FISCAL YEAR 2004

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

October 22, 2004

DoD
MILITARY RETIREMENT FUND
FISCAL YEAR 2004
AUDITED FINANCIAL
STATEMENTS

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As of September 30, 2004

Description of the Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund. Within DoD, the Office of the Under Secretary of Defense for Personnel and Readiness has as one of its missions to oversee the operations of the Military Retirement System, including the accounting, investing, and reporting of the Military Retirement Fund (the Fund). The Fund was established by Public Law (P.L.) 98-94 (currently Chapter 74 of Title 10, U.S.C.). In FY 2004, the Fund paid out approximately $37 billion in benefits to military retirees and survivors. In addition to staff members of the reporting entity and the DoD Office of the Actuary, hundreds of individuals employed by a DoD contractor in Cleveland, Ohio, along with a small government oversight organization are involved in making the benefit payments. However, the discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost, annual payments from Treasury to amortize the unfunded liability, and investment income. During Fiscal Year (FY) 2004, the Fund received approximately $14 billion in normal cost payments, $18 billion Treasury payment, and $10 billion in investment income, net of premium/discount amortization. No accounts of the Fund have been excluded from the Fund's financial statements.

Summary

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

The system is a funded, noncontributory defined benefit plan that includes nondisability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs, and special compensation programs for certain disabled retirees. The Service Secretaries may approve immediate nondisability retired pay at any age with credit of at least 20 years of active duty service. Reserve retirees must be at least 60 years old and have at least 20 qualified years of service before retired pay commences. There is no vesting before retirement.

Significant Changes During FY 2004

The most significant change in FY 2004 was the implementation of the concurrent receipt provision in the FY 2004 National Defense Authorization Act (NDAA) (P.L. 108-136) (hereafter referred to as NDAA 2004 Concurrent Receipt). Through December 31, 2003, retired pay earned from DoD for military service was offset by any payment received from the Department of Veterans Affairs (VA) for a VA-rated disability. NDAA 2004 Concurrent Receipt provides a phase-out of the offset to military retired pay due to receipt of VA disability compensation for members whose combined disability rating is 50% or greater. Members retired under disability provisions must have at least 20 years of service. P.L. 108-136 also expands eligibility under the Combat Related Special Compensation program to include qualified retirees at any combined percentage rating for certain combat-related disabilities compensated by the VA. Certain retirees who meet the 50% criteria specified by the statute will have their offset phased out over a ten year period beginning in 2004 and ending in 2013. During calendar year 2004, the maximum monthly amount that a VA offset to retired pay is reduced is $750 for a qualified retiree with 100% VA disability rating, grading down to $100 for a member with a 50% rating. Some retirees who receive other special payments, such as Combat Related Special Compensation, may not be subject to the ten year offset phase-out.

*** NDAA 2004 Concurrent Receipt paid an additional 49,000 retirees approximately $.58 billion in FY 2004. The new Concurrent Receipt legislation added $73.3 billion to the actuarial liability of the Fund.

Other changes during FY 2004 included: (1) updating retiree VA offset factors which reflect the increasing VA offsets to the DoD military retired pay for new and continuing retirees; (2) updating the Career Status Bonus (CSB) take-rate parameter which measures the percentage of service members first entering the armed services after August 1, 1986 who elect to receive the $30,000 Career Status Bonus; and (3) the introduction of the new January 1, 2004, pay table which continues the annual military pay adjustments to bridge the gap between military and civilian pay.

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 (TIPS), which are indexed for inflation. 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.

Non Disability Retirement From Active Service

There are three distinct nondisability benefit formulas related to three populations within the military retirement system. *Final pay*: Military personnel who first became members of a uniformed service before September 8, 1980, have retired pay equal to final basic pay times a multiplier. The multiplier is equal to 2.5 percent times years of service and is limited to 75 percent. *High-3:* If the retiree first became a member of a uniformed service on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of final basic pay. *Redux:* Members who first became a member of a uniformed service on or after August 1, 1986 and who elect to receive the Career Status Bonus outlined below are subject to a multiplier penalty if they retire with less than 30 years of service; however, at age 62, their retired pay is recomputed without the penalty. They also have retired pay computed on a base of the average of their highest 36 months of basic pay. The FY 2000 National Defense Authorization Act provided that Redux members have a choice of (a) receiving High-3 benefits or (b) staying under the Redux formula and receiving a lump-sum $30,000 payment, called a Career Status Bonus. Members make their election during the fifteenth year of service. Those who choose the lump-sum payment must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the $30,000.

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

As of September 30, 2004, there were approximately 1.38 million nondisability retirees from active duty receiving retired pay. In FY 2004, nondisability retirees were paid approximately $29.93 billion.

*** These figures do not include members who are NDAA 2004 Concurrent Receipt eligible.

Disability Retirement

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

In disability retirement, the member receives retired pay equal to the larger of (1) the accrued nondisability retirement benefit regardless of eligibility to retire or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75 percent of base pay. Only the excess of (1) over (2) is subject to federal income taxes if the member had service on or before September 24, 1975. If not a member of a uniformed service on September 24, 1975, disability retired pay is tax-exempt only for those disabilities that are combat or hazardous duty related. Base pay is equal to final basic pay if the retiree first became a member of a uniformed service before September 8, 1980; otherwise, base pay is equal to the average of the highest 36 months of basic pay.

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

As of September 30, 2004, there were approximately 87,000 disability retirees receiving retired pay. In FY 2004, disability retirees were paid approximately $1.14 billion.

*** These figures do not include members who are NDAA 2004 Concurrent Receipt eligible.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service, the last six of which must be in a reserve component. However, reserve retired pay is not payable until age 60. Retired pay is computed as base pay times 2.5 percent times years of service. If the reservist was first a member of a uniformed service before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on active duty for the 36 months immediately preceding age 60. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, a point is awarded for a day of service or drill attendance, with 15 points being awarded for a year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation. Non-active duty points are limited in any year to no more than 90. Lesser limitations have applied in the past.

As of September 30, 2004, there were approximately 271,000 reserve retirees receiving retired pay. In FY 2004, reserve retirees were paid approximately $3.01 billion.

*** These figures do not include members who are NDAA 2004 Concurrent Receipt eligible.

Survivor Benefits

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

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

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

The SBP survivor annuity is initially 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than $300 or more than the member's full retired pay. If the member elects the Career Status Bonus with REDUX and is subject to a penalty for service under 30 years in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty.

The spouse's annuity is considered a two-tier benefit because, at age 62, the annuity is reduced to 35 percent of the base amount. Prior to the enactment of the two-tier benefit, survivor annuities were offset to reflect the availability of Social Security. The offset computation was based solely on military earnings. SBP participants and active and reserve personnel with at least 20 years of service on October 1, 1985, were grandfathered so that their survivors are given the higher of the two annuities at age 62.

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

Beginning in April 1992, retirees with base amounts equal to full retired pay could also elect a supplemental annuity for their surviving spouses after age 62 in increments of 5 percent of the base amount, up to a maximum 20 percent of the base amount. The cost of this supplemental SBP benefit is borne by retirees in the form of a reduction in retired pay over and above the usual 6.5 percent reduction for SBP.

Members who die on active duty are assumed to have retired with full disability on the day they died and to have elected full SBP coverage for spouses, former spouses, and/or children. Insurable interest elections may be applicable in some cases. These benefits have been improved and expanded over the history of the program. SBP annuities are reduced by any VA survivor benefits (Dependency and Indemnity Compensation (DIC)) and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities and premiums are annually increased with cost-of-living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the Career Status Bonus dies before age 62, the survivor is subject to partial COLAs and his/her annuity is increased on what would have been the member's 62nd birthday to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter. For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. A second set of optional reductions, under the Reserve Component Survivor Benefit Plan (RCSBP), provides annuities to survivors of reservists who die before age 60, but after attaining 20 years of qualified service. The added cost of this coverage is borne completely by reservists through deductions from retired pay and survivor annuities. A paid-up provision eliminating the reduction in retired pay for premiums for SBP and RSFPP coverage will be effective October 1, 2008, for participants age 70 or older whose retired pay has been reduced for 30 years or more.

As of September 30, 2004, there were approximately 274,000 survivors of military members receiving annuity payments. In FY 2004, survivors were paid approximately $2.16 billion.

Temporary Early Retirement Authority (TERA)

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

As of September 30, 2004, there were 55,000 TERA retirees receiving retired pay. In FY 2004, TERA retirees were paid approximately $725 million.

*** These figures do not include members who are NDAA 2004 Concurrent Receipt eligible.

Cost-of-Living Increase

All nondisability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. Cost-of-living adjustments (COLAs) are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January. The "full" COLA effective December 1 is computed by calculating the percentage increase in the average CPI over the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W) and is rounded to the nearest tenth of one percent. The benefits of retirees (and their survivors) are increased annually with the full COLA, except for those first entering the armed services on or after August 1, 1986, who elect the $30,000 Career Status Bonus. Their benefits are increased annually with a partial COLA equal to the full COLA minus 1 percent. A one-time restoral is given to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, retired pay (or the survivor benefit if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with Department of Veterans Affairs (VA) Benefits

The VA provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of or in combination with DoD retired pay, but through December 31, 2003 were not fully additive. Since VA benefits are exempt from federal income taxes, it is often to the advantage of a member to elect them. Through 2003, retired pay earned from DoD for military service was offset by any VA payment received for a VA-rated disability. The Concurrent Receipt provision of the FY 2004 NDAA that became effective

January 1, 2004, has further integrated the relationship between the DoD and VA.

VA benefits also overlap survivor benefits through the Dependency and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefit are returned to the survivor.

Interrelationship with Other Federal Service

For retirement purposes, no credit is given for other federal service, except where cross-service transferability is allowed. Military service is generally creditable toward the federal civilian retirement systems if military retired pay is waived.

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is based and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative, for comparative purposes, of salary levels in the public and private sectors. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) cash or in-kind allowances (the housing allowance, which varies by grade, location, and dependency status, and a subsistence allowance) and (3) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 69 percent of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 67 percent of RMC. Consequently, a 20-year retiree may be entitled to 50 percent of basic pay, but only 34 percent of RMC. For a 30-year retiree, the corresponding entitlements are 75 percent of basic pay, but only 55 percent of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

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

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

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

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

Performance Measures

During FY 2004, the Fund made monthly disbursements to approximately two million retirees and annuitants.

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

a. September 30, 2004 = .36840
b. September 30, 2003 = .38989
c. September 30, 2002 = .37376
d. September 30, 2001 = .34476
e. September 30, 2000 = .35085
f. September 30, 1999 = .35142
g. September 30, 1998 = .34567
h. September 30, 1997 = .32200
i. September 30, 1996 = .31314
j. September 30, 1995 = .30375

The yield of the Fund on September 30, 2004, was 5.19%.

Changes for FY 2005

The effects of the increase in the normal cost percentage due to the Concurrent Receipt benefits included in the FY 2004 NDAA are to be fully paid by Treasury annually beginning on October 1, 2004. This amount for FY 2005 is $1.5 billion.

The FY 2005 NDAA increases SBP benefits by phasing out the age-62 reduction in survivor benefits (from 55% to 35%) by March 2008, as well as including a one-year Open Season for participation in SBP beginning on October 1, 2005. These new benefits are expected to increase the actuarial liability by $21.1 billion. This legislation also accelerates the phase-in of some of the Concurrent Receipt benefits, which is expected to lead to a $0.6 billion increase in the actuarial liability.

Projected Long-term Health of the Fund

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

The table below presents a projection of contributions to and disbursements from the Fund. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-year projection period.

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

Fiscal Year	Basic Payroll	Normal Cost Payments		Amortization of Unfunded Liability		Investment Income		Fund Disbursements		Fund Balance End of Year	
2005	$50.1	$14.8	(0.294)	$21.4	(0.426)	$12.4	(0.246)	$38.4	(0.766)	$198.2	(3.954)
2006	$51.0	$15.0	(0.293)	$22.2	(0.435)	$13.0	(0.255)	$39.6	(0.777)	$208.7	(4.094)
2007	$52.2	$15.3	(0.293)	$23.0	(0.441)	$13.7	(0.262)	$41.0	(0.786)	$219.6	(4.210)
2008	$53.5	$15.6	(0.292)	$23.9	(0.446)	$14.4	(0.269)	$42.5	(0.795)	$231.0	(4.318)
2009	$54.9	$16.0	(0.292)	$24.7	(0.450)	$15.1	(0.275)	$44.1	(0.804)	$242.7	(4.418)
2010	$56.5	$16.5	(0.291)	$25.7	(0.454)	$15.9	(0.281)	$45.6	(0.807)	$255.1	(4.513)
2011	$58.2	$17.0	(0.291)	$26.6	(0.458)	$16.7	(0.286)	$47.0	(0.807)	$268.4	(4.611)
2012	$60.0	$17.5	(0.291)	$27.6	(0.461)	$17.5	(0.292)	$48.2	(0.804)	$282.8	(4.714)
2013	$61.8	$18.0	(0.291)	$28.7	(0.464)	$18.5	(0.299)	$49.7	(0.804)	$298.3	(4.823)
2014	$64.0	$18.6	(0.291)	$29.7	(0.465)	$19.5	(0.304)	$51.2	(0.800)	$314.9	(4.920)
2015	$66.3	$19.3	(0.291)	$30.9	(0.466)	$20.6	(0.310)	$52.7	(0.795)	$332.9	(5.023)
2016	$68.7	$19.9	(0.291)	$32.0	(0.466)	$21.7	(0.317)	$54.2	(0.790)	$352.4	(5.133)
2017	$71.1	$20.6	(0.291)	$33.2	(0.467)	$23.0	(0.324)	$55.8	(0.785)	$373.5	(5.254)
2018	$73.6	$21.4	(0.290)	$34.5	(0.469)	$24.4	(0.331)	$57.5	(0.781)	$396.2	(5.386)
2019	$76.1	$22.1	(0.290)	$35.8	(0.470)	$25.8	(0.339)	$59.2	(0.778)	$420.7	(5.527)
2020	$78.7	$22.9	(0.290)	$37.1	(0.471)	$27.4	(0.348)	$61.0	(0.775)	$447.1	(5.678)
2021	$81.5	$23.7	(0.290)	$38.5	(0.472)	$29.1	(0.357)	$62.8	(0.771)	$475.6	(5.836)
2022	$84.4	$24.5	(0.290)	$39.9	(0.473)	$31.0	(0.367)	$64.7	(0.766)	$506.3	(5.999)
2023	$87.4	$25.4	(0.290)	$43.3	(0.495)	$33.1	(0.378)	$66.6	(0.761)	$541.5	(6.193)

Core Performance Measures

No operating costs are calculated for the Fund.

Expected Problems

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

Expected Changes Between the Expected and Actual Investment Rate of Return

Due to the currently increasing trend in interest rates, the increasing deficit, the volatility in the markets with regard to energy prices, and the current state of international conflict, along with the newly passed tax cuts, one might expect the U.S. budget deficit to increase. This will necessitate increased borrowing by the U.S. Government for the foreseeable future and therefore there may be a greater opportunity to purchase treasury market securities at higher rates of interest. A redistribution of the funds portfolio toward TIPS-type investments might serve as a hedge against any future inflation impact and could increase the profitability of the fund over time.

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the Military Retirement Fund in accordance with the 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 Military Retirement Fund 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.

Improper Payments and Information Act

The Department conducts various types of prepayment and postpayment reviews for military retirement payments. One example is that all payments more than $9,000 made to retirees and more than $5,500 made to annuitants are reviewed. Another example is a monthly review of the retired military pay file for similar Social Security numbers, which helps minimize duplicate payments.

The Department projected $33.9 million of improper payments (underpayments and overpayments) for the Military Retirement Fund in FY 2004. This represents an error rate of 0.1% of the $33.6 billion in payments made to military retirees during FY 2004.

DoD MILITARY RETIREMENT FUND

PRINCIPAL STATEMENTS

Principal Statements

Department of Defense
DoD Military Retirement Fund
BALANCE SHEETS
As of September 30
(In Thousands)

		2004		2003
ASSETS				
Intragovernmental:				
Fund Balances with Treasury (Note 3)	$	20,677	$	25,198
Investments (Note 4)		187,962,462		182,568,848
Total Intragovernmental Assets (Note 2)	$	187,983,139	$	182,594,046
Accounts Receivable (Note 5)		25,257		14,736
TOTAL ASSETS	$	188,008,396	$	182,608,782
LIABILITIES				
Intragovernmental:				
Other Liabilities (Notes 6 & 7)	$	905	$	669
Total Intragovernmental Liabilities	$	905	$	669
Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 6 & 9)		834,582,098		736,061,601
Other Liabilities (Notes 6, 7 & 8)		3,120,454		2,963,217
TOTAL LIABILITIES	$	837,703,457	$	739,025,487
NET POSITION				
Cumulative Results of Operations		(649,695,061)		(556,416,705)
TOTAL NET POSITION	$	(649,695,061)	$	(556,416,705)
TOTAL LIABILITIES AND NET POSITION	$	188,008,396	$	182,608,782

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF NET COST
For the Years Ended September 30
(In Thousands)

		2004		2003
PROGRAM COSTS				
(Less: Intragovernmental Earned Revenue) (Note 10)	$	(42,384,504)	$	(41,645,876)
Intragovernmental Net Costs	$	(42,384,504)	$	(41,645,876)
Gross Costs With the Public (Note 10)		135,662,860		44,545,886
Net Costs With the Public	$	135,662,860	$	44,545,886
Total Net Cost	$	93,278,356	$	2,900,010
Net Cost of Operations	$	93,278,356	$	2,900,010

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30
(In Thousands)

	2004	2003
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	$ (556,416,705)	$ (553,516,695)
Net Cost of Operations	93,278,356	2,900,010
Ending Balances	$ (649,695,061)	$ (556,416,705)

The accompanying notes are an integral part of these statements.

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

		2004		2003
BUDGETARY RESOURCES				
Budget Authority:				
Appropriations received	**$**	42,256,826	**$**	42,155,447
Unobligated Balance:				
Beginning of period		176,028,930		169,269,176
Total Budgetary Resources	$	218,285,756	$	211,424,623
STATUS OF BUDGETARY RESOURCES				
Obligations incurred:				
Direct	$	37,152,632	$	35,395,693
Unobligated balance:				
Exempt from apportionment		181,133,124		176,028,930
Total Status of Budgetary Resources	$	218,285,756	$	211,424,623
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS				
Obligated Balance, Net - beginning of period	$	2,963,018	$	3,135,082
Obligated Balance, Net - end of period:				
Accounts payable	$	3,120,239	$	2,963,018
Outlays:				
Disbursements	$	36,995,411	$	35,567,756
Less: Offsetting receipts		(18,189,000)		(17,928,000)
Total Outlays	$	18,806,411	$	17,639,756

The accompanying notes are an integral part of these statements.

DoD Military Retirement Fund
STATEMENTS OF FINANCING
For the Years Ended September 30
(In Thousands)

		2004		2003
RESOURCES USED TO FINANCE ACTIVITES				
Budgetary Resources Obligated				
Obligations incurred	$	37,152,632	$	35,395,693
Less: Offsetting receipts		(18,189,000)		(17,928,000)
Total resources used to finance activities	$	18,963,632	$	17,467,693
RESOURCES USED TO FINANCE ITEMS NOT PART OF THE NET COST OF OPERATIONS				
Total resources used to finance the net cost of operations	$	18,963,632	$	17,467,693
COMPONENTS OF THE NET COST OF OPERATIONS THAT WILL NOT REQUIRE OR GENERATE RESOURCES IN THE CURRENT PERIOD				
Components Requiring or Generating Resources in Future Periods:				
Other	$	98,520,513	$	9,146,222
Components not Requiring or Generating Resources (Note 11):				
Trust Fund Exchange Revenue (Note 11)		(24,195,504)		(23,717,875)
Other		(10,285)		3,970
Total components of net cost of operations that will not require or generate resources in the current period	$	74,314,724	$	(14,567,683)
Net Cost of Operations	$	93,278,356	$	2,900,010

Additional information included in Note 11.

The accompanying notes are an integral part of these statements.

Principal Statements

DoD MILITARY RETIREMENT FUND

FOOTNOTES TO THE PRINCIPAL STATEMENTS

Footnotes ____

NOTES TO THE DOD MILITARY RETIREMENT FUND 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) Military Retirement Fund was authorized by Public Law (PL) 98-94 for the accumulation of funds to finance the liabilities of the DoD under military retirement and survivor benefit programs.

These financial statements have been prepared to report the financial position and results of operations of the Military Retirement 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 the Office of Management and Budget (OMB) Bulletin No. 01-09, as amended, “Form and Content of Agency Financial Statements,” and accounting principles generally accepted in the United States of America. The Military Retirement Fund financial statements are prepared by the Military Retirement Fund in addition to the financial reports required pursuant to OMB directives that are used to monitor and control the Military Retirement Fund’s use of budgetary resources.

A more detailed explanation of these financial statement elements is discussed in the applicable footnote.

B. Mission of the Reporting Entity. The mission of the DoD Military Retirement Fund is to accumulate funds in order to finance on an actuarially sound basis the liabilities of the DoD under military retirement and survivor benefit programs.

The asset accounts used to prepare the statements are categorized as either entity or nonentity 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. Nonentity 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 Military Retirement Fund is a pension program established in Fiscal Year (FY) 1984 by PL 98-94, for the payment of annuities and pensions to retired military personnel and their survivors. The DoD Retirement Board of Actuaries determines the contributions made to the Military Retirement Fund. The DoD contribution is a percentage of basic pay. The Department of Treasury contribution is the annual unfunded amortization payment. Excess funds from the contributions are invested and accrued interest revenue is used to cover future liabilities of the Fund.

D. Basis of Accounting. Under the 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 Office of Management and Budget (OMB) and the Comptroller General, 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 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 Statements 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) Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations plus AICPA and Financial Accounting Standards Board (FASB) pronouncements if made applicable to Federal governmental entities by a FASAB Statement or Interpretation; (B) FASAB Technical Bulletins and the following pronouncements if specifically made applicable to Federal governmental entities by the AICPA and cleared by the FASAB: AICPA Industry Audit and Accounting Guides and AICPA Statement 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; and (D) Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government.

In the absence of a pronouncement covered by Federal GAAP or another source of established accounting principles, the auditor of a federal government entity may consider other accounting literature, depending on its relevance in the circumstances. 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 the OMB Bulletin No. 01-09.

E. Revenues and Other Financing Sources. Financing sources for the Military Retirement Fund are provided primarily through monthly Military Service contributions as a percentage of base pay, an annual unfunded liability payment from the U.S. Department of Treasury, and interest earned on investments. 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 Military Retirement Fund purchases and redeems non-marketable market based securities issued by the U.S. Department of Treasury, Bureau of Public Debt. Non-marketable market based securities include Treasury bills, notes, bonds, Treasury Inflation-Indexed Securities (TIPS), and over-night certificates. Treasury bills are short-term securities with maturity of one year or less and are purchased at a discount. Treasury notes have a maturity of at least one-year, but not more than ten, 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.

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 Military Retirement Fund's financial resources are maintained in U.S. Department of Treasury Accounts. DFAS Arlington processes all fund receipts and adjustments. DFAS-Arlington prepares monthly reports, which provide information to the U.S. Department of Treasury, by appropriation, on transfers, deposits, and collections received. The U.S. Department of Treasury then records this information to the appropriation Fund Balance with Treasury (FBWT) account maintained in the U.S. Department of Treasury system. Differences between the Military Retirement Fund's recorded balance in the FBWT account and the U.S. Department of 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. Government Securities. Intra-governmental 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 U.S. Department of Treasury, Bureau of Public Debt. 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 Sheets. Material disclosures are provided at Note 4.

K. Contingencies and Other Liabilities. Contingencies occur when DoD Military Retired Pay is offset by Department of Veterans Affairs (DVA) payments. DoD entitlements are payable to the exact date of death and DVA entitlements end in the month preceding death. The contingency becomes payable by DoD to cover retiree benefits not paid by DVA during the month of death.

L. Net Position. Changes in Net Position reflect changes in net cost of operations.

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

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

O. Actuarial Information. The DoD Military Retirement 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 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)	**FY 2004**			**FY 2003**
	Nonentity	Entity	Total	Total
1. Intragovernmental Assets:				
a Fund Balance With Treasury	$0	$20,677	$20,677	$25,198
b Investments	$0	$187,962,462	$187,962,462	$182,568,848
c Total Intragovernmental Assets	$0	$187,983,139	$187,983,139	$182,594,046
2. Nonfederal Assets				
a Accounts Receivable	$905	$24,352	$25,257	$14,736
b Total Nonfederal Assets	$905	$24,352	$25,257	$14,736
3. Total Assets	$905	$188,007,491	$188,008,396	$182,608,782

4. Line 2.b, Accounts Receivable of $905 represents "Penalties, Fines, and Administration Fees Receivable (USSGL 1360)," net of the "Allowance for Loss on Penalties, Fines, and Administration Fees (USSGL 1369)," which will be collected on behalf of U.S. Department of Treasury. This amount is also reflected in Note 6 and 7 as a custodial liability of $905.

NOTE 3. FUND BALANCE WITH TREASURY:

($ In Thousands)	**FY 2004**	**FY 2003**
1. Fund Balances:	Entity Assets	Entity Assets
Fund Type		
a. Trust Funds	$20,677	$25,198
b. Total	$20,677	$25,198
2. Fund Balance Per Treasury Versus Agency:		
a. Fund Balance Per Treasury	$20,677	$25,198
b. Fund Balance Per Military Retirement Fund	$20,677	$25,198
c. Reconciling Amount	$ 0	$ 0

Fund Balance with Treasury (FBWT) decreased from $25,198 in FY 2003 to $20,677 in FY 2004. The FBWT is maintained to ensure that sufficient funds are available to cover estimated disbursements for the last business day of the fiscal year.

Footnotes

NOTE 4. INVESTMENTS:

($ In Thousands)

	FY 2004				
	Cost	Amortization Method	Amortized (Premium)/ Discount	Investments Net	Market Value Disclosure
1. Intra-governmental Securities:					
a. Non-Marketable, Market Based	$199,372,589	Effective Interest	$ (15,139,903)	$184,232,686	$195,469,245
b. Subtotal	$199,372,589		$ (15,139,903)	$184,232,686	$195,469,245
c. Accrued Interest	3,729,776			3,729,776	3,729,776
Total	$203,102,365		$ (15,139,903)	$187,962,462	$199,199,021
Total Intra-governmental:	$203,102,365		$(15,139,903)	$187,962,462	$199,199.021

	FY 2003	
1. Intra-governmental Securities:		
	Investments Net	Market Value Disclosure
a. Non-Marketable, Market Based	$178,965,689	$194,400,568
b. Subtotal	$178,965,689	$194,400,568
c. Accrued Interest	3,603,159	3,603,159
Total	$182,568,848	$198,003,727

Investments at amortized cost increased from $182,568,848 in FY 2003 to $187,962,462 in FY 2004 because of cumulative positive cash flow. The cumulative positive cash flow occurred due to Earned Revenue for Program Costs being greater than Benefit Outlays.

The investments listed above are presented at amortized cost and market value as of September 30, 2004 and 2003. Listed below is par value of the U.S. Treasury Securities referenced above.

	FY 2004		FY 2003
Bonds	$ 64,897,911	Bonds	$ 65,344,785
Notes	$ 79,875,820	Notes	$ 52,354,778
TIPS	$ 16,547,320	TIPS	$ -
Nite	$ 15,959,284	Nite	$ 54,662,780
Total	$177,280,335	Total	$ 172,362,343

Contributions to the Military Retirement Fund (Fund) are calculated so as to maintain the Fund on an actuarially sound basis. This means that there will be sufficient funds to make all benefit payments to eligible recipients 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 Retirement Board of Actuaries, as required by Chapter 74 of Title 10, United States Code. The Board is a Federal Advisory Committee appointed by the President.

NOTE 5. ACCOUNTS RECEIVABLE:

($ In Thousands)	FY 2004			FY 2003
	Gross Amount Due	(Allowance for Estimated Uncollectibles)	Net Amount Due	Net Amount Due
1. Entity Receivables:				
With the Public	$30,421	$ (5,164)	$25,257	$14,736

The General Reserve Method, under which a reserve is based on age of debts and bad debt experience, is used as stated in Volume 4, Chapter 3, Annex 1 (3) of the DoD Financial Management Regulation to calculate an allowance percentage.

Accounts Receivable increased from $14,736 in FY 2003 to $25,257 in FY 2004 because of reconciliations performed between the source reports for debt and accounts receivable and the department level accounting system (STARS). The source reports come from multiple sources (Defense Debt Management System and the Retired Pay office). Upon review of the STARS data, it was discovered that corrections were required to ensure the correct accounts receivable balances were posted to the Fund's accounts. After the reconciliation, the Accounts Receivable as of September 30, 2003 would have been $17,905. In addition, during FY 2003, consolidation of Military Retirement Trust Fund reporting processes occurred. The process improvements from consolidated operations standardized the reporting of accounts receivable data for both retirees and annuitants.

In addition, interest, penalties and fees are assessed in Defense Debt Management System on delinquent accounts receivable and included in accounts receivable. The fees relate to collection costs and may also relate to costs of separate tracking. Treasury receives all interest, penalties and fees collected so there are additional tracking requirements within that process. Previously, the accounts receivable portion of interest, penalties and fees was only updated yearly. The Fund now updates the amount monthly. The increase in interest, penalties and fees relates to the reconciliation process described above. Within that reconciliation, additional Fund receivables and the associated interest, penalties and fees were identified.

NOTE 6. LIABILITIES NOT COVERED AND COVERED BY BUDGETARY RESOURCES:

($ In Thousands)	FY 2004 Covered by Budgetary Resources	FY 2004 Not Covered by Budgetary Resources	FY 2004 Total
1. Intragovernmental Liabilities:			
a. Other	$0	$905	$905
Total Intragovernmental Liabilities	$0	$905	$905
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 9)	$181,133,124	$653,448,974	$834,582,098
b. Other	$3,120,240	$214	$3,120,454
Total Nonfederal Liabilities	$184,253,364	$653,449,188	$837,702,552
3. Total Liabilities:	$184,253,364	$653,450,093	$837,703,457

($ In Thousands)	FY 2003 Covered by Budgetary Resources	FY 2003 Not Covered by Budgetary Resources	FY 2003 Total
1. Intragovernmental Liabilities:			
a. Other	$0	$669	$669
Total Intragovernmental Liabilities	$0	$669	$669
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities (Note 9)	$176,028,930	$560,032,671	$736,061,601
b. Other	$2,963,018	$199	$2,963,217
Total Nonfederal Liabilities	$178,991,948	$560,032,870	$739,024,818
3. Total Liabilities:	$178,991,948	$560,033,539	$739,025,487

For FY 2004 and FY 2003, Line 1.a., Other Intra-governmental liability of $905 and $669, respectively, represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2. to the U.S. Department of Treasury. The nonentity asset replaces the budgetary resource to cover the liability. The change in other intra-governmental liabilities and other non-federal liabilities are explained in further details in Note 7.

NOTE 7 . OTHER LIABILITIES:

($ In Thousands)	FY 2004	FY 2003
1. Intragovernmental:		
a. Other Liabilities	$905	$669
Total Intragovernmental Other Liabilities	$905	$669
2. Nonfederal: (Note 8)		
a. Accrued Funded Payroll and Benefits	$3,120,240	$2,963,018
b. Other Liabilities	$214	$199
c. Total Nonfederal Other Liabilities	$3,120,454	$2,963,217
3. Total Other Liabilities	$3,121,359	$2,963,886

4. Other Information Pertaining to Other Liabilities:

Line 1.A, Other Intra-governmental Liabilities of $905 for FY 2004 represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2 to the U.S. Department of Treasury.

As a result of the improvement process for Accounts Receivable," Penalties, Fines, and Administrative Fees Receivable" increased from $669 in FY 2003 to $905 in FY 2004. As referenced above, the "Penalties, Fines, and Administrative Fees Receivable" are collected on behalf of the U.S. Department of Treasury, therefore, as the receivable amount increases so does the custodial liability.

NOTE 8. COMMITMENTS AND CONTINGENCIES:

($ In Thousands)

Disclosures Related to Commitments and Contingencies:

	FY 2004	FY 2003
1. Other Liabilities Covered by Budgetary Resources:		
With the Public:	$3,120,240	$2,963,018
Total:	$3,120,240	$2,963,018
2. Other Liabilities Not Covered by Budgetary Resources:		
With the Public		
Death Payment Contingencies	$214	$199
Total:	$214	$199
Other Liabilities Total:	$3,120,454	$2,963,217

Other Information:

Other Liabilities of $3,120,240 for FY 2004 and $2,963,018 for FY 2003 represent accrued entitlement benefits for military retirees and survivors. Death Payment Contingencies of $214 for FY 2004 and $199 for FY 2003 resulted from a DoD responsibility to pay entitlements to exact date of death while Department of Veterans Affairs (DVA) entitlements end in the month preceding death. The contingency amount becomes payable by DoD to cover the retiree benefits not paid by DVA during the month of death.

NOTE 9. MILITARY RETIREMENT BENEFITS AND OTHER EMPLOYMENT RELATED ACTUARIAL LIABILITIES:

($ In Thousands)

Major Program Activities	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Actuarial Liability
FY 2004				
Military Retirement Pensions	$834,582,098	6.25%	$ (181,133,124)	$653,448,974
Total:	$834,582,098		$ (181,133,124)	$653,448,974
FY 2003				
Total:	$736,061,601	6.25%	$ (176,028,930)	$560,032,671

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

   a. Actuarial Cost Method Used: Aggregate entry-age normal method.

   b. The Military Retirement System is a single-employer, defined benefit plan. Administrative costs of the Fund are not ascertainable. Projected revenues into the Fund, authorized by PL 98-94, come from three sources: Interest earnings on Fund assets, monthly DoD contributions, and annual contributions from the Treasury Department. The monthly DoD contributions are determined as a percentage (approved by the DoD Retirement Board of Actuaries) of basic pay. 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, 1984, as well as the amortization of actuarial gains and losses that have arisen since then. Beginning with FY 2005, Treasury will also make an annual contribution to the Fund that represents the normal cost amount for the new concurrent receipt provisions of the 2004 National Defense Authorization Act. The Board determines Treasury's contribution and the Secretary of Defense directs the Secretary of Treasury to make the payment.

   The long-term economic assumptions for the FY 2003 valuation were 6.25 percent interest, 3.0 percent Consumer Price Index, and 3.75 percent salary increase. For fiscal years 2004 and 2005, the inflation rates of 2.1 percent (actual) and 2.4 percent (estimated), and the salary increases of 3.7 percent (actual) and 3.5 percent (estimated) were used. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward, using accepted actuarial methods, from the prior year valuation results as reported in the DoD Office of Actuary Valuation of the Military Retirement System. The current year (FY 2004) long-term economic assumptions are used in the roll-forward. For purposes of the Fund's financial reporting, this process is applied annually.

NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF NET COST:

($ In Thousands)		FY 2004	FY 2003
Earned Revenue for Program Costs:			
1.	Service Contributions as a Percentage of Base Pay	$ 14,070,799	$13,719,439
2.	Annual Unfunded Liability Payment	18,189,000	17,928,000
3	Interest on Investments	10,124,705	9,998,336
4.	Transfers	0	101
	Total	$42,384,504	$41,645,876

Line 4., Transfers of $101 for FY 2003, represent a one-time payment from the Office of Personnel Management (OPM) to fund the benefits of one retired military judge.

Interest on investments increased from $9,998,336 in FY 2003 to $10,124,705 in FY 2004 principally due to the increase in the Service Contributions and the Annual Unfunded Liability Payment.

Gross Costs with the Public increased from $44,545,886 in FY 2003 to $135,662,860 in FY 2004 principally due to the increase in the change in actuarial liability that was $9,146,203 in FY 2003 and $98,520,497 in FY 2004 and increase in benefit expense that was $35,395,693 in FY 2003 and $37,152,632 in FY 2004. Due to this increase in the actuarial liability and benefit expense, the Net Cost of operations also increased respectively.

NOTE 10A: BENEFIT PROGRAM EXPENSE:

($ In Thousands)		FY 2004	FY 2003
1.	Service Cost	$12,857,181	$13,719,438
2.	Period Interest on the Benefit Liability	45,272,408	44,755,214
3.	Prior (or past) Service Cost	81,062,746	880,298
4.	Period Actuarial (Gains) or Losses	(4,048,320)	(14,491,980)
6.	Total Benefit Program Expense	$135,144,015	$44,862,970

The benefit program expenses provide components of the change in the actuarial liability from September 30, 2003, to September 30, 2004. The use of expected Service Cost (Line 1.) is a change over prior years' methodology, which used actual service cost contributions. The expected service cost is used in order to be consistent with the projected service cost stream used in developing the beginning-of-year liability. The September 30, 2004, actuarial liability is calculated using the components of benefit program expenses as well as the expected benefit payments during FY 2004. Expected benefit payments are used in order to be consistent with the projected benefit stream used in developing the beginning-of-year liability. The September 30, 2004, actuarial liability is equal to the September 30, 2003, liability plus the total benefit program expenses minus the expected benefit payments. The large increase in Prior Service Cost (Line 3.) was primarily due to the new concurrent receipt legislation contained in the 2004 National Defense Authorization Act. The decrease in absolute value of Period Actuarial Gains or Losses (Line 4.) was due to actual experience during 2004 being closer to what was expected than the experience in 2003.

NOTE 11. DISCLOSURES RELATED TO THE STATEMENT OF FINANCING:

($ In Thousands)

Other Components Requiring or Generating Resources in Future Periods of $24,195,504 for FY 2004 represents Interest Revenue of $10,124,705 and Benefit Program Revenue of $14,070,799. The comparable amount of $23,717,875 for FY 2003 represents $9,998,336 of Interest Revenue and $13,719,539 of Benefit Program Revenue.

Other Components not Requiring or Generating Resources of $10,285 for FY 2004 represents the change in Accounts Receivable, from over-payments of benefits made to military retirees and survivors, from the end of the prior year of $9,488 and change in the allowance for estimated uncollectibles of $797. The comparable amounts of $3,970 for FY 2003 represent a $(3,615) change in Accounts Receivable and change in the allowance for estimated uncollectibles of $(355). The calculation for the allowance for estimated uncollectibles is discussed in Note 5.

NOTE 12: OTHER DISCLOSURES:

Net Pension Expense: The net pension expense for the change in the actuarial accrued liability is developed in the table below.

($ In Thousands)		FY 2004	FY 2003
A.	Beginning of Year Accrued Liability	$736,061,601	$726,915,398
B.	Normal Cost Liability	12,857,181	13,719,438
C.	Plan Amendment Liability	81,062,746	880,298
D.	Assumption Change Liability	(32,540)	(4,626,302)
E.	Benefit Outlays	(36,623,518)	(35,716,768)
F.	Interest on Pension Liability	45,272,408	44,755,214
G.	Actuarial Loss (Gain)	(4,015,780)	(9,865,677)
H.	End-of-Year Accrued Liability (A+B+C+D+E+F+G)	$834,582,098	$ 736,061,601
I.	Net Change in Actuarial Liabilities (B+C+D+E+F+G)	$98,520,497	$9,146,203

Other Information:

Each year the Accrued Liability is expected to increase with the normal cost, decrease with benefit outlays, and increase with the interest cost. In the absence of (1) actuarial gains and losses, (2) plan benefit changes, and (3) assumption changes, an increase of $21.506 billion in the Accrued Liability was expected during FY 2004.

The September 30, 2004, reported Accrued Liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include an updated set of retiree offset factors and updated assumptions pertaining to members' choice of the Redux Career Status Bonus, the net effect of which is a decrease in the September 30, 2004, Accrued Liability of $32.540 million, shown on Line D. The change in retirement benefits for FY 2004 includes the new concurrent receipt benefits and the reform of basic pay rates in the 2004 National Defense Authorization Act.

The combined effect of these benefit changes is an increase in the September 30, 2004, Accrued Liability of $81.063 billion shown on Line C. The decrease in Accrued Liability due to the net experience gain of $4.016 billion, shown on line G, reflects the new population on which the September 30, 2003, roll-forward is based, as well as other economic and non-economic experience being different than assumed.

DoD MILITARY RETIREMENT FUND

REQUIRED SUPPLEMENTARY INFORMATION

DoD
Military Retirement Fund
Intragovernmental Transactions
For the Year Ended September 30, 2004

($ In Thousands)

Schedule, Part A Intragovernmetal Asset Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index	Fund Balance with Treasury	Investments
Department of the Treasury	20	$20,677	$187,962,462
Total		$20,677	$187,962,462

Schedule, Part B Intragovernmental Liability Balances Which Reflect Entity Amount with Other Federal Agencies	Treasury Index	Other
Department of the Treasury	20	$905
Total		$905

Schedule, Part C DoD Intragovernmental Revenues and Related Costs with Other Federal Agencies	Treasury Index	Earned Revenue
Department of the Treasury	20	$10,124,705
Department of the Navy	17	$4,554,425
Department of the Army	21	$5,724,611
Department of the Air Force	57	$3,791,763
Other Defense Organizations	97	$18,189,000
Total		$42,384,504

Required Supplementary Information

DoD MILITARY RETIREMENT FUND

OTHER ACCOMPANYING INFORMATION

Other Information

MILITARY RETIREMENT FUND
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2004 AND 2003

($ in Thousands)

		September 30, 2004 [1]	September 30, 2003
1	Present value of future benefits		
	a. Annuitants now on roll	$510,443,224	$451,482,384
	b. Non-retired reservists	$102,298,810	$93,461,965
	c. Active duty personnel [2]	$336,894,654	$285,743,304
	d. Total	$949,636,688	$830,687,653
2	Present value of future normal cost contributions	$115,054,590	$94,626,052
3	Actuarial accrued liability	$834,582,098	$736,061,601
4	Assets [3]	$181,133,124	$176,028,930
5	Unfunded accrued liability	$653,448,974	$560,032,671

1 Rolled forward from September 30, 2003

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

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

Other Information

DoD MILITARY RETIREMENT FUND

INDEPENDENT AUDITORS' REPORTS

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
UNDER SECRETARY OF DEFENSE (PERSONNEL AND READINESS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2004 Military Retirement Fund Financial Statements (Report No. D-2005-018)

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 Department of Defense Military Retirement Fund (MRF) Financial Statements.

Unqualified Audit Opinion. We concur with the Deloitte & Touche unqualified opinion dated October 22, 2004. Deloitte & Touche opined that the FY 2004 MRF Financial Statements and accompanying notes present fairly, in all material respects, the MRF financial position as of September 30, 2004 and 2003, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary resources to net cost for the years then ended. The Defense Finance and Accounting Service prepared the financial statements in conformity with accounting principles generally accepted in the United States.

We further concur with the Deloitte & Touche report on internal control over financial reporting in connection with the audit of the FY 2004 MRF Financial Statements. The report concluded that the general controls over electronic data processing (EDP) at the computer processing locations the MRF uses do not support reliable processing of financial information within the business cycles. The review disclosed deficiencies in the design or operation of controls related to EDP security 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 in accordance with all appropriate requirements. The deficiencies comprise a reportable condition; however, Deloitte & Touche stated it was not material for financial statement purposes. Other auditors could consider this condition to be significant in the context of a material weakness for DoD information security purposes.

As part of the audit, Deloitte & Touche had to obtain reasonable assurance that the FY 2004 MRF Financial Statements are free of material misstatement. Deloitte & Touche performed tests to determine whether the MRF was administered in compliance with certain provisions of law and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. Office of Management and Budget (OMB) Bulletin No. 01-02, "Audit Requirements for Federal Financial Statements," requires that test results be reported if noncompliance with certain other laws and regulations occurs. Specifically, the noncompliance concerns the following.

- MRF data are processed on EDP systems that are not fully compliant with OMB Circular A-127, "Financial Management Systems."

- The MRF uses a general ledger system that is not transaction based or derived from an integrated financial system.

Audit Responsibilities. We are responsible for obtaining reasonable assurance that the principal statements are fairly presented and free of material misstatement, according to 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 MRF; performed independent tests of the accounting records; and performed other procedures appropriate to the circumstances. Deloitte & Touche formed their opinion on the basic financial statements taken as a whole. Because the required supplementary information is not part of the basic financial statements, Deloitte & Touche did not audit that information and did not express an opinion on it.

We appreciate the courtesies extended to the audit team. Questions should be directed to Mr. Douglas P. Neville at (703) 428-1061 (DSN 328-1061) or Mr. Thomas J. Winter at (703) 428-1082 (DSN 328-1082).

Joseph E. Schmitz
Inspector General
Department of Defense

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

Deloitte.

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INDEPENDENT AUDITORS' REPORT

To the Inspector General of the
Department of Defense

We have audited the accompanying balance sheets of the Department of Defense ("DoD") Military Retirement 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.

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.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the DoD Military Retirement 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 22, 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 audits.

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 22, 2004

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

To the Inspector General of the
Department of Defense

We have audited the financial statements of the Department of Defense ("DoD") Military Retirement Fund (the "Fund") as of and for the year ended September 30, 2004, and have issued our report thereon dated October 22, 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 a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. 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. The reportable condition we noted is described in the following paragraph.

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 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 internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

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, 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 which are summarized in the following paragraphs:

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

2. While the general ledger system utilized by the Fund is compliant with the United States Standard General Ledger (SGL), it is not transaction based or derived from an integrated financial system.

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 22, 2004