

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

**INTERNAL CONTROLS AND COMPLIANCE
WITH LAWS AND REGULATIONS FOR THE
DOD MILITARY RETIREMENT TRUST FUND
FINANCIAL STATEMENTS FOR FY 1996**

Report No. 97-177

June 25, 1997

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Department of Defense

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Acronyms

| | |
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| DFAS | Defense Finance and Accounting Service |
| FMFIA | Federal Managers' Financial Integrity Act of 1982 |
| FMR | Financial Management Regulation |
| IG | Inspector General |
| JFMIP | Joint Financial Management Improvement Program |
| OMB | Office of Management and Budget |
| TERA | Temporary Early Retirement Authority |



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884



June 25, 1997

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

SUBJECT: Audit Report on the Internal Controls and Compliance With Laws and
Regulations for the DoD Military Retirement Trust Fund Financial
Statements for FY 1996 (Report No. 97-177)

We are providing this report for your information and use. Financial statement audits are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994. The Office of Management and Budget Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, requires the Inspector General, DoD, to render an opinion on the DoD Military Retirement Trust Fund financial statements and to report on the adequacy of internal controls and compliance with laws and regulations. Part I includes separate sections on internal controls and compliance with laws and regulations. Part II provides relevant appendixes for management's use.

On May 5, 1997, we issued an unqualified audit opinion on the FY 1996 DoD Military Retirement Trust Fund Financial Statements. The internal control structure effectively accounted for and managed resources, ensured compliance with laws and regulations, and provided reasonable assurance that the financial statements were free of material misstatements. However, we found that certain internal control weaknesses and noncompliances were not material to the financial statements but merit management attention. See Part I for details.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent, Audit Program Director, at (703) 604-9110 (DSN 664-9110) (DVincent@DODIG.OSD.MIL), or Mr. John M. Seeba, Audit Project Manager, at (703) 604-9134 (DSN 664-9134) (JSeeba@DODIG.OSD.MIL). Appendix E lists the report distribution. The audit team members are listed inside the back cover.

David K. Steensma

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Office of the Inspector General, DoD

Report No. 97-177
(Project No. 6FH-2027.01)

June 25, 1997

Internal Controls and Compliance With Laws and Regulations for the DoD Military Retirement Trust Fund Financial Statements for FY 1996

Executive Summary

Introduction. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires an annual audit of the financial statements of the DoD Military Retirement Trust Fund (the Fund). The DoD Military Retirement Trust Fund Financial Statements for FY 1996 reported total assets of \$135 billion, investments of \$131 billion, and a future funding requirement of \$415 billion. The Fund manager is the Deputy Under Secretary of Defense (Requirements and Resources). The Defense Finance and Accounting Service (DFAS) administers the fund from the DFAS Cleveland Center, Cleveland, Ohio, and the DFAS Denver Center, Denver, Colorado. The Fund manager and DFAS management are responsible for establishing internal controls and for compliance with laws and regulations.

Audit Objectives. The objective of the audit was to determine whether the DoD Military Retirement Trust Fund Financial Statements for FY 1996 were fairly presented in accordance with Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. In addition, we assessed the internal controls and compliance with laws and regulations related to the financial statements. We followed up on conditions noted in our previous audit of the Fund's financial statements. See Appendix A for a discussion of the audit scope and methodology.

Unqualified Audit Opinion. On May 5, 1997, we issued an unqualified audit opinion on the FY 1996 DoD Military Retirement Trust Fund Financial Statements. Our opinion letter was included in the financial statements transmitted by the Under Secretary of Defense (Comptroller) to the Office of Management and Budget. See Appendix D for the financial statements and the audit opinion.

Internal Controls. Overall, management has established a sound internal control structure over the Fund's activities. The internal control structure was effective in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. Management has also established internal controls for reporting performance measures. However, we identified errors in the payment computations for 3 of 120 retiree and annuitant accounts that we reviewed. We also identified a potential weakness in the computation of retiree accounts when the computation is based on the highest years of active-duty pay and we reported our concern to the DFAS Cleveland Center. The DFAS Cleveland Center is reviewing this issue to determine whether a systemic weakness exists in its method of computing retiree pay based on the highest 3 years of active duty pay. However, only a small number of the total population of retiree accounts is currently based on that method of computation. We also followed up on internal control weaknesses identified during the audit of the FY 1995 DoD Military Retirement Trust Fund Financial Statements. The weaknesses were in internal controls over whether retirees were paid from the proper appropriation at the DFAS Cleveland

Center, and over debt collection techniques at the DFAS Cleveland and Denver Centers. The DFAS Cleveland Center had taken action to correct the internal control weakness over whether retiree disbursements were made from the proper appropriations. However, the debt collection techniques at the DFAS Cleveland and Denver Centers had not been corrected, and those Centers had not begun reporting delinquent debts to the Department of the Treasury for collection. The weaknesses in payment computations are not material to the financial statements, but the weaknesses over debt collection techniques are noncompliant with Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982, and Public Law 104-134, the "Debt Collection Improvement Act of 1996," April 26, 1996. Part I.A. is our report on internal controls.

Also, in its FY 1996 Annual Statement of Assurance, the DFAS Cleveland Center reported one uncorrected and one corrected material internal management control weakness as defined by DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996. Those weaknesses were directly related to the DoD Military Retirement Trust Fund. The DFAS Cleveland Center had reported the weaknesses in its FY 1995 Annual Statement of Assurance, which stated that data in the retired pay system had not been reconciled with data in the Services' personnel systems, and that appointments of trustees for mentally incompetent Air Force retirees had been delayed. The DFAS Cleveland Center took action in FY 1995 to correct the weakness regarding reconciliation between the pay systems that should be corrected in FY 1997. We believe the corrective actions to reconcile the data between the retired pay system and the Services' personnel systems should correct the weakness when fully implemented. In future audits, we will monitor the status of this material weakness and its effect on the DoD Military Retirement Trust Fund financial statements. The DFAS Cleveland Center also reported that the material internal control weakness regarding delays in appointing trustees for mentally incompetent Air Force retirees was corrected in FY 1996. During our review of internal controls at the DFAS Cleveland Center and our recomputation of payments to retirees and annuitants, we did not identify any significant errors in the Defense Retiree and Annuitant Pay System data or computations that would indicate that those material internal control weaknesses, as reported by the DFAS Cleveland Center in its FY 1996 Annual Statement of Assurance, had a material effect on the FY 1996 DoD Military Retirement Trust Fund Financial Statements.

Compliance With Laws and Regulations. We reviewed compliance with laws and regulations pertaining to the accuracy of the financial statements. Our tests did not disclose any material noncompliance affecting the financial statements. However, management did not comply with the requirements of the Federal Financial Management Act of 1994, which required the submission of audited financial statements to the Office of Management and Budget by March 1, 1997. Therefore, we were unable to render an audit opinion on the financial statements to the Under Secretary of Defense (Comptroller) before March 1, 1997. Except for the minor noncompliances described above, management complied with the provisions we reviewed. With respect to items not tested, nothing came to our attention that caused us to believe the DoD Military Retirement Trust Fund had not complied, in all material respects, with applicable laws and regulations. Part I.B. is our report on compliance with laws and regulations.

Management Comments. This report contains no recommendations. Therefore, comments were not required and none were received.

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Part I - Audit Results

Audit Background

The Chief Financial Officers Act, as amended by the Federal Financial Management Act of 1994, requires an annual audit of financial statements for trust funds such as the DoD Military Retirement Trust Fund (the Fund). The Fund manager is the Deputy Under Secretary of Defense (Requirements and Resources). The Defense Finance and Accounting Service (DFAS) and the DoD Office of the Actuary are responsible for preparing the financial statements.

Audit Opinion. On May 5, 1997, we issued an unqualified audit opinion on the FY 1996 DoD Military Retirement Trust Fund Financial Statements. Our opinion was included in the financial statements transmitted by the Under Secretary of Defense (Comptroller) to the Office of Management and Budget. See Appendix D for the audit opinion and financial statements.

Fund Administration. The DFAS consolidated the military retired and annuity pay systems and operations into the Defense Retiree and Annuitant Pay System at the DFAS Cleveland and Denver Centers. The consolidation was completed in April 1995. The Defense Retiree and Annuitant Pay System consists of two subsystems that gather, store, and process data. These data are used to generate and account for the payments made by the DoD Military Retirement Trust Fund to retirees, former spouses, and annuitants. The DFAS Cleveland Center, Cleveland, Ohio, establishes and maintains retiree accounts, and the DFAS Denver Center, Denver, Colorado, establishes and maintains annuitant accounts. The DoD Office of the Actuary determines the funding requirements for the Fund. Based on those requirements, the Investment Trust Fund Directorate, Accounting Deputate, Headquarters, DFAS, monitors the contributions that the Services and the U.S. Treasury make to the Fund and invests those contributions in market-based U.S. securities.

Audit Objectives

Our overall objective was to determine whether the DoD Military Retirement Trust Fund Financial Statements for FY 1996 were presented fairly in accordance with Office of Management and Budget (OMB) Bulletin 94-01, "Form and Content of Agency Financial Statements," November 16, 1993. Additional objectives were to evaluate internal controls and compliance with applicable laws and regulations related to the financial statements. We followed up on conditions noted in our previous audit of the Fund's financial statements. Part I.A. is our report on internal controls. Part I.B. is our report on compliance with laws and regulations. Part II, Appendix A, includes the audit scope, methodology, auditing standards, and accounting principles.

**Part I.A. - Review of Internal Control
Structure**

Introduction

Audit Responsibilities. Our audit objective was to determine whether controls over transactions supporting the accounts in the FY 1996 financial statements were adequate to ensure that the accounts were free of material error. In planning and performing our audit of the Fund for the year ended September 30, 1996, we evaluated the internal control structure, including implementation of the DoD management control program. The purposes of this evaluation were to:

- o determine our auditing procedures for rendering an opinion on the financial statements; and

- o determine whether an internal control structure had been established.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we attempted to perform tests to determine the level of assurance that could be placed on those controls.

Management Responsibilities. Management of the Fund is responsible for establishing and maintaining an internal control structure. The responsibility requires management to make estimates and judgments to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- o transactions are properly recorded and accounted for in order to prepare reliable financial statements and to maintain accountability over assets;

- o funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and

- o transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and in compliance with any other laws and regulations that the OMB, the entity's management, or we, have identified as being significant for which compliance can be objectively measured and evaluated.

Internal Control Structure. The three elements of the control structure are the control environment, accounting and related systems, and control procedures. The control environment is the collective effects of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and

procedures. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of control and the emphasis placed on it within the entity. Accounting and related systems are the methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and to maintain accountability for the related assets and liabilities. Control procedures are policies and procedures that management has established, in addition to the control environment and accounting and related systems, to provide reasonable assurance that specific entity objectives will be achieved.

Reportable Conditions

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal control structure element does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors or irregularities would be in amounts that would be material to the statements being audited and would not be detected within a timely period by employees in the normal course of performing their functions.

Material Weaknesses Reported by Management. DFAS, in its combined FY 1996 Annual Statement of Assurance, reported one uncorrected and one corrected material internal control weakness that related to the Fund. DFAS initially reported those weaknesses in the FY 1995 Annual Statement of Assurance. The weaknesses were related to reconciling the retired pay system to the Services' personnel systems and delays in processing certain Air Force retirees' accounts.

Weakness in Personnel Systems. The DFAS Cleveland Center had reported that data in the Defense Retiree and Annuitant Pay System had not been reconciled with the Services' personnel systems. Reconciliations would assist in resolving errors in data elements and in identifying fraudulent or erroneous accounts. In its FY 1996 Annual Statement of Assurance, the DFAS Cleveland Center reported the reconciliation weakness as an uncorrected material internal control weakness to be corrected in FY 1997. During FYs 1995 and 1996, the DFAS Cleveland Center submitted retiree personnel data to the Army, the Air Force, and the Marine Corps for reconciliation with the personnel systems. In FY 1997, the DFAS Cleveland Center will submit retiree data to the Navy for reconciliation with the Navy personnel system. In discussions with DFAS Cleveland Center personnel, we determined that the corrective action initiated by the DFAS Cleveland Center was adequate and should correct the weakness when fully implemented. In future audits, we will continue to monitor the status of this material weakness and its effect on the DoD Military Retirement Trust Fund financial statements.

Review of Internal Control Structure

We agree that this is a material weakness as defined by DoD Directive 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. This material weakness is reportable under DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. However, the weakness did not materially affect the DoD Military Retirement Trust Fund Financial Statements for FY 1996. During our review of the internal controls at the DFAS Cleveland Center and our recomputation of the payments made by the Fund to 60 retirees and 60 annuitants, we did not identify any significant errors in the Defense Retiree and Annuitant Pay System data to indicate that the material internal control weakness, as reported in the DFAS Cleveland Center FY 1996 Annual Statement of Assurance, materially affected the FY 1996 DoD Military Retirement Trust Fund Financial Statements.

Delays in Appointing Trustees. The DFAS Cleveland Center also reported that the material internal control weakness regarding delays in appointing trustees for mentally incompetent Air Force retirees was corrected in FY 1996. The DFAS Cleveland Center reported that they had established standard operating procedures and developed a database to manage those cases, hired additional personnel to review the cases, and performed a management review to validate the effectiveness of the corrective actions. Because the DFAS Cleveland Center actions to correct the material internal control weakness were adequate, we do not plan to monitor the weakness in future audits.

We classified the significant internal controls, policies, and procedures into the following categories: Investments, Payments, Contributions, and Actuarial Cycles. Our evaluation of the internal control structure included all of these categories. During our review of those account balances, we did not identify any material internal control weaknesses that would affect the financial statements. We also determined that the Fund management had established internal controls for reporting performance measures.

We noted other matters involving the internal control structure and its operations that were not material to the financial statements of the Fund but require disclosure.

- o We identified errors in the payment computations for 3 of the 60 retiree accounts that we reviewed during our recomputation tests. We did not identify any errors in the payment computations for the 60 annuitant accounts reviewed.

- o We identified potential internal control weaknesses over a type of retiree payment computation that is based on the highest 3 years of active duty pay. This type of payment computation is called the High 3 average base pay and represents about 24,000 of the 1.6 million retirees paid by the Fund. We selected a separate judgmental sample of 32 retiree accounts that were based on that type of payment computation, and determined that 7 of the 32 accounts were computed incorrectly.

- o We followed up on internal control weaknesses identified in the audit of the DoD Military Retirement Trust Fund Financial Statements for FY 1995.

The weaknesses were in internal controls over debt collection techniques at the DFAS Cleveland and Denver Centers, and over whether retirees were paid from the proper appropriation at the DFAS Cleveland Center. The DFAS Cleveland and Denver Centers had not corrected the internal control weaknesses over debt collection techniques, and those Centers had not implemented procedures to report delinquent debts to the Department of the Treasury for collection.

- o The DFAS Cleveland Center had taken action to correct the internal control weakness over whether retiree disbursements were made from the proper appropriations. See Part II, Appendixes A and B, for a discussion of that weakness.

Payment Computations. During our recomputation tests, we identified 3 errors in the 60 retiree computations made by the DFAS Centers. Based on a separate sample of 32 retiree accounts, we also identified potential internal control weaknesses in the retiree payment computations that were based on the High 3 average base pay. The DFAS made manual errors in processing the 3 retiree accounts; we did not identify any payment errors in the 60 annuitant accounts. The DFAS Cleveland Center overpaid one retiree \$60 in FY 1996 because an incorrect birth date was established in the retiree's account. Additionally, the DFAS Cleveland Center overpaid two retirees \$24 each in FY 1996 because the payment computation using the High 3 average base pay was incorrect. The errors in the three retirees' accounts resulted in a \$108 overpayment to those accounts in FY 1996. Those errors did not have a material effect on the financial statements and did not indicate a systemic weakness in internal controls. Because of the errors identified in the two retiree accounts for which retirement pay was computed using the High 3 average base pay, we expanded our review of those types of accounts.

We requested that the DFAS Cleveland Center compile a database of all retiree accounts for which retirement pay was computed using the High 3 average base pay. The DFAS Cleveland Center identified about 24,000 retiree accounts that were computed using the High 3 average base pay. We selected a judgmental sample of 32 High 3 retiree accounts from the 24,000 accounts. We determined that 7 of the 32 accounts were computed incorrectly. As a result, the retirement pay we computed for those retirees' accounts varied by a \$1 per month overpayment to a \$9 per month underpayment from the monthly retirement pay reported by the DFAS Cleveland Center. We reported the results of that review to the DFAS Cleveland Center in a separate memorandum; the DFAS Cleveland Center agreed that the computations for the seven accounts were incorrect and has made corrections. The DFAS Cleveland Center is also determining whether a systemic weakness exists in computing retiree pay using the High 3 average base pay. We will follow up on the results of that review in our audit of the DoD Military Retirement Trust Fund Financial Statements for FY 1997.

Debt Collection Techniques. During the audit of the DoD Military Retirement Trust Fund Financial Statements for FY 1995, we reported that the DFAS Cleveland and Denver Centers did not consistently apply Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982, to retirees' and annuitants' debts owed to the Fund. During the FY 1996 audit, we followed up on that weakness to determine whether management had implemented

Review of Internal Control Structure

procedures to correct the weakness and whether the Centers had established internal controls to report delinquent debts to the Department of the Treasury for collection, as required by Public Law 104-134, the "Debt Collection Improvement Act of 1996," April 26, 1996.

Public Law 97-365 authorizes Federal agencies to assess interest, penalties, and administrative charges on debts owed by individuals. Public Law 104-134 states that the head of an agency shall notify the Secretary of the Treasury of any nontax debts over 180 days old and shall transfer those debts to the Secretary of the Treasury for collection. During FY 1995, the DFAS Cleveland Center implemented a new policy, and the DFAS Denver Center submitted a systems change request to require the assessment of interest on retiree and annuitant debt. However, the DFAS Cleveland Center had not implemented controls to ensure that the interest was consistently assessed on debts owed to the Fund by retirees. Additionally, the DFAS Denver Center had not implemented the systems change request during FY 1995. Based on our discussions with personnel at the DFAS Cleveland and Denver Centers during the FY 1996 audit, we determined that neither the DFAS Cleveland nor Denver Center had implemented procedures during FY 1996 to correct those weaknesses. As a result, retirees and annuitants were receiving interest-free loans, and the U.S. Government was not receiving the required interest revenue.

The DFAS Denver Center will implement a systems change request in FY 1997 to assess interest, penalties, and administrative charges on annuitants' debts. The implementation of that request should bring the DFAS Denver Center into compliance with Public Law 97-365. We will continue to monitor the implementation of the systems change request by the DFAS Denver Center, and we will determine whether the DFAS Cleveland Center implements additional procedures to assess interest consistently on retirees' debts to the Fund in order to comply with Public Law 97-365. The DFAS Cleveland and Denver Centers also had not established any procedures or policy to comply with Public Law 104-134 because they had not received guidance from Headquarters, DFAS, regarding the implementation of the law. In future audits, we will continue to monitor the DFAS implementation of policies and procedures to comply with Public Law 104-134, and we will determine whether the DFAS Cleveland and Denver Centers are in compliance.

Summary

Overall, internal controls for the Fund appear to be working as designed. Although we found instances of control breakdown, the internal control structure is adequate and effective and identifies any potential problems that could materially affect the financial statements.

**Part I.B. - Review of Compliance With
Laws and Regulations**

Introduction

We evaluated the DoD Military Retirement Trust Fund for material instances of noncompliance with laws and regulations for the fiscal year ended September 30, 1996. Our objective was to assess compliance with laws and regulations to obtain reasonable assurance that the financial statements were free of material misstatements; our objective was not to render an opinion on overall compliance with such provisions. The Under Secretary of Defense (Comptroller) and the Director, DFAS, are responsible for ensuring compliance with laws and regulations applicable to the Fund. The list of laws and regulations we reviewed is in Part II, Appendix C.

Reportable Conditions

Material instances of noncompliance are failures to follow requirements, laws, or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or the sensitivity of the matter would cause others to perceive it as significant.

Our tests of compliance with laws and regulations did not disclose any material weaknesses affecting the financial statements. However, management did not comply with the requirements of the Federal Financial Management Act of 1994, which required the submission of audited financial statements to the Office of Management and Budget by March 1, 1997. We were unable to provide an audit opinion on the financial statements to the Under Secretary of Defense (Comptroller) by March 1, 1997, because of the delayed submission. The IG, DoD, will be unable to issue audit opinions when due if the financial statements are not provided in sufficient time to complete our audit work before the March 1 deadline.

The results of our tests indicate that with respect to the items tested, except for noncompliance with Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994; Public Law 97-365, the "Debt Collection Act of 1982," October 25, 1982; and Public Law 104-134, the "Debt Collection Improvement Act of 1996," April 26, 1996, the Fund complied in all material respects with the applicable laws and regulations. The noncompliance with Public Laws 97-165 and 104-134 was discussed as a reportable condition in our review of internal controls (see Part I.A.).

Except for the minor noncompliances described above, management complied with the provisions we reviewed. With respect to items not tested, nothing came to our attention that caused us to believe that the Fund management had not complied, in all material respects, with the provisions identified above.

Part II - Additional Information

Appendix A. Scope and Methodology

Statements Reviewed. We examined the Principal Statements and the Notes to the Principal Statements of the DoD Military Retirement Trust Fund for the fiscal years ended September 30, 1995, and September 30, 1996. The Principal Statements include the Statement of Financial Position and the Statement of Operations and Changes in Net Position. Also included are the Footnotes, Overview, and Supplemental Information. Our opinion is based on the Principal Statements dated April 1, 1997.

Auditing Standards. We conducted our financial related audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States (the Comptroller General), as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Principal Statements are free of material misstatements. We relied on the guidelines suggested by the GAO and our professional judgment in assessing the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses.

Accounting Principles. Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, OMB; the Secretary of the Treasury; and the Comptroller General, who are the principals of the Joint Financial Management Improvement Program (JFMIP). Specific standards agreed on by those officials are issued by the Director, OMB, and the Comptroller General. Financial statement reporting is governed by accounting standards approved by the JFMIP.

To date, seven accounting standards and two accounting concepts have been published in final form and three accounting standards have been published in draft form. Another accounting standard (No. 8) has been approved by the Federal Accounting Standards Advisory Board, but it must undergo a congressional review before it is promulgated by OMB. OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, incorporates these standards and concepts, and should be used by Federal agencies to prepare financial statements. Table 1 lists the accounting standards and concepts.

Table A-1. Statements of Federal Financial Accounting Standards and Concepts

| <u>Number</u> | <u>Title</u> | <u>Status</u> | <u>Effective Date</u> |
|----------------|---|---------------|-----------------------|
| Standard No. 1 | Accounting for Selected Assets and Liabilities, March 30, 1993 | Final | FY 1994 |
| Standard No. 2 | Accounting for Direct Loans and Loan Guarantees, August 23, 1993 | Final | FY 1994 |
| Standard No. 3 | Accounting for Inventory and Related Property, October 27, 1993 | Final | FY 1994 |
| Standard No. 4 | Managerial Cost Accounting Concepts and Standards for the Federal Government, July 31, 1995 | Final | FY 1997 |
| Standard No. 5 | Accounting for Liabilities of the Federal Government, December 20, 1995 | Final | FY 1997 |
| Standard No. 6 | Accounting for Property, Plant and Equipment, November 30, 1995 | Final | FY 1998 |
| Standard No. 7 | Accounting for Revenue and Other Financing Sources, May 10, 1996 | Final | FY 1998 |
| Standard No. 8 | Supplementary Stewardship Reporting | Approved | |
| Concept No. 1 | Objectives of Federal Financial Reporting, September 2, 1993 | Final | |
| Concept No. 2 | Entity and Display, June 6, 1995 | Final | |

Through FY 1996, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as follows:

- o the standards agreed to and published by the JFMIP Principals;
 - o the form and content requirements of OMB Bulletin No. 94-01;
 - o the accounting standards in agency guidance as of March 29, 1991;
- and
- o accounting principles published by other authoritative sources.

Appendix A. Scope and Methodology

Beginning in FY 1997, agencies are required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, as follows:

- o standards agreed to and published by the Director, OMB; the Secretary of the Treasury, and the Comptroller General;
- o interpretations of the standards issued by OMB;
- o requirements of the effective OMB form and content bulletin; and
- o accounting principles published by other authoritative sources.

Because only three accounting standards and two accounting concepts were effective in FY 1996, most accounting standards for the "other comprehensive basis of accounting" came from the DoD accounting guidance. Previously, DoD 7220.9-M, the "DoD Accounting Manual," June 17, 1991, was the primary DoD accounting guidance. Since FY 1992, the USD(C) has updated sections of DoD 7220.9-M and has incorporated those sections into new volumes of DoD 7000.14-R, the "DoD Financial Management Regulation." The USD(C) has issued 14 volumes as of April 1997 and plans to issue one additional volume. DoD 7000.14-R, when issued in full, will be the single DoD-wide regulation that all DoD Components will use for accounting, budgeting, finance, and financial management training. However, after FY 1996, neither DoD 7220.9-M or DoD 7000.14-R will be the authoritative basis for preparing financial statements.

Scope of the Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. We believe that our audit efforts provide a reasonable basis for our results.

Our review of the internal control structure would not necessarily disclose all matters that might be reportable conditions, and would not necessarily disclose all reportable conditions that are also considered material weaknesses.

We reviewed the internal controls over the establishment and management of retiree and annuitant accounts at the DFAS Cleveland and Denver Centers. Also, we statistically selected 60 retiree and 60 annuitant accounts from the Defense Retiree and Annuitant Pay System data reported by the DFAS Cleveland and Denver Centers to the Defense Manpower Data Center, Monterey, California. We made the statistical selection to verify the reliability of the retiree and annuitant data maintained in the Defense Retiree and Annuitant Pay System and the accuracy of the Defense Retiree and Annuitant Pay System computations. We compared the Defense Retiree and Annuitant Pay System data with source documents to determine whether the retiree and annuitant data maintained in the Defense Retiree and Annuitant Pay System were valid and accurate. We also recomputed the monthly gross retiree and annuitant pay amounts based on source documents to determine whether the

Defense Retiree and Annuitant Pay System computations were accurate. We judgmentally selected a separate sample of 32 retiree accounts from a database of retirees, developed from the Defense Retiree and Annuitant Pay System, whose retirement pay was computed using the High 3 average base pay. For those 12 accounts, we recomputed the monthly gross retiree pay to determine whether the Defense Retiree and Annuitant Pay System computations were accurate and whether a systemic weakness existed in computing retiree pay based on the High 3 method.

We followed up on internal control weaknesses, identified during the audit of the DoD Military Retirement Trust Financial Statements for FY 1995, regarding whether retirees were paid from the proper appropriation. We discussed with personnel at the DFAS Cleveland Center the implementation of internal controls over payments to retirees who retired under the temporary early retirement authority (TERA) granted under Public Law 102-484, the "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992. We reviewed the September and April 1996 vouchers for the monthly retirement payments made to retirees by the DFAS Cleveland Center to verify that the disbursements to TERA retirees were reported under the proper appropriation and that the internal controls implemented by the DFAS Cleveland Center were effective. We also verified that the DFAS Cleveland Center took action to correct payments that had been disbursed from the incorrect appropriation in prior years. We tested the internal controls in the Defense Retiree and Annuitant Pay System to verify that the payments to TERA retirees were properly transferred between appropriations.

To determine whether the DFAS Cleveland and Denver Centers were in compliance with Public Laws 97-365 and 104-134, we verified the status of actions that the Centers had taken since our audit of the DoD Military Retirement Trust Fund Financial Statements for FY 1995. We reviewed the actions taken to correct internal control weaknesses over debt collection techniques, and we verified whether delinquent debts were reported to the Department of the Treasury for collection. We verified the status of those actions in discussions with personnel at the DFAS Cleveland and Denver Centers.

We reviewed the internal controls over the management and computation of the investments and contributions, and, based on supporting documentation, we recomputed the amount of the investment and contributions.

We verified whether the Fund managers had established internal controls over performance measures.

Scope of the Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of the Fund managers. As part of our examination to obtain reasonable assurance that the Principal Statements were free of material misstatements, we performed tests of compliance with laws and regulations that may directly affect the financial statements and other laws and regulations designated by the OMB and DoD. See Part II, Appendix C, for a list of the laws and regulations we reviewed.

Appendix A. Scope and Methodology

As part of our examination, we reviewed management's compliance with DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, which requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls. We compared management's most recent Annual Statement of Assurance with our evaluation of the Fund's policies, procedures, and systems for documenting and supporting financial, statistical, and other information presented to us in the Overview to the Fund's Principal Statements, as well as supplemental financial and management information. It was not our objective, however, to provide an opinion on overall compliance with such provisions.

Audit Period. The audit was conducted from June 1996 to March 1997.

Computer-Processed Data. To achieve the audit objective, we relied on computer-processed data in the Defense Retiree and Annuitant Pay System and the Service payroll systems. We assessed the reliability of the Defense Retiree and Annuitant Pay System data by reviewing the general controls at the DFAS Cleveland and Denver Centers. We determined that the retiree and annuitant data maintained in the Defense Retiree and Annuitant Pay System were valid and accurate by comparing data in that system to source documents. We also determined that the Defense Retiree and Annuitant Pay System accurately computed the monthly gross pay amount for those retirees and annuitants by independently recomputing the pay based on original source documents. To recompute, on a test basis, the amount of the FY 1996 contributions the Services were required to make to the Fund, we relied on the base pay data reported in the Services' payroll systems. We accepted the base pay amounts as reported in the Services' payroll systems; we did not test those systems. We also reconciled the contributions reported by the Services to the Fund's financial statements for FY 1996. We did not identify any significant errors in the Defense Retiree and Annuitant Pay System data or computations during our review of the internal controls at the DFAS Cleveland and Denver Centers. Our recomputations of the retiree and annuitant payments, the Fund's investments, and the Services' contributions indicate that the computer-processed data were reliable. As a result of the audit work performed, nothing came to our attention that caused us to believe that the computer-processed data used by DFAS in compiling the Fund's financial statements were not reliable.

We reviewed the "Annual Report on DFAS Cleveland Center Operating Accounting Systems for Fiscal Year 1996" and the "Annual Report on DFAS Denver Operating, Accounting Systems for Fiscal Year 1996," both required by the "Federal Managers' Financial Integrity Act of 1982" (FMFIA), section 4. During FY 1996, the DFAS Cleveland and Denver Centers evaluated the financial management systems at each of those Centers and reported the results of the reviews in the FY 1996 Annual Statements of Assurance compiled by those Centers. We reviewed the results of the FMFIA reviews, as reported by the DFAS Cleveland and Denver Centers in the FY 1996 Annual Statement of Assurance for each of those Centers, to determine whether management identified any weaknesses in the Defense Retiree and Annuitant Pay System (DRAS). We reviewed the "Technical Data Report for: DRAS," August 6, 1996, which contains compliance information on the Defense Retiree and

Annuitant Pay System and is used to develop the Annual Statements of Assurance. The DFAS Cleveland Center reported that the Defense Retiree and Annuitant Pay System had no weaknesses under the FMFIA. In the FY 1996 Annual Statement of Assurance, the DFAS Cleveland Center reported that based on the system manager's review, the Defense Retiree and Annuitant Pay System was an operating accounting system substantially in compliance with accounting principles, standards, and requirements of the General Accounting Office.

A separate audit of the Defense Retiree and Annuitant Pay System general and application controls was performed under Inspector General, DoD, Project No. 6FG-0093, "Audit of Selected General and Application Controls Over the Defense Retiree and Annuitant Pay System." The audit began in September 1996; the audit objective was to evaluate selected general and application controls over the Defense Retiree and Annuity System to ensure the production of authorized, accurate, complete, and reliable data. The results of that audit will be published in a separate report.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD, the General Accounting Office, and the National Personnel Records Center, St. Louis, Missouri. Further details are available on request.

Appendix B. Prior Audits and Other Reviews

Prior Audits. Since our audit of the FY 1995 DoD Military Retirement Trust Fund Financial Statements, there have been no other audits of the DoD Military Retirement Trust Fund.

We issued an unqualified opinion on the FY 1995 DoD Military Retirement Trust Fund Financial Statements. In our review of internal controls during that audit, we found internal control weaknesses over debt collection techniques at the DFAS Cleveland and Denver Centers and over whether retiree disbursements were made from the proper appropriations at the DFAS Cleveland Center. During our audit of the FY 1996 DoD Military Retirement Trust Fund Financial Statements, we followed up on those internal control weaknesses to determine whether the Centers had implemented procedures to correct the weaknesses. We reported that the DFAS Cleveland and Denver Centers were not charging interest on all retiree and annuitant debts (see Part I.A.). The DFAS Cleveland Center had taken action to correct the internal control weaknesses over whether disbursements to retirees were made from the proper appropriations. As part of the FY 1995 audit, we reported that internal control weaknesses existed over whether disbursements were made from the proper appropriations for certain retiree payments at the DFAS Cleveland Center. Public Law 102-484, the "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992, gives the Services temporary early retirement authority (TERA) to offer early retirements to members with more than 15 but less than 20 years of service. The TERA retirees should be paid from each Service's appropriation for military personnel funding until the retiree has reached 20 years of service, at which time the pay is recomputed and the retiree is paid from the Fund's appropriation. However, the DFAS Cleveland Center had not established internal controls to ensure that individuals retiring under the TERA were paid from the Services' appropriations and that payments to TERA retirees were made from the Fund after those retirees met their 20-year service requirement.

In the FY 1996 audit, we determined that the DFAS Cleveland Center had taken action to correct the retiree payments that were disbursed from the incorrect appropriation and had implemented internal controls to ensure that vouchers reported the disbursements under the proper appropriations. Also, the Defense Retiree and Annuitant Pay System had internal controls to ensure that disbursements to retirees were properly transferred between appropriations when retirees met the 20-year service requirement.

Other Audits. IG, DoD, Project No. 6FG-0093, "Audit of Selected General and Application Controls Over the Defense Retiree and Annuitant Pay System," was a separate audit of the Defense Retiree and Annuitant Pay System general and application controls. The audit began in September 1996; the audit objective was to evaluate selected general and application controls over the Defense Retiree and Annuitant Pay System to ensure the production of authorized, accurate, complete, and reliable data. The results of that audit will be published in a separate report.

Appendix B. Prior Audits and Other Reviews

Other Reviews. DFAS included the Fund as one of five areas reviewed in a fraud detection project, Operation Mongoose. The DFAS established Operation Mongoose with the IG, DoD, and the Defense Manpower Data Center in August 1994. The purpose of the project was to track, match, compare, and monitor high-risk data to identify irregular data profiles that require additional investigation. Operation Mongoose staff members and personnel from the IG, DoD; the Defense Manpower Data Center; the U.S. Secret Service; the Department of Veterans Affairs; and the Social Security Administration traveled to nine foreign countries to verify the existence of retired military and civilian DoD employees and their surviving dependents who were receiving payments. As a result of those trips, Operation Mongoose identified \$3.9 million of improper retiree and annuitant payments, and 464 retiree and annuitant accounts were suspended.

The DFAS conducted a review of the Annuity Pay Subsystem at the DFAS Denver Center from November 27 through December 8, 1995, and reported the results of that review in the "FMFIA, Section 4, Review Report of the Annuity Pay System at DFAS-Denver Center," January 8, 1996. The DFAS Denver Center uses the Annuity Pay Subsystem, a migratory subsystem of DPAS, to establish, adjudicate, and maintain accountability over annuitant accounts. DFAS evaluated the Defense Retiree and Annuitant Pay System to determine whether the DoD migratory and interim migratory accounting systems reasonably complied with statutory and regulatory requirements for system design, procedures, and control techniques. The purpose of the evaluation was to determine whether the Annuity Pay Subsystem operated in accordance with the accounting principles and standards of the General Accounting Office, and with OMB and DoD directives and regulations. The evaluation consisted of an independent review of accounting procedures, feeder systems, functional operations, and reporting capabilities of the Annuity Pay Subsystem and the Annuity Pay Directorate. Based on that review, DFAS determined that the Annuity Pay Subsystem generally conforms to the accounting principles and standards of the General Accounting Office and with OMB and DoD directives and regulations. The review also identified eight conditions that were unrelated to the internal controls of the Annuity Pay Subsystem. However, those conditions were not material internal control weaknesses that would adversely affect the DoD Military Retirement Trust Fund Financial Statements for FY 1996.

Appendix C. Laws and Regulations Reviewed

Subtitle III, Financial Management, Title 31, United States Code, including the requirements for accounting and accounting systems and information in 31 U.S.C., 3511, 3512, 1513, and 3514, and financial statement requirements in 31 U.S.C. 3515

Subtitle A, General Military Law, title 10, United States Code, Armed Forces (as amended through December 1, 1994), chapter 74 - Department of Defense Military Retirement Fund, March 1995

Public Law 96-513¹, "Personnel Management Act of 1981," December 12, 1980

Public Law 97-365, "Debt Collection Act of 1982," October 25, 1982

Public Law 104-134, "Debt Collection Improvement Act of 1996," April 26, 1996

Public Law 98-94², "Department of Defense Authorization Act of 1983,"
September 24, 1983)

Public Law 98-369³, "Deficit Reduction Act of 1984," July 18, 1984

Public Law 99-177, "Public Debt Limit-Balanced Budget and Emergency Deficit Control Act of 1985"

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 102-484, "National Defense Authorization Act for Fiscal Year 1993,"
October 23, 1992

Public Law 103-62, "Government Performance and Results Act of 1993," August 3,
1993

Public Law 103-337, "Department of Defense Authorization Act of 1995," October 5,
1994

Public Law 103-356, "Government Management Reform Act of 1994," October 13,
1994

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements,"
January 8, 1993

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements,"
November 16, 1993)

¹Changed the method of computation to the High 3 average base pay method.

²Established the Military Retirement Trust Fund.

³Made entitlements payable at the beginning of the month.

Appendix C. Laws and Regulations Reviewed

- OMB Circular No. A-121, Revised, "Management Accountability and Control,"
June 21, 1995
- OMB Circular No. A-129, "Managing Federal Credit Programs," November 25, 1988
- OMB Statement of Federal Financial Accounting Standards and Concepts
- Treasury Financial Manual, June 12, 1990
- DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996
- DoD Directive 5010.40, "Management Control (MC) Program Procedures,"
August 28, 1996
- DoD Directive 7200.1, "Administrative Control of Appropriations," May 4, 1995
- DoD Directive 7045.13, "DoD Credit Management and Debt Collection Program,"
October 31, 1986
- DoD Instruction 7220.9, "DoD Accounting Policy," October 1981
- "DoD Guidance on Form and Content of Financial Statements for FY 1994/1995
Financial Activity," October 20, 1994, as supplemented by guidance dated
November 27, 1995
- DoD 7000.14-R, "Financial Management Regulation," volume 1, "General Financial
Management Information, Systems, and Requirements," May 1993
- DoD 7000.14-R, "Financial Management Regulation," volume 5, "Disbursing Policy
and Procedures," December 1993
- DoD 7000.14-R, "Financial Management Regulation," volume 7B, "Military Pay
Policy and Procedures for Retired Pay," June 1995
- DoD 7000.14-R, "Financial Management Regulation," volume 14, "Administrative
Control of Funds and Antideficiency Act Violations," August 1995
- DoD 7000.14-R, "Financial Management Regulation," volume 15, "Security
Assistance Policy and Procedures," March 1993

**Appendix D. DoD Military Retirement Trust
Fund Consolidated Financial Statements for
FY 1996**

DoD Military Retirement Trust Fund

Chief Financial
Officer
Annual Financial
Statement
FY 1996

May 1997

***DoD
MILITARY RETIREMENT
TRUST FUND***

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Overview

***DOD
MILITARY RETIREMENT
TRUST FUND***

OVERVIEW

Overview

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

AS OF SEPTEMBER 30, 1996

A. OVERVIEW

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). Those not in plans administered by the Department of Defense are not 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. The National Defense Authorization Act for FY93 (P.L. 102-484) grants temporary early retirement authority (TERA) for the military services to offer early retirements to members with more than 15 but less than 20 years of service. As of September 30, 1996, there were 42,248 TERA retirees receiving monthly retired pay of \$40.0 million. This authority is scheduled to expire at the end of FY99.

There are three distinct nondisability benefit formulas (relevant to three distinct populations) within the military retirement system. 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%) times (years of service) and is limited to 75%. 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. 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.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

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 are adjusted 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 are annually increased by the percentage change in the CPI minus 1%. At the 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%) continues annually for life.

Nondisability Retirement From Active Service

The current system allows voluntary retirement upon completion of least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (basic 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%) times (years of service, rounded down to the nearest month) and is limited to 75%. Members who first entered the Armed Services on or after August 1, 1986, 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% (50% minus 10%). At age 62, the retired pay is recomputed with the penalty removed.

In FY96, 1.29 million nondisability retirees from active duty were paid \$23.86 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the disability is at least 30% (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% 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 military on or after September 8, 1980, base pay is equal to the average of the highest 36 months of basic pay.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

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% of base pay.

In FY96, 119,000 disability retirees were paid \$1.49 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%) 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 the 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 last three years that he/she was a member of the Armed Services. In effect, the retired pay of any member who entered the Armed Forces on or after September 8, 1980, and who separates from a reserve component before turning 60 is based on active duty pay at the time of separation.

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 a 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 without 20 creditable years, although points earned in non-creditable years are used in the retirement calculation.

In FY96, 216,000 reserve retirees were paid \$2.11 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% of retired pay. RSFPP was designated 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.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

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. Since the present value of the reductions in retired pay of all participating members is only a portion of the present value of SBP benefits payable under the program, total SBP costs are shared by the Government and retirees.

The SBP survivor annuity is initially 55% 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% 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 FY87 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. This age was lowered from 60 to 55. (If remarriage ends in divorce or death the annuity is reinstated.)

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 any eligible 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 when the member first entered the Armed Services. 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 apply to survivor benefits after the reservist reaches age 60 (when the reservist begins to receive retired pay). A second set of optional reductions (funded by the member only) extends this coverage to reservists who have enough service to retire, but have not attained age 60. The added cost of the pre-age 60 coverage is deducted from the member's retired pay and the survivor's annuity.

In FY96, 224,000 surviving families were paid \$1.51 billion.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

Cost-of-Living Increases

All nondisability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. COLAs are automatically scheduled to occur every 12 months, on December 1st, to be reflected in checks issued at the beginning of January. These increases are scheduled to be delayed by nine months through 1998.

The "full" COLA increase normally 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 (CPIW) and is rounded to the nearest 1/10 of one percent.

The benefits of retirees (and their survivors) first entering the Armed Services before August 1, 1986 are annually increased with the full COLA; all other benefits are annually increased with a "partial" COLA. The partial COLA is the full COLA minus 1%. A onetime restoral is given to a partial-COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, the retiree benefit (or 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 Veterans Administration Benefits

The Veterans Administration (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.

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

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

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). Retired regular officers employed by the Federal Government lose a substantial portion of their retired pay while so employed, and all retired members are subject to a combined ceiling equivalent to level V of the Executive Schedule. The ceiling does not apply to those who had retired before October 13, 1978 (or were under age 60 and eligible for reserve retirement on that date) and were continuously employed by the Federal Government since that date.

Relationship of Retired 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 truly comparable to salary levels in the public or private sectors. Reasonable comparisons can be made, however, to basic military compensation (BMC) or regular military compensation (RMC). BMC is the sum of basic pay, the quarters allowance (either cash or in kind), a subsistence allowance (either cash or in kind), and the Federal tax advantages accruing to allowances, since they are not subject to Federal income tax. RMC is BMC plus the average variable housing allowance (which varies by location) and the additional tax advantage it brings. Basic pay represents approximately 76% of BMC or 72% of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 74% of BMC or 69% of RMC. Consequently, a 20-year retiree may be entitled to 50% of basic pay, but only 37% of BMC or 35% of RMC. For a 30-year retiree, the corresponding entitlements are 75% of basic pay but only 60% of BMC or 56% of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Overview

Performance Measures

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 eight years:

- a. October 1, 1995 = .30375
- b. October 1, 1994 = .30306
- c. September 30, 1993 = .28314
- d. September 30, 1992 = .27018
- e. September 30, 1991 = .25127
- f. September 30, 1990 = .21878
- g. September 30, 1989 = .19549
- h. September 30, 1988 = .16211

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Overview _____

Principal Statements

DoD
MILITARY RETIREMENT
TRUST FUND

PRINCIPAL STATEMENTS

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements _____

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements

**Department of Defense
Dod Military Retirement Fund
Statement of Financial Position
as of September 30, 1996
(Thousands)**

| ASSETS | 1996 | 1995 |
|--|----------------------|----------------------|
| 1. Entity Assets: | | |
| a. Transactions with Federal (Intragovernmental) Entities: | | |
| (1). Fund Balances with Treasury (Note 2) | \$57,869 | (\$22,202) |
| (2). Investments, Net (Note 4) | 131,065,203 | 126,728,254 |
| (3). Accounts Receivable, Net (Note 5) | 0 | 0 |
| (4). Interest Receivable | 4,200,579 | 4,294,988 |
| (5). Advances and Prepayments | 0 | 0 |
| (6). Other Federal (Intragovernmental) (Note 6) | 0 | 0 |
| b. Transactions with Non-Federal (Governmental) Entities: | | |
| (1). Investments, Net (Note 4) | 0 | 0 |
| (2). Accounts Receivable, Net (Note 5) | 12,253 | 11,203 |
| (3). Credit Program Receivables/ Related Foreclosed Property, Net (Note 7) | 0 | 0 |
| (4). Interest Receivable, Net | 0 | 0 |
| (5). Advances and Prepayments | 0 | 0 |
| (6). Other Non-Federal (Governmental) (Note 6) | 0 | 0 |
| c. Cash and Other Monetary Assets (Note 3) | 0 | 0 |
| d. Inventory, Net (Note 8) | 0 | 0 |
| e. Work in Process (Note 9) | 0 | 0 |
| f. Operating Materials/Supplies, Net (Note 10) | 0 | 0 |
| g. Stockpile Materials, Net (Note 11) | 0 | 0 |
| h. Seized Property (Note 12) | 0 | 0 |
| i. Forfeited Property, Net (Note 13) | 0 | 0 |
| j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14) | 0 | 0 |
| k. Property, Plant and Equipment, Net (Note 15) | 0 | 0 |
| l. Other Entity Asset | 0 | 0 |
| m. Total Entity Assets | <u>\$135,335,904</u> | <u>\$131,012,243</u> |
| 2. Non-Entity Assets: | | |
| a. Transactions With Federal (Intragovernmental) Entities: | | |
| (1). Fund Balance with Treasury (Note 2) | 0 | 0 |
| (2). Accounts Receivable, Net (Note 5) | 0 | 0 |
| (3). Interest Receivable, Net | 0 | 0 |
| (4). Other (Note 6) | 0 | 0 |

The accompanying notes are an integral part of these statements.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements

Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1996
(Thousands)

| | 1996 | 1995 |
|---|----------------------|----------------------|
| Assets Continued | | |
| 2. Non-Entity Assets Continued: | | |
| b. Transactions With Non-Federal (Governmental) Entities: | | |
| (1). Accounts Receivable, Net (Note 5) | \$0 | \$0 |
| (2). Interest Receivable, Net | 0 | 0 |
| (3). Other (Note 6) | 0 | 0 |
| c. Cash and Other Monetary Assets (Note 3) | 0 | 0 |
| d. Other Non-Entity Assets | 0 | 0 |
| e. Total Non-Entity Assets | <u>0</u> | <u>0</u> |
| 3. Total Assets | <u>\$135,335,904</u> | <u>\$131,012,243</u> |
| LIABILITIES | | |
| 4. Liabilities Covered by Budgetary Resources: | | |
| a. Transactions with Federal (Intragovernmental) Entities: | | |
| (1). Accounts Payable | \$0 | \$0 |
| (2). Interest Payable | 0 | 0 |
| (3). Debt (Note 16) | 0 | 0 |
| (4). Other Federal (Intragovernmental) Liabilities (Note 17) | 0 | 0 |
| b. Transactions with Non-Federal (Governmental) Entities: | | |
| (1). Accounts Payable | 2,548,044 | 2,386,616 |
| (2). Accrued Payroll and Benefits | | |
| (a). Salaries and Wages | 0 | 0 |
| (b). Annual Accrued Leave | 0 | 0 |
| (c). Severance Pay and Separation Allowance | 0 | 0 |
| (3). Interest Payable | 0 | 0 |
| (4). Liabilities for Loan Guarantees (Note 7) | 0 | 0 |
| (5). Lease Liabilities (Note 18) | 0 | 0 |
| (6). Pensions and Other Actuarial Liabilities (Note 19) | 132,787,860 | 128,625,627 |
| (7). Other Non-Federal (Governmental) Liabilities (Note 17) | 0 | 0 |
| c. Total Liabilities Covered by Budgetary Resources: | <u>\$135,335,904</u> | <u>\$131,012,243</u> |

The accompanying notes are an integral part of these statements.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements

**Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1996
(Thousands)**

| | 1996 | 1995 |
|--|------------------------|------------------------|
| Liabilities, Continued | | |
| 5. Liabilities Not Covered by Budgetary Resources: | | |
| a. Transactions with Federal (Intragovernmental) Entities: | | |
| (1). Accounts Payable | \$0 | \$0 |
| (2). Debt (Note 16) | 0 | 0 |
| (3). Other Federal (Intragovernmental) Liabilities (Note 17) | 0 | 0 |
| b. Transactions with Non-Federal (Governmental) Entities: | | |
| (1). Accounts Payable | 0 | 0 |
| (2). Debt (Note 16) | 0 | 0 |
| (3). Lease Liabilities (Note 18) | 0 | 0 |
| (4). Pensions and Other Actuarial Liabilities (Note 19) | 414,912,140 | 407,169,188 |
| (5). Other Non-Federal (Governmental) Liabilities (Note 17) | 110 | 103 |
| c. Total Liabilities Not Covered By Budgetary Resources | <u>\$414,912,250</u> | <u>\$407,169,291</u> |
| 6. Total Liabilities | <u>\$550,248,154</u> | <u>\$538,181,534</u> |
| NET POSITION (Note 20) | | |
| 7. Balances: | | |
| a. Unexpended Appropriations | \$0 | \$0 |
| b. Invested Capital | 0 | 0 |
| c. Cumulative Results of Operations | 0 | 0 |
| d. Other | 0 | 0 |
| e. Future Funding Requirements | (414,912,250) | (407,169,291) |
| f. Total Net Position | <u>(\$414,912,250)</u> | <u>(\$407,169,291)</u> |
| 8. Total Liabilities and Net Position | <u>\$135,335,904</u> | <u>\$131,012,243</u> |

The accompanying notes are an integral part of these statements.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements

Department of Defense
DoD Military Retirement Fund
Statement of Operations (and Changes in Net Position)
For Period Ended September 30, 1996
(Thousands)

| | 1996 | 1995 |
|--|-----------------------|---------------------|
| REVENUES AND FINANCING SOURCES (Note 1E) | | |
| 1. Appropriated Capital Used | \$0 | \$0 |
| 2. Revenues from Sales of Goods and Services | 0 | 0 |
| a. To the Public | 0 | 0 |
| b. Intragovernmental | 0 | 0 |
| 3. Interest and Penalties, Non-Federal | 11,280,558 | 10,891,234 |
| 4. Interest, Federal | 0 | 0 |
| 5. Taxes (Note 21) | 21,873,163 | 23,708,444 |
| 6. Other Revenues and Financing Sources (Note 22) | 0 | 0 |
| 7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies | 0 | 0 |
| 8. Total Revenues and Financing Sources | <u>\$33,153,721</u> | <u>\$34,599,678</u> |
| EXPENSES | | |
| 9. Program or Operating Expenses (Note 23) | \$28,991,489 | \$27,904,862 |
| 10. Cost of Goods Sold (Note 24) | 0 | 0 |
| a. To the Public | 0 | 0 |
| b. Intragovernmental | 0 | 0 |
| 11. Depreciation and Amortization | 0 | 0 |
| 12. Bad Debts and Write-offs | 0 | 0 |
| 13. Interest | 0 | 0 |
| a. Federal Financing Bank/Treasury Borrowing | 0 | 0 |
| b. Federal Securities | 0 | 0 |
| c. Other | 18,600,000 | 0 |
| 14. Other Expenses (Note 25) | <u>\$47,591,489</u> | <u>\$27,904,862</u> |
| 15. Total Expenses | <u>\$47,591,489</u> | <u>\$27,904,862</u> |
| 16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items | (\$14,437,768) | \$6,694,816 |
| 17. Plus (Minus) Extraordinary Items (Note 26) | (7) | 109 |
| 18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | <u>(\$14,437,775)</u> | <u>\$6,694,925</u> |

The accompanying notes are an integral part of these statements.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

| | Principal Statements | |
|---|-------------------------------|-------------------------------|
| Department of Defense Dod Military Retirement Fund Statement of Operations (and Changes in Net Position) For Period Ended September 30, 1996 (Thousands) | 1996 | 1995 |
| EXPENSES, Continued | | |
| 19. Net Position, Beginning Balance, as Previously Stated | (\$407,169,291) | (\$407,169,400) |
| 20. Adjustments (Note 27) | <u>6,694,816</u> | <u>0</u> |
| 21. Net Position, Beginning Balance, as Restated | (\$400,474,475) | (\$407,169,400) |
| 22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses | (14,437,775) | 6,694,925 |
| 23. Plus (Minus) Non Operating Changes (Note 28) | <u>0</u> | <u>(6,694,816)</u> |
| 24. Net Position, Ending Balance | <u><u>(\$414,912,250)</u></u> | <u><u>(\$407,169,291)</u></u> |

The accompanying notes are an integral part of these statements.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Principal Statements _____

The accompanying notes are an integral part of these statements.

Footnotes

***DOD
MILITARY RETIREMENT
TRUST FUND***

***FOOTNOTES
TO THE
PRINCIPAL STATEMENTS***

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes _____

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

**NOTES TO THE DOD MILITARY RETIREMENT FUND
PRINCIPAL STATEMENTS
AS OF SEPTEMBER 30, 1996**

Note 1. Significant Accounting Policies

A. The DoD Military Retirement Fund was authorized by PL98-94 for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs. These financial statements have been prepared to report the financial position and results of operations of the Department of Defense Military Retirement Fund, as required by the Chief Financial Officers (CFO) Act of 1990, and other appropriate legislation. They have been prepared from the books and records of the Defense Finance and Accounting Service Accounting Deputate Investment Trust Directorate (DFAS-HQ/AE). These financial statements are presented on the accrual basis of accounting in accordance with the requirements of the Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements", and subsequent issues.

The program is funded by:

- (1) Annual unfunded liability payment from Treasury
- (2) Monthly Service contributions as a percentage of base pay
- (3) Interest on investments.

B. **Accounting Method Used to Present Actuarial Liability:** Starting in FY 1995 and future years the Military Retirement Trust Fund financial statements will present the unfunded actuarial liability which was determined at the beginning of the fiscal year. This change is in accordance with FAS 35 which permits pension plans to present actuarial data calculated at the beginning of the plan year. This change is needed because of the lengthy time required to develop an accurate end of year actuarial estimate and the accelerated deadlines for financial statements.

Note 2. Fund Balances with Treasury

(Thousands)

Trust Funds \$57,869

Entity Assets (Available). Securities are redeemed to cover expenses.

Note 3. Cash, Foreign Currency and Other Monetary Assets. Not Applicable

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

Note 4. Investments, Net

(Thousands)

| | (1) | (2) | (3) | (4) | (5) |
|---|---------------|---------------|---------------------|------------------------------|-----------------|
| | Cost | Market Value | Amortization Method | Amortized Premium (Discount) | Investments Net |
| A. Intragovernmental Securities: | | | | | |
| Non-Marketable | | | Effective | | |
| Market Based | \$136,554,318 | \$146,294,217 | Interest | \$5,489,115 | \$131,065,203 |

The method used to determine amount amortized, book value of investments, as of September 30, 1996, currently held and related yield on investments conforms to the prevailing practice in the financial community. The calculated yields match up with yields in published security tables of U.S. Treasury securities.

Note 5. Accounts Receivable, Net

(Thousands)

A. Entity Receivables: Governmental Gross/Net amount Due \$12,253

Note 6. Other Federal (Intragovernmental) and Non-Federal (Governmental) Assets
Not Applicable

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers Not Applicable

Note 8. Inventory, Net Not Applicable

Note 9. Work in Process Not Applicable

Note 10. Operating Materials and Supplies (OM&S), Net Not Applicable

Note 11. Stockpile Materials, Net Not Applicable

Note 12. Seized Property Not Applicable

Note 13. Forfeited Property, Net Not Applicable

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

Note 14. Goods Held Under Price Support and Stabilization Programs, Net Not Applicable

Note 15. Property, Plant, and Equipment, Net Not Applicable

Note 16. Debt Not Applicable

Note 17. Other Liabilities
(Thousands)

A. Other Liabilities Covered by Budgetary Resources, Not Applicable

B. Other Information, Not Applicable

C. Other Liabilities Not Covered by Budgetary Resources:
Death Payment Contingency \$110

Note 18. Leases Not Applicable

Note 19. Pensions and Other Actuarial Liabilities
(Thousands)

| | (1) | (2) | (3) | (4) |
|-----------------------------|--|---------------------------------|---|------------------------------------|
| | Actuarial Present Value of Accumulated Plan Benefits | Assumed Interest Rate (%) | Assets Available to Pay Benefits | Unfunded Actuarial Liability |
| Major Program Activities | | | | |
| Pension Plan | \$547,700,000 | 6.75 | \$132,787,860 | \$414,912,140 |

Other Information: The Military Retirement System is a single-employer plan. It is a defined benefit plan. Administrative costs are not borne by the plan. The Fund uses an aggregate entry-age normal cost funding. The actuarial cost method used is the aggregate entry-age-normal. Projected revenues, as authorized by PL98-94, are to be paid into the Fund at the beginning of each fiscal year by the Secretary of the Treasury as certified by the Secretary of Defense. This permanent indefinite appropriation, determined by the Board of Actuaries, represents the unfunded liability for service performed prior to October 1, 1984.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

Accounting Method Used to Present Actuarial Liability: Starting in FY 1995, the Military Retirement Trust Fund financial statements will present the unfunded actuarial liability which was determined at the beginning of the fiscal year. The "Assets Available to Pay Benefits" are determined as of the end of the fiscal year. This is a change from prior year reporting but represents the latest information available to the Department. This change is needed because of the lengthy time required to develop an accurate end of year actuarial estimate and the accelerated deadlines for financial statements.

Actuarial Cost Method: The financial statements present the actuarial liability as of the beginning of the fiscal year using the "accumulated benefit obligation" (ABO) cost method as opposed to the "projected benefit obligation" (PBO) cost method required by the Office of Management and Budget (OMB) Statement of Federal Financial Accounting Standards No. 5 "Accounting for Liabilities of the Federal Government". The ABO cost method presumes no future salary increases.

Note 20. Net Position

(Thousands)

| | |
|------------------------------------|----------------------|
| Future Funding Requirements | \$414,912,250 |
| Trust Fund | |

Note 21. Taxes Not Applicable

Note 22. Other Revenues and Financing Sources

(Thousands)

| | 1996 | 1995 |
|--|-------------------|-------------------|
| (1) Normal Cost Contributions from Services | \$11,174,163 | \$12,238,444 |
| (2) Unfunded Liability Payment from Treasury | <u>10,699,000</u> | <u>11,470,000</u> |
| Total | \$21,873,163 | \$23,708,444 |

Note 23. Program or Operating Expenses

(Thousands)

| | 1996 | 1995 |
|--|--------------|--------------|
| A. Operating Expenses by Object Classification: | | |
| Insurance Claims and Indemnities | \$28,991,489 | \$27,904,862 |

Note 24. Cost of Goods Sold Not Applicable

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

Note 25. Other Expenses

(Thousands)

| | |
|--|--------------|
| Change in Actuarial Liability for period | \$18,600,000 |
|--|--------------|

This represents an increase in the actuarial liability applicable to the period October 1, 1994 through October 1, 1995 but was not known until May 1996 when the actuarial valuation was determined.

Note 26. Extraordinary Items

(Thousands)

| | |
|---|-------|
| Death Payment Contingency - (Increase) - Decrease | (\$7) |
|---|-------|

Note 27. Prior Period Adjustments

(Thousands)

| | |
|--|------------------|
| Reversal of prior year Non Operating Changes | <u>6,694,816</u> |
| Total Prior Period Adjustments | \$6,694,816 |

For FY 1995, the amount reported on line 23 "Plus (minus) Non Operating Changes" represented the differences in "Assets Available to Pay Benefits" (shown on line 4.b.(6) of the Statement of Financial Position) between end of period September 30, 1994 and September 30, 1995. That adjustment was intended to bring the reporting time frames into agreement for the actuarial liabilities and the amounts currently available to pay those liabilities. The Department has changed its method of accounting and will report the latest known actuarial liability (as of October 1 of the fiscal year reported) and the latest known assets available to pay benefits (as of September 30 of the fiscal year reported). The reversal is a one time occurrence to bring net position into agreement with September 30, 1996, general ledger balances.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Footnotes

Note 28. Non-Operating Changes

(Thousands)

| | 1996 | 1995 |
|--|------------|----------------------|
| A. Increases: | | |
| (1) Transfers-In: | | |
| (a) _____ | 0 | 0 |
| (b) _____ | 0 | 0 |
| (c) _____ | 0 | 0 |
| (2) Unexpended Appropriations | 0 | 0 |
| (3) Donations Received | 0 | 0 |
| (4) Other Increases | 0 | 0 |
| (5) Total Increases | <u>\$0</u> | <u>\$0</u> |
| | 1996 | 1995 |
| B. Decreases: | | |
| (1) Transfers-Out: | | |
| (a) _____ | 0 | 0 |
| (b) _____ | 0 | 0 |
| (c) _____ | 0 | 0 |
| (2) Donations | 0 | 0 |
| (3) Other Decreases | 0 | \$6,694,816 |
| (4) Total Decreases | <u>0</u> | <u>\$6,694,816</u> |
| C. Net Non-Operating Changes (Transfers): | <u>\$0</u> | <u>(\$6,694,816)</u> |

D. Other Information: See Note 27 above.

Note 29. Intrafund Eliminations Not reported for FY 1996.

Note 30. Contingencies Not Applicable

Note 31. Other Disclosures Not Applicable

Supplemental

***DOD
MILITARY RETIREMENT
TRUST FUND***

***SUPPLEMENTAL FINANCIAL
AND
MANAGEMENT INFORMATION***

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Supplemental _____

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Supplemental

TABLE 1

**DEPARTMENT OF DEFENSE
MILITARY RETIREMENT FUND
STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS
(\$ in thousands)**

| | <u>For the Plan Year Ended:</u> | |
|---|---------------------------------|-----------------------------|
| | <u>Sept 30, 1994</u> | <u>Sept 30, 1995</u> |
| Assets | | |
| Investments, at fair market value, U.S. Government securities ¹ | \$129,851,484 | \$146,761,497 |
| Accounts receivable Accrued interest ² | \$4,226,344 | \$4,294,988 |
| Due from Military Retirees or their Survivors | \$32,540 | \$11,203 |
| Cash | \$17,440 | (\$22,202) |
| Total Assets | <u>\$134,127,808</u> | <u>\$151,045,486</u> |
| Accounts Payable | (\$2,299,603) | (\$2,386,616) |
| Total Assets Available for Benefits | <u>\$131,828,204</u> | <u>\$148,658,870</u> |

¹ Fair market value of securities has been measured by quoted prices (bid price) in the active U.S. Government securities market. Bid price used represents the over-the-counter quotations as of 4 p.m. Eastern time, as reported in the Wall Street Journal on October 1, 1995.

² Includes accrued interest receivable (including interest purchased).

Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996

Supplemental

TABLE 2

DEPARTMENT OF DEFENSE
MILITARY RETIREMENT FUND
STATEMENT OF CHANGES IN NET ASSETS
AVAILABLE FOR BENEFITS
(\$ in thousands)

| | For the Plan Year Ended: | |
|---|--------------------------|---------------|
| | Sept 30, 1994 | Sept 30, 1995 |
| Net assets available for benefits at beginning of plan year | \$143,262,140 | \$131,828,279 |
| Investment income | | |
| Interest | \$11,513,214 | \$12,034,761 |
| Net appreciation (depreciation) in fair market value of investment ¹ | (\$20,859,161) | \$8,992,248 |
| Contributions | | |
| From services | \$12,808,373 | \$12,238,444 |
| Appropriation to amortize unfunded liability | \$11,908,000 | \$11,470,000 |
| Total additions | \$15,370,426 | \$44,735,454 |
| Benefits paid to participants ² | \$26,804,361 | \$27,904,862 |
| Net assets available for benefits at end of plan year | \$131,828,204 | \$148,658,870 |

¹ Investments bought, sold and held during the plan year ended September 30 appreciated (depreciated) in value as follows:

| | PY 1994 | PY 1995 |
|--|-----------------------|--------------------|
| Appreciated (depreciated) fair value over book value | (\$19,689,733) | \$10,135,775 |
| Amortized discount | 25,460 | 66,949 |
| Amortized premium | (1,194,888) | (1,210,476) |
| Gain (loss) on sale | 0 | 0 |
| | <u>(\$20,859,161)</u> | <u>\$8,992,248</u> |

² The statement has been adjusted to show benefits paid to participants on an accrual basis.

| | PY 1994 | PY 1995 |
|---|---------------------|---------------------|
| Benefits paid on cash basis | \$26,721,434 | \$27,817,850 |
| Increase in liability for benefits due at end of year | 82,927 | 87,013 |
| Benefits paid on accrual basis | <u>\$26,804,361</u> | <u>\$27,904,862</u> |

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Supplemental

TABLE 3

**DEPARTMENT OF DEFENSE
MILITARY RETIREMENT FUND
STATEMENT OF ACCUMULATED PLAN BENEFITS
(\$ in billions)**

| <u>ACCUMULATED PLAN BENEFITS</u> ¹ | For the Plan Year Ended: | |
|--|--------------------------|---------------|
| | Sept 30, 1994 | Sept 30, 1995 |
| Actuarial present value of vested benefits | | |
| Participants currently receiving payments ² | \$409.9 | \$431.3 |
| Other vested participants | \$55.5 | \$55.1 |
| Total vested | \$465.5 | \$486.4 |
| Actuarial present value of non-vested benefits | \$63.6 | \$61.2 |
| Total actuarial present value of accumulated plan benefits | \$529.1 | \$547.7 |
| <u>TOTAL ASSETS</u> ² | \$134.1 | \$151.0 |
| <u>EXCESS OF ACCUMULATED BENEFITS OVER NET ASSETS</u> | \$395.0 | \$396.6 |

¹ See definition of accumulated plan benefits on preceding page.

² Total assets are reported in this table because the liability for benefit payments due is included in the actuarial present value of benefits for participants currently receiving payments.

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Supplemental

TABLE 4

**MILITARY RETIREMENT SYSTEM
STATEMENT OF CHANGES IN PRESENT
VALUE OF ACCUMULATED PLAN BENEFITS
(\$ in billions)**

| | <u>For the Plan Year Ended:</u> | |
|---|---------------------------------|----------------------|
| | <u>Sept 30, 1994</u> | <u>Sept 30, 1995</u> |
| 1. Actuarial present value of accumulated plan benefits at beginning of plan year | \$530.7 | \$529.1 |
| 2. Increase (decrease) during the year ¹ attributable to: | | |
| a. Benefits accumulated and actuarial loss (gain) | \$11.6 | \$18.6 |
| b. Plan amendment(s) | \$0.0 | \$0.0 |
| c. Changes in actuarial assumptions | (\$13.2) | \$0.0 |
| 3. Net increase | (\$1.6) | \$18.6 |
| 4. Actuarial present value of plan benefits at end of year | \$529.1 | \$547.7 |

¹ The assumed order of occurrence was: (1) plan amendments, (2) changes in actuarial assumptions, and (3) benefits accumulated and actuarial loss (gain).

Audit Opinion

***DOD
MILITARY RETIREMENT
TRUST FUND***

AUDIT OPINION

**Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996**

Audit Opinion _____

Appendix D. DoD Military Retirement Trust Fund
Consolidated Financial Statements for FY 1996

Audit Opinion



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

May 5, 1997

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

SUBJECT: Audit Opinion on the DoD Military Retirement Trust Fund Financial Statements
for FY 1996 (Project No. 6FH-2027)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibility of management and the auditors with respect to the financial statements, internal controls, and compliance with laws and regulations. Fund managers are responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to the Military Retirement Trust Fund (the Fund). Our responsibility is to express an opinion on the financial statements based on our audit, to determine whether internal controls are adequate, and to determine whether the Fund complies with applicable laws and regulations.

Unqualified Audit Opinion. In our opinion, the Principal Statements, including the Notes to the Principal Statements, present fairly, in all material respects, the assets, liabilities, and net financial position of the DoD Military Retirement Trust Fund as of September 30, 1996, and September 30, 1995, and the results of operations and changes in net position for the years ended September 30, 1996, and September 30, 1995, in conformity with the accounting principles described below.

Accounting Principles. Accounting principles and standards for the Federal Government remain under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to the Director, Office of Management and Budget (OMB); the Secretary of the Treasury; and the Comptroller General of the United States, who establish accounting standards for the Federal Government. Until financial statement reporting is governed by accounting standards that constitute generally accepted accounting principles for the Federal Government, agencies are required to follow the hierarchy of accounting principles described in OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993.

Scope. We have audited the Principal Statements and Notes to the Principal Statements of the Military Retirement Trust Fund as of September 30, 1996 and September 30, 1995. The Principal Statements include the Statement of Financial Position and the Statement of Operations (and Changes in Net Position).

An audit includes examining, on a test basis, evidence supporting amounts and disclosures in those statements. An audit also includes assessing the accounting principles used, the significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Appendix D. DoD Military Retirement Trust Fund Consolidated Financial Statements for FY 1996

Audit Opinion

Our audit would not necessarily disclose all internal control and compliance conditions that might be considered material weaknesses. Reportable internal control and compliance conditions are summarized in this report and will be further addressed when we issue our reports on internal controls and compliance.

Internal Controls. We reviewed the internal control structure of the Fund and obtained an understanding of the internal control policies and procedures. In addition, we reviewed the Fund managers' implementation of the management control program. We performed applicable tests of the internal control structure to determine whether the controls were effective and working as designed.

The internal control structure was effective in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. However, in its FY 1996 Annual Statement of Assurance, the Defense Finance and Accounting Service Cleveland Center reported an uncorrected material weakness: there was no reconciliation between the retired pay system and the Military personnel systems. The weakness was first reported in the FY 1995 Annual Statement of Assurance and is scheduled to be corrected in FY 1997. We agree with DFAS Cleveland that this is a material weakness; however, our tests did not identify any adverse effects on the financial statements because of this weakness. We will continue to monitor the status of this material weakness and its effects on the Fund's financial statements in future audits.

We also noted instances of noncompliance in the area of debt collection. This weakness is not material to the financial statements, but is noncompliant with the Debt Collection Act of 1982 and the Debt Collection Improvement Act of 1996. DFAS management has initiated corrective actions, and we will continue to monitor the status of those actions.

Compliance With Laws and Regulations. We reviewed compliance with selected provisions of laws and regulations as they pertain to the accuracy of the financial statements. Our tests of compliance did not disclose any material noncompliance affecting the financial statements. However, management did not comply with the requirements of the Federal Financial Management Act of 1994, which required agencies to submit their audited financial statements to the Office of Management and Budget by March 1, 1997. We were unable to provide an audit opinion on the financial statements by March 1, 1997, because we did not receive the financial statements in sufficient time to complete our audit work by the deadline. Except for the noncompliance with the Debt Collection Act of 1982 and the Debt Collection Improvement Act of 1996 described above, management complied with the provisions we reviewed.



Robert J. Lieberman
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Appendix E. Report Distribution

Office of the Secretary of Defense

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House Subcommittee on National Security, Committee on Appropriations
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House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology,
Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight

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