



FISCAL YEAR 2004

**MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND**

AUDITED FINANCIAL STATEMENTS

October 27, 2004

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND
FISCAL YEAR 2004
AUDITED FINANCIAL STATEMENTS

Table of Contents

Management’s Discussion and Analysis.....	1
Principal Statements.....	13
Notes to the Principal Statements.....	19
Required Supplementary Information.....	32
Other Accompanying Information.....	34
Independent Auditors’ Reports.....	36

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

MANAGEMENT'S
DISCUSSION
AND
ANALYSIS

Management's Discussion and Analysis

DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND MANAGEMENT'S DISCUSSION AND ANALYSIS

YEAR ENDED SEPTEMBER 30, 2004

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Medicare Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The FY2001 National Defense Authorization Act (NDAA) directed the establishment of the Medicare Eligible Retiree Health Care Fund to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for space available care in 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.)

Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness, through the Office of the Assistant Secretary of Defense for Health Affairs (TRICARE Management Activity [TMA]), has as one of its missions to oversee the operations of the Defense TRICARE Health Delivery System, including management of the Medicare Eligible Retiree Health Care Fund (the Fund). In FY 2004, the Fund initially authorized approximately \$5.4 billion in total health care services, civilian providers (\$4.0B), military medical treatment facilities (\$0.9B) and Military Service Personnel Accounts (\$0.5B), on behalf of Medicare eligible retirees, retiree dependents, and survivors. In comparison, FY 2003 initial expenditures were \$4.6 billion in total health care services, of which \$3.4 billion supported civilian sector care, \$0.8 billion supported operations and maintenance in military medical facilities, and \$0.4 billion was reimbursed to the Military Service Personnel Accounts. In addition to staff members of the TRICARE Management Activity, the Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund. The DoD Office of the Actuary is responsible for supporting the Board of Actuaries in the valuation of the Fund.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's Service cost, annual payments from the Treasury to amortize the unfunded liability, and investment income. During the first two years of the Fund's operation, the income was received from the following sources:

<u>Fiscal Year</u>	<u>Treasury UAL</u>	<u>Normal Cost</u>	<u>Interest on Investment</u>
FY 2003	\$14.369 billion	\$8.201 billion	\$0.196 billion
FY 2004	\$16.260 billion	\$8.140 billion	\$0.943 billion

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

Overview of the Defense Health Program

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

- Active duty Service members
- Dependents of active duty Service members
- Military retirees
- Dependents of military retirees
- Full-time reservists

Management's Discussion and Analysis

- Dependents of full-time reservists
- Survivor dependents of military retirees and those who died on active duty

The TRICARE program consists of a combination of military medical treatment facilities (MTFs) and regional networks of civilian providers that work together to provide care to eligible beneficiaries. The MTFs include 70 inpatient facilities and 826 medical and dental clinics in the United States and overseas. Those facilities provide care for approximately 9.1 million beneficiaries and also serve as a training ground for military medical personnel. Because the direct care health system's capacity is not large enough to serve the health care needs of all eligible beneficiaries, DoD has ensured that active duty Service members receive top priority for care at the military facilities, while other beneficiaries can receive direct care services on a "space-available" basis. If care is not available in MTFs, beneficiaries seek care from civilian providers paid through the TRICARE program via the Managed Care Support Contracts and the TRICARE for Life program.

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

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

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

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

Medicare Eligible Retiree Health Care Plan of Benefits

The FY 2001 NDAA significantly expanded the DoD health care benefits for Medicare-eligible military retirees, their dependents and survivors. The NDAA established the TRICARE Senior Pharmacy Program that began on April 1, 2001, and the "TRICARE for Life" benefits that became effective on October 1, 2001.

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.

Management's Discussion and Analysis

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

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

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

Health Care Purchased From Civilian Providers

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

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

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

At the beginning of each Fiscal Year, a new Funding Authorization Document (FAD) for the TRICARE for Life/TRICARE Senior Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management Division. By agreement with DFAS, disbursement transactions are provided by email the day prior to payment processing. DFAS uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The actual purchased care payments for FY 2004 were approximately \$3.868 billion, as compared to \$3.311 billion in FY 2003.

In the past, purchased care claims have been processed by one of two Fiscal Intermediaries (FIs); Wisconsin Physician's Service (WPS) or Palmetto Government Business Administration (PGBA), depending on the managed care region in which the Medicare-Eligible beneficiary received care. Each

Management's Discussion and Analysis

region is managed by a different Primary Managed Care Contractor. The FIs serve as sub-contractors to the Managed Care Support Contractors for each of the managed care regions. The region in which care was received by the Medicare-eligible beneficiaries, then, determined which FI processed the TRICARE claim as a second payer to Medicare.

However, in April 2004, TMA awarded a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) to WPS. Dual eligibility refers to health care users who are both DoD beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. With the TDEFIC contract, WPS now processes all claims supported by the Fund, regardless of geographic region in which care was received.

Having a single FI to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication. Further, cost savings are realized with the claims administrative processing fees. Under the old FI contracts, claims administrative costs averaged \$1.40 for electronic claims and \$5.98 for paper claims. The TDEFIC contract stipulates \$1.31 for electronic claims and \$3.93 for paper claims.

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

TMA annually develops prospective payment amounts for care estimated to be provided in MTFs to Medicare-eligible beneficiaries. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and Defense Health Program (DHP) Operations and Maintenance (O&M) costs. TMA provides a memo to DFAS with the payment amounts by Service for MILPERS and DHP O&M that is reported on the Statement of Transactions (FMS 224) by DFAS.

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

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

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

The actual O&M expenditure for MTF provided care to Medicare-eligible beneficiaries in FY 2004 was \$0.9 billion versus \$0.8 billion in FY 2003. The actual MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries in FY 2004 was \$0.5 billion versus \$0.4 billion in FY 2003.

Performance Measures

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, 2004, the Fund had net assets available to pay benefits of \$38.086 billion and an actuarial liability of \$504.074 billion; the funding ratio was 7.6%. 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. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

Type of Investments

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

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

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

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

The Fund receives management oversight from the Department of Defense Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service, the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller) and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board met in FY 2004 and considered investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. In October 2003, the Investment Board approved an Investment Strategy. After reviewing current cash flow needs of the Fund, the Strategy seeks to establish a ladder of investment maturities over a period of 10 years.

Improper Payments Information Act

The Improper Payments Information Act requires federal agencies to report payments that should not have been made or that were made in an amount different than that required by law, regulation, or

Management's Discussion and Analysis

contract. The Office of Management and Budget Circular A-11, "Preparation, Submission, and Execution of the Budget," includes provisions implementing this Act.

In accordance with these provisions, the Department of Defense is reviewing all programs and activities and identifying those which are susceptible to significant improper payments. The Department will then estimate the amount of improper payments and establish goals to reduce the amount of these payments. Programs that meet the threshold criteria established in this guidance will be reported in next year's report. Those not meeting the criteria will be tracked internally to ensure that all cost-effective measures are being taken to minimize the amount of improper payments.

The Defense Health Program has numerous prepayment and post payment controls built into the claims processing system to minimize improper payments.

One control is the claims edit system, which re-bundles services that should be billed under a single comprehensive procedure code, but are broken out by medical service providers to increase reimbursement. This is a fraudulent practice condemned by national professional medical organizations.

A cost avoidance of \$87.6 million was realized in fiscal year 2003 as a result of the military health benefits program re-bundling edits. Anticipating that the trend will continue, we project approximately a 10% increase in the amount of the cost avoidance for FY 2004.

The Department projected \$100.074 million of improper payments (underpayments and overpayments) for the Defense Health Program—purchased care program—in fiscal year 2004. This represents an error rate of approximately 2.16%. Please note that 2.16% is a preliminary payment error rate. The final payment error rate is not available until the administrative process associated with the audits has been completed. Historically, the final figure has been less than the 2% threshold allowed by contract. In support of this position, last year's DoD Performance and Accountability Report listed the preliminary payment error rate for FY 2003 as 1.36%. The final payment error rate for fee-for-service claims was 0.85%.

Status of FY 2003 Audit Findings

Our independent auditors noted material weaknesses and other discrepancies during the conduct of the FY 2003 Financial Statement Audit. The material weaknesses center around two issues; the lack of a patient-level cost accounting system and 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.

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

These average cost per weighted workload unit can then be applied to specific care provided to specific patients by reviewing the Standard Inpatient Data Record (SIDR) and Standard Ambulatory Data Record (SADR) reported in the MHS Data Repository (MDR). The SIDRs and SADRs are prepared for each patient encounter and contain patient specific information, to include name, Social Security Number, sponsor or dependent status, and Medicare eligibility. Further, the SIDRs and SADRs reflect the diagnosis and any procedures that were performed on the patient for that specific encounter. The average costs per weighted workload unit computed in MEPRS is then applied against the specific data contained

Management's Discussion and Analysis

in the SIDRs and SADR's to determine an average cost for the specific care provided to a specific patient. Estimates of the weighted workload that will be provided to Medicare-eligible beneficiaries are calculated for each MTF based on historical experience. When the weighted workload costs are applied against the projected workload volume for each MTF, a prospective payment distribution plan can be computed for each MTF for the next fiscal year.

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

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

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

Bradson Corporation deliverables are phased to ensure MERHCF Balance Sheet beginning balances affected by the reported material weaknesses are ready for audit by FY 2006. All Financial Statements affected by the reported material weaknesses should be ready for audit by FY 2007. To meet this schedule, Bradson will deliver to TMA by December 31, 2004 a list of corrective action priorities. By May 31, 2005, Bradson will provide analytical findings on which to build risk screens and cost effective long term financial improvements. A report on material problems and risk areas will be delivered to TMA by July 29, 2005. Finally, on September 30, 2005, they will deliver a report on recommended courses of action and a detailed TMA Financial Management Improvement Plan. As deficiencies are identified and corrective actions are recommended, Bradson will work with TMA and other applicable entities to ensure timely correction of discrepancies.

The other material weakness dealing with the controls over the timeliness and accuracy of the medical record coding processes at the MTFs is continually being addressed. Coding accuracy of inpatient records is approximately 90% to 95%. However, accuracy of coding outpatient and ambulatory surgery encounters is much less, 10% to 20%. Proper and accurate coding of medical records is essential for ensuring quality of care and to accurately document diagnosis and treatment procedures in the SIDRs and SADR's. Health Affairs (HA) has long since identified medical record coding as a deficiency requiring attention. HA/TMA has published both a DoD Directive for medical records retention and coding and a DoD Instruction on medical encounter and coding at MTFs. Realistic goals for medical records coding accuracy have been established and discussed with the Services' Surgeons General.

Additionally, the three Surgeons General are required to certify monthly data quality reports. In completing the quality reports, the MTFs are required to randomly select inpatient, outpatient, and

Management's Discussion and Analysis

ambulatory surgery encounters for review to determine coding accuracy and, then, reflect the results in the monthly quality reports. Furthermore, Health Affairs has, for several years, contracted with AdvanceMed to conduct independent audits of a random sample of inpatient, outpatient, and ambulatory surgery records at MTFs to verify coding accuracy. The results of these independent audits are shared with the Service Surgeons General.

To the extent we can minimize the element of human error, we can positively affect coding accuracy of medical records. Therefore, included in the new workload reporting system, Composite Health Care System II (CHCS II), is an enhanced provider coding capability. However, it will require several years to fully deploy the system to all our MTFs. In the interim, the Services are deploying a software application, Provider Graphical User Interface (P-GUI), which offers a provider coding capability until such time as CHCS II is fully deployed.

It is expected that deployment of P-GUI and, later, CHCS II will significantly improve medical record coding. However, improving/maintaining coding accuracy of medical records is an iterative process that requires continual attention. Therefore, HA/TMA are committed to continue monitoring of the coding accuracy of medical records, to include independent audits.

Completion of End-of-Month Purchased Care Data for Inclusion in Financial Statements

Claims payments for care provided in the civilian sector to Medicare-eligible beneficiaries is made by a managed care support contractor and its fiscal intermediary. Currently, there are no explicit provisions in these contracts requiring the managed care support contractors to provide, and certify to, incurred claims amounts for a particular time period. The MERHCF Board of Actuaries has recommended that such provisions be included in the contracts as a means to insure that all financial, actuarial, auditing, and management analyses are based on consistent and accurate data.

Claims are processed and paid on a daily basis through the last workday of the month. DFAS, in turn, is on a very short suspense to complete financial statements with footnotes and asks the purchased care financial activities, disbursements, accounts receivable, accounts payable, and undelivered orders, be provided by the 5th of the month. TMA has a particularly difficult time providing this information, especially the disbursements which must coincide with the information provided to the Department of the Treasury. We have discussed the possibility of reporting actual financial activities through the 25th of the month and then estimating activities for the final 5 or 6 days of the month. However, TMA is reluctant to use that suggestion for disbursements due to concerns the estimate will not equal figures reported to Treasury.

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care for the Fund's beneficiaries relies on data files provided by TMA to the Office of the Actuary (OOA). Because of the lack of a fully integrated financial management system to support the Defense Health System, certain data is provided to OOA from health care operational sources, rather than from the accounting and financial records of claims payment activity. As a result, inconsistencies were noted in the accumulation of the data utilized for the IBNR estimation process as compared with the Fund's financial records. It is suspected that the variance is due primarily to improperly defining the population supported by the MERHCF when retrieving claims data for the IBNR calculation. Corrective action has been taken to accurately identify the discrepancies and resolve the issue.

The requirements of the financial statement process, particularly reconciliation issues, such as those cited above, as well as problems associated with continually accelerated financial statement deadlines, are

Management's Discussion and Analysis

proving to be a difficult burden to TMA, as systems and personnel resources were established when these requirements did not exist.

DFAS representatives will visit TMA, Aurora, CO. in early FY 2005 and attempt to reach agreement on how best to resolve these issues.

Coast Guard Issues

Subsequent to the issuance of the FY 2003 MERHCF Financial Statements, two issues involving support to Coast Guard activities required the attention of the MERHCF Audit Committee. The first issue involved the Coast Guard notifying the DFAS on December 29, 2003, subsequent to the publication of the FY 2003 MERHCF financial statements, of a revised amount for the actuarial liability being transferred to the MERHCF financial statements—the revised liability (\$7.8 billion) was \$2.8 billion higher than the previously reported amount (\$5 billion). The Department's position, approved by the Defense Financial Auditing Service, Office of the Inspector General, was that since the change in estimate was not material to the MERHCF financial statements and would not adversely affect the conclusions drawn by a reasonable reader, no changes were made to the FY 2003 financial statements. Instead, the immaterial effects of the change in estimate were accounted for in the FY 2004 financial statements and disclosed in the footnotes. This position was coordinated with the Deputy Chief Financial Officer, Deputy Under Secretary of Defense Personnel and Readiness Program Integration, Deputy Assistant Secretary of Defense Health Budgets and Financial Policy, and the Director Defense Finance and Accounting Service.

The second issue associated with the Coast Guard involves determining the amount of funds to be provided by the MERHCF to the Coast Guard for care provided in their clinics to Medicare-eligible beneficiaries. Coast Guard representatives presented to the MERHCF Audit Committee an annual requirement of approximately \$2.5 million. This estimate was based on historic budget reports and average costs to patients seen in their clinics and prescribed medications from their pharmacies. The Committee members questioned the rationale of the assumptions and computations used to project the annual requirement. The Coast Guard was asked to have their Inspector General review and approve the cost estimate methodology and the funds request. Further, they were asked to submit a formal written request signed by a senior official in the Coast Guard once their methodology was reviewed and approved by their IG. At the close of FY 2004, the Coast Guard was still involved with their IG in obtaining approval of their methodology. The MERHCF Audit Committee will not approve the release of MERHCF funds to Coast Guard clinics until a formal written request is submitted by the Coast Guard indicating their IG approval.

Army Over-payment of Monthly Normal Cost Contribution

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

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

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

- The Military Services calculate their monthly normal cost contributions
 - o Military Services prepare monthly end-strength reports

Management's Discussion and Analysis

- Multiply monthly end-strength by the standard full-time (active duty) or part-time (Guard/Reserve) normal cost contribution rate provided by the Office of the Actuary (OOA)
- The Services provide the contribution information to the appropriate DFAS Center
- Each DFAS Center transfers the contribution to the MERHCF via the Intragovernmental Payment and Collection System (IPAC)

The DoD MERHCF Board of Actuaries approves all methods and assumptions used for determination of the normal cost contribution rates. OOA calculates the normal cost contribution rates each year based on an actuarial model that computes the amount needed to fund the current-year liability for a cohort of new entrants to the military. For FY 2003, the full-time rate was \$353, and the part-time rate was \$134. For FY 2004, the full-time rate was \$381, and the part-time rate was \$155.

On April 15, 2004, the Army verbally notified the MERHCF of a possible over-reporting of its personnel end-strength, resulting in a possible over-payment of the normal cost contributions to the Fund. At the time, the Army did not know the amount of the possible over-payment. The MERHCF disclosed information regarding this issue in Note 19A of MERHCF's Unaudited Financial Statements for the six months ended March 31, 2004.

Subsequently, the Army completed a schedule that compares actual payments made to payments calculated using its revised Army end-strength reports for active duty and ready reserve. The revisions resulted in calculated over-payments to the Fund of \$394.6 million and \$241.4 million in Fiscal Years 2003 and 2004, respectively.

For FY 2003 and FY 2004, the Army Reserve Budget Office calculated the MERHCF contribution using the monthly end-strength reports and the appropriate part-time rates. However, the Active Army Budget Office also calculated the MERHCF normal cost contribution for those same activated Reserves and made payments at the full-time rate from Active Army funds. The Active Army Budget Office made these over-payments for the activated Reserves from October 2002 to February 2004.

In May 2004, the DoD General Counsel provided an opinion that the refund should be made to FY 2003 funds and FY 2004 funds in the same amounts as over-paid from these years.

Over-payments by the Army to the Fund were verified by the Chairman of the MERHCF Audit Committee.

Review of the impact on the FY 2003 and FY 2004 MERHCF financial statements revealed that the Balance Sheet for FY 2003 and the quarterly Balance Sheets for FY 2004 would have changed by the amount of the over-payments. The Army over-payment of normal cost contributions and the resulting over-statement of revenues do not affect the ending Actuarial Liability balance, and the amount of the change is less than 1% of the total Actuarial Liability. Therefore, we concluded that the \$394.6 million change in FY 2003 and the \$241.4 million over-statement of revenues in FY 2004 interim financial statements was not material and did not adversely affect the conclusions drawn by a reasonable reader, and represented a change in the previous estimates of required Army contributions.

Since the change in estimate was not material to the MERHCF financial statements for any period and would not adversely affect the conclusions drawn by a reasonable reader, we did not make any changes to previously issued FY 2003 and FY 2004 financial statements. We did adjust the un-audited financial statements for the nine months ended June 30, 2004 by the \$394.6 million payable to Army, a \$241.4 million prepaid revenue and a reduction in revenues for \$636.0 million. The correction to the over-

Management's Discussion and Analysis

payment is the recognition of the liability to the Army when it becomes probable and measurable as per Statement of Federal Financial Accounting Standard No. 5. Over-payments in FY 2004 were credited to future FY 2004 contributions. Therefore, the MERHCF applied the FY 2004 over-payment to required FY 2004 Army contributions. All corrective actions were taken prior to September 30, 2004. Appropriate disclosure of the change in estimate was made in the 3rd quarter and year-end FY 2004 MERHCF financial statements and footnotes.

Legislative Proposals

The 2005 National Defense Authorization Act (NDAA), Section 725, directs that at the beginning of each fiscal year after September 30, 2005, the Treasury will pay into the Fund the normal cost contribution previously paid by the Services' MILPERS accounts. No impact is expected on the operation of the Fund as a result of this action. It appears that the Treasury will make one lump-sum normal cost contribution on behalf of the Services at the beginning of the fiscal year along with the accrued unfunded liability payment. Rather than the Services providing monthly payments into the Fund based on actual monthly personnel end-strengths, the Treasury will make one payment based on programmed/estimated end-strength. As has been the case with the monthly payments made by the Services, the Treasury payment will be computed using the actuarially developed per capita rates.

Limitations of the Financial Statements

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

Comparative Financial Data

To comply with DoD Financial Management Regulation Volume 6B, "Form and Content of the Department of Defense Audited Financial Statements," all of the MERHCF's principal statements include comparative data for FY 2003. Balances representing a 10 percent increase between fiscal years on any component of a line item are considered material and are discussed in the corresponding footnote.

* * * * *

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

PRINCIPAL STATEMENTS

Principal Statements

**Department of Defense
DoD Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30
(In Thousands)**

	<u>2004</u>	<u>2003</u>
ASSETS		
Intragovernmental:		
Fund Balances with Treasury (Note 3)	\$ 5,000	\$ 5,010
Investments (Note 4)	38,585,158	18,445,191
Total Intragovernmental Assets (Note 2)	\$ 38,590,158	\$ 18,450,201
Accounts Receivable (Note 5)	8,018	0
TOTAL ASSETS	<u>\$ 38,598,176</u>	<u>\$ 18,450,201</u>
LIABILITIES		
Accounts Payable (Note 6)	\$ 129,226	105,961
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Notes 5 & 8)	504,073,807	476,170,267
Other Liabilities (Notes 5 & 7)	491,344	254,912
TOTAL LIABILITIES	<u>\$ 504,694,377</u>	<u>\$ 476,531,140</u>
NET POSITION		
Cumulative Results of Operations	(466,096,201)	(458,080,939)
TOTAL NET POSITION	<u>\$ (466,096,201)</u>	<u>\$ (458,080,939)</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$ 38,598,176</u>	<u>\$ 18,450,201</u>

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2004</u>	<u>2003</u>
PROGRAM COSTS		
Intragovernmental Gross Costs	\$ 1,380,721	\$ 1,272,068
(Less: Intragovernmental Earned Revenue)	<u>(25,342,438)</u>	<u>(22,765,600)</u>
Intragovernmental Net Costs	\$ <u>(23,961,717)</u>	\$ <u>(21,493,532)</u>
Gross Costs With the Public	\$ 29,133,679	\$ 67,375,671
(Less: Earned Revenue from the Public)	<u>0</u>	<u>0</u>
Net Costs With the Public	\$ <u>29,133,679</u>	\$ <u>67,375,671</u>
Total Net Cost	\$ 5,171,962	\$ 45,882,139
Net Cost of Operations	\$ <u><u>5,171,962</u></u>	\$ <u><u>45,882,139</u></u>

Additional information included in Note 9.

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2004</u>	<u>2003</u>
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (458,080,939) \$	0
Other Financing Sources:		
Transfers-in/out without reimbursement	(2,843,300)	(412,198,800)
Net Cost of Operations	<u>5,171,962</u>	<u>45,882,139</u>
Ending Balances	<u>\$ (466,096,201) \$</u>	<u>(458,080,939)</u>

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2004</u>	<u>2003</u>
BUDGETARY RESOURCES		
Budget Authority:		
Appropriations received	\$ 25,100,279	\$ 22,765,600
Unobligated Balance		
Beginning of period	18,182,430	0
Total Budgetary Resources	\$ <u>43,282,709</u>	\$ <u>22,765,600</u>
 STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	\$ 5,196,769	\$ 4,583,170
Unobligated balance:		
Apportioned	206,625	31,679
Unobligated balance not available	37,879,315	18,150,751
Total Status of Budgetary Resources	\$ <u>43,282,709</u>	\$ <u>22,765,600</u>
 RELATIONSHIP OF OBLIGATIONS TO OUTLAYS		
Obligated Balance, Net - beginning of period	\$ 267,771	\$ 0
Undelivered Orders	\$ 132,833	\$ 161,810
Obligated Balance, Net - end of period:		
Accounts payable	\$ 129,225	\$ 105,961
Outlays:		
Disbursements	\$ 5,202,482	\$ 4,315,399
Less: Offsetting receipts	(25,342,438)	(22,765,600)
Total Outlays	\$ <u>(20,139,956)</u>	\$ <u>(18,450,201)</u>

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2004</u>	<u>2003</u>
RESOURCES USED TO FINANCE ACTIVITIES		
Budgetary Resources Obligated		
Obligations incurred	\$ 5,196,769	\$ 4,583,170
Less: Offsetting receipts	(25,342,438)	(22,765,600)
Transfers in/out without reimbursement	(2,843,300)	(412,198,800)
Total resources used to finance activities	\$ (22,988,969)	\$ (430,381,230)
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS		
Undelivered Orders	\$ 28,977	\$ (161,810)
Other	2,843,300	412,198,800
Total resources used to finance items not part of the net cost of operations	\$ 2,872,277	\$ 412,036,990
Total resources used to finance the net cost of operations	\$ (20,116,692)	\$ (18,344,240)
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD		
Total components Requiring or Generating Resources in Future Periods:	\$ 25,296,672	\$ 64,226,379
Total components of net cost of operations that will not require or generate resources:	(8,018)	0
Total components of net cost of operations that will not require or generate resources in the current period:	\$ 25,288,654	\$ 64,226,379
Net Cost of Operations	\$ 5,171,962	\$ 45,882,139

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

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

***NOTES
TO THE
PRINCIPAL STATEMENTS***

DoD MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND NOTES TO THE PRINCIPAL STATEMENTS FOR THE YEARS ENDED SEPTEMBER 30, 2004 AND 2003

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

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

These financial statements report the financial position and results of operations for the Fund, as required by the Chief Financial Officers (CFO) Act of 1990, expanded by the Government Management Reform Act (GMRA) of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the Trust Fund Accounting Division, Accounting Directorate, Defense Finance and Accounting Service (DFAS), in accordance with the requirements of Office of Management and Budget (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements," and accounting principles generally accepted in the United States of America. The Fund's financial statements are prepared by DFAS in addition to the financial reports, pursuant to OMB directives, which are used to monitor and control budgetary resources within the Fund.

More detailed explanations of these financial statement elements are discussed in applicable footnotes.

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

The asset accounts used to prepare the statements are categorized as either entity or non-entity assets, where applicable. Entity accounts consist of resources that the agency has the authority to use, or where management is legally obligated to use funds to meet entity obligations. Non-entity accounts are assets that are held by an entity but are not available for use in the operations of the entity.

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

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

D. Basis of Accounting. Under authority of the CFO Act of 1990, the Federal Accounting Standards Advisory Board (FASAB) was established to recommend Federal Accounting Standards to the Secretary of the Treasury, the Director of the OMB, the Director of the Office of Personnel Management and the Comptroller General; who are co-principals of the Joint Financial Management Improvement Program (JFMIP). The Statements of Federal Financial Accounting Standards (SFFAS) have been issued by the Director of the OMB and the Comptroller General, some of which have deferred effective dates.

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

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

Notes to the Principal Statements

- (B) FASAB Technical Bulletins and the following pronouncements, if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position.
- (C) AICPA Accounting Standards Executive Committee (ACSEC) Practice Bulletins, if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB.
- (D) Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government.

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance to the circumstance. When directed by OMB, through OMB Bulletin No. 01-09, generally accepted accounting principles in the United States of America serve as authoritative guidance for federal agencies in preparing reports that are addressed within OMB Bulletin No. 01-09.

E. Revenues and Other Financing Sources. Financing sources for the Fund are provided primarily through an annual unfunded actuarial liability payment from Treasury, monthly contributions from the Military Services and Uniformed Services (United States Coast Guard, the National Oceanic and Atmospheric Administration, and the United States Public Health Service), and interest earned on investments. The monthly contributions are calculated by multiplying the monthly per capita rates (full time and part time) provided by the DoD Office of the Actuary by the reported end strength for the most recently reported month. Contributions are recognized when due to the Fund.

F. Recognition of Expenses. For financial reporting purposes, the Fund recognizes benefit expenses in the period incurred.

G. Accounting for Intragovernmental Activities. The Fund purchases and redeems non-marketable market-based securities issued by the United States Treasury, Bureau of Public Debt. Non-marketable market-based securities include Treasury bills, notes, bonds, Treasury Inflation-Indexed Securities (TIPS), and overnight certificates. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. Treasury notes have maturities of at least one-year, but not more than ten years, and are purchased at a discount or premium. Treasury bonds are long-term securities with maturity terms of ten years or more and are purchased at either a discount or premium. TIPS are floating-rate instruments designed to protect against inflation and the principal amount is indexed to the consumer price index (CPI) by adjusting the current CPI to the CPI at issuance; as inflation increases, so does the principal amount and the coupon.

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

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

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

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

I. Accounts Receivable. As presented in the Balance Sheets, accounts receivable includes accounts, claims, and refunds receivable from the public. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the Fund.

J. Investments in U.S. Department of Treasury Securities. Intergovernmental securities represent non-marketable market-based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. These securities are redeemable at market value exclusively through the Federal Investment Branch of Treasury. These non-marketable market-based Treasury securities are not traded on any securities exchange, but mirror the prices of marketable securities with similar terms. Investments are recorded at amortized cost on the Balance Sheet. Material disclosures are provided at Note 4.

Notes to the Principal Statements

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

K. Comparative Data. Certain FY 2003 amounts have been reclassified to conform to the FY 2004 presentation.

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

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

NOTE 2. ASSETS

(\$ In Thousands)	<u>FY2004</u>			<u>FY2003</u>
	Nonentity	Entity	Total	Total
1. Intragovernmental Assets:				
a Fund Balance With Treasury	\$0	\$5,000	\$5,000	\$5,010
b Investments	<u>\$0</u>	<u>\$38,585,158</u>	<u>\$38,585,158</u>	<u>\$18,445,191</u>
c Total Intragovernmental Assets	<u>\$0</u>	<u>\$38,590,158</u>	<u>\$38,590,158</u>	<u>\$18,450,201</u>
2. Nonfederal Assets				
a Accounts Receivable	\$0	<u>\$8,018</u>	<u>\$8,018</u>	\$0
b Total Nonfederal Assets	<u>\$0</u>	<u>\$8,018</u>	<u>\$8,018</u>	<u>\$0</u>
3. Total Assets	<u>\$0</u>	<u>\$38,598,176</u>	<u>\$38,598,176</u>	<u>\$18,450,201</u>
4. Other Information:				

Asset accounts are categorized either as entity or nonentity. Entity accounts consist of resources that the agency has the authority to use, or when management is legally obligated to use funds to meet entity obligations. Nonentity assets are assets held by an entity, but not available for use in the operation of the entity. The Investments balances of \$38,585,158 and \$18,445,191 for 2004 and 2003, respectively, represent investments in non-marketable, market-based Treasury securities. The U.S. Department of Treasury allows the Fund to be fully invested.

Accounts Receivable amounts represent refunds due for purchase care resulting from retrospective review of claims paid. These amounts are typically applied against future payments to healthcare providers.

Notes to the Principal Statements

NOTE 3. FUND BALANCES WITH TREASURY

(\$ In Thousands)	FY 2004	FY 2003
1. Fund Balances:	Entity <u>Assets</u>	Entity <u>Assets</u>
Fund Type		
a. Trust Funds	<u>\$5,000</u>	<u>\$5,010</u>
b. Total	<u>\$5,000</u>	<u>\$5,010</u>
2. Fund Balance Per Treasury Versus Agency:		
a. Fund Balance Per Treasury	\$5,000	<u>\$5,010</u>
b. Fund Balance Per Medicare-Eligible Retiree Health Care Fund	<u>\$5,000</u>	<u>\$5,010</u>
c. Reconciling Amount	<u>\$ 0</u>	<u>0</u>

FBWT is generally maintained at approximately \$5,000 thousand to ensure that sufficient funds are available to cover estimated daily disbursements with the remaining funds invested in non-marketable market-based securities.

NOTE 4. INVESTMENTS

(\$ In Thousands)	FY 2004				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
1. Intragovernmental Securities:					
a. Non-Marketable, Market Based	\$38,576,057	Effective Interest	\$ (233,059)	\$38,342,998	\$38,971,708
b. Subtotal	<u>\$38,576,057</u>		<u>\$ (233,059)</u>	<u>\$38,342,998</u>	<u>\$38,971,708</u>
c. Accrued Interest	242,160			242,160	242,160
Total	<u>\$38,818,217</u>		<u>\$(233,059)</u>	<u>\$38,585,158</u>	<u>\$39,213,868</u>
Total Intragovernmental:	<u>\$38,818,217</u>		<u>\$(233,059)</u>	<u>\$38,585,158</u>	<u>\$39,213,868</u>
				FY 2003	
1. Intra-governmental Securities:					
a. Non-Marketable, Market Based				\$18,445,191	\$18,445,191
b. Subtotal				\$18,445,191	\$18,445,191
c. Accrued Interest				<u>0</u>	<u>0</u>
Total				<u>\$18,445,191</u>	<u>\$18,445,191</u>

Line 1.a., Investments. Investments at amortized cost increased from \$18,445,191 in FY 2003 to \$38,342,998 in FY 2004 as a result of a cumulative positive cash flow. The investments listed above are presented at amortized cost and market value (for information purposes) as of September 30, 2004 and 2003. Listed below are the par values of the U.S. Treasury Securities referenced above.

Notes to the Principal Statements

<u>Par Value</u>	<u>FY 2004</u>	<u>Par Value</u>	<u>FY 2003</u>
Bonds	\$ 2,000,000	Bonds	\$ 0
Notes	23,384,102	Notes	0
Overnights	2,205,928	Overnights	18,445,191
TIPS	<u>8,273,660</u>	TIPS	<u>0</u>
Total	<u>\$35,863,690</u>	Total	<u>\$18,445,191</u>

Contributions to the Medicare-Eligible Retiree Health Care Fund (Fund) are calculated so the Fund will be maintained on an actuarially sound basis. This means that there will be sufficient funds to make all covered payments on behalf of eligible beneficiaries each year, and that the Fund balance is projected to eventually equal the actuarial liability, i.e., all unfunded liabilities are liquidated. In order to accomplish this, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded) and any emerging actuarial gains or losses. The initial unfunded liability of the program is being amortized over a 50-year period. All subsequent gains and losses experienced by the system are amortized over a 30-year period. Methods and assumptions used to compute actuarial costs and liabilities, and to amortize the initial unfunded liability as well as all actuarial gains and losses, must be approved by the Department of Defense Medicare-Eligible Retiree Health Care Board of Actuaries, as required by Chapter 56 of Title 10, United States Code. The Board is a Federal Advisory Committee appointed by the Secretary of Defense.

Notes to the Principal Statements

NOTE 5. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES

FY 2004			
(\$ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Accounts Payable	\$0	\$0	\$0
Total Intragovernmental Liabilities	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
2. Nonfederal Liabilities:			
a. Accounts Payable (Note 6)	\$129,226	\$0	\$129,226
b. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 8)	\$38,085,939	\$465,987,868	\$504,073,807
c. Other Liabilities (Note 7)	\$ 0	\$ 491,344	\$ 491,344
Total Nonfederal Liabilities	<u>\$38,215,165</u>	<u>\$466,479,212</u>	<u>\$504,694,377</u>
3. Total Liabilities:	<u>\$38,215,165</u>	<u>\$466,479,212</u>	<u>\$504,694,377</u>
FY 2003			
(\$ In Thousands)	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	\$0	\$0	\$0
Total Intragovernmental Liabilities	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
2. Nonfederal Liabilities:			
a. Accounts Payable (Note 6)	\$105,961	\$0	\$105,961
b. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 8)	\$18,182,430	\$457,987,837	\$476,170,267
c. Other Liabilities (Note 7)	\$0	\$254,912	\$254,912
Total Nonfederal Liabilities	<u>\$18,288,391</u>	<u>\$458,242,749</u>	<u>\$476,531,140</u>
3. Total Liabilities:	<u>\$18,288,391</u>	<u>\$458,242,749</u>	<u>\$476,531,140</u>

Line 2b, Military Retirement Benefits and Other Employment-Related Actuarial Liability consists of Actuarial Liability of \$504,073,807. The amount displayed in the "Covered by Budgetary Resources" column is the sum of the balances of USSGL account 4450, Unapportioned Authority of \$37,879,315, USSGL account 4510, and Apportionments of \$206,624.

Notes to the Principal Statements

NOTE 6. ACCOUNTS PAYABLE

(\$ In Thousands)	FY 2004			FY 2003
	Accounts Payable	(Interest, Penalties, and Administrative Fees)	Total	Total
1. Intra-governmental Payables	\$0	N/A	\$0	\$0
2. Non-Federal Payables (to the Public)	<u>\$129,226</u>	<u>\$0</u>	<u>\$129,226</u>	<u>\$105,961</u>
3. Total Accounts Payable	<u>\$129,226</u>	<u>\$0</u>	<u>\$129,226</u>	<u>\$105,961</u>

Current Non Federal Accounts Payable increased from \$105,961 in Fiscal Year 2003 to \$129,226 in Fiscal Year 2004. The \$23,265 increase includes an increase of \$21,228 in claims payable and an increase of \$6,238 in amounts due for administration costs and adjustments, net of decreases in pharmacy and other claims. The net increase is primarily attributable to new contracts being let in 2004 with different payment terms.

NOTE 7. OTHER LIABILITIES

(\$ In Thousands)	FY 2004	FY 2003
1. Intragovernmental:		
a. Other Liabilities	<u>\$0</u>	<u>\$0</u>
Total Intragovernmental Other Liabilities	<u>\$0</u>	<u>\$0</u>
2. Nonfederal:		
a. Accrued Funded Payroll and Benefits	<u>\$491,344</u>	<u>\$254,912</u>
b. Total Nonfederal Other Liabilities	<u>\$491,344</u>	<u>\$254,912</u>
3. Total Other Liabilities	<u>\$491,344</u>	<u>\$254,912</u>
4. Other Information Pertaining to Other Liabilities:		

Line 2a represents the actuarially-determined estimate of Incurred But Not Reported (IBNR) claims liabilities for covered services rendered prior to September 30, 2004 and 2003. The liability increase of \$236,432 represents an increase of \$61,000 based on a review of assumptions used in prior year's IBNR estimate, increased margin in assumptions used in the calculation in order to increase accuracy of IBNR estimate; an increase of \$88,000 based on inclusion for FY 2004 of additional components, including associated admin costs, allowance for adverse experience, and mail order drugs; and a \$87,432 increase on the level of claims due to medical inflation and increased utilization.

Notes to the Principal Statements

NOTE 8. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT-RELATED ACTUARIAL LIABILITIES

	FY 2004			
(\$ In Thousands)	Actuarial Present Value of Projected <u>Plan Benefits</u>	Assumed Interest <u>Rate (%)</u>	(Less: Assets Available to <u>Pay Benefits)</u>	Unfunded Actuarial <u>Liability</u>
<u>Major Program Activities</u>				
Medicare-Eligible Retiree Benefits	<u>\$504,073,807</u>	6.25%	\$ (38,085,939)	<u>\$465,987,868</u>
Total:	<u>\$504,073,807</u>		\$ (38,085,939)	<u>\$465,987,868</u>

	FY 2003			
(\$ In Thousands)	Actuarial Present Value of Projected <u>Plan Benefits</u>	Assumed Interest <u>Rate (%)</u>	(Less: Assets Available to <u>Pay Benefits)</u>	Unfunded Actuarial <u>Liability</u>
<u>Major Program Activities</u>				
Medicare-Eligible Retiree Benefits	<u>\$476,170,267</u>	6.25%	\$ (18,182,430)	<u>\$457,987,837</u>
Total:	<u>\$476,170,267</u>		\$ (18,182,430)	<u>\$457,987,837</u>

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

FY 2004

Actuarial Cost Method Used: Aggregate Entry-Age Normal Method.

Assumptions: Interest Rate: 6.25%

Medical Trend:

Medicare Inpatient:	5.1% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Outpatient:	6.8% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Prescriptions (Direct Care):	9.7% from FY03 to FY04, ultimate rate of 6.25% in 2028.
Medicare Prescriptions (Purchased Care):	14.6% from FY03 to FY04, ultimate rate of 6.25% in 2028.

The medical cost-trend rate assumptions have a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the actuarial present value of projected plan benefits as of September 30, 2004, by 28%, or approximately \$141,326,193.

Market Value of Investments in Market-Based and Marketable Securities (\$ in thousands): \$38,971,708

Change in MERHCF Actuarial Liability

a. Actuarial Liability as of September 30, 2003 (all uniformed services Medicare)	\$476,170,267
b. Expected Normal Cost for FY 2004	10,187,814
c. Expected Benefit Payments for FY 2004	(5,911,780)
d. Interest Cost for FY 2004	29,892,243
e. Actuarial (gains)/losses due to other factors	(1,430,258)
f. Actuarial (gains)/losses due to changes in trend assumptions	<u>(4,834,479)</u>
g. Actuarial Liability as of September 30, 2004 (all uniformed services Medicare)	<u>\$504,073,807</u>
h. Change in Actuarial Liability	<u>\$ 27,903,540</u>

Notes to the Principal Statements

Each year the Actuarial Liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of \$34,168,277 in the Actuarial Liability was expected during FY 2004 (line b plus line c plus line d). The September 30, 2004, Actuarial Liability includes changes due to new assumptions and actuarial experience. The gain due to new medical trend assumptions is -\$4,834,479 (line f). The gains and losses due to other factors (net -\$1,430,258, line e) include new population data, other actuarial experience being different from assumed, and actuarial assumption changes other than the change in trend assumptions.

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2004 liability (\$ in thousands) is:

.DoD	\$493,716,990
Coast Guard	9,263,717
Public Health Service	1,024,851
NOAA	68,249
Total	<u>\$504,073,807</u>

FY 2004 Service contributions to the MERHCF (\$ in thousands) were:

DoD	\$7,918,756
Coast Guard	192,332
Public Health Service	27,391
NOAA	1,210
Total	<u>\$8,139,689</u>

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

Projected revenues into the Medicare Eligible Retiree Health Care Fund, authorized by Chapter 56 of Title 10, United States Code, come from three sources: interest earnings on Fund assets, monthly Uniformed Services contributions, and annual contributions from the Treasury Department. The monthly contributions are determined as a per-capita amount (approved by the DoD Medicare Eligible Retiree Health Care Board of Actuaries) times end strength. The contribution from Treasury is paid into the Fund at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed prior to October 1, 2002, as well as the amortization of actuarial gains and losses that have arisen since then. The Board determines Treasury's contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

The actuarial liability reported above does not include \$491,344 and \$254,912 in incurred but not reported liabilities as of September 30, 2004 and 2003, respectively. These liabilities are disclosed in Note 5, Liabilities Not Covered and Covered by Budgetary Resources, and Note 7, Other Liabilities.

Other Information Pertaining to Military Retirement Benefits and Other Employment-Related Actuarial Liabilities – Comparable Information for FY 2003:

Actuarial Cost Method Used: Aggregate Entry-Age Normal Method.

Assumptions: Interest Rate: 6.25%

Medical Trend:

Medicare Inpatient: 4.0% from 2002 to 2003, ultimate rate of 6.25% in 2027.

Medicare Outpatient: 5.5% from 2002 to 2003, ultimate rate of 6.25% in 2027.

Medical Prescriptions (Direct Care): 10.08% from 2002 to 2003, ultimate rate of 6.25% in 2027.

Medical Prescriptions (Purchased Care): 15.54% from 2002 to 2003, ultimate rate of 6.25% in 2027.

Market Value of Investments in Market-Based and Marketable Securities (\$ in thousands): \$18,445,191

Notes to the Principal Statements

Change in MERHCF Actuarial Liability – FY 2003

(\$ in Thousands)

a. Actuarial Liability as of September 30, 2002 (DoD Medicare)	\$405,553,000
b. Transferred Actuarial Liability as of September 30, 2002 (non-DoD uniformed services Medicare)	<u>\$ 6,645,800</u>
c. Actuarial Liability as of September 30, 2002 (all uniformed services Medicare)	\$412,198,800
d. Expected Normal Cost	\$ 7,923,175
e. Expected Benefit Payments	\$ (5,584,055)
f. Interest Cost	\$ 25,834,415
g. Estimated actuarial (gains)/losses on non-DoD uniformed services liabilities	\$ 2,347,317
h. Actuarial (gains)/losses due to other factors	\$ 25,680,437
i. Actuarial (gains)/losses due to changes in trend assumptions	<u>\$ 7,770,178</u>
j. Actuarial Liability as of September 30, 2003 (all uniformed services Medicare)	<u>\$476,170,267</u>
k. Change in Actuarial Liability	<u>\$ 63,971,467</u>

Each year the Accrued Liability is expected to increase with normal cost, decrease with benefit payments, and increase with the interest cost. In the absence of actuarial gains and losses or benefit changes, an increase of \$28.2 billion in the Accrued Liability was expected during FY 2003 (line d minus line e plus line f). The September 30, 2003, Accrued Liability includes changes due to new assumptions and actuarial experience. The loss due to new medical trend assumptions is \$7.8 billion (line i). The gains and losses are on the calculation of the non-DoD Uniformed Services liability (\$2.3 billion, line g), new population data, other actuarial experience being different from assumed, and other actuarial assumption changes (net \$25.7 billion, line h).

Prior to the establishment of the Medicare-Eligible Retiree Health Care Fund effective October 1, 2002, the actuarial liabilities for the covered benefits for the uniformed services were recorded in the financial statements of the participating employers, the DoD, the United States Coast Guard, the United States Public Health Service, and the National Oceanic and Atmospheric Administration (NOAA). During fiscal year 2003, the actuarial liabilities as of September 30, 2002 for the eligible beneficiaries of the Fund were transferred to the Fund by the participating employers, as follows:

DoD	<u>\$405,553,000</u>
Coast Guard	\$ 5,000,000
Public Health Service	\$ 1,547,000
NOAA	<u>\$ 98,800</u>
	<u>\$ 6,645,800</u>

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout for the September 30, 2003 liability (\$ in thousands) was as follows:

DoD	\$466,537,416
Coast Guard	\$ 8,613,156
Public Health Service	\$ 954,225
NOAA	<u>\$ 65,470</u>
TOTAL	<u>\$476,170,267</u>

Notes to the Principal Statements

FY 2003 Uniformed Services contributions to the MERHCF (\$ in thousands) was as follows:

DoD	\$ 8,001,525
Coast Guard	\$ 172,728
Public Health Service	\$ 25,144
NOAA	<u>\$ 1,157</u>
Total	<u>\$ 8,200,554</u>

NOTE 9. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

	<u>FY 2004</u>	<u>FY 2003</u>
Earned Revenue for Program Costs: (\$ In Thousands)		
1. Service Contributions	\$ 8,139,689	\$ 8,200,554
2. Annual Unfunded Liability Payment	16,260,000	14,369,000
3. Interest on Investments	<u>942,749</u>	<u>196,046</u>
Total	<u>\$25,342,438</u>	<u>\$22,765,600</u>

Line 1, above reflects the total contributions from the Military Services plus the US Public Health Service, US Coast Guard, and National Oceanic Atmospheric Administration.

Service contributions decreased from \$8,200,554 in Fiscal Year 2003 to \$8,139,689 in Fiscal Year 2004. The FY 2004 service contributions decreased by \$60,847 principally due to adjustments made to previously reported 2003 and 2004 end-strength information by the Army. The effects of the change in reported Army end-strength information were \$394,650 related to FY 2003 and \$241,425 related to FY 2004 for a total of \$636,075.

U.S. Treasury Annual Unfunded Liability Payment increased from \$14,369,000 in FY 2003 to \$16,260,000 in FY 2004 based on the computation furnished by the Board of Actuaries.

Interest on investments increased from \$196,046 in Fiscal Year 2003 to \$942,749 in Fiscal Year 2004 due to the increased size of the Fund and the purchase of long term notes. Only overnight securities were bought in FY03.

Intragovernmental Earned Revenue increased from \$22,765,600 in Fiscal Year 2003 to \$25,342,438 in Fiscal Year 2004 due to the increased U.S. Treasury Annual Unfunded Liability Payment based on the computation furnished by the Board of Actuaries, and due to an increase in interest on investments.

Gross Costs with the Public decreased from \$67,375,671 in FY 2003 to \$29,133,679 FY 2004 due to the increase of the Incurred but Not Recorded (IBNR) liabilities of \$236,432, the increase in payables/payments to the daily Purchased Care Operations and Maintenance of \$695,733, the increase in Accounts Receivable of \$8,018 that decreased expenses, and the change in estimate of the actuarial liability that resulted in a decrease of \$38,241,992 to expenses.

In December 2003, the estimate of the actuarial liabilities as of October 1, 2002 for the covered benefits for the US Coast Guard participants in the Fund was revised from \$5,000,000 to \$7,843,300. The increase in the transfer from the US Coast Guard to the Fund of \$2,843,300 thousand is recorded in the Fund's FY 2004 financial statements as a decrease to Gross Costs with the Public.

Notes to the Principal Statements

NOTE 9A: BENEFIT PROGRAM EXPENSE

	<u>FY 2004</u>	<u>FY 2003</u>
1. Service Cost	\$10,187,814	\$ 7,923,175
2. Period Interest on the Benefit Liability	29,892,243	25,834,415
3. Prior (or past) Service Cost	0	0
4. Period Actuarial (Gains) or Losses	(1,430,258)	28,027,754
5. Gains/Losses Due to Changes in Medical Inflation Rate Assumption	(4,834,479)	7,770,178
6. Total Benefit Program Expense	<u>\$33,815,320</u>	<u>\$69,555,522</u>

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

The benefit program expense (BPE) includes: normal (or service) cost, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments). BPE for FY 2004 was less than BPE for FY 2003 primarily because of two factors. The first is new medical trend assumptions adopted each year by the DoD Medicare Eligible Retiree Health Care Board of Actuaries (Board) relative to the prior year's valuation; the new assumptions increased liabilities in FY 2003 by \$7,770,178 and decreased liabilities in FY 2004 by \$4,834,479, as reflected in the "gains/losses due to changes in medical inflation rate assumption" line in the BPE note. The second factor is the "period actuarial gains or losses" component of BPE, which in FY 2003 included significant demographic assumption changes related to a new methodology that projects a substantial increase in the amount of reservists who qualify for retirement. All other actuarial gains and losses are also included in this line of BPE, but a substantial portion of the \$28,027,754 increase in liabilities in FY 2003 is due to the new reserve methodology. For FY 2004, the net amount of the "period actuarial gains or losses" was a \$1,430,258 decrease in liabilities.

The service cost components and interest cost components of the BPE are generally expected to increase each year. However, actuarial gains and losses always occur, and it is impossible to predict the effect of possible new assumptions in future years, the effect of gains and losses due to actuarial experience in future years, and the effect of possible benefit changes in future years, hence the BPE can vary by substantial amounts from year to year.

NOTE 10: OTHER DISCLOSURES

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

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2004 and 2003 includes approximately \$81 billion (16% of total) and \$76 billion (16% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the DoD-managed 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, 2004, include approximately \$3.9 billion and \$1.4 billion, respectively, and for the year ended September 30, 2003, include approximately \$3.5 billion and \$1.3 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have patient-level accounting systems and therefore cannot report the costs of an individual patient's care.

* * * * *

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

REQUIRED
SUPPLEMENTARY
INFORMATION

Required Supplementary Information

DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND
INTRAGOVERNMENTAL TRANSACTIONS
FOR THE YEAR ENDED SEPTEMBER 30, 2004

(\$ In Thousands)

Schedule, Part A Intragovernmental Asset Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index	Fund Balance with Treasury	Investments
Department of the Treasury	20	<u>\$5,000</u>	<u>\$38,585,158</u>
Total		<u>\$5,000</u>	<u>\$38,585,158</u>

Schedule, Part C DoD Intragovernmental Revenues and Related Costs with Other Federal Agencies	Treasury Index	Earned Revenue
Department of the Treasury	20	\$ 942,749
Department of Commerce	13	\$ 1,210
Department of Health and Human Services	75	\$ 27,391
Homeland Security	70	\$ 192,332
Department of the Navy	17	\$ 2,814,997
Department of the Army	21	\$ 3,002,417
Department of the Air Force	57	\$ 2,101,342
Other Defense Organizations	97	<u>\$16,260,000</u>
Total		<u>\$25,342,438</u>

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

OTHER ACCOMPANYING
INFORMATION

Other Accompanying Information

DoD
MEDICARE-ELIGIBLE RETIREE HEALTH CARE FUND
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2004 AND 2003

(\$ In Thousands)

	<u>September 30, 2004</u>	<u>September 30, 2003</u>
1. Present value of future benefits		
a. Current inactive	\$301,185,333	\$289,244,138
b. Active duty personnel ¹	\$154,360,137	\$142,321,865
c. Non-retired reservists	<u>\$129,930,550</u>	<u>\$121,128,929</u>
d. Total	\$585,476,020	\$552,694,932
2. Present value of future normal cost contributions	<u>\$(81,402,213)</u>	<u>\$(76,524,665)</u>
3. Actuarial accrued liability	\$504,073,807	\$476,170,267
4. Assets ²	<u>\$(38,085,939)</u>	<u>\$(18,182,430)</u>
5. Unfunded accrued liability ³	<u>\$465,987,868</u>	<u>\$457,987,837</u>

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

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

³ The unfunded accrued liability does not include \$491,344 and \$254,912 for the actuarially determined estimate of Incurred But Not Reported (IBNR) claims for covered services rendered as of September 30, 2004 and 2003, respectively, as disclosed in Note 5 (Liabilities Not Covered and Covered By Budgetary Resources) and Note 7 (Other Liabilities) to the financial statements.

DoD
MEDICARE-ELIGIBLE RETIREE
HEALTH CARE FUND

INDEPENDENT AUDITORS’
REPORTS



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

November 8, 2004

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 FY 2004 DoD
Medicare-Eligible Retiree Health Care Fund Financial Statements
(Report No. D-2005-019)

The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires Federal agency Inspectors General appointed under the Inspector General Act of 1978, as amended, to audit the financial statements of the Federal agency or determine that “an independent external auditor” should conduct such audits. For FY 2004, we determined that Deloitte & Touche LLP (Deloitte & Touche) should perform the audit of the DoD Medicare-Eligible Retiree Health Care Fund (the Fund) financial statements.

Qualified Audit Opinion. We concur with the Deloitte & Touche qualified opinion dated October 27, 2004. Deloitte & Touche opined that, except for the direct care cost component, the FY 2004 financial statements and accompanying notes present fairly, in all material respects, the Fund’s financial position as of September 30, 2004, and 2003.

Deloitte & Touche qualified its opinion because it was unable to obtain patient-level information in support of the allocated costs of direct care provided by the DoD-managed military treatment facilities. Additionally, Deloitte & Touche could not relate the direct care costs (being allocated) to specific appropriations or find sufficient evidence that controls exist to ensure the completeness, validity, recording, and cutoff of costs reported. Deloitte & Touche also could not satisfy itself as to the direct care component of the reported amount of the actuarial liability of retiree benefits using other auditing procedures.

Report on Internal Controls. Deloitte & Touche concurrently issued a report on the internal control over financial reporting and compliance with laws and regulations as part of the audit of the Fund’s FY 2004 Financial Statements. We concur with the Deloitte & Touche internal control report.

Financial reporting. Deloitte & Touche reported 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, 1994, with respect to consistent internal control over data entry, transaction processing, and reporting. Deloitte & Touche reported material weaknesses with respect to direct care costs as well as the following reportable conditions.

- Inconsistencies existed between the purchase care claims data (provided by health care operational sources) that was "incurred but not reported" and the Fund's financial records. Specifically, the actuarial determination of the Fund's liability for incurred but not reported claims for purchased care for the Fund's participants and beneficiaries was based on data files provided by the Tricare Management Activity to the Office of the Actuary (the Actuary). Because of the lack of a fully integrated financial management system to support the Defense Health System, certain data were provided to the Actuary from health care operational sources, rather than from the accounting and financial records of the claims payment activity.
- Controls over electronic data processing at the computer processing locations that support the Fund did not result in reliable processing of financial information within the related business cycles. The audit disclosed deficiencies in the design or operation of controls related to electronic data processing security policies, procedures, configurations, business continuity arrangements, and system software support activities that could adversely affect the Fund's ability to record, process, and summarize its financial information and protect sensitive data in accordance with all appropriate requirements.

Compliance with laws and regulations. Deloitte & Touche performed tests that disclosed noncompliance with certain provisions of laws and regulations. Specifically, the noncompliance concerns the following.

- The Fund's data were processed on electronic data processing systems that were not compliant with OMB Circular A-127.
- Although the general ledger system was compliant with the U.S. Standard General Ledger, it was not transaction based or derived from an integrated financial management 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 was not in full compliance with OMB Circulars A-123, "Management Accountability and Control," June 21, 1995, and A-127 "Financial Management Systems," and the Federal Financial Management Integrity Act.

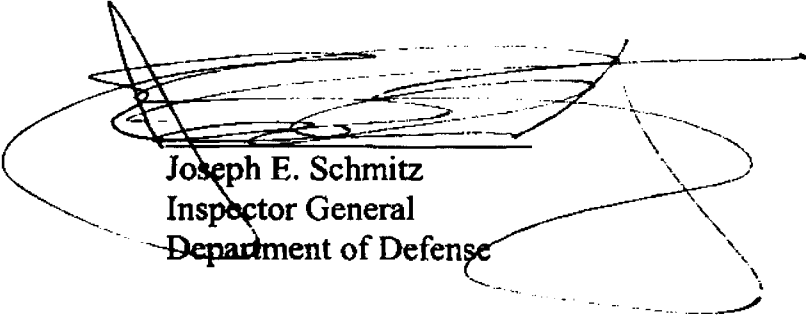
Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000, requires that test results be reported if noncompliance with certain laws and regulations occurs. 38

"A regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." –Constitution of the United States, Article I, Section 9


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

To fulfill our oversight responsibilities for the contract with Deloitte & Touche, we complied with Government Auditing Standards, OMB Bulletin No. 01-02, and the "GAO/PCIE Financial Audit Manual," July 2004. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; met with partners and staff members of Deloitte & Touche; 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. Deloitte & Touche formed their qualified opinion on the basic financial statements taken as a whole. Because the required supplementary information is not part of the basic financial statements, auditing standards do not require Deloitte & Touche to audit that information. Deloitte & Touche did not audit it or express an opinion on it.

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



Joseph E. Schmitz
Inspector General
Department of Defense



Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing Service



Deloitte & Touche LLP
Suite 800
1750 Tysons Boulevard
McLean, VA 22102-4219
USA

Tel: 703-251-1000
Fax: 703-251-3400
www.us.deloitte.com

INDEPENDENT AUDITORS' REPORT

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of September 30, 2004 and 2003, and the related statements of net cost, changes in net position, budgetary resources and financing for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended. Those standards 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain patient-level information in support of allocated costs of direct care provided by the DoD-managed Military Treatment Facilities (MTFs). As discussed in Note 10 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2004 and 2003 includes approximately \$81 billion (16% of total) and \$76 billion (16% 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, 2004, include approximately \$3.9 billion and \$1.4 billion, respectively, and for the year ended September 30, 2003, include approximately \$3.5 billion and \$1.3 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have patient-level accounting systems and therefore cannot report the costs of an individual patient's care. While activity-based costing techniques have been used to apply total program costs to individuals, 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, the primary basis of allocation. Additionally, 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

To the Inspector General of the
Department of Defense

cutoff of the costs reported. We were not able to satisfy ourselves as to the direct-care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

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, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Medicare-Eligible Retiree Health Care Fund as of September 30, 2004 and 2003, and its net cost, changes in net position, budgetary resources and financing for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 27, 2004 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying required supplementary information included in the sections entitled "Management's Discussion & Analysis," "Required Supplementary Information," and "Other Accompanying Information," are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America, OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, as amended, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and we do not express an opinion on it.

Deloitte & Touche LLP

October 27, 2004



Deloitte & Touche LLP
Suite 800
1750 Tysons Boulevard
McLean, VA 22102-4219
USA

Tel: 703-251-1000
Fax: 703-251-3400
www.us.deloitte.com

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

To the Inspector General of the
Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Medicare-Eligible Retiree Health Care Fund (the "Fund") as of and for the year ended September 30, 2004, and have issued our report thereon dated October 27, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, as amended.

Internal Control over Financial Reporting

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

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

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

To the Inspector General of the
Department of Defense

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

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

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

1. The actuarial liability for Medicare-eligible retiree benefits as of October 1, 2003 and September 30, 2004 includes approximately \$76 billion (16% of total) and \$81 billion (16% 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, 2004, include approximately \$3.9 billion and \$1.4 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 the extracted data, the MTFs do not have patient – level accounting systems and therefore cannot report the costs of an individual patient’s care. While activity-based costing techniques have been used to apply total program costs to individuals, 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, the primary basis of allocation. Additionally, 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. The procedures in place to determine the allocated costs of direct care provided by the MTFs are not adequate to ensure presentation of the direct-care costs in conformity with accounting principles generally accepted in the United States of America.

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 liability of the Fund, as well to the determination of amounts contributed by the Services for their active duty participants. These costs are incurred in the multitude of Medical Treatment Facilities (MTFs) managed by the Services in various locations.

To the Inspector General of the
Department of Defense

The Fund makes prospective payments to the Services based on estimates of these direct care costs in order to support the operations of the MTFs on an ongoing basis.

The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the Services that have not been audited. The MTF – level data is based upon budget execution processes, rather than accrual - based accounting. There is insufficient evidence that appropriate cut-off of accounting activity occurred at the MTF - level. During 2004, the Fund had not yet established 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, during 2004, the Fund performed the first reconciliation review 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, based on 2003 data. The results of the reconciliation will be used in the determination of prospective budget requirements for 2005 and 2006 to support the MTFs' operations.

3. The actuarial determination of the Fund's liability for incurred but not reported (IBNR) claims for purchased care for the Fund's participants and beneficiaries relies on data files provided by the TRICARE Management Activity (TMA) of the Defense Health System to the Office of the Actuary (OOA). Because of the lack of a fully integrated financial management system to support the Defense Health System, certain data is provided to OOA from health care operational sources, rather than from the accounting and financial records of claims payment activity. As a result, inconsistencies were noted in the accumulation of the data utilized for the IBNR estimation process as compared with the Fund's financial records. We noted that insufficient management level control and reconciliation processes exist to ensure that the data files provided to the OOA are consistent with the information represented to be included therein, particularly with respect to the activity for Medicare – eligible beneficiaries under age 65.
4. Certain general electronic data processing (EDP) controls at certain computer processing locations used by the Fund do not support the reliable processing of financial information within the related business cycles. Our review disclosed deficiencies in the design or operation of controls related to EDP security policies, procedures, and configurations, business continuity arrangements, and system software support activities that could adversely affect the Fund's ability to record, process, and summarize its financial information and protect sensitive data in accordance with all appropriate requirements.

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

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the

To the Inspector General of the
Department of Defense

Fund's internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. Of the reportable conditions noted above, the observations with respect to direct – care costs discussed at items 1. and 2. are, in our judgment, material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we perform tests of its compliance with certain provisions of laws and regulations, contracts, and agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, as amended. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, as amended, and that are described below.

1. The EDP systems utilized by the Fund are not compliant with OMB Circular A-127, *Financial Management Systems*. The Circular requires that federal financial systems provide complete, reliable, consistent and useful information on a timely basis. Our procedures identified deficiencies in the design and operation of certain EDP controls that may increase the risk of unauthorized access, modification, or loss of sensitive programs and data which could compromise the ability of the systems to provide reliable financial data.
2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger (SGL), it is not transaction based or derived from an integrated financial system.
3. The financial management systems utilized by the Fund do not comply substantially with the requirements for Federal financial management systems set forth in OMB Circular A – 130, in that they do not fully, efficiently and effectively support the Fund's efforts to:
 - ◇ Prepare financial statements and other required financial and budget reports using information generated by the financial management systems;
 - ◇ Provide reliable and timely financial information for managing current operations;
 - ◇ Account for assets reliably, so that they can be properly protected from loss, misappropriation, or destruction; and
 - ◇ Do all of the above in a way that is consistent with Federal accounting standards and the Standard General Ledger

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

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

To the Inspector General of the
Department of Defense

Distribution

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

Deloitte & Touche LLP

October 27, 2004