of Distributed Offsetting Receipts	✓		✓			
<i>Total Material Weaknesses</i>	3	0	1	0	0	2
Effectiveness of Internal Controls over Operations (FMFIA § 2)						
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)	✓					✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓					✓
<i>Total Material Weaknesses</i>	2	0	0	0	0	2

## Other Accompanying Information

<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)	✓					✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓					✓
Total non-conformances	2	0	0	0	0	2

<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	

**EXHIBIT 3**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND  
IPIA REPORTING DETAILS  
SEPTEMBER 30, 2008

**IMPROPER PAYMENTS INFORMATION ACT REPORTING**

The Improper Payments Information Act (IPIA) of 2002, as implemented by the OMB Circular A-123, Appendix C, "Requirements for Effective Measurement and Remediation of Improper Payments," requires Federal agencies to review all programs and activities annually, and identify those that may be susceptible to significant erroneous payments. The Department's FY 2008 review did not identify any programs at risk of significant erroneous payments in accordance with OMB criteria (programs with erroneous payments exceeding both \$10.0 million and 2.5 percent of program payments).

**RISK ASSESSMENT**

The Department's risk assessment for Military Health Benefits addressed the effectiveness of internal controls for preventing improper payments (such as prepayment reviews), as well as system weaknesses identified internally or by outside audit activities. While the Department's improper payment percentages are low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

On a quarterly basis, the Department audits statistically valid samples of health care claims. Over the years, these audits consistently have produced an error rate of less than the 2% performance standard contained in TRICARE contracts. Errors in health care claims processing potentially can be related to improperly submitted claims by providers, as well as a minimal degree of human error expected with handling a large volume of claims under the tight time parameters established by the Prompt Payment Act regulations and the claims processing timeliness performance standard. The FY 2007 improper payment rate for military health benefits was estimated to be \$156.0 million or 2%. The actual performance was significantly less: 0.93% or \$88.6 million.

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

**STATISTICAL SAMPLING PROCESS**

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

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

**CORRECTIVE ACTION PLAN**

The Department's contracts have had payment performance standards for military health benefit claims processing in place for many years. The estimate of 2 percent is based on the contract performance standard. However, actual results have been consistently less than 2 percent. FY 2007 results reflect an improper payment rate of 0.93 percent. Contractors exceeding the 2% performance standard are subjected to a financial disincentive for erroneous claims payments. In addition, the contractors are financially liable for payment of non-allowable claims. This contractual design, combined with numerous prepayment and post-payment controls, effectively minimizes improper payments and ensures the Government's risk for improper payments in military health benefits is minimized.

**MILITARY HEALTH BENEFITS PROGRAM IMPROPER PAYMENT REPORTING**

FY 2007			FY 2008			FY 2009 Estimated			FY 2010 Estimated			FY 2011 Estimated		
Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)
\$9.5	0.93	\$88.6	\$8.9	2	\$178	\$10.8	2	\$216	\$10.5	2	\$211	\$10.8	2	\$216

1. The final payment error rate for FY 2007 is 0.93%, which is less than the contract performance standard of 2% used in the FY 2007 AFR calculation. The error rate in FY 2008 and beyond is a conservative estimate based on the 2% contract performance standard.
2. The FY 2007 outlays include all benefit dollars subject to the audit process. Fee-for-service claims are considered susceptible to improper payments as payment is made based upon an individual claim submitted by a provider or beneficiary certifying services were provided as billed. Administrative or change order costs are not included, as those costs do not fall into the definition of areas susceptible to improper payments.
3. The FY 2007 outlays do not include:
  - a. The Designated Providers (U.S. Family Health Plan) contracts, through which a set amount is paid for each patient's care on a per member per month basis. The contractor is 100% responsible for improper payments; there is no shared risk with the Government. The Defense Contract Audit Agency conducts reconciliations to validate correct capitated payments for the enrolled population. Government liability is limited to the amount paid to the contractor regardless of the cost of health care services.
  - b. Pharmacy claims. The Department is developing an audit process.
  - c. Foreign claims. The Department is developing an audit process.

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

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

# Independent Auditors' Reports



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

November 10, 2008

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 Opinion on the Fiscal Year 2008 DoD Medicare-  
Eligible Retiree Health Care Fund Financial Statements  
(Report No. D-2009-015)

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. The DoD Comptroller requires that the Fund prepare audited financial statements in accordance with the DoD Financial Management Regulation. We contracted with Kearney & Company to perform the Fund's FY 2008 audit.

**Qualified Audit Opinion.** We agree with the Kearney & Company qualified opinion dated October 31, 2008. Kearney & Company reported that, except for amounts related to the Fund's direct care costs, 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, 2008 and 2007. Kearney & Company also reported that, other than the effects of the direct care weaknesses identified above, the statements conformed with accounting principles generally accepted in the United States of America.

Kearney & Company 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.

**Report on Internal Control.** We also agree with the Kearney & Company report on internal control over financial reporting and compliance with laws and regulations as part of the audit of the Fund's FY 2008 financial statements.

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

- The actuarial liability for Medicare-eligible retiree benefits includes the actuarial present value of the projected direct care costs for benefits provided at Military Treatment Facilities. The Fund bases the costs on data extracted from various systems that are noncompliant and are not transaction based.
- The Fund bases the Military Treatment Facility-level health care cost data 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, the Fund may not be recording some transactions in the correct accounting period.
- 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 activities. 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.** Kearney & Company performed tests that disclosed the Fund did not comply 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 OMB 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 OMB Circular A-130, "Management of Federal Information Resources," November 28, 2000.
- Collectively, the Fund did not fully comply with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004; OMB Circular 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. OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,<sup>\*</sup> requires that auditors report test results if the financial statements do not comply with certain laws and regulations.

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<sup>\*</sup> OMB Memorandum M-08-24, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," August 25, 2008.

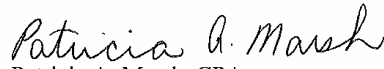
## Independent Auditors' Reports

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**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 Kearney & Company, we complied with government auditing standards; OMB Bulletin No. 07-04, as amended; and the "GAO/PCIE Financial Audit Manual," July 2008. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; reviewed documentation prepared by Kearney & Company; met with Kearney & Company partners and staff members; evaluated the key judgments; met with officials of the Fund; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

We appreciate the courtesies extended to the staff. Please direct questions to Mr. Mark Starinsky (614) 751-1400 extension 231.



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



**INDEPENDENT AUDITOR'S 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, 2008 and 2007, and the related Statement of Net Cost, Statement of Changes in Net Position, and Statement of 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, standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and 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 to support the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTF). As discussed in Note 14 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2008 and 2007, includes approximately \$71 billion (14% of total) and \$75 billion (14% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2008, include approximately \$3.3 billion and \$1.7 billion, respectively, and for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 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, which is a significant factor in the allocation processes. We were unable to obtain sufficient evidence as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

In our opinion, except for the effects on the financial statements of the amounts related to the Fund's direct-care costs, if any, as might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct-care component of the actuarial liability for Medicare-eligible retiree benefits; such financial statements present fairly, in all material respects, the financial position of the Fund, as of September 30, 2008 and 2007, 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.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2008 on our consideration of the Fund's internal control over financial reporting and 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.



October 31, 2008  
Alexandria, Virginia

**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, 2008, and have issued our report thereon dated October 31, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and 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 auditing 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 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 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 necessary to comply with internal and external reporting requirements. These requirements include the requirements for financial statements to be prepared in accordance with the form and content rules prescribed by OMB, and reporting requirements prescribed by 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 interrelationships 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, including the following:

1. The actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2008 and 2007, includes approximately \$71 billion (14% of total) and \$75 billion (14% of total), respectively, of amounts reflecting the actuarial present value of projected direct-care costs of benefits to be provided by the Military Treatment Facilities (MTF), 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, 2008, include approximately \$3.3 billion and \$1.6 billion, respectively, and for the year ended September 30, 2007, include approximately \$3.7 billion and \$1.8 billion, respectively, of amounts related to direct-care costs. 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, which is 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 inadequate to ensure presentation of the direct-care costs in conformity with accounting principles generally accepted in the United States of America.

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 as to the determination of amounts contributed by the Services for their active duty participants. These costs are incurred in the multitude of 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 has 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 2008, 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.

3. 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, which 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 detail here. Instead, as requested by the Office of Inspector General (OIG), the specifics will be presented in a separate, limited distribution report, which will address other control deficiencies involving the Fund's internal control over financial reporting and other matters identified during our audit.

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, to be material weaknesses.

With respect to internal control relevant to data that supports reported performance measures on page 5 of Management's Discussion & Analysis, which accompanies 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 such an opinion.

## 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. As part of our work, we performed tests of compliance with the Federal Financial Management Improvement Act (FFMIA), Section 803(a) requirements. 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, 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
  - Account for assets reliably, so that they can be properly protected from loss, misappropriation, and/or destruction
  - Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger.

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 internal control over financial reporting, indicate that the Fund is not fully compliant 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 DoD OIG, the Audit Committee, and management of the Fund, who then provided us with technical comments, which we incorporated as appropriate. The Audit Committee and 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 DoD OIG, the Audit Committee, management of the Fund, other Defense Organizations, OMB, 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.



October 31, 2008  
Alexandria, Virginia