



Fiscal Year 2018

Medicare- Eligible Retiree Health Care Fund Audited Financial Statements



November 7, 2018

Table of Contents

MANAGEMENT’S DISCUSSION AND ANALYSIS.....	1
1. REPORTING ENTITY, MISSION AND MANAGEMENT STRUCTURE.....	1
2. PERFORMANCE MEASURES	5
3. FINANCIAL STATEMENT ANALYSIS	6
4. SYSTEMS, CONTROLS AND LEGAL COMPLIANCE	12
5. OTHER MANAGEMENT INFORMATION.....	16
6. LIMITATIONS ON THE FINANCIAL STATEMENTS	20
PRINCIPAL STATEMENTS	21
Balance Sheets.....	22
Statements of Net Cost.....	23
Statements of Changes in Net Position	24
Statements of Budgetary Resources	25
FOOTNOTES TO THE PRINCIPAL STATEMENTS	26
Note 1. Significant Accounting Policies	27
Note 2. Fund Balance with Treasury.....	31
Note 3. Investments.....	32
Note 4. Accounts Receivable	34
Note 5. Cash and Other Monetary Assets	35
Note 6. Liabilities Not Covered by Budgetary Resources	35
Note 7. Accounts Payable	35
Note 8. Other Liabilities.....	36

Note 9. Commitments and Contingencies	36
Note 10. Military Retirement and Other Federal Employment Benefits	38
Note 11. General Disclosures Related to the Statements of Net Cost.....	44
Note 12. Disclosures Related to the Statement of Changes in Net Position	45
Note 13. Disclosures Related to the Statement of Budgetary Resources	45
Note 14. Reconciliation of Net Cost of Operations to Budget.....	46
Note 15. Other Disclosures	47
OTHER INFORMATION.....	48
Exhibit 1--Summary of Financial Statement Audit and Management Assurances	49
Exhibit 2--IPIA Reporting Details September 30, 2018	52
DoD Transmittal of Auditor's Opinion	67
Independent Auditor's Report	70

Management's Discussion and Analysis

Department of Defense Medicare-Eligible Retiree Health Care Fund For the Year Ended September 30, 2018

The Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund's (the "Fund" or MERHCF) discussion and analysis provides an overview of MERHCF's financial activities for the fiscal year (FY) ended September 30, 2018. Since this information is designed to focus on the current year's activities, resulting changes, and currently known facts, it should be read in conjunction with the MERHCF's principal statements and notes (beginning on page 21).

1. REPORTING ENTITY, MISSION AND MANAGEMENT STRUCTURE

Reporting Entity and Mission. The reporting entity is MERHCF. The "mission" of the MERHCF, administered by the Secretary of the Treasury, is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of DoD under uniformed services health care programs for specific Medicare-eligible beneficiaries, as designated by Sections 1111 through 1117 of Title 10, U. S. Code. The FY 2001 National Defense Authorization Act (NDAA) directed the establishment of the MERHCF to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for the Military Health System (MHS) (including the Defense Health Program [DHP] and Military Pay appropriations). The Fund covers Medicare-eligible beneficiaries, regardless of age. In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees (i.e., retirees themselves, dependents of retirees, and survivors).

Board of Actuaries. The 2001 NDAA also established an independent three-member DoD Medicare-Eligible Retiree Health Care Board of Actuaries (MERHCF Board) appointed by the Secretary of Defense. The MERHCF Board approves the methods and assumptions used to calculate the per capita normal cost rates and the U.S. Treasury contribution. Details about the methods and assumptions used in the calculation of the 2017 actuarial liability are reported in the MERHCF Board of Actuaries minutes of the August 3, 2018 meeting and are available upon request. The MERHCF Board is required to review the actuarial status of the Fund, to report annually to the Secretary of Defense, and to report to the President and the Congress on the status of the Fund at least every four years. The DoD Office of the Actuary (OACT), under the Defense Human Resources Activity, provides all technical and administrative support to the Board and is essential in providing the actuarial assessments regarding contributions to the Fund and calculations of the actuarial liability as well as impacts of either current or proposed future retiree program changes. The OACT operates in accordance with the provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in the DoD Financial Management Regulation (FMR), Volume 12, Chapter 16, dated October 2015.

Defense Health Agency (DHA) Establishment. A change in reporting entity for FY 2014 was made effective October 1, 2013 to establish the DHA and disestablish the TRICARE Management Activity (TMA). The DoD Directive 5136.13, "Defense Health Agency," dated September 30, 2013, transfers appropriate TMA functions to the DHA. Any reference in law, rule, regulation, or

issuance to TMA will be deemed to be a reference to DHA, unless otherwise specified by the Secretary of Defense. There is no financial reporting change to the MERHCF because of the DHA establishment. Within DoD the Office of the Under Secretary of Defense for Personnel and Readiness through the Office of the Assistant Secretary of Defense for Health Affairs (OASD (HA)), DHA has as one of its missions the operational oversight of the MHS, including management of the Fund. DHA management responsibilities include accounting for, documenting, and projecting annual budget distribution requirements (purchased care claims, demands, and military treatment facilities (MTFs) prospective payments for anticipated care provided in the direct care system), oversight of claims processors, monitoring/management of the Improper Payments Information Act (IPIA) of 2002, and preparation of financial statements and footnotes.

Defense Finance and Accounting Service (DFAS). The DFAS Trust Fund Accounting and Reporting Division (TFAR) provides accounting and investment services for the Fund. The Investment Fund Manager is responsible for investing cash balances of MERHCF not required to meet current expenditures. Investments are limited to market-based U.S. Government Special Securities issued by the U. S. Treasury and are made in accordance with the provisions of Sections 1111 to 1117 of Title 10, U.S. Code.

TRICARE Plans and Programs for Medicare-Eligible Beneficiaries

TRICARE for Life (TFL). The TFL was created as “wrap-around” coverage to Medicare-eligible military retirees by Section 712 of the *Floyd D. Spence National Defense Authorization Act* for FY2001 (P.L. 106-398). TFL functions as a second payer to Medicare, paying out-of-pocket costs for medical services covered under Medicare for beneficiaries who are entitled to Medicare Part A based on age, disability, or end-stage renal disease. TFL covers Medicare-eligible retirees, including retired guardsmen, reservists, and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The Medicare-eligible retirees and family members of the non-DoD Uniformed Services (Coast Guard, Public Health Service (PHS), and National Oceanic and Atmospheric Administration) are also eligible for these benefits. TFL serves as the final payer for Medicare covered benefits, and first payer for TRICARE benefits that are not covered in the Medicare or other health insurance (OHI) programs.

TRICARE Pharmacy Program. The TRICARE Pharmacy Program authorizes eligible beneficiaries to obtain low-cost prescription medications from the TRICARE Mail Order Pharmacy (TMOP) and TRICARE civilian pharmacies (network and non-network). Beneficiaries may also continue to use military hospital and clinic pharmacies at no charge. The FY 2013 NDAA requires TRICARE to increase copayments on brand name and non-formulary medications that are not filled at military clinics or hospitals. There is no increase to copayments for generic medications. New copayments for prescription drugs covered by TRICARE went into effect February 2016.

TRICARE Plus. TRICARE Plus is an MTF primary care enrollment program that is offered at selected local MTFs. All beneficiaries eligible for care in MTFs (except those enrolled in TRICARE Prime, a civilian Health Maintenance Office, or Medicare can seek enrollment for

primary care at MTFs where enrollment capacity exists. Non-enrollment in TRICARE Plus does not affect TFL benefits or other existing programs.

Designated Provider Program (DPP) formerly Uniformed Services Family Health Plan (USFHP). Finally, DoD beneficiaries, including Medicare-eligible beneficiaries, in specific locations where DPP, formerly the USFHP, facilities are available, may enroll in capitation rate plans. These plans include inpatient and outpatient services and a pharmacy benefit. The capitation rate is paid by DoD. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs as well as for benefits under the TFL (or other TRICARE plans) and Pharmacy programs. Prior to August 20, 2012, USFHP enrollees were not required to participate in Medicare. Beginning October 2012, a military retiree (or eligible family member) who becomes eligible for Medicare due to age may not enroll or stay enrolled in the USFHP, unless the military retiree (or eligible family member) was enrolled in the plan prior to September 30, 2012.

Health Care Purchased from Civilian Providers

Purchased Care. In accordance with DoD 7000.14-R, *Financial Management Regulation*, Volume 12, Chapter 16, the DHA Contract and Resource Management (CRM) reports daily obligations to the Fund for health care purchased from civilian providers or “purchased care”. Daily claims are validated by the voucher edit procedures required by the TRICARE/Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) *Automated Data Processing Manual* 6010.50-M, dated May 1999, to ensure that only costs attributable to Medicare-eligible beneficiaries are included in payments drawn from the Fund.

DHA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services for purposes of processing all claims supported by the Fund, regardless of the geographic region in which care was received. Dual eligibility refers to health care users who are both Uniformed Services beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single fiscal intermediary to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication.

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

For more detailed information about DHA CRM purchased care processes and controls, please see the “DoD DHA CRM Management's Discussion and Analysis for the Years Ended September 30, 2018 and 2017.”

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care relies on data files provided by DHA, through the MHS Data Repository (MDR), to the OACT. The IBNR is determined quarterly, using claims triangles that represent paid claims in the month they were incurred. For pharmacy IBNR, OACT relies on a paid claims report that summarizes amount paid by date incurred. Standard actuarial methods are used to compute the IBNR, including the development of month-to-month completion factors, IBNR smoothing techniques, as well as analysis and research of patterns, trends, and anomalies. Separate MERHCF accounting reports with line item detail are also used to estimate the outstanding administration costs associated with IBNR claims.

Health Care Provided in MTFs

Direct Care. The Fund develops prospective payment amounts for health care estimated to be provided directly in MTFs (Direct Care) to Medicare-eligible beneficiaries based on DoD policy established in the FMR, Volume 12, Chapter 16, October 2015. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and DHP Operations and Maintenance (O&M) costs.

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent FY for which data is complete at the time the calculations are prepared. DHA develops, in coordination with the Military Departments and Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), MTF-specific rates in accordance with the FMR, Volume 12, Chapter 16, October 2015. MEPRS cost data is recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using budget data provided by the Military Services, and standard Office of Management and Budget (OMB) Consumer Price Index-Urban Medical inflation rates listed in the President's Budget applicable to those years. MEPRS data is recorded and maintained by the Military Services in accordance with DoD 6010.13-M, *Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities*, dated April 2008.

OUSD(C) transfers MERHCF funds quarterly for the MTF prospective payments (based on the DHA-calculated annual total direct care program amounts) to the Military Services for MILPERS costs and to DHA for DHP O&M costs. DHA, in turn, distributes DHP O&M funds to the Service Medical Activities (SMA) of the Army, Navy, Air Force, and National Capital Region – Medical Directorate for execution. OUSD(C) includes financial authority in the DHP expense operating budget to finance the annual financial plan requirement of the prospective payment. When the year of execution is completed and the associated workload and cost data is available, DHA conducts an execution review in coordination with OUSD(C) and the Military Services. A comparison of prospective payment amounts to actual workload and costs is accomplished in accordance with the FMR, October 2015.

The prospective O&M payment for MTF-provided care to Medicare-eligible beneficiaries was \$1.7 billion in FY 2018 and \$1.6 billion in FY 2017. While the unit costs of inpatient and

outpatient services have risen slightly, utilization of inpatient services has continued to decrease while costs related to pharmacy non-ingredient O&M have increased. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries was \$0.5 billion in FYs 2018 and 2017.

2. PERFORMANCE MEASURES

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2018, the Fund had net assets available to pay benefits of \$237.6 billion and an actuarial liability of \$535.3 billion (See Note 10 – Military Retirement and Other Employment Benefits); the funding ratio was 44.4%. As of September 30, 2017, the Fund had net assets available to pay benefits of \$223.3 billion and an actuarial liability of \$527.0 billion; the funding ratio was 42.4%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the DoD Board of Actuaries. The 38-year amortization period for the initial unfunded liability is scheduled to end in FY 2040.

The table and variance analysis in the following section presents certain comparative financial statement information for the MERHCF.

3. FINANCIAL STATEMENT ANALYSIS

Comparative Financial Data

Medicare-Eligible Retiree Health Care Fund				
Analysis of Financial Statements				
for the years ended September 30, 2018 and 2017				
(\$ In Thousands)				
<u>Balance Sheets</u>	<u>2018</u>	<u>2017</u>	<u>Difference</u> Increase/ (Decrease)	<u>%</u> <u>Change</u>
Fund Balance with Treasury	\$94,388	\$61,866	\$32,522	53%
Investments, Intragovernmental Securities	\$266,269,629	\$250,733,546	\$15,536,083	6%
Accounts Payable (Nonfederal)	\$122,857	86,171	\$ 36,686	43%
Liabilities Not Covered by Budgetary Resources ¹	297,671,422	\$303,679,871	(\$6,008,449)	(2%)
Military Retirement and Other Federal Employment Benefits	\$535,949,009	\$527,574,870	\$8,374,139	2%
<u>Statements of Net Cost</u>				
Net Cost of Operations	(\$7,178,194)	(\$41,694,073)	\$34,515,879	83%
<u>Statements of Budgetary Resources</u>				
Agency Outlays, Net	(\$5,961,089)	(\$5,153,078)	(\$808,011)	(16)%
Net Amount of Budgetary Resources Obligated for Undelivered Orders	110,056	\$184,329	(\$74.273)	(40%)

¹ included as a component of the line titled "Military Retirement and Other Federal Employment Benefits"

Comparative Financial Data Variance Analysis

BALANCE SHEETS

Fund Balance with Treasury (Note 2)

Fund Balance with Treasury (FBWT) increased \$32.5 million (53%) due to a \$39.0 million increase in the September end of month holdback estimated to cover final month-end disbursements and a decrease of \$6.5 million in the final month-end disbursements made by the DHA for September 2018 versus September 2017. Each month, a holdback amount is estimated based on the current month to date DHA disbursements versus the average monthly disbursement over the past 12 months.

Investments - Intragovernmental Securities (Note 3)

Total Intragovernmental Securities, Net Investments increased \$15.5 billion (6%). This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. PHS, National Oceanic and Atmospheric Administration, and U.S. Coast Guard), net of benefits paid. Investment of these funds has a cumulative effect with an expectation invested balances will continue growing to cover future benefits. The amounts not required for current year benefit payments were reinvested. The MERHCF purchased \$17.0 billion in long-term securities in FY 2018.

Accounts Payable (Nonfederal) (Note 7)

Accounts Payable, Nonfederal, increased \$36.7 million (43%) due to payable increases of \$20.7 million in the Miscellaneous Healthcare Program and \$16.0 million in Mail Order Pharmacy Program caused by payment due dates changing from 15 to 30 days. In FY 2017, OMB published a Memorandum providing authority to make accelerated payments to contractors by the 15th day. The memo expired on December 31, 2017. The authority was not extended into 2018 so all payables are reported on the books for 30 days until disbursed.

Liabilities Not Covered by Budgetary Resources (Note 6)

Total Liabilities Not Covered by Budgetary Resources decreased \$6.0 billion (2%). This change is due to an increase of \$8.4 billion in Military Retirement and Other Federal Employment Benefits Liability, offset by an increase of \$14.4 billion in net receipts from contributions, interest income, and outlays that are available to pay future benefits. See Note 10, Military Retirement and Other Federal Employment Benefits, for additional information about these changes.

Military Retirement and Other Federal Employment Benefits (Note 10)

The present value of Military Retirement and Other Federal Employment Benefits Liability increased \$8.4 billion (2%). This resulted primarily from the net effect of an increase of \$20.1 billion due to expected increases (interest and normal costs less benefit outlays), an increase of \$14.9 billion due to changes in key assumptions, a decrease of \$18.2 billion due to a plan change, and a \$8.5 billion decrease due to actual experience being different from what was assumed (demographic and claims data). The remaining increase is attributable to estimated liabilities for IBNR medical claims.

STATEMENT OF NET COST (Note 11)

Net Cost of Operations increased \$34.5 billion (83%), which is primarily caused by the year to date change in actuarial liability and an increase in revenue earned. In 2018, the actuarial liability increased \$8.4 billion. In 2017, the actuarial liability decreased \$30.2 billion, which impacts Net Cost by \$38.6 billion. In addition, there was a \$2.7 billion increase in interest earnings on investments.

STATEMENT OF BUDGETARY RESOURCES (SBR) (Note 13)

Agency outlays, net, decreased \$808 million (16%) attributable to an increase of \$897.0 million from the annual contribution made by Department of the Treasury. See Note 18, Statement of Net Cost, for additional information.

The Net Amount of Budgetary Resources Obligated for Undelivered Orders decreased \$74.3 million (40%) and is primarily the result of lower drug costs and beneficiaries moving from TMOP to retail pharmacies.

Assets

Assets of \$266.6 billion, included in the Comparative Financial Data table on page 6 and shown in Figure 1, represent amounts that the MERHCF owns and manages. Assets increased by \$15.6 billion during FY 2018. This increase is largely attributable to a net increase in investments of \$15.5 billion. The net increase in investments is related to expected normal growth to cover unfunded portions of future military retirement benefits. Funds not needed to pay current benefits are invested in U.S. Treasury securities.

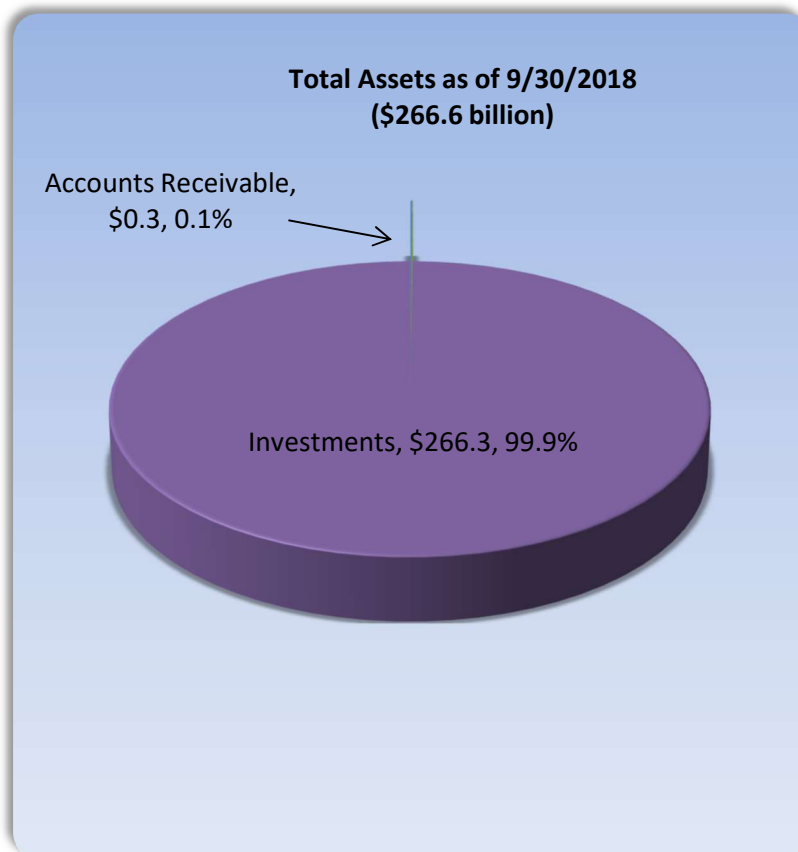


Figure 1

Investments

The Fund receives investment income from a variety of U.S. Treasury-based instruments such as bills, notes, bonds, and overnight investment certificates. U.S Treasury bills are short-term securities with maturities of less than one year issued at a discount. U.S Treasury notes are intermediate securities with maturities of one to ten years. U.S Treasury bonds are long-term debt instruments with maturities of greater than ten years. Overnight certificates are interest-based market securities purchased from the U.S 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.

Figure 2 below depicts the par value of investment holdings (includes inflation and interest receivable), net of amortization, as of September 30, 2018.

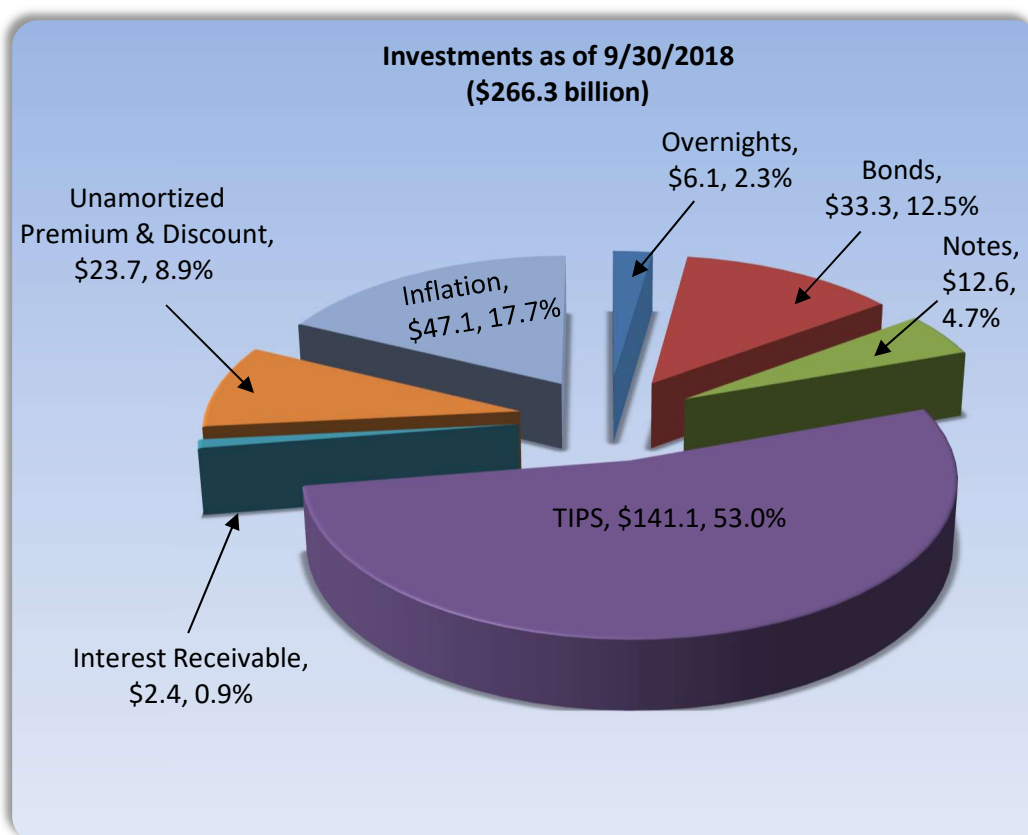


Figure 2

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

All of these instruments are debt obligations of the U.S Government and are backed by the “full faith and credit” of the federal government. Debt obligations of the U.S. 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, Defense Finance and Accounting Service; the Deputy Chief Financial Officer (CFO), OUSD(C); and a senior military member from the financial management community. The Investment Board reviews the public law governing the Fund and U. S. Treasury guidelines to ensure compliance with statutory authority and broad policy guidance, respectively.

Liabilities

Liabilities of \$536.3 billion included in the Comparative Financial Data table and shown in Figure 3 represent liabilities related to military retirement medical benefits for Medicare-eligible beneficiaries. The liabilities of the MERHCF primarily consist of actuarial liability for future benefit payments. Liabilities increased by \$8.4 billion during FY 2018. This increase is largely attributable to the increase in the actuarial liability.

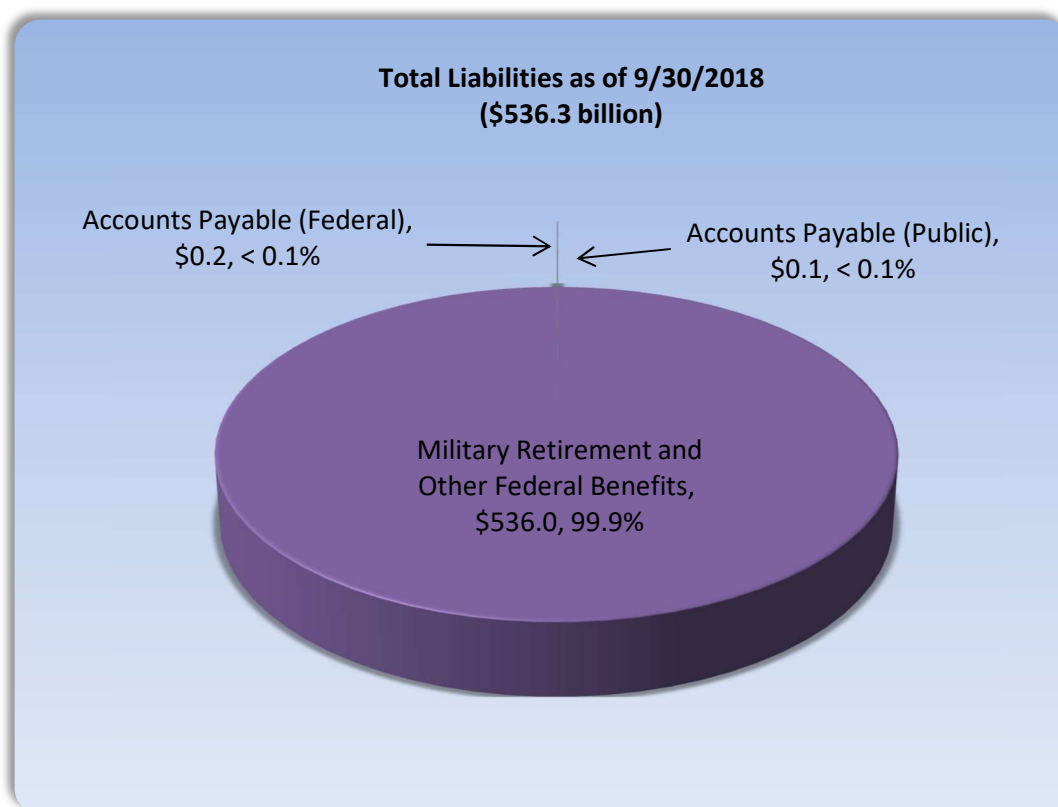


Figure 3

MERHCF Requirements and Funding Plan

In FY 2018 and FY 2017 respectively, the Fund authorized approximately \$10.4 billion and \$10.5 billion in total health care services, \$8.2 billion and \$8.4 billion to civilian providers for purchased care, \$1.7 billion and \$1.6 billion to MTFs, and \$0.5 billion and \$0.5 billion to Military Service Personnel Accounts, on behalf of Medicare-eligible retirees, retiree dependents, and survivors. Purchased Care end of year MERHCF obligations were \$7.8 billion and \$7.7 billion in FY 2018 and FY 2017 respectively.

During the last two years of the Fund's operation, requirements were funded at the following amounts:

\$ In Billions				
Fiscal Year	Purchased Care	Operations & Maintenance	Military Personnel	Final
2018	\$8.2	\$1.7	\$0.5	\$10.4
2017	\$8.4	\$1.6	\$0.5	\$10.5

MERHCF Revenues and Contributions

The Fund receives income from three sources:

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

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

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2018	\$6.6	\$8.4	\$10.6
2017	\$5.7	\$7.2	\$7.9

Amounts contributed to MERHCF by the DoD, other uniformed services, and the U. S. Treasury must be based on determinations by the OACT under methods and assumptions approved by the MERHCF Board in accordance with applicable provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in the FMR, Volume 12, Chapter 16, October 2015.

4. SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

Management Assurances

Federal Managers' Financial Integrity Act (FMFIA). The FMFIA requires executive branch agencies to provide annual assurance statements regarding systems of accounting and administrative control. Accounting and administrative controls include program, operational and administrative areas, as well as accounting and financial management.

OMB Circular A-123 is the government-wide implementation guidance for FMFIA. The DHA and TFAR conducted assessments of the effectiveness of internal controls over financial reporting in accordance with OMB Circular A-123, and Appendix A, Internal Control over Financial Reporting. The OMB guidance in Appendix A establishes a strengthened management process for assessing internal control over financial reporting and requires an additional and separate annual statement of assurance specifically addressing the effectiveness of internal control over financial reporting. The objectives of the systems of internal controls of MERHCF are to provide reasonable assurance of:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

The evaluation of internal controls for the statement of assurance extended to every responsibility and activity undertaken by the organizations that execute the MERHCF and applies to program, administrative, and operational controls. The internal control testing follows the Financial Improvement and Audit Readiness (FIAR) Guidance established by the OUSD(C). This process includes the development of process flowcharts and narratives that include the identification of key controls that address FIAR-defined Financial Reporting Objectives, risk assessments associated with those key controls, test plans for those key controls, and reporting of test results based on execution of those test plans. Based on the results of this assessment, the DHA and TFAR are able to provide a qualified statement of assurance that the internal controls over financial reporting as of June 30, 2018 were operating effectively with the exception of the material weakness noted in this section under "Material Weaknesses 2018."

Federal Financial Management Improvement Act (FFMIA) (PL 104-208). The DHA internal review of MERHCF also included the effectiveness of the internal controls over the integrated financial management systems for DHA, SMA, and MERHCF financial statement reporting entities. For MERHCF, the DHA is able to provide a qualified statement of assurance that the internal controls over the integrated financial management system as of June 30, 2018, are in compliance with the Federal Financial Management Improvement Act and OMB Circular A-123 Appendix D with the exception of one systems non-conformance noted in this section under "Material Weaknesses 2018."

Please see Exhibits 1 and 2 in the Other Information section for additional details on management assurances and a discussion of controls and reporting on improper payments.

Material Weaknesses 2018

The MERHCF independent auditors noted one material weakness during the FY 2018 Financial Statement Audit.

Direct Care Costs Data Accumulation. Health care cost data from the MTFs provided for the direct care cost estimation process is aggregated or derived from information in both financial and non-financial systems within the DHA SMAs. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the health care encounters for MERHCF beneficiaries are not tracked for accounting purposes in financial general ledger systems, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to SMAs in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. As of FY 2018, the MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care. The auditor noted the MERHCF performs annual retrospective reconciliation reviews of the MTF patient workload data for purposes of comparing the two-year historical data used in the prospective payment development to the actual patient workload realized in the year of payment. The reconciliations are performed in the following FY after all payments have been made, and the results of the reconciliations are used for the purpose of determining if any significant transfer of funds should be returned to the MERHCF, as well as to adjust the prospective payment methodology as may be warranted.

Finally, there is insufficient evidence effective controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation process for assigning costs to the MTFs.

Direct Care Cost Accumulation

At issue with the conditions of unaudited, non-accrual based MTF level data and the lack of SFIS compliant accounting systems is the fact that direct health care costs provide input to the development of the actuarially determined long-term health care liability of MERHCF, as well as the determination of amounts contributed by the branches of military service for active duty participants. The actuarial liability for direct care related to Medicare-eligible retiree benefits as of September 30, 2018 and 2017 is approximately \$118.1 billion (22% of total) and \$110.2 billion (21% of total), respectively, which reflects the actuarial present value of the projected direct-care costs of benefits to be provided by MTFs to MERHCF beneficiaries.

Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2018, include approximately \$3.5 billion and \$2.2 billion, respectively, and for the year ended September 30, 2017, include approximately \$2.8 billion and \$2.1 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are based on cost allocation methods using data extracted from various Service-specific financial, personnel, and workload systems within DoD as well as patient encounter data. With respect to the extracted data, the MTFs do not have OMB Circular A-123 Appendix D, *Financial Management Systems* compliant, transaction-based accounting systems and cannot report the costs of an individual patient's care.

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

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

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for the direct care portion of the actuarial liability. The reconciliation tasks performed by DHA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service, data to support both the prospective payment and calculation of the actuarial liability. The MERHCF Rate Summary Analysis is a process by which the DHA determines the annual prospective payment to the Service and the National Capital Region Medical Directorate (NCR MD) MTFs for the coverage of the pharmaceutical ingredient costs associated with dispensing to Medicare-eligible retirees. The ingredient costs for pharmaceuticals dispensed for Medicare-eligible retirees at MTFs are calculated based on the Prime Vendor invoices for all continental United States (CONUS) based facilities for the National Drug Codes within their Generic Sequence Numbers based on a weighted average basis of the average acquisition cost (the price paid by the MTF for the pharmaceutical product) during the relevant FY.

The prospective payments made to the MTFs are reconciled with actual workload activity after the close of the FY. The results of the reconciliation are used to adjust projections of MTF workload

levels and costs for the future prospective payment distribution plan. The results of the reconciliation will not be used to make adjustments to the current prospective payment distribution plan either during execution year activities or to a specific distribution subsequent to the close of the FY's operation.

Issues with the prospective payment process include non-accrual based expenditures, auditability of the SMAs' validation and reconciliation of the financial data prior to its input into the MEPRS cost allocation process, archiving MEPRS data at the close of each month, and reconciling in a timely manner the FY prospective payment plan.

Actions Taken

Since FY 2003, when the Fund was established, MERHCF management has attempted to resolve auditor-identified material weaknesses through the development of key milestone initiatives. These initiatives were established and managed by DHA leadership and intended to serve as work-around solutions because MERHCF management cannot address the Military Services financial systems' or MTF-level data deficiencies. The material weaknesses are associated with the computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs.

To mitigate risks associated with these weaknesses, and to initiate appropriate corrective actions, we are developing, in conjunction with the development and deployment of the new electronic health record, a revised financial improvement plan with key milestones to incorporate a methodology to use patient itemized bills (inpatient admissions & outpatient encounters) to address the auditor-identified weakness related to direct care. Original corrective action focused on development of a per capita rate, which has proven to be unattainable. Use of itemized patient bills for all patients provided care in our MTFs will offer the necessary transaction-level audit trail for MTF care needed for full audit (MTF care along with purchased care services) of the MERHCF financial statements & will be attainable with the deployment of the new Electronic Health Record scheduled for full deployment across the MHS by close of FY 2025. This methodology will also be used by the OACT to compute the MERHCF Direct Care portion of the health care liability. The use of real time itemized patient bills will enable the MERHCF to eliminate the need to rely on MTFs for auditable financial information and, thus, move to an unqualified audit opinion independent of the Military Uniformed Services' receipt of unqualified audit opinions on their financial statements.

DHA Business Support Directorate - Program Integrity Office

The DHA Business Support Directorate (BSD) - Program Integrity Office manages anti-fraud and abuse activities for DHA to protect benefit dollars and safeguard eligible beneficiaries. Program Integrity responsibilities include:

- Central coordinating office for allegations of fraud and abuse within the TRICARE Program.
- Develops and executes anti-fraud/abuse policies and procedures.
- Monitors and provides oversight of contractor program integrity activities.

- Develops cases for criminal fraud/abuse prosecutions and civil fraud/abuse lawsuits.
- Coordinates investigative activities and exchanges information with the Department of Justice (DoJ), law enforcement agencies, federal agencies, and state agencies.
- Initiates administrative remedies to enforce provisions of the law, regulation and policy in the administration of TRICARE program.

5. OTHER MANAGEMENT INFORMATION

Management Initiatives

All Retiree Fund Proposals. As mentioned in the December 2013 (as well as December 2005 and 2009) *Report to the President and Congress on the Department of Defense Medicare-Eligible Retiree Health Care Fund* submitted by the OACT, a significant portion of military retiree health benefits are not covered by the MERHCF. Benefits for retirees who are not yet Medicare-eligible are a significant cost because of the young age at which many military members retire, and because the program pays for the full cost of their health care (whereas under the Medicare-eligible program, a large portion is paid by Medicare). The OACT noted that both the private sector and public sector (states and municipalities follow Government Accounting Standards Board Statements No. 43 and 45) account for both pre-Medicare and post-Medicare retiree health benefits on an advance accrual basis. The MERHCF Board believes that consideration should be given to extend the Fund to cover all retiree health care costs, so that the budgetary treatment of pre-Medicare retiree health costs would be similar to the treatment of Medicare-eligible retiree costs, and all of the economic efficiencies and proper incentives promoted by the Fund would reflect the full cost to DoD of future retiree benefit entitlements being earned by military members' current service. MERHCF management agreed with the OACT recommendation and has initiated discussions with OMB and representatives of the DoD Comptroller's Office to implement this recommendation. Both OMB and the DoD Comptroller agree with the recommendation, and OMB has initiated discussions with appropriate Congressional Committees to obtain their approval. While this legislative change proposal has not yet been adopted, MERHCF management believes the proposal will be finally considered by Congress during FY 2020, for possible implementation in FY 2021.

Financial Management Systems Framework

MERHCF Reliance on SMA Financial Systems and Data. The cost of care provided directly in MTFs and medical coding record data used in direct care cost allocations is reported to the MDR by the Army Medical Command (SMA-Army), Navy Bureau of Medicine and Surgery (SMA-Navy), Air Force Medical Service (SMA-Air Force), and the SMA-NCR MD. The MERHCF direct care funding is executed by the four SMA Components, each of which relies on the financial systems and procedures of its parent Line Service.

The one material weakness identified in the MERHCF audit is directly related to the SMAs' financial management systems, data accumulation, and financial reporting deficiencies. MERHCF management has no direct control over SMA financial management system or data compliance. The Accounting and Financial Integrity (A&FI) branch of the DHA BSD's Budget & Resource Management continually strives to work with the SMA Representatives to improve the SMA audit

readiness by following the FIAR guidance and objectives. The A&FI branch has worked with SMA Representatives to accomplish the following in support of DoD audit readiness objectives during FY 2016:

- Asserted to the audit readiness for key assessable units of the OUSD(C) FIAR Guidance. These assessable units include Civilian Pay, Contract/Vendor Pay, and Reimbursable Work Orders. These assertions were made for SMA components.
- Continued Federal Information Systems Compliance Audit Manual assessments of the owner controls for DHA-owned systems material to financial statements, including Defense Medical Logistics Standard Support, Composite Health Care System, Armed Forces Billing and Collection Utilization Solution, and Coding Compliance Editor (CCE) in support of OUSD(C) assertion requirements. Also assessed user controls for material feeder systems owned by other DoD components.

In FY 2015, the SMA underwent an examination of the Statement of Budgetary Activity and received an adverse opinion. In FY 2018 the SMA underwent an audit of its financial statements. From the audit and the resulting issuance of Notice of Findings and Recommendations (NFRs), SMA officials are able to better develop corrective action plans to ultimately address discrepancies and prepare for an additional SMA audit in FY 2019.

Retail Pharmacy Refund Program (Standard Discount Program)

TRICARE Standard Discount Program (SDP) formerly known as Mandatory Agreements Retail Refunds (MARR)

The SDP (Program 006) is a Standard or Minimum Refund, formerly known as MARR, on a Section 703 Covered Drug. It is by law equal to the difference between Non-Federal Average Manufacturer Price (Non-FAMP) and Federal Ceiling Price (FCP) ($FCP = 76\% \times \text{Non-FAMP}$).

The NDAA for FY 2008 (NDAA-08), §703 enacted 10 U.S.C. 1074g(f) which mandated all covered TRICARE Retail Pharmacy Network prescriptions filled after January 28, 2008, be subject to FCPs.

The initial rule, published in the Code of Federal Regulations at 32 C.F.R. 199.21(q), subjected the TRICARE retail pharmacy program to pricing standards known as FCP by prohibiting pharmaceutical manufacturers from receiving more than the FCPs for pharmaceuticals purchased by DoD for the TRICARE retail pharmacy program.

The Office of General Counsel (OGC) requested waiver/compromise authority from DoJ, received it, and has resolved all pending waiver/compromise requests applicable to the "Retro Period" (January 2008 through June 2009) based upon the provisions of 32 C.F.R. §199.11.

The DHA in FY 2017 continued to aggressively collect pharmacy refunds for both the Standard and Additional Discount Programs (ADP). Through the concerted efforts of DHA-CRM, the Pharmacy Operations Division, Health Care Data Analysis, and the OGC, DHA collected 98.9% of the delinquent debt from 1st Quarter Calendar Year (CY) 2008 through 2nd Quarter CY 2017.

All unpaid debts for these quarters have been referred to the OGC's Claims Collections Section and/or to the Department of the Treasury for further collection activity.

The percent collected for 3rd Quarter CY 2017 through 1st Quarter CY 2018 is 97.8% with payments due for 2nd Quarter CY 2018 in November 2018.

(Sources: Pharmacy Data Warehouse Reconned Cases Status 9.30.18 for 1QCY2015 to 2QCY2018 & DHA AR Activity 30-SEP-2018 for 1QCY2008 to 4QCY2014)

TRICARE ADP formerly known as Voluntary Agreements Retail Rebates (VARR)

The DHA initiated a new retail pharmacy rebate program during FY 2007, ADP, formerly known as VARR. Manufacturers may offer rebates to the DoD for pharmaceutical agents dispensed through the TRICARE Retail pharmacy network. The Uniform Formulary VARR is contingent upon pharmaceutical agents being included on the 1st (generic drugs) or 2nd (formulary brand drugs) tiers of the DoD Uniform Formulary. There are two types of additional discounts:

- ADP #1 (Program 009) - WAC (% of Wholesale Acquisition Cost): The manufacturer's list price for the drug to wholesalers or direct purchasers in the United States, not including prompt pay or other discounts, rebates or reductions in price, as reported in wholesale price guides or other publications of drug pricing data.
- ADP #2 (Program 010) – (FCP - additional discount): The maximum price the manufacturer can charge for a Federal Supply Schedule (FSS) listed drug to the Big 4 -- VA, DoD, PHS, and the Coast Guard; calculated annually by VA using Non-FAMP and other data submitted by the manufacturer.

The table on the following page highlights DoD activity since the inception of the Program. DoD has collected \$12.0 billion to date and continues rigorous collection efforts for both programs.

TRICARE Retail Pharmacy Refunds Program

Program To Date (CY 2008-3rd Quarter, CY 2018)	Total	DHP	Non-DoD	MERHCF
SDP -				
Billed	\$7,767,316,589	\$3,533,064,654	\$119,650,058	4,114,601,877
Collected	(7,468,113,084)	(3,403,791,255)	(114,168,670)	(3,950,153,159)
Net	299,203,505	129,273,399	5,481,388	164,448,718
ADP -				
Billed	4,745,537,027	2,151,949,586	73,985,370	2,519,602,071
Collected	(4,543,283,635)	(2,063,943,291)	(70,563,736)	(2,408,776,608)
Net	202,253,392	88,006,295	3,421,634	110,825,463
UDC ¹	(349,828)	(151,345)	(6,076)	(192,407)
Total -				
Billed	\$12,512,853,616	\$5,685,014,240	\$193,635,428	\$6,634,203,948
Collected	(12,011,396,719)	(5,467,734,546)	(184,732,406)	(6,358,929,767)
UDC	(349,828)	(151,345)	(6,076)	(192,407)
Net	\$501,107,069	\$217,128,349	\$8,896,946	\$275,081,774
Aging -				
Current	\$418,112,159	\$180,888,729	\$7,262,643	\$229,960,787
61 Days to 2 Years ²	15,592,652	6,445,418	632,190	8,515,044
Over 2 Years	67,402,257	29,794,201	1,002,112	36,605,944
Total³	\$501,107,068	\$217,128,348	\$8,896,945	\$275,081,775

1. Unidentified Drug Collections (UDC) applied to CY18.

2. Pharmacy debt not delinquent until 70 days. 70-day A/R aging bucket not available; 61-day aging used instead.

3. 3QCY2018 Estimate added to Billings to reconcile with A/R: \$117,137,000 MERHCF; \$95,841,000 DHP & Non-DoD.

TRICARE has a waiver dated September 23, 1996, 10 USC 1079a, *Champus: Treatment of Refunds and Other Amounts Collected* that states:

“All refunds and other amounts collected in the administration of the CHAMPUS shall be credited to the appropriation available for that program for the FY in which the refund or amount is collected.”

Thus TRICARE records all collections/refunds into the current year and decreases budgetary disbursements for the current year. The refunds collected are not treated as offsetting collections.

6. LIMITATIONS ON THE FINANCIAL STATEMENTS

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

Principal Statements

The accompanying notes are an integral part of these financial statements

Balance Sheets

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30, 2018 and 2017
(\$ In Thousands)**

	<u>2018</u>	<u>2017</u>
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$ 94,388	\$ 61,866
Investments (Note 3)	266,269,629	250,733,546
Total Intragovernmental	266,364,017	250,795,412
Accounts Receivable, Net (Note 4)	275,031	254,062
Cash and Other Monetary Assets (Note 5)	<u>2,707</u>	<u>18</u>
TOTAL ASSETS	\$ <u>266,641,755</u>	\$ <u>251,049,492</u>
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 7)	\$ 188,285	\$ 187,730
Total Intragovernmental	188,285	187,730
Accounts Payable (Note 7)	122,857	86,171
Military Retirement and Other Federal		
Employment Benefits (Notes 6 and 10)	535,949,009	527,574,870
Other Liabilities (Note 8)	2,707	18
TOTAL LIABILITIES	\$ <u>536,262,858</u>	\$ <u>527,848,789</u>
NET POSITION		
Cumulative Results of Operations – Other Funds	\$ (269,621,103)	\$ (276,799,297)
TOTAL NET POSITION	<u>(269,621,103)</u>	<u>(276,799,297)</u>
TOTAL LIABILITIES AND NET POSITION	\$ <u>266,641,755</u>	\$ <u>251,049,492</u>

The accompanying notes are an integral part of these financial statements

Statements of Net Cost

Department of Defense Medicare-Eligible Retiree Health Care Fund STATEMENTS OF NET COST For the Years Ended September 30, 2018 and 2017 (\$ In Thousands)		
	<u>2018</u>	<u>2017</u>
Gross Program Costs		
Military Retirement Benefits		
Actuarial Non-Assumption Costs	\$ (6,617,437)	\$ 8,678,617
Other Program Costs	<u>10,124,470</u>	<u>9,904,023</u>
Total Gross Costs	\$ 3,507,033	\$ 18,582,640
Less: Earned Revenue	<u>(25,634,746)</u>	<u>(20,777,862)</u>
Net Military Retirement Benefits Costs	\$ <u>(22,127,713)</u>	\$ <u>(2,195,222)</u>
(Gain)/Loss on Military Retirement Benefits		
Actuarial Assumption Changes (Note 11)	\$ <u>14,949,519</u>	\$ <u>(39,498,851)</u>
Net Program Costs Including Assumption Changes	\$ <u>(7,178,194)</u>	\$ <u>(41,694,073)</u>
Net Cost of Operations	<u><u>\$ (7,178,194)</u></u>	<u><u>\$ (41,694,073)</u></u>

The accompanying notes are an integral part of these financial statements

Statements of Changes in Net Position

	2018	2017
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (276,799,297)	\$ (318,493,370)
Net Cost of Operations (+/-)	<u>(7,178,194)</u>	<u>(41,694,073)</u>
Net Change	<u>7,178,194</u>	<u>41,694,073</u>
Cumulative Results of Operations	<u>(269,621,103)</u>	<u>(276,799,297)</u>
Net Position	\$ <u><u>(269,621,103)</u></u>	\$ <u><u>(276,799,297)</u></u>

The accompanying notes are an integral part of these financial statements

Statements of Budgetary Resources

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2018 and 2017
(\$ In Thousands)**

	2018	2017
BUDGETARY RESOURCES		
Appropriations (discretionary and mandatory)	\$ 10,029,110	\$ 9,955,998
Total Budgetary Resources	<u>\$ 10,029,110</u>	<u>\$ 9,955,998</u>
STATUS OF BUDGETARY RESOURCES		
New obligations and upward adjustments (total)	\$ 10,029,110	\$ 9,955,998
Total Budgetary Resources	<u>\$ 10,029,110</u>	<u>\$ 9,955,998</u>
OUTLAYS, NET		
Outlays, net (total) (discretionary and mandatory)	10,066,142	9,940,788
Distributed offsetting receipts (-)	<u>(16,027,231)</u>	<u>(15,093,866)</u>
Agency Outlays, net (discretionary and mandatory)	<u>\$ (5,961,089)</u>	<u>\$ (5,153,078)</u>

The accompanying notes are an integral part of these financial statements

Footnotes 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 MERHCF, as required by the CFO Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared using the books and records of MERHCF in accordance and to the extent possible, with U.S. GAAP promulgated by the Federal Accounting Standards Advisory Board; OMB Circular No. A-136, "Financial Reporting Requirements"; and the FMR. The accompanying financial statements account for all resources for which MERHCF is responsible unless otherwise noted.

The MERHCF currently has one auditor-identified financial statement material weakness: Direct Care Costs Data Accumulation. Health care cost data from the MTFs provided for the direct care cost estimation process is aggregated or derived from information in both financial and non-financial systems within the DHA SMAs. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the health care encounters for MERHCF beneficiaries are not tracked for accounting purposes in financial general ledger systems, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to SMAs in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. As of FY 2018, the MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care.

Finally, there is insufficient evidence effective controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation process for assigning costs to the MTFs.

Accounting standards require all reporting entities to disclose that accounting standards allow certain presentations and disclosures to be modified, if needed, to prevent the disclosure of classified information.

B. Mission of the Reporting Entity

The mission of MERHCF is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of health care programs for DoD Military Services and other Uniformed Services. The

DoD MERHCF Footnotes to the Principal Financial Statements

MERHCF provides benefits for a Medicare-eligible member of a participating Military Service or other Uniformed Service entitled to retired or retainer pay and such member's Medicare-eligible dependents or survivors.

C. Use of Estimates

The MERHCF's management makes assumptions and reasonable estimates in the preparations of financial statements based on current conditions which may affect the reported amounts. Actual results could differ materially from the estimated amounts. Significant estimates include actuarial liabilities for military retirement.

D. Appropriations and Funds

Public Law 106-398, The Floyd D. Spence NDAA for FY 2001, authorized MERHCF 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 law does not specify an amount of budget authority for the indefinite appropriation; however, the law does specify a variable factor that determines the amount available until expended.

The MERHCF is a special fund. Accordingly, the funds in MERHCF are used, in compliance with the law, to provide benefits for the Medicare-eligible beneficiaries listed in paragraph 1B.

E. Basis of Accounting

The MERHCF's financial management systems record and report on the accrual basis. Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with U.S. GAAP.

The financial statements and supporting trial balances are compiled from the underlying financial data. The underlying data for the MERHCF is largely derived from budgetary transactions (obligations, disbursements, and collections) and proprietary transactions (assets and liabilities) and accruals made for major items such as accounts receivable, accounts payable, and health care liabilities.

F. Revenues and Other Financing Sources

Using methods and assumptions approved by the MERHCF Board of Actuaries, the OACT determines the amount of the contributions to MERHCF. The contribution consists of two parts: a U.S. Treasury warrant for the amortization payment of the original unfunded liability and an annual contribution from each Uniformed Service: Army, Navy, Air Force, Marine Corps, U.S. Coast Guard, PHS, and National Oceanic and Atmospheric Administration. Funds from the contributions that exceed the amounts required to pay current year expenses are invested in long-term securities. These investments and their associated interest revenues will be used to cover future liabilities of MERHCF.

G. Recognition of Expenses

For financial reporting purposes, DoD policy requires the recognition of benefit expenses for the period incurred. Estimates are used in the computation of actuarial liabilities. The current financial management systems for MERHCF collect and record financial information on the full accrual accounting basis for liabilities and expenses of the fund.

H. Accounting for Intragovernmental Activities

The Treasury Financial Manual Part 2 – Chapter 4700, “Agency Reporting Requirements for the Financial Report of the United States Government”, provides guidance for reporting and reconciling intragovernmental balances. The MERHCF is able to reconcile balances pertaining to investments in federal securities.

The DoD’s proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DoD’s financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenue.

I. Funds with the U.S. Treasury

The MERHCF’s monetary resources of collections and disbursements are maintained in U.S. Treasury accounts. The disbursing offices of the Defense Finance and Accounting Service (DFAS) and other Defense Agency financial service centers process the majority of MERHCF’s cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS and other DoD Agency service centers submit reports to the U.S. Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable FBWT account.

The U.S. Treasury allows MERHCF to be fully invested; therefore, FBWT may be zero at various times during the FY. Controls are in place to prevent abnormal balances at the U.S. Treasury.

J. Cash and Other Monetary Assets

Cash is the total of cash resources under the control of DoD including coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. The MERHCF transacts all business in U.S. dollars. See Note 5, Cash and Other Monetary Assets, for further information and disclosures

K. Accounts Receivable

Accounts receivable from other federal entities or the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are

DoD MERHCF Footnotes to the Principal Financial Statements

based upon factors such as: aging of accounts receivable, debtor's ability to pay, and payment history. The DoD does not recognize an allowance for estimated uncollectible amounts from other federal agencies as receivables from other federal agencies are considered to be inherently collectible. Claims for accounts receivable from other federal agencies are resolved between the agencies in accordance with the Intragovernmental Business Rules published in the Treasury Financial Manual.

Since the beginning of the FCP Program, outpatient pharmaceuticals purchased by DoD for medical treatment facility pharmacies have been subject to FCPs, as have those under the TMOP program. The MERHCF implemented FCPs for the TRICARE Retail Pharmacy program in compliance with the NDAA for FY 2008, §703. The Final Rule was published March 17, 2009, with an effective date of May 26, 2009. The MERHCF applied this rule to all retail prescriptions filled on or after January 27, 2008, unless the DHA, formerly TMA, granted a waiver to a particular manufacturer. Compliance is mandatory and the advantage to the manufacturers is that their drugs will be included on the DoD Uniform Formulary (list of available prescription drugs). The MERHCF will record accounts receivable upon receipt of the calculation from the TRICARE Pharmacy Operations Directorate and will post collections from the manufacturers to the FY of receipt pursuant to Title 10, U.S.C. §1079a.

TRICARE has a waiver dated September 23, 1996, 10 USC 1079a, Champus: Treatment of Refunds and Other Amounts Collected that states: "All refunds and other amounts collected in the administration of the CHAMPUS shall be credited to the appropriation available for that program for the FY in which the refund or amount is collected." Thus TRICARE records all collections/refunds into the current year and decreases budgetary disbursements for the current year. The refunds collected are not treated as offsetting collections.

L. Investments in U.S. Treasury Securities

The MERHCF reports investments in 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 method. The MERHCF's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities.

The MERHCF invests in nonmarketable, market-based U.S. Treasury securities issued to federal agencies by the U. S. Treasury's Bureau of Fiscal Service. These securities are not traded on any financial exchange but are priced consistently with publicly traded U.S. Treasury securities. The MERHCF receives interest semiannually from the U.S. Treasury on the value of these securities.

M. Contingencies and Other Liabilities

The SFFAS No. 5, "Accounting for Liabilities of the Federal Government," as amended by SFFAS No. 12, "Recognition of Contingent Liabilities Arising from Litigation," defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to

DoD MERHCF Footnotes to the Principal Financial Statements

occur. The MERHCF 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.

There are three cases or claims pending with the DHA meeting the threshold guidance. Information pertaining to these cases is disclosed in the Commitments and Contingencies disclosure in Note 9.

N. Net Position

Net position consists of cumulative results of operations. Cumulative results of operations represent the net of expenses, losses, and financing sources (including appropriations, revenue, and gains) since inception.

O. Reclassifications

Certain amounts in the prior year's SBR have been reclassified to conform to the current year's presentation. These reclassifications had no effect on the previously reported SBR.

P. Military Retirement and Other Federal Employment Benefits

The DoD applies SFFAS No. 33, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates," in selecting the discount rate and valuation date used in estimating actuarial liabilities. In addition, gains and losses from changes in long-term assumptions used to estimate the actuarial liability are presented separately on the Statement of Net Cost. Refer to Note 10, Military Retirement and Other Federal Employment Benefits, and Note 11, General Disclosures Related to the Statement of Net Cost, for additional information.

Note 2. Fund Balance with Treasury

As of September 30	2018	2017
(\$ In Thousands)		
Unobligated Balance – Unavailable	\$ 238,277,587	\$ 223,894,998
Obligated Balance not yet Disbursed	421,198	458,231
Non-FBWT Budgetary Accounts	(238,604,397)	(224,291,363)
Total	\$ 94,388	\$ 61,866

The Status of FBWT reflects the budgetary resources to support the FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

DoD MERHCF Footnotes to the Principal Financial Statements

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority not set aside to cover future obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities that are temporarily precluded from obligation by law. The unobligated balance for the MERHCF is restricted for use by the public law establishing the fund and becomes available without further congressional action.

Obligated Balance not yet Disbursed represents funds obligated for goods and services not received and those received but not paid. The MERHCF balance represents amounts payable to the Defense Logistics Agency (DLA) for purchases of pharmaceuticals, to private contractors waiting for DLA to replenish the pharmaceutical supply, and to private health care providers.

The MERHCF Non-FBWT Budgetary Account balance represents investments in U.S. Treasury securities that are reflected in the MERHCF's budgetary resources, but are not part of the FBWT.

Note 3. Investments

		Amounts for 2018 Balance Sheet Reporting				
(\$ In Thousands)	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/ Discount</u>	<u>Interest Receivable</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities						
	Nonmarketable, Market-Based	Effective Interest	\$ (15,090,257)	\$ 2,378,752	\$ 266,269,629	\$ 284,354,253
Total	\$ 278,981,134		\$ (15,090,257)	\$ 2,378,752	\$ 266,269,629	\$ 284,354,253
		Amounts for 2017 Balance Sheet Reporting				
(\$ In Thousands)	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/ Discount</u>	<u>Interest Receivable</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities						
	Nonmarketable, Market-Based	Effective Interest	\$ (13,604,412)	\$ 2,195,986	\$ 250,733,546	\$ 283,078,773
Total	\$ 262,141,972		\$ (13,604,412)	\$ 2,195,986	\$ 250,733,546	\$ 283,078,773

Information Regarding Investments and Related Interest

The MERHCF purchases and redeems nonmarketable, market-based U.S. Treasury securities fluctuating in tandem with the current selling price of the equivalent marketable securities on the open market. The MERHCF purchases securities with the intent to hold until maturity; therefore, balances are not adjusted to market value.

The cash generated from investments is deposited in the U.S. Treasury and is used for general Government purposes. The U.S. Treasury securities are issued to MERHCF as evidence of its receipts and are an asset to the MERHCF and a liability to the U.S. Treasury. Since MERHCF and the U.S. Treasury are both parts of the Federal Government, these assets and liabilities offset

DoD MERHCF Footnotes to the Principal Financial Statements

each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Governmentwide financial statements.

The U.S. Treasury securities provide MERHCF with authority to access funds to make future benefit payments or other expenditures. When MERHCF requires redemption of securities to make expenditures, the Federal Government will meet the requirement by using accumulated cash balances, raising taxes or other receipts, borrowing from the public or repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

At the semiannual meetings, the DoD Investment Board approves the strategy for the type of securities purchased by MERHCF. These securities can include U.S. Treasury bills, notes, bonds, inflation-protected securities, and overnight certificates. The 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 either 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. The TIPS provide protection against inflation and are purchased at either a discount or premium. The TIPS principal increases with inflation and decreases with deflation, as measured by the CPI. When TIPS mature, the U.S. Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the securities. Overnight securities are short-term securities purchased at face value. They mature the business day after purchase and earn interest at the daily Federal Reserve repurchase agreement rate.

The cost of the U.S. Treasury Securities is displayed in the following table.

COST FY 2018		COST FY 2017	
(in millions)		(in millions)	
Notes	\$12,958	Notes	\$10,968
Bonds	43,201	Bonds	32,326
TIPS	216,735	TIPS	212,032
Overnights	<u>6,087</u>	Overnights	<u>6,816</u>
Total Cost	<u>\$278,981</u>	Total Cost	<u>\$262,142</u>

Note 4. Accounts Receivable

(\$ In Thousands)

	2018		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ <u>281,777</u>	\$ <u>(6,746)</u>	\$ <u>275,031</u>
Total Accounts Receivable	\$ <u>281,777</u>	\$ <u>(6,746)</u>	\$ <u>275,031</u>

(\$ In Thousands)

	2017		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ <u>260,570</u>	\$ <u>(6,508)</u>	\$ <u>254,062</u>
Total Accounts Receivable	\$ <u>260,570</u>	\$ <u>(6,508)</u>	\$ <u>254,062</u>

Information Related to Accounts Receivable

Accounts receivable represent the MERHCF's claim for payment from other entities. The MERHCF only recognizes an allowance for uncollectible amounts from the public. The allowance for uncollectible is calculated based on a percentage determined by taking a 12 month average of the accounts receivable balance against a 12 month average on the write off balance. An exception to this methodology exists for the Suspended Pharmacy receivables where 100% methodology is used. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

As of September 30, 2018, the total net receivables recorded for the pharmaceutical Standard Discount Program (SDP) were \$150.0 million. This program resulted from the implementation of the Federal Ceiling Program for the TRICARE Retail Pharmacy Program as required by the FY 2008 National Defense Authorization Act, Section 703.

Also recorded are net receivables of \$80.6 million originating from the TRICARE ADP, a voluntary additional discount from pharmaceutical manufacturers for preferred products.

DoD MERHCF Footnotes to the Principal Financial Statements

Note 5. Cash and Other Monetary Assets

(\$ In Thousands)	<u>2018</u>	<u>2017</u>
Cash	\$ <u>2,707</u>	\$ <u>18</u>
Total Cash and Other Monetary Assets	\$ <u>2,707</u>	\$ <u>18</u>

Cash and other monetary assets consist of undeposited collections received after the U.S. Treasury month-end cutoff. A corresponding liability is created because MERHCF is not entitled to use the funds until deposited with the U.S. Treasury. This liability is reported on Note 8.

Note 6. Liabilities Not Covered by Budgetary Resources

(\$ In Thousands)	<u>2018</u>	<u>2017</u>
Military Retirement and Other Federal Employment Benefits (Note 10)	\$ <u>297,671,422</u>	\$ <u>303,679,871</u>
Total Liabilities Not Covered by Budgetary Resources	297,671,422	303,679,871
Total Liabilities Covered by Budgetary Resources	<u>238,591,436</u>	<u>224,168,918</u>
Total Liabilities	\$ <u>536,262,858</u>	\$ <u>527,848,789</u>

The MERHCF Liabilities Not Covered by Budgetary Resources represents the portion of the actuarial liability for health benefits for which current assets are not yet available. Refer to Note 10, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Note 7. Accounts Payable

(\$ In Thousands)	<u>2018</u>	<u>2017</u>
Intragovernmental Payables	\$ <u>188,285</u>	\$ <u>187,730</u>
Nonfederal Payables (to the Public)	<u>122,857</u>	<u>86,171</u>
Total Accounts Payable	\$ <u>311,142</u>	\$ <u>273,901</u>

The Accounts Payable includes amounts owed to federal and nonfederal entities for goods and services received by the MERHCF. This balance represents amounts payable to DLA for purchases of pharmaceuticals, to private contractors waiting for DLA to replenish the pharmaceutical supply, and to private health care providers.

Note 8. Other Liabilities

(\$ In Thousands)	<u>2018</u>	<u>2017</u>
Deposit Funds and Suspense Accounts	\$ 2,707	\$ 18

Deposit Funds and Suspense Accounts consist of undeposited collections received after the U.S. Treasury month-end cutoff. These undeposited collections are reported on Note 5.

Note 9. Commitments and Contingencies

The MERHCF is a party in various administrative proceedings and legal actions related to claims for contractual bid processes. The MERHCF is unaware of any contingent liabilities for legal actions.

The MERHCF accrues contingent liabilities for legal actions where the OGC considers an adverse decision probable and the amount of loss measurable. In the event of an adverse judgment against the Government, some of the liabilities may be payable from the U.S. Treasury Judgment Fund. The MERHCF records contingent liabilities in Note 8, Other Liabilities.

Amounts disclosed for litigation claims and assessments are fully supportable and agree with the DHA legal representation letters and management summary schedule.

The MERHCF will disclose amounts for potential future obligations such as contractual arrangements for fixed price contracts with escalation, price redetermination, or incentive clauses; contracts authorizing variations in quantities; and contracts where allowable interest may become payable based on contractor claims under the “Disputes” clause contained in contracts, when there are any. Amounts disclosed will represent future potential liabilities and will not include amounts already recognized as contingent liabilities in Note 8. Consideration will be given in disclosing the difference between the maximum or ceiling amounts and those amounts recognized in Note 8 when it is reasonably possible the maximum amount may be paid.

There are three cases or claims pending with the DHA meeting the threshold guidance of an amount being claimed at or exceeding \$2.4 million or multiple cases or claims arising out of a single action, incident or factual circumstances where, in the aggregate, the amount claimed is or exceeds \$8.7 million.

Ingham Regional Medical Center v. United States (Court of Federal Claims). Class action, but not certified, alleging DoD, in reaching a resolution of hospital outpatient radiology claims, entered into contracts with the named plaintiffs. Plaintiffs’ First Amended Complaint was filed on November 17, 2014. The Amended Complaint alleges breach of express contract, breach of implied contract, mutual mistake, breach of the covenant of good faith and fair dealing, and violations of a statutory mandate under the TRICARE statute. The suit alleges 5,200 hospitals were underpaid for outpatient procedures. On March 22, 2016, the Court of Federal Claims issued its decision granting the Government’s Motion to Dismiss Plaintiffs’ Amended Complaint.

Plaintiffs appealed to the Court of Appeals for the Federal Circuit. On November 3, 2017, the Court of Appeals reversed the dismissal of Ingham's breach of contract claim and remanded the case to the trial court for further proceedings on that claim. On March 20, 2018, the government filed its Answer to the First Amended Complaint. The parties are proceeding with discovery.

Central Rexall Drugs, Inc. v. Defense Health Agency Director, Raquel C. Bono (U.S. District Court, Eastern District of Louisiana). Plaintiff seeks a Writ of Mandamus ordering the DHA Director to lift the claims payment suspension and pay pending claims worth approximately \$21 million. Plaintiff alleges the permissible length of time the DHA may suspend claims payment expired and, therefore, the DHA is obligated to pay the claims. The DHA contends it has authority to continue the suspension. The DOJ filed a Motion to Dismiss on 7 July 2017, and the Court's decision is pending.

Smart Pharmacy, Inc., et al. v. Vice Admiral Raquel C. Bono, Director, Defense Health Agency (U.S. District Court, District of Florida). Plaintiffs are compound pharmacies. In response to revelations compound pharmacies had been submitting fraudulent claims to the Government, the DHA suspended claims processing payments for several compound pharmacies, including Plaintiffs, pending an investigation. Plaintiffs seek declaratory judgments prohibiting the DHA from suspending claim processing and payments, from collecting claim clawbacks, and that the HHS OIG is violating federal laws and regulations. Plaintiffs allege the DHA improperly suspended claims processing, while the DHA contends it has authority to suspend claims processing under these circumstances. Plaintiffs filed the Complaint on April 19, 2018, and mailed the Complaint and A Notice of a Lawsuit and Request to Waive Service of a Summons to Vice Admiral Bono on April 27, 2018. Based on the allegations in the Complaint, the amount sought is at least \$4 million. The Government is reviewing the Complaint's allegations and will decide whether to file an Answer or dispositive motion(s).

Note 10. Military Retirement and Other Federal Employment Benefits

(\$ In Thousands)		2018			
Major Program Activities	Present Value of Benefits		(Less: Assets Available to Pay Benefits)		Unfunded Liabilities
Medicare-Eligible Retiree Benefits	\$ 535,318,159	\$	(237,646,737)	\$	297,671,422
Other	630,850		(630,850)		0
Total	\$ 535,949,009	\$	(238,277,587)	\$	297,671,422
(\$ In Thousands)		2017			
Major Program Activities	Present Value of Benefits		(Less: Assets Available to Pay Benefits)		Unfunded Liabilities
Medicare-Eligible Retiree Benefits	\$ 526,986,077	\$	(223,306,206)	\$	303,679,871
Other	588,793		(588,793)		0
Total	\$ 527,574,870	\$	(223,894,999)	\$	303,679,871

DoD MERHCF Footnotes to the Principal Financial Statements

Change in Actuarial Liability

(\$ In Thousands)

	FY 2018	FY 2017
Beginning Actuarial Liability	\$ 526,986,077	\$ 557,806,311
Plus Expenses:		
Normal Cost	10,498,293	11,152,665
Interest Cost	20,223,891	22,546,268
Plan Amendments	(18,195,037)	0
Experience (Gain)/Loss	(8,491,856)	(14,310,744)
Other factors	1	0
Subtotal: Expenses before (Gain)/Loss from Actuarial Assumption Changes	4,035,292	19,388,189
Actuarial (Gain)/Loss due to:		
Changes in trend assumptions	(6,598,129)	(53,632,892)
Changes in assumptions other than trend	21,547,648	14,134,041
Subtotal: (Gain)/Loss from Actuarial Assumption Changes	14,949,519	(39,498,851)
Total Expenses	\$ 18,984,811	\$ (20,110,662)
Less Benefit Outlays	10,652,729	10,709,572
Total Changes in Actuarial Liability	\$ 8,332,082	\$ (30,820,234)
Ending Actuarial Liability	\$ 535,318,159	\$ 526,986,077

Information Related to Military Retirement and Other Federal Employment Benefits

The MERHCF accumulates funds to pay for health care programs for DoD and other Uniformed Services Medicare-eligible retirees and their Medicare-eligible dependents and survivors.

The schedules in the first two tables above reflect two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled “Military Medicare-Eligible Retiree Health Benefits” represents the actuarial (or accrued) liability for future health care benefits provided to Medicare-eligible retired beneficiaries that are not yet incurred, i.e., the present value of future benefits less the present value of future normal costs. The line entitled “Other” represents the incurred-but-not-reported reserve (IBNR), which is an estimate of MERHCF benefits already incurred but not yet reported to DoD.

This schedule also computes “unfunded liabilities”, i.e. liabilities not covered by budgetary resources. The assets presented in this schedule differ from those reported on the balance sheet. The balance sheet assets consist primarily of investments, the value of which is based on the fully amortized cost or “book value” of the securities (see Note 4, Investments and Related Interest). The value of assets available to pay benefits presented in the above schedule is based on available budgetary funding. The difference between investments and assets available to pay benefits is

DoD MERHCF Footnotes to the Principal Financial Statements

the premium on U.S. Treasury Securities. At the time of purchase, budgetary funding is reduced by the premium on U.S. securities because the premium on securities is no longer a budgetary resource.

Effective FY 2010, the MERHCF implemented requirements of SFFAS No. 33, which directs that the discount rate, underlying inflation rate, and other economic assumptions be consistent with one another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2018, financial statement valuation, the application of SFFAS No. 33 required OACT to set the long-term inflation (CPI) to be consistent with the underlying Treasury spot rates used in the valuation.

The MERHCF actuarial liability is adjusted at the end of each FY. The 4th Quarter, FY 2018 balance represents the September 30, 2018 amount that will be effective through 3rd Quarter, FY 2019.

Actuarial Cost Method

As prescribed by law, the MERHCF is funded using the Aggregate Entry-Age Normal (AEAN) cost method. Per SFFAS No. 5, AEAN is also used to compute the actuarial liabilities reported herein. AEAN is a method whereby projected retiree medical plan costs are spread over the projected service of a new entrant cohort.

Revenues

The MERHCF receives revenues from three sources: interest earnings on MERHCF assets, Uniformed Services normal cost contributions, and a U.S. Treasury contribution. The normal cost contributions are paid annually, at the beginning of the FY, by the U.S. Treasury from amounts appropriated to the Military Services and are calculated at the approved full-time and part-time per capita rates times the budgeted full-time and part-time force strengths, respectively. The contribution from the U.S. Treasury is also paid into the MERHCF annually, at the beginning of each FY, and represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses. The MERHCF Board approves the methods and assumptions used to calculate the per capita normal cost rates and the U.S. Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payments.

Assumptions

The Board sets the long-term assumptions for each valuation performed for funding purposes. Prior to FY 2010, the same long-term assumptions were used for the financial-statement valuations. The distinction between the two different valuations is discussed further below.

For the FY 2018 financial-statement valuation, the long-term assumptions include a 3.6% discount rate and medical trend rates that were developed using a 1.5% inflation assumption. (For the most recent funding valuation, the long-term assumptions included a 5.25% discount rate and medical trend rates that were developed using a 2.75% inflation assumption.) Note that the term 'discount

DoD MERHCF Footnotes to the Principal Financial Statements

rate’ refers to the interest rate used to discount cash flows. The terms ‘interest rate’ and ‘discount rate’ are often used interchangeably in this context.

For the FY 2017 financial-statement valuation, the long-term assumptions included a 3.8% discount rate and medical trend rates that were developed using a 1.7% inflation assumption. (For the most recent funding valuation at the time of the FY 2017 financial statements, the long-term assumptions included a 5.25% discount rate and medical trend rates that were developed using a 2.75% inflation assumption.)

The difference in the long-term assumptions between funding and financial statement valuations is attributable to SFFAS No. 33. This applicable financial statement standard is described further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on a blend of actual experience and future expectations. Because of reporting deadlines and as permitted by SFFAS No. 33, the current year actuarial liability is rolled forward from the prior year valuation results as reported in OACT’s *Valuation of the Medicare-Eligible Retiree Health Care Fund* using accepted actuarial methods. Modifications are made as necessary to convert liabilities to a financial-statement basis. For purposes of the Fund’s financial reporting, this roll-forward process is applied annually.

In calculating the FY 2018 “rolled-forward” actuarial liability, the following assumptions were used:

Discount Rate	3.6%
Inflation	1.5%

<u>Medical Trend (Medicare)</u>	<u>FY 2017 - FY 2018</u>	<u>Ultimate Rate FY 2042</u>
Direct Care Inpatient	2.50%	4.00%
Direct Care Outpatient	4.00%	4.00%
Direct Care Prescription Drugs	3.80%	4.00%
Purchased Care Inpatient	1.00%	4.00%
Purchased Care Outpatient	3.00%	4.00%
Purchased Care Prescription Drugs	3.12%	4.00%
Purchased Care USFHP	2.52%	4.00%

After a 25 year select period, an ultimate trend rate is assumed for all future projection years.

The medical cost trend rate assumptions have a significant effect on the amounts reported. For example, if each of the assumed trend rates had increased by one percentage point, the actuarial liability would have increased 28.2%, or approximately \$151.1 billion.

Contributions to the MERHCF are calculated to maintain the Fund on an actuarially sound basis. This means there will be sufficient funds to make all benefit payments to eligible recipients each year, and the Fund balance is projected to eventually equal the actuarial liability; i.e., all unfunded liabilities are liquidated. In order to accomplish this, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization

DoD MERHCF Footnotes to the Principal Financial Statements

payments are calculated to fund liabilities that were present at plan inception (initial unfunded liability) and any emerging actuarial gains or losses.

The initial unfunded liability of the program was amortized over a 50-year period through the FY 2012 payment. At its August 2012 and July 2017 meetings, the Board decided to decrease the period over which the initial unfunded liability is fully amortized by 5 years and 7 years, respectively. The reason for the shorter amortization period is to ensure that the annual amortization payment covers, at a minimum, the interest growth on the initial unfunded liability. The last payment on the initial unfunded liability is expected to be made October 1, 2039. In addition, at its July 2017 meeting, the Board reduced the amortization period for all actuarial gains and losses from 30 years to 20 years. Chapter 56 of Title 10, United State Code (U.S.C.), requires that the Board approve the 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 Secretary of Defense.

DoD complies with SFFAS No. 33, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates." The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement and other postemployment benefits. SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities. SFFAS No. 33, as published on October 14, 2008, by the Federal Accounting Standards Advisory Board (FASAB) requires the use of a yield curve based on marketable U.S. Treasury securities to determine the discount rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable U.S. Treasury securities.

The statement is effective for periods beginning after September 30, 2009, and applies to information provided in general purpose federal financial statements. It does not affect statutory or other special-purpose reports, such as pension or Other Retirement Benefit reports. SFFAS No. 33 requires a minimum of five periodic rates for the yield curve input and consistency in the number of historical rates used from period to period. It permits the use of a single average discount rate if the resulting present value is not materially different from what would be obtained using the yield curve.

The OACT annually performs two MERHCF valuations. The primary one is for funding purposes, is governed by Chapter 56 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other valuation is for financial statement purposes and is governed by FASAB standards. For the September 30, 2018, financial-statement valuation, OACT determined a single equivalent discount rate of 3.6% by using a 10-year average of quarterly zero coupon Treasury spot rates. These spot rates are based on the U.S. Department of the Treasury – Office of Economic Policy's 10-year Average Yield Curve for Treasury Nominal Coupon Issues (TNC yield curve), which represents average rates from April 1, 2008 through March 31, 2018. The same spot rate data source was used to produce last year's financial statements. In the summer of 2018, the Board approved a discount rate of 5.25% for the September 30, 2017, funding valuation, which differs from the SFFAS No. 33 equivalent rate by 165 basis points. Using the SFFAS No. 33 long-term

DoD MERHCF Footnotes to the Principal Financial Statements

economic assumptions (as compared to the Board assumptions) increases the MERHCF actuarial liability by 26.1%.

FY 2018 Actuarial Liability for the Uniformed Services

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2018, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$	522,491,586
Coast Guard		11,408,492
Public Health Service		1,333,227
National Oceanic and Atmospheric Administration		84,854
Total	\$	<u>535,318,159</u>

FY 2018 Military Service and Other Uniformed Service Contributions

The FY 2018 Military Service and other Uniformed Service contributions to MERHCF (\$ in thousands) were as follows:

DoD	\$	8,146,781
Coast Guard		204,136
Public Health Service		31,966
National Oceanic and Atmospheric Administration		1,584
Total	\$	<u>8,384,467</u>

Market Value of MERHCF's Securities

The market value of MERHCF's nonmarketable, market-based securities as of September 30, 2018, totaled \$284.4 billion. This amount is also reported on Note 3, Investments.

Note 11. General Disclosures Related to the Statements of Net Cost

(\$ In Thousands)	2018	2017
Military Retirement Benefits		
Gross Cost	\$ 3,507,033	\$ 18,582,640
Less: Earned Revenue	<u>(25,634,746)</u>	<u>(20,777,862)</u>
Losses/(Gains) from Actuarial Assumption		
Changes for Military Retirement Benefits	<u>14,949,519</u>	<u>(39,498,851)</u>
Net Cost of Operations	\$ <u>(7,178,194)</u>	\$ <u>(41,694,073)</u>

Information Related to the Statement of Net Cost

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of MERHCF that are 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.

The following table displays the MERHCF intragovernmental revenue:

Intragovernmental Earned Revenue for Program Costs

(\$ in Billions)	<u>FY 2018</u>	<u>FY 2017</u>
1. Uniformed Services Contributions	\$ 8.4	\$ 7.2
2. U.S. Treasury Annual Unfunded Liability Payment	6.6	5.7
3. Interest on Investments	<u>10.6</u>	<u>7.9</u>
4. Total Intragovernmental Revenue	<u>\$ 25.6</u>	<u>\$ 20.8</u>

Uniformed Service Contributions represent the amount contributed by Treasury on behalf of the Uniformed Services at the beginning of each FY. The contribution rates are determined by the DoD Retirement Board of Actuaries and are based on approved per capita normal cost rates and expected average strengths for the Uniformed Services.

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

Interest on Investments represents the interest income received by the MERHCF for FYs 2018 and 2017.

MERHCF costs are reported in accordance with SFFAS No. 33, Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates.

Note 12. Disclosures Related to the Statement of Changes in Net Position

Year Ended September 30, 2018
(\$ In Thousands)

Reconciliation of Appropriations on the Statement of Budgetary Resources to
 Appropriations Received on the Statement of Changes in Net Position

	Total
Appropriations, Statement of Budgetary Resources	\$10,029,110
Appropriations Received, Statement of Changes in Net Position	<u>0</u>
Total Reconciling Amount	\$10,029,110

Items Reported in Net Cost of Operations, Statement of Changes in Net Position

Trust and Special Fund Receipts	\$10,029,110
Total Reconciling Items	\$10,029,110

There was a difference of \$10.0 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations on the SBR. MERHCF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with OMB reporting requirements.

Note 13. Disclosures Related to the Statement of Budgetary Resources

(\$ In Thousands)

	<u>2018</u>	<u>2017</u>
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ <u>110,056</u>	\$ <u>184,329</u>

The MERHCF reported \$10.0 billion in direct, Category B obligations. Category B obligations are apportioned funds related to a specific project or program.

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

Public Law 106-398, The Floyd D. Spence NDAA for FY 2001, provided and authorized MERHCF a permanent, indefinite appropriation.

The MERHCF's unobligated balances of budget authority represent the portion of special fund receipts collected in the current FY (1) exceeding the amount needed to pay benefits or other valid obligations and (2) exceeding the receipts temporarily precluded from obligation by law. The receipts, however, are assets of MERHCF and are available for obligation as needed in the future. There are no material differences between amounts reported on the SBR and the SF 133, Report on Budget Execution.

Note 14. Reconciliation of Net Cost of Operations to Budget

(\$ in Thousands)	2018	2017
Resources Used to Finance Activities:		
Budgetary Resources Obligated—Obligations incurred	\$ 10,029,110	\$ 9,955,998
Less: Offsetting receipts (-)	<u>(16,027,231)</u>	<u>(15,093,866)</u>
Net obligations	(5,998,121)	(5,137,868)
Total resources used to finance activities	<u>(5,998,121)</u>	<u>(5,137,868)</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 (-)	74,273	(30,391)
Resources that fund expenses recognized in prior Periods (-)	(13,173,509)	(30,852,312)
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	<u>(182,766)</u>	<u>1,142</u>
Total resources used to finance items not part of the Net Cost of Operations	<u>(13,282,002)</u>	<u>(30,881,561)</u>
Total resources used to finance the Net Cost of Operations	<u>(19,280,123)</u>	<u>(36,019,429)</u>
Components Requiring or Generating Resources in Future Period Other (+/-)	21,547,649	0
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	(9,424,750)	(5,685,136)
Other	<u>(20,970)</u>	<u>10,492</u>
Total Components of Net Cost of Operations that will not Require or Generate Resources	(9,445,720)	(5,674,644)
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	<u>12,101,929</u>	<u>(5,674,644)</u>
Net Cost of Operations	\$ <u>(7,178,194)</u>	\$ <u>41,694,073</u>

Information Related to the Reconciliation of Net Cost of Operations to Budget

Components Requiring or Generating Resources in Future Period – Other displays the change in the FY 2018 actuarial liability and the FY 2018 IBNR reserve amounts. The actuarial liability amount represents estimated health care liabilities not covered by budgetary resources. The IBNR amount represents an estimate of medical benefits already incurred but not yet reported to the DoD. Refer to Note 10, Military Retirement and Other Federal Employment Benefits.

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables since the beginning of both FY 2017 and FY 2018. These changes represent refunds receivable for (1) amounts due from drug manufacturers as required by the FCP program, (2)

duplicate or other erroneous MERHCF payments made to contractors for care of the beneficiaries, and (3) copayments from MERHCF beneficiaries for mail order prescriptions. These refunds receivable are recorded as an offset to expenses. This line also includes the changes in bad debts for FY 2017 and FY 2018. These bad debts occurred because erroneous payments made to MERHCF beneficiaries or to nonfederal providers of medical services were not repaid.

Note 15. Other Disclosures

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2018 and 2017, includes approximately \$118.1 billion (22% of total) and \$110.2 billion (21% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2018, include approximately \$3.5 billion and \$2.2 billion, respectively, and for the year ended September 30, 2017, include approximately \$2.8 billion and \$2.1 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various Military Service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have OMB Circular A-123 (Appendix D), compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

Other Information

Exhibit 1--Summary of Financial Statement Audit and Management Assurances**SEPTEMBER 30, 2018**

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

DHA includes auditor identified weaknesses in its annual assessment of internal controls from the prior year audit. Specifically, the MTFs do not currently have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by the DoD's planned Standard Financial Information Structure (SFIS). There is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, documentation and cut-off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs. Further, the healthcare cost data from the MTFs provided for the estimation process are aggregated or derived from information in both financial and non-financial systems within the branches of military services that have not been audited. The MTF-level data is based on budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cutoff of accounting activity occurs at the MTF level. The timing of DHA's assessment (dated August, 2018) may cause it to differ from the auditor's reported weaknesses (dated September, 2018) for the current FY. In its FY 2018 assessments, DHA management assessed that, except for direct care related material weaknesses, the MERHCF Financial Statement Reporting Entity (FSRE) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Services have implemented financial systems that comply with (FMFIA § 4).

Except for the one direct care-related material weakness as documented in DHA's Annual Statement Required Under the FMFIA, dated August, 2018, and the above referenced Service-related FMFIA § 4 weakness, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2018 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weaknesses and non-conformances.

Table 1.
Summary of Financial Statement Audit

Audit Opinion	Qualified				
Restatement	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of USSGL Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from FY 2005)	✓				✓
<i>Total Material Weaknesses</i>	1	0	0	0	1

Table 2.
Summary of Management Assurances

Effectiveness of Internal Controls over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Re-assessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant USSGL transaction-based accounting systems to support the costs of direct care provided by DoD-managed MTFs. (Carried Forward and Updated Finding from FY 2005)	✓					✓
<i>Total Material Weaknesses</i>	1	0	0	0	0	1

Table 3.

Conformance with financial management system requirements (FMFIA § 4)

Statement of Assurance	Purchased Care systems conform to financial management systems requirements: Direct Care Costs systems do not comply with financial management systems requirements.					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant USSGL transaction-based accounting systems to support the costs of direct care provided by DoD-managed MTFs. (Carried Forward and Updated Finding from FY 2005)	✓					✓
Total non-conformances	1	0	0	0	0	1

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

Note: The above uncorrected weakness combines the reported Direct Care material weakness identified by the independent auditor in the audit of the FY 2018 MERHCF financial statements. Identification and implementation of appropriate corrective actions to resolve this one material weakness will result in successful correction of the Direct Care material uncorrected weakness identified in the FY 2018 MERHCF audit.

Exhibit 2--IPIA Reporting Details September 30, 2018**PAYMENT INTEGRITY**

The [*Federal Improper Payments Coordination Act of 2015*](#) amended the Improper Payment Elimination and Recovery Improvement Act of 2012 ([*IPERIA*](#)) and earlier legislation¹ affecting improper payment and requires extension of Departmental reporting of its data analytics performance. The intent is to ensure federal and state entities maintain strong financial management controls to better detect, prevent, and report improper payments to the President and the Congress in the annual Agency Financial Report (AFR).

Office of Management and Budget (OMB) Circular No. A-123, [*Appendix C*](#) defines an improper payment as any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts are overpayments or underpayments that are made to eligible recipients (including inappropriate denials of payment or services, any payment that does not account for credit for applicable discounts, payments that are for an incorrect amount, and duplicate payments). An improper payment also includes any payment that was made to an ineligible recipient or for an ineligible good or service, or payments for goods or services not received (except for such payments authorized by law). In addition, when an agency's review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation, this payment must also be considered an improper payment.

The Defense Health Agency (DHA) reports its improper payments and payment recapture programs in accordance with applicable laws and regulations. The following subcategories are included in this section:

- I. Risk Assessment
- II. Payment Reporting
 - a. Root Causes
 - b. Corrective Actions
- III. Recapture of Improper Payment Reporting
- IV. Agency Improvement of Payment Accuracy with the Do Not Pay Initiative
- V. Barriers
- VI. Accountability
- VII. Agency Information Systems and Other Infrastructure
- VIII. Sampling and Estimation
- IX. Significant Accomplishments

The DHA reports improper payments for the Military Health System (MHS) TRICARE purchased health care program for payments made by the DHA to private sector contractors for delivery of health care services to TRICARE eligible beneficiaries. For fiscal year (FY) 2018 the Agency reports improper payments for the following private sector contracts, DHA administrative costs and other plans and programs:

¹ Improper Payments Information Act of 2002 ([*IPIA*](#)), as amended by the Improper Payments Elimination and Recovery Act of 2010 ([*IPERA*](#)) and the Improper Payments Elimination and Recovery Improvement Act of 2012 ([*IPERIA*](#))

- Managed Care Support Contracts (MCSCs)
 - T-3 North Region, HealthNet Federal Services
 - T-3 South Region, Humana Government Business
 - T-3 West Region, UnitedHealthcare Military and Veterans
- TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC)
- TRICARE Overseas Program (TOP)
- TRICARE Pharmacy Program (TPharm)
- Active Duty Dental Program (ADD)
- DHA Administrative Contract Cost
- Other
 - Uniformed Services Family Health Plan (USFHP)
 - Women, Infants, and Children (WIC)
 - TRICARE Dental Program
 - TRICARE Retiree Dental Program
 - Mail Order Pharmacy

I. Risk Assessment

The DHA risk assessment process is managed through contracts with an external independent contractor (EIC) to provide an independent, impartial review of reimbursements and claims processing procedures used by DHA's purchased-care contractors. The EIC identifies improper payments resulting from the contractors' noncompliance with The Military Health Care System (collectively referred to as TRICARE in this report) benefit and/or reimbursement policies, regulations, and contract requirements. The risk level of programs is evaluated based on results of these compliance reviews.

In Fiscal Year (FY) 2018, the Agency applied statistical sampling estimation methods to produce and report statistically valid improper payment estimates for the Military Health Benefits Program. In accordance with OMB Circle A-123, Appendix C, agencies are not required to perform additional risk assessments on programs reporting improper payment estimates. However, any new programs identified must be assessed for improper payment risk prior to reporting an improper payment estimate. DHA had no new program(s) implemented in FY 2017, and therefore no additional risk assessment was required for FY 2018 reporting.

II. Payment Reporting

Table 1 reports the estimated amounts that were improperly paid and the corresponding percent by program for FY 2018. It also reports the estimated amount of improper payments that resulted in overpayments or under payments and the DHA contractual reduction targets by program for FY 2019.

Other Information

Table 1 ¹ Improper Payment Reduction Outlook (\$ in millions)												12 month Sampling Timeframe for FY 2018 data	
Program Name	FY 2017 Outlays (\$M)	FY 2017 IP Amount (\$M)	FY 2017 IP Rate	FY 2018 Outlays (\$M)	FY 2018 IP Amount (\$M)	FY 2018 IP Rate	FY 2018 Over-payment \$	FY 2018 Under- payment \$	FY 2019 Est. Outlays ²	FY 2019 Est. IP % ³	FY 2019 Est. IP \$	Month and Year start date for data	Month and Year end date for data
T3 North Region	\$ 3,513.32	\$ 18.29	0.43%	\$ 3,548.47	\$ 12.90	0.36%	\$ 6.85	\$ 6.06	\$ 3,686.86	1.75%	\$ 64.52	10/1/2016	9/1/2017
T3 South Region	\$ 4,632.31	\$ 18.41	0.71%	\$ 4,451.16	\$ 29.71	0.67%	\$ 25.57	\$ 4.14	\$ 4,624.75	1.75%	\$ 80.93	10/1/2016	9/1/2017
T3 West Region	\$ 3,985.06	\$ 32.21	1.37%	\$ 3,668.40	\$ 23.72	0.65%	\$ 18.34	\$ 5.37	\$ 3,811.46	1.75%	\$ 66.70	10/1/2016	9/1/2017
TDEFIC	\$ 3,558.68	\$ 7.60	0.38%	\$ 3,531.99	\$ 8.48	0.24%	\$ 6.08	\$ 2.40	\$ 3,669.74	1.75%	\$ 64.22	10/1/2016	9/1/2017
TOP	\$ 238.37	\$ 2.71	1.36%	\$ 234.32	\$ 3.36	1.43%	\$ 2.80	\$ 0.56	\$ 243.46	1.75%	\$ 4.26	9/1/2016	8/1/2017
TPharm	\$ 3,161.13	\$ 70.21	0.74%	\$ 2,758.49	\$ 11.86	0.43%	\$ 11.75	\$ 0.12	\$ 2,866.07	1.75%	\$ 50.16	11/1/2016	10/1/2017
ADDP	\$ 81.26	\$ 0.75	0.30%	\$ 82.79	\$ 1.21	1.46%	\$ 1.00	\$ 0.22	\$ 86.02	1.75%	\$ 1.51	8/1/2016	7/1/2017
DHA Administrative ⁴	\$ 1,225.77	\$ -		\$ 751.73	\$ -	0.00%	\$ -	\$ -	\$ 781.05	0.00%	\$ -	10/1/2016	9/1/2017
Other ⁵	\$ 3,487.40	\$ -		\$ 4,269.21	\$ -	0.00%	\$ -	\$ -	\$ 4,435.71	0.00%	\$ -	10/1/2016	9/1/2017
TOTAL	\$ 23,883.30	\$ 150.17	0.63% ⁶	\$ 23,296.55	\$ 91.24	0.39%	\$ 72.38	\$ 18.86	\$ 24,205.12	1.37%	\$ 332.30		

Footnotes:

1 - DHA reports data 12 months in arrears, thus this FY2018 AFR includes data from FY2017 reviews. 2019 outlay estimates.

3 - DHA uses 1.75% as its out-year target because that is the contractual claims processing performance requirement. However, contractors' performance error rates have historically been well below this target.

4 - "DHA Administrative" data represents payments shared among multiple contractors to administer the TRICARE program. These costs include contractually defined claim rates for processing TRICARE claims, and non-claim rate administrative costs (i.e., contract change orders, per member per month charges and contract incentive payments). Payments are validated via TED system program edits, COR review/validation procedures, and/or internal/external financial audits.

5 - "Other" data represents contracts that are not included in DHA EIC independent audits but which have internal and external pre- and post-payment controls. The following contracts are included in the "Other" category:

- a. Uniformed Services Family Health Plan ("USFHP")
- b. Women, Infants, and Children ("WIC")
- c. TRICARE Dental Program ("TDP")
- d. TRICARE Retiree Dental Program ("TRDP")
- e. Mail Order Pharmacy ("MOP")

6 - The 'FY 2017 IP Rate' of 0.63% does not represent a true statistical estimate for the agency because the 2015'10-2016'09 low dollar TPharm audit that was not conducted (due to the contractor opting out of participating in the audit, as approved by the Contracting Officer). This audit represented \$138,057,695 paid dollars.

Table A below reports the estimated amount and percentage of payments made correctly under the DHA Health Benefits Program in FY 2017.

Table A: Amount and Percentage of DHA Improper vs. Proper Payments

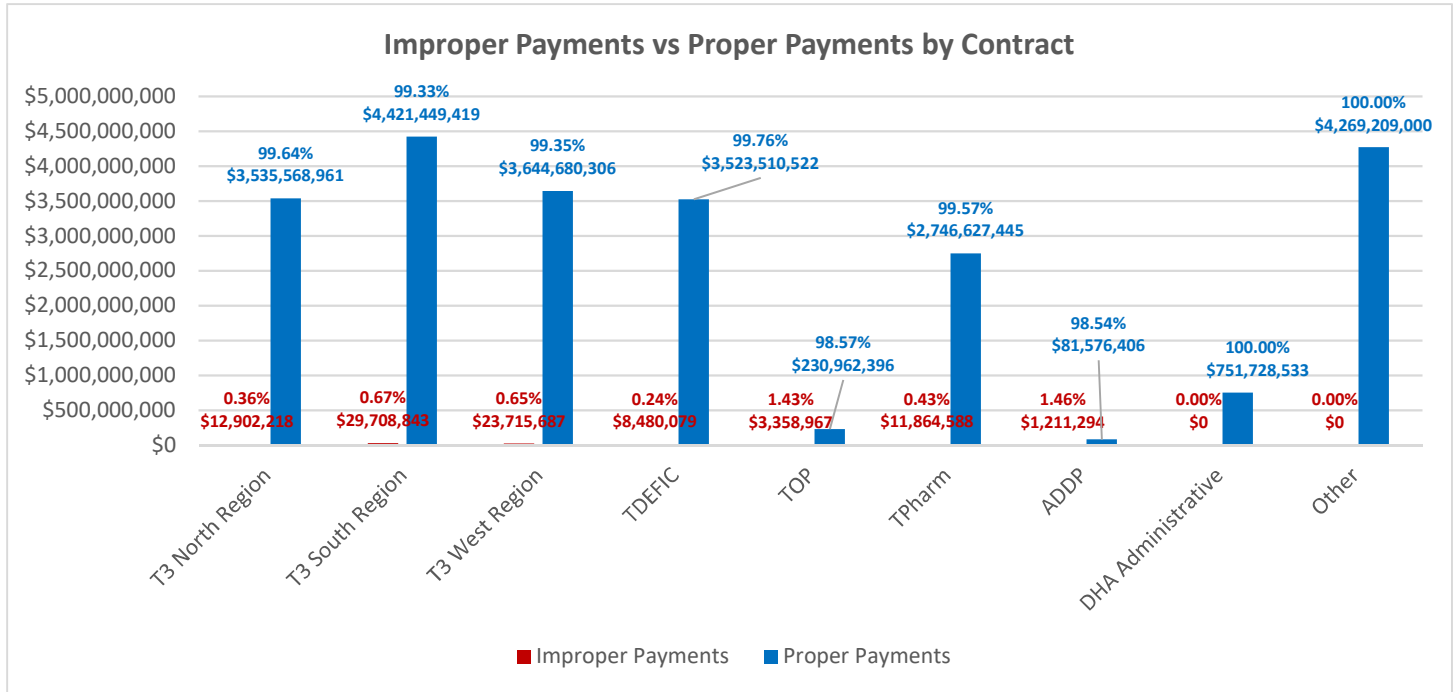


Table 2 below provides current year estimate statistical information.

Table 2
CY Estimate Statistical Information

Program Name	CY Confidence Level	CY Margin of Error
T3 North Region	90%	0.20%
T3 South Region	90%	0.25%
T3 West Region	90%	0.27%
TDEFIC	90%	0.29%
TOP	90%	0.33%
TPharm	90%	0.25%
ADDP	90%	0.56%
DHA Administrative	90%	0.00%
Other	90%	0.00%
TOTAL	90%	0.09%

Other Information

Table 3 reports the root cause for overpayments and underpayments by amount and by program for FY 2018.

Table 3
Improper Payment Root Cause Category Matrix
(\$ in millions)

Program Name	Payment Type	Program Design or Structural Issue	Inability to Authenticate Eligibility: Inability to Access Data	Failure to Verify: Death Data	Failure to Verify: Financial Data	Failure to Verify: Excluded Party Data	Failure to Verify: Prisoner Data	Failure to Verify: Other Eligibility Data (explain)	Administrative or Process Errors Made by: Federal Agency	Administrative or Process Errors Made by: State or Local Agency	Administrative or Process Errors Made by: Other Party (e.g., participating lender, health care provider, or any other organization administering Federal dollars)	Medical Necessity	Insufficient Documentation to Determine	Other reason (1): Authorization/Preauthorization Needed	Other reason (2): Development Required	Other reason (3): OHI Payment Omitted	Other reason (4): DRG Reimbursement Error	Other reason (5): Timely Filing Error	TOTAL
T3 North Region	Overpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 4.562	\$ -	\$ -	\$ -	\$ -	\$ 1.899	\$ 0.386	\$ -	\$ 6.847
T3 North Region	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 6.023	\$ -	\$ -	\$ 0.032	\$ -	\$ -	\$ -	\$ -	\$ 6.055
T3 South Region	Overpayments	\$ -	\$ 0.016	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 25.360	\$ -	\$ 0.002	\$ 0.149	\$ 0.044	\$ -	\$ -	\$ -	\$ 25.571
T3 South Region	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3.003	\$ -	\$ -	\$ 0.664	\$ -	\$ -	\$ 0.471	\$ -	\$ 4.138
T3 West Region	Overpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 11.489	\$ -	\$ 0.000	\$ 1.317	\$ -	\$ 5.517	\$ -	\$ 0.018	\$ 18.342
T3 West Region	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 2.703	\$ -	\$ -	\$ 0.020	\$ -	\$ -	\$ 2.651	\$ -	\$ 5.374
TDEFIC	Overpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3.308	\$ -	\$ -	\$ 0.337	\$ -	\$ 2.436	\$ -	\$ -	\$ 6.081
TDEFIC	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 2.281	\$ -	\$ -	\$ 0.062	\$ -	\$ 0.057	\$ -	\$ -	\$ 2.400
TOP	Overpayments	\$ -	\$ 0.001	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.603	\$ -	\$ 0.055	\$ 0.943	\$ 1.200	\$ 0.001	\$ -	\$ -	\$ 2.802
TOP	Underpayments	\$ -	\$ 0.001	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.526	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.030	\$ -	\$ 0.557
TPharm	Overpayments	\$ -	\$ 0.000	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 10.350	\$ 0.086	\$ 0.010	\$ 0.641	\$ -	\$ 0.170	\$ -	\$ 0.489	\$ 11.746
TPharm	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.074	\$ -	\$ -	\$ -	\$ -	\$ 0.045	\$ -	\$ -	\$ 0.119
ADDP	Overpayments	\$ -	\$ 0.006	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.575	\$ 0.096	\$ 0.145	\$ 0.173	\$ -	\$ -	\$ -	\$ -	\$ 0.996
ADDP	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 0.059	\$ -	\$ -	\$ 0.157	\$ -	\$ -	\$ -	\$ -	\$ 0.216
DHA Administrative	Overpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
DHA Administrative	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other	Overpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other	Underpayments	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
																			\$ 91.24

Footnotes:

1 - Figures were derived by multiplying the proportion of sample error dollars for each error category by the extrapolated overpayment or underpayment dollars from Table 1. For example, for TPharm, 'Medical Necessity' overpayments from samples totaled \$1,143.89. All sample overpayments from the TPharm samples totaled \$156,973.23. Therefore, this error category accounted for 0.7287% of total sample overpayment dollars (\$1,143.89 divided by \$156,973.23). 0.7287% of the TPharm 'FY2018 Over-payment \$' from Table 1 (\$11,745,514.25) yields \$85,591.51. Rounded to millions, this number becomes \$0.86 (which is shown in this table). This process was repeated for each cell in the table.

A. Root Causes

The following section provides additional information regarding the root causes of improper payments for each program reported in Table 3 above.

The DHA contracts with an External Independent Contractor (EIC) to conduct quarterly, semi-annual and annual compliance reviews of previously processed healthcare claims. EIC auditors review claims to identify improper payments, and to validate the accuracy of the claims processing procedures utilized by TRICARE private sector contractors. Overpayment or underpayment errors can be assessed for (but not limited to) payments in the correct amount being sent to the wrong payee, incorrect denial of a payable claim, misapplication or calculation of a patient's deductible or co-payment/share liability, or payment of a non-covered service or supply. In FY 2017, EIC compliance reviews determined the root cause for over/underpayment errors was the result of the following:

- **Inability to Authenticate Eligibility:** DHA private sector contractors incorrectly paid or denied healthcare claim(s) as a result of an incorrect patient eligibility determination.
- **Administrative or Process Errors Made by Other Party:** DHA's EIC determined throughout the course of compliance reviews that DHA private sector contractors incorrectly processed healthcare claims by either:
 - Applying an incorrect reimbursement determination or methodology when processing a healthcare claim;
 - Incorrectly calculating the Government's liability after consideration of other health insurance (OHI) payment(s);
 - Based on a patient's healthcare claims history, incorrectly made duplicative payments for previously paid healthcare services or supplies;
 - Miscalculated the patient's cost-share or benefit deductible liability;
 - Made a payment for services or supplies which were not a TRICARE benefit or incorrectly denied payment for services or supplies that were a TRICARE benefit;
 - Incorrectly calculated the government's reimbursement of healthcare based on a billed amount other than what was being reported on a healthcare claim form or itemized medical bill; or
 - Incorrectly based its reimbursement determination/methodology on an incorrect procedure code.
- **Medical Necessity–** the claims processor failed to follow TRICARE medical necessity review policy requirements prior to processing and paying a healthcare claim, or failed to provide the medical necessity review documentation needed to support or substantiate the adjudication of the claim being reviewed during audit.
- **Insufficient Documentation to Determine–** the EIC determined during a compliance review that the claims documentation provided by private sector contractors was insufficient and/or did not support the adjudication of the healthcare, as a result the EIC determined the services or procedures rendered should not have been paid.

- Other: In addition to the OMB established root cause categories listed above, DHA established a number of individual payment error categories that the further defines the rational for error assessment. For FY 2018 the EIC assessed the following individual payment errors against private sector contractors:
 - 1) Authorization/Pre-Authorization Needed – the claims processor failed to follow TRICARE authorization or pre-authorization requirements prior to processing a payment for a healthcare claim, or on audit failed to provide the authorization/prior-authorization documentation needed to support the adjudication of the healthcare claim.
 - 2) Claims Development Required – the private sector contractor processed and paid a healthcare claim without obtaining additional or correct information needed to support or justify the payment of the healthcare claim, as required by TRICARE policy.
 - 3) OHI Payment Omitted – claims documentation submitted for processing contained information of OHI payment, however the claims processor failed to consider such information when determining Government liability.
 - 4) Diagnosis Related Group (DRG) Reimbursement Error – the claims processor made an error in calculating the reimbursement due to an institution based on the DRG reimbursement system.
 - 5) Timely Filing Error – the claims processor processed and paid claims for benefit dates of service that did not meet TRICARE timely filing requirements, and failed to obtain the appropriate timely filing waiver(s) needed to authorize such payments.

Table 4 below reports the amount of improper payments identified in samples by contract that resulted in actual monetary losses to the government. The purpose of this classification is to estimate the monetary loss to the Federal Government due to improper payments. Monetary loss to the Government would be an amount that must not have been paid and in theory should/could be recovered. This table excludes improper payments resulting from insufficient supporting documentation.

Table 4
Improper Payment Classification
 (\$ in millions)

Program or Activity	Actual Monetary loss to the Government identified in Sample	Estimated Total Monetary Loss to the Government
T3 North Region	\$ 0.19	\$ 6.85
T3 South Region	\$ 1.96	\$ 25.57
T3 West Region	\$ 1.20	\$ 18.34
TDEFIC	\$ 0.13	\$ 6.08
TOP	\$ 0.48	\$ 2.80
TPharm	\$ 0.16	\$ 11.75
ADDP	\$ 0.02	\$ 1.00

Other Information

Program or Activity	Actual Monetary loss to the Government identified in Sample	Estimated Total Monetary Loss to the Government
DHA Administrative	\$ -	\$ -
Other	\$ -	\$ -
TOTAL	\$ 4.14	\$ 72.39

B. Corrective Actions

Military Health Benefits (FY 2018 IP Amount = \$91.24M)

DHA private sector contractors are monetarily incentivized or dis-incentivized, through payment accuracy performance standards, to reduce and/or eliminate improper payments. The fewer improper payments the contractors make, the less money is deducted from their reimbursements. Additionally, details of the EIC compliance reviews are shared with the private sector contractors, DHA Program Offices, private sector contract Contracting Officers, and Contracting Officer Representatives to coordinate appropriate corrective action plans with the respective private sector contractor. Moreover:

- Upon completion of an EIC compliance review, contractors review results, formulate an action plan to mitigate future findings, and derive a process to avoid future improper payments.
- If warranted, contractor claims processing systems are modified to meet the Department's healthcare policy, reimbursement, or benefit requirements.
- If review results show a potential error pattern for a certain type of claim, additional claims are pulled to conduct a focused study, and adjustment actions are taken as appropriate.

Each private sector contractor has its own business process for evaluating compliance review results, conducting root cause analyses to ensure the accuracy of future claims payment, and developing internal corrective action plans. If required, DHA Contracting Officers and Contracting Officer Representatives issue contractor corrective action plans to resolve and track noncompliance with TRICARE healthcare policy/regulations and purchased-care contracts.

For each payment error/root cause category assessed as a result of ongoing compliance reviews, DHA will continue to instruct private sector contractors to follow Code of Federal Regulation (CFR) Chapter 199.11 – Overpayment Recovery instructions and to investigate and make necessary adjustments to those claims identified as having payment errors. In addition, DHA will:

- 1) Modify TRICARE purchased care contracts requiring contractors to develop procedures for reporting CAPs for each payment error category/root cause assessed against a claim during a quarterly or semi-annual compliance review cycle as well as developing procedures for Government entities to validate proposed CAPs;
- 2) Develop Contract Data Requirements List (CDRL) requirements that require contractors to provide monthly status reports on CAPs established for each payment error category/root cause assessed for a specified compliance review cycle (reference

TRICARE Operations Manual (TOM), Chapter 14, for additional information regarding DHA CDRL requirements);

- 3) Include TRICARE private sector contractor CAP reports as part of DHA's AFR reporting to the DoD Comptroller annually; and
- 4) Develop database or tracking tool to monitor TRICARE private sector contractor CAP reporting and contractor actions taken.

III. Recapture of Improper Payments Reporting

Table 5 (on the following page) reports each program or activity that exceeds \$1 million or more annually that recapture payments outside of a payment recapture audit and the amounts recovered through sources other than recapture audits.

DHA utilizes a number of different mechanisms to prevent, identify, and collect improper payments. These include claims auditing by an EIC, contractor utilization of DHA's Duplicate Claims System, and periodic independent reviews of private-sector payments. This process utilizes pre and post-payment review techniques, performed internally and by external contractors with overpayment recoveries returned to the Military Health Benefits program.

Contract payments comprise a large volume of transactions with high-dollar values; therefore, DHA is vigilant to ensure payment accuracy. In addition to the pre and post-payment reviews, DHA also utilizes various internal manual and automated prepayment initiatives to prevent improper payments. During FY 2017, DHA recovered \$192.26 million in overpayments as a result of overpayment errors identified by the EIC, refunds occurring in the course of routine claims adjustments, and ongoing private sector contractor internal audits, resulting in a 266% overpayment recovery rate.

Table 5
Overpayment Payment Recaptures with and without Recapture Audit Programs
(\$ in millions)

Does this include funds recaptured from a High-Priority Program (Y/N)	Program or Activity	Overpayments Recaptured through Payment Recapture Audits				Overpayments Recaptured outside of Payment Recapture Audits	
		Amount Identified in FY 2018	Amount Recaptured in FY 2018	Recapture Rate in FY 2018	FY2019 Recapture Rate Target	Amount Identified in FY 2018	Amount Recaptured in FY 2018
N	T3 North Region					\$ 6.85	\$ 39.71
N	T3 South Region					\$ 25.57	\$ 44.37
N	T3 West Region					\$ 18.34	\$ 41.82
N	TDEFIC					\$ 6.08	\$ 30.36
N	TOP					\$ 2.80	\$ 5.50
N	TPharm					\$ 11.75	\$ 30.43
N	ADDP					\$ 1.00	\$ 0.07
N	DHA Administrative					\$ -	\$
N	Other					\$ -	\$
	TOTAL					\$ 72.39	\$ 192.26

Footnotes:

1 - 'Amount Identified in FY 2018' represents the total extrapolated overpayment dollars in the universe ('FY2018 Over-payment \$' from Table 1).

2 - 'Amount Recovered in FY 2018' represents negative TED transactions to DHA (recoupments) for claims in audit universes. DHA only included recoupments that occurred after each audit's end date, as recoupments occurring before an audit concluded should not be considered a recoupment due to that audit. In contrast, recoupments that occurred after an audit concluded can reasonably be expected to be a result of findings from that audit.

DHA chose to report recoupments this way to match the extrapolation methodology for overpayments. Overpayments from sample results are extrapolated to represent the entire universe (reported as 'FY2018 Over-payment \$' in Table 1). Therefore, DHA considers any negative payment across the universe to be a recoupment, regardless of whether the claim was randomly selected to be part of the sample.

The 'Amount Recaptured in FY 2018' includes recoupments for overpayments identified in audits as well as refunds occurring in the course of routine claim adjustments (for claims initially paid in FY17 and other fiscal years). DHA has no way to distinguish overpayment recoupments from routine claim adjustments.

3 - The Active Duty Dental Program (ADDP) refunds were calculated differently. The amount recovered in FY 2018 figure for ADPP represents refunds shown on contractor invoices to DHA. ADPP data is not included in the TED system, thus contractor invoices were used because TED transactions are not available.

IV. Agency Improvement of Payment Accuracy with the Do Not Pay Initiative

Individual Payments. The DHA processes relatively few (5-20) case recoupment refunds each month for small dollar amounts (\$5 – \$20,000). The Single Online Search service is utilized pre-payment for 100 percent of all case recoupment refunds to verify (1) a business or individual has not been placed on the List of Excluded Individuals/Entities (LEIE), and (2) an individual has not died. Any matches will be referred to the DHA Office of General Counsel.

Vendor, Contract Payments. The DHA processes approximately 226 routine payments per month for 13 unique contractor payees. The Single Online Search service is utilized pre-payment once a month to verify a DHA contractor payee has not been placed on the Excluded Parties List System (EPLS) or the List of Excluded Individuals/Entities (LEIE). Any matches are validated with the Treasury Offset Program (TOP) ensuring the contractor does not have the same Employer Identification Number (EIN) as a person's Social Security Number (SSN). The contractor is responsible for resolving these matching issues due to proprietary reasons. If the contractor is on the list, the finding is referred to the assigned Contracting Officer. DHA processed approximately 312 payments totaling \$2,088,582,881.81 with no matches on the Do-Not-Pay system for Fiscal Year of 2018.

The risk for payments to a subcontractor or individual via the contractor, however, lies outside of DHA control. DHA contractors are not required to utilize the Do-Not-Pay database, and there is no current mechanism in place to require the contractors to use the Do-Not-Pay databases at the prepayment phase to comply with IPERA.

Table 6 below provides results of the Do Not Pay Initiative for DHA's Military Health Benefits program.

Table 6
Results of the Do Not Pay Initiative in Preventing Improper Payments
(In millions)

	Number (#) of payments reviewed for possible improper payments	Dollars (\$) of payments reviewed for possible improper payments	Number (#) of payments stopped	Dollars (\$) of payments stopped	Number (#) of potential improper payments reviewed and determined accurate	Dollars (\$) of potential improper payments reviewed and determined accurate
Reviews with the IPERIA specified Databases	312	\$2,088.6	0	\$ 0	312	\$2,088.6
Reviews with databases not listed in IPERIA	0	\$0	0	\$ 0	0	\$0

V. Barriers

The Agency did not identify any statutory or regulatory barriers limiting its corrective actions in reducing improper payments in those programs determined in FY 2018 to be susceptible to significant improper payments.

VI. Accountability

The Under Secretary of Defense (Comptroller)/Chief Financial Officer is the Accountable Official for the Department and is responsible for ensuring that, to the greatest extent possible, all DoD disbursements are accurate.

Certifying Officer Legislation, [*10 U.S.C. 2773a*](#), holds Certifying and Disbursing Officers accountable for government funds. In accordance with this law, 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. This is further captured in the [*DoD Financial Management Regulation \(DoDFMR\), Volume 5, Chapter 33*](#), entitled “Certifying Officers, Accountable Officials, and Review Officials.” The Department’s efforts to recover overpayments from a recipient must be undertaken in accordance with the debt collection procedures outlined in the [*DoDFMR, Volume 5, Chapter 28*](#), “Management and Collection of Individual Debt,” and [*DoDFMR, Volume 10, Chapter 18*](#), “Contractor Debt”.

The DoD FMR contains other policies that specifically address Improper Payments ([*DoDFMR Volume 4, Chapter 14*](#)) and Recovery Auditing ([*DoDFMR Volume 10, Chapter 22*](#)). Beginning in Quarter 3, FY 2013, all reporting DoD Components were required to begin downloading their improper payment reports to the DFAS ePortal, as the Office of the Deputy Chief Financial Officer’s Accounting & Finance Policy Directorate was designated as the Executive Agent to manage this information and its associated reporting requirements. This centralized electronic system allows the reporting Components to access improper payment information without regard to the time zone in which they are located. More importantly, it allows management to ensure all Components’ submissions are timely and accurate.

VII. Agency Information Systems and Other Infrastructure

DHA has much of the information and infrastructure needed to reduce improper payments. DHA Purchased Care Program (managed by the Contract Resource Management (CRM)) includes an immense volume of claims processed by TRICARE purchased care contractors. To track programs, CRM utilizes the following systems:

- TRICARE Encounter Data (TED). TED is a financial feeder system, through which all claims are processed to Oracle Federal Financials (OFF). TED is the entry point of claims information from DHA purchased care contractors. TED records provide detailed information for each treatment encounter and are submitted as either an institutional or non-institutional record. TED is primarily required by DHA to account for the expenditure of government funds, develop statistical information, and is a data source of records for

EIC audits. Records submitted through the TED System (TEDS) must pass numerous validation edits prior to being accepted into TEDS.

- E-Commerce System (ECS). ECS is an integrated, centralized major system that improves DHA's core financial, contracting and business process by providing seamless integrated financial and contracting systems.
- Oracle Federal Financials (OFF). OFF is the financial subsystem of the DHA ECS. It supports budget and accounting/financial functions and healthcare (TEDS) claims processing and contains TRICARE Claims Management, Accounts Receivable, Accounts Payable, Purchase Orders and the General Ledger modules. CRM uses OFF to track commitments and obligations. These transactions are submitted to DFAS and become the primary source into financial statements.

In addition to internal DHA financial systems, DHA purchased care contractors claims processing systems are developed and designed in accordance with TRICARE System Manual <http://manuals.tricare.osd.mil/pages/v3/DisplayManual.aspx?SeriesId=TS15> requirements and contain numerous system edits. These edits include patient eligibility (verified via the Defense Enrollment Eligibility Reporting System (DEERS)), provider eligibility, and more. If a claim passes initial eligibility edits, benefit calculations occur based on programmed payment rules and reimbursement methods determined by TRICARE Reimbursement Policy. The claims processing systems are able to determine the appropriate reimbursement methodology based on information included in the healthcare claim such as type of service, claim form type, provider specialty, etc.

Further, DHA has developed the TRICARE Duplicate Claims System (DCS). This tool facilitates the identification of duplicate claim payments, the initiation and tracking of recoupments, required by purchased care contractors, and the ultimate cancellation of duplicate records from the TEDS database. DHA purchased care contractors are contractually required to use the DCS and resolve duplicate payments.

VIII. Sampling and Estimation

DHA followed OMB Circular A-123, Appendix C, dated October 20, 2014, when developing its sampling methodology to select FY 2017 claims for its EIC compliance review. This statistically valid sampling methodology met OMB's requirements of a 90 percent confidence level and a margin of error of ± 2.5 percent. By using this methodology, DHA is able to identify valid sample sizes and project improper payment percentages for the Agency's improper payment program. DHA performs 100 percent pre-payment reviews of its administrative and other program disbursements.

DHA defines samples (sets strata boundaries, calculates sample sizes, and randomly selects claims for review) and the EIC reviews the selected claims to identify improper payments. Payment accuracy compliance reviews include two sample types: a payment sample (to ensure payment accuracy by identifying underpayment and overpayments) and a denied sample (to ensure appropriate claim denial). Paid samples are conducted as a stratified random sample based on paid amounts and denied samples are conducted as a stratified random sample based on billed amounts.

Samples are drawn on either a quarterly or semi-annual basis, respective of DHA purchased care contract requirements.

- **Payment Sample:** Paid samples are conducted to identify improper payments and measure payment accuracy. Depending on the private sector contract type (i.e., MCSC, TDEFIC, TOP, etc.), the universe for a paid sample may contain between several hundred thousand to 30 million claims. All claims with government payment amount above a high-dollar threshold (i.e., \$200,000) are reviewed by the EIC. Claims between the high-dollar threshold and a low-dollar threshold (i.e., \$100) are randomly sampled based on stratification of the government payment amount and reviewed by the EIC. Claims below the low-dollar threshold are not included in EIC audits (but are represented by DHA Low-Dollar Internal Reviews).
 - Samples for paid claims include between four and 12 strata, depending on the composition of the claims in the universe. Mathematical formulas are utilized to identify optimal strata boundary points, and sample sizes are calculated to meet (or exceed) an estimate with a minimum of 90% confidence plus or minus 2.5 percentage points (as stipulated in the OMB Circular A-123, Appendix C guidelines).
- **Low-Dollar Internal Review:** In addition to the ongoing EIC quarterly and semi-annual reviews, the EIC conducts an annual statistically valid review of low-dollar claims that fall below the low-dollar threshold for payment samples. Audits for these EIC reviews are stratified if appropriate, given the composition of the universe data.
- **Denied Sample.** The primary purpose of the denied payment samples is to ensure that health care/supplies are not being denied inappropriately (which may represent obstacles in TRICARE beneficiaries' access to care) by private sector contractors. Records that encompass the denied payment sample universe are limited to records with government payment amount equal to zero. All denied claims with a billed amount above a high-dollar threshold are reviewed, and claims below this threshold are randomly sampled based on stratification of the billed amount. Depending on the contract type, a denied audit universe may contain between several thousand to over 1 million claims.
 - The denied payment sample is similar in design to the payment sample; the primary difference is that the denied sample is stratified based on billed amount since the paid amount for a denied claim is equal to \$0.
- **Combining the Samples:** Results from the payment sample, denied sample, and DHA's internal low-dollar review are all considered when DHA calculates the overall improper payment rate.

IX. Significant Accomplishments

The DHA is committed to full compliance with the requirements of IPERIA. As part of the Agency's audit efforts, DHA Components diligently review and report all payments subject to IPERIA, as well as examine processes for identifying the complete universe of payments.

Moreover, DHA continues to explore measures to improve its internal controls to prevent improper payments, and strengthen post payment reviews to identify and recover improper payments. To ensure the accurate and reliable reporting of improper payments, DHA modified the TRICARE pharmacy contract to require the contractor to participate in the annual low-dollar pharmacy claim reviews. As a result, DHA's reported improper payment estimates includes the complete universe of payments, as required by OMB guidance.

DoD Transmittal of Auditor's Opinion

DoD Transmittal of Auditor's Opinion



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 7, 2018

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

SUBJECT: Transmittal of the Independent Auditor's Report on the DoD Medicare-Eligible
Retiree Health Care Fund Financial Statements and Related Notes for
FY 2018 and FY 2017 (Project No. D2018-D000FT-0122.000,
Report No. DODIG-2019-009)

We contracted with the independent public accounting firm of Kearney & Company to audit the DoD Medicare-Eligible Retiree Health Care Fund (MERHCF) FY 2018 and FY 2017 Financial Statements and related notes as of September 30, 2018, and 2017, and for the years then ended, and to provide a report on internal control over financial reporting and compliance with laws and regulations. The contract required Kearney & Company to conduct the audit in accordance with generally accepted government auditing standards (GAGAS); Office of Management and Budget audit guidance; and the Government Accountability Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2008.¹ Kearney & Company's Independent Auditor's Reports are attached.

Kearney & Company's audit resulted in a qualified opinion. Kearney & Company could not obtain sufficient, appropriate audit evidence to support the costs of direct care provided by DoD-managed military treatment facilities. Kearney & Company concluded that, except for the effects on the financial statements of the amounts related to MERHCF's direct care costs, the MERHCF FY 2018 and FY 2017 Financial Statements and related notes as of September 30, 2018, and 2017, and for the years then ended, are presented fairly, in all material respects, in conformity with Generally Accepted Accounting Principles.

¹ In June 2018, the Government Accountability Office issued an updated Financial Audit Manual. Kearney & Company updated its audit procedures to be in accordance with the updates issued in the Government Accountability Office/Council of the Inspectors General on Integrity and Efficiency, "Financial Audit Manual," June 2018.

DoD Transmittal of Auditor's Opinion

Kearney & Company's separate report on "Internal Control Over Financial Reporting" discusses one material weakness related to the MERHCF internal controls over financial reporting. Specifically, Kearney & Company found a material weakness relating to the direct care costs data accumulation. Kearney & Company's additional report on "Compliance with Laws, Regulations, Contracts, and Grant Agreements" discusses one instance of noncompliance with applicable laws and regulations.

In connection with the contract, we reviewed Kearney & Company's reports and related documentation and discussed the audit results with Kearney & Company representatives. Our review, as differentiated from an audit in accordance with GAGAS, was not intended to enable us to express, and we did not express, an opinion on the MERHCF FY 2018 and FY 2017 Financial Statements and related notes, conclusions about the effectiveness of internal controls, conclusions on whether the MERHCF's financial management systems substantially complied with the "Federal Financial Management Improvement Act of 1996," or conclusions on whether MERHCF complied with laws and regulations.

Kearney & Company is responsible for the attached reports, dated November 7, 2018, and the conclusions expressed in these reports. However, our review disclosed no instances in which Kearney & Company did not comply, in all material respects, with GAGAS.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945.



Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

Attachments:
As stated

Independent Auditor's Report



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INDEPENDENT AUDITOR'S REPORT

To:
The Assistant Secretary of Defense for Health Affairs
The Inspector General of the Department of Defense

Report on the Financial Statements

We have audited the accompanying financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), which comprise the balance sheets as of September 30, 2018 and 2017, the related statements of net cost and changes in net position, and the combined statements of budgetary resources (hereinafter referred to as the "financial statements for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 19-01 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.



We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

We were unable to obtain sufficient, appropriate evidential matter to support the costs of direct care provided by the Department of Defense (DoD)-managed Military Treatment Facilities (MTF). As discussed in Note 15 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2018 and 2017, includes approximately \$118.1 billion (22% of total) and \$110.2 billion (21% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2018, include approximately \$3.5 billion and \$2.2 billion, respectively, and for the year ended September 30, 2017, include approximately \$2.8 billion and \$2.1 billion, respectively, of amounts related to the direct-care costs.

The MERHCF recognizes expenses based on quarterly prospective payments made to support the operations of MTFs. The prospective payments for direct care are fixed based on estimated costs for the anticipated number of patients that will use an MTF to receive health care. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. We were unable to obtain sufficient evidence as to the direct care component of the reported amounts in the accompanying financial statements for Medicare-eligible retiree beneficiaries by performing other audit procedures.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section above, the financial statements referred to above present fairly, in all material respects, the financial position of the MERHCF as of September 30, 2018 and 2017 and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis (hereinafter referred to as the "required supplementary information") be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by OMB and the Federal Accounting Standards Advisory Board (FASAB), who consider it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context.

Independent Auditor's Report



We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing it for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audits of the financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. Other information, as named in the Agency Financial Report (AFR), is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the financial statements; accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01, we have also issued reports, dated November 7, 2018, on our consideration of the MERHCF's internal control over financial reporting and on our tests of the MERHCF's compliance with provisions of applicable laws, regulations, contracts, and grant agreements, as well as other matters for the year ended September 30, 2018. The purpose of those reports 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 internal control over financial reporting or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 and should be considered in assessing the results of our audits.

A handwritten signature in blue ink that reads "Kearney & Company".

Alexandria, Virginia
November 7, 2018



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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To:
The Assistant Secretary of Defense for Health Affairs
The Inspector General of the Department of Defense

We have audited the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2018, and we have issued our report thereon dated November 7, 2018. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the MERHCF's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the MERHCF's internal control. Accordingly, we do not express an opinion on the effectiveness of the MERHCF's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 19-01. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies; therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings, we identified certain deficiency in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. We consider the deficiency described in the accompanying Schedule of Findings to be a material weakness.

Independent Auditor's Report



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

We noted certain additional matters involving internal control over financial reporting that we will report to the MERHCF's management in a separate letter.

The MERHCF's Response to Findings

The MERHCF's response to the findings identified in our audit is described in the Management's Discussion and Analysis (MD&A) of the Agency Financial Report. The MERHCF's response was not subjected to the auditing procedures applied in our audit of the financial statements; accordingly, we do not express an opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of the MERHCF's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in blue ink that reads "Kearney & Company". The signature is stylized and cursive.

Alexandria, Virginia
November 7, 2018



Schedule of Findings

Material Weakness

I. MTF – Direct Care Costs Data Accumulation (Repeat Condition)

Background: The costs of health care services provided directly by the Department of Defense (DoD) in Military Treatment Facilities (MTF) (i.e., direct care costs) for the MERHCF beneficiaries represent significant input to the development of the actuarially determined health care liabilities of the MERHCF, as well as the determination of amounts contributed to the MERHCF by the branches of military service for active duty participants. In addition, the MERHCF recognizes expenses based on quarterly prospective payments made to the Defense Health Program (DHP) Service Medical Activity (SMA) components to support the operations of the MTFs on an ongoing basis as a result of care provided to MERHCF beneficiaries.

Direct care costs are incurred by the multitude of the MTFs managed by the SMA components in various locations. The prospective payments for direct care are fixed based on estimated costs for the anticipated number of patients that will use an MTF to receive health care. The anticipated number of patients is based on the actual workload two years prior to the budget execution year.

Condition: The MERHCF FY 2018 quarterly prospective payments included \$2.2 billion in expenses for direct care costs. The health care cost data from the MTFs provided for the direct care cost estimation process is aggregated or derived from information in both financial and non-financial systems within the DHP SMAs. The MTF-level data is based on budget execution processes, rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the health care encounters for MERHCF beneficiaries are not tracked for accounting purposes in financial general ledger systems, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to SMAs in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. As of FY 2018, the MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care. MERHCF performs annual retrospective reconciliation reviews of the MTF patient workload data for purposes of comparing the two-year historical data used in the prospective payment development to the actual patient workload realized in the year of payment. The reconciliations are performed in the following FY after all payments have been made, and the results of the reconciliations are used for the purpose of determining if any significant transfer of funds should



be returned to the MERHCF, as well as to adjust the prospective payment methodology as may be warranted.

Finally, there is insufficient evidence that effective controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation process for assigning costs to MTFs.

Cause: MTFs are not currently performing patient-level accounting for MERHCF beneficiaries and MTF health care encounters for MERHCF beneficiaries are not tracked for billing purposes. Rather, the cost of direct care provided to MERHCF beneficiaries for FY 2018, with the exception of the pharmacy ingredient cost, is fixed based on estimated costs for the anticipated number of MERHCF beneficiaries that will use an MTF to receive health care. The anticipated number of patients is based on the actual workload two years prior to the budget execution year.

SMA-managed MTFs have not established effective business processes with associated internal controls to properly account for medical services using the accrual basis of accounting. The MERHCF, therefore, has developed the prospective payment methodology for direct care costs, which cannot be supported with appropriate transaction-level details for patient encounters.

Effect: As the MTF-level data is based on budget execution processes, rather than accrual-based accounting, the effect for this finding is cannot be determined or calculated. There is insufficient evidence supporting the completeness, validity, and appropriateness and consistent cut-off of accounting activity occurring at the MTF level associated with health care provided to MERHCF beneficiaries.

The lack of effective business processes and associated internal controls for the accounting treatment of medical services at SMA-managed MTFs has resulted in non-compliance with Federal accounting standards and, accordingly, the Federal Financial Management Improvement Act of 1996 (FFMIA). The MERHCF financial statements may contain misstatements associated with Accounts Payable and Advances to Others on the Balance Sheet, as well as Expenses on the Statement of Net Cost.

Recommendation: Kearney recommends that the MERHCF implement the necessary management control and reconciliation processes to support direct care costs with actual patient workload data from the current FY, as well as continue the design of improved financial management information systems as part of the overall DoD business transformation efforts.

Specifically, Kearney recommends that the MERHCF:

1. Through coordination with the DHP SMAs, develop a Memorandum of Understanding (MOU) for care provided to MERHCF beneficiaries at MTFs. The MOU should address how the MERHCF will be notified or billed in support of care provided. The MERHCF should require appropriate billing, with supporting transactional data evidencing the health care encounters, to support distribution payments made to the DHP SMAs. Billing encounters should be recorded appropriately in the MERHCF general ledger system at



- the transaction level or at the batch level with applicable supporting transaction details available in a subledger.
2. Implement procedures to comply with the recommended accounting treatment issued by the Defense Audit Remediation Working Group (DARWG) Research and Recommendation Paper, *MERHCF Transfer of Budgetary Resources to DHP*. Distribution payments should be recorded as an Advance Payment, and expenses should be recognized as supported by billings from MTFs. Distribution payments made in excess of billings during the FY should be reflected as an asset of the MERHCF at year-end.

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANT AGREEMENTS

To:
The Assistant Secretary of Defense for Health Affairs
The Inspector General of the Department of Defense

We have audited the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2018, and we have issued our report thereon dated November 7, 2018. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 19-01, *Audit Requirements for Federal Financial Statements*.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the MERHCF's financial statements are free from material misstatement, we performed tests of its compliance with provisions of applicable laws, regulations, contracts, and grant agreements, non-compliance which could have a direct and material effect on the financial statements, and provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions and did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the MERHCF. Providing an opinion on compliance with those provisions was not an objective of our audit; accordingly, we do not express such an opinion. The results of our tests, exclusive of those referred to in the FFMIA, disclosed no instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 19-01.

The results of our tests of compliance with FFMIA disclosed that the MERHCF's financial management systems did not comply substantially with the Federal financial management system's requirements, applicable Federal accounting standards, or application of the United States Standard General Ledger at the transaction level, as described in the accompanying Schedule of Findings.

The MERHCF's Response to Findings

The MERHCF's response to the findings identified in our audit is described in the Management's Discussion and Analysis (MD&A) of the Agency Financial Report. The MERHCF's response was not subjected to the auditing procedures applied in our audit of the financial statements; accordingly, we do not express an opinion on it.



Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 19-01 in considering the entity's compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in blue ink that reads "Kearney & Company". The signature is written in a cursive, flowing style.

Alexandria, Virginia
November 7, 2018



Schedule of Findings

Non-Compliance and Other Matters

FFMIA Non-Compliance (Repeat Condition)

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires an entity's overall financial management systems environment to operate, process, and report data in a meaningful manner to support business decisions. Compliance with FFMIA is achieved through substantial compliance with the following three Section 803(a) requirements:

- Federal financial management system requirements
- Applicable Federal accounting standards
- United States Standard General Ledger (USSGL) at the transaction level.

The effects of the material weakness reported in the accompanying *Report on Internal Control over Financial Reporting*, with respect to direct care cost data accumulation, indicate substantial non-compliance with the requirements of Section 803(a) of FFMIA.

Federal Financial Management Systems Requirements

With respect to direct care costs, the MERHCF's financial management system does not meet the requirements of a financial management system, as defined in Section 803(a) of the FFMIA. MERHCF is unable to provide reliable, timely, and accurate financial information for managing day-to-day operations and reporting on its financial condition.

Applicable Federal Accounting Standards

With respect to direct care costs, the MERHCF is not in compliance with the system design requirements necessary to meet internal and external reporting mandates. This includes the requirement for financial statements to be prepared in accordance with the form and content rules prescribed by OMB, reporting requirements prescribed by the Department of the Treasury (Treasury), and the requirement to monitor the financial management system to ensure the integrity of financial data.

The financial management systems utilized by the MERHCF, with respect to direct care costs, do not fully, efficiently, and effectively support the MERHCF's efforts to:

- Consistently, completely, and accurately record and account for Federal revenues, expenditures and costs
- Provide timely and reliable Federal financial management information of appropriate form and content
- Execute all of the above in a way that is consistent with Federal accounting standards and the United States Standard General Ledger (USSGL).



Standard General Ledger at the Transaction Level

While the general ledger system utilized by the MERHCF is compliant with the USSGL with respect to direct care costs, it is not transaction-based.

Recommendations:

Kearney has provided detailed recommendations in our *Report on Internal Control over Financial Reporting* as it pertains to direct care cost data accumulation.

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