



FISCAL YEAR 2008

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

November 7, 2008

DoD
MILITARY RETIREMENT FUND
FISCAL YEAR 2008
AUDITED FINANCIAL
STATEMENTS

Table of Contents

Management's Discussion and Analysis	1
Principal Statements.....	14
Notes to the Principal Statements	19
Other Accompanying Information.....	33
Independent Auditors' Reports	35

DoD
MILITARY RETIREMENT
FUND

MANAGEMENT'S DISCUSSION AND
ANALYSIS

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

For the Years Ended September 30, 2008 and 2007

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund (MRF). The military retirement system provides benefits for retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The mission of the MRF is to accumulate funds in order to finance on an actuarially sound basis the liabilities of DoD under military retirement and survivor benefit programs.

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

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

In Fiscal Year (FY) 2008, the Fund paid out approximately \$46 billion in benefits to military retirees and survivors. In FY 2007, the Fund paid out approximately \$44 billion in benefits to military retirees and survivors. In addition to staff members of OUSD (C) and OUSD (P&R), hundreds of individuals at the DFAS Pay Centers are involved in making the benefit payments. However, the discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt per Public Law 108-136; and investment income. During FY 2008, the Fund received approximately \$16 billion in normal cost payments, a \$49 billion Treasury payment, and approximately \$16 billion in investment income, net of premium/discount amortization and accrued inflation compensation. During FY 2007, the Fund received approximately \$14 billion in normal cost payments, a \$29 billion Treasury payment, and approximately \$10 billion in investment income, net of premium/discount amortization and accrued inflation compensation.

Summary

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Homeland Security), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of Commerce). Only those members in plans administered by DoD are included in this report, except in cases where Coast Guard data is shown for informational purposes.

The system is a funded, non-contributory defined benefit plan that includes non-disability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs, and special compensation programs for certain disabled retirees. The Service Secretaries may approve immediate non-disability retired pay at any age with credit of

at least 20 years of active duty service. Reserve retirees generally must be at least 60 years old and have at least 20 qualified years of service before retired pay commences; in some cases the age can be less than 60 if the reservist performed certain types of active service. Public Law 110-181 allows a 90-day reduction in the reserve retirement age from age 60 for every 3 months of certain active duty service, for service after January 28, 2008 (not to exceed ten years). There is no vesting before retirement.

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

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

Non-Disability Retirement From Active Service

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

As of September 30, 2008, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2008, non-disability retirees were paid approximately \$37.17 billion. As of September 30, 2007, there were approximately 1.46 million non-disability retirees from active duty receiving retired pay. In FY 2007, non-disability retirees were paid approximately \$35.5 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the member has at least 20 years of service or the disability, as rated by the DoD, is at least 30 percent (under a standard schedule of rating disabilities by the Veterans Administration) and either (1) the member has at least eight years of service; (2) the disability results from active duty; or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

In disability retirement, the member may elect to receive retired pay equal to either (1) the accrued non-disability retirement benefit regardless of eligibility to retire or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75 percent of base pay. Only the excess of (1) over (2) is subject to federal income taxes if the member had service on or before September 24, 1975. If not a member of a uniformed service on September 24,

Management's Discussion and Analysis

1975, disability retired pay is tax-exempt only for those disabilities that are combat or hazardous duty related. Base pay is equal to final basic pay if the retiree first became a member of a uniformed service before September 8, 1980; otherwise, base pay is equal to the average of the highest 36 months of basic pay.

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

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

As of September 30, 2008, there were approximately 85,000 disability retirees receiving retired pay. In FY 2008, disability retirees were paid approximately \$1.28 billion. As of September 30, 2007, there were approximately 85,000 disability retirees receiving retired pay. In FY 2007, disability retirees were paid approximately \$1.29 billion.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service. However, reserve retired pay is not payable until age 60 unless the member performs certain types of active duty or active service subsequent to the passing of the National Defense Authorization Act for FY 2008 (P.L. 110-181). Retirement age is reduced below 60 by three months for every 90 days of active service with a limit of 10 years. Eligibility for retiree health benefits remains at age 60 even if the eligibility age for retired pay is reduced. Retired pay is computed as base pay times 2.5 percent times years of service. If the reservist was first a member of a uniformed service before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on active duty for the entire period preceding age 60. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, one point is awarded for one day of active duty service (e.g. active duty training) or one inactive duty training (IDT) drill attendance. Reservists may perform two IDT periods in one day thereby receiving two retirement points per day. In addition, 15 points are awarded for completion of one year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member generally cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation. Beginning with years of service that include October 30, 2007, non-active duty points are limited in any year to no more than 130. Lesser limitations have applied in the past.

As of September 30, 2008, there were approximately 327,000 reserve retirees receiving retired pay. In FY 2008, reserve retirees were paid approximately \$4.29 billion. As of September 30, 2007, there were approximately 313,000 reserve retirees receiving retired pay. In FY 2007, reserve retirees were paid approximately \$3.86 billion.

Survivor Benefits

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

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

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

The SBP survivor annuity is 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than \$300 or more than the member's full retired pay. If the member elects CSB/Redux and is subject to a penalty for service under 30 years in the calculation of retired pay, the maximum base amount is equal to the full

retired pay without the penalty. However, the annuity for a survivor of a CSB/Redux retiree is subject to the reduced CPI.

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

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

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

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

SBP annuities are reduced by any VA survivor benefits (Dependency and Indemnity Compensation (DIC)) and all premiums relating to the reductions are returned to the survivor. The National Defense Authorization Act for FY 2008 (P.L. 110-181) included a temporary Special Survivor Indemnity Allowance that pays a monthly amount (\$50 in FY 2009, increasing to \$100 by FY 2014, in \$10 increments) to surviving spouses with a DIC offset; the authority for the allowance ends in 2016. As with retired pay, SBP annuities and premiums are annually increased with cost-of-living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the Career Status Bonus dies before age 62, the survivor is subject to partial COLAs and his/her annuity is increased on what would have been the member's 62nd birthday to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. The RCSBP provides annuities to survivors of reservists who die before age 60, provided they attained 20 years of qualified service. The added cost of this coverage is borne completely by reservists through deductions from future retired pay and/or survivor annuities.

A paid-up provision eliminating the reduction in retired pay for premiums for SBP and RSFP coverage was effective October 1, 2008, for participants age 70 or older whose retired pay has been reduced for 30 years or more.

As of September 30, 2008, there were approximately 289,000 survivors of military members receiving annuity payments. In FY 2008, survivors were paid approximately \$3.37 billion. As of September 30, 2007, there were approximately 287,000 survivors of military members receiving annuity payments. In FY 2007, survivors were paid approximately \$2.92 billion.

Temporary Early Retirement Authority (TERA)

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

As of September 30, 2008, there were approximately 56,000 TERA retirees receiving retired pay. In FY 2008, TERA retirees were paid approximately \$839 million. As of September 30, 2007, there were approximately 58,000 TERA retirees receiving retired pay. In FY 2007, TERA retirees were paid approximately \$834 million.

Management's Discussion and Analysis

Cost-of-Living Increase

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

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

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

Relationship with Department of Veterans Affairs (VA) Benefits

The Department of Veterans Affairs (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of or in combination with DoD retired pay, but through December 31, 2003, were not fully additive. Since VA benefits are exempt from federal income taxes, it is often to the advantage of a member to elect them. Through 2003, retired pay earned from DoD for military service was offset by any payment received from VA for a VA-rated disability. Beginning with the National Defense Authorization Act for FY 2004 (P.L. 108-136), a series of legislation has been enacted that increasingly reduces or eliminates the offset to military retired pay due to receipt of VA disability compensation. Members with a combined VA disability rating of 50% or greater who have at least 20 years of service will have their offset eliminated under the Concurrent Retirement and Disability Pay (CRDP) program. The CRDP program has a ten-year phase-in schedule that began in 2004; however, the offset is already fully eliminated for members whose disabilities are rated total or make the individual unemployable. Members whose disability meets certain combat-related criteria can elect to receive payments against the offset under the Combat Related Special Compensation (CRSC) program. Under CRSC, members are not subject to a phase-in schedule, are not required to have at least 20 years of service (per P.L. 110-181), and are not required to have at least a 50% VA disability rating. Although CRSC amounts are calculated based on retired pay lost due to offset and are paid from the Military Retirement Fund, CRSC is not technically considered retired pay. CRSC payments are tax exempt. A member may not participate in both the CRDP and CRSC programs simultaneously, but may change from one to the other during an annual "open season."

VA benefits also overlap survivor benefits through the Dependency and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefits are returned to the survivor. The National Defense Authorization Act for FY 2008 (P.L. 110-181) included a temporary Special Survivor Indemnity Allowance that pays a monthly amount (\$50 in FY 2009, increasing to \$100 by FY 2014, in \$10 increments) to survivors with a DIC offset; the authority for the allowance ends in 2016.

Interrelationship with Other Federal Service

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

Relationship of Retired Pay to Military Compensation

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

which varies by grade, location, and dependency status, (3) the subsistence allowance and, (4) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 70 percent of RMC for all retirement eligible members. For the 20-year retiree, basic pay is approximately 67 percent of RMC. Consequently, a member retired with 20-years of service and entitled to 50 percent of basic pay, would only receive 34 percent of RMC. For a 30-year retiree, the corresponding entitlements are 73 percent of basic pay, but only 55 percent of RMC. Public Law 109-364 allows members, retired since January 1, 2007, with greater than 30 years of service, to retire with entitlements exceeding 75 percent of basic pay. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

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

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

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

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

Significant Changes During FY 2008

Changes during FY 2008 included the following assumption changes: (1) Board adoption of a new long-term interest assumption of 5.75%, down from 6%, (2) updated rates and factors used to project Non-disability Retired Pay, which results in a better allocation of full- and part-time costs, and (3) an updated mortality improvement trend used to project increasing life expectancies. Of these, the lower interest rate was the most significant. The DoD Board of Actuaries approved these new assumptions at their August 2008 meeting.

Benefit changes during FY 2008: (1) early reserve retirement; (2) expansion of Concurrent Receipt benefits; and (3) additional monthly allowance for those annuitants subject to DIC offset.

Changes during FY 2007 included: (1) updated rates and factors used to project Non-disability Retired Pay, (2) updated rates and factors used to project Survivor Annuities, (3) targeted pay increases for particular pay grades along with longevity increases between 28 and 40 years of service for senior members, and (4) refinements to the methodologies used to calculate survivor annuities for those members who die while serving on Active Duty. Of these adoption of the updated rates and factors used to project Non-disability Retired Pay was the most significant. The DoD Board of Actuaries approved these assumptions at their August 2007 meeting.

Changes for FY 2009

The possible benefit changes with respect to the Military Retirement Fund for FY 2009 include: (1) "Wounded Warrior" bills which focus on combat-related severely injured members, (2) SBP refinements, (3) Concurrent Receipt

Management's Discussion and Analysis

refinements, (4) refinements to general retired pay, and (5) revamping of the Military Retirement System based on the findings of the 10th Quadrennial Review of Military Compensation.

Performance Measures

During FY 2008 and 2007, the Fund made monthly disbursements to approximately 2.2 and 2.1 million retirees and annuitants, respectively.

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

- a. September 30, 2008 = .350
- b. September 30, 2007 = .343
- c. September 30, 2006 = .328
- d. September 30, 2005 = .334
- e. September 30, 2004 = .338
- f. September 30, 2003 = .351
- g. September 30, 2002 = .378
- h. September 30, 2001 = .347
- i. September 30, 2000 = .354
- j. September 30, 1999 = .352

The effective yield of the Fund during FY 2008 was approximately 6.2%.

Projected Long-Term Health of the Fund

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

Basic pay for FY 2008 was projected to be \$56.5 billion. Normal cost payments were projected to be \$18.7 billion. The unfunded liability amortization payment was projected to be \$46.2 billion. Investment income was projected to be \$15.3 billion. Fund disbursements for FY 2008 were projected to be \$45.6 billion; the actual amount for FY 2008 was \$45.8 billion. The table below presents a projection of contributions to and disbursements from the Fund. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-year projection period.

Management's Discussion and Analysis

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

Fiscal Year	Basic Payroll	Normal Cost Payments	Amortization of Unfunded Liability	Investment Income	Fund Disbursements	Fund Balance End of Year
2009	\$56.2	\$19.7 (0.351)	\$51.1 (0.910)	\$17.3 (0.308)	\$48.6 (0.866)	\$290.3 (5.168)
2010	\$58.0	\$20.5 (0.353)	\$53.0 (0.915)	\$19.8 (0.342)	\$50.4 (0.870)	\$333.2 (5.746)
2011	\$60.2	\$21.2 (0.353)	\$55.0 (0.915)	\$22.5 (0.374)	\$51.9 (0.863)	\$380.1 (6.318)
2012	\$62.4	\$22.0 (0.353)	\$57.1 (0.915)	\$25.4 (0.407)	\$53.3 (0.855)	\$431.2 (6.912)
2013	\$64.6	\$22.8 (0.353)	\$59.2 (0.917)	\$28.6 (0.442)	\$55.0 (0.850)	\$486.9 (7.534)
2014	\$66.9	\$23.6 (0.352)	\$61.5 (0.918)	\$32.0 (0.479)	\$56.6 (0.845)	\$547.4 (8.178)
2015	\$69.4	\$24.5 (0.352)	\$63.8 (0.919)	\$35.8 (0.516)	\$58.0 (0.837)	\$613.4 (8.839)
2016	\$72.0	\$25.3 (0.352)	\$66.2 (0.919)	\$39.9 (0.554)	\$59.5 (0.827)	\$685.2 (9.523)
2017	\$74.6	\$26.3 (0.352)	\$68.6 (0.920)	\$44.3 (0.594)	\$61.4 (0.823)	\$763.0 (10.230)
2018	\$77.2	\$27.2 (0.352)	\$71.2 (0.923)	\$49.1 (0.636)	\$63.4 (0.822)	\$847.1 (10.975)
2019	\$79.9	\$28.1 (0.352)	\$73.9 (0.925)	\$54.3 (0.680)	\$65.6 (0.821)	\$937.8 (11.741)
2020	\$82.7	\$29.1 (0.352)	\$76.6 (0.927)	\$59.9 (0.724)	\$67.8 (0.820)	\$1,035.7 (12.531)
2021	\$85.5	\$30.1 (0.352)	\$79.5 (0.930)	\$65.9 (0.770)	\$70.1 (0.819)	\$1,141.1 (13.341)
2022	\$88.5	\$31.2 (0.352)	\$82.5 (0.932)	\$72.4 (0.817)	\$72.4 (0.818)	\$1,254.8 (14.175)
2023	\$91.6	\$32.2 (0.352)	\$85.6 (0.935)	\$79.3 (0.866)	\$74.8 (0.817)	\$1,377.1 (15.038)
2024	\$94.7	\$33.3 (0.352)	\$88.8 (0.938)	\$86.8 (0.917)	\$77.4 (0.817)	\$1,508.6 (15.931)
2025	\$98.0	\$34.5 (0.352)	\$125.6 (1.281)	\$96.9 (0.988)	\$79.9 (0.815)	\$1,685.7 (17.196)
2026	\$101.6	\$35.8 (0.352)	\$133.1 (1.309)	\$107.9 (1.062)	\$82.3 (0.810)	\$1,880.1 (18.503)
2027	\$105.4	\$37.1 (0.352)	\$3.8 (0.036)	\$111.8 (1.061)	\$84.9 (0.805)	\$1,947.9 (18.486)
2028	\$109.3	\$38.4 (0.352)	\$3.9 (0.036)	\$115.8 (1.060)	\$87.8 (0.803)	\$2,018.4 (18.473)

NOTE: At its August 2007, meeting, the Military Retirement Fund Board of Actuaries decided to shorten the amortization period of the initial unfunded liability such that it will be extinguished in 2026 rather than 2033. This led to an increase in the FY 2008 amortization payment amount of \$16 billion.

Expected Problems

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

Type of Investments

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt; and investment income.

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

The Fund also invests in Treasury Inflation-Protected Securities (TIPS), which are indexed for inflation. TIPS are fixed-rate instruments designed to protect against inflation and the principal amount is indexed to the consumer price

Management's Discussion and Analysis ---

index (CPI) by adjusting the CPI at issuance to the current CPI; as inflation increases, so does the principal amount and the rate.

All of these instruments are debt obligations of the U.S Government and are backed by the "full faith and credit" of the government. Debt obligations of the U.S. Government have virtually no risk of nonpayment of principal and interest at the specified due date.

The Fund receives management oversight from the DoD Investment Board established in September 2003. The members of the Investment Board are the Director, DFAS, the Deputy Chief Financial Officer, OUSD (C) and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board meets twice each fiscal year to consider investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. At the September 30, 2008 meeting, the Investment Board approved a revised Investment Strategy that replaced the duration matching strategy with a ladder approach for the investments and reiterated the "hold to maturity" policy.

Anticipated Changes Between the Expected and Actual Investment Rate of Return

Due to the current volatility in interest rates, the increasing deficit, the volatility in the markets with regard to energy prices, and the current state of international conflict one might expect the U.S. budget deficit to increase. This will necessitate increased borrowing by the U.S. Government for the foreseeable future and therefore there may be a greater opportunity to purchase treasury market securities at higher rates of interest. Conversely, uneasy equity markets tend to push participants to the Government securities as a flight to quality causing downward pressure on the interest rates. Modern Corporate Financial Theory also pushes non-federal government firms to Government securities for pension plan investments. It is unknown where the equilibrium will settle. An investment strategy has been developed to shift towards Treasury Inflation Protected Securities to hedge against any future inflation to increase the profitability of the Fund over time.

Financial Data

The table below presents comparative financial statement information for the MRF.

Management's Discussion and Analysis

Military Retirement Fund

Analysis of Financial Statements

For the Years Ended September 30, 2008 and 2007

(\$ in Thousands)

<u>Statements of Net Assets</u>	<u>2008</u>	<u>2007</u>	<u>Difference</u> Increase/(Decrease)
Fund Balance with Treasury			
- Sufficiency of funds available to cover estimated disbursements	\$17,515	\$20,376	(\$2,861) (14%)
Investments			
- Revenue from Treasury Payments Service Contribution, and Interest	\$253,046,615	\$218,084,995	\$34,961,620 16%
Account Receivable, Net amounts, including both inter- and intra-governmental			
- Continued emphasis placed on collecting these amounts	\$24,513	\$143,116	(\$118,603) (83%)
Other Liabilities			
- Custodial Liability due to Treasury	\$1,622	\$759	\$863 114%
Military Retirement Benefit Liabilities			
- Updated non-disability rates and factors	\$1,154,108,091	\$1,028,850,683	\$125,257,408 12%
Cumulative Results of Operations			
- Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by \$125.3 billion and total assets increased by \$34.8 billion.	(\$901,021,262)	(\$810,603,152)	(\$90,418,110) (11%)
<u>Statements of Net Costs</u>			
Gross Cost of Operations			
- Higher Actuarial Liability in FY 08 due to the lowering of the long-term interest rate	\$171,077,638	\$105,253,018	\$65,824,620 63%
<u>Statements of Budgetary Resources</u>			
Distributed Offsetting Receipts			
- Unfunded liability amortization payment (FY 08) from Treasury	\$46,187,000	\$26,048,000	\$20,139,000 77%

Management Assurances

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

Management's Discussion and Analysis

In its FY 2008 assessments, MRF management assessed that the MRF (as an OMB-designated Financial Statement Reporting Entity (FSRE)) has effective internal controls to support effective and efficient programmatic operations and reliable financial reporting. The MRF management is in the process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). Although the current financial management systems do not currently conform to financial systems requirements (FMFIA § 4), MRF management is working with DFAS to implement corrective actions.

Improper Payments Information Act of 2002 (Public Law No. 107-300)

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

The Department's risk assessments for Military Retirement addressed the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well as system weaknesses identified internally or by outside audit activities. While the Department's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments. The Department of Defense uses random sampling methods designed to meet or exceed the OMB requirement of annual estimates of improper payments with a 90% confidence interval of (plus or minus 2.5%).

Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. Based on FY 2007 reviews, the Department projected approximately \$49 million in improper payments for this program, with almost the entire amount paid to deceased retirees. This represents an overpayment rate of 0.13% of the estimated \$37 billion in annual military retirement payments. In certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in FY 2007 indicated that the Department recovered 93% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

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

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

The Department has the information and infrastructure needed to reduce improper payments. The Department also is implementing a Business Activity Monitoring service which will employ the latest technology to increase the efficiency and effectiveness of improper payment detection efforts for commercial pay.

Military Retirement faces statutory or regulatory barriers limiting corrective actions. The barriers include: (1) the Retired and Annuitant Pay service contract and (2) the Federal Acquisition Regulation.

In January 2002, the Defense Finance and Accounting Service (DFAS) awarded the Retired and Annuitant Pay service operations to a contractor. Although most functions remained unchanged from when the Government performed these functions, there are now contractual limits to the Government's involvement in the day-to-day operations of Retired and Annuitant Pay. The Continuing Government Activity Office was formed to oversee this contract; however, the Government can no longer direct how the work is accomplished. To bring about an operational change, both the

Management's Discussion and Analysis

Government and the contractor must agree on how to effect and fund the change. The Federal Acquisition Regulation requires a contract modification for any scope change to the current contract.

The Department conducts monthly random reviews of both the confirmed deceased accounts and the overall population of retired and annuitant pay accounts. A monthly random sample of 135 accounts (1,620 annually) from an average monthly population of approximately 3,400 confirmed deceased retiree accounts is reviewed. Monthly random samples of 500 accounts (6,000 annually) also are reviewed from the retiree and annuitant pay files. All sampling plans are designed to produce annual estimates of improper payments with 95% probability (plus or minus 2.5% sampling precision).

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the Military Retirement Fund in accordance with the generally accepted accounting principles for Federal entities and formats prescribed by the Office of Management and Budget, the statements are in addition to the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization they are for a component of the U.S. Government, a sovereign entity; unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation; and the payment of all liabilities other than for contracts can be abrogated by DoD.

DoD
MILITARY RETIREMENT
FUND

PRINCIPAL STATEMENTS

**Department of Defense
Military Retirement Fund
BALANCE SHEETS
September 30, 2008 and 2007
(In Thousands)**

	2008	2007
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 17,515	\$ 20,376
Investments (Note 4)	253,046,615	218,084,995
Accounts Receivable, Net (Note 5)	0	118,950
Total Intragovernmental Assets	\$ 253,064,130	\$ 218,224,321
Accounts Receivable, Net (Note 5)	24,513	24,166
TOTAL ASSETS	\$ 253,088,643	\$ 218,248,487
LIABILITIES		
Intragovernmental:		
Accounts Payable	\$ 0	\$ 0
Other Liabilities (Note 6)	1,622	759
Total Intragovernmental Liabilities	\$ 1,622	\$ 759
Military Retirement Benefit Liabilities (Notes 6 & 7)	\$ 1,154,108,091	\$ 1,028,850,683
Other Liabilities (Note 6)	192	197
TOTAL LIABILITIES	\$ 1,154,109,905	\$ 1,028,851,639
NET POSITION		
Cumulative Results of Operations - Earmarked Funds	\$ (901,021,262)	\$ (810,603,152)
TOTAL NET POSITION	\$ (901,021,262)	\$ (810,603,152)
TOTAL LIABILITIES AND NET POSITION	\$ 253,088,643	\$ 218,248,487

The accompanying notes are an integral part of these statements.

Principal Statements

**Department of Defense
Military Retirement Fund
STATEMENTS OF NET COST
For the Years Ended September 30, 2008 and 2007
(In Thousands)**

	<u>2008</u>	<u>2007</u>
PROGRAM COSTS		
Gross Costs (Note 8)	\$ 171,077,638	\$ 105,253,018
Less: Earned Revenue (Note 8)	<u>(80,659,528)</u>	<u>(53,311,182)</u>
Net Program Costs	\$ <u>90,418,110</u>	\$ <u>51,941,836</u>
NET COST OF OPERATIONS	\$ <u>90,418,110</u>	\$ <u>51,941,836</u>

The accompanying notes are an integral part of these statements.

**Department of Defense
Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2008 and 2007
(In Thousands)**

	<u>2008</u>	<u>2007</u>
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (810,603,152)	\$ (758,661,316)
Net Cost of Operations (+/-)	<u>90,418,110</u>	<u>51,941,836</u>
Net Change	\$ <u>(90,418,110)</u>	\$ <u>(51,941,836)</u>
Cumulative Results of Operations	\$ <u>(901,021,262)</u>	\$ <u>(810,603,152)</u>
Net Position	\$ <u><u>(901,021,262)</u></u>	\$ <u><u>(810,603,152)</u></u>

The accompanying notes are an integral part of these statements.

Principal Statements

Department of Defense
Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2008 and 2007
(In Thousands)

	<u>2008</u>	<u>2007</u>
Budgetary Resources		
Unobligated Balance, brought forward, October 1	\$ 0	\$ 0
Budget Authority:		
Appropriation	<u>80,751,005</u>	<u>53,452,702</u>
Subtotal	\$ 80,751,005	\$ 53,452,702
Temporarily not available pursuant to Public Law	<u>(35,102,235)</u>	<u>(9,822,597)</u>
Total Budgetary Resources	\$ <u><u>45,648,770</u></u>	\$ <u><u>43,630,105</u></u>
 Status of Budgetary Resources		
Obligations Incurred:		
Direct	\$ <u>45,648,770</u>	\$ <u>43,630,105</u>
Subtotal	\$ 45,648,770	\$ 43,630,105
Unobligated Balance:		
Exempt from apportionment	\$ <u>0</u>	\$ <u>0</u>
Subtotal	\$ <u>0</u>	\$ <u>0</u>
Unobligated balance not available	<u>0</u>	<u>0</u>
Total Status of Budgetary Resources	\$ <u><u>45,648,770</u></u>	\$ <u><u>43,630,105</u></u>
 Change in Obligated Balance:		
Obligated balance, net:		
Unpaid obligations, brought forward, October 1	\$ <u>3,530,196</u>	\$ <u>3,409,801</u>
Total unpaid obligated balance, net	3,530,196	3,409,801
Obligations incurred net (+/-)	\$ 45,648,770	43,630,105
Less: Gross outlays	\$ <u>(45,819,719)</u>	\$ <u>(43,509,710)</u>
Obligated balance, net, end of period		
Unpaid obligations	<u>3,359,247</u>	\$ <u>3,530,196</u>
Total unpaid obligated balance, net, end of period	\$ <u><u>3,359,247</u></u>	\$ <u><u>3,530,196</u></u>
 Net Outlays:		
Gross outlays	\$ 45,819,719	\$ 43,509,710
Less: Distributed offsetting receipts	<u>(46,187,000)</u>	<u>(26,048,000)</u>
Net Outlays	\$ <u><u>(367,281)</u></u>	\$ <u><u>17,461,710</u></u>

The accompanying notes are an integral part of these statements.

DoD
***MILITARY RETIREMENT
FUND***

***NOTES
TO THE
PRINCIPAL STATEMENTS***

Notes to the Principal Statements

DoD MILITARY RETIREMENT FUND

NOTES TO THE PRINCIPAL STATEMENTS

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund (MRF), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of MRF in accordance with the Department of Defense (DoD) Financial Management Regulation; the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*; and, to the extent possible, generally accepted accounting principles (GAAP). The accompanying financial statements account for all resources for which MRF is responsible unless otherwise noted.

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

C. Appropriations and Funds. The National Defense Authorization Act for FY 1984 (P. L. 98-94), authorized MRF and provided a permanent, indefinite appropriation. Permanent authority becomes available based upon standing provisions of law without any further legislative action by the Congress after transmittal of the budget for each year.

The MRF is designated as an earmarked fund. Earmarked funds are financed by specifically identified revenues. The primary financing sources for MRF are (1) monthly Military Service contributions as a percentage of base pay; (2) an annual warrant from the U.S. Treasury for the unfunded liability and for the concurrent receipt provisions for certain disabled retirees; and (3) interest earned on investments. Using methods and assumptions approved by the DoD Board of Actuaries, the DoD Office of the Actuary determines the amount of the contributions made to MRF. The U.S. Treasury appropriation is received at the beginning of each fiscal year. Funds from the contributions that exceed the amounts required to pay current year expenses are invested. Those investments at maturity and their associated interest revenues will be used to cover future liabilities of MRF.

Earmarked funds also are required by statute to be used for designated activities, benefits, or purposes, and remain available over time. Earmarked funds also have a requirement to account for and report on the receipt, use, and retention of revenues and other financing sources.

The MRF is a non-revolving trust fund. Trust funds contain receipts and expenditures of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

D. Basis of Accounting. For FY 2008, the financial feeder systems used by MRF did not meet all of the requirements for full accrual accounting. These systems were designed and implemented before the issuance of GAAP for federal agencies and were not designed to collect and record financial information on the full accrual basis as required by GAAP. When necessary, MRF and the Defense Finance and Accounting Service (DFAS) have established manual controls to work around these system issues. For example, the accounting system used by MRF does not record information on a budgetary basis. Instead, the reporting system derives the budgetary account balances from information contained in the proprietary accounts.

The DoD has undertaken efforts to determine the actions required to bring its financial and non-financial feeder systems and processes into compliance with GAAP. One such action is the current revision of its accounting systems to record transactions based on the U.S. Standard General Ledger. Until all of MRF's financial and non-financial feeder systems and processes are updated to collect and report financial information as required by GAAP, MRF's financial data will be derived from transactions from non-compliant feeder systems, information from the proprietary accounts, and accruals made for major items such as estimated payables owed to beneficiaries.

E. Revenues and Other Financing Sources. Financing sources for MRF are provided primarily through monthly Military Service contributions as a percentage of basic pay, the annual amortization payments from the U.S. Treasury for the unfunded liability and a portion of accruing costs for active military members, and interest earned on investments.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of operating expenses in the period incurred. However, because MRF's financial system was not designed to collect and record financial information on the full accrual accounting basis, accruals are made for major items such as estimated payables owed to beneficiaries.

G. Accounting for Intragovernmental Activities. Preparation of reliable financial statements requires the elimination of transactions occurring among entities within DoD or between two or more federal agencies. Seller entities within DoD provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal DoD accounting offices. In most cases, the buyer-side records are adjusted to agree with DoD seller-side balances. Intra-DoD balances are then eliminated. The MRF is able to reconcile its records and no adjustments are needed. The DoD is developing long-term system improvements to ensure accurate intragovernmental information, to include sufficient up-front edits and controls, eliminating the need for after-the-fact reconciliations.

The U.S. Treasury Financial Management Service is responsible for eliminating transactions between DoD and other federal agencies. The *Treasury Financial Manual*, Part 2 - Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government*, and the U.S. Treasury's *Federal Intragovernmental Transactions Accounting Policy Guide*, provide guidance for reporting and reconciling intragovernmental balances. The MRF is able to reconcile balances pertaining to investments in federal securities.

The DoD's proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DoD's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

H. Funds with the U.S. Treasury. The MRF's monetary resources are maintained in the U.S. Treasury accounts. The disbursing offices of DFAS, the Military Departments, and other Federal Government financial service centers process the majority of MRF's cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on check issues, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites submit reports by appropriation to the U.S. Treasury on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable fund balance with treasury (FBWT) account. The MRF-recorded balance in FBWT account and U.S. Treasury's FBWT accounts must balance monthly.

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

I. Accounts Receivable. As presented in the Balance Sheet, accounts receivable includes three categories: accounts, claims, and refunds receivable from other federal entities or from the public. The MRF calculates allowances for uncollectible accounts due from the public using the general reserve method. Under this method, a reserve is based on the age of debts and bad debt experience. The DoD does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the *Treasury Financial Manual*.

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

The MRF invests in Non-Marketable Market-based U.S. Treasury securities. These are U.S. Treasury securities that are issued by the Bureau of the Public Debt to federal agencies. They are not traded on any securities exchange but mirror the prices of particular U.S. Treasury securities traded in the government securities market. The MRF receives interest on the value of its non-marketable, market-based securities from the U.S. Treasury on a semi-annual basis.

K. Contingencies and Other Liabilities. The Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*, defines a contingency as an existing condition, situation, or set of circumstances that involves an

Notes to the Principal Statements

uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The MRF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectability of accounts receivable, pending or threatened litigation, and possible claims and assessments. The MRF reports death payment contingencies that result from DoD's responsibility to cover retiree benefits not paid by the Department of Veterans Affairs during the month of death.

L. Net Position. Net position consists of cumulative results of operations. Cumulative results of operations represent the net of expenses, losses, and financing sources (including appropriations, revenue, and gains) since the inception of the Fund. Beginning in FY 1998, the cumulative results also include donations and transfers in and out of assets without reimbursement.

M. Comparative Data. The MRF's financial statements and notes are presented on a comparative basis.

N. Unexpended Obligations. Unexpended obligations include both obligations for which goods and services have been delivered (title passed) and a liability recognized and obligations for which no delivery has occurred and no liability recognized. The balance of unexpended obligations appears immediately before net outlays in the Statement of Budgetary Resources and is referred to as "Total, unpaid obligated balances, net, end of period." For the MRF, this balance represents the amount of earned and accrued pension and annuity payments reported as accounts payable.

O. Undistributed Disbursements and Collections. All disbursements for MRF are made by DFAS Cleveland Retired Pay Operations. The DFAS Cleveland reports these disbursements to the U.S. Treasury. The contributions to the MRF are made by the Military Services and the U.S. Treasury and are processed by the Trust Fund Accounting Division (TFAD) and reported by TFAD to the U.S. Treasury. The TFAD records these transactions in the Trust Fund Accounting System (TFAS) and reconciles to the U.S. Treasury each month-end. All transactions reported to the U.S. Treasury are included in TFAS. Therefore, MRF has no undistributed disbursements or collections.

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

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

NOTE 2. NON-ENTITY ASSETS

(\$ In Thousands)	<u>FY 2008</u>	<u>FY 2007</u>
Accounts Receivable	\$ 1,622	\$ 759
Total Non-Entity Assets	\$ 1,622	\$ 759
 Total Entity Assets	 <u>253,087,021</u>	 <u>218,247,728</u>
Total Assets	\$ <u>253,088,643</u>	\$ <u>218,248,487</u>

Non-entity assets are assets for which the MRF maintains stewardship accountability and responsibility to report, but are not available for MRF's operations. Entity assets consist of resources that the MRF has the authority to use to meet entity obligations.

Notes to the Principal Statements

Nonfederal Assets, Accounts Receivable, represent the amounts of interest, penalties, and administrative charges that are collected by MRF on behalf of the U.S. Treasury. Once collected, these amounts are transferred to the appropriate U.S. Treasury receipt account. This amount, which represents a liability for MRF as well, is also reported on Note 6, Liabilities Not Covered by Budgetary Resources.

Accounts Receivable of \$1,622.0 and \$759.0 for FYs 2008 and 2007, respectively, represent the amounts of interest, penalties, and administrative charges, net of an allowance for loss, that are collected by MRF on behalf of the U.S. Treasury. These amounts are also reflected in Note 6 as a custodial liability.

NOTE 3. FUND BALANCE WITH TREASURY (FBWT)

(\$ In Thousands)	<u>FY 2008</u>	<u>FY 2007</u>
Fund Balance:		
Total Trust Funds	\$ <u>17,515</u>	\$ <u>20,376</u>
Status of Fund Balance with Treasury:		
Unobligated Balance - Unavailable	\$ 246,956,712	\$ 211,854,477
Obligated Balance not yet Disbursed	3,359,247	3,530,196
Non-Budgetary FBWT	<u>(250,298,444)</u>	<u>(215,364,297)</u>
Total	\$ <u>17,515</u>	\$ <u>20,376</u>

The FBWT has a normal fluctuation due to a timing difference between the receipt of the notification of the actual final payment and the required investment deadline at the U.S. Treasury. The MRF withholds \$25 million in FBWT from overnight investments to ensure the availability of sufficient funds to cover disbursements made on the last business day of each month that cannot be captured in time to meet the month-end investment timeframe.

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 classified as available or unavailable, are related to trust fund accounts, which are restricted by the public laws that established the funds. These balances become available subsequently without further congressional action.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods that have not been received or services that have not been performed, and goods and services that have been delivered/received but not yet paid. The MRF balance represents benefits payable on October 1, 2008.

Non-FBWT Budgetary Accounts represent adjustments to budgetary accounts that do not affect FBWT. The MRF balance represents investment accounts that reduce the Status of FBWT.

NOTE 4. INVESTMENTS

(\$ In Thousands)	<u>FY 2008</u>				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) /Discount</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities,					
Non-Marketable,	\$ 255,722,202	Effective	\$ (5,423,758)	\$ 250,298,444	\$ 240,912,686
Market-based		Interest			
Subtotal	<u>\$ 255,722,202</u>		<u>\$ (5,423,758)</u>	<u>\$ 250,298,444</u>	<u>\$ 240,912,686</u>
Accrued Interest	<u>2,748,171</u>			<u>2,748,171</u>	<u>2,748,171</u>
Total Investments	<u>\$ 258,470,373</u>		<u>\$ (5,423,758)</u>	<u>\$ 253,046,615</u>	<u>\$ 243,660,857</u>

Notes to the Principal Statements

(\$ In Thousands)

	FY 2007				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) /Discount</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities, Non-Marketable, Market-based	\$ 222,030,479	Effective Interest	\$ (6,666,182)	\$ 215,364,297	\$ 212,242,566
Subtotal	\$ 222,030,479		\$ (6,666,182)	\$ 215,364,297	\$ 212,242,566
Accrued Interest	<u>2,720,698</u>			<u>2,720,698</u>	<u>2,720,698</u>
Total Investments	\$ <u>224,751,177</u>		\$ <u>(6,666,182)</u>	\$ <u>218,084,995</u>	\$ <u>214,963,264</u>

The DoD Investment Board approves the strategy for the type of securities purchased by the MRF at its semi-annual meetings. These intragovernmental non-marketable, market-based securities can include U.S. Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS) and overnight certificates.

U.S. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at a discount or premium. The U.S. Treasury bonds are long-term securities with maturities of ten years or more and are purchased at either a discount or premium. Treasury TIPS are securities with maturities of five to twenty years and are purchased at a discount or premium. The TIPS provide protection against inflation. The principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. At maturity, the recipient is paid the adjusted principal or original principal, whichever is greater. The MRF records investments at book value, representing amortized cost. The MRF recognizes the amortization of discounts and premiums using the effective interest method. The MRF 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.

Total Intragovernmental Securities, Investments Net, increased \$35.0 billion (16%). This increase is the result of investing annual contributions from the U.S. Treasury, net of current disbursements for benefits paid. The increase in the annual investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover the unfunded portions of future benefits.

The Federal Government does not set aside assets to pay future benefits and expenditures associated with earmarked funds. The cash receipts collected from the public for an earmarked fund are deposited in the U.S. Treasury, which uses the cash for general Government purposes. The U.S. Treasury securities are issued to the earmarked funds as evidence of earmarked fund receipts. The U.S. Treasury securities are an asset to the MRF and a liability to the U.S. Treasury. Because the MRF and the U.S. Treasury both are 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 Federal Government-wide financial statements.

The U.S. Treasury securities provide the MRF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the MRF requires redemption of these securities to make expenditures, the Federal Government finances those expenditures out of accumulated cash balances by raising taxes or other receipts, by borrowing from the public, repaying less debt, or by curtailing other expenditures. This is the same way that the Federal Government finances all other expenditures.

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

(\$ In Thousands)

<u>SECURITIES</u>	<u>COST FY 2008</u>	<u>COST FY 2007</u>
Notes	\$ 50,905,963	\$ 52,049,273
Bonds	1,347,938	27,958,981
TIPS	200,004,938	136,102,834
Overnights	<u>3,463,363</u>	<u>5,919,391</u>
Totals	\$ <u>255,722,202</u>	\$ <u>222,030,479</u>

Notes to the Principal Statements

NOTE 5. ACCOUNTS RECEIVABLE

(\$ In Thousands)

	FY 2008		
<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>	
Entity Receivables:			
With the Public	\$ 29,911	\$ (5,398)	\$ 24,513
Intragovernmental	<u>0</u>	<u>0</u>	<u>0</u>
Total Receivables	<u>\$ 29,911</u>	<u>\$ (5,398)</u>	<u>\$ 24,513</u>

(\$ In Thousands)

	FY 2007		
<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible</u>	<u>Net Amount Due</u>	
Entity Receivables:			
With the Public	\$ 29,197	\$ (5,031)	\$ 24,166
Intragovernmental	<u>118,950</u>	<u>0</u>	<u>118,950</u>
Total Receivables	<u>\$ 148,147</u>	<u>\$ (5,031)</u>	<u>\$ 143,116</u>

Intragovernmental Accounts Receivable decreased by \$118.9 million due to a late contribution made in FY 2008 that was applicable to FY 2007. The Marine Corps paid their September 2007 contribution on October 4, 2007. There were no intragovernmental receivables in FY 2008; all contributions were made prior to fiscal year-end.

The MRF uses the general reserve method to calculate a percentage for an allowance for estimated uncollectible accounts receivable. This method establishes a reserve based on age of the debts and bad debt experience. Accounts receivable includes amounts, claims and refunds receivable from retirees and annuitants.

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

(\$ In Thousands)

	FY 2008	FY 2007
Intragovernmental Liabilities:		
Other	\$ <u>1,622</u>	\$ <u>759</u>
Total Intragovernmental Liabilities	\$ 1,622	\$ 759
Non-Federal Liabilities:		
Military Retirement Benefits Liability (Note 7)	\$ 903,792,133	\$ 813,466,010
Other	<u>192</u>	<u>197</u>
Total Non-Federal Liabilities	\$ <u>903,792,325</u>	\$ <u>813,466,207</u>
Total Liabilities Not Covered by Budgetary Resources	\$ 903,793,947	\$ 813,466,966
Total Liabilities Covered by Budgetary Resources	<u>250,315,958</u>	<u>215,384,673</u>
Total Liabilities	<u>\$ 1,154,109,905</u>	<u>\$ 1,028,851,639</u>

The MRF Liabilities Not Covered by Budgetary Resources represents the difference between the actuarial liability for future benefit payments and the current assets of MRF. These liabilities increased \$90.3 billion (11%). The increase is primarily attributable to the increase in the actuarial liability of \$125.3 billion, offset by a \$35.0 billion increase in investments (see Note 4).

Notes to the Principal Statements

The Intragovernmental Other Liabilities represent a custodial liability for the Military Retirement Fund that is comprised of interest, penalties, and administrative charges to be collected on behalf of the U.S. Treasury. This amount is also reported in Note 2, Nonentity Assets.

The Military Retirement and Other Federal Employment Benefits not covered by budgetary resources represent pension benefits. Refer to Note 7, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

The Nonfederal Other Liabilities represent estimated death payment contingent liabilities payable by the Department of Defense.

NOTE 7. MILITARY RETIREMENT BENEFIT LIABILITIES

(\$ In Thousands)

<u>Major Program Activities</u>	FY 2008			
	<u>Present Value of Benefits</u>	<u>Assumed Interest Rate (%)</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Military Retirement Pensions Actuarial Liability	\$ 1,150,748,844	5.75%	\$ (246,956,711)	\$ 903,792,133
Benefits Due and Payable	<u>3,359,247</u>		<u>(3,359,247)</u>	<u>0</u>
Total:	\$ <u>1,154,108,091</u>		\$ <u>(250,315,958)</u>	\$ <u>903,792,133</u>

<u>Major Program Activities</u>	FY 2007			
	<u>Present Value of Benefits</u>	<u>Assumed Interest Rate (%)</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Military Retirement Pensions Actuarial Liability	\$ 1,025,320,487	6.00%	\$ (211,854,477)	\$ 813,466,010
Benefits Due and Payable	<u>3,530,196</u>		<u>(3,530,196)</u>	<u>0</u>
Total:	\$ <u>1,028,850,683</u>		\$ <u>(215,384,673)</u>	\$ <u>813,466,010</u>

The Total Military Retirement and Other Federal Employment Benefits line item increased by \$125.3 billion (12%) primarily due to the increase in the FY 2008 actuarial liability. The majority of this increase is due to changes in assumptions, benefits and actuarial experience (expected versus actual). The two key assumption changes in FY 2008 were a 0.25% interest rate reduction (which led to a \$41.7 billion increase) and mortality improvement factors (which resulted in a \$13.2 billion increase).

Actuarial experience from military pay and cost of living adjustments led to a \$23.3 billion increase, while benefit improvement for reservists who retire early resulted in an \$8.1 billion increase. The remaining increase resulted from anticipated growth due to normal cost, interest cost and liability released through benefit payments (\$34.0 billion). See Note 13 for additional information.

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

Notes to the Principal Statements

The MRF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2008, balance represents the September 2008 amount.

The above table displays two distinct types of liabilities that are related to Military Retirement and Other Federal Employment Benefits. It presents the actuarial liability for future pension benefits not yet incurred displayed on the line titled "Military Retirement Pensions." It also presents the retirement benefits that are due and payable on the first day of the next reporting period displayed on the line titled "Other Federal Employment Benefits."

Other Information Pertaining to Military Retirement Benefits Actuarial Liabilities:

Actuarial Cost Method

Actuarial Cost Method: Aggregate entry-age normal method. As dictated by law, the Military Retirement System is funded using the aggregate entry-age normal method. This is a method whereby projected retirement costs are spread over the projected future salaries of a cohort at the point of entry.

Projected Revenues

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

Assumptions

The Board sets the long-term economic assumptions for each valuation. The long-term assumptions for the FY 2007 valuation were 6.0% interest, 3.0% Consumer Price Index, and 3.75% salary increase. For the FY 2008 valuation, the long-term economic assumption for interest is 5.75%; the inflation and salary assumptions are the same. The interest rate assumption represents the long-term Fund yield. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward from the prior year valuation results as reported in the DoD Office of Actuary Valuation of the Military Retirement System, published subsequent to September 30, 2007. Accepted actuarial methods are used for this roll-forward process, which is applied annually at September 30. Changes in the estimated rolled forward values from the prior to the current year are included in the determination of the actuarial gains and losses for the current period as presented in Note 9.

In calculating the FY 2008 roll-forward amount, the following assumptions were used:

	<u>Inflation</u>	<u>Salary</u>	<u>Interest</u>
Fiscal Year 2008	2.3 % (actual)	3.5 % (actual)	5.75 %
Fiscal Year 2009	6.2 % (estimated)	3.9 % (estimated)	5.75 %
Long-Term	3.0 %	3.75 %	5.75 %

Contributions to MRF are calculated to maintain MRF on an actuarially sound basis. An actuarially sound basis means that there will be sufficient funds to make all benefit payments to eligible recipients each year and that the asset balance is projected to eventually equal the actuarial liability; i.e., all unfunded liabilities are covered. In order to accomplish this process, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded) and any emerging actuarial gains or losses.

The initial unfunded liability of the program was being amortized over a 50-year period through the FY 2007 payment. At its August 2007 meeting, the Board decided to decrease the period over which the initial unfunded liability is fully amortized to

Notes to the Principal Statements

42 years. The Board's decision was made to ensure that, at a minimum, the amortization payment at least covered the interest on the unfunded actuarial liability. Therefore, starting with the FY 2008 payment, the initial unfunded liability will be paid over a 42-year period, with the last payment expected to be made October 1, 2025. All subsequent gains and losses experienced by the system are amortized over a 30-year period. As mandated by Chapter 74 of Title 10, United States Code, the Board must approve methods and assumptions used to (1) compute actuarial costs and liabilities, (2) amortize the initial unfunded liability, and (3) amortize all actuarial gains and losses. The Board is a Federal Advisory Committee appointed by the President.

NOTE 8. DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

(\$ In Thousands)

	<u>FY 2008</u>	<u>FY 2007</u>
Intragovernmental Costs	\$ 0	\$ 0
Public Costs	<u>171,077,638</u>	<u>105,253,018</u>
Total Costs	\$ 171,077,638	\$ 105,253,018
Intragovernmental Earned Revenue	\$ (80,659,528)	\$ (53,311,182)
Public Earned Revenue	<u>0</u>	<u>0</u>
Total Earned Revenue	\$ (80,659,528)	\$ (53,311,182)
Net Cost of Operations	<u>\$ 90,418,110</u>	<u>\$ 51,941,836</u>

Total Net Cost increased \$38.5 billion (74%). The increase is primarily due to an increase of \$63.8 billion in the actuarial liability over prior year costs. The major component of MRF total cost is the change in actuarial liability. The FY 2008 increase in liability of \$125.3 billion was significantly higher than the \$61.6 billion change in FY 2007. Factors impacting the change in the actuarial liability are discussed in Notes 7 and 13.

The increase in costs was offset by a \$20.5 billion increase in the required U.S. Treasury contribution. This increase is a direct result of the DoD Board of Actuaries' decision to accelerate the liquidation of the initial unfunded liability by increasing the annual contribution amounts.

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity.

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

Intragovernmental earned revenue is comprised primarily of the following:

Intragovernmental Earned Revenues for Program Costs

(\$ In Thousands)

	<u>FY 2008</u>	<u>FY 2007</u>
1. Military Service Contributions as a Percentage of Base Pay	\$ 16,138,795	\$ 14,483,714
2. Annual Treasury Unfunded Liability Payment	46,187,000	26,048,000
3. Annual Treasury Normal Cost Payment	2,776,000	2,452,000
4. Interest on Investments	15,518,902	10,327,468
5. Gain on Disposition of Investments	<u>38,831</u>	<u>0</u>
Total	<u>\$ 80,659,528</u>	<u>\$ 53,311,182</u>

NOTE 9. BENEFIT PROGRAM EXPENSE

(\$ In Thousands)	<u>FY 2008</u>	<u>FY 2007</u>
1. Service Cost	\$ 18,914,714	\$ 17,728,766
2. Period Interest on the Benefit Liability	60,727,879	57,059,086
3. Prior (or past) Service Cost	8,057,970	1,597,497
4. Period Actuarial (Gains) or Losses	<u>83,410,778</u>	<u>28,766,450</u>
5. Total Benefit Program Expense	<u>\$ 171,111,341</u>	<u>\$ 105,151,799</u>

The benefit program expense provides 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 benefit program expense as well as the expected benefit payments during FY 2008. The September 30, 2008, actuarial liability is equal to the September 30, 2007 liability plus the total benefit program expenses minus the expected benefit payments. The increase in Prior Service Cost (Line 3) is primarily due to the early retirement provision of reserve retirees for active service subsequent to the signing of the National Defense Authorization Act for FY 2008 (P.L. 110-181), whereas in FY 2007 the benefit change was primarily due to the removal of the 75% multiplier cap used in the calculation of non-disability retired pay. The increase in Period Actuarial (Gains) or Losses (Line 4) is primarily due to the new (lower) interest rate assumption of 5.75% approved by the DoD Board of Actuaries at the August 2008 meeting, whereas in FY 2007 the Actuarial (Gains) or Losses was lower primarily due to the Board updating non-disability rates at the August 2007 meeting.

NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION

There was a difference of \$80.8 billion between Appropriations Received on the Statement of Changes in Net Position and Appropriations Received on the Statement of Budgetary Resources (SBR). This difference is due to additional resources included in the Appropriations Received line on the SBR. Refer to Note 11, Disclosures Related to the Statement of Budgetary Resources, for additional details.

NOTE 11. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES

The Net Outlays decreased \$17.8 billion (102%) primarily due to an increase in receipts for U.S. Treasury contributions. Additional details are provided in Note 8.

The MRF reported \$45.6 billion of direct obligations that are exempt from apportionment.

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

There was a difference of \$80.8 billion between appropriations on the Statement of Changes in Net Position (SCNP) and appropriations received on the SBR. This difference represents current receipts, immediately available for obligation, reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR.

Notes to the Principal Statements

NOTE 12. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

(\$ In Thousands)

	<u>FY 2008</u>	<u>FY 2007</u>
RESOURCES USED TO FINANCE ACTIVITIES:		
Budgetary Resources Obligated		
Obligations incurred	\$ 45,648,770	\$ 43,630,105
Less: Offsetting receipts (-)	<u>(46,187,000)</u>	<u>(26,048,000)</u>
Net obligations	\$ (538,230)	\$ 17,582,105
Other Resources	\$ 0	\$ 0
Total resources used to finance activities	<u>\$ (538,230)</u>	<u>\$ 17,582,105</u>
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS:		
Change in budgetary resources obligated for goods, Services and benefits ordered but not yet provided		
Undelivered orders (-)	\$ 0	\$ 0
Total resources used to finance items not part of the net cost of operations	<u>\$ 0</u>	<u>\$ 0</u>
Total resources used to finance the net cost of operations	<u>\$ (538,230)</u>	<u>\$ 17,582,105</u>
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD:		
Components Requiring or Generating Resources in Future Periods - Other	\$ 125,428,353	\$ 61,624,209
Total Components of net cost of operations that will require or generate resources in future periods	<u>\$ 125,428,353</u>	<u>\$ 61,624,209</u>
Components not Requiring or Generating Resources – Other		
Revaluation of assets or liabilities (+/-)	\$ (38,831)	\$ 0
Other (+/-)		
Trust Fund Exchange Revenue	(34,433,697)	(27,263,182)
Other	<u>515</u>	<u>(1,296)</u>
Total components of net cost of operations that will not require or generate resources	<u>\$ (34,472,013)</u>	<u>\$ (27,264,478)</u>
Total components of net cost of operations that will not require or generate resources in the current period	<u>\$ 90,956,340</u>	<u>\$ 34,359,731</u>
NET COST OF OPERATIONS	<u>\$ 90,418,110</u>	<u>\$ 51,941,836</u>

The following note schedule lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated:

- Obligations Incurred
- Obligations Net of Offsetting Collections and Recoveries

- Less: Offsetting Receipts
- Net Obligations

Components Requiring or Generating Resources in Future Periods – Other displays the change in actuarial liability of \$125.4 billion.

Components not Requiring or Generating Resources – Other displays the change in accounts receivable since the beginning of both FY 2007 and FY 2008. These amounts represent refunds receivable for erroneous payments to military retirees or their survivors. These refunds receivable are recorded as an offset to expenses. This line also displays the changes in bad debts for both FY 2007 and FY 2008. These bad debts occurred because erroneous payments made to Military Retirement Fund beneficiaries were not repaid.

The MRF reported \$903.8 billion in pension liabilities that are not covered by budgetary resources. These liabilities represent amounts for which MRF has no assets available, nor are these liabilities due and payable, in the current fiscal year. Refer to Note 7, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

NOTE 13. OTHER DISCLOSURES

FY 2008 Change in MRF Actuarial Liability

The net pension expense for the change in the actuarial accrued liability from September 30, 2007 to September 30, 2008 is developed in Table 1 below:

Table 1: Change in Actuarial Liability

(\$ In Thousands)	<u>FY 2008</u>	<u>FY 2007</u>
A. Beginning of Year Accrued Liability	\$ 1,025,320,486	\$ 963,696,277
B. Normal Cost Liability	18,914,714	17,728,766
C. Plan Amendment Liability	8,057,970	1,597,497
D. Assumption Change Liability	60,075,022	26,530,870
E. Benefit Outlays	(45,682,983)	(43,527,589)
F. Interest on Pension Liability	60,727,879	57,059,086
G. Actuarial Loss (Gain)	<u>23,335,756</u>	<u>2,235,579</u>
H. End-of-Year Accrued Liability	\$ <u>1,150,748,844</u>	\$ <u>1,025,320,486</u>
I. Net Change in Actuarial Liabilities	\$ <u><u>125,428,358</u></u>	\$ <u><u>61,624,209</u></u>

Each year the accrued liability is expected to increase with the normal cost (Line B), decrease with benefit outlays (Line E), and increase with the interest cost (Line F) resulting in an expected increase of \$34.0 billion in the accrued liability during FY 2008.

The September 30, 2008, accrued liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include a lower interest rate, a new set of mortality improvement factors, and a new set of non-disability retiree death and “other loss” rates. The net effect of these new assumptions is an increase in the September 30, 2008, accrued liability of \$60.1 billion, shown on Line D in Table 1 above (\$41.7 billion of this increase is due to the lower interest rate assumption).

The change in retirement benefits for FY 2008 includes the early reserve retirement provision in the National Defense Authorization Act for FY 2008 (P.L. 110-181). The effect of this benefit change is \$8.1 billion, shown on Line C above. The increase in the accrued liability due to the net experience loss of \$23.3 billion, shown on Line G above, reflects the new population on which the September 30, 2008 roll-forward is based, as well as other economic experience being different from that assumed.

The end-of-year accrued liability (Line H) is the sum of lines A through G; the net change in the actuarial liability from the prior year (Line I) is the sum of lines B through G.

Notes to the Principal Statements

Treasury Contributions

The October 1, 2007, U.S. Treasury contribution, which is determined in accordance with methodology set by the Board, increased \$20.5 billion (from \$28.5 billion in FY 2007 to \$49.0 billion in FY 2008). Reasons for the change include an expected increase of \$977.0 million inherent in the Board's unfunded liability amortization methodology and the Board's decision to accelerate the liquidation of the initial unfunded liability, which accounted for \$14.4 billion of the increase.

Military Services Contributions

The contributions from the Military Services are the product of basic pay and Normal Cost Percentages (NCPs) determined in accordance with the methodology set by the Board. Basic pay generally increases each year, and on January 1, 2008, there was a 3.5% across-the-board basic pay increase. The Board set the NCPs for FY 2007 in its August 2005 letter set in the August 2005 public meeting: 26.5% (full-time) and 17.5% (part-time). The Board set the NCPs for FY 2008 in its October 2006 letter amending those set in the August 2006 public meeting: 29.0% (full-time) and 19.1% (part-time).

Market Value of Investments

The market value of investments in MRF's nonmarketable market-based securities as of September 30, 2008, totaled \$243.7 billion.

NOTE 14. SUBSEQUENT EVENT

On October 16, 2008 the Cost of Living Adjustment index of 5.8% was issued for the benefits payments beginning January 1, 2009. The actuarial valuation model used to develop the actuarial liability included on the Balance Sheet used the 6.2% projected index at the time the liability was calculated. The DoD Office of the Actuary estimates the impact of the reduction in the index caused an overstatement to the actuarial liability of \$3 billion. This overstatement is included in the actuarial liability in the accompanying Balance Sheet at September 30, 2008.

DoD
MILITARY RETIREMENT
FUND

OTHER ACCOMPANYING
INFORMATION

Other Accompanying Information

**MILITARY RETIREMENT SYSTEM
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2008 AND 2007**

(\$ In Thousands)

	<u>FY 2008</u> ¹	<u>FY 2007</u>
1 Present value of future benefits		
a. Annuitants now on roll	\$ 714,145,466	\$ 637,166,322
b. Non-retired reservists	158,725,870	128,186,214
c. Active duty personnel ²	<u>455,777,087</u>	<u>408,865,072</u>
d. Total	\$ 1,328,648,423	\$ 1,174,217,608
2 Present value of future normal cost contributions	\$ <u>177,899,579</u>	\$ <u>148,897,122</u>
3 Actuarial accrued liability	\$ 1,150,748,844	\$ 1,025,320,487
4 Assets ³	\$ <u>246,956,711</u>	\$ <u>211,854,477</u>
5 Unfunded accrued liability	\$ <u><u>903,792,133</u></u>	\$ <u><u>813,466,010</u></u>

¹ Rolled forward from September 30, 2007.

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

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

DoD
MILITARY RETIREMENT
FUND

INDEPENDENT AUDITORS’
REPORTS



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

November 7, 2008

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

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2008 DoD Military Retirement
Fund Financial Statements (Report No. D-2009-009)

The requirement for audited Federal Government financial statements was established by the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). The Office of Management and Budget (OMB) Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,* requires audited financial statements for the DoD Military Retirement Fund. We contracted Acuity Consulting, Inc. (Acuity Consulting) to perform the FY 2008 Military Retirement Fund audit.

Unqualified Audit Opinion. We agree with the Acuity Consulting unqualified opinion dated November 7, 2008. Acuity Consulting reported that the Military Retirement Fund financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2008, and its net cost of operations, changes in net position, and budgetary resources for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Report on Internal Control. We also agree with the Acuity Consulting Report on Internal Control over Financial Reporting and on Compliance and Other Matters. Acuity Consulting, in planning and performing their audit, considered the Military Retirement Fund internal control over financial reporting as a basis for designing audit procedures but not for expressing an opinion on its effectiveness. In this report, Acuity Consulting cites three significant deficiencies relating to the Military Retirement Fund internal control over financial reporting.

- **Contributions to the Fund.** The control deficiencies identified within the Military Services regarding the calculation, authorization, and payment of required contributions (Retired Pay Accrual) negatively affected the Military Retirement Fund. The documentation provided to the Defense Finance and Accounting Service (DFAS) Trust Fund Division (TFAD) for Military Service contributions was not sufficient. The insufficient documentation did not allow DFAS TFAD to perform the appropriate level of review for accuracy and completeness of the calculation that supports the determination

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

of the Military Services' contribution payment amounts. This limits the DFAS TFAD ability to determine and review, respectively, that the contribution amounts are appropriate, accurate, and complete. Acuity Consulting commented that DFAS TFAD has made significant improvements to this validation process and have asked DFAS Internal Review to study its new procedures and make further recommendations.

- **Data Processing.** Certain general electronic data processing (EDP) controls at certain computer processing locations may not support the reliable processing of financial information within the related business cycles. Deficiencies exist in the design or operation of controls related to EDP security configurations, business continuity arrangements, and system network software change management activities. The deficiencies could adversely affect the ability to record, process, and summarize financial information and the ability to protect sensitive data in accordance with all appropriate requirements. Because disclosure of detailed information about EDP weaknesses may further compromise controls, Acuity Consulting provided no additional details in its report. Instead, Acuity Consulting will present the specifics in a separate, limited distribution report citing these and other control deficiencies, and other matters that Acuity Consulting identified during its audit.
- **Data Used to Pay Retirees and Annuitants.** Data provided by the Military Services to DFAS Cleveland that are used to process and pay retirees and annuitants are not complete or properly supported. Acuity Consulting testing revealed that adequate supporting documentation was not available for 31% of the items tested. DFAS Cleveland relies upon certain data maintained electronically by the Military Services. This electronic data is transmitted to DFAS Cleveland to establish a retiree account and to determine the appropriate benefit payment. However, the Military Retirement Fund does not have policies or procedures in place to require that the Military Services provide accurate and complete data. Additionally, DFAS Cleveland does not require the submission of supporting documents maintained by the Military Services. The lack of complete and adequately supported payee files increases the risk that incorrect data might be used in calculating retiree pay. However, testing by Acuity Consulting identified no instances of incorrect payments.

Compliance and Other Matters. We further agree with the Acuity Consulting Report on Compliance and Other Matters. Acuity Consulting performed tests to determine whether management administered the Military Retirement Fund in compliance with certain provisions of laws and regulations. In this report, Acuity Consulting cites two instances of noncompliance.

- The EDP systems that management uses for the Military Retirement 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. Acuity Consulting 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 that could compromise the ability of the systems to provide reliable financial data and to protect sensitive data.

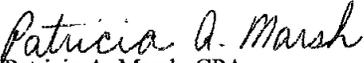
- The general ledger system that management uses for the Military Retirement Fund complied with the U.S. Government Standard General Ledger, but it is not transaction-based or derived from an integrated financial system.

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, as amended, requires that auditors report test results if they identify noncompliance with certain provisions of laws and regulations.

Audit Responsibilities. We were responsible for obtaining reasonable assurance that the basic financial statements 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 of Acuity Consulting audit work, we complied with the following: government auditing standards issued by the Comptroller General of the United States; OMB Bulletin No. 07-04, as amended; 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; reviewed documentation prepared by Acuity Consulting; met with Acuity Consulting partners and staff members; reviewed the key judgments; met with officials of the Military Retirement Fund; performed independent tests of the accounting records; and performed other procedures appropriate to the circumstances. Acuity Consulting formed their opinion on the basic financial statements taken as a whole. Because the required supplementary information is not part of the basic financial statements, Acuity Consulting did not audit that information and did not express an opinion on it.

We appreciate the courtesies extended to the audit team. Please direct questions to Mr. Mark Henricks at (703) 601-5942 or Mr. Thomas J. Winter at (703) 601-5918.


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



Acuity Consulting, Inc.

Bringing Tomorrow's Solutions into Focus Today

333 N. Fairfax St, Suite 401
Alexandria, VA 22314

Phone (703) 739-1091
Fax (703) 739-1094

INDEPENDENT AUDITORS' REPORT

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

Introduction

We have audited the balance sheet of the Department of Defense Military Retirement Fund (the Fund) as of September 30, 2008, as well as the related statements of net cost, changes in net position, and budgetary resources (the financial statements) for the year then ended. The financial statements of the Fund as of September 30, 2007, were audited by other auditors whose report dated November 30, 2007, expressed an unqualified opinion on those statements.

The objective of our audit was to express an opinion on the fair presentation of the financial statements as of September 30, 2008. In connection with our audit, we also considered the Fund's internal controls over financial reporting and tested the Fund's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion of the financial statements, we found that the Fund's financial statements as of and for the year ended September 30, 2008, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal controls would not necessarily disclose all significant deficiencies in the internal controls over financial reporting that might be significant deficiencies under standards issued by the American Institute of Certified Public Accountants (AICPA) and Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. We identified significant deficiencies with the financial system, Trust Fund Accounting System (TFAS), used by the Fund. TFAS is in substantial noncompliance with the requirements of the Federal Financial Management Improvement Act (FFMIA).

The results of our tests of compliance with certain provisions of laws and regulations disclosed two instances of noncompliance that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States and OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

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

Independent Auditors' Reports

Independent Auditors' Report On The Financial Statements

We have audited the accompanying balance sheet of the Department of Defense (“DoD”) Military Retirement Fund (the “Fund”) as of September 30, 2008 and the related statements of net cost, changes in net position, and budgetary resources for the year then ended. The financial statements of the Fund as of September 30, 2007, were audited by other auditors whose report dated November 30, 2007, expressed an unqualified opinion on those statements. These financial statements are the responsibility of the Fund’s management. Our responsibility is to express an opinion on the September 30, 2008 financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*. 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 audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement Fund as of September 30, 2008, and its net cost of operations, changes in net position, and budgetary resources for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated November 7, 2008 on our consideration of the Fund’s internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

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

We have audited the financial statements of the Department of Defense Military Retirement Fund (the “Fund”) as of and for the year ended September 30, 2008, and have issued our report thereon dated November 7, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the

Independent Auditors' Reports

standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

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 considered the matters discussed in the following paragraphs to be significant deficiencies.

1. As reported in previous years, the Fund is impacted by control deficiencies identified within the Services regarding the calculation, authorization and payment of required contributions (Retired Pay Accrual) to the Fund. There is insufficient documentation provided to the Defense Finance and Accounting Service ("DFAS") Trust Fund Accounting Division (TFAD) for Service Contributions (based on base pay and the normal cost percentage) for the appropriate level of review for accuracy and completeness of the calculation that supports the determination of the Services' contribution payment amounts. This limits the TFAD's ability to determine and review, respectively, that the amounts of the contributions are appropriate, accurate, and complete.

In the current year, there have been significant improvements made by the TFAD to validate the accuracy and completeness of the Service contributions received on a monthly basis. Specifically, on a monthly basis, the TFAD obtains copies of the independently prepared DD Forms 1002, Appropriation Status Report, for each of the Services' Military Personnel Appropriations. This reports the cumulative status of the Military Personnel Appropriation funds obligated through the fiscal year. Using this methodology, the TFAD is able to ascertain within 10% the funds expended for each Service for military payroll. These amounts are captured and applied to the normal cost percentages appropriate for each fiscal year. The result is compared to the actual Service Contributions received. If significant variances are identified, the TFAD contacts the Service to obtain explanation or correction. Additionally, the TFAD has solicited the assistance of the DFAS Internal Review to review their procedures and provide any recommendations for improved accuracy. At the end of our fieldwork, this review was in process and is not scheduled to be complete until after this report is released.

2. As reported in prior years, certain general electronic data processing ("EDP") controls at certain computer processing locations used by the Fund may not support the reliable processing of financial information within the related business cycles. Our review disclosed deficiencies in the design or operation of controls related to EDP security configurations, business continuity arrangements, and system and network software 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

Independent Auditors' Reports

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.

3. Data provided by the Services to DFAS-CL used to process and pay retirees and annuitants is not complete or properly supported. Our testing revealed that adequate supporting documentation was not available for 31% of the items tested. DFAS-CL relies upon certain data maintained electronically by the Services. This electronic data is transmitted to DFAS-CL to establish a retiree account and to determine the appropriate benefit payment. However, the Fund does not have policies or procedures in place to ensure that the Services provide accurate and complete data. Additionally, DFAS-CL does not require the submission of supporting documents maintained by the Services. The lack of complete and adequately supported payee files increases the risk that incorrect data might be used in calculating retiree pay. No instances of incorrect payments were identified in our fieldwork.

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.

With respect to internal control relevant to data that support reported performance measures on page 8 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 continue to be 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 and protect sensitive 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. During FY 2008, the TFAD has been actively pursuing a replacement system for TFAS. A replacement system has been identified, Microsoft Dynamics, and a contract has been awarded. The TFAD currently is working to ensure specific requirements are in place.

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 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.

Acuty Consulting, Inc.

November 7, 2008