



FISCAL YEAR 2001

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

February 1, 2002

DoD
MILITARY RETIREMENT FUND
FISCAL YEAR 2001
AUDITED FINANCIAL STATEMENTS

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Overview

DoD
MILITARY RETIREMENT
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OVERVIEW

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

As of September 30, 2001

Description of the Reporting Entity

The reporting entity is the Office of the Under Secretary of Defense for Personnel and Readiness, one of whose missions is to oversee the accounting, investing, and reporting of the Military Retirement Fund (the Fund). In FY 2001, the Fund paid out approximately \$34 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 at the DFAS Cleveland and Denver Pay Centers are involved in making the benefit payments. 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 FY 2001, the Fund received \$11 billion in normal cost payments, a \$16 billion unfunded liability amortization payment, and \$15 billion in investment income. No fund accounts have been excluded by this statement.

Summary

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Transportation), 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 are included in this valuation.

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

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 the armed services before September 8, 1980 have retired pay equal to (terminal 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 the armed services on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of terminal basic pay. *Redux*: Members first entering the armed services on or after August 1, 1986 are subject to a penalty if they retire with less than 30 years of service; at age 62, their retired pay is recomputed without the penalty. The FY 2000 Defense Authorization Act provided that Redux members now have a choice of (a) receiving High-3 benefits or

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(b) staying under the Redux formula and receiving a lump-sum \$30,000 payment. 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.

Retiree and survivor 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 after that date but who elect to switch to the High-3 benefit formula, are 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 payment are annually increased by the percentage change in the CPI minus 1 percent. At the military member's age 62, 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 life.

Nondisability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of the armed services before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5 percent) times (years of service, rounded down to the nearest month) and is limited to 75 percent. Members first entering the armed services on or after August 1, 1986, who elect the \$30,000 and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40 percent (50 percent minus 10 percent). At age 62, the retired pay is recomputed with the penalty removed.

In FY 2001, 1.37 million nondisability retirees from active duty were paid \$28.3 billion.

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 Veterans Administration) and either (1) the member has 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, 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. Base pay is equal to terminal basic pay if the retiree first became a member of the armed services before September 8, 1980. If the retiree first entered the Services on or after September 8, 1980, 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.

In FY 2001, 98,000 disability retirees were paid \$1.30 billion.

Reserve Retirement

Members of the reserves may retire after 20 years of creditable service, the last eight 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 the armed services 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 that he/she was a member of the armed services. 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 automatic 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.

In FY 2001, 243,000 reserve retirees were paid \$2.61 billion.

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.

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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 and still pays 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 a penalty for service under 30 years is included 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 integrated with Social Security. SBP participants and active and reserve personnel with at least 20 years of service on October 1, 1985 were grandfathered into the two-tier system. Their survivors will be 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 benefit. (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 with over 20 years of service are assumed to have retired on the day they died and to have elected full SBP coverage for spouses and/or children.

SBP annuities are reduced by any VA survivor benefits and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities are annually increased with cost-of-living adjustments (COLAs). These COLAs may be based on full or partial CPI increases, depending on the benefit formula covering the member. If the member dies before age 62 and the survivor is subject to partial COLAs, the survivor's annuity is increased (on 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, provides annuities to survivors of reservists who die before

age 60, but after attaining 20 years of 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 is effective October 1, 2008 for participants age 70 or older whose retired pay has been reduced for 30 years or more.

In FY 2001, 259,000 surviving families were paid \$1.96 billion.

Temporary Early Retirement Authority (TERA)

The National Defense Authorization Act for FY 1993 (P.L. 102-484) grants 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 is calculated in the usual way except that there is 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 treated like regular military retirees for the purposes of other retirement fringe benefits. This authority is scheduled to expire at the end of 2001.

As of September 30, 2001, there were 55,000 TERA retirees receiving retired pay at an annual rate of \$694 million.

Cost-of-Living Increases

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 CPI from 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 electing the \$30,000. Their benefits are annually increased 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.

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Relationship with VA Benefits

The Department of Veterans Affairs (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 they are not additive. Since VA benefits are exempt from federal income taxes, it is sometimes to the advantage of a member to elect them.

Veterans Administration 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. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees).

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is computed 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 70 percent of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 68 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.

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.

Overview

Performance Measures

During FY 2001, the Fund made disbursements to approximately two million retirees and annuitants. All checks are sent out on a monthly basis.

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 sixteen years:

- a. September 30, 2001 = .34476
- b. September 30, 2000 = .35085
- c. September 30, 1999 = .35142
- c. September 30, 1998 = .34567
- d. September 30, 1997 = .32200
- e. September 30, 1996 = .31314
- f. September 30, 1995 = .30375
- g. September 30, 1994 = .30306
- h. September 30, 1993 = .28314
- i. September 30, 1992 = .27018
- j. September 30, 1991 = .25127
- k. September 30, 1990 = .21878
- l. September 30, 1989 = .19549
- m. September 30, 1988 = .16211
- n. September 30, 1987 = .11431
- o. September 30, 1986 = .07187

The weighted average yield of the Fund on September 30, 2001 was 7.6%.

Core Performance Measures

No operating costs are calculated for the Fund.

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 that they are for a federal entity, that unfunded liabilities reported in the financial statements

can not be liquidated without the enactment of an appropriation, and that 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 2000. 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
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PRINCIPAL STATEMENTS

Principal Statements

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

	<u>2001</u>	<u>2000</u>
ASSETS:		
Intragovernmental Assets:		
Fund Balances with Treasury (Note 3)	\$ 18,236	\$ 20,640
Investments, Net (Note 4)	169,177,362	162,628,640
Total Intragovernmental Assets	169,195,598	162,649,280
Accounts Receivable, Net (Note 5)	19,613	21,626
Total Assets	\$ 169,215,211	\$ 162,670,906
LIABILITIES:		
Intragovernmental:		
Other Liabilities (Notes 6 & 7)	\$ 297	\$ 544
Total Intragovernmental Liabilities	297	544
Military Retirement Benefits and Other Employment-Related		
Actuarial Liabilities (Note 9)	705,248,945	687,583,547
Other Liabilities (Notes 7 & 8)	3,006,931	2,898,474
Total Liabilities	708,256,173	690,482,565
NET POSITION :		
Cumulative Results of Operations	(539,040,962)	(527,811,659)
Total Net Position	(539,040,962)	(527,811,659)
Total Liabilities and Net Position	\$ 169,215,211	\$ 162,670,906

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2001</u>	<u>2000</u>
Program Costs:		
With the Public	\$ 51,872,109	\$ 58,759,603
Total Program Cost	51,872,109	58,759,603
(Less: Earned Revenues)	<u>(40,642,806)</u>	<u>(39,451,006)</u>
Net Program Costs	11,229,303	19,308,597
Net Cost of Operations	<u>\$ 11,229,303</u>	<u>\$ 19,308,597</u>

Additional information included in Note 10.

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2001</u>	<u>2000</u>
Net Cost of Operations	\$ 11,229,303	\$ 19,308,597
Financing Sources (Other than Exchange Revenue)	<u>0</u>	<u>0</u>
Net Results of Operations (Financing Sources less Net Cost of Operations)	<u>(11,229,303)</u>	<u>(19,308,597)</u>
Net Change in Cumulative Results of Operations	<u>(11,229,303)</u>	<u>(19,308,597)</u>
Change in Net Position	(11,229,303)	(19,308,597)
Net Position-Beginning of the Period	<u>(527,811,659)</u>	<u>(508,503,062)</u>
Net Position-End of the Period	<u>\$ (539,040,962)</u>	<u>\$ (527,811,659)</u>

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2001</u>	<u>2000</u>
BUDGETARY RESOURCES:		
Budget Authority	\$ 40,662,287	\$ 38,805,637
Unobligated Balance - Beginning of Period	154,952,267	149,058,579
Total Budgetary Resources	\$ <u>195,614,554</u>	\$ <u>187,864,216</u>
STATUS OF BUDGETARY RESOURCES:		
Obligations Incurred	\$ 34,204,932	\$ 32,911,949
Unobligated Balances - Available	161,409,622	154,952,267
Total, Status of Budgetary Resources	\$ <u>195,614,554</u>	\$ <u>187,864,216</u>
OUTLAYS:		
Obligations Incurred	\$ 34,204,932	\$ 32,911,949
Obligated Balance, Net - Beginning of Period	2,898,327	2,794,213
Less: Obligated Balance, Net - End of Period	(3,006,772)	(2,898,327)
Total Outlays	\$ <u>34,096,487</u>	\$ <u>32,807,835</u>

The accompanying notes are an integral part of these statements.

Principal Statements

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

	<u>2001</u>	<u>2000</u>
OBLIGATIONS AND NONBUDGETARY RESOURCES:		
Obligations Incurred	\$ 34,204,932	\$ 32,911,949
Less: Trust or Special Fund Receipts Related to Exchange in the Entity's Budget	<u>(40,642,806)</u>	<u>(39,451,006)</u>
Total Obligations as Adjusted and Nonbudgetary Resources	<u>(6,437,874)</u>	<u>(6,539,057)</u>
RESOURCES THAT DO NOT FUND NET COST OF OPERATIONS:		
Change in Amount of Goods, Services, and Benefits Ordered but Not Yet Received or Provided - (Increases)/Decreases	<u>0</u>	<u>0</u>
Total Resources That Do Not Fund Net Costs of Operations	<u>0</u>	<u>0</u>
COSTS THAT DO NOT REQUIRE RESOURCES:		
Bad Debts Related to Uncollectible Non-Credit Reform Receivables	879	4,139
Other - Increases/(Decreases)	<u>887</u>	<u>104</u>
Total Costs That Do Not Require Resources	<u>1,766</u>	<u>4,243</u>
Financing Sources Yet to be Provided	<u>17,665,411</u>	<u>25,843,411</u>
Net Cost of Operations	<u>\$ 11,229,303</u>	<u>\$ 19,308,597</u>

Additional information included in Note 11.

The accompanying notes are an integral part of these statements.

Principal Statements

DoD
MILITARY RETIREMENT
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FOOTNOTES
TO THE
PRINCIPAL STATEMENTS

NOTES TO THE DOD MILITARY RETIREMENT FUND PRINCIPAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2001 AND 2000

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, in accordance with the requirements of the Office of Management and Budget (OMB) Bulletin No. 97-01, 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, in addition to the financial reports, are prepared by the Military Retirement Fund pursuant to OMB directives, which are used to monitor and control the Military Retirement Fund's use of budgetary resources.

For FY 2001, OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements", requires the Military Retirement Fund to meet the accelerated reporting requirement date of February 27, 2002 for the comparative audited financial statements. For FY 2002, audited financial statements are due February 1, 2003. Interim financial reporting will be phased in beginning in FY 2002 with mid-year financial reports, and quarterly financial reports starting in FY 2003.

For future years, OMB Bulletin No. 01-09, "Form and Content of Agency Financial Statements", requires the revision of the format for the Statement of Budgetary Resources to improve the comparability between the Statement of Budgetary Resources and the Budget of the U.S. Government. OMB also requires the format revision for the Statement of Changes in Net Position and the Statement of Financing to improve budget integration.

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 for the payment of annuities and pensions to retired personnel and the survivor benefit plan. The FY 1984 Defense Authorization Act, Public Law 98-94, changed the method of financing this fund effective October 1, 1984. Under the former method, the department estimated retired pay requirements for the forthcoming year, obtained an appropriation from the Congress, and made periodic payments of retired pay, retainer pay, and survivor benefits. Under the new law, such payments are made to the Military Retirement Fund.

Military Retirement Funds' appropriations are designated trust funds. These appropriations and funds are used to fund and report how resources have been used in the course of executing the Military Retirement Funds' mission.

The DoD Military Retirement Fund is classified as a trust fund and makes use of both receipt and expenditure accounts since it is not designated as a trust revolving fund. Trust funds represent the receipts and expenditure of funds held in trust by the government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

The Military Retirement Fund symbol is 97X8097. The account uses a budget activity level structure. Lower level accounts are established as necessary to meet reporting requirements.

Footnotes

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) through 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, accounting principles generally accepted 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. Accounting for Intragovernmental Activities. The Military Retirement Fund purchases and redeems non-marketable market based securities issued by the United State's Treasury Bureau of Public Debt. Non-marketable market based securities include Treasury bills, notes, bonds, 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 Military Retirement Fund records investments at market value on the trial balance in SGL 1600. Discounts and Premiums are recorded on Fund's trial balances in SGL 1611 and 1612 respectively. The Fund calculates amortization of discounts and premiums using the effective interest method and records amortization on the trial balance in SGL 1613.

The Military Retirement Fund receives interest on the value of its non-marketable market based securities from Treasury on a semi-annual basis.

G. Funds with the U.S. Treasury. The Military Retirement Fund's financial resources are maintained in U.S. Treasury Accounts. The Defense Finance and Accounting Service (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 appropriation Fund Balance with Treasury (FBWT) account maintained in the Treasury's system. Differences between the Military Retirement Fund's recorded balance in the FBWT account and Treasury's FBWT are reconciled.

H. 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.

I. Investments in U.S. Government Securities. Intragovernmental securities represent non-marketable market based securities issued by the United States Treasury's Bureau of Public Debt. These securities are redeemable at market value exclusively through the Federal Investment Branch. 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.

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

K. 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.

L. 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)	FY01			FY00
	Nonentity	Entity	Total	Total
1. Intragovernmental Assets:				
a Fund Balance With Treasury	\$0	\$18,236	\$18,236	\$20,640
b Investments	<u>\$0</u>	<u>\$169,177,362</u>	<u>\$169,177,362</u>	<u>\$162,628,640</u>
c Total Intragovernmental Assets	\$0	\$169,195,598	\$169,195,598	\$162,649,280
2. Nonfederal Assets				
a Accounts Receivable	<u>\$297</u>	<u>\$19,316</u>	<u>\$19,613</u>	<u>\$21,626</u>
b Total Nonfederal Assets	\$297	\$19,316	\$19,613	\$21,626
3. Total Assets	<u>\$297</u>	<u>\$169,214,914</u>	<u>\$169,215,211</u>	<u>\$162,670,906</u>

4. Line 2.b, Accounts Receivable of \$297 thousand, represents Penalties, Fines, and Administration Fees Receivable (SGL 1360), net of the Allowance for Loss on Penalties, Fines, and Administration Fees (SGL 1369), which will be collected on behalf of Treasury. This amount is also reflected in Note 6 as a custodial liability of \$297 thousand

NOTE 3. FUND BALANCES WITH TREASURY:

(\$ In Thousands)	FY 01	FY 00
	Entity <u>Assets</u>	Entity <u>Assets</u>
1. Fund Balances:		
Fund Type		
a Trust Funds	<u>\$18,236</u>	<u>\$20,640</u>
b Total	<u>\$18,236</u>	<u>\$20,640</u>
2. Fund Balance Per Treasury Versus Agency:		
a Fund Balance Per Treasury	\$18,236	\$20,640
b Fund Balance Per Military Retirement Fund	<u>\$18,236</u>	<u>\$20,640</u>
c Reconciling Amount	<u>\$ 0</u>	<u>\$ 0</u>

Footnotes

NOTE 4. INVESTMENTS:

(\$ In Thousands)	<u>FY 01</u>				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/ Discount</u>	<u>Investments Net</u>	<u>Market Value Disclosure</u>
1. Intragovernmental Securities:					
a. Non-Marketable, Market Based	\$174,282,322	Effective Interest	(\$9,892,486)	\$164,389,836	\$184,223,662
b. Subtotal	<u>\$174,282,322</u>		<u>(\$9,892,486)</u>	<u>\$164,389,836</u>	<u>\$184,223,662</u>
c. Accrued Interest	<u>4,787,526</u>			<u>4,787,526</u>	<u>4,787,526</u>
Total	<u>\$179,069,848</u>			<u>\$169,177,362</u>	<u>\$189,011,188</u>
Total Intragovernmental:	<u>\$179,069,848</u>		<u>(\$9,892,486)</u>	<u>\$169,177,362</u>	<u>\$189,011,188</u>
				<u>FY 00</u>	
1. Intragovernmental Securities:					
a. Non-Marketable, Market Based				\$157,829,955	\$170,125,011
b. Subtotal				<u>\$157,829,955</u>	<u>\$170,125,011</u>
c. Accrued Interest				<u>4,798,685</u>	<u>4,798,685</u>
Total				<u>\$162,628,640</u>	<u>\$174,923,696</u>

NOTE 5. ACCOUNTS RECEIVABLE:

(\$ In Thousands)	<u>FY 01</u>			<u>FY 00</u>
	<u>Gross Amount Due</u>	<u>(Allowance for Estimated Uncollectibles)</u>	<u>Net Amount Due</u>	<u>Net Amount Due</u>
1. Entity Receivables:				
With the Public	\$24,702	(\$5,089)	\$19,613	\$21,626
2. The General Reserve Method, under which a reserve is based on age of debts and bad debt experience, is used as stated in Chapter 3, of Volume 4, Section 030212A of the DoD Financial Management Regulation to calculate an allowance percentage.				
3. Accounts Receivable With the Public represents Refunds Receivable of overpayments of benefits. For FY 00, the allowance for uncollectibles total is \$4,172 thousand. The increase in the change in the allowance for bad debt uncollectibles between FY 01 and FY 00 is discussed in Note 11.				

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES:

(\$ In Thousands)	FY 01		
	Covered by Budgetary Resources	Not Covered by Budgetary Resources	Total
1. Intragovernmental Liabilities:			
a. Other	<u>\$297</u>	<u>\$0</u>	<u>\$297</u>
Total Intragovernmental Liabilities	<u>\$297</u>	<u>\$0</u>	<u>\$297</u>
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities	\$161,409,622	\$543,839,323	\$705,248,945
b. Other	<u>\$3,006,771</u>	<u>\$160</u>	<u>\$3,006,931</u>
Total Nonfederal Liabilities	<u>\$164,416,393</u>	<u>\$543,839,483</u>	<u>\$708,255,876</u>
3. Total Liabilities:	<u>\$164,416,690</u>	<u>\$543,839,483</u>	<u>\$708,256,173</u>
	FY 00		
1. Intragovernmental Liabilities:			
a. Other	<u>\$0</u>	<u>\$544</u>	<u>\$544</u>
Total Intragovernmental Liabilities	<u>\$0</u>	<u>\$544</u>	<u>\$544</u>
2. Nonfederal Liabilities:			
a. Military Retirement Benefits and Other Employment-Related Actuarial Liabilities	\$154,952,267	\$532,631,280	\$687,583,547
b. Other	<u>\$2,898,327</u>	<u>\$147</u>	<u>\$2,898,474</u>
Total Nonfederal Liabilities	<u>\$157,850,594</u>	<u>\$532,631,427</u>	<u>\$690,482,021</u>
3. Total Liabilities:	<u>\$157,850,594</u>	<u>\$532,631,971</u>	<u>\$690,482,565</u>

For FY 01, Line 1.a., Other Intragovernmental liability of \$297 thousand, represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2. to the Department of Treasury. The nonentity asset replaces the budgetary resource to cover the liability.

Footnotes

NOTE 7. OTHER LIABILITIES:

(\$ In Thousands)	<u>FY 01</u>	<u>FY 00</u>
1. Intragovernmental:		
a. Other Liabilities	<u>\$297</u>	<u>\$544</u>
Total Intragovernmental Other Liabilities	<u>\$297</u>	<u>\$544</u>
2. Nonfederal:		
a. Accrued Funded Payroll and Benefits	\$3,006,771	\$2,898,327
b. Other Liabilities	<u>\$160</u>	<u>\$147</u>
c. Total Nonfederal Other Liabilities	<u>\$3,006,931</u>	<u>\$2,898,474</u>
3. Total Other Liabilities	<u>\$3,007,228</u>	<u>\$2,899,018</u>
4. Other Information Pertaining to Other Liabilities:		

Line 1.A, Other Intragovernmental Liabilities of \$297 thousand, Line 1.a, represents a custodial liability. This liability is an obligation to transfer the nonentity asset presented in Note 2. to the Department of Treasury.

NOTE 8. COMMITMENTS AND CONTINGENCIES:

Disclosures Related to Commitments and Contingencies:

(\$ In Thousands)	<u>FY 01</u>	<u>FY 00</u>
1. Other Liabilities Covered by Budgetary Resources:		
With the Public:	<u>\$3,006,771</u>	<u>\$2,898,327</u>
Total:	<u>\$3,006,771</u>	<u>\$2,898,327</u>
2. Other Liabilities Not Covered by Budgetary Resources:		
With the Public		
Death Payment Contingencies	<u>\$160</u>	<u>\$147</u>
Total:	<u>\$160</u>	<u>\$147</u>
3. Other Information:		

Other Liabilities of \$3,006,771 thousand represent accrued entitlement benefits for military retirees and survivors.

Death Payment Contingencies of \$160 thousand occur because DoD Military Retired Pay is offset, in some cases, 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 is payable by DoD to cover retiree benefits not paid by DVA during the month of death.

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

(\$ In Thousands)	FY 01			
	Actuarial Present Value of Projected Plan Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Actuarial Liability
Major Program Activities				
Military Retirement Pensions	\$705,248,945	6.25%	(\$161,409,622)	\$543,839,323
Total:	\$705,248,945		(\$161,409,622)	\$543,839,323
	FY 00			
Total:	\$687,583,547	6.25%	\$154,952,267	\$532,631,280

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. The Board determines Treasury's contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payment. The same long-term economic assumptions were used in both the FY 01 and FY 00 valuations. Along with the 6.25 percent assumed annual interest rate, the long-term annual increase in the Consumer Price Index is assumed to be 3.0 percent. The long-term annual salary increase is assumed to be 3.5 percent. For FY 01 and FY 02 the actual inflation rates of 3.5 percent and 2.6 percent, and the actual salary increases of 3.7 percent and 4.6 percent 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's valuation results as reported in the DoD Office of the Actuary's valuation of the military retirement system. For purposes of the Fund's financial reporting, this process is applied annually.

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

(\$ In Thousands)	FY 01	FY 00
Earned Revenue for Program Costs:		
1. Service Contributions as a Percentage of Base Pay	\$ 11,370,897	\$11,402,375
2. Annual Unfunded Liability Payment	16,089,000	15,302,000
3. Interest on Investments	13,182,876	12,746,631
4. Transfers	33	0
Total	\$40,642,806	\$39,451,006

Line 4., Transfers of \$33 thousand, represents a one-time payment from OPM to fund the benefits of one retired military judge.

Footnotes

NOTE 10A: BENEFIT PROGRAM EXPENSE:

(\$ In Thousands)	<u>FY 01</u>	<u>FY 00</u>
1. Service Cost	\$11,370,897	\$11,402,375
2. Period Interest on the Benefit Liability	42,271,194	40,696,769
3. Prior (or past) Service Cost	3,058,225	0
4. Period Actuarial (Gains) or Losses	(4,829,063)	(2,209,260)
5. Gains/Losses Due to Changes in Medical Inflation Rate Assumption	<u>0</u>	<u>0</u>
6. Total Benefit Program Expense	<u>\$51,871,253</u>	<u>\$49,889,884</u>

Other:

Line 6 of Note 10.A., less the Fund Outlays, represents the total change in actuarial liability.

For FY 00, Period Actuarial Gains of \$2,209,260 thousand, reflected in Line 4., did not include the assumption change loss of \$8,865,569 thousand, reflected in Line D of Note 12. This amount would have increased the Period Actuarial (Gains) or Losses, reflected in 10.A, Line 4, by \$8,865,569 thousand, thus increasing the Total Benefit Program Expenses, reflected in 10.A, Line 6 to \$58,755,543 thousand.

NOTE 11. FOOTNOTE DISCLOSURES RELATED TO THE STATEMENT OF FINANCING:

(\$ In Thousands)

The FY 01 amount of \$879 thousand represents bad debts uncollectible on accounts receivable from military retirees and survivors. The amount of bad debts uncollectible for FY 00 totaled \$4,139 thousand. The FY 01 calculation for the allowance for bad debts uncollectible is discussed in Note 5.

Account 6790, "Other Expenses not Requiring Budgetary Resources," is a non-budgetary expense account created when the over-payment of benefits are made to military retirees and survivors. The \$887 thousand amount recorded in account 6790 is the difference between account 1316 at the end of the prior year and at the end of the current year. A review of account 6790 is conducted to determine what portion of the account is uncollectible from the military retirees and survivors. The uncollectible amount is written off to account 1319, Allowance for Bad Debts.

NOTE 12: OTHER DISCLOSURES :

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

(\$ In Thousands)	<u>FY 01</u>	<u>FY 00</u>
A. Beginning of Year Accrued Liability	\$687,583,547	\$661,740,147
B. Normal Cost Liability	11,370,897	11,402,375
C. Plan Amendment Liability	3,058,225	0
D. Assumption Change Liability	(48,699)	8,865,569
E. Benefit Outlays	(34,205,855)	(32,912,053)
F. Interest on Pension Liability	42,271,194	40,696,769
G. Actuarial Loss (Gain)	<u>(4,780,364)</u>	<u>(2,209,260)</u>
H. End-of-Year Accrued Liability (A+B+C+D+E+F+G)	<u>\$705,248,945</u>	<u>\$687,583,547</u>
I. Net Change in Actuarial Liabilities (B+C+D+E+F+G)	<u>\$17,665,398</u>	<u>\$25,843,400</u>

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 \$19.436 billion in the Accrued Liability was expected during FY 01 and \$19.187 billion for FY 00.

The September 30, 2001 Accrued Liability includes changes due to (1) new demographic assumptions, (2) benefit changes, and (3) an experience gain. The new assumptions include (a) nondisability retiree death and other loss rates, and (b) corrections and updates to active duty termination rates and the amount of retired pay offset by VA payments.

For FY 2001, the Plan Amendment Liability (Line C.), which is identical to Line 3 in Note 19E, represents the (a) reform of basic pay rates mandated by the FY 2001 DoD Authorization Act, and (b) the effect of 30 year (and age 70) paid-up Survivor Benefit Plan (SBP) premiums. The combined effect of the benefit changes is an increase in the September 30, 2001 Accrued Liability of \$3,058,225 thousand, shown on Line C. The combined effect of the actuarial assumption changes is a decrease in the September 30, 2001 Accrued Liability of \$48,699 thousand, shown on Line D. The net experience gain of \$4,780,364 thousand shown on Line G. reflects primarily the new population on which the September 30, 2001 roll-forward is based.

The September 30, 2000 Accrued Liability included changes due to (1) new demographic assumptions and (2) an experience gain. The FY 2000 assumptions included (a) permanent disability retiree death and other loss rates, (b) updated mortality improvement factors, and (c) restructured promotion and merit increase scales arising from reform of basic pay rates mandated by the FY 00 DoD Authorization Act.

For FY 2000 there were no changes in retirement benefits affecting the Plan Amendment Liability. The combined effect of the actuarial assumption changes was an increase in the September 30, 2000 Accrued Liability of \$8,865,569 thousand, shown on Line D. A net experience gain of \$2,209,260 thousand shown on Line G, reflected primarily the new population on which the September 30, 2000 roll-forward is based.

Footnotes

DoD
MILITARY RETIREMENT
FUND

Required
Supplementary
Information

Required Supplementary Information _____

Required Supplementary Information

**DoD
Military Retirement Fund
Intragovernmental Transactions
For the Year Ended September 30, 2001**

(\$ 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>\$18,236</u>	<u>\$169,177,362</u>
Total		<u>\$18,236</u>	<u>\$169,177,362</u>

Schedule, Part B
Not Applicable

Schedule, Part C DoD Intragovernmental Revenues and Related Costs with Other Federal Agencies	Treasury Index	Earned Revenue
Department of the Treasury	20	\$13,182,876
Office of Personnel Management	24	\$33
Department of the Navy	17	\$4,023,021
Department of the Army	21	\$4,236,663
Department of the Air Force	57	\$3,111,213
Other Defense Organization	97	<u>\$16,089,000</u>
Total		<u>\$40,642,806</u>

Required Supplementary Information _____

DoD
MILITARY RETIREMENT
FUND

OTHER ACCOMPANYING
INFORMATION

Other Accompanying Information _____

Other Accompanying Information

TABLE 1

**MILITARY RETIREMENT SYSTEM
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2001 AND 2000**

(\$ in thousands)

	<u>September 30, 2001</u>	<u>September 30, 2000</u>
1. Present value of future benefits		
a. Annuitants now on roll	\$468,180,451	\$441,646,986
b. Non-retired reservists	\$57,103,498	\$54,254,562
c. Active duty personnel ¹	<u>\$262,746,104</u>	<u>\$279,037,689</u>
d. Total	\$788,030,053	\$774,939,237
2. Present value of future normal cost contributions	\$82,781,107	\$87,355,690
3. Actuarial accrued liability	\$705,248,945	\$687,583,547
4. Assets ²	\$161,409,622	\$154,952,267
5. Unfunded accrued liability	\$543,839,323	\$532,631,280

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

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

Other Accompanying Information _____

DoD
MILITARY RETIREMENT
FUND

INDEPENDENT
AUDITORS'
REPORTS

Independent Auditors' Report _____



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

February 1, 2002

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

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2001 Military
Retirement Fund Financial Statements (Project No. D2001FH-0117.000)

In accordance with the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, the Inspector General (IG), DoD, is responsible for auditing the Military Retirement Fund (MRF) Financial Statements. For FY 2001, we contracted with Deloitte & Touche LLP to audit the MRF Financial Statements. Deloitte & Touche LLP is an independent certified public accounting (CPA) firm that was competitively selected for this audit by the IG, DoD.

Unqualified Audit Opinion. We concur with the Deloitte & Touche LLP unqualified opinion dated February 1, 2002, that the FY 2001 MRF Financial Statements and accompanying notes present fairly, in all material respects, the MRF financial position as of September 30, 2001, and its net cost, changes in net position, budgetary resources, and reconciliation of budgetary resources to net cost for the year then ended. The financial statements were prepared in conformity with accounting principles generally accepted in the United States of America.

We concur with the Deloitte & Touche LLP report on internal controls over financial reporting in connection with the audit of the FY 2001 MRF Financial Statements, which stated:

A certain matter involving the internal controls over financial reporting was considered to be a reportable condition. Specifically, the general electronic data processing (EDP) controls at the computer processing locations used by the MRF do not provide reasonable assurance that logical security tools and techniques have been implemented, configured, and administered to restrict access to programs, data, and other information resources. Although a reportable condition, Deloitte & Touche LLP believed that the reportable condition was not a material weakness. However, this reportable condition could be considered significant in the context of a material weakness for DoD information security purposes.

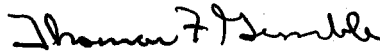
As part of obtaining reasonable assurance about whether the MRF financial statements are free of material misstatement, tests were performed of the MRF's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin 01-02, "Audit Requirements for Federal Financial Statements," October 16, 2000. The results

of these tests performed by Deloitte & Touche LLP disclosed instances of noncompliance that are required to be reported. Specifically, the noncompliance concerns are the following.

- EDP systems utilized by the MRF that are not fully compliant with OMB Circular A-127, "Financial Management Systems."
- The general ledger system utilized by the MRF is not transaction based or derived from an integrated financial system.

Audit Responsibilities. We are responsible for obtaining reasonable assurance about whether the Principal Statements are fairly presented and free of material misstatement, in conformity with accounting principles generally accepted in the United States of America.

To help fulfill these responsibilities, we contracted with Deloitte & Touche LLP to perform the financial statement audit in accordance with generally accepted Government auditing standards; OMB Bulletin No. 01-02; and the GAO "Financial Audit Manual," December, 1997. The IG, DoD, evaluated the nature, timing, and extent of the work, monitored progress throughout the audit, met with partners and staff members of the CPA firm, evaluated the key judgments, met with officials of the MRF, performed independent tests of the accounting records, and performed other procedures appropriate in the circumstances.



Thomas F. Gimble

Acting

Deputy Assistant Inspector General
for Auditing



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, 2001 and 2000, 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 management of the Fund. 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*. 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 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, 2001 and 2000, and its net cost, changes in net position, budgetary resources and reconciliation of budgetary resources to net cost for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

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

To the Inspector General of the
Department of Defense

In accordance with *Government Auditing Standards*, we have also issued our report dated February 1, 2002 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 grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

February 1, 2002



INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND COMPLIANCE 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, 2001, and have issued our report thereon dated February 1, 2002. 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*.

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 assurance 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 operations 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.

A material weakness is a 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 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 below is not a material weakness.

1. The general electronic data processing (EDP) controls at the computer processing locations used by the Fund do not provide reasonable assurance that logical security tools and techniques have been implemented, configured, and administered to restrict and control

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access to programs, data, and other information resources. Our review disclosed deficiencies in the design and operation of certain EDP access controls, security policies and procedures, business continuity arrangements, and system software and program change controls that could adversely affect the Fund's ability to record, process, and summarize its financial information in accordance with all appropriate requirements. Because disclosure of detailed information about security 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.

Compliance

As part of obtaining reasonable assurance about whether the Fund's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, 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. 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 that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, 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 EDP controls that increase the risk of unauthorized access to and modification of sensitive data. This condition compromises the ability of the systems to provide reliable 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, management of the Fund, other Defense Organizations, the Office of Management and Budget, the General Accounting 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

February 1, 2002