FISCAL YEAR 2008

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

AUDITED FINANCIAL STATEMENTS

October 31, 2008

DoD

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND FISCAL YEAR 2008 AUDITED FINANCIAL STATEMENTS

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YEARS ENDED SEPTEMBER 30, 2008 AND 2007

Description of the Reporting Entity

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

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

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

In Fiscal Year (FY) 2008, the Fund authorized approximately $8.4 billion (B) in total health care services, civilian providers ($6.7B), military medical treatment facilities ($1.3B), and Military Service Personnel Accounts ($0.4B), on behalf of Medicare eligible retirees, retiree dependents, and survivors.

In FY 2007, the Fund initially authorized approximately $7.7B in total health care services, civilian providers ($5.9B), military medical treatment facilities ($1.4B) and Military Service Personnel Accounts ($0.4B), on behalf of Medicare eligible retirees, their dependents, and survivors. An additional purchased care requirement of $30M was identified and approved by OMB in early September 2007 in support of increased utilization, particularly pharmacy services, and $650 thousand for the mandatory mailing of letters to Medicare-eligible beneficiaries explaining the availability and features of the Medicare Part D, Voluntary Pharmacy Benefit Program.

Final Fiscal Year Requirements and Funding Plan

Fiscal Year	Purchased Care (Billions)	Operations & Maintenance (Billions)	Military Personnel (Billions)	Final (Billions)
2008	$6.7	$1.3	$.4	$8.4
2007	$5.9	$1.4	$.4	$7.7

The Fund receives income from three sources:

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

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

MERHCF Funding Sources

Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment (Billions)	Normal Cost Contribution (Billions)	Interest on Investments (Billions)
2008	$12.9	$11.5	$8.2
2007	$15.6	$11.5	$4.4

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

Medicare-Eligible Retiree Health Care Plan of Benefits

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

TFL covers Medicare-eligible retirees 65 years of age or older, including retired guardsmen and reservists and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The 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 Designated Provider Program (DPP), formerly the Uniformed Services Family Health Plan (USFHP), facilities are available, may enroll in capitation rate plans. These plans include inpatient and outpatient services and a pharmacy benefit. The capitation rate is paid by DoD. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs as well as benefits under the TRICARE for Life and Senior Pharmacy programs.

Health Care Purchased From Civilian Providers

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

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

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

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TFL/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management (CRM) Division. By agreement with DFAS-IN, disbursement transactions are provided by email the day prior to payment processing. DFAS-IN uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The purchased care payments planned for FY 2008 were approximately $6.7B as compared to $5.9B in FY 2007.

TMA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services (WPS) for purposes of processing all claims supported by the Fund, regardless of geographic region in which care was received. Dual eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single Fiscal Intermediary (FI) to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. The TDEFIC contract stipulates a cost of $0.70 per unit for electronic claims and $3.66 for paper claims.

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

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

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent fiscal year for which data is complete at the time the calculations are prepared. TMA develops, in coordination with the Military Departments and Office of the Under Secretary of Defense Comptroller (OUSD(C)), MTF-specific rates in accordance with DoDI 6070.2, dated July 19, 2002. MEPRS cost data are recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using Service-provided budget data, and standard OMB inflation rates listed in the President's Budget applicable to those years. MEPRS data are recorded and maintained by the Military Departments in accordance with DoD 6010.13-M, "Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities," dated April, 2007.

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, dated July 19, 2002.

The prospective O&M payment for MTF provided care to Medicare-eligible beneficiaries in FY 2008 was $1.3B versus $1.4B in FY 2007. The decrease in O&M expenditures was due to decreased utilization of inpatient, outpatient, and outpatient pharmacy services. While the unit costs of inpatient and outpatient services have risen slightly, utilization of these services has continued to decline at a greater rate. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries in FY 2008 was $0.40B versus $0.42B in FY 2007.

Performance Measures

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2008, the Fund had net assets available to pay benefits of $134.3B and an actuarial liability of $500.2B; the funding ratio was 26.8%. As of September 30, 2007, the Fund had net assets available to pay benefits of $109.6B and an actuarial liability of $516.5B; the funding ratio was 21.2%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

Types of Investments

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

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

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

The Fund receives management oversight from the 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 Board reviews the Fund's Law and Department of Treasury guidelines to ensure compliance with broad policy guidance and public law.

The Investment Board met in FY 2008, and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income and holding investments to maturity. The Board adopted a new investment strategy which included:

a.) Eliminate the "duration matching strategy" (matching assets to the duration of the liability), since it is not feasible. The duration of the unfunded actuarial liability is 40+ years while the duration of the securities available to invest is 24 years, at most.

b.) Eliminate the average maturity of the portfolio. The MERHCF will use a ladder approach to TIPS investing with total investment of funds not required for current year benefits broken into 90% TIPS in a 6-year ladder. The remaining 10% is invested in conventional Treasury bills, notes, and bonds

Status of FY 2007 Audit Findings

Our independent auditors noted material weaknesses and other discrepancies during the conduct of the FY 2007 Financial Statement Audit. The material weaknesses center around two 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

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, 2008 and 2007 includes approximately $71B (14% of total) and $75B (14% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2008, include approximately $3.3B and $1.7B, respectively, and for the year ended September 30, 2007, include approximately $3.7B and $1.8B, 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, which enables MTFs to allocate all costs associated with the daily operation of the facility into the inpatient, outpatient, dental, and ancillary service cost centers. Average costs per weighted workload unit can then be computed for various patient care activities.

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

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for the actuarial liability. The reconciliation tasks performed by TMA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service (PDTS), data to support both the prospective payment and calculation of the actuarial liability.

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

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

Actions Taken

Since FY 2003, when the Fund was established, MERHCF management has attempted to resolve the auditor-identified material weaknesses through the development of key milestone initiatives. These initiatives were established and managed by TMA leadership and intended to serve as work-arounds to address the Military Services' financial systems' deficiencies. The material weaknesses are associated with the computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs.

Unfortunately, the milestone initiatives have not produced the desired results in the projected time frame. Clearly, each of the Military Services must become more actively involved in the resolution of the identified weaknesses. We have initiated coordination with the DoD Comptroller Financial Improvement and Audit Readiness (FIAR) Office to engage the Military Services in better defining their required corrective actions and assuming more direct responsibility in resolving the material weaknesses. Each of the Military Services will incorporate into their existing FIAR plans key milestones to correct the auditor-identified deficiencies associated with medical record coding and the accurate documentation of costs to support the delivery of health care to Medicare-eligible beneficiaries in MTFs.

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care for the Fund's beneficiaries relies on data files provided by TMA to the DoD Office of the Actuary (OOA). Due to the lack of a fully integrated financial management system to support the Defense Health System, certain data are provided to the 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. 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 quarterly purchased care claims backlog metric to report to OUSD(C).

Each quarter the MERHCF estimates the IBNR purchased claims liability. IBNR represents health care received by Medicare-eligible beneficiaries for which DoD has not yet received a claim. 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 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 must include a large percentage of claims included, and most importantly, the degree of incompleteness should remain relatively constant over time.

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 EST on the last business day of the month. The cutoff was established to ensure IBNR calculations could be completed in time to meet reporting requirements. For FY 2007 and again in FY 2008, the IBNR calculation included 100% of available monthly claims.

Legislative Proposals

The 2007 National Defense Authorization Act (NDAA) included several relevant sections concerning the MERHCF. Section 592 of the Conference Report, "Revision in Government Contributions to Medicare-Eligible Retiree Health Care Fund," excluded from the term "members of the uniformed services on active duty" cadets at the United States Military Academy, the United States Air Force Academy, or the Coast Guard Academy or Midshipmen at the United States Naval Academy. This change (with 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 took effect beginning with FY 2008.

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

Section 703 of the 2008 NDAA states that any prescription filled on or after 28 January 2008 through the TRICARE Retail Pharmacy Network shall be treated as an element of the DoD for purposes of procurement of drugs by Federal agencies. The Veterans Health Care Act of 1992, established the Federal Ceiling Prices (FCPs) of covered pharmaceuticals requiring a minimum 24% discount off non-federal average manufacturing prices. Since the beginning of the FCP program, outpatient pharmaceuticals provided by DoD through MTF pharmacies have been subject to FCPs, as have those under the TMOP program since it began. This legislation addresses the disparity with the retail pharmacy program. It is envisioned the new rule will stipulate that an agreement by a manufacturer to honor the FCP in the Retail Pharmacy Network component of the Pharmacy Benefit Program is a condition of inclusion of a drug on the uniform formulary. A drug not under such an agreement will require preauthorization to be provided through the Retail Pharmacy Network.

DoD estimates MERHCF cost reductions from applying FCPs to the Retail Pharmacy Program of $367 million in FY 2009, growing to $444 million in FY 2011.

Given that the final DoD policy guidance has not yet been published, and that further litigation may be possible, the MERHCF Board of Actuaries decided at the July 2008 Board meeting to apply only half the estimated savings to the MERHCF actuarial liability to the FY 2008 calculation of the liability. As a result, the conservative impact of this legislation is a reduction of $35.3 billion on the MERHCF actuarial health care liability.

Voluntary Agreements for TRICARE Retail Network Rebates (VARRs)

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

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

As of September 30, 2008, the MERHCF received a total of $110.5M in pharmacy retail network rebates under both VARR programs. In FY 2007, receipts from both VARR programs were $15.9M.

Limitations of the Financial Statements

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

Comparative Financial Data

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

Medicare-Eligible Retiree Health Care Fund Analysis of Financial Statements for the years ended September 30, 2008 and 2007 ($ in Thousands)			
Consolidated Balance Sheet	**2008**	**2007**	**Difference** Increase/ (Decrease)
Investments (Intra-Governmental Securities) - Revenue from Treasury payments and Service contributions excess to current year health care benefit payments is invested in Treasury securities	$134,291,659	$109,549,060	$24,742,599 23%
Liabilities Not Covered by Budgetary Resources - Represents difference between actuarial liability for future benefit payments and current assets	$368,254,642	$409,025,006	($40,770,364) 10%
Accounts Payable (Intra-Governmental) - A/P associated with resupply of TMOP contractor drug inventory by DLA	$61,386	$70,276	($8,890) (13%)
Accounts Payable (Non-Federal)	$138,429	$186,361	($47,932) (26%)
Military Retirement and Other Federal Employment Benefits - Represents actuarial liability of future health care benefit	$500,195,710	$516,479,229	($16,283,519) (3%)
Statement of Net Cost			
Net costs of operation - Changes in computation of actuarial health care liability are the major contributor to changes in net costs of operation	$41,086,980	$45,485,110	($4,398,130) (10%)
Statement of Budgetary Resources			
Undelivered orders	$40,286,055	$112,135,569	($71,849,514) (64%)

Investments – Intra-Governmental Securities

Total Intra-governmental Securities, Net Investments, for MERHCF increased $24.7 billion, 23%. This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. Public Health Service, National Oceanographic and Atmospheric Administration, and the U.S. Coast Guard) net of current disbursements for benefits paid. Investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover the unfunded portions of future benefits.

Liabilities Not Covered by Budgetary Resources

Total liabilities Not Covered by Budgetary Resources decreased $40.8 billion, (10%). This variance is comprised primarily of the increase in assets added to the decrease in the actuarial liability. The increase in assets of $24.7 billion was largely attributable to the receipt of annual contributions from the U.S. Treasury and Uniformed Services during the 1st Quarter, FY 2008. The decrease in the actuarial liability of $16.3 billion was caused by changes in two key economic assumptions and the addition of a new assumption. See section below on "Military Retirement and Other Federal Employment Benefits", for additional information about the change in the actuarial liability.

Accounts Payable (Intra-Governmental)

Intra-Governmental Accounts Payables decreased $8.9 million, (13%), primarily due to a reduction in the number of prescriptions processed by the contractor in September 2008 compared to September 2007. The MERHCF intra-governmental accounts payable are directly related to the Defense Logistics Agency's (DLA) replenishment of the contractor's drug inventory. The replenishment of the contractor's inventory creates an accounts receivable for DLA and an accounts payable for MERHCF. Therefore, a decrease in the replenishment requirements correlates to a decrease in MERHCF accounts payable.

Accounts Payable (Non-Federal)

Non-federal Payables (to the Public) decreased $47.9 million, (26%), primarily due to an early cut-off in September 2008 of 7 days for the processing of pharmacy claims. The cut-off was initiated by the pharmacy contractor, Express Scripts, who processes claims once every 2 weeks. As a result, fewer claims were processed resulting in a reduction of accounts payable.

Military Retirement and Other Federal Employment Benefits

The total Military Retirement and Other Federal Employment Benefits decreased $16.3 billion, (3%) due to the decrease in the FY 2008 actuarial liability. This decrease is due to changes in assumptions, a new assumption, and actuarial experience (expected versus actual) resulting in a $49.2 billion decrease offset by the expected increase in the actuarial liability of $32.9 billion (growth due to service and interest, liability released through benefit payments). Changes in two key assumptions and the addition of a new assumption comprise most of the decrease. The two key assumption changes were a 0.25% reduction in the discount rate (which led to a $30.6 billion increase) and revised medical trend rates (which led to a $43.9 billion decrease). A new assumption was added to reflect mandated federal ceiling prices for retail prescription drugs (which led to a $35.3 billion decrease).

Statements of Net Cost

The Net Cost of Operations decreased $4.4 billion, (10%). This decrease is primarily due to a decrease of $16.3 billion in the actuarial liability affecting current year costs. The major component of MERHCF total cost is the change in the actuarial liability. The September 30, 2007, decrease in liability was $21.5 billion. Factors impacting the change are discussed in the "Military Retirement Benefits and Other Federal Employment Benefits section

Statements of Budgetary Resources

The Net Amount of Budgetary Resources Obligated for Undelivered Orders decreased $71.8 million, (64%). This variance was primarily due to de-obligations of outstanding projected annual enrollment fees for the U.S. Family Health Plan (USFHP). Throughout fiscal year 2008, a reconciliation performed on the obligations for the USFHP resulted in the closure of obligation lines for completed contracts. The USFHP is an alternative health care delivery plan offered in limited locations by private health care companies (similar to health maintenance organizations) which provide full health care services to enrolled beneficiaries. The MERHCF pays the annual enrollment fees for the Medicare-eligible beneficiaries. This enrollment requires the beneficiaries to obtain all health care from the USFHP facility.

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

The accompanying notes are an integral part of these statements

Department of Defense
Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
For the Years Ended September 30, 2008, and 2007
(In Thousands)

	2008	2007
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	$ 5,000	$ 5,000
Investments (Note 3)	134,291,659	109,549,060
Total Intragovernmental Assets	$ 134,296,659	$ 109,554,060
Accounts Receivable, Net (Note 4)	12,486	10,393
TOTAL ASSETS	$ 134,309,145	$ 109,564,453
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 6)	$ 61,387	$ 70,276
Total Intragovernmental Liabilities	$ 61,387	$ 70,276
Accounts Payable (Note 6)	138,429	186,361
Military Retirement Benefit Liabilities (Notes 5 and 7)	500,195,710	516,479,229
Benefits Due and Payable (Note 7)	623,470	625,418
TOTAL LIABILITIES	$ 501,018,996	$ 517,361,284
NET POSITION		
Cumulative Results of Operations – Earmarked Funds	$ (366,709,851)	$ (407,796,831)
TOTAL NET POSITION	$ (366,709,851)	$ (407,796,831)
TOTAL LIABILITIES AND NET POSITION	$ 134,309,145	$ 109,564,453

The accompanying notes are an integral part of these statements

Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF NET COST
For the Years Ended September 30, 2008, and 2007
(In Thousands)

	2008	2007
PROGRAM COSTS		
Gross Costs	$ (8,429,788)	$ (13,945,803)
Less: Earned Revenue	$ (32,657,192)	$ (31,539,307)
Net Program Costs	$ (41,086,980)	$ (45,485,110)
NET COST OF OPERATIONS	$ (41,086,980)	$ (45,485,110)

Additional information included in Note 8.

The accompanying notes are an integral part of these statements

Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2008, and 2007
(In Thousands)

	2008	2007
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$ (407,796,831)	$ (453,467,941)
Budgetary Financing Sources		
Transfers In/Out Without Reimbursement	$ 0	$ 186,000
Other Financing Sources	0	0
Total Financing Sources	$ 0	$ 186,000
Net Cost of Operations (+/-)	$ (41,086,980)	$ (45,485,110)
Net Change	$ 41,086,980	$ 45,671,110
Cumulative Results of Operations	$ (366,709,851)	(407,796,831)
Unexpended Appropriations, Beginning Balance	$ 0	$ 0
Budgetary Financing Sources	0	0
Total Unexpended Appropriations	$ 0	$ 0
Net Position	$ (366,709,851)	$ (407,796,831)

The accompanying notes are an integral part of these statements

Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2008, and 2007
(In Thousands)

	2008	2007
BUDGETARY RESOURCES		
Unobligated balance, brought forward, October 1	$ 0	$ 0
Budget authority		
Appropriation	32,270,819	31,200,621
Subtotal	$ 32,270,819	$ 31,200,621
Nonexpenditure transfers, net, anticipated and actual	0	186,000
Temporarily not available pursuant to Public Law	(24,484,897)	(23,810,932)
Total Budgetary Resources	$ 7,785,922	$ 7,575,689
STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	$ 7,785,922	$ 7,575,689
Subtotal	$ 7,785,922	$ 7,575,689
Unobligated balance:		
Apportioned	0	0
Subtotal	$ 0	$ 0
Unobligated balance not available	0	0
Total status of budgetary resources	$ 7,785,922	$ 7,575,689
CHANGE IN OBLIGATED BALANCE		
Obligated Balance, net		
Unpaid obligations, brought forward, October 1	$ 368,773	$ 397,172
Total unpaid obligated balance, net	$ 368,773	$ 397,172
Obligations incurred net (+/-)	7,785,922	7,575,689
Less: Gross outlays	(7,914,594)	(7,604,088)
Obligated balance, net, end of period		
Unpaid obligations	240,101	368,773
Total unpaid obligated balance, net, end of period	$ 240,101	$ 368,773
NET OUTLAYS		
Net Outlays		
Gross Outlays	$ 7,914,594	$ 7,604,088
Less: Distributed Offsetting Receipts	(20,774,860)	(19,653,179)
Total Outlays	$ (12,860,266)	$ (12,049,091)

Additional information included in Note 10.

The accompanying notes are an integral part of these statements

DoD

MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND FUND

NOTES TO THE PRINCIPAL STATEMENTS

DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND
NOTES TO THE PRINCIPAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2008, AND 2007

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. 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, Department of Defense (DoD) Audited Financial Statements and Trust Funds Directorate, Corporate Accounting, Standards and Compliance, Defense Finance and Accounting Service (DFAS), in accordance with the requirements of Office of Management and Budget (OMB) Circular No. A-136, "Financial Reporting Requirements," as revised, and accounting principles generally accepted in the United States of America. The Fund's financial statements are prepared by DFAS in addition to the financial reports, pursuant to OMB directives, which are used to monitor and control budgetary resources within the Fund. More detailed explanations of these financial statement elements are discussed in applicable footnotes. The financial statements account for all resources for which the Fund is responsible, unless otherwise noted.

B. Mission of the Reporting Entity. The mission of the DoD Medicare-Eligible Retiree Health Care Fund (the Fund or MERHCF) is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of health care programs for DoD Military Services and other Uniformed Services. The MERHCF provides benefits for a Medicare-eligible member of a participating Military Service or other Uniformed Service entitled to retired or retainer pay and such member's Medicare-eligible dependents or survivors.

C. Appropriations and Funds . Public Law 106-398, *The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001,* authorized MERHCF and provided a permanent, indefinite appropriation. Permanent authority becomes available based upon standing provisions of law without any further legislative action by the Congress after transmittal of the budget for each year. The law does not specify an amount of budget authority for the indefinite appropriation; however, the law does specify a variable factor that determines the amount available until expended.

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

The MERHCF is a special fund. The funds in MERHCF are used, in compliance with the law, to provide benefits for a Medicare-eligible member of a participating Military Service or other Uniformed Service entitled to retired or retainer pay and such member's Medicare-eligible dependents or survivors.

The MERHCF funds are designated as earmarked funds. Earmarked funds are financed by specifically identified revenues; are required by statute to be used for designated activities, benefits, or purposes; and remain available over time. Earmarked funds also have a requirement to account for and report on the receipt, use, and retention of revenues and other financing sources that distinguish such funds from general revenues.

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.

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

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

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

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) 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 Statement of Position;
>
> (C) AICPA Accounting Standards Executive Committee 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; and
>
> (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 No. 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 the Circular.

E. Revenues and Other Financing Sources. Financing sources for the MERHCF are provided primarily through the annual contributions from the Military Services and other Uniformed Services made at the beginning of each fiscal year; a U.S. Treasury warrant, made at the beginning of each fiscal year, for annual amortization of the unfunded liability; and interest earned on investments.

F. Recognition of Expenses. For financial reporting purposes, the MERHCF recognizes benefit expenses in the period incurred. However, because MERHCF's financial feeder systems were not designed to collect and record financial information on the full accrual basis, accrual adjustments are made for major items such as accounts receivable and accounts payable.

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

Preparation of reliable financial statements requires the elimination of transactions occurring among entities within DoD or between two or more federal agencies. Seller entities within DoD provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal DoD accounting offices. In most cases, the buyer entities adjust their records to agree with DoD seller-side balances. Intra-DoD balances are then eliminated. The MERHCF is able to reconcile its buyer/seller transactions. The DoD is developing long-term system improvements to ensure accurate intra-governmental information, to include sufficient up-front edits and controls, eliminating the need for after-the-fact reconciliations.

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

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

H. Funds with the U.S. Treasury. The U.S. Treasury allows the MERHCF to be fully invested. Therefore, the Fund Balance with Treasury (FBWT) may be zero during various quarters of the fiscal year. However, precautions are taken to prevent abnormal balances at Treasury.

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

In addition, DFAS submits reports to Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The Treasury then records this information to the FBWT account maintained in the Treasury system. The MERHCF-recorded balance in the FBWT account and U.S. Treasury's FBWT accounts must balance monthly.

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 MERHCF does not recognize an allowance for estimated uncollectible amounts due from intragovernmental receivables. Claims against these agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the "Treasury Financial Manual."

J. Investments in U.S. Department of Treasury Securities. Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, BPD. These securities are redeemable at market value exclusively through the Federal Investment Branch of Treasury. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. The MERHCF's intent is to hold investments to maturity, unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities. The MERHCF receives interest semiannually on the value of its marketable, market-based securities from the U.S. Treasury. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 3.

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

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

L. Comparative Data. For comparative purposes, the financial statements display both FY 2007 and FY 2008 data.

M. Unexpended Obligations. The MERHCF obligates funds to provide goods and services; some of which are not yet delivered. The financial statements do not reflect this liability for payment for goods and services not yet delivered, unless title passes. Unexpended obligations include (1) obligations for which goods and services have been delivered (title passed) and a liability recognized and (2) obligations for which no delivery has occurred and no liability recognized. The balance of unexpended obligations appears immediately before net outlays in the Statement of Budgetary Resources and is referred to as "Total unpaid obligated balances, net, end of period."

N. 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.

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

NOTE 2. FUND BALANCES WITH TREASURY (FBWT)

($ In Thousands)	**FY 2008**	**FY 2007**
Fund Balance		
Total Special Funds	$ 5,000	$ 5,000
Status of Fund Balance with Treasury		
Unobligated Balance -Unavailable	$ 132,564,539	$ 108,079,641
Obligated Balance not yet Disbursed	240,101	368,773
Non-FBWT Budgetary Accounts	(132,799,640)	(108,443,414)
Total	$ 5,000	$ 5,000

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

Status of Fund Balance with Treasury (FBWT). This status reflects the budgetary resources to support the FBWT.

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

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

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

NOTE 3. INVESTMENTS

($ In Thousands)	FY 2008				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
Intragovernmental Securities:					
Non Marketable, Market-Based	$ 135,483,350	Effective Interest	$ (2,683,711)	$ 132,799,639	$ 127,002,399
Subtotal	$ 135,483,350		$ (2,683,711)	$ 132,799,639	$ 127,002,399
Interest Receivable	1,492,020		0	1,492,020	1,492,020
Total Investments	$ 136,975,370		$ (2,683,711)	$ 134,291,659	$ 128,494,419

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

Investments, Net, increased $24.7 billion (23%). This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. Public Health Service, National Oceanic and Atmospheric Administration, and the U.S. Coast Guard) net of current disbursements for benefits paid. Investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover the unfunded portions of future benefits.

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

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

The investments listed above are presented at amortized cost and market value as of September 30, 2008, and 2007. The table below displays the value of the U.S. Treasury Securities held by the MERHCF.

($ In Thousands)

	COST FY 2008		**COST FY 2007**
Notes	$ 14,313,315	Notes	$ 17,308,868
Bonds	3,203,750	Bonds	3,203,750
TIPS	115,980,754	TIPS	85,087,256
Overnights	1,985,531	Overnights	4,606,470
Total Cost	**$135,483,350**	**Total Cost**	**$110,206,344**

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

The DoD Investment Board approves the strategy for the type of securities purchased by MERHCF at the semiannual meetings. These securities may include U.S. Treasury bills, notes, bonds, inflation-protected securities, and overnight certificates. The U.S. Treasury bills are short-term securities with maturities of 1 year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least 1 year, but not more than 10 years, and are purchased at either a discount or premium. The U.S. Treasury bonds are long-term securities with maturities of 10 years or more and are purchased at either a discount or premium. The U.S. Treasury Inflation-Protected Securities (TIPS) provide protection against inflation. The TIPS principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, the U.S. Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the shares. Overnight securities are short-term securities, purchased at face value, that mature the next business day and earn interest at the daily Federal Reserve repurchase agreement rate.

NOTE 4. ACCOUNTS RECEIVABLE

($ In Thousands)	FY 2008		
	Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intragovernmental Receivables	$ 0	$ N/A	$ 0
Nonfederal Receivables from the Public	$ 12,537	$ (51)	$ 12,486
Total Accounts Receivables	$ 12,537	$ (51)	$ 12,486

($ in Thousands)	FY 2007		
	Gross Amount Due	Allowance for Estimated Uncollectibles	Accounts Receivable, Net
Intra-governmental Receivables	$ 0	$ N/A	$ 0
Nonfederal Receivables from the Public	$ 10,450	$ (57)	$ 10,393
Total Accounts Receivables	$ 10,450	$ (57)	$ 10,393

The MERHCF does not recognize an allowance for estimated uncollectible amounts from other Federal Agencies.

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

NOTE 5. LIABILITIES COVERED AND NOT COVERED BY BUDGETARY RESOURCES

($ in Thousands)	FY 2008	FY 2007
Non-Federal Liabilities:		
Military Retirement Benefits Liabilities (Note 7)	$ 368,254,642	$ 409,025,006
Total Non-Federal Liabilities	$ 368,254,642	$ 409,025,006
Total Liabilities Not Covered by Budgetary Resources	$ 368,254,642	$ 409,025,006
Total Liabilities Covered by Budgetary Resources	$ 132,764,354	$ 108,336,278
Total Liabilities	$ 501,018,996	$ 517,361,284

Liabilities not covered by budgetary resources represent the difference between the actuarial liability for future benefit payments and the current assets of the Medicare-Eligible Retiree Health Care Fund.

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

The Total Liabilities Not Covered by Budgetary Resources decreased $40.8 billion (10%). This variance is comprised primarily of the increase in assets added to the decrease in the actuarial liability. The increase in assets of $24.7 billion was largely attributable to the receipt of annual contributions from the U.S. Treasury and Uniformed Services during the 1st Quarter, FY 2008. The decrease in the actuarial liability of $16.3 billion was caused by changes in two key economic assumptions and the addition of a new assumption

NOTE 6. ACCOUNTS PAYABLE

($ in Thousands)	FY 2008	FY 2007
Intragovernmental Payables	$ 61,387	$ 70,276
Nonfederal Payables (to the Public)	138,429	186,361
Total Accounts Payable	$ 199,816	$ 256,637

The Medicare-Eligible Retiree Health Care Fund's system does not track intra-governmental transactions by customer at the transaction level. Therefore, internal Department of Defense buyer-side balances are adjusted to agree with internal seller-side balances for revenue and accounts receivable. Accounts payable were adjusted by reclassifying amounts between federal and nonfederal accounts payable.

Intra-governmental Accounts Payable decreased $8.9 million (13%) primarily due to a reduction in the number of prescriptions processed by the contractor in September 2008 compared to September 2007. The MERHCF intragovernmental accounts payable are directly related to the Defense Logistics Agency's (DLA) replenishment of the contractor's inventory. The replenishment of the contractor's inventory creates an accounts receivable for DLA and an accounts payable for MERHCF. Therefore, a decrease in the replenishment requirements correlates to a decrease in MERHCF accounts payable.

Nonfederal Payables (to the Public) decreased $47.9 million (26%) primarily due to an early cut-off of 7 days in September 2008 for the processing of pharmacy claims. The cutoff was initiated by the pharmacy contractor, Express Scripts, who processes claims once every 2 weeks. As a result, fewer claims were processed and the corresponding liability to Express Scripts was reduced.

NOTE 7. MILITARY RETIREMENT BENEFIT LIABILITIES

($ In Thousands)	FY 2008			
Major Program Activities	Liabilities	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liability
Medicare-Eligible Retiree Benefits	$ 500,195,710	5.75%	$ (131,941,068)	$ 368,254,642
Total	$ 500,195,710		$ (131,941,068)	$ 368,254,642
Benefits Due and Payable	$ 623,470		$ (623,470)	$ 0
Total Military Retirement and Benefits Due and Payable	$ 500,819,180		$ (132,564,538)	$ 368,254,642

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

The Total Military Retirement and Benefits Due and Payable decreased $16.3 billion (3%) due to the decrease in the FY 2008 actuarial liability. This decrease is due to changes in two key assumptions and a new assumption that were offset by the expected increase in the actuarial liability of $32.9 billion (growth due to service and interest, and liability released through benefit payments). The two key assumption changes were a 0.25% reduction in the discount rate (which led to a $30.6 billion increase) and revised medical trend rates (which led to a $43.9 billion decrease). A new assumption was added to reflect mandated federal ceiling prices for retail prescription drugs (which led to a $35.3 billion decrease).

The table for this note displays two distinct types of liabilities that are related to Military Retirement and Other Federal Employment Benefits. This table presents the actuarial liability for health care benefits which are not yet incurred on the line titled “Medicare-Eligible Retiree Benefits.” It also displays the incurred-but-not-reported reserve estimate that represents an estimate of benefits already incurred but not yet reported to the DoD on the line titled “Benefits Due and Payable.”

Projected Revenues

Projected revenues into the MERHCF, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on MERHCF assets, annual Uniformed Services normal cost contributions, and an annual U.S. Treasury contribution. The normal cost contributions are paid annually at the beginning of the fiscal year by the U.S. Treasury from the amounts appropriated to the Military Services and are calculated at the approved full-time and part-time per capita rates times the budgeted full-time and part-time force strengths. The contribution from the U.S. Treasury is also paid into MERHCF at the beginning of each fiscal year and represents the amortization of the unfunded liability for services performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses. The DoD MERHCF Board of Actuaries approves the U.S. Treasury’s contribution, and the Secretary of Defense directs the Secretary of the Treasury to make the payment.

Computation of Liability

The Medicare-Eligible Retiree Health Care Fund (MERHCF) accumulates funds to pay for health care programs for Medicare-eligible Military and other Uniformed Service retirees and their Medicare-eligible dependents or survivors.

The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2008, balance represents the September 30, 2008, amount.

Actuarial Cost Method

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

Assumptions

Assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. The discount rate used was 5.75% and represents the expected long-term rate of return on U.S. Treasuries. The discount rate was reduced 0.25% from the prior actuarial valuation. Incurred cost assumptions for direct care were based on actual experience in FY 2007. Assumptions for purchased care were developed from actual experience incurred during FY 2005 through FY 2007. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year's results. The FY 2008 change in the actuarial liability is displayed below. In calculating the actuarial liabilities, the following medical trend assumptions were used:

Medical Trend	FY 2007 - FY 2008	Ultimate Rate 2032
Medicare Inpatient (Direct Care)	5.65%	6.25%
Medicare Inpatient (Purchased Care)	6.65%	6.25%
Medicare Outpatient (Direct Care)	3.33%	6.25%
Medicare Outpatient (Purchased Care)	4.33%	6.25%
Medicare Prescriptions (Direct Care)	3.00%	6.25%
Medicare Prescriptions (Purchased Care)	8.55%	6.25%
USFHP (Purchased Care)	10.00%	6.25%

Beginning with the actuarial liability determined for the September 30, 2008, MERHCF financial statements, separate medical trend rates were used for direct care and purchased care costs to incorporate the assumption that purchased care medical trends will be higher than direct care medical trends. In addition, a new set of trends was introduced for the U.S. Family Health Plan (USFHP) costs. The USFHP costs are now valued as a separate benefit in order to more accurately reflect that portion of the liability.

The medical cost trends assumptions have a significant effect on the amounts reported. For example, if the FY 2008 assumed rates had increased by one percentage point, the actuarial present value of projected plan benefits would have increased by 28.6%, or approximately $143.0 billion.

FY 2008 Change in MERHCF Actuarial Liability
($ in Thousands)

A.	Actuarial Liability as of September 30, 2007 (all Uniformed Services Medicare)	$ 516,479,229
B.	Expected Normal Cost for FY 2008	10,070,293
C.	Expected Benefit Payments for FY 2008	(8,545,983)
D.	Interest Cost for FY 2008	31,340,326
E.	Actuarial (Gains)/Losses Due to Other Factors	(5,248,219)
F.	Actuarial (Gains)/Losses Due to Changes in Trend Assumptions	(43,899,936)
G.	Actuarial Liability as of September 30, 2008 (all Uniformed Services Medicare)	500,195,710
H.	Change in Actuarial Liability (Line G-Line A)	$ (16,283,519)

Each year the actuarial liability is expected to increase with normal (or service) cost (Line B), decrease with benefit payments (Line C), and increase with interest cost (interest on the liability during the period) (Line D), resulting in an expected increase of $32.9 billion in the FY 2008 actuarial liability (Line B + Line C + Line D). The September 30, 2008, actuarial liability incorporates changes in assumptions, new assumptions, and actuarial experience. The

Actuarial Gains and Losses Due to Other Factors (Line E) decreased the liability by an additional $5.2 billion. Key factors contributing to these "Other Factors" include a 0.25% decrease in the discount rate, adding an assumption to reflect mandated federal ceiling prices for retail prescription drugs, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions and discount rate. The actuarial gain due to changes in medical trend assumptions (and the introduction of new trend rates for USFHP) (Line F) decreased the liability by $43.9 billion.

FY 2008 Actuarial Liability for the Uniformed Services

The MERHCF liability included Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2008, Medicare liability ($ in thousands) for all Uniformed Services is as follows:

DoD	$	489,038,340
Coast Guard		10,015,552
Public Health Service		1,070,835
National Oceanic and Atmospheric Administration		70,983
Total	$	500,195,710

FY 2008 Military Service and Other Uniformed Service Contributions

The FY 2008 Military Service and other Uniformed Service contributions to the MERHCF ($ in thousands) were as follows:

DoD	$	11,185,399
Coast Guard		272,111
Public Health Service		36,647
National Oceanic and Atmospheric Administration		1,802
Total	$	11,495,959

Market Value of Securities for the MERHCF

The market value of the non-marketable, market based securities as of September 30, 2008, totaled $128.5 billion.

FY 2007

Actuarial Cost Method

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

Assumptions

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

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

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

FY 2007 Change in MERHCF Actuarial Liability

($ in Thousands)

A.	Actuarial Liability as of September 30, 2006 (all Uniformed Services Medicare)	$	538,032,547
B.	Expected Normal Cost for FY 2007		10,801,492
C.	Expected Benefit Payments for FY 2007		(8,494,519)
D.	Interest Cost for FY 2007		34,040,697
E.	Actuarial (Gains)/Losses Due to Other Factors		(4,783,551)
F.	Actuarial (Gains)/Losses Due to Changes in Trend Assumptions		(53,117,437)
G.	Actuarial Liability as of September 30, 2007 (all Uniformed Services Medicare)	$	516,479,229
H.	Change in Actuarial Liability (Line G-Line A)	$	(21,553,318)

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

FY 2007 Actuarial Liability for the Uniformed Services

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

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

FY 2007 Military Service and Other Uniformed Service Contributions

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

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

Market Value of Securities for the MERHCF

The market value of the non-marketable, market based securities as of September 30, 2007, totaled $107.8 billion.

NOTE 8. GENERAL DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

($ In Thousands)

	FY 2008	FY 2007
Intragovernmental Costs	$ 2,365,012	$ 2,398,537
Public Costs	(10,794,800)	(16,344,340)
Total Costs	$ (8,429,788)	$ (13,945,803)
Intragovernmental Earned Revenue	$ (32,657,192)	$ (31,539,307)
Public Earned Revenue	0	0
Total Earned Revenue	$ (32,657,192)	$ (31,539,307)
Net Cost of Operations	**$** (41,086,980)	**$** (45,485,110)

The Net Cost of Operations decreased $4.4 billion (10%). This variance is primarily due to a decrease of $16.3 billion in the actuarial liability affecting current year costs. The major component of the MERHCF total cost is the change in the actuarial liability. The September 30, 2008, decrease is $16.3 billion; the September 30, 2007, decrease in liability was $21.5 billion. Factors impacting the change are discussed in Note 7, Military Retirement Benefits Liabilities.

The FY 2008 abnormal balance on the Statement of Net Cost (SNC), a negative $8.4 billion, is due to a $16.3 billion decrease in the MERHCF actuarial liability which was updated September 30, 2008. This decrease was caused by changes in the actuarial assumptions, new assumptions, experience, and assumed discount rate and was offset by $7.9 billion in normal benefit expenses.

The FY 2007 abnormal balance on the SNC, a negative $13.9 billion, was due to a significant decrease in the actuarial liability of the MERHCF. This liability is updated annually each September. The $21.6 billion decrease in the actuarial liability was caused by changes in the actuarial assumptions related to participation trend rates, medical trend rates, and the assumed discount rate and was offset by $5.2 billion in normal benefit expenses. The decrease in the actuarial liability was also the primary reason for the $21.7 billion decrease in Public Costs.

The SNC represents the net cost of programs and organizations of the Federal Government supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program organization administered by a responsible reporting entity. The Department's current processes and systems do not capture and report accumulated costs for major programs based upon the performance measures as required by the Government Performance and Results Act. The Department is in the process of reviewing available data and developing a cost reporting methodology as required by the Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government.*

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

Intragovernmental Earned Revenue is comprised of the following amounts:

Intragovernmental Earned Revenues for Program Costs

($ in Thousands)		FY 2008		FY 2007
1. Uniformed Service Contributions	$	11,495,959	$	11,547,442
2. Annual Treasury Unfunded Liability Payment		12,930,000		15,608,000
3. Interest on Investments		8,231,233		4,383,865
4. Total Intragovernmental Revenue	**$**	$32,657,192	**$**	$31,539,307

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

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

Line 3. Interest on Investments represents the interest income received by the MERHCF for FYs 2008 and 2007.

NOTE 9, DISCLOSURES RELATED TO THE STATEMENT OF CHANGES IN NET POSITION.

There was a difference of $32.3 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations Received on the Statement of Budgetary Resources (SBR). This difference represents current receipts reported as exchange revenue on the Statement of Net Cost, as appropriations on the SBR, and as a part of the Net Cost of Operations on the SCNP. As of September 30, 2007, the difference between the MERHCF's two statements was $31.2 billion.

NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES

($ in Thousands)		2008		2007
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	$	40,286	$	112,136

The Net Amount of Budgetary Resources Obligated for Undelivered Orders decreased $71.8 million. This variance was primarily due to deobligations of outstanding projected annual enrollment fees for the U.S. Family Health Plan (USFHP). Throughout FY 2008, a reconciliation performed on the obligations for the USFHP resulted in the closure of obligation lines for completed contracts. The USFHP is an alternative health care delivery plan offered in limited locations by private health care companies (similar to health maintenance organizations) which provide full health care services to enrolled beneficiaries. The MERHCF pays the annual enrollment fees for the Medicare-eligible beneficiaries. This enrollment requires the beneficiaries to obtain all health care from the USFHP facility.

Apportionment Categories. The OMB Circular No. A-136 specifically requires disclosure of the amount of direct and reimbursable obligations incurred against certain apportionment categories. As of September 30, 2008, the MERHCF reported $7.8 billion in direct, Category B obligations which are apportioned funds that relate to a specific project or program. As of September 30, 2007, the MERHCF reported $7.6 billion in direct, Category B obligations.

Permanent Indefinite Appropriation. Title 10, U.S. Code 1111 provides the MERHCF a permanent indefinite appropriation with which to finance, on an actuarially sound basis, the liabilities of DoD's uniformed services retiree health care programs for Medicare-eligible beneficiaries. These funds are only available to pay for the costs of the retiree health care program for all eligible beneficiaries of the MERHCF. Amounts that are not needed to pay the current costs of the Fund may be invested in non-marketable market-based securities purchased through the Department of the Treasury. A permanent indefinite appropriation provides budget authority of an unspecified amount of money that is available as a result of previously enacted legislation and which does not require new legislation for the current year.

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

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

The U.S. Treasury issues annual warrants that pay amortized payments for the unfunded actuarial liabilities of the Fund. The Fund's annual warrant for FY 2008 totaled $12.9 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, $12.9 billion is duplicated on the DoD Agency-wide SBR. As of September 30, 2007, the Fund's annual warrant was $15.6 billion, which was duplicated on the DoD Agency-wide SBR for FY 2007.

In addition, the Fund reports Appropriations Received for contributions that the Army, Navy, and Air Force pay. The Military Departments also include these amounts in their respective Appropriations Received. For FY 2008, the Fund reported a total of $11.2 billion for the Military Departments, which is duplicated on the DoD Agencywide SBR. As of September 30, 2007, the Fund also reported $11.2 billion in contributions from the Military Departments, which was duplicated on the DoD Agency-wide SBR for FY 2007.

NOTE 11. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

($ In Thousands)		
RESOURCES USED TO FINANCE ACTIVITIES	**FY 2008**	**FY 2007**
Budgetary Resources Obligated		
Obligations incurred	$ 7,785,922	$ 7,575,689
Less: Offsetting receipts (-)	(20,774,860)	(19,653,179)
Net obligations	$ (12,988,938)	$ (12,077,490)
Total resources used to finance activities	$ (12,988,938)	$ (12,077,490)
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 (-)	$ 71,850	$ 12,662
Resources that fund expenses recognized in prior periods	$ (16,285,468)	$ (21,532,564)
Total resources used to finance items not part of the Net Cost of Operations	$ (16,213,618)	$ (21,519,902)
Total resources used to finance the Net Cost of Operations	$ (29,202,556)	$ (33,597,392)
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD:		
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	$ (11,882,332)	$ (11,886,128)
Other	(2,092)	(1,590)
Total components of Net Cost of Operations that will not require or generate resources in the current period	$ (11,884,424)	$ (11,887,718)
Net Cost of Operations	$ (41,086,980)	$ (45,485,110)

The previous note schedule lines are presented as combined instead of consolidated due to intraagency budgetary transactions not being eliminated: Obligations Incurred; Obligations Net of Offsetting Collections and Recoveries; Less: Offsetting Receipts; Net Obligations; and Undelivered Orders.

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables for both FY 2007 and FY 2008. These amounts represent refunds receivable for duplicate or other erroneous MERHCF payments made to contractors for care of the beneficiaries and for copayments from MERHCF beneficiaries for prescriptions. These refunds receivable are recorded as an offset to expenses. This line also displays the changes in bad debts for both FY 2007 and FY 2008. These bad debts occurred because erroneous payments made to MERHCF beneficiaries or to nonfederal providers of medical services were not repaid.

NOTE 12. BENEFIT PROGRAM EXPENSE

FY 2008 Change in MERHCF Actuarial Liability

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

Table 1. Benefit Program Expenses

($ In Thousands)

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

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

In FY 2008, the Period Actuarial (Gains) or Losses component of BPE (Line D) contributed a net gain (liability decrease) reflecting the net of various gains and losse4s resulting from experi4ernce and changes in assumptions. The (Gains)/Losses Due to Changes in Medical Trend Assumption component of BPE (Line E) also produced a gain in FY 2008; however, the new medical trend rate assumptions used in FY 2007 produced a larger gain. Each year, the MERHCF Board of Actuaries approves the assumption changes.

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

NOTE 13 EARMARKED FUNDS

BALANCE SHEET	2008	2007
Assets		
Fund balance with Treasury	$ 5,000	$ 5,000
Investments	134,291,659	109,549,060
Accounts and Interest Receivable	12,486	10,393
Total Assets	$ 134,309,145	$ 109,564,453
Liabilities And Net Position		
Military Retirement Benefits and Other Federal Employment Benefits	$ 500,819,180	$ 517,104,647
Other Liabilities	199,816	256,637
Total Liabilities	$ 501,018,996	517,361,284
Cumulative Results of Operations	(366,709,851)	(407,796,831)
Total Liabilities And Net Position	$ 134,309,145	$ 109,564,453
STATEMENT OF NET COST		
Program Costs	$ (8,429,788)	$ (13,945,803)
Less Earned Revenue	(32,657,192)	(31,539,307)
Net Program Costs	$ (41,086,980)	$ (45,485,110)
Net Cost of Operations	$ (41,086,980)	$ (45,485,110)
STATEMENT OF CHANGES IN NET POSITION		
Net Position Beginning of the Period	$ (407,796,831)	$ (453,467,941)
Net Cost of Operations	(41,086,980)	(45,485,110)
Budgetary Financing Sources	0	186,000
Change in Net Position	$ 41,086,980	$ 45,671,110
Net Position End of Period	$ (366,709,851)	$ (407,796,831)

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

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

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

DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

OTHER ACCOMPANYING INFORMATION

EXHIBIT 1

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

($ in Thousands)

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

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

[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 $623.5.million and $625.4 million for the estimated incurred-but-not-reported liabilities as of September 30, 2008, and 2007, respectively, as presented in the Balance Sheet as “Benefits Due and Payable” and as discussed in Note 7, “Military Retirement Benefit Liabilities.”

EXHIBIT 2

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

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

In its FY 2008 assessments, TMA management assessed that, except for direct care related material weaknesses addressed below, the MERCHF (as an OMB-designated Financial Statement Reporting Entity (FSRE)) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2); while the current financial management systems do not currently conform to financial systems requirements (FMFIA § 4) TMA management is working with DFAS to implement corrective actions for purchased care operations to comply with (FMFIA § 4). The MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Military Services have implemented financial systems that comply with (FMFIA § 4). The OUSD (C)-published Financial Improvement and Audit Readiness Report as of March 2008, indicates a FY 2017 timeline for the Military Services to achieve (FMFIA § 4) compliance.

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

The correct classification of offsetting receipts is significant to the accurate reporting of intragovernmental activity for the DoD and U.S. Government financial statements.

Therefore, the MERHCF corrected the presentation of the FY 2007 financial statements and restated the FY 2006 financial statements and related disclosures.

The Status of FY 2008 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA§ 2) and non-conformances (FMFIA § 4) and summary of corrective actions to resolve the material weaknesses and non-conformances.

Table 1. Summary of Financial Statement Audit

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

Table 2. Summary of Management Assurances

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

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

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

EXHIBIT 3

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

IMPROPER PAYMENTS INFORMATION ACT REPORTING

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

RISK ASSESSMENT

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

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

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

STATISTICAL SAMPLING PROCESS

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

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

CORRECTIVE ACTION PLAN

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

MILITARY HEALTH BENEFITS PROGRAM IMPROPER PAYMENT REPORTING

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

1. The final payment error rate for FY 2007 is 0.93%, which is less than the contract performance standard of 2% used in the FY 2007 AFR calculation. The error rate in FY 2008 and beyond is a conservative estimate based on the 2% contract performance standard.

2. The FY 2007 outlays include all benefit dollars subject to the audit process. Fee-for-service claims are considered susceptible to improper payments as payment is made based upon an individual claim submitted by a provider or beneficiary certifying services were provided as billed. Administrative or change order costs are not included, as those costs do not fall into the definition of areas susceptible to improper payments.

3. The FY 2007 outlays do not include:

a. The Designated Providers (U.S. Family Health Plan) contracts, through which a set amount is paid for each patient's care on a per member per month basis. The contractor is 100% responsible for improper payments; there is no shared risk with the Government. The Defense Contract Audit Agency conducts reconciliations to validate correct capitated payments for the enrolled population. Government liability is limited to the amount paid to the contractor regardless of the cost of health care services.

b. Pharmacy claims. The Department is developing an audit process.

c. Foreign claims. The Department is developing an audit process.

DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND

INDEPENDENT AUDITORS' REPORTS

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

November 10, 2008

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

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

The Medicare-Eligible Retiree Health Care Fund (the Fund) was established by Public Law No. 106-398 (The National Defense Authorization Act for FY 2001). In accordance with the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act (Public Law 103-356) of 1994, agencies are required to submit financial statements for each revolving fund and trust fund. The DoD Comptroller requires that the Fund prepare audited financial statements in accordance with the DoD Financial Management Regulation. We contracted with Kearney & Company to perform the Fund's FY 2008 audit.

Qualified Audit Opinion. We agree with the Kearney & Company qualified opinion dated October 31, 2008. Kearney & Company reported that, except for amounts related to the Fund's direct care costs, the financial statements and accompanying notes present fairly, in all material respects, the Fund's financial position, net cost, changes in net position, and budgetary resources as of September 30, 2008 and 2007. Kearney & Company also reported that, other than the effects of the direct care weaknesses identified above, the statements conformed with accounting principles generally accepted in the United States of America.

Kearney & Company qualified its opinion because it was unable to obtain sufficient, appropriate audit evidence from compliant transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities.

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

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

- The actuarial liability for Medicare-eligible retiree benefits includes the actuarial present value of the projected direct care costs for benefits provided at Military Treatment Facilities. The Fund bases the costs on data extracted from various systems that are noncompliant and are not transaction based.

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

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

Compliance with Laws and Regulations. Kearney & Company performed tests that disclosed the Fund did not comply with certain provisions of the following laws and regulations.

- The Fund's data were processed on electronic data processing systems that did not comply with OMB Circular A-127.

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

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

- Collectively, the Fund did not fully comply with OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004; OMB Circular A-127; and the Federal Managers' Financial Integrity Act.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,[*] requires that auditors report test results if the financial statements do not comply with certain laws and regulations.

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

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

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

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

Patricia A. Marsh

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

KEARNEY& COMPANY
Certified Public Accountants and Consultants

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INDEPENDENT AUDITOR'S REPORT

To:

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

We have audited the accompanying Balance Sheets of the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the Fund) as of September 30, 2008 and 2007, and the related Statement of Net Cost, Statement of Changes in Net Position, and Statement of Budgetary Resources for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We were unable to obtain sufficient, appropriate audit evidence from compliant, transaction-based accounting systems to support the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTF). As discussed in Note 14 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2008 and 2007, includes approximately $71 billion (14% of total) and $75 billion (14% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2008, include approximately $3.3 billion and $1.7 billion, respectively, and for the year ended September 30, 2007, include approximately $3.7 billion and $1.8 billion, respectively, of amounts related to the direct-care costs.

Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems. While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording, and cut-off of the costs reported.

Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation processes. We were unable to obtain sufficient evidence as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

KEARNEY&
COMPANY

In our opinion, except for the effects on the financial statements of the amounts related to the Fund's direct-care costs, if any, as might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct-care component of the actuarial liability for Medicare-eligible retiree benefits; such financial statements present fairly, in all material respects, the financial position of the Fund, as of September 30, 2008 and 2007, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated October 31, 2008 on our consideration of the Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance, and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

Kearney & Company

October 31, 2008
Alexandria, Virginia

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

To:

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

We have audited the financial statements of the Department of Defense (DoD) Medicare- Eligible Retiree Health Care Fund (the Fund) as of and for the year ended September 30, 2008, and have issued our report thereon dated October 31, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and requirements of Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

INTERNAL CONTROL OVER FINANCIAL REPORTING

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

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

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

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

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

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

Our assessment is based upon various factors noted during our audit, including the following:

1. The actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2008 and 2007, includes approximately $71 billion (14% of total) and $75 billion (14% of total), respectively, of amounts reflecting the actuarial present value of projected direct-care costs of benefits to be provided by the Military Treatment Facilities (MTF), managed by the Services, to eligible participants in the Fund. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2008, include approximately $3.3 billion and $1.6 billion, respectively, and for the year ended September 30, 2007, include approximately $3.7 billion and $1.8 billion, respectively, of amounts related to direct-care costs.
   MTF-related amounts of direct-care costs are estimated by the Fund's actuaries and others using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems, applying common and consistent business rules, in a manner envisioned by the DoD's planned Standard Financial Information Structure (SFIS) While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording, and cut-off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation processes.

   Therefore, the procedures in place to determine the allocated costs of direct-care provided by the MTFs are inadequate to ensure presentation of the direct-care costs in conformity with accounting principles generally accepted in the United States of America.

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

   The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the Services that has not been audited. The MTF-level data is based upon budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the MTF-level. During 2008, the Fund had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

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

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

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

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

With respect to internal control relevant to data that supports reported performance measures on page 5 of Management's Discussion & Analysis, which accompanies the financial statements, we obtained an understanding of the design of significant internal control relating to the existence and completeness assertions, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide assurance on the internal control over reported performance measures and, accordingly, we do not express such an opinion.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 07-04. As part of our work, we performed tests of compliance with the Federal Financial Management Improvement Act (FFMIA), Section 803(a) requirements. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and the requirements of OMB Bulletin No. 07-04, and which are summarized in the following paragraphs:

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

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

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

   - Prepare financial statements and other required financial and budget reports using information generated by the financial management systems
   - Provide reliable and timely financial information for managing current operations
   - Account for assets reliably, so that they can be properly protected from loss, misappropriation, and/or destruction
   - Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger.

These conditions, in the aggregate, result in significant departures from the requirements of OMB Circulars A-123, A-127, and A-130.

The significant deficiencies and material weaknesses identified above, with respect to internal control over financial reporting, indicate that the Fund is not fully compliant with the requirements of OMB Circulars A-123 and A-127 and the FMFIA.

VIEWS OF RESPONSIBLE OFFICIALS

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

DISTRIBUTION

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

Kearney & Company

October 31, 2008
Alexandria, Virginia