# FISCAL YEAR 2006

# MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

# AUDITED FINANCIAL STATEMENTS

**November 1, 2006**

# *DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND FISCAL YEAR 2006 AUDITED FINANCIAL STATEMENTS*

## *Table of Contents*

# *DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND*

# *MANAGEMENT'S DISCUSSION AND ANALYSIS*

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

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**YEARS ENDED SEPTEMBER 30, 2006 AND 2005**

## Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The FY2001 National Defense Authorization Act (NDAA) directed the establishment of the Medicare-Eligible Retiree Health Care Fund to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for space available care in Military Treatment Facilities (MTFs). The Fund covers Medicare-eligible beneficiaries, regardless of age. (In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees, i.e., retirees themselves, dependents of retirees, and survivors.)

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

Within DoD, the Office of the Under Secretary of Defense (OUSD) for Personnel and Readiness (P&R), through the Office of the Assistant Secretary of Defense (OASD) for Health Affairs (HA) (TRICARE Management Activity [TMA]), has as one of its missions operational oversight of the Defense TRICARE Health Delivery System, including management of the Medicare-Eligible Retiree Health Care Fund (the Fund). The Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund.

In Fiscal Year (FY) 2006, the Fund initially authorized approximately $7.1 billion (B) in total health care services, civilian providers ($5.4B), military medical treatment facilities (MTFs) ($1.3B) and Military Service Personnel Accounts ($0.4B), on behalf of Medicare-eligible retirees, retiree dependents, and survivors. An additional purchased care requirement of $150 million (M) was identified and approved by the Office of Management and Budget (OMB) in early September 2006 in support of increased utilization, particularly pharmacy services, above projected demand. During FY 2005 budget execution, an additional purchased care requirement of $1.2B was identified and approved by OMB in support of similar increased utilization demands.

**Final Fiscal Year Requirements and Funding**

| Fiscal Year | Final (Billions) | Purchased Care (Billions) | Operations & Maintenance (Billions) | Military Personnel (Billions) |
|---|---|---|---|---|
| 2006 | $7.2 | $5.5 | $1.3 | $.4 |
| 2005 | $6.5 | $4.9 | $1.2 | $.4 |
| 2004 | $5.4 | $4.0 | $ .9 | $.5 |
| 2003 | $4.6 | $3.4 | $ .8 | $.4 |

The Fund receives income from three sources:

1. For FY 2005 and prior fiscal years monthly normal cost payments from the Services to pay for the current year's Service cost. This process changed starting in FY 2006 to a once-a-year Treasury payment at the beginning of the year based on budgeted force strengths.
2. Annual payments from the Treasury to amortize the unfunded liability, and
3. Investment income.

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

**MERHCF Funding Sources**

| Fiscal Year | Treasury Unfunded Actuarial Liability (UAL) Payment (Billions) | Normal Cost Contribution (Billions) | Interest on Investments (Billions) |
|---|---|---|---|
| 2006 | $16.6 | $11.1 | $4.1 |
| 2005 | $15.7 | $10.5 | $2.2 |
| 2004 | $16.3 | $8.1 | $.9 |
| 2003 | $14.4 | $8.2 | $.2 |

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

**<u>Overview of the Defense Health Program (DHP)</u>**

The Defense Health Program is known as TRICARE. Covered beneficiaries include:

- Active duty Service members
- Dependents of active duty Service members
- Military retirees
- Dependents of military retirees
- Full-time reservists
- Dependents of full-time reservists
- Survivor dependents of military retirees and those who died on active duty

The TRICARE program consists of a combination of military MTFs and regional networks of civilian providers that work together to provide care to eligible beneficiaries. The MTFs include 70 inpatient facilities and 826 medical and dental clinics in the United States and overseas. Those facilities provide care for approximately 9.2 million beneficiaries and also serve as a training ground for military medical personnel. Because the direct care health system's capacity is not large enough to serve the health care needs of all eligible beneficiaries, DoD has ensured that active duty Service members receive top priority for care at the military facilities, while other beneficiaries can receive direct care services on a "space-available" basis. If care is not available in MTFs, beneficiaries seek care from civilian providers paid through the TRICARE program via the Managed Care Support Contracts and the TRICARE for Life (TFL) program.

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

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

- ***TRICARE Prime*** is similar to a civilian health maintenance organization (HMO). Beneficiaries are assigned to a primary care manager, who coordinates all aspects of their medical care. Enrolled beneficiaries may be assigned a MTF primary care manager or a civilian primary care manager.
- ***TRICARE Extra*** is similar to a civilian preferred provider organization (PPO). Beneficiaries pay lower co-payments than they would under TRICARE Standard if they seek care from a provider in the TRICARE network.
- ***TRICARE Standard*** is a fee-for-service plan that allows beneficiaries to seek care from any civilian provider and be reimbursed for a portion of the costs after paying co-payments and meeting deductibles.

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

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

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

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

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

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

## Health Care Purchased From Civilian Providers

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

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

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

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TRICARE for Life/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management Division. By agreement with DFAS, disbursement transactions are provided by email the day prior to payment processing. DFAS uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The purchased care payments for FY 2006 were approximately $5.3 billion as compared to $4.8 billion in FY 2005.

TMA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services (WPS). Dual eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. With the TDEFIC contract, WPS now processes all claims supported by the Fund, regardless of geographic region in which care was received.

Having a single FI to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. The TDEFIC contract stipulates $1.31 for electronic claims and $3.93 for paper claims.

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

TMA annually develops prospective payment amounts for care estimated to be provided in MTFs to Medicare-eligible beneficiaries. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and Defense Health Program (DHP) Operation and Maintenance (O&M) costs. TMA provides a memo to DFAS with the payment amounts by Service for MILPERS and DHP O&M that is reported on the Standard Form 1081, Voucher and Schedule of Withdrawals and Credits by DFAS.

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

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

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

The prospective payment for O&M for MTF provided care to Medicare-eligible beneficiaries in FY 2006 was $1.3 billion versus $1.1 billion in FY 2005. Increases in O&M expenditures are primarily due to increased drug costs and utilization of outpatient pharmacy services. While the cost of inpatient and outpatient services has risen slightly, the utilization of these services has declined slightly. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries in FY 2006 was $0.43 billion versus $0.42 billion in FY 2005.

## Performance Measures

The mission of the Fund is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. 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, 2006, the Fund had net assets available to pay benefits of $84.3 billion and an actuarial liability of $538.0 billion; the funding ratio was 15.7%. As of September 30, 2005, the Fund had net assets available to pay benefits of $59.8 billion and an actuarial liability of $537.4 billion; the funding ratio was 11.1%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

## Types of Investments

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost (this process changed starting in FY 2006 to a once-a-year Treasury payment at the beginning of the year based on budgeted force strengths), annual payments from Treasury to amortize the unfunded liability, and investment income.

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

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

All of these instruments are debt obligations of the U.S Government and are backed by the "full faith and credit" of the 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 Department of Defense Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service, the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller) and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board met in FY 2006 and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. The current investment strategy reviews current cash flow needs of the Fund and invests excess funds to match the duration of the assets with the duration of the liability.

## Improper Payments Information Act

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

For FY 2005, the error rate for the MERHCF and the TDEFIC contract was 1.77%, under the 2% contract standard and in compliance with the IPIA. Under the TDEFIC contract, the DoD has a zero tolerance for unallowable costs. If the contractor pays a claim that is not allowable, the Department will not reimburse the contractor.

## Status of FY 2005 Audit Findings

Our independent auditors noted material weaknesses and other discrepancies during the conduct of the FY 2005 Financial Statement Audit. The material weaknesses center around three issues:

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

At issue with the lack of a patient-level cost accounting system is the fact that the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2006 and 2005 includes approximately $83 billion (15% of total) and $91 billion (17% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2006, include approximately $4.0 billion and $1.7 billion, respectively, and for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

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

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

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

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

At issue with the prospective payment process are several applications; validation/reconciliation of financial data prior to its input into the MEPRS cost allocation process, archiving of MEPRS data at the close of each month, and timeliness of the reconciliation of the fiscal year prospective payment plan. Additionally, there may be several other issues, not classified as material weaknesses, which may require resolution.

To assist in resolving these discrepancies and in developing a detailed corrective action plan leading to an unqualified audit opinion on the MERHCF Financial Statements, TMA management has contracted with a support contractor, *BRADSON CORPORATION*. *BRADSON*, a local accounting consulting firm, has extensive experience in assisting other government agencies in making improvements in their financial reporting processes underlying their financial statements. They are coordinating TMA corrective action responsibilities with DFAS and other entities' responsibilities to ensure appropriate and complete corrective actions are taken to raise the financial management activities of each appropriate entity to a level that will lead to an unqualified opinion for the MERHCF Financial Statements.

To address the issue of validation/reconciliation of financial data prior to its input into MEPRS cost allocation process, *BRADSON* is working with TMA, each of the Services' Surgeon's General (SG) Offices, and DFAS to develop detailed, Service specific financial reconciliation processes. While they have visited all three Service SG Offices and selected Army, Navy, and Air Force MTFs, they have concentrated their initial efforts on Navy medical facility operations.

During FY 2006, *BRADSON* made significant progress toward the goal of providing supporting evidence to the DoD IG and the independent auditor to audit the Navy Bureau of Medicine (BUMED) MERHCF direct care costs during the FY 2007 audit. *BRADSON* completed two types of BUMED MERHCF direct care cost reconciliations for the Fiscal Year ending September 30, 2005, and is in process of working with BUMED to complete these reconciliations for each quarter in FY 2006 and institutionalizing these processes going forward into FY 2007. Specifically, *BRADSON* focused on two types of reconciliation processes:

1. Daily, weekly, monthly, quarterly, and other periodic reconciliation processes performed at the BUMED MTFs to verify that expenses/costs source documents (supporting evidence) provide an audit trail to and support the amounts accounted for in the MTF trial balances generated daily in the Standard Accounting and Reporting System – Field Level (STARS-FL) and its related reporting and analysis tool the Summarized Medical Analysis Resource Tool (SMART). The individual MTF trial balances are rolled up to support BUMED-level financial statements. *BRADSON* documented processes and reconciliation procedures that demonstrate BUMED MTF reconciliation processes for the direct care costs reported in STARS-FL are auditable and support the balances found on BUMED (Navy direct care) financial statements. *BRADSON* accomplished this by completing detailed reconciliation analyses for the three largest BUMED MTFs that were reviewed and approved by the MTF resource managers.

2. Reconciliation of expense/cost data reported in STARS-FL/SMART for MERHCF with expense/cost data generated by the Medical Expense and Performance Reporting System (MEPRS) and its related Expense Assignment System (EAS IV) to the Defense Department Reporting System (DDRS) financial statements. The MERHCF currently uses MEPRS business rules to support the allocation of direct care costs between MERHCF and non-MERHCF direct care beneficiaries. *BRADSON* developed and documented an "apples to apples" reconciliation process based on decomposition of MEPRS/EAS IV, STARS-FL and

BUMED command-level STARS-MCR/FDR trial balances by Unit Identification Codes (UICs).

*BRADSON* also continued to work with the Army and Air Force Surgeon's General Offices to develop MERHCF direct care cost financial statement to MEPRS/EAS IV reconciliation processes.

The second material weakness dealing with the controls over the timeliness and accuracy of the medical record coding processes at the MTFs is continually being addressed. Coding accuracy of inpatient records is approximately 90%. However, accuracy of coding outpatient and ambulatory surgery encounters is much less, 10% to 20%. Proper and accurate coding of medical records is essential for ensuring quality of care and to accurately document diagnosis and treatment procedures in the SIDRs and SADRs. Health Affairs (HA) has long since identified medical record coding as a deficiency requiring attention. HA/TMA has published both a DoD Directive for medical records retention and coding and a DoD Instruction on medical encounter and coding at MTFs. Realistic goals for medical records coding accuracy have been established and discussed with the Services' Surgeons General.

Additionally, the three Surgeons General are required to certify monthly data quality reports. In completing the data quality reports, the MTFs are required to randomly select inpatient, outpatient, and ambulatory surgery encounters for review to determine coding accuracy and, then, reflect the results in the monthly quality reports. Furthermore, Health Affairs has, for several years, contracted with AdvanceMed to conduct independent audits of a random sample of inpatient, outpatient, and ambulatory surgery records at MTFs to verify coding accuracy. The results of these independent audits are shared with the Service Surgeons General and the Tri-Service Data Quality Management Control committee.

To the extent the element of human error can be minimized, medical record coding will be positively affected. Therefore, included in the new clinical workload reporting system, the Armed Forces Health Longitudinal Technology Application (ALHTA), also known as the Military's Electronic Health Record, is an enhanced provider coding capability. This new coding capability is designed to be used by the provider at the time care is rendered to the patient. Deployment of ALHTA throughout the DoD medical treatment facilities should be completed by February 2007. Concurrently, the DoD is deploying a new retrospective coding compliance automated system referred to as the Coding Compliance Editor (CCE). This system will provide coding clerks the capability to review coded records after all data associated with the patient encounter has been included in the record and initiate appropriate corrective action where coding inconsistencies exist. Deployment of ALHTA and CCE should improve medical record coding, although improvement and maintenance are iterative processes that require continual attention.

The issue of medical record coding discrepancies is a current material weakness that, due to operational control, belongs to the Services' Medical Services. Health Affairs/TMA are committed to monitoring the Services' development of corrective action plans to improve medical record coding accuracy and to continue reviews of coding accuracy, to include independent audits.

While continuing to improve the accuracy of medical record coding, Fund management is concurrently working to determine the impact of medical record coding on the Fund's financial statements. Specifically Fund management is working with its contractors to:

- Assess/isolate coding accuracy of outpatient medical record coding based on direct care workload drivers that impact assignment of patient encounter to weighted workload product. An independent review of previously audited medical records was conducted in June 2006 and revealed that, while overall outpatient coding errors were significant, the assignment of the patient encounter to the proper weighted workload unit was 96% accurate. However, the data reviewed was from FY 2004, and the results of the study can not be extrapolated to the overall population of medical records.

- A new contract to an independent contractor was awarded in September, 2006. The contractor will perform monthly audits of medical record coding accuracy as was done before. However, the contractor will now perform monthly analyses of components' coding that could impact assignment of patient encounters to weighted workload products.

The third material weakness identified in the FY 2005 audit addressed inadequate systems integration testing of TRICARE Encounter Data System ("TEDS") implementation, resulting in a Purchased Care Claims backlog. TMA management has taken corrective actions to address the related material weaknesses, including clearing the purchased care claims backlog. These actions include:

- The Executive Information and Decision Support (EI/DS) program office implemented corrective actions and incorporated the required guidance, the Capstone Test & Evaluation Master Plan, Annex A, Patient Encounter Processing and Reporting (PEPR) to support overall program management and oversight. Additionally, EI/DS participates with TMA Purchased Care Management and Resource Management offices on the TEDS management work group to develop, implement, and monitor TEDS processing change requests as quickly and efficiently as possible.
- The EI/DS program office is acquiring a separate database query capability to support financial accounting and reporting requirements without impacting the TEDS operational environment.
- All records from transactions occurring in FY 2004 and FY 2005 were made available, including business rules existent at the time of processing, as well as complete header information. However, TMA management was concerned about being able to establish sufficient controls to ensure it could produce an exact re-enactment of the claims processing in FY 2004 and FY 2005. Further, after extensive analysis, EI/DS and the TMA Office of Business and Economic Analysis (BEA) concluded that significant time and expense would have to be devoted to reprocessing the data in order to arrive at reliable figures. This processing would have interfered with ongoing business functions, with the probability of causing work slippages and claims processing backlogs in FY 2006.
- The EI/DS program office implemented the required controls to manage TEDS processing, to include problem identification, resolution, and escalation to the appropriate TMA offices.

## Computation of Incurred Claims Reserve

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

The Contract Resource Management (CRM) Division in Aurora, Colorado, monitors claims processing activities performed by the TDEFIC fiscal intermediary, WPS, in support of purchased care activities for Medicare-eligible beneficiaries. During FY 2004, CRM transitioned to a new claims documenting data base. The transition process resulted in claims processing discrepancies that generated significant claims processing backlogs in the last quarter of FY 2004 and the first quarter of FY 2005 (aggregating approximately $133 million). Consequently, the IBNR calculation as of September 30, 2004, was understated due to the missing claims data, and no update to the IBNR calculation for the first quarter of FY 2005 could be made. Estimates for the remainder of FY2005 included a substantial margin of conservatism due to the concerns about the accuracy and completeness of the underlying claims data. The backlog of claims appears to have been resolved and have been included in the calculations of IBNR as of September 30, 2006. However, we have not quantified the complete budgetary and proprietary accounting effects of the backlog on the MERHCF financial statements for FY 2004, FY 2005, and FY 2006.

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

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

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

The goal is to ensure the IBNR calculation is based upon no less than 85% of the liability contained on all processed and backlogged claims. It is anticipated that 8% to 12% of available monthly claims will not be included in the IBNR calculation due to the cutoff of processed claims by 10:00 am the last business day of the month. The cutoff was established to ensure IBNR calculations could be completed in time to meet reporting requirements. As of September 30, 2006, the IBNR calculation included 100% of available monthly claims.

**Coast Guard Issue**

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

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

Through FY 2005 and FY 2006, the Coast Guard and the CGIG were in the process of developing an acceptable methodology for the computation of MERHCF funding requirements to support Coast Guard MTF care given to Medicare dual-eligible beneficiaries. The MERHCF Audit Committee will not approve the release of MERHCF funds to Coast Guard clinics until a formal written request is submitted with CGIG approval.

**DoD Inspector General Audit of Military Services' Monthly Normal Cost Contribution**

The MERHCF receives revenue from the Treasury. These intragovernmental earned revenues include the following:

1. Annual unfunded actuarial liability payment from the Treasury
2. Annual contributions from the Treasury on behalf of the Uniformed Services (normal cost), and
3. Interest earned on investments from the Treasury

The 2005 National Defense Authorization Act (NDAA), Section 725, directed that at the beginning of each fiscal year (after September 30, 2005), the Treasury to pay into the Fund the normal cost contribution previously paid by the Services' MILPERS accounts. The Department of Treasury makes one lump-sum normal cost contribution on behalf of the Services at the beginning of the fiscal year along with the unfunded accrued liability payment. Rather than the Services providing monthly payments into the Fund based on actual monthly personnel end-strengths (as was the case prior to FY 2006), the Treasury now makes one payment based on the expected average force strength (budgeted). As has been the case with the monthly payments made by the Services, the Treasury payment will be computed using the actuarially developed per capita rates.

Specifically, the DoD MERHCF Board of Actuaries now issues a letter each year approving the required amortization payment and the required normal cost contributions for DoD, U.S. Coast Guard, Public Health Service (PHS), and National Oceanic and Atmospheric Agency (NOAA). The normal cost per capita rates determined by the Board of Actuaries are multiplied by the expected average force strength for the fiscal year. The Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) then prepares a letter to the Secretary of the Treasury for the Secretary of Defense signature certifying the total amortization payment and the DoD normal cost contribution amounts. In addition, the letter requests the Treasury issue warrants at the start of the fiscal year to the MERHCF for the amortization payment and to the 10 new MERHCF contribution accounts set up by the Office of Management and Budget (OMB) for the DoD contributions. Each of these contribution accounts corresponds to one of the 10 military personnel accounts (Active, Reserve or National Guard). OUSD(C) also submits a letter apportionment request to OMB for the 10 MERHCF contribution accounts. Once the Treasury issues the warrants at the start of the fiscal year, the Services, that same day, transfer all of the funding to the MERHCF. DoD contributions are then complete for the fiscal year. The Secretaries of Commerce, Department of Homeland Security, and Health and Human Services separately certify and request warrants from the Treasury for their normal cost contributions.

The DoD MERHCF Board of Actuaries approves all methods and assumptions used for determination of the normal cost contribution rates. OOA calculates the normal cost contribution rates each year based on an actuarial model that computes the amount needed to fund the current-year liability for a cohort of new entrants to the military. For FY 2006, the full-time rate was $471, and the part-time rate was $277. For FY 2005, the full-time rate was $447, and the part-time rate was $261.

During FY 2005, the DODIG conducted an audit on the "Accuracy of the Contributions to the Medicare-Eligible Retiree Health Care Fund" (Project No. D2005-D2000FJ-0081.000). On July 12, 2005, the DODIG issued its findings and recommendations as follows:

**FY 2005 DODIG Findings:** The Military Departments did not always contribute the correct amounts to the Fund in the two quarters the DODIG reviewed. The Military Departments underpaid the

Fund by $218.8 million in the first quarter of FY 2005. The Navy and the Air Force made adjusted payments to the Fund to correct FY 2005 underpayments identified during this audit. The Army's FY 2005 underpayment of $32.97 million was a result of the Army erroneously using the FY 2004 per capita normal cost contribution amount instead of the FY 2005 per capita amount in the first quarter of FY 2005. This underpayment was not paid into the Fund as of the close of FY 2005. Therefore, an intragovernmental receivable was booked in the fourth quarter of FY 2005 and was recouped in the first quarter of FY 2006.

In response to the findings, the Under Secretary of Defense (Comptroller) has placed written guidance in the Financial Management Regulation (FMR) describing implementation of the legislative change requiring the Department of Treasury to start making annual normal cost contributions on behalf of the Services in FY 2006. This process has been disclosed in the footnotes of the MERHCF financial statements.

The Office of the Actuary and the DoD General Counsel have agreed that only one normal cost contribution payment will be made by the Department of Treasury at the beginning of the year, and it will be based on "expected average force strength". If actual force sizes throughout the fiscal year vary from the expected size, no retroactive adjustment will be made to the normal cost contribution. To the extent there is a difference, the normal actuarial process will adjust/fund through the actuarial gain/loss mechanism addressed in the current law (USC, Title 10, Chapter 56, (1115(c)(4)).

**Army Under-Payment of FY 2005 Monthly Normal Cost Contribution**

From the start of the Fund's operation in FY 2003 through FY 2005, monthly contributions were made from the Uniformed Services into the Fund. As stated earlier, starting in FY 2006, the Treasury makes one lump-sum normal cost contribution payment at the beginning of the fiscal year on behalf of the Services based on budgeted end strengths times the full-time (Active Duty) and part-time (Guard and Reserve) rates, as appropriate.

Each month, the Military Services' contributions process included the following actions:

- The Military Services calculated their monthly contributions.
- The Services provided the contribution information to the appropriate Defense Finance and Accounting Service (DFAS) Center.
- Each DFAS Center transferred the contributions to the MERHCF via the Intragovernmental Payment and Collection System (IPAC).

The Services calculated the contribution by multiplying the monthly end strength for that Military Service by the standard monthly full-time (Active Duty) or part-time (Guard and Reserve) per capita contribution rates. The Services prepared monthly end strength reports and used these reports to calculate the contributions to the MERHCF. The DoD MERHCF Board of Actuaries estimates the required per capita contribution rates each year. For FY 2005, the full-time rate was $447 and the part-time rate was $261.

During the audit of the FY 2005 MERHCF Financial Statements, a discrepancy was discovered in the Army Reserve Normal Cost Contribution payment for September 2005. The Army Reserve Personnel Office should have paid into the Fund an estimated additional $43,104,933 based on Army-provided Reserve personnel end strengths and the Board of Actuary-determined part-time per capita rate. The MERHCF recorded the estimated accounts receivable from the Army Reserve and disclosed this information in the footnotes of the MERHCF's Unaudited Financial Statements for the three months ended December 31, 2005 (1st Quarter, FY 2006).

Subsequently, the Army completed a schedule that compared payments made versus payments calculated using Army actual end strength reports for Reserve personnel. The differences resulted in an underpayment of $32,855,033, calculated on a retrospective basis for the entire FY 2005. The difference between this revised Army account receivable and the amount recorded at the close of FY 2005, $43,104,933 was discussed with the MERHCF Audit Committee. All members agreed to the revised receivable of $32,855,033 and payment of the Army Account Receivable was received by DFAS-DE into the Fund on September 29, 2006.

**Legislative Proposals**

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

Section 708(b) of the 2007 NDAA Conference Report directs the Secretary of Defense to transfer $186,000,000 from the un-obligated balances of the National Defense Stockpile Transaction Fund to the Department of Defense Medicare-Eligible Retiree Health Care Fund.

**Pharmaceutical Refunds for Retail Pharmacy Support**

The Veterans Health Care Act (VHCA) of 1992, codified at 38 U.S.C., 126, established federal ceiling prices (FCP) of covered pharmaceuticals (requiring a minimum 24% discount off non-Federal average manufacturing prices (non-FAMP) – non-FAMP procured by the four designated agencies covered in the Act: Department of Veterans Affairs (VA), Department of Defense (DoD), Coast Guard, and the Public Health Service/Indian Health Service. VA administers the VHCA discount program on behalf of the four specified agencies. Under the Federal Supply Schedule (FSS) program (41 U.S.C., 259(b)(3)(A)), the General Services Administration (GSA) has authorized VA to award and manage schedule contracts with pharmaceutical companies. FSS contracts allow Federal agencies to obtain pharmaceuticals at prices associated with volume buying which, at times, may be lower than FCPs under VHCA. DoD currently has access to FCP and FSS prices for pharmaceuticals used in military treatment facilities (MTFs) and the TRICARE Mail Order Pharmacy (TMOP) program by either direct purchases or procurements through a Defense Supply Center Philadelphia (DSCP) Prime Vendor. Federal prices were not available to DoD through retail pharmacies under the previous at-risk TRICARE Managed Care Support Contracts (MCSCs) because VA had determined that the contracts were not structured to meet the VHCA statutory requirements for an agency-controlled centralized commodity management system. The VA's decision reflected concerns that pharmaceuticals would not be traceable to DoD, pharmaceutical payments were not made directly by DoD, and there was no assurance that DoD (vis-à-vis a contractor) would receive the benefit of federal pricing.

The new TRICARE Retail Pharmacy Program (TRRx) carved out retail pharmacy from the MCSCs, consolidated delivery of retail prescriptions under a single Pharmacy Benefits Manager (PBM) contract, and addressed VA's previous concerns under VHCA. The PBM contractor provides a retail pharmacy network and acts as fiscal intermediary, upon TMA authorization, to issue funds from a government account in payment for prescriptions dispensed to TRICARE beneficiaries. A government organization, the DoD Pharmacy Benefits Office (PBO), uses the reporting and audit capabilities of the Pharmacy Data Transaction Service (PDTS)* to verify beneficiary eligibility from the Defense Enrollment Eligibility Reporting System (DEERS), check for drug interactions, and authorize prescription payments. PDTS also identifies covered drugs eligible for federal pricing. The PBO, using industry standard reports from PDTS, will provide to manufacturers itemized data on covered drugs procured through TRICARE retail network pharmacies to obtain appropriate refunds on covered drugs subject to federal pricing. The PBM contractor has no role in DoD's process for obtaining refunds for the government based on FCPs already established by the VA and DoD, in accordance with the VHCA. DoD's contract with and payments to the PBM contractor are not related, either directly or indirectly, to federal pricing of pharmaceuticals dispensed to TRICARE beneficiaries by network pharmacies.

*The PDTS, fully deployed since June 2001, creates a centralized data repository that records information about prescriptions filled for DoD beneficiaries at MTFs, the TRICARE Retail Pharmacy Network, and the TRICARE Mail Order Pharmacy Program. Transactions and messaging are based on National Council for Prescription Drug Program (NCPDP) standards, which is the Health Insurance Portability and Accountability Act (HIPAA) standard pharmacy transaction code set. The primary purpose of the PDTS is to improve the quality of prescription services and enhance patient safety by conducting on-line interactive screening of the patient's entire medication profile and alert notification prior to the dispensing of the prescription; thereby reducing the likelihood of drug-drug interactions, therapeutic overlaps, and duplicate treatments. PDTS also serves as the conduit for eligibility verification via the DEERS and transmission of TRICARE Encounter Data (TED) for financial accountability for the TRICARE Mail Order Pharmacy and TRICARE Retail Pharmacy contracts.

**Discussion**

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

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

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

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

**Limitations of the Financial Statements**

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

**Comparative Financial Data**

Comparatively, several line items on two of the financial statements have changed significantly from FY 2005 to FY 2006. The presentation of the FY 2005 data has been updated for the changes in presentation required in conjunction with the OMB Circular A-136, "Financial Reporting Requirements," updated and revised in July 2006 and certain FY 2005 balances have been reclassified to conform to the FY 2006 presentation.

The Balance Sheet reflects significant changes in "Total Assets," "Actuarial Liabilities," and "Benefits Due and Payable" (Incurred But Not Reported, IBNR). Total Assets increased from $60.7 billion in FY 2005 to $85.4 billion in FY 2006. The increase in FY 2006 is attributable primarily to Service normal cost contributions of $11.1 billion, Treasury annual unfunded actuarial liability payments of $16.6 billion in, and interest on investments of $4.1 billion. This phenomenon will continue into future years as the annual deposits/investments into the Fund exceed annual health care expenditures.

The Actuarial Liability has increased from $537.4 billion to $538.0 billion. The increase ($ in Thousands) tracked as follows:

| | |
|---|---|
| Actuarial Liability as of 9/30/05 | $537,397,092 |
| Expected Normal Cost for FY 2006 | $ 11,043,720 |
| Expected Benefit Payments for FY 2006 | $ (7,461,017) |
| Interest Cost for FY 2006 | $ 34,047,927 |
| Actuarial (gains)/losses due to other factors | $ 42,129,764 |
| Actuarial (gains)/losses due to changes in trend assumptions | $ (79,124,939) |
| Actuarial Liability as of 9/30/06 | $ 538,032,547 |
| Change in Actuarial Liability | $ 635,455 |

Each year the Actuarial Liability is expected to increase with normal cost (+$11.0 billion), decrease with benefit payments (-$7.5 billion), and increase with the interest cost (+$34.0 billion). The actuarial gains due to new medical trend assumptions are $79.1 billion. The actuarial gains and losses due to other factors (net - +$42.1 billion) includes new population data, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend assumptions.

Other liabilities on the Balance Sheet represent the purchased care claims reserve, also known as the Incurred But Not Reported (IBNR) liabilities. Current IBNR liabilities decreased $157.5 million (21%) from fourth quarter FY 2005 to fourth quarter FY 2006. These IBNR costs, which represent an actuarially determined estimate of liabilities for covered medical services rendered before the end of the 4th Quarter, FY 2006, decreased for the following reasons:

1. Improved reporting of overhead costs ($38 million)
2. Lower expected trend in incurred claims ($77 million)
3. Refinements to the claims reporting system and faster claims processing ($42.5 million)

The Net Cost of Operations on the Statement of Net Cost reflects an increase in Intragovernmental Costs of $261.2 million (13%) as described in the footnotes to the financial statements, which is attributable to increased ambulatory pharmacy use and increases in actual costs per patient encounter for inpatient, outpatient, and pharmacy care/services.

The $32.6 billion (86%) decrease in Public Costs is primarily attributable to the difference between the change in the actuarial liability in FY 2005, and the change in the actuarial liability in FY 2006. For FY 2005, the actuarial liability increased $33.3 billion; for FY 2006, the actuarial liability increased only $635.5 million. The increase in FY 2005 was close to the expected increase in the actuarial liability, had all actuarial assumptions remained the same as those used for FY 2004. The increase for FY 2006 was much less than the expected increase in the actuarial liability, had all actuarial assumptions remained the same as those used for FY 2005. Contributing factors included changed assumptions related to average medical costs, administrative costs, and medical cost inflation.

More detailed comparisons between FY 2005 and FY 2006 line items can be found in all of the MERHCF's principal statements and footnotes. Balances representing a 10 percent increase between fiscal years on any component of a line item are considered material and are discussed in the corresponding footnote.

**Management Assurances**

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

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

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

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

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

# *PRINCIPAL STATEMENTS*

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

| | 2006 | 2005 |
|---|---|---|
| **ASSETS** | | |
| Intragovernmental: | | |
| Fund Balances with Treasury (Note 2) | $ 37,855 | $ 5,000 |
| Investments (Note 3) | 85,394,986 | 60,691,679 |
| Accounts Receivable, Net (Note 4) | 0 | 32,970 |
| Total Intragovernmental Assets | $ 85,432,841 | $ 60,729,649 |
| Accounts Receivable, Net (Note 4) | 8,803 | 11,256 |
| **TOTAL ASSETS** | $ 85,441,644 | $ 60,740,905 |
| **LIABILITIES** | | |
| Intragovernmental: | | |
| Accounts Payable (Note 6) | $ 49,109 | $ 43,043 |
| Total Intragovernmental Liabilities | $ 49,109 | $ 43,043 |
| Accounts Payable (Notes 6 and 12) | 223,265 | 198,662 |
| Military Retirement Benefits and Other Employment Benefits (Note 7) | 538,032,547 | 537,397,092 |
| Benefits Due and Payable (Notes 5 and 7) | 604,664 | 762,163 |
| **TOTAL LIABILITIES** | $ 538,909,585 | $ 538,400,960 |
| **NET POSITION** | | |
| Cumulative Results of Operations | (453,467,941) | (477,660,055) |
| **TOTAL NET POSITION** | $ (453,467,941) | $ (477,660,055) |
| **TOTAL LIABILITIES AND NET POSITION** | $ 85,441,644 | $ 60,740,905 |

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

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

| | | 2006 | | 2005 |
|---|---|---|---|---|
| **PROGRAM COSTS** | | | | |
| Gross Costs | $ | 7,610,604 | $ | 39,976,250 |
| (Less: Intragovernmental Earned Revenue) | | (31,802,718) | | (28,412,396) |
| Net Program Costs | $ | (24,192,114) | $ | 11,563,854 |
| **Net Cost of Operations** | $ | (24,192,114) | $ | 11,563,854 |

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

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

| | | 2006 | | 2005 |
|---|---|---|---|---|
| **CUMULATIVE RESULTS OF OPERATIONS** | | | | |
| Beginning Balances | $ | (477,660,055) | $ | (466,096,201) |
| Budgetary Financing Sources | $ | 0 | $ | 0 |
| Other Financing Sources | | 0 | | 0 |
| Total Financing Sources | $ | 0 | $ | 0 |
| Net Cost of Operations (+/-) | $ | (24,192,114) | $ | 11,563,854 |
| Net Change | $ | 24,192,114 | $ | (11,563,854) |
| Cumulative Results of Operations | $ | (453,467,941) | $ | (477,660,055) |
| Unexpended Appropriations, Beginning Balance | $ | 0 | $ | 0 |
| Budgetary Financing Sources | | 0 | | 0 |
| Total Unexpended Appropriations | $ | 0 | $ | 0 |
| **Net Position** | $ | (453,467,941) | $ | (477,660,055) |

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

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

| | | 2006 | | 2005 |
|---|---|---|---|---|
| **BUDGETARY RESOURCES** | | | | |
| **Unobligated balance, brought forward, October 1:** | $ | 97,212 | $ | 206,625 |
| Budget Authority: | | | | |
| Appropriation | $ | 31,528,510 | $ | 28,128,834 |
| Subtotal | $ | 31,625,722 | $ | 28,335,459 |
| Temporarily not available pursuant to Public Law | | (24,549,875) | | (21,839,520) |
| **Total Budgetary Resources** | $ | 7,075,847 | $ | 6,495,939 |
| **STATUS OF BUDGETARY RESOURCES** | | | | |
| Obligations incurred: | | | | |
| Direct | $ | 7,075,847 | $ | 6,398,727 |
| Subtotal | $ | 7,075,847 | $ | 6,398,727 |
| Unobligated balance: | | | | |
| Apportioned | $ | 0 | $ | 97,212 |
| Subtotal | $ | 0 | $ | 97,212 |
| Unobligated Balance Not Available | $ | 0 | $ | 0 |
| **Total Status of Budgetary Resources** | $ | 7,075,847 | $ | 6,495,939 |
| **CHANGE IN OBLIGATED BALANCE** | | | | |
| Obligated Balance, net | | | | |
| Unpaid obligations, brought forward October 1 | $ | 387,881 | $ | 262,058 |
| Total unpaid obligated balance, net | $ | 387,881 | $ | 262,058 |
| Obligations incurred net (+/-) | $ | 7,075,847 | $ | 6,398,727 |
| Less: Gross Outlays | | (7,066,556) | | (6,272,905) |
| Obligated Balance, Net - end of period | | | | |
| Unpaid Obligations | | 397,172 | | 387,880 |
| **Total unpaid obligated balance, net, end of period** | $ | 397,172 | $ | 387,880 |
| **NET OUTLAYS** | | | | |
| Net Outlays: | | | | |
| Gross Outlays | $ | 7,066,556 | $ | 6,272,905 |
| Less: Distributed Offsetting Receipts | | (31,802,719) | | (28,379,426) |
| **Total Outlays** | $ | (24,736,163) | $ | (22,106,521) |

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

**DoD Medicare-Eligible Retiree Health Care Fund**
**STATEMENTS OF FINANCING**
**For the Years Ended September 30**
**(In Thousands)**

| | | 2006 | | 2005 |
|---|---|---|---|---|
| **RESOURCES USED TO FINANCE ACTIVITIES** | | | | |
| Budgetary Resources Obligated | | | | |
| Obligations incurred | $ | 7,075,847 | $ | 6,398,727 |
| Less: Offsetting receipts | | (31,802,719) | | (28,379,426) |
| Net Obligations | $ | (24,726,872) | $ | (21,980,699) |
| Other Resources | $ | 0 | $ | 0 |
| **Total resources used to finance activities** | $ | (24,726,872) | $ | (21,980,699) |
| **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 | $ | 21,378 | $ | (13,343) |
| Resources that fund expenses recognized in prior periods | | 0 | | 0 |
| **Total resources used to finance items not part of the net cost of operations** | $ | 21,378 | $ | (13,343) |
| **Total resources used to finance the net cost of operations** | $ | (24,705,494) | $ | (21,994,042) |
| **COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD** | | | | |
| Components Requiring or Generating Resources in Future Periods: | | | | |
| Other | $ | 477,956 | $ | 33,594,104 |
| Total components of Net Cost of Operations that will require or generate resources in future periods | $ | 477,956 | $ | 33,594,104 |
| Components not Requiring or Generating Resources: | | | | |
| Other (+/) | | | | |
| Trust Fund Exchange Revenue | $ | 0 | $ | (32,970) |
| Other | | 35,424 | | (3,238) |
| **Total components of net cost of operations that will not require or generate resources in the current period** | $ | 513,380 | $ | 33,557,896 |
| **Net Cost of Operations** | $ | (24,192,114) | $ | 11,563,854 |

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

# *DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND*

# *NOTES TO THE PRINCIPAL STATEMENTS*

**DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND**
**NOTES TO THE PRINCIPAL STATEMENTS**
**FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005**

## NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

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

These financial statements report the financial position and results of operations for the Fund, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Trust Fund Accounting Division, Accounting Directorate, Defense Finance and Accounting Service (DFAS), in accordance with the requirements of Office of Management and Budget (OMB) Circular A-136, "Financial Reporting Requirements," and accounting principles generally accepted in the United States of America. The Fund's financial statements are prepared by DFAS in addition to the financial reports, pursuant to OMB directives, which are used to monitor and control budgetary resources within the Fund. More detailed explanations of these financial statement elements are discussed in applicable footnotes.

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

C. Appropriations and Funds. The Fund was authorized by the "Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001." The purpose of the Fund is to pay the costs of all Military Service and uniformed services retiree health care programs for the benefit of members or former members of a participating service who are entitled to retired or retainer pay and are Medicare-eligible, their dependents who are Medicare-eligible, and their survivors who are Medicare-eligible.

The Fund's appropriations are designated special funds. These appropriations are used to fund the daily execution of the Fund's mission. The Fund is classified as a special fund and uses both receipt and expenditure accounts. The Fund's U.S. Treasury symbol is 97X5472.

D. Basis of Accounting. Under authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to its three principal members, the Secretary of the Treasury, the Director of the OMB, and the Comptroller General of the United States. The Statements of Federal Financial Accounting Standards (SFFAS) have been issued by the FASAB, following procedures adopted by the FASAB principles. Some SFFAS have deferred effective dates.

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

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

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

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

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

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance to the circumstance. When directed by OMB, through OMB Circular A-136, generally accepted accounting principles in the United States of America serve as authoritative guidance for federal agencies in preparing reports that are addressed within OMB Circular A-136.

E. Revenues and Other Financing Sources. The FY 2005 Defense Authorization Act assigned Treasury, vice the Uniformed Services, the responsibility of paying normal cost contributions into the Fund, starting in FY 2006. In FY 2006, the beginning of fiscal year Treasury contribution also included the total normal cost amount for the year, determined based on Board-approved per capita normal cost rates and expected average force strengths for the Uniformed Services. Thus, the Uniformed Services no longer make monthly contributions into the Fund. In FY 2005, the financing sources for the Fund were provided primarily through an annual unfunded actuarial liability payment from Treasury, monthly contributions from the Military Services and the other Uniformed Services (United States Coast Guard, the National Oceanic and Atmospheric Administration, and the United States Public Health Service), and interest earned on investments. The monthly contributions were calculated by multiplying the monthly per capita rates (full time and part time) provided by the DoD Office of the Actuary by the reported end strength for the most recently reported month. Contributions are recognized when due to the Fund.

F. Recognition of Expenses. For financial reporting purposes, the Fund recognizes benefit expenses in the period incurred. As of the 3rd Quarter, FY 2006, payments are now made in the quarter that the Military Treatment Facility (MTF) expenses will be incurred. Previously, during the interim quarters, prior to the last quarter, advances were made for the upcoming quarter's MTF expenses. Those expenses were recognized at the outset of each quarter and recorded as an advance to the MTFs. There were no advances recorded at September 30, 2006 or September 30, 2005, and there will be no advances recorded in any future quarter.

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

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

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

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

I. Accounts Receivable. As presented in the Balance Sheets, accounts receivable includes accounts, claims, and refunds receivable from the public as well as intragovernmental receivables due from the Uniformed Services. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the Fund. The DoD does not recognize an allowance for estimated uncollectible amounts due from intragovernmental receivables.

J. Investments in U.S. Department of Treasury Securities. Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. These securities are redeemable at market value exclusively through the Federal Investment Branch of Treasury. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 3.

K. Net Position. Net position consists of unexpended appropriations and cumulative results of operations.

L. Comparative Data. For comparative purposes, the financial statements display both FY 2005 and 2006 data. Certain FY 2005 balances have been reclassified to conform to the FY 2006 presentation. Also, the presentation of the FY 2005 data has been updated for the changes in presentation required in conjunction with the OMB Circular A-136, "Financial Reporting Requirements," updated and revised in July 2006.

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

N. Actuarial Information. The Medicare-Eligible Retiree Health Care Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year based on population information as of the beginning of the year and updated to the end of the year using accepted actuarial techniques. The "projected benefit obligation" method is used as required by SFFAS No. 5, "Accounting for Liabilities of the Federal Government."

## NOTE 2. FUND BALANCES WITH TREASURY

| ($ in Thousands) | | FY 2006 | | FY 2005 |
|---|---|---|---|---|
| Fund Balances: | | | | |
| Trust Funds | $ | 37,855 | $ | 5,000 |
| Status of Fund Balance with Treasury | | | | |
| Unobligated Balance | | | | |
| Available | $ | 0 | $ | 97,212 |
| Unavailable | | 84,268,709 | | 0 |
| Obligated Balance not yet Disbursed | | 397,173 | | 60,106,716 |
| Non-FBWT Budgetary | | (84,628,027) | | (60,198,928) |
| Total | $ | 37,855 | $ | 5,000 |

Other Information

**Fund Balances**. The Fund Balance with Treasury (FBWT) increased $32.9 million, which represents a collection from the Army Reserves on the last business day of September 2006. These funds, which were an underpayment of the Army Reserves' FY 2005 normal cost payment, remained in the FBWT because they were received too late to invest. Generally, the FBWT is maintained at approximately $5 million to ensure that sufficient funds are available to cover estimated daily disbursements with the remaining funds invested in non-marketable market-based securities.

**Status of Fund Balance**. The Office of Management and Budget advised that certain U.S. Standard General Ledger accounts are inconsistent with the budget presentations for certain Special and Trust Fund Receipts. Consequently, the unobligated fund balance brought forward to FY 2005 had to be reclassified as receipts unavailable or precluded from obligation for the DoD Medicare-Eligible Retiree Health Care Fund. The amounts of Unobligated Balances, Obligated Balance not yet Disbursed, and Non-FBWT Budgetary Accounts were impacted by the OMB-directed restatement for FY 2005. Beginning with September 30, 2005, year-end reporting, the unobligated unavailable balance is no longer visible on the Statement of Budgetary Resources.

**NOTE 3. INVESTMENTS**

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

| | FY 2005 | | | | |
|---|---|---|---|---|---|
| | Cost | Amortization Method | Amortized (Premium)/ Discount | Investments, Net | Market Value Disclosure |
| Intragovernmental Securities: | | | | | |
| Non-Marketable, Market-Based | $ 60,873,720 | Effective Interest | $ (684,873) | $ 60,188,847 | $ 60,085,976 |
| Subtotal | $ 60,873,720 | | $ (684,873) | $ 60,188,847 | $ 60,085,976 |
| Accrued Interest | 502,832 | | 0 | 502,832 | 502,832 |
| Total | $ 61,376,552 | | $ (684,873) | $ 60,691,679 | $ 60,588,808 |

Intragovernmental securities represent nonmarketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. Non-marketable market-based securities include Treasury bills, notes, bonds, Treasury Inflation-Protected Securities (TIPS), and overnight certificates.

Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at a discount or premium. Treasury bonds are long-term securities with maturity terms of ten years ore more and are purchased at either a discount or premium. TIPS are fixed-rate instruments designed to protect against inflation and the principal amount is indexed to the consumer price index (CPI) by adjusting the current CPI to the CPI at issuance; as inflation increases, so does the principal amount and the coupon.

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

Investments increased from $60.2 billion in FY 2005 to $84.6 billion in FY 2006 because of a cumulative positive cash flow. The investments listed above are presented at Amortized Cost and Market Value as of September 30, 2006, and 2005. Listed below are the Par Values of the U.S. Treasury Securities referenced above:

| **Par Value** | | **FY 2006** | **Par Value** | | **FY 2005** |
|---|---|---|---|---|---|
| ($ in Thousands) | | | ($ in Thousands) | | |
| Bonds | $ | 2,000,000 | Bonds | $ | 2,000,000 |
| Notes | | 19,384,102 | Notes | | 22,384,102 |
| Overnights | | 4,841,189 | Overnights | | 3,499,832 |
| TIPS | | 46,514,635 | TIPS | | 24,989,166 |
| Total | $ | 72,739,926 | Total | $ | 52,873,100 |

Note: Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the CPI. When a TIPS matures, Treasury pays the adjusted principal or original principal, whichever is greater.

## NOTE 4. ACCOUNTS RECEIVABLE

| **($ in Thousands)** | **FY 2006** | | | | | |
|---|---|---|---|---|---|---|
| | | Gross Amount Due | | Allowance for Estimated Uncollectibles | | Accounts Receivable Net |
| Intragovernmental Receivables | $ | 0 | $ | 0 | $ | 0 |
| Nonfederal Receivables (from the Public) | | 9,016 | | (213) | | 8,803 |
| Total Accounts Receivable | $ | 9,016 | $ | (213) | $ | 8,803 |

| **($ in Thousands)** | **FY 2005** | | | | | |
|---|---|---|---|---|---|---|
| | | Gross Amount Due | | Allowance for Estimated Uncollectibles | | Accounts Receivable Net |
| Intragovernmental Receivables | $ | 32,970 | $ | 0 | $ | 32,970 |
| Nonfederal Receivables (from the Public) | | 11,604 | | (348) | | 11,256 |
| | $ | 44,574 | $ | (348) | $ | 44,226 |

Other Information ($ in thousands, unless otherwise noted)

Intragovernmental

The $32.9 million in intragovernmental receivables recorded in FY 2005 was a result of the Army Reserves underpaying its normal cost contributions for FY 2005. This receivable was subsequently paid in full to the Fund during FY 2006.

Non-Federal

Non-Federal Accounts Receivable, Net, decreased $2.5 million (22%) primarily due to the aggressive collection efforts by the TRICARE Dual-Eligible Fiscal Intermediary Contract (TDEFIC) contractor, the Wisconsin Physician Services, from FY 2005 through FY 2006. This debt pertained to the transfer of responsibility for processing all TRICARE for Life dual-eligible claims from the Managed Care Support contractors to the TRICARE Dual-Eligible Fiscal Intermediary Contract (TDEFIC) contractor. These receivables represent expected collections of claim overpayments made to the Medicare-eligible beneficiaries by contractors and expected collections of co-payments for prescriptions.

The Allowance for Estimated Uncollectibles is calculated as a percentage (three percent) of receivables from all sources. The majority of the receivables are held by the TDEFIC. The allowance for uncollectible accounts is based on an analysis of the actual uncollectible amounts experienced during FY 2006 as well as the 4th Quarter, FY 2005.

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

| ($ in Thousands) | | FY 2006 | | FY 2005 |
|---|---|---|---|---|
| Nonfederal Liabilities: | | | | |
| Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 7) | $ | 453,763,838 | $ | 477,581,045 |
| Benefits Due and Payable | | 604,664 | | 762,163 |
| Total Nonfederal Liabilities | $ | 454,368,502 | $ | 478,343,208 |
| Total Liabilities Not Covered by Budgetary Resources | $ | 454,368,502 | $ | 478,343,208 |
| Total Liabilities Covered by Budgetary Resources | $ | 84,541,083 | $ | 60,057,752 |
| Total Liabilities | $ | 538,909,585 | $ | 538,400,960 |

Total Liabilities Covered by Budgetary Resources increased $24,483,331 in FY 2006 and the Liabilities Not Covered by Budgetary Resources decreased $23,974,706 in FY 2006 primarily due to the increase in the availability of assets to pay benefits to the Medicare-eligible beneficiaries.

**NOTE 6. ACCOUNTS PAYABLE**

**($ in Thousands)**

| | | FY 2006 | | FY 2005 |
|---|---|---|---|---|
| Intragovernmental Payables | $ | 49,109 | $ | 43,043 |
| Non-Federal Payables (to the Public) | | 223,265 | | 198,662 |
| Total Accounts Payable | $ | 272,374 | $ | 241,705 |

Intra-governmental payables increased from $43,043 in FY 2005 to $49,109 in FY 2006. These payables have existed since the start of Medicare-Eligible Retiree Health Care Fund (MERHCF) operations in the 1st Quarter, FY 2003. However, they have been commingled with the nonfederal payables (to the public) until the 3rd Quarter, FY 2006. The MERHCF had been awaiting coordination of a procedure with the Defense Logistics Agency (DLA) trading partner to ensure the MERHCF intragovernmental accounts payable would match DLA accounts receivable. The FY 2005 amount has been adjusted to reflect the identification of intragovernmental payables. The increase of $6,066 (14%) is attributable to both the increased use of the mail order pharmacy benefit by DoD Medicare-eligible beneficiaries and the increased cost of pharmaceuticals.

Current Non-Federal Accounts Payable increased from $198,662 in FY 2005 to $223,265 in FY 2006. The $223,265 in nonfederal payables includes $53.8 million in pharmaceutical collections. Due to the federal ceiling price litigation, these collections are scheduled for repayment to drug companies in the 1st Quarter, FY 2007. The repayment is to pharmaceutical manufacturers for discount payments they had made to the MERHCF in FY 2005 and FY 2006 in support of pharmaceuticals dispensed by retail pharmacies to Uniformed Services beneficiaries. See additional discussion in Note 12.

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

**($ in Thousands)**

| Major Program Activities | FY 2006 Present Value of Benefits | Assumed Interest Rate (%) | (Less: Assets Available to Pay Benefits) | Unfunded Liability |
|---|---|---|---|---|
| Medicare-Eligible Retiree Benefits | $ 538,032,547 | 6.25% | $ (84,268,709) | $ 453,763,838 |
| Total | $ 538,032,547 | | $ (84,268,709) | $ 453,763,838 |

**($ in Thousands)**

| Major Program Activities | FY 2005 Present Value of Benefits | Assumed Interest Rate (%) | (Less: Assets Available to Pay Benefits) | Unfunded Liability |
|---|---|---|---|---|
| Medicare-Eligible Retiree Benefits | $ 537,397,092 | 6.25% | $ (59,816,047) | $ 477,581,045 |
| Total | $ 537,397,092 | | $ (59,816,047) | $ 477,581,045 |

The Military Medicare-Eligible Retiree Benefits line displays a net increase of $635.5 million in the present value of benefits (actuarial liability) from FY 2005 to FY 2006.

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

The actuarial liability reported above does not include $604.7 million and $762.2 million in incurred but not reported liabilities as of September 30, 2006 and 2005, respectively. These liabilities are presented in the accompanying balance sheets as Benefits Due and Payable, and are disclosed in Note 5, Liabilities Not Covered and Covered by Budgetary Resources.

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

Projected revenues into the Medicare-Eligible Retiree Health Care Fund, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on Fund assets, annual "normal cost" contributions (paid by Treasury at the beginning of the fiscal year), and annual unfunded liability amortization contributions (paid by Treasury at the beginning of the fiscal year). The "normal cost" contributions are determined as per-capita amounts (approved by the DoD Medicare-Eligible Retiree Health Care Board of Actuaries) times expected average force strength. The unfunded liability amortization contribution represents the amortization of the unfunded

liability for service performed before October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines the unfunded liability amortization contribution.
FY 2006

Actuarial cost method used for the MERHCF liability: Aggregate Entry-Age Normal
Assumptions: Interest Rate: 6.25%

| | |
|---|---|
| Medical Trend: | |
| Medicare Inpatient: | 5.6% from FY 2005 to FY 2006, ultimate rate of 6.25% in 2030 |
| Medicare Outpatient: | 7.8% from FY 2005 to FY 2005, ultimate rate of 6.25% in 2030 |
| Medicare Prescriptions (Direct Care): | 8.1% from FY 2005 to FY 2006, ultimate rate of 6.25% in 2030 |
| Medicare Prescriptions (Purchased Care): | 11.2% from FY 2005 to FY2006, ultimate rate of 6.25% in 2030 |

The medical cost trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2006, by 28%, or approximately $148.7 billion.

Market Value of Investments in Market-Based and Marketable Securities ($ in thousands): $82,962,706.

***Change in MERHCF Actuarial Liability***
**($ in Thousands)**

| | | | |
|---|---|---|---|
| a. | Actuarial Liability as of 09/30/05 (all Uniformed Services Medicare) | $ | 537,397,092 |
| b. | Expected Normal Cost for FY 2006 | | 11,043,720 |
| c. | Expected Benefit Payments for FY 2006 | | (7,461,017) |
| d. | Interest Cost for FY 2006 | | 34,047,927 |
| e. | Actuarial (gains)/losses due to other factors | | 42,129,764 |
| f. | Actuarial (gains)/losses due to changes in trend assumptions | | (79,124,939) |
| g. | Actuarial Liability as of 09/30/06 (all Uniformed Services Medicare) | $ | 538,032,547 |
| h. | Change in Actuarial Liability | $ | 635,455 |

($ in Thousands)

Each year the actuarial liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of $37,630,630 in the actuarial liability was expected during FY 2006 (line b plus line c plus line d).
The September 30, 2006, actuarial liability includes changes due to new assumptions and actuarial experience. The actuarial gain due to new medical trend assumptions is $(79,124,939) (line f). The actuarial gains and losses due to other factors (net $42,129,764, line e) includes new population data, other actuarial experience being different from assumed and actuarial assumption changes other than the change in trend assumptions.

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2006, liability ($ in Thousands) is:

| | | |
|---|---|---|
| DoD | $ | 526,295,514 |
| Coast Guard | | 10,545,121 |
| Public Health Service | | 1,118,244 |
| NOAA | | 73,668 |
| Total | $ | 538,032,547 |

FY 2006 Military Service contributions to the MERHCF ($ in Thousands) were:

| | | |
|---|---|---|
| DoD | $ | 10,841,216 |
| Coast Guard | | 260,533 |
| Public Health Service | | 34,477 |
| NOAA | | 1,645 |
| Total | $ | 11,137,871 |

FY 2005

Actuarial Cost Method Used: Aggregate Entry-Age Normal Method.
Assumptions: Interest Rate: 6.25%

Medical Trend:

| | |
|---|---|
| Medicare Inpatient: | 3.2% from FY 2004 to FY 2005, ultimate rate of 6.25% in 2029 |
| Medicare Outpatient: | 5.6% from FY 2004 to FY 2005, ultimate rate of 6.25% in 2029 |
| Medicare Prescriptions (Direct Care): | 0.0% from FY 2004 to FY 2005, ultimate rate of 6.25% in 2029 |
| Medicare Prescriptions (Purchased Care): | 5.2% from FY 2004 to FY 2005, ultimate rate of 6.25% in 2029 |

The medical cost-trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2005, by 28 percent, or approximately $149.9 billion.

Market Value of Investments in Market-Based and Marketable Securities ($ in thousands): $60,085,976

***Change in MERHCF Actuarial Liability***
**($ in Thousands)**

| | | | |
|---|---|---|---|
| a. | Actuarial Liability as of 09/30/04 (all Uniformed Services Medicare) | $ | 504,073,807 |
| b. | Expected Normal Cost for FY 2005 | | 10,613,753 |
| c. | Expected Benefit Payments for FY 2005 | | (6,546,888) |
| d. | Interest Cost for FY 2005 | | 31,629,776 |
| e. | Actuarial (gains)/losses due to other factors | | (14,902,660) |
| f. | Actuarial (gains)/losses due to changes in trend assumptions | | 12,529,304 |
| g. | Actuarial Liability as of 09/30/05 (all Uniformed Services Medicare) | $ | 537,397,092 |
| h. | Change in Actuarial Liability | $ | 33,323,285 |

($ in Thousands)

Each year the actuarial liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of $35,696,641 in the actuarial liability was expected during FY 2005 (line b plus line c plus line d). The September 30, 2005, actuarial liability includes changes due to new assumptions and actuarial experience. The actuarial loss due to new medical trend assumptions is $12,529,304 (line f). The actuarial gains and losses due to other factors (net $(14,902,660), line e) include new population data, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions.

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2005, liability ($ in thousands) is:

| | | |
|---|---|---|
| DoD | $ | 526,082,475 |
| Coast Guard | | 10,176,676 |
| Public Health Service | | 1,066,976 |
| NOAA | | 70,965 |
| Total | $ | 537,397,092 |

FY 2005 Military Service contributions to the MERHCF ($ in thousands) were:

| | | |
|---|---|---|
| DoD | $ | 10,220,002 |
| Coast Guard | | 236,749 |
| Public Health Service | | 32,053 |
| NOAA | | 1,492 |
| Total | $ | 10,490,296 |

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

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

| | | FY 2006 | | FY 2005 |
|---|---|---|---|---|
| Intragovernmental Costs | $ | 2,280,871 | $ | 2,019,699 |
| Public Costs | | 5,329,733 | | 37,956,551 |
| Total Costs | $ | 7,610,604 | $ | 39,976,250 |
| | | | | |
| Intragovernmental Earned Revenue | $ | (31,802,718) | $ | (28,412,396) |
| Public Earned Revenue | | 0 | | 0 |
| Total Earned Revenue | $ | (31,802,718) | $ | (28,412,396) |
| | | | | |
| Net Cost of Operations | $ | (24,192,114) | $ | 11,563,854 |

The Intragovernmental Costs increased $261.1 million (13%) from FY 2005 to FY 2006. This change is attributable to increased ambulatory pharmacy use and increases in actual costs per encounter for inpatient, outpatient, and pharmacy care/services. In 3rd Quarter, FY 2006, the Fund began identifying Intragovernmental payables for its pharmaceutical purchases separately. The FY 2005 Intragovernmental Costs have been adjusted to reflect the costs related to the pharmaceutical purchases had this identification process been implemented in FY 2005.

The Public Costs decreased $32.6 billion (86%) from FY 2005, to FY 2006. This change is attributable to the net effect of year-to-year changes in actuarial assumptions related to average medical costs, administrative costs, and medical cost inflation.

**Earned Revenue for Program Costs**
**($ in Thousands)**

| | | FY 2006 | | FY 2005 |
|---|---|---|---|---|
| 1. Uniformed Services Contribution | $ | 11,137,871 | $ | 10,523,266 |
| 2. Annual Unfunded Liability Payment | | 16,612,000 | | 15,721,000 |
| 3. Interest on Investments | | 4,052,847 | | 2,168,130 |
| Total | $ | 31,802,718 | $ | 28,412,396 |

Line 1: This line reflects the total contributions from the Military Services plus the U.S. Public Health Service, U.S. Coast Guard, and National Oceanic Atmospheric Administration. The Uniformed Services contributions increased $614.6 million from FY 2005 to FY 2006 due to an increase in normal cost contribution rates provided by the Board of Actuaries.

Line 2: U.S. Treasury Annual Unfunded Liability Payment increased by $891.0 million in FY 2006 based on the computation furnished by the Board of Actuaries.

Line 3: Interest on investments increased $1.9 billion from FY 2005 to FY 2006. This change is primarily due to the large increase in Uniformed Services contributions that were paid annually in October rather than monthly throughout FY 2006 and the compounding effect of higher rates of return since October 2005.

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

**Apportionment Categories.** The Office of Management and Budget Circular No. A-136, section 9.27, specifically requires disclosure of the amount of direct and reimbursable obligations incurred against amounts apportioned under categories A (related to a specific period of time); B (related to a specific program or project); and exempt from apportionment. As of September 30, 2006, the Medicare-Eligible Retiree Health Care Fund (MERHCF) reported $1.5 billion in category B obligations and $4.2 billion in exempt from apportionment obligations. The MERHCF reported no category A obligations. As of September 30, 2005, the MERHCF reported $6.3 billion in category A obligations.

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

**Use of Unobligated Balances of Budget Authority.** The MERHCF's unobligated balances of budget authority represent the portion of trust fund receipts collected in the current fiscal year (1) that exceed the amount needed to pay benefits or other valid obligations and (2) that exceed receipts temporarily precluded from obligation by law due to a benefit formula or other limitation. The receipts, however, are assets of the MERHCF and are available for obligations as needed in the future.

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

**Reconciliation Differences.** The Department of the Treasury issues annual warrants that pay amortized payments for the unfunded actuarial liabilities of the MERHCF. The MERHCF's annual warrant for FY 2006 totaled $16.6 billion. The Other Defense Organizations General Fund credits, and subsequently expends, this amount to the MERHCF in accordance with OMB guidance. The OMB is aware, and approves, of this duplicate reporting. As a result, $16.6 billion is duplicated on the DoD Agency-wide Statement of Budgetary Resources (SBR). As of September 30, 2005, the MERHCF's annual warrant was $15.7 billion, which was duplicated on the DoD Agency-wide SBR for FY 2005.

In addition, the MERHCF reports Appropriations Received for contributions that the Army, Navy, and Air Force pay. The Military Departments also include these amounts in their respective Appropriations Received. For FY 2006, the MERHCF reported a total of $10.8 billion for the Military Departments, which is duplicated on the DoD Agency-wide SBR. As of September 30, 2005, the MERHCF reported $10.2 billion in contributions from the Military Departments, which was duplicated on the DoD Agency-wide SBR for FY 2005.

## FOOTNOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF FINANCING

Components of Net Cost of Operations That Will Require or Generate Resources in Future Periods report unfunded expenses that were incurred during FY 2006. The cumulative total of unfunded expenses from all fiscal years is reported as "Liabilities Not Covered by Budgetary Resources" in Note 5.

## NOTE 11. BENEFIT PROGRAM EXPENSE

**($ in Thousands)**

| | | FY 2006 | FY 2005 |
|---|---|---|---|
| 1 | Service Cost | $ 11,043,720 | $ 10,613,753 |
| 2 | Period Interest on the Benefit Liability | 34,047,927 | 31,629,776 |
| 3 | Prior (or Past) Service Cost | 0 | 0 |
| 4 | Period Actuarial (Gains) or Losses | 42,129,764 | (14,902,660) |
| 5 | (Gains)/Losses Due to Changes in Medical Trend Assumptions | (79,124,939) | 12,529,304 |
| 6 | Total | $ 8,096,472 | $ 39,870,173 |

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

The benefit program expense (BPE) includes normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments). The BPE for FY 2006 was less than the BPE for FY 2005 largely because of new medical trend assumptions adopted by the DoD Medicare-Eligible Retiree Health Care Board of Actuaries (Board) for FY 2006, which led to a decrease in liabilities; whereas the new trend assumptions for FY 2005 increased liabilities (line 5). Every year, there is also a "period actuarial gains or losses" component of BPE (line 4), which in FY 2006 increased liabilities, reflecting the net of an increase due to new assumptions regarding plan participation and a small net increase due to other assumptions and experience, offset by reductions due to new administrative cost assumptions and claims experience. In FY 2005, this component was a net decrease, reflecting gains due to administrative cost assumptions and certain assumptions related to claims costs, offset by net losses in other assumptions and experience.

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

**NOTE 12. OTHER DISCLOSURES**

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

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2006 and 2005 includes approximately $83 billion (15% of total) and $91 billion (17% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2006, include approximately $4.0 billion and $1.7 billion, respectively, and for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have compliant, transaction-based accounting systems and therefore cannot report the costs of an individual patient's care.

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

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

Pharmaceutical Company Rebates for Retail Pharmacy Support:

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

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

By decision dated September 11, 2006, the Court of Appeals for the Federal Circuit set aside the "Dear Manufacturer" letter and, on procedural grounds, ruled against the government's position in the federal drug pricing litigation. As a result of the Court decision, TMA has been advised by counsel to suspend indefinitely the quarterly refund invoicing to manufacturers involving network retail pharmacy drugs. The VA General Counsel has requested the Department of Justice not to seek rehearing of the Court's decision. Therefore, TMA General Counsel has advised the MERHCF to reimburse any refunds received in FY 2005 and FY 2006. A nonfederal payable to the public of $53.8 million has been established to reimburse affected pharmaceutical manufacturers during the 1st Quarter, FY 2007. In accordance with 10 U.S.C. 1113(c)(2), transfers from the MERHCF must be made no later than September 30, 2007 for FY 2005 refunds and no later than September 30, 2008 for FY 2006 refunds.

## NOTE 13. SUBSEQUENT EVENTS

The FY 2007 National Defense Authorization Act (NDAA), as signed by the President on October 16, 2006, included the several relevant sections concerning the MERHCF. Section 592 of the Conference Report, "Revision in Government Contributions to Medicare-Eligible Retiree Health Care Fund," excluded from the term "members of the uniformed services on active duty" cadets at the United States Military Academy, the United States Air Force Academy, or the Coast Guard Academy or Midshipmen at the United States Naval Academy. This change, other things being equal, will reduce the Board of Actuaries annually calculated normal cost contribution and the health care liability beginning with FY 2008.

Section 708(b) of the 2007 NDAA Conference Report directs the Secretary of Defense to transfer $186 million from the unobligated balances of the National Defense Stockpile Transaction Fund to the MERHCF.

* * * * *

# *DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND*

# *OTHER ACCOMPANYING INFORMATION*

**TABLE 1**

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2006

($ In Thousands)

| | | September 30, 2006 | September 30, 2005 |
|---|---|---|---|
| 1. | Present value of future benefits | | |
| | a. Current inactives | $330,842,715 | $324,191,274 |
| | b. Active duty personnel [1] | $160,999,865 | $163,277,268 |
| | c. Non-retired reservists | $128,420,451 | $135,775,752 |
| | d. Total | $620,263,031 | $623,244,294 |
| 2. | Present value of future normal cost contributions | $(82,230,484) | $(85,847,202) |
| 3. | Actuarial accrued liability | $538,032,547 | $537,397,092 |
| 4. | Assets [2] | $84,268,709 | $(59,816,047) |
| 5. | Unfunded accrued liability [3] | $453,763,838 | $477,581,045 |

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

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

3 The unfunded accrued liability does not include $604.7 million and $762.2 million for the estimated Incurred But Not Reported (IBNR) liabilities as of September 30, 2006 and 2005, respectively, as presented in the Balance Sheets as “Benefits Due and Payable,” and as discussed in Note 7, “Liabilities Not Covered and Covered By Budgetary Resources.”

# *DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND*

# *INDEPENDENT AUDITORS' REPORTS*

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

November 8, 2006

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

SUBJECT: Endorsement of the Qualified Opinion on the Fiscal Year 2006 DoD Medicare-Eligible Retiree Health Care Fund Financial Statements (Report No. D-2007-017)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, assigns the Department of Defense Inspector General responsibility for auditing the DoD Medicare-Eligible Retiree Health Care Fund (the Fund) Financial Statements. For FY 2006, we contracted with Deloitte & Touche, LLP (Deloitte & Touche) to perform the audit.

**Qualified Audit Opinion.** We concur with the Deloitte & Touche qualified opinion dated November 1, 2006. Deloitte & Touche opined that, except for amounts related to the Fund's direct care costs and the impact of a September 30, 2004, backlog of unprocessed purchased care transactions, the financial statements and accompanying notes present fairly, in all material respects, the Fund's financial position, net cost, changes in net position, budgetary resources, and financing, as of September 30, 2006 and 2005. Deloitte & Touche also opined that the statements were presented in conformity with accounting principles generally accepted in the United States of America.

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

**Report on Internal Controls**. Deloitte & Touche concurrently issued a report on the internal control over financial reporting and compliance with laws and regulations as part of the audit of the Fund's FY 2006 financial statements. We concur with the Deloitte & Touche internal control report.

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

- The actuarial liability for Medicare-eligible retiree benefits includes the projected value of direct care costs in today's dollars. Direct care costs are based on data extracted from various noncompliant systems that are not transaction based.

- The Military Treatment Facility-level health care cost data are based on budget execution processes rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the Military Treatment Facility level. As a result, some transactions may not be recorded in the correct accounting period.

- The accuracy and completeness of the data files provided to the Office of the Actuary (the Actuary) for determining the funds incurred but not reported liability were impacted by a backlog of unprocessed purchased care claims with an aggregate value of $133 million as of September 30, 2004. However, uncertainties exist about the completeness of the population of the aggregate unprocessed claims as of September 30, 2004, and the extent and timing of subsequent reprocessing of the claims. A retrospective analysis indicated that the actuarial estimate of claims incurred but not reported as of September 30, 2005, was overstated by approximately $215 million. The Fund's management was unable to provide Deloitte & Touche complete information to identify a complete population of the claims transactions backlog as of September 30, 2004, and all transaction details necessary to assess the complete budgetary and proprietary accounting impacts on the FY 2004, 2005, and 2006 financial statements.

- The Fund's financial management improvement initiatives have not been finalized for all Services and implemented at all Military Treatment Facilities.

- Computer processing locations that support the Fund had inadequate controls over data processing to ensure reliable processing of financial information within the related business cycles. The audit disclosed deficiencies in the design or operation of data processing controls related to security policies, procedures, configurations, business continuity arrangements, and network and database change management locations. These deficiencies could adversely affect the Fund's ability to record, process, and summarize the Fund's financial information in accordance with all appropriate requirements.

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

- The Fund's data were processed on Electronic Data Processing systems that did not comply with Office of Management and Budget Circular A-127, "Financial Management Systems."

- Although the general ledger system complied with the U.S. Government Standard General Ledger, it was not transaction-based or derived from an integrated financial system.

- The financial management system did not comply substantially with Office of Management and Budget Circular A-130, "Management of Federal Information Resources," November 28, 2000.

- Collectively, the Fund did not fully comply with Office of Management and Budget Circulars A-123, "Management's Responsibility for Internal Control," December 21, 2004, and A-127, "Financial Management Systems," and the Federal Managers' Financial Integrity Act.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget Bulletin No. 06-03, "Audit Requirements for Federal Financial Statements," August 23, 2006, requires that test results be reported if noncompliance with certain laws and regulations occurs.

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

To fulfill our oversight responsibilities for the contract with Deloitte & Touche, we complied with government auditing standards, Office of Management and Budget Bulletin No. 06-03, and the "GAO/PCIE Financial Audit Manual," July 2004. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of Deloitte & Touche; reviewed the key judgments; met with officials of the Fund; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. James L. Kornides (614) 751-1400 ext. 211 or Mr. Mark Starinsky (614) 751-1400 ext. 231.

Paul J. Granetto

Paul J. Granetto, CPA
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**INDEPENDENT AUDITORS' REPORT**

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources and financing for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraphs, we conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of Office of Management and Budget ("OMB") Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain patient-level data from compliant, transaction-based accounting systems in support of the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTFs). As discussed in Note 12 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2006 and 2005 includes approximately $83 billion (15% of total) and $91 billion (17% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2006, include approximately $4.0 billion and $1.7 billion, respectively, and for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems. While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording and cut-off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, a significant factor in the allocation processes. We were not able to satisfy ourselves as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

As discussed in Note 12 to the financial statements, during the year ended September 30, 2005, a misstatement of approximately $133 million was identified in the amount of purchased care claims reported for the year ended September 30, 2004. Deficiencies in the controls over the systems used to process the purchased care claims existed prior to September 30, 2004, and were uncorrected at that date, resulting in an undetected backlog of unprocessed claims. The identified claims, aggregating $133 million, were re-submitted for processing during the year ended September 30, 2005, resulting in an overstatement of 2005 reported claims The claims backlog was also inappropriately excluded from the data used in the actuarial estimate of claims incurred but not reported recorded as a liability as of September 30, 2004. The impact of the above misstatement on the estimate of claims incurred but not reported as of September 30, 2004 was estimated to be a $133 million understatement.

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

We were not able to obtain sufficient details about the recorded transactions related to the claims backlog necessary to determine the complete budgetary and proprietary accounting impacts on the MERHCF financial statements for the years ended September 30, 2006 and 2005, beyond the estimated understatements and overstatements identified above, nor were we able to satisfy ourselves by means of other auditing procedures.

In our opinion, except for the effects on the financial statements of (1) the amounts related to the Fund’s direct-care costs, if any, as might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct-care component of the actuarial liability for Medicare-eligible retiree benefits; and (2) the complete population, and budgetary and proprietary accounting impacts, of the claims backlog transactions existing as of September 30, 2004 and subsequently reprocessed; the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Medicare-Eligible Retiree Health Care Fund as of September 30, 2006 and 2005, and its net cost, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying “Management’s Discussion & Analysis” and

"Other Accompanying Information," are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America, OMB Circular A - 136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

In accordance with *Government Auditing Standards,* we have also issued our report dated November 1, 2006 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

November 1, 2006

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

To the Inspector General of the
Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of and for the year ended September 30, 2006, and have issued our report thereon dated November 1, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of Office of Management and Budget ("OMB") Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

**Internal Control over Financial Reporting**

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

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

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

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

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

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

1. The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2006 and 2005, includes approximately $83 billion (15% of total) and $91 billion (17% of total), respectively, of amounts reflecting the actuarial present value of the projected direct care costs of benefits to be provided by the Military Treatment Facilities (“MTFs”), managed by the Services, to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2006, include approximately $4.0 billion and $1.7 billion, respectively, and for the year ended September 30, 2005, include approximately $4.4 billion and $1.6 billion, respectively, of amounts related to the direct care costs.

   Such MTF-related amounts of direct care costs are estimated by the Fund’s actuaries and others using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems, applying common and consistent business rules, in a manner envisioned by the DoD’s planned Standard Financial Information Structure (“SFIS”). While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording and cut - off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, a significant factor in the allocation processes.

   Therefore, the procedures in place to determine the allocated costs of direct care provided by the MTFs are not adequate to ensure presentation of the direct care costs in conformity with accounting principles generally accepted in the United States of America.

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

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

   The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the Services that have not been audited. The MTF–level data is based upon budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the MTF-level. During 2006, the Fund had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

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

   We understand that the Fund intends to develop a methodology using market rates for patient encounters for purposes of the determination and allocation of the prospective payments made to the MTFs, beginning in FY 2008. We also understand that the Fund's intention is also to utilize market rates in the Office of the Actuary's determination of the Fund's direct care-related liabilities.

   We believe that the use of market rates in the actuarial valuation process may not be consistent with the requirements of accounting principles generally accepted in the United States of America unless and until it can be demonstrated that the Fund's direct care liabilities are able to be settled in full at such market-based rates.

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

3. The actuarial determination of the Fund's liability for incurred but not reported ("IBNR") claims for purchased care for the Fund's participants and beneficiaries relies on data files provided by the TRICARE Management Activity ("TMA") of the Military Health System to the Office of the Actuary ("OOA"). During 2005, the accuracy and

completeness of the data files provided to the OOA were impacted by a backlog of purchased care claims aggregating $133 million that existed as of September 30, 2004. The backlog of claims was identified subsequent to September 30, 2004, and resulted from claims that had been submitted by the claims contractor, but which were not processed by TMA on a timely basis. As a result, the claims were inappropriately omitted from the FY 2004 financial statements, not only with respect to the impact on the determination of the IBNR liability, but also as FY 2004 claims expense, cash payments to the contractor, or accounts payable as of September 30, 2004.

Uncertainties continued to exist during the year ended September 30, 2005, about the completeness of the population of the aggregate unprocessed claims as of September 30, 2004, and the extent and timing of subsequent reprocessing. Due to these uncertainties, the actuarial estimate of claims incurred but not reported as of September 30, 2005, included a margin of conservatism. A retrospective analysis indicates that the actuarial estimate of claims incurred but not reported as of September 30, 2005 was overstated by approximately $215 million, with related impacts on recorded claims expense for the years ended September 30, 2006 and 2005.

The claims backlog occurred due to computer processing issues arising from a systems conversion process at TMA related to the TRICARE Encounter Data System (“TEDS”), as well as deficiencies in internal control. Certain of the claims backlog transactions were resubmitted for processing during FY 2005 and the claims expense was recorded at that time, along with the effect of the additional claims on the actuarial estimate for the liabilities for claims incurred but not reported.

However, we were unable to obtain from TMA complete information to identify a complete population of the claims transactions backlog as of September 30, 2004, nor all transaction details necessary to assess the complete budgetary and proprietary accounting impacts on the FY 2004, 2005, and 2006 financial statements. TMA indicated that (1) the $133 million in claims identified in FY 2005 did not represent the complete population of affected transactions; (2) they declined to perform the necessary queries against the On-Line Data Source (“ODS”) database to provide transaction details for the claims transactions, (3) they are unable to provide any information regarding the subsequent processing of the affected batches; and (4) no analyses of the claims backlog transactions detail has been performed to evaluate the full financial statement impacts, either at the time the backlog issue was identified, nor subsequently.

Thus, there continued to be insufficient information about the recorded transactions related to the claims backlog necessary to determine the complete budgetary and proprietary accounting impacts on the Fund’s financial statements for the years ended September 30, 2006 and 2005, beyond the estimated understatements and overstatements identified above. Subsequent analyses of claims information performed during the year ended September 30, 2006, indicate it is probable that, through the passage of time, all claims that may have been part of the backlog as of September 30, 2004, have since been reprocessed. We also note that the Fund has implemented procedures to prevent a recurrence of an undetected claims transaction backlog. Therefore, we are not recommending any further corrective actions at this time.

4. Since 2005, the Fund has undertaken a number of improvement initiatives in connection with the DoD Financial Improvement and Audit Readiness ("FIAR") process managed under the Office of the Under Secretary of Defense - Comptroller ("OUSD-C"). The initiatives are intended to address the necessary corrective actions with respect to the identified deficiencies in the direct care cost processes and medical record coding, as discussed above. From discussions with TMA and their support contractor, we understand that efforts have been undertaken to document and test certain direct care related reconciliation processes from the MTF level through to the financial statement level for the Services. However, as of September 30, 2006, the process and procedures have not yet been finalized for all Services nor deployed to all MTFs.

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

5. Certain general electronic data processing ("EDP") controls at certain computer processing locations used by the Fund do not support the reliable processing of financial information within the related business cycles. Our review disclosed deficiencies in the design or operation of controls related to: (1) EDP security policies, procedures, and configurations, (2) business continuity arrangements; and (3) network and database change management activities, that could adversely affect the Fund's ability to record, process, and summarize its financial information and protect sensitive data in accordance with all appropriate requirements.

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

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the Fund's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. Of the reportable conditions noted above, the observations with respect to direct – care costs discussed at items 1. and 2., and the observations with respect to the claims backlog at item 3., are, in our judgment, material weaknesses.

With respect to internal control relevant to data that support reported performance measures on page 6 of Management's Discussion and Analysis accompanying the financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on the internal control over reported performance measures and, accordingly, we do not express an opinion on such control.

To the Inspector General of the
Department of Defense

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we perform tests of its compliance with certain provisions of laws and regulations, contracts, and agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 06-03. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 06-03, and that are described below.

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

2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger ("SGL"), it is not transaction-based nor is it derived from an integrated financial system.

3. The financial management systems utilized by the Fund do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A – 130, in that they do not fully, efficiently and effectively support the Fund's efforts to:

   ◊ Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;

   ◊ Provide reliable and timely financial information for managing current operations;

   ◊ Account for assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and

   ◊ Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger

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

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

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To the Inspector General of the
Department of Defense

**Distribution**

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

Deloitte & Touche LLP

November 1, 2006