



**Fiscal Year
2011**



**Military
Retirement
Fund
Audited
Financial
Statements**



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Table of Contents

| | |
|---|----------|
| Management’s Discussion and Analysis | 1 |
| Reporting Entity | 1 |
| The Fund | 2 |
| General Benefit Information | 2 |
| Non-Disability Retirement from Active Service | 5 |
| Disability Retirement | 6 |
| Reserve Retirement | 7 |
| Survivor Benefits | 8 |
| Temporary Early Retirement Authority (TERA)..... | 10 |
| Cost-of-Living Increase | 10 |
| Fund Relationships..... | 11 |
| Department of Veterans Affairs Benefits | 11 |
| Other Federal Service | 12 |
| Retired Pay to Military Compensation | 12 |
| Social Security Benefits..... | 12 |
| Significant Changes | 13 |
| During FY 2011 and FY 2010 | 13 |
| Changes for FY 2012 | 14 |
| Performance Measures..... | 14 |
| Projected Long-Term Health of the Fund | 14 |
| U.S. Credit Rating Downgrade | 15 |
| Unified Budget of the Federal Government..... | 15 |
| 20-Year Projection | 16 |
| Expected Problems..... | 18 |
| Investments | 18 |
| Management Oversight..... | 18 |
| Anticipated Changes between the Expected and Actual Investment Rate of Return | 19 |
| Financial Performance Overview | 20 |
| Financial Data | 20 |
| Assets | 20 |
| Liabilities | 21 |
| Management Assurances | 22 |
| Improper Payments Information Act of 2002 (Public Law No. 107-300)..... | 23 |
| Limitations of the Financial Statements | 24 |

| | |
|--|-----------|
| DoD Transmittal of Auditors' Opinion | 25 |
| Independent Auditors' Report..... | 26 |
| Introduction..... | 26 |
| Independent Auditors' Report on the Financial Statements | 27 |
| Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based Upon the Audit Performed in Accordance with <i>Government Auditing Standards</i> | 28 |
| Agency Comments..... | 31 |
| Principal Statements..... | 32 |
| Consolidated Balance Sheet..... | 33 |
| Consolidated Statements of Net Cost | 34 |
| Consolidated Statements of Changes in Net Position..... | 35 |
| Statements of Budgetary Resources..... | 36 |
| DoD Military Retirement Fund Notes to the Principal Statements | 37 |
| NOTE 1. Significant Accounting Policies | 37 |
| NOTE 2. Non-Entity Assets | 40 |
| NOTE 3. Fund Balance With Treasury (FBWT)..... | 40 |
| NOTE 4. Investments..... | 42 |
| NOTE 5. Accounts Receivable | 44 |
| NOTE 6. Liabilities Not Covered By Budgetary Resources | 44 |
| NOTE 7. Other Liabilities..... | 45 |
| NOTE 8. Commitments and Contingencies..... | 45 |
| NOTE 9. Military Retirement Benefit Liabilities | 46 |
| NOTE 10. Disclosures Related to the Statements of Net Cost | 49 |
| NOTE 11. Benefit Program Expense..... | 50 |
| NOTE 12. Disclosures Related to the Statements of Changes in Net Position | 51 |
| NOTE 13. Disclosures Related to the Statements of Budgetary Resources | 51 |
| NOTE 14. Reconciliation of Net Cost of Operations to Budget..... | 52 |
| NOTE 15. Earmarked Funds..... | 53 |
| NOTE 16. Other Disclosures | 54 |
| NOTE 17. Subsequent Event..... | 54 |

Management's Discussion and Analysis Summary of the Military Retirement System For the Years Ended September 30, 2011 and 2010

Reporting Entity

The reporting entity is the Department of Defense (DoD) Military Retirement Fund (MRF). The Military Retirement System (MRS) provides benefits for military members' retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The mission of the MRF is to accumulate adequate funds to finance, on an actuarially sound basis, the liabilities of DoD under military retirement and survivor benefit programs. Statutorily, military retirees are entitled to either "retired pay" or "retainer pay" as opposed to a "pension." For purposes of these statements, however, the terms can be used interchangeably.

Within DoD, the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), the Office of the Under Secretary of Defense for Personnel and Readiness (OUSD(P&R)), and the Defense Finance and Accounting Service (DFAS) jointly oversee the operations of the MRS. DFAS is responsible for the accounting, investing, payment of benefits, and reporting of the MRF. The DoD Office of the Actuary (OACT) within OUSD(P&R) calculates the actuarial liability of the MRF. The Office of Military Personnel Policy within OUSD(P&R) issues policy related to retirement benefits. While the MRF does not have a specified Chief Financial Officer (CFO), the OUSD (C) has oversight of the MRF's financial reporting processes.

The Fund was established by Public Law (P.L.) 98-94 (currently Chapter 74 of Title 10, U.S.C.). This law also established an independent, three-member DoD Retirement Board of Actuaries, appointed by the President. P.L. 110-181 eliminated the DoD Retirement Board of Actuaries and created the DoD Board of Actuaries. The members of the DoD Board of Actuaries are appointed by the Secretary of Defense. The DoD Board of Actuaries is required to review valuations of the MRS, determine the method of amortizing unfunded liabilities, report annually to the Secretary of Defense, and report to the President and the Congress on the status of the MRF at least every four years. OACT provides all technical and administrative support to the DoD Board of Actuaries.

In Fiscal Year (FY) 2011, the MRF paid out approximately \$54.86 billion in benefits to military retirees and survivors. In FY 2010, the MRF paid out approximately \$50.58 billion in such benefits. In addition to OUSD(C) and OUSD(P&R) staff, hundreds of individuals at the DFAS Pay Centers are involved in making the benefit payments. The administrative costs of supporting MRF's activities are not reflected in these financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services that pay for the current year's service cost; annual payments from the U.S. Treasury to amortize the unfunded liability and pay for the normal cost due to Concurrent Receipt (P.L. 108-136); and investment income.

Management's Discussion and Analysis

During FY 2011, the MRF received approximately \$20.97 billion in normal cost payments, a \$66.35 billion payment from the U.S. Treasury, and earned approximately \$18 billion in investment income, net of premium/discount amortization and accrued inflation compensation. In comparison, in FY 2010 the MRF received approximately \$20.41 billion in normal cost payments, a \$63.14 billion payment from the U.S. Treasury, and earned approximately \$10.42 billion in investment income, net of premium/discount amortization and accrued inflation compensation (see the Financial Performance Overview section for an explanation of the changes).

The Fund

General Benefit Information

The MRS 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 (system administered by the Department of Homeland Security), officers of the Public Health Service (system administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (system administered by the Department of Commerce). This report applies only to members in plans administered by the Department.

The MRS is a funded, noncontributory, defined-benefit plan that includes non-disability retired pay, disability retired pay, retired pay for reserve service, survivor annuity programs, and special compensation programs for certain disabled retirees. The Service Secretaries may approve immediate non-disability retired pay at any age with credit of at least 20 years of active duty service. Reserve retirees generally must be at least 60 years old and have at least 20 qualifying years of service before retired pay commences; in some cases, the age can be less than 60 if the reservist performs certain types of active service. P.L. 110-181 allows a 90-day reduction in the reserve retirement age from age 60 for every 3 months of certain Active Duty service served within a fiscal year for service after January 28, 2008 (not to exceed 10 years). There is no vesting of benefits before retirement.

There are three distinct non-disability benefit formulas related to three populations within the MRS.

- 1) Final Pay: Military personnel who first became members of a uniformed service before September 8, 1980, have retired pay equal to final basic pay times a multiplier (final basic pay refers to terminal pay of the member). The multiplier is equal to 2.5 percent times years of service.
- 2) High-3: If the retiree first became a member of a uniformed service on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of final basic pay.
- 3) Career Status Bonus (CSB)/Redux: Those who first became a member of a uniformed service on or after August 1, 1986, may choose between a High-3 and CSB/Redux retirement. Those who elect CSB/Redux receive the CSB outlined below and also have retired pay computed on a base of the average of their highest 36 months of basic pay; however, those who choose to receive the CSB/Redux are subject to a penalty if they

Management's Discussion and Analysis

retire with less than 30 years of service. At age 62, their retired pay is recomputed without the penalty. Members make this election during their 15th year of service and may receive the CSB of \$30,000 in either a lump-sum or installments. Those who elect CSB/Redux must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the \$30,000 (exceptions include death and disability retirement).

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

The FY 2011 National Defense Authorization Act (NDAA) (P.L. 111-383) statutorily required amounts of retired and retainer pay due to a retired member of the uniformed services shall be paid on the first day of each month beginning after the month in which the right to such pay accrues. This means that when the first day of the month falls on a non-business day (weekend / holiday), the pay must be paid the preceding business day. Since October 1, 2011 fell on a Saturday, the MRF distributed the October retired and retainer pay entitlements on September 30, 2011. This legislation did not address, or affect, survivor annuitant pay and certain combat-related compensation. In certain fiscal years, this results in retirees receiving 13 payments in some and 11 payments in others; however, the usual 12 monthly payments will be the most frequent occurrence. For comparative purposes, annual fiscal year amounts shown throughout the MD&A represent 12 monthly payments without regard to the 2011 NDAA and are identified as such.

See Tables 1 and 2.

MILITARY RETIREMENT SYSTEM PROPERTIES
(FOR NONDISABILITY RETIREMENT FROM ACTIVE DUTY)

| Benefit System | Final Pay | High-3 (HI-3) | Career Status Bonus (CSB)/Redux |
|--------------------------------------|---|---|---|
| Applies to: | First became member of a uniformed service before September 8, 1980 | First became member of a uniformed service on or after September 8, 1980 and prior to July 31, 1986, and members joining after July 31, 1986 who elect not to accept the CSB at the 15-year anniversary | First became member of a uniformed service on or after August 1, 1986 and elect to accept the CSB with additional 5-year service obligation |
| Retired Pay Computation Basis: | Final basic pay rate | Highest 36 months of basic pay rate | Highest 36 months of basic pay rate |
| Multiplier: | 2.5% per year of service | 2.5% per year of service | 2.5% per year of service less 1% for each year of service less than 30 (restored at age 62) |
| Cost-of-Living Adjustment Mechanism: | Full Clerical Worker Consumer Price Index (CPI-W) | Full CPI-W | Full CPI-W minus 1% (one-time catchup at age 62) |
| Additional Benefit: | -- | -- | \$30,000 CSB payable at 15-year anniversary upon assumption of 5-year obligation to remain on continuous active duty |

Table 1. Military Retirement System Properties

MILITARY RETIREMENT SYSTEM MULTIPLIERS
(FOR NONDISABILITY RETIREMENT FROM ACTIVE DUTY)

| Years of Service | Final Pay/Hi-3 Multiplier | CSB/Redux Multiplier | |
|------------------|---------------------------|----------------------|--------------|
| | | Before Age 62 | After Age 62 |
| 20 | 50% | 40% | 50% |
| 21 | 52.5 | 43.5 | 52.5 |
| 22 | 55.0 | 47.0 | 55.0 |
| 23 | 57.5 | 50.5 | 57.5 |
| 24 | 60.0 | 54.0 | 60.0 |
| 25 | 62.5 | 57.5 | 62.5 |
| 26 | 65.0 | 61.0 | 65.0 |
| 27 | 67.5 | 64.5 | 67.5 |
| 28 | 70.0 | 68.0 | 70.0 |
| 29 | 72.5 | 71.5 | 72.5 |
| 30 | 75.0 | 75.0 | 75.0 |
| 31 | 77.5 | 77.5 | 77.5 |
| 32 | 80.0 | 80.0 | 80.0 |
| 33 | 82.5 | 82.5 | 82.5 |
| 34 | 85.0 | 85.0 | 85.0 |
| 35 | 87.5 | 87.5 | 87.5 |
| 36 | 90.0 | 90.0 | 90.0 |
| 37 | 92.5 | 92.5 | 92.5 |
| 38 | 95.0 | 95.0 | 95.0 |
| 39 | 97.5 | 97.5 | 97.5 |
| 40 | 100.0 | 100.0 | 100.0 |
| 41 | 102.5 | 102.5 | 102.5 |
| 42 | 105.0 | 105.0 | 105.0 |

Table 2. Military Retirement System Multipliers

Non-Disability Retirement from Active Service

The current retirement system allows for voluntary retirement at any age upon completion of at least 20 years of service, subject to Service Secretary’s approval. The military retiree immediately receives retired pay calculated as base pay multiplied by the specified factor. “Base pay” is equal to terminal basic pay if the retiree first became a member of a uniformed service before September 8, 1980; for all other members, “base pay” is equal to the average of the highest 36 months of basic pay. The factor is equal to 2.5 percent multiplied by the number of years of service, rounded down to the nearest month.

Management's Discussion and Analysis

Members who first entered a Uniformed Service on or after August 1, 1986, who elect CSB/Redux and who retire with less than 30 years of service, receive a temporary penalty until they reach the age of 62. This penalty reduces the factor used to compute retired pay by one percentage point for each full year of service under 30 years. For example, the multiplier for a 20-year retiree would be 40 percent (50% minus 10%, where 50% equals 20 years multiplied by 2.5%) of base pay. At age 62, the retired pay is recomputed with the penalty removed.

As of September 30, 2011, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2011, non-disability retirees were paid approximately \$40.62 billion. (As a result of NDAA 2011, approximately \$43.86 billion was paid in FY 2011.)

As of September 30, 2010, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2010, non-disability retirees were paid approximately \$40.26 billion.

Disability Retirement

A military member in an active component or on Active Duty for more than 30 days who is found unfit for duty is entitled to disability retired pay if the disability:

- 1) is incurred while entitled to basic pay;
- 2) is neither the result of the member's intentional misconduct nor willful neglect;
- 3) was not incurred during a period of unauthorized absence; and
- 4) either:
 - a. the member has at least 20 years of service; or
 - b. the disability is rated at least 30 percent under the Department of Veterans Affairs Schedule of Rating Disabilities (VASRD) and one of the following conditions is met:
 - i. the disability was not noted at the time of the member's entrance on Active Duty (unless clear and unmistakable evidence demonstrates that the disability existed before the member's entrance on Active Duty and was not aggravated by active military service);
 - ii. the disability is the proximate result of performing Active Duty;
 - iii. the disability was incurred in the line of duty in time of war or national emergency; or
 - iv. the disability was incurred in the line of duty after September 14, 1978.

Under certain conditions, members on Active Duty for 30 days or less or on inactive-duty training also are entitled to disability retired pay for disabilities incurred or aggravated in the line of duty.

In disability retirement, the member may elect to receive retired pay equal to either:

- 1) the accrued non-disability retirement benefit regardless of eligibility to retire; or
- 2) base pay multiplied by the rated percent of disability.

Management's Discussion and Analysis

Except for members with more than 30 years of service, the benefit cannot exceed 75 percent of base pay. The excess of the accrued non-disability retirement benefit (1, above) over the disability pay (2, above) is subject to federal income taxes if the member had service on or before September 24, 1975. If not a member of a uniformed service on September 24, 1975, disability retired pay is tax-exempt only for those disabilities that are combat or hazardous duty related. Base pay is equal to final basic pay if the retiree first became a member of a uniformed service before September 8, 1980; otherwise, base pay is equal to the average of the highest 36 months of basic pay.

Members whose disabilities may not be permanent are placed on a temporary-disability retired list and receive disability retirement pay just as if they were permanently disabled; however, the member must be physically examined every 18 months for any change in disability, with a final determination made within 5 years. The temporary disability pay is calculated like the permanent disability retired pay, except that it cannot be less than 50 percent of base pay.

Members who elected the CSB/Redux retirement option, but who retired for disability, are not subject to the reduced CSB/Redux retired pay multiplier and are awarded retired pay based on the disability retired rules outlined above. However, such members continue to be subject to the reduced CPI as CSB recipients.

As of September 30, 2011, there were approximately 95,000 disability retirees receiving retired pay. In FY 2011, disability retirees were paid approximately \$1.36 billion. (As a result of NDAA 2011, approximately \$1.46 billion was paid in FY 2011.)

As of September 30, 2010, there were approximately 93,000 disability retirees receiving retired pay. In FY 2010, disability retirees were paid approximately \$1.37 billion.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service; however, reserve retired pay is not payable until age 60 unless the member performs certain types of active duty or active service specified in the National Defense Authorization Act (NDAA) for FY 2008 (P.L. 110-181). In these cases, the age at which the reserve retiree may collect is reduced below age 60 by 3 months for every 90 days of such service performed within a fiscal year. However, the age cannot go below 50, and eligibility for retiree health benefits remains at age 60 even if the eligibility age for receipt of retired pay is reduced.

Retired pay is computed as base pay multiplied by 2.5 percent for each year of service. If the Reservist was first a member of a Uniformed 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 retired pay begins. If the Reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on Active Duty for the entire period preceding retired pay commencement. The years of service are determined by using a point system, where 360 points convert to one year of service. Typically, one point is awarded for one day of Active Duty service (e.g. Active Duty training) or one inactive duty training (IDT) drill attendance.

Management's Discussion and Analysis

Reservists often perform two IDT periods in one day, thereby receiving 2 retirement points per day. In addition, 15 points are awarded for completion of one 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 generally cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation.

Beginning with years of service that include October 30, 2007, non-active duty points are limited to no more than 130 in any one year. Lower point limitations have applied in the past.

As of September 30, 2011, there were approximately 365,000 reserve retirees receiving retired pay. In FY 2011, reserve retirees were paid approximately \$5.10 billion. (As a result of NDAA 2011, approximately \$5.52 billion was paid in FY 2011.)

As of September 30, 2010, there were approximately 355,000 reserve retirees receiving retired pay. In FY 2010, reserve retirees were paid approximately \$4.96 billion.

Survivor Benefits

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

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

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

The SBP survivor annuity is 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than \$300 or more than the member's full gross monthly retired pay, with one exception. If the member elects CSB/Redux and is subject to a penalty for service under 30 years in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty. However, the annuity for a survivor of a CSB/Redux retiree is subject to the reduced CPI.

When SBP started in 1972, survivor benefits for those 62 and older were reduced by the estimated amount of Social Security for which the survivor would be eligible based on the member's military pay. In 1985, that reduction formula was changed so all annuitants 62 and over received a reduced flat rate of 35 percent of the member's base amount. Beginning October 1, 2005, the reduced rate at age 62 was phased out in increments of 5 percent. On April 1, 2008, the survivor benefit reduction at age 62 was fully eliminated and the rate of 55 percent of the member's elected base amount became the standard for all survivors, regardless of age.

Management's Discussion and Analysis

During FY 1987, SBP's benefits to those survivors who had remarried were changed. Prior to the change, the survivor annuity benefit for a surviving spouse who remarried before age 60 was suspended. In FY 1987, SBP changed to suspend benefits when the remarriage occurred at the age of 55. If the remarriage ends in divorce or death, the annuity is reinstated.

Members who died on Active Duty, in the line of duty on or after September 11, 2001, are assumed to have retired with full disability on the day they died and to have elected full SBP coverage for spouses, former spouses, and/or children. Insurable interest elections may be applicable in some cases. These benefits have been improved and expanded over the history of the program.

The surviving spouse (or dependent children, if there is no surviving spouse or if the spouse subsequently dies) of a reservist who dies in the line of duty while performing inactive service is entitled to an SBP annuity based on the reservist's years of service.

SBP annuities generally are reduced by any Department of Veterans Affairs (VA) survivor benefits (Dependency and Indemnity Compensation [DIC]), and all premiums relating to the reductions are returned to the survivor. The 2008 NDAA enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary Special Survivor Indemnity Allowance (SSIA) that pays a monthly amount (\$50 in FY 2009 gradually increasing to \$310 in FY 2017) to survivors with a DIC offset. The authority for the allowance ends in 2017.

The relationship between SBP and DIC has been the subject of litigation in the U.S. Court of Appeals. As a result of the "Sharp Case" ruling, the SBP benefit of survivors with entitlement to both DIC and SBP who remarry after age 57 is not reduced by DIC benefits received.

As with retired pay, SBP annuities and premiums are annually increased with cost of living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the CSB dies before the age of 62, the survivor's benefit is subject to partial COLAs and his/her annuity increased, on what would have been the member's 62nd birthday, to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the retired pay reductions applicable under SBP take effect for survivor coverage after a Reservist turns 60 (or earlier if they have certain active service) and begins to receive retired pay. The Reserve Component Survivor Benefit Plan (RC-SBP) provides annuities to survivors of Reservists who die before age 60 (or earlier if they have certain active service) provided they attained 20 years of qualified service and elected to participate in the program (or were within their 90-day election window after receiving a letter confirming 20 years of credible service). However, if the death occurs either on active or inactive duty as described above, the survivor receives an annuity under SBP. The added cost of RC-SBP is borne completely by Reservists through deductions from future retired pay.

Management's Discussion and Analysis

Beginning October 1, 2008, a "paid-up" provision eliminated the reduction in retired pay for premiums for SBP, RC-SBP and RSFPP coverage for participants age 70 or older whose retired pay had been reduced for at least 360 months.

As of September 30, 2011, there were approximately 294,000 survivors of military members receiving annuity payments. In FY 2011, survivors were paid approximately \$3.61 billion. (Not affected by NDAA 2011.)

As of September 30, 2010, there were approximately 294,000 survivors of military members receiving annuity payments. In FY 2010, survivors were paid approximately \$3.62 billion.

Temporary Early Retirement Authority (TERA)

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

As of September 30, 2011, there were approximately 57,000 TERA retirees receiving retired pay. In FY 2011, TERA retirees were paid approximately \$907 million. (As a result of NDAA 2011, approximately \$982 million was paid in FY 2011.)

As of September 30, 2010, there were approximately 57,000 TERA retirees receiving retired pay. In FY 2010, TERA retirees were paid approximately \$903 million.

Cost-of-Living Increase

All non-disability retirement, disability retirement, and most survivor annuities are adjusted annually for inflation. COLAs are automatically scheduled to occur every 12 months, on December 1, to be reflected in checks issued at the beginning of January.

The "full" COLA, effective December 1, is computed by calculating the percentage increase in the average CPI from the third quarter of the prior calendar year to the third quarter of the current calendar year. The increase is based on the Urban Wage Earner and Clerical Worker Consumer Price Index (CPI-W) and is rounded to the nearest tenth of one percent.

The benefits of retirees (and most survivors) are increased annually with the full COLA, except for those first entering the armed services on or after August 1, 1986, who elect the \$30,000 CSB. Their benefits are increased annually with a partial COLA equal to the full COLA minus 1 percent (except if the full COLA is less than or equal to 1 percent). A one-time restoral is given

Management's Discussion and Analysis

to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, retired pay (or the survivor benefit, if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoration.

Fund Relationships

Department of Veterans Affairs Benefits

The VA provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of or in combination with DoD retired pay, but through December 31, 2003, were not fully additive. Since VA benefits are exempt from federal income taxes, it is often to the advantage of a member to elect them. Through calendar year 2003, retired pay earned from the Department for military service was offset by any payment received from VA for a VA-rated disability. Beginning with the NDAA for FY 2004 (P.L. 108-136), a series of legislation has been enacted that increasingly reduces or eliminates the offset to military retired pay due to receipt of VA disability compensation. Members with a combined VA disability rating of 50 percent or greater who have at least 20 years of service will have their offset eliminated under the Concurrent Retirement and Disability Pay (CRDP) program. The CRDP program has a 10-year phase-in schedule that began in 2004; however, the offset is already fully eliminated for members whose disabilities are rated total or make the individual unemployable. Members whose disability meets certain combat-related criteria can elect to receive payments against the offset under the Combat Related Special Compensation (CRSC) program. Under CRSC, members are not subject to a phase-in schedule, are not required to have at least 20 years of service, and are not required to have at least a 50 percent VA disability rating. Although CRSC amounts are calculated based on retired pay lost due to offset and are paid from the MRF, CRSC is not technically considered retired pay. CRSC payments are tax exempt. A member may not participate in both the CRDP and CRSC programs simultaneously, but may change from one to the other during an annual "open season."

VA benefits also overlap survivor benefits through the DIC program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefits are returned to the survivor. The 2008 NDAA enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary Special Survivor Indemnity Allowance that pays a monthly amount (\$50 in FY 2009 gradually increasing to \$310 in FY 2017) to survivors with a DIC offset. The authority for this allowance ends in 2017.

The offset relationship between SBP and DIC has been the subject of litigation in the U.S. Court of Appeals. As a result of the "Sharp Case" ruling, the SBP benefit of survivors with entitlement to both DIC and SBP who remarry after age 57 is not reduced by DIC benefits received.

Management's Discussion and Analysis

Other Federal Service

For military retirement purposes, no credit is given for other federal service, except for TERA and 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 and Disability Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees). Military retirees may qualify separately for Civil Service retirement and receive concurrent pay from both systems.

Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which non-disability retired pay is based and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative of salary levels in the public and private sectors for comparative purposes. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay; (2) the housing allowance, which varies by grade, location, and dependency status; (3) the subsistence allowance; and, (4) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 69 percent of RMC for all retirement eligible members. For the 20-year retiree, basic pay is approximately 68 percent of RMC. Consequently, a member retired with 20-years of service and entitled to 50 percent of basic pay only receives 34 percent of RMC. For a 30 year retiree, basic pay is approximately 73 percent of RMC and such member would be entitled to 75 percent of basic pay or 55 percent of RMC. P.L. 109-364 allows members, who retire after January 1, 2007, with greater than 30 years of service, to retire with entitlements exceeding 75 percent of basic pay. These relationships should be considered when military retired pay is compared to compensation under other retirement systems

Social Security Benefits

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

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

For the Old Age, Survivors, and Disability Insurance (OASDI) program, military members must contribute the employee portion of the OASDI payroll tax, with the Federal Government

Management's Discussion and Analysis

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

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

Significant Changes

During FY 2011 and FY 2010

Changes in the MRF valuation during FY 2011 included:

- 1) new long-term economic assumptions due to the Federal Accounting Standards Advisory Board (FASAB) financial reporting Statement of Federal Financial Accounting Standards No. 33 (SFFAS No. 33), discussed further in Note 9, Military Retirement Benefit Liabilities;
- 2) new retired pay offset factors and adjustments;
- 3) new mortality improvement factors; and
- 4) miscellaneous modeling refinements.

Of the changes listed above, SFFAS No. 33, which provides standards for selecting discount rate assumptions and the valuation date for measuring pension liabilities, was the most significant. SFFAS No. 33 requires the use of a yield curve based on marketable Treasury securities to determine the interest rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable Treasury securities. The DoD Board of Actuaries approved items 2 – 4 at their July 2011 meeting. Item 1 is prescribed per standard and therefore the resulting economic assumptions will be different than those assumed by the DoD Board of Actuaries for funding calculations.

There were no legislative benefit changes during FY 2011 that impacted the valuation.

Changes during FY 2010 included: (1) initial implementation of SFFAS No. 33; (2) new non-disabled retirement rates; and (3) new Active Duty decrement rates. All items 1 – 3 are classified as assumption changes to the actuarial valuation. Of these, the initial implementation of SFFAS No. 33 (item 1) was the most significant. The DoD Board of Actuaries approved

Management's Discussion and Analysis

assumption items 2 and 3 at their July 2010 meeting. Item 1 is prescribed per standard and the resulting economic assumptions will be different than those assumed by the DoD Board of Actuaries for funding calculations.

Changes for FY 2012

The potential benefit changes with respect to the MRF in FY 2012 include:

- 1) reform of the Military Retirement System;
- 2) expansion of the SSIA;
- 3) Concurrent Receipt enhancements;
- 4) refinements to the Active and Reserve Duty systems; and
- 5) "Wounded Warrior" legislation reforming the disability retirement system.

Performance Measures

During FY 2011 and 2010, MRF made monthly disbursements to approximately 2.2 million retirees and annuitants.

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for the annuitant population is commonly used. The following information provides the historical ratios for the last 10 years:

- 1) September 30, 2011 = 46.2%
- 2) September 30, 2010 = 43.1%
- 3) September 30, 2009 = 38.0%
- 4) September 30, 2008 = 35.4%
- 5) September 30, 2007 = 34.3%
- 6) September 30, 2006 = 32.8%
- 7) September 30, 2005 = 33.4%
- 8) September 30, 2004 = 33.8%
- 9) September 30, 2003 = 35.1%
- 10) September 30, 2002 = 37.8%

The effective yield of MRF during FY 2011 was approximately 4.9%.

Projected Long-Term Health of the Fund

The projected long-term health of MRF is adequate due to the fact that it has three different sources of funding. The first two sources are appropriated funds:

- 1) annual payments from Treasury to amortize the unfunded liability and pay the normal cost of the concurrent receipt benefits; and

Management's Discussion and Analysis

- 2) monthly normal cost payments from the Services to pay for the current year's service cost.

The third source of funding is earnings on investments, projected to be an increasing contribution to the MRF as the earnings on the investments increase due to an increasing fund balance. All three of these sources can be considered secure sources of funding, backed by the "full faith and credit" of the U.S. Government.

U.S. Credit Rating Downgrade

On August 5, 2011, Standard & Poor's (S&P), a Nationally Recognized Statistical Rating Organization, downgraded the long-term U.S. credit rating by one notch to "AA+" (from the highest rating of "AAA"). The S&P downgrade followed a fiscal plan that Congress and the administration had agreed upon to reduce spending (that S&P viewed as inadequate), and increase the statutory borrowing authority (debt ceiling). In spite of the downgrade, U.S. Treasury instruments are still considered to be a "safe haven" for the world's investment community, as evidenced by their continued low yields. The "safe haven" distinction is partly a result of the U.S. dollar carrying the status of the world's reserve currency, as well as their attractiveness relative to bonds of other nations.

Per FASAB standard (SFFAS No. 33), the MRF is required to set the interest rate assumption for present value estimates based on historical experience of marketable U.S. Treasury securities. This means that a financial shock affecting U.S. Treasury yields in a given quarter will be incorporated in the interest assumption as experience emerges, which is currently over a 10-year period (or 40 quarters).

Unified Budget of the Federal Government

The Military Retirement Trust Fund was created inside the Unified Budget of the Federal Government for the monies of the MRS. All three sources of fund income are intra-governmental transactions consisting of transfers from one Government account to another. The only transactions in a particular year that directly affect the deficit of the Unified Budget are those that pass in or out of the Government, such as tax collections ("in") and beneficiary payments ("out"). These intra-governmental transfers are debits and credits within the federal budget, with no direct effect on the deficit. Conversely, the purchase of securities by the Fund does increase the national debt, specifically the portion of the debt held by the Government – the portion held by the public will not change.

See Figure 1.

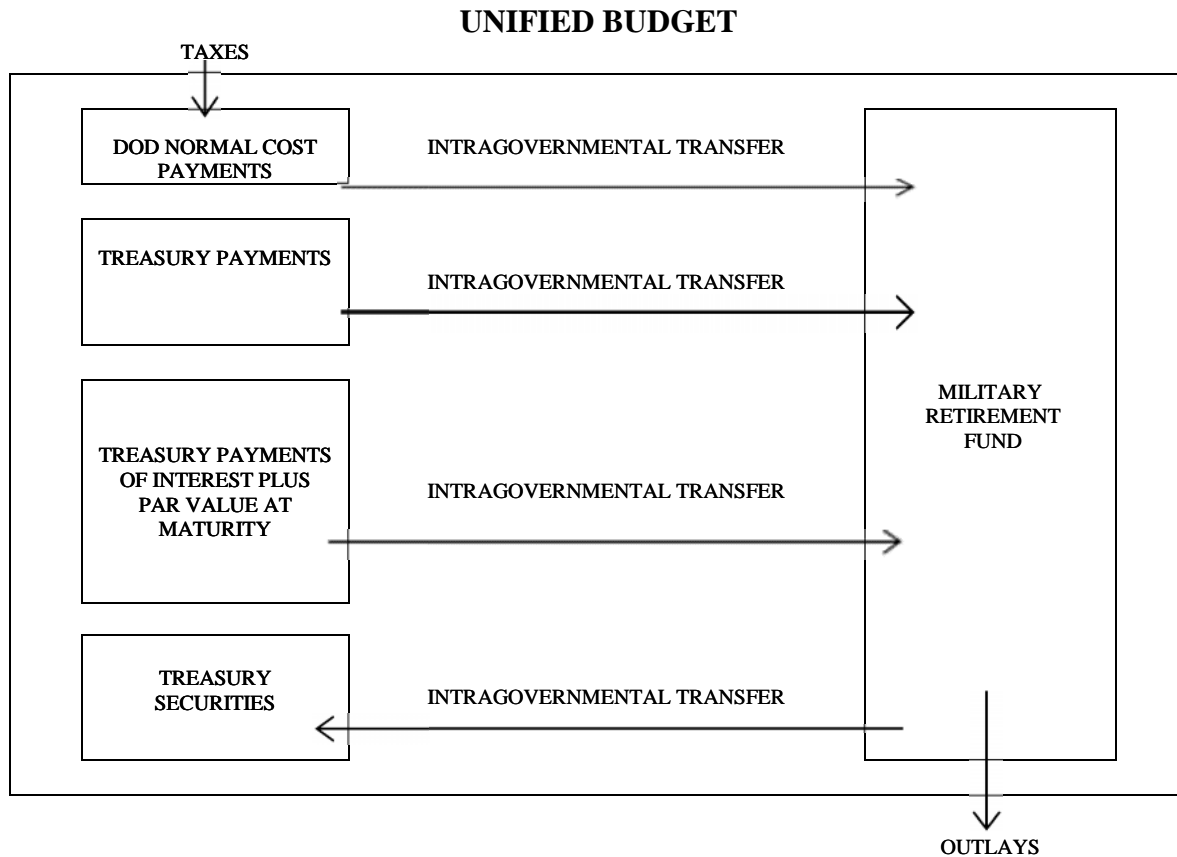


Figure 1. Unified Budget

However, funding does have an effect on the DoD budget. With the normal cost payments (except for Concurrent Receipt) included in the DoD budget, policymakers now consider the impact on future retirement costs when they make manpower decisions, which could have a significant impact on future federal budgets. For example, if a decision were made today to double the size of the active duty and reserve forces, the DoD budget would automatically have an immediate increase in retirement obligations. Under the pay-as-you-go system, the retirement expenses would not necessarily be considered in the initial decision since they would not show up for 20 years.

The fact that MRF costs are fully recognized in advance provides greater benefit security over the long term. Also, when there is a retirement fund, the MRS is not as dependent on obtaining the necessary appropriation from Congress each year in order to pay benefits for that year. This can provide additional benefit security in the short run.

20-Year Projection

Table 3 presents a projection of contributions to and disbursements from the MRF. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-

Management's Discussion and Analysis

year projection period. Further, so long as the funding sources continue making the required payments to the MRF in a timely fashion, the Fund is projected to remain solvent well beyond the 20-year projection horizon.

The following projections were made for FY 2011:

- Basic pay for FY 2011 was projected to be \$60.8 billion.
- Normal cost payments were projected to be \$24.1 billion.
- The unfunded liability amortization payment was projected to be \$61.4 billion.
- Investment income was projected to be \$21.8 billion.
- Fund disbursements for FY 2011 were projected to be \$50.8 billion.

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

| Fiscal Year | Basic Payroll | Normal Cost Payments | Amortization of Unfunded Liability | Investment Income | Fund Disbursements | Fund Balance End of Year |
|-------------|---------------|----------------------|------------------------------------|-------------------|--------------------|--------------------------|
| 2012 | \$63.1 | \$26.3 (0.417) | \$64.8 (1.027) | \$24.9 (0.395) | \$51.7 (0.819) | \$442.5 (7.013) |
| 2013 | \$64.8 | \$27.0 (0.417) | \$67.2 (1.037) | \$28.7 (0.443) | \$53.1 (0.819) | \$512.3 (7.906) |
| 2014 | \$66.7 | \$27.8 (0.417) | \$69.7 (1.045) | \$32.9 (0.493) | \$54.7 (0.820) | \$588.0 (8.816) |
| 2015 | \$68.6 | \$28.6 (0.417) | \$72.3 (1.054) | \$37.3 (0.544) | \$56.2 (0.819) | \$670.0 (9.767) |
| 2016 | \$70.3 | \$29.2 (0.415) | \$75.0 (1.067) | \$42.2 (0.600) | \$57.8 (0.822) | \$758.7 (10.792) |
| 2017 | \$72.2 | \$30.0 (0.416) | \$77.8 (1.078) | \$47.4 (0.657) | \$59.4 (0.823) | \$854.6 (11.837) |
| 2018 | \$74.4 | \$31.0 (0.417) | \$80.8 (1.086) | \$53.1 (0.714) | \$60.9 (0.819) | \$958.5 (12.883) |
| 2019 | \$76.7 | \$31.9 (0.416) | \$83.8 (1.093) | \$59.2 (0.772) | \$62.6 (0.816) | \$1,070.8 (13.961) |
| 2020 | \$79.2 | \$32.9 (0.415) | \$86.9 (1.097) | \$65.8 (0.831) | \$64.9 (0.819) | \$1,191.6 (15.045) |
| 2021 | \$82.0 | \$34.1 (0.416) | \$90.2 (1.100) | \$72.9 (0.889) | \$67.3 (0.821) | \$1,321.6 (16.117) |
| 2022 | \$84.9 | \$35.3 (0.416) | \$93.6 (1.102) | \$80.6 (0.949) | \$69.9 (0.823) | \$1,461.1 (17.210) |
| 2023 | \$87.9 | \$36.6 (0.416) | \$97.1 (1.105) | \$88.8 (1.010) | \$72.6 (0.826) | \$1,611.0 (18.328) |
| 2024 | \$91.0 | \$37.8 (0.415) | \$100.7 (1.107) | \$97.6 (1.073) | \$75.4 (0.829) | \$1,771.8 (19.470) |
| 2025 | \$94.2 | \$39.2 (0.416) | \$104.5 (1.109) | \$107.0 (1.136) | \$78.2 (0.830) | \$1,944.2 (20.639) |
| 2026 | \$97.5 | \$40.5 (0.415) | \$108.4 (1.112) | \$117.1 (1.201) | \$81.1 (0.832) | \$2,129.1 (21.837) |
| 2027 | \$100.9 | \$41.9 (0.415) | -\$2.3 (0.023) | \$121.3 (1.202) | \$84.2 (0.834) | \$2,205.9 (21.862) |
| 2028 | \$104.5 | \$43.4 (0.415) | \$14.1 (0.135) | \$126.6 (1.211) | \$87.5 (0.837) | \$2,302.5 (22.033) |
| 2029 | \$108.4 | \$45.0 (0.415) | \$14.6 (0.135) | \$132.2 (1.220) | \$90.9 (0.839) | \$2,403.4 (22.172) |
| 2030 | \$112.4 | \$46.7 (0.415) | \$15.2 (0.135) | \$138.0 (1.228) | \$94.1 (0.837) | \$2,509.1 (22.323) |
| 2031 | \$116.5 | \$48.4 (0.415) | \$15.7 (0.135) | \$144.0 (1.236) | \$97.5 (0.837) | \$2,619.8 (22.488) |

Table 3. Military Retirement System Past and Projected Flow of Plan Assets

NOTES: - The preceding projections assume a long-term 5.75% interest rate each year.
- The projections will vary in the short-term depending on the actual economic experience.
- The table is also presented in the September 30, 2010, 'Valuation of the Military Retirement System.'
- The above Fund Disbursements do not include the effect of NDAA 2011 (retired pay date change).

Management's Discussion and Analysis

Expected Problems

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

Investments

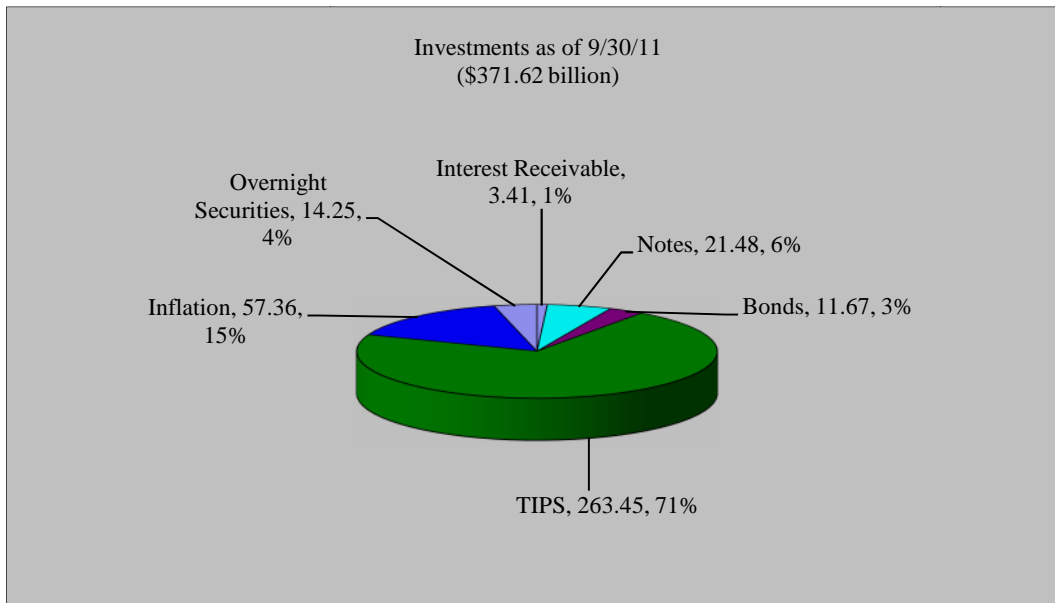


Figure 2. Investments

Figure 2 depicts the book value (par plus premium/discount less amortization of premium/discount plus interest receivable) of investment holdings as of September 30, 2011

Management Oversight

The Fund receives management oversight from the DoD Investment Board established in September 2003. The members of the Investment Board are the Director, DFAS; the Deputy CFO, OUSD(C); and a senior military member, currently the Director, Army Budget. The Investment Board meets twice each fiscal year to consider investment objectives, policies, performance, and strategies with the goal of maximizing MRF's investment income. The Investment Board reviews MRF's law and Department of Treasury guidelines to ensure that MRF complies with board policy guidance and public law. At the September 14, 2011 meeting, the Investment Board approved the FY 2012 investments recommended by the new Investment Advisory Committee (a group of Military Reservists whose civilian expertise is investing). No changes were made to the Investment Policy Statement that incorporated all previously approved strategies into one document. This includes a ladder approach for investments and the "hold to maturity" policy.

Management's Discussion and Analysis

Anticipated Changes between the Expected and Actual Investment Rate of Return

The past few years has seen increased volatility in interest rates, increased volatility in equity markets, increasing deficits, volatility in the markets with regard to energy prices, elevated states of international conflict, increasing sovereign debt levels, and slow economic growth. These items have been a catalyst in the current discussion of implementing strong U.S. fiscal control and monetary policy among politicians. This would necessitate increased borrowing by the U.S. Government for the foreseeable future and there may therefore be a greater opportunity to purchase Treasury market securities at higher rates of interest. Conversely, uneasy equity markets tend to push participants toward Government securities causing downward pressure on the interest rates. Modern corporate financial theory also suggests that non-Federal Government firms may tend to increase pension plan investments in Government securities. An investment strategy has been developed to shift toward U.S. Treasury Inflation-Protected Securities (TIPS) to hedge against any future inflation to maximize the return of MRF over time.

The Fund receives investment income from a variety of U.S. Treasury-based instruments such as bills, notes, bonds and overnight investment certificates. U.S. Treasury bills are short-term securities with maturities of less than one year issued at a discount. U.S. Treasury notes are intermediate securities with maturities of one to 10 years. U.S. Treasury bonds are long-term debt instruments with maturities of greater than 10 years. Overnight certificates are interest-based market securities purchased from the U.S. Treasury that mature the next business day and accrue interest based on the Federal Reserve Bank of New York survey of Reserve repurchase agreement rates.

The Fund also invests in TIPS, which are indexed for inflation. TIPS are fixed-rate instruments designed to protect against inflation and the principal amount is indexed to the CPI by adjusting the CPI at issuance to the current CPI; as inflation increases, so does the principal amount and the coupon.

Management's Discussion and Analysis

Financial Performance Overview

Financial Data

Table 4, presents comparative financial statement information for the MRF

Military Retirement Fund
Analysis of Financial Statements
For the Years Ended September 30, 2011 and 2010
(\$ in Thousands)

| <u>Balance Sheet</u> | <u>2011</u> | <u>2010</u> | <u>Difference Increase / (Decrease)</u> | <u>% Change</u> |
|--|-----------------|-----------------|---|---------------------|
| Fund Balance with Treasury | | | | |
| Sufficiency of funds available to cover estimated disbursements | \$370,337 | \$25,383 | \$344,953 | 1359% |
| Investments | | | | |
| Intragovernmental Securities plus Accrued Interest | \$371,616,281 | \$321,686,840 | \$49,929,440 | 16% |
| Account Receivable, Net amounts, including both inter- and intra-governmental | | | | |
| Continued emphasis placed on collecting these amounts | \$233,475 | \$37,043 | \$196,433 | 530% |
| Other Liabilities | | | | |
| Custodial Liability due to Treasury | \$1,680 | \$1,819 | (\$139) | -8% |
| Military Retirement Benefit Liabilities | | | | |
| Change in Prescribed SFFAS No. 33 Assumptions | \$1,361,267,842 | \$1,262,672,927 | \$98,594,914 | 8% |
| Cumulative Results of Operations | | | | |
| Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by \$102.5 billion and total assets increased by \$50.5 billion. | (\$989,049,609) | (\$940,925,661) | (\$48,123,947) | -5% |
| <u>Statement of Net Costs</u> | | | | |
| Gross Cost of Operations | | | | |
| - Higher Actuarial Liability in FY 11 due to Change in Prescribed SFFAS No. 33 Assumptions | \$153,446,332 | \$136,097,972 | \$17,348,360 | 12% |
| <u>Statement of Budgetary Resources</u> | | | | |
| Distributed Offsetting Receipts | | | | |
| - Unfunded liability amortization payment (FY 11) from Treasury | \$61,404,000 | \$58,619,000 | \$2,785,000 | 5% |

Table 4. Analysis of Financial Statements

Assets

Assets of \$372.2 billion included in Table 4 and shown in Figure 3 represent amounts that the MRF owns and manages. Assets increased \$49.93 billion, 16%, at the end of FY 2011. This increase is largely attributable to purchasing new investments of \$43.4 billion with funds received from the U.S. Treasury payments, Service contributions, and interest received. The net increase in investments is related to expected normal growth to cover unfunded portions of future

Management's Discussion and Analysis

military retirement benefits. Funds not needed to pay current benefits are held in separate trust and special funds and invested in U.S. Treasury securities.

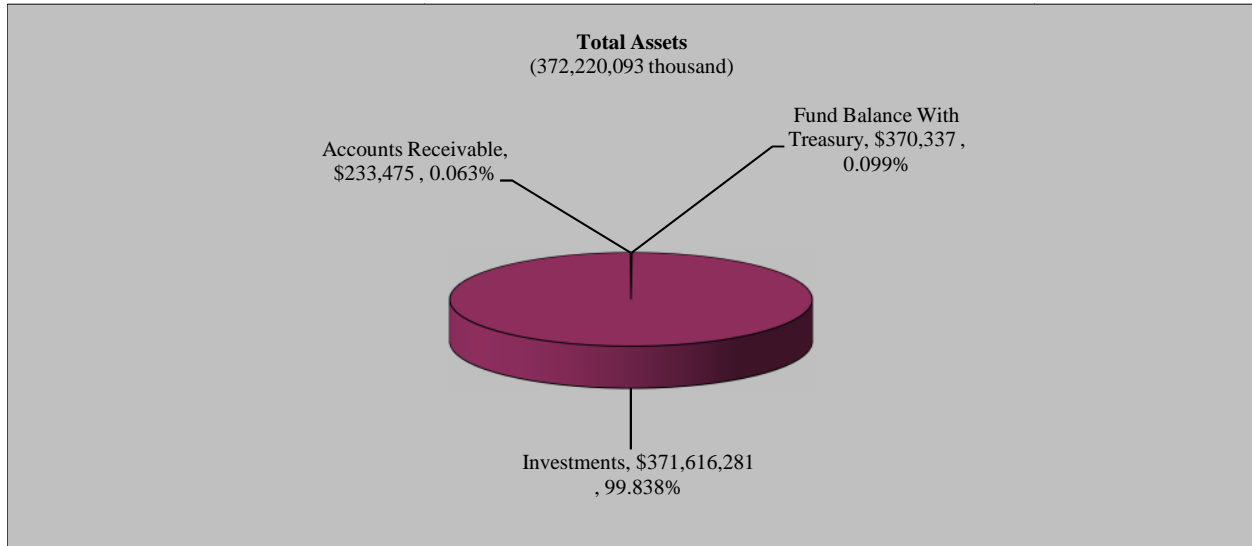


Figure 3. Total Assets

Liabilities

Liabilities of \$1.36 trillion included in Table 4 and shown in Figure 4 represent liabilities related to military retirement pension benefits. The liabilities of the MRF primarily consist of actuarial liability for future benefit payments. Liabilities increased \$98.59 billion, 8%, at the end of FY 2011. This increase is largely attributable to the increase in the actuarial liability calculation.

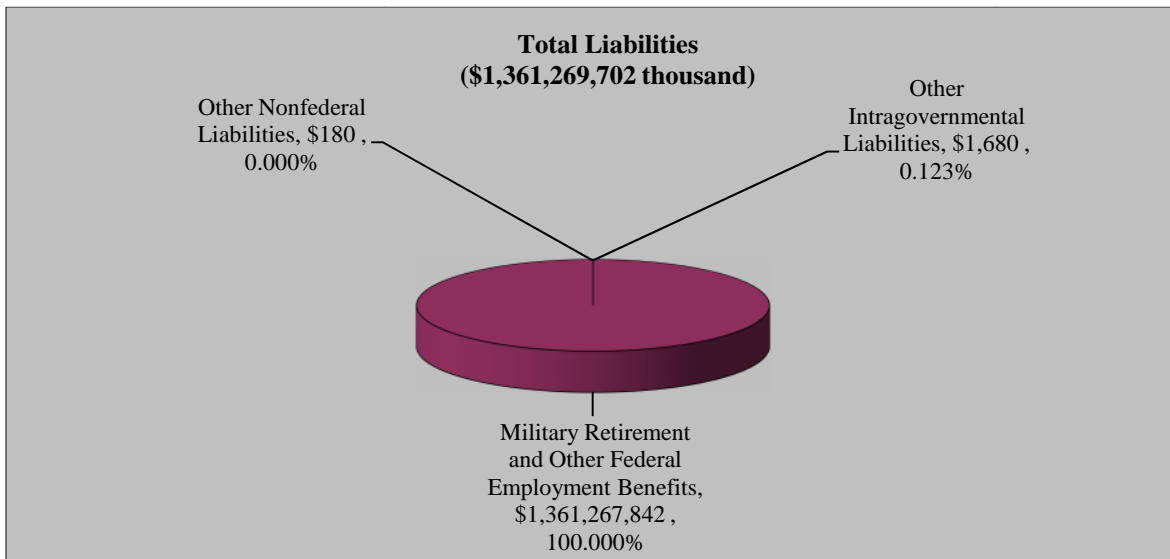


Figure 4. Total Liabilities

Management's Discussion and Analysis

The MRF is confident in its ability to meet its financial obligations. Of the \$1.36 trillion in liabilities, approximately \$368 billion (27%) is covered primarily by investments in U.S. Treasury securities (Figure 5). While the liability presents a negative financial position, the majority of the unfunded portion will come from annual appropriations external to DoD, ensuring benefits are paid regardless of available assets. The initial unfunded actuarial liability, \$529 billion in 1984, is being amortized over 42 years and is expected to be fully funded through U.S. Treasury contributions by FY 2026. The current investments, the interest received on the investments, and the amortization of the initial liability will provide sufficient funds to cover the financial obligations of the MRF.

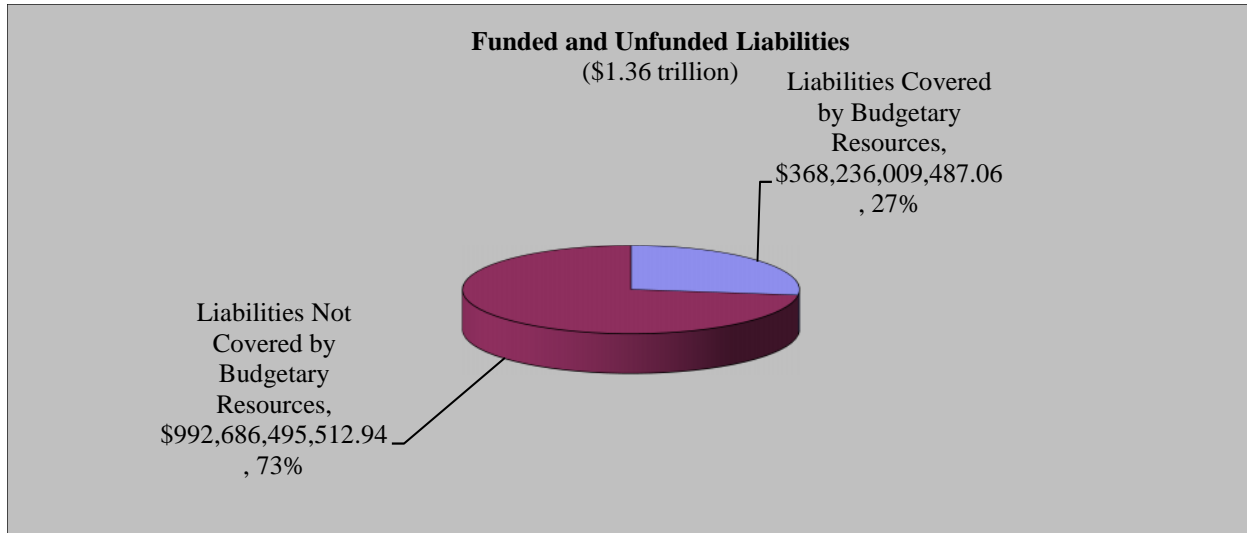


Figure 5. Funded and Unfunded Liabilities

Management Assurances

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of the MRF Management's Discussion and Analysis, DoD, and not MRF, represents the legislative definition of an agency. Beginning with FY 2006, as directed in Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, *Internal Control over Financial Reporting*, the 24 CFO Act agencies (including DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall Federal Managers Financial Integrity Act (FMFIA) assurance statement.

In FY 2011, MRF management determined that the MRF has effective internal controls to support effective and efficient programmatic operations and reliable financial reporting. In FY 2009, the MRF management implemented corrective actions to become substantially compliant with applicable laws and regulations (FMFIA § 2). The current financial management

Management's Discussion and Analysis

systems conforms to financial systems requirements as of year-end and is substantially FMFIA compliant.

The MRF management is responsible for establishing and maintaining effective internal control and financial management systems that meet the objectives of the FMFIA. The MRF conducted its assessment of the effectiveness of internal control over the effectiveness and efficiency of operations and compliance with applicable laws and regulations in accordance with OMB Circular A-123, *Management's Responsibility for Internal Control*. Based on the results of this evaluation, the MRF can provide reasonable assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations for FY 2011 were operating effectively and no material weaknesses were found in the design or operation of the internal controls.

In addition, MRF conducted its assessment of the effectiveness of internal control over financial reporting, which includes safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. Based on the results of this evaluation, the MRF can provide reasonable assurance that its internal control over financial reporting as of June 30, 2011 was operating effectively and no material weaknesses were found in the design or operation of the internal control over financial reporting.

Improper Payments Information Act of 2002 (Public Law No. 107-300)

The MRF public accounts receivable, \$49.6 million, consists mostly of improper payments to deceased retirees and survivors. This is less than 0.02% of the total assets and less than 0.1% of the annual incurred benefit outlays. In comparison, on the FY 2010 Government-Wide Financial statements, that same figure (as a percent of total assets) was about 3%.

The Improper Payments Information Act of 2002, as implemented by OMB Circular A-123, Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments*, requires Federal agencies to review all programs and activities annually and identify those that may be susceptible to significant erroneous payments (i.e., programs with erroneous payments exceeding both \$10 million and 2.5% of program payments). The terms improper and erroneous are used interchangeably. An improper payment occurs when the funds go to the wrong recipient, the recipient receives the incorrect amount of funds, or the recipient receives payment for an ineligible service. Improper payments also include duplicate payments and payments for services not received.

The MRF's risk assessments address the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well as system weaknesses identified internally or by outside audit activities. While MRF's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. In certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in

Management's Discussion and Analysis

FY 2008 indicated that the Department recovered 96% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

The MRF's control processes to prevent, identify, and reduce overpayments to deceased retirees include a series of periodic eligibility notifications, early detection data mining efforts, and partnerships with other Federal and state entities. The MRF takes a proactive approach, routinely comparing retired and annuity payroll master file databases to Social Security Administration "deceased" records and periodically comparing records with the Office of Personnel Management deceased files. "Ad hoc" death match file comparisons are also conducted with the VA's cemetery database files and with individual states (e.g., Texas, California, Florida) with sizable retiree and annuitant populations. Retirees identified as deceased in these comparisons must validate their continued eligibility, or the accounts are suspended.

Certifying officer legislation holds certifying and disbursing officers accountable for Government funds. In accordance with section 2773a of title 10, U.S.C., pecuniary liability attaches automatically when there is a fiscal irregularity, i.e., (1) a physical loss of cash, vouchers, negotiable instruments, or supporting documents; or (2) an improper payment. Efforts to recover from a recipient must be undertaken in accordance with the debt collection procedures in Volume V, Chapters 29 and 30, of the DoD Financial Management Regulation.

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the MRF pursuant to the requirements of the Chief Financial Officers Act (CFO) of 1990. While the statements have been prepared from the books and records of MRF in accordance with the generally accepted accounting principles for Federal entities and formats prescribed by the OMB, the statements are in addition to the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. Unfunded liabilities reported in the financial statements cannot be liquidated without the enactment of an appropriation.

DoD Transmittal of Auditors' Opinion



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

November 4, 2011

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

SUBJECT: Independent Auditor's Report on the DoD Military Retirement Fund, FY 2011 and
FY 2010 Basic Financial Statements (Report No. DoDIG-2012-008)

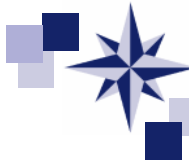
We contracted with the independent certified public accounting firm of Acuity Consulting, Inc., to audit the financial statements of the Military Retirement Fund (MRF), as of September 30, 2011, and for the year then ended, and provide a report on internal controls over financial reporting and compliance with laws and regulations. The contract required that Acuity Consulting, Inc., conduct the audit in accordance with U.S. generally accepted government auditing standards, Office of Management and Budget audit guidance, and the Government Accountability Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2008. Acuity Consulting's audit resulted in an unqualified opinion. Acuity Consulting concluded that the financial statements were presented fairly, in all material respects, and conformed with U.S. generally accepted accounting principles. The report discusses three significant deficiencies related to MRF internal controls over financial reporting. The results of the audit are presented in the attached report.

We reviewed Acuity Consulting's report and related documentation and discussed audit results with Acuity representatives. Our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the MRF's financial statements, conclusions about the effectiveness of internal controls, conclusions on whether the MRF's financial management systems substantially complied with the "Federal Financial Management Improvement Act of 1996," or conclusions on compliance with laws and regulations. Acuity Consulting is responsible for the attached auditor's report, dated November 4, 2011, and the conclusions expressed in the report. However, our review disclosed no instances where Acuity Consulting did not comply, in all material respects, with U.S. generally accepted government auditing standards.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5868 (DSN 329-5868).

Patricia A. Marsh
Patricia A. Marsh, CPA
Assistant Inspector General
Financial Management and Reporting

Attachment:
As stated



Acuity Consulting, Inc.

Bringing Tomorrow's Solutions into Focus Today

2800 Eisenhower Avenue, Suite 100
Alexandria, VA 22314

Phone (703) 739-1091
Fax (703) 329-0294

Independent Auditors' Report

TO: The Audit Committee of the Department of Defense Military Retirement Fund
The Deputy Under Secretary of Defense for Program Integration, Department of Defense

Introduction

We have audited the balance sheets of the Department of Defense (DoD) Military Retirement Fund (MRF or the Fund) as of September 30, 2011 and 2010, as well as the related statements of net cost, changes in net position, and budgetary resources (the financial statements) for the years then ended. The objective of our audit was to express an opinion on the fair presentation of the financial statements as of September 30, 2011 and 2010. In connection with our audits, we also considered the Fund's internal controls over financial reporting and tested the Fund's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion of the financial statements, we found that the Fund's financial statements as of and for the years ended September 30, 2011 and 2010, are presented fairly, in all material respects, and in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal controls would not necessarily disclose all significant deficiencies in the internal control over financial reporting that might be significant deficiencies under standards issued by the American Institute of Certified Public Accountants (AICPA) and Office of Management and Budget (OMB) Bulletin 07-04, Audit Requirements for Federal Financial Statements. The audit disclosed no instances in which the Fund's systems did not substantially comply with the Federal Financial Management Improvement Act (FFMIA) of 1996 § 803(a) requirements. The results of our tests of compliance with certain provisions of laws and regulations did not disclose any instances of noncompliance required to be reported herein under Government Auditing Standards, issued by the Comptroller General of the United States and OMB Bulletin No. 07-04, Audit Requirements for Federal Financial Statements.

The following sections discuss in more detail our report on the Fund's financial statements, our consideration of the internal control over financial reporting, and our tests of the Fund's compliance with certain provisions of applicable laws and regulations.

Independent Auditors' Report

Independent Auditors' Report on the Financial Statements

We have audited the accompanying balance sheets of the Department of Defense (DoD) MRF as of September 30, 2011 and 2010, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

The MRF is required to invest in Treasury securities. On August 5, 2011 the U.S. credit rating was downgraded to AA+ by a nationally recognized statistical rating organization. The detailed discussion of this matter is included in Note 4.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the DoD MRF as of September 30, 2011 and 2010, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated November 4, 2011, on our consideration of the Fund's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts,

Independent Auditors' Report

agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

Independent Auditors' Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based Upon the Audit Performed in Accordance with *Government Auditing Standards*

We have audited the financial statements of the DoD MRF as of and for the years ended September 30, 2011 and 2010, and have issued our report thereon dated November 4, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

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

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified deficiencies in internal control over financial reporting, described below, that we consider to be significant deficiencies in internal control over financial reporting.

We considered the following matters to be *significant deficiencies*:

1. The MRF has partially effective controls over Benefit Payments. The Fund's payment of entitlements is highly automated and the control activities over the Benefit Payments cycle are primarily information technology (IT) application controls. Review of 45 High-3 method

Independent Auditors' Report

retiree payment accounts determined that six retirees were incorrectly paid every month. Specifically, the calculated base pay using the High-3 years' of pay reflected on the Form 99 generated from the Defense Joint Military Pay System (DJMS) does not agree with the amount reflected in the Retiree and Casualty Pay Subsystem (RCPS). These errors were due to miscalculations by either the Service or the Defense Finance and Accounting Service – Cleveland (DFAS-CL).

The controls in place to validate retiree information, provided by the Services, and proper retirement benefit calculations were not effective. In this sample, the net effect of these errors is an overall underpayment of \$28 per month. The evaluation of the sample did not identify the need for an adjustment to the financial statements.

We noted that DFAS-CL has developed some compensating controls to help maintain data integrity and proper payments. These controls appear to be partially effective. Specifically, the data matching with the military pay system, Social Security Administration, and Veterans Affairs data appear to be effective in verifying retired status and ensuring retirement benefits are not paid to deceased members. Also, DFAS-CL developed and implemented a *HI-36 Calculator Tool* to validate new account payment amounts specifically for the High-3 payment method.

Management stated that “in 2010, DFAS-CL built a HI-36 calculator that made it much easier for New Accounts Operations to calculate the High-3 Base Amount for manual cases. This calculator was tested and proved to work for many types of exception cases. It improved efficiency and accuracy of the High-3 calculation for manual cases. We also began work to build the batch version of the High-3 calculator. Testing continued through May and it was implemented in June 2011. In each month since June, DFAS-CL runs the High-3 Batch Calculator for all the High-3 accounts for the month. The tool extracts the High-3 Base Amount from the Retired & Annuitant Pay System and compares it to the results of the calculation. Differences are corrected manually. DFAS-CL has determined they will use this tool prospectively and not attempt to validate historical accounts that were established prior to its implementation.”

In addition, the following actions have been taken:

- A systems fix was proposed in a White Paper, which was approved in July 2011. The existing requirements for the automated High-3 routine were modified to include edits and reject conditions to ensure that accounts with bad data were rejected and sent to New Accounts for manual correction.
- Requirements have been written and reviewed; coding and unit testing is underway. The intention is to implement the system fix in the January 2012 release.

We recommend that the DFAS-CL Retired and Annuity Pay Division correct the retiree accounts for the noted errors to reflect the proper amounts due. Also, we recommend they develop and implement a plan to validate the initial High-3 calculation for all members receiving benefit payments of this calculation method.

Independent Auditors' Report

2. Review of Defense Retiree Annuitant Pay System (DRAS) System Authorization Access Request (SAAR) Forms identified an internal control weakness in regard to the maintenance of and proper authorization of SAAR Forms. Specifically, review of 50 SAAR Forms identified three discrepancies (6%). DFAS-CL was unable to provide SAAR Forms for three users, as these user accounts were overlooked and the SAAR Forms were misplaced. Without a SAAR Form it is possible users may be provided access that they do not require to complete their job functions, and/or they may have access that is inconsistent or incompatible with their positions.

Defense Finance and Accounting Service – Cleveland (DFAS-CL) reported the three users no longer required access to the system. Therefore, we recommended the user accounts be disabled or deleted and provide supporting documentation to Acuity once corrective action had been taken. Acuity confirmed that DFAS-CL Retired and Annuity Pay deleted the three user accounts during audit and, accordingly, no further corrective action is required to correct these specific exceptions.

While the error rate related to this year's audit is relatively low, this internal control weakness has been identified each year since Fiscal Year (FY) 2008 with little evidence of improvement in internal controls. Accordingly, we recommend DFAS-CL Retired and Annuity Pay:

- a. Continue storing all DRAS SAAR Forms in a central repository.
 - b. Conduct a quarterly review of DRAS SAAR Forms to ensure appropriate access rights are granted to users and SAAR Forms are properly completed with valid signatures and dates.
3. While the Office of the Under Secretary of Defense (Comptroller) (OUSD(C)) has oversight of the MRF's financial reporting processes, the Fund does not have a specified Chief Financial Officer (CFO). Responsibility for management of the MRF is shared among the following three organizations: the Defense Finance and Accounting Service, the Office of the Actuary, and the OUSD(C). This creates a potential weakness, as no specific function or office has total ownership of the Fund. This has been a persistent condition and reported to Fund management since FY 2008. Management has not yet assigned and appointed overall responsibility to a single entity for the MRF. To consolidate responsibility for an agency's financial management, the CFO Act requires that "an agency Chief Financial Officer shall oversee all financial management activities relating to the programs and operations of the agency." This creates a potential weakness, as no specific function or office has total ownership of the Fund.

Management stated OUSD(C) assumes financial management responsibilities for the Fund while Personnel and Readiness (P&R) performs operational functions of the Fund within P&R's purview. These roles and responsibilities will be outlined in a charter establishing a governance board charged with overseeing the Fund, which is currently in draft.

Acuity recommends MRF management appoint a responsible party to be assigned overall responsibility for the Fund.

Independent Auditors' Report

Other internal control deficiencies we did not consider to be significant, either individually or collectively, are to be reported to management separately in a management letter to be dated November 30, 2011.

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

Other matters of noncompliance with laws and regulations that we do not consider to be significant, either individually or collectively, are to be reported to management separately in a management letter to be dated November 30, 2011.

Agency Comments

Throughout the audit as internal control weaknesses were identified, we provided them to representatives of the Audit Committee and management of the Fund, who then provided us with comments, which we incorporated as appropriate. The Audit Committee and the management of the Fund expressed their continuing commitment to address the deficiencies identified in this report. Management's planned corrective actions provide reasonable assurance the reported conditions will be detected and corrected in the future.

This report on Internal Control over Financial Reporting and on Compliance and Other Matters is intended solely for the information and use of the Inspector General of the Department of Defense, the Audit Committee and management of the Fund, other Defense Organizations, OMB, the Government Accountability Office (GAO), and the United States Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Acuity Consulting, Inc.

November 4, 2011

Principal Statements

Principal Statements

Consolidated Balance Sheet

**Department of Defense
Military Retirement Fund
CONSOLIDATED BALANCE SHEETS
As of September 30, 2011 and 2010**

| (\$ In Thousands) | <u>2011</u> | <u>2010</u> |
|---|-------------------------|-------------------------|
| ASSETS | | |
| Intragovernmental: | | |
| Fund Balance with Treasury (Note 3) | \$ 370,337 | \$ 25,383 |
| Investments (Note 4) | 371,616,281 | 321,686,840 |
| Accounts Receivable (Note 5) | <u>186,057</u> | <u>0</u> |
| Total Intragovernmental Assets | \$ 372,172,675 | \$ 321,712,223 |
| Accounts Receivable, Net (Note 5) | <u>47,418</u> | <u>37,043</u> |
| TOTAL ASSETS | \$ <u>372,220,093</u> | \$ <u>321,749,266</u> |
| LIABILITIES | | |
| Intragovernmental: | | |
| Other Liabilities (Note 7) | <u>1,680</u> | <u>1,819</u> |
| Total Intragovernmental Liabilities | \$ <u>1,680</u> | \$ <u>1,819</u> |
| Military Retirement Benefit Liabilities (Notes 6 & 9) | 1,361,267,842 | 1,262,672,927 |
| Other Liabilities (Note 7) | <u>180</u> | <u>181</u> |
| TOTAL LIABILITIES | \$ 1,361,269,702 | \$ 1,262,674,927 |
| NET POSITION | | |
| Cumulative Results of Operations - Earmarked Funds | <u>(989,049,609)</u> | <u>(940,925,661)</u> |
| TOTAL NET POSITION | \$ <u>(989,049,609)</u> | \$ <u>(940,925,661)</u> |
| TOTAL LIABILITIES AND NET POSITION | \$ <u>372,220,093</u> | \$ <u>321,749,266</u> |

The accompanying notes are an integral part of these statements.

Principal Statements

Consolidated Statements of Net Cost

**Department of Defense
Military Retirement Fund
CONSOLIDATED STATEMENTS OF NET COST
For the Years Ended September 30, 2011 and 2010**

| (\$ In Thousands) | <u>2011</u> | <u>2010</u> |
|---|-----------------------------|-----------------------------|
| Program Costs | | |
| Gross Costs (Note 10) | \$ 50,986,816 | \$ 51,091,079 |
| (Less: Earned Revenue) (Note 10) | <u>(105,322,384)</u> | <u>(93,929,724)</u> |
| Net Cost before Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits | (54,335,568) | (42,838,645) |
| Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits | <u>102,459,516</u> | <u>85,006,894</u> |
| Net Cost of Operations (Note 14) | \$ <u><u>48,123,948</u></u> | \$ <u><u>42,168,249</u></u> |

The accompanying notes are an integral part of these statements.

Principal Statements

Consolidated Statements of Changes in Net Position

**Department of Defense
Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2011 and 2010**

| (\$ In Thousands) | <u>2011</u> | <u>2010</u> |
|---|-------------------------|-------------------------|
| CUMULATIVE RESULTS OF OPERATIONS | | |
| Beginning Balances | \$ (940,925,661) | \$ (898,757,412) |
| Net Cost of Operations | <u>48,123,948</u> | <u>42,168,249</u> |
| Net Change | <u>(48,123,948)</u> | <u>(42,168,249)</u> |
| Cumulative Results of Operations | <u>(989,049,609)</u> | <u>(940,925,661)</u> |
| Net Position (Note 12) | \$ <u>(989,049,609)</u> | \$ <u>(940,925,661)</u> |

The accompanying notes are an integral part of these statements.

Principal Statements

Statements of Budgetary Resources

Department of Defense
Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2011 and 2010

| (\$ In Thousands) | <u>2011</u> | <u>2010</u> |
|--|-----------------------|-----------------------|
| Budgetary Resources (Note 13) | | |
| Unobligated balance, brought forward, October 1 | \$ 0 | \$ 0 |
| Budget authority | | |
| Appropriation | <u>104,852,827</u> | <u>93,678,557</u> |
| Subtotal | 104,852,827 | 93,678,557 |
| Temporarily not available pursuant to Public Law | <u>(53,855,497)</u> | <u>(42,582,432)</u> |
| Total Budgetary Resources | \$ <u>50,997,330</u> | \$ <u>51,096,125</u> |
| | | |
| Status of Budgetary Resources | | |
| Obligations incurred: | | |
| Direct | \$ <u>50,997,330</u> | \$ <u>51,096,125</u> |
| | | |
| Total status of budgetary resources | \$ <u>50,997,330</u> | \$ <u>51,096,125</u> |
| | | |
| Change in Obligated Balance: | | |
| Obligated balance, net | | |
| Unpaid obligations, brought forward, October 1 | <u>4,209,938</u> | <u>3,698,756</u> |
| Total unpaid obligated balance | 4,209,938 | 3,698,756 |
| Obligations incurred net | 50,997,330 | 51,096,125 |
| Less: Gross outlays | <u>(54,861,931)</u> | <u>(50,584,943)</u> |
| Obligated balance, net, end of period | | |
| Unpaid obligations | <u>345,337</u> | <u>4,209,938</u> |
| Total, unpaid obligated balance, net, end of period | \$ <u>345,337</u> | \$ <u>209,938</u> |
| | | |
| Net Outlays: | | |
| Gross outlays | 54,861,931 | 50,584,943 |
| Less: Distributed Offsetting receipts | <u>(61,404,000)</u> | <u>(58,619,000)</u> |
| Net Outlays | \$ <u>(6,542,069)</u> | \$ <u>(8,034,057)</u> |

The accompanying notes are an integral part of these statements.

DoD Military Retirement Fund Notes to the Principal Statements

NOTE 1. Significant Accounting Policies

A. Basis of Presentation. These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Fund (MRF), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of MRF in accordance with, to the extent possible, U.S. generally accepted accounting principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board; the Office of Management and Budget Circular No. A-136, *Financial Reporting Requirements*; and the *Department of Defense (DoD) Financial Management Regulation*. The accompanying financial statements account for all resources for which MRF is responsible unless otherwise noted.

B. Mission of the Reporting Entity. The mission of MRF is to accumulate funds to finance, on an actuarially sound basis, the liabilities of DoD military retirement and survivor benefit programs. The MRF is a program for the payment of pensions to retired military personnel, annuities to eligible survivors, and special compensation for certain disabled retirees.

C. Appropriations and Funds. P.L. 98-94, *The Defense Authorization Act of 1984*, authorized MRF and provided a permanent, indefinite appropriation. Permanent authority becomes available based upon standing provisions of law without any further legislative action by the Congress after transmittal of the budget for each year.

The MRF is a non-revolving trust fund. Trust funds contain receipts and expenditures of funds held in trust by the Government for use in carrying out specific purposes or programs in accordance with the terms of the donor, trust agreement, or statute.

The MRF funds are designated as earmarked funds. Earmarked funds are financed by specifically identified revenues, required by statute to be used for designated activities, benefits, or purposes, and remain available over time. The MRF is required to separately account for and report on the receipt, use, and retention of revenues and other financing sources for earmarked funds.

D. Basis of Accounting. The MRF's financial management systems meet all full accrual accounting requirements. The MRF's accounting systems record transactions based on the U.S. Standard General Ledger (USSGL). Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information as required by USGAAP.

The financial statements and supporting trial balances are compiled from the underlying financial data and trial balances. The underlying data for the MRF is largely derived from budgetary (obligations, disbursements, and collections) and proprietary transactions (assets and liabilities) and accruals made for major items such as accounts receivable and pension liabilities.

Notes to the Principal Statements

E. Revenues and Other Financing Sources. Using methods and assumptions approved by the DoD Board of Actuaries, the DoD Office of the Actuary determines the amount of the contributions made to MRF. The Military Services make a monthly contribution, which is a percentage of basic pay, to cover accruing costs for currently active military members. The MRF also receives a U. S. Treasury warrant at the beginning of each fiscal year (1) to amortize unfunded liability and (2) to cover accruing costs for concurrent receipts (certain beneficiaries with combat-related injuries who are receiving payments from the Department of Veterans Affairs [VA]). In addition, interest is earned on investments. Funds from the contributions that exceed the amounts required to pay current-year expenses are invested in long-term securities. These investments and their associated interest revenues will be used to cover future liabilities of MRF.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of benefit expenses in the period incurred. The current financial management systems for MRF collect and record on full accrual accounting basis for liabilities and expenses of the fund.

G. Accounting for Intragovernmental Activities. The U.S. Treasury's Federal Intragovernmental Transactions Accounting Policy Guide and the Treasury Financial Manual, Part 2 - Chapter 4700, Agency Reporting Requirements for the Financial Report of the United States Government, provide guidance for reporting and reconciling intragovernmental balances. The MRF is able to reconcile balances pertaining to investments in federal securities.

The DoD's proportionate share of public debt and related expenses of the federal Government is not included. The federal Government does not apportion debt and its related costs to federal agencies. The DoD's financial statements do not report any public debt, interest, or source of public financing, whether from issuance of debt or tax revenues.

H. Funds with the U.S. Treasury. The MRF's monetary resources are maintained in U.S. Treasury accounts. The disbursing offices of the Defense Finance and Accounting Service (DFAS) process MRF's cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites submit reports to the U.S. Treasury, by appropriation, on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account. The MRF reconciles monthly with the U.S. Treasury account with no outstanding discrepancies.

The U.S. Treasury allows MRF to be fully invested; therefore FBWT may be zero at various times during the fiscal year, including the end of a quarter or a fiscal year. Precautions are taken to prevent abnormal balances at the U.S. Treasury.

I. Accounts Receivable. Accounts receivable from other federal entities or from the public include accounts receivable, claims receivable, and refunds receivable. Allowances for

Notes to the Principal Statements

uncollectible accounts due from the public are based upon an analysis of actual collection experience by MRF during the previous three years. The DoD does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intragovernmental Business Rules published in the Treasury Financial Manual.

J. Investments in U.S. Treasury Securities. The MRF reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts (book value). Premiums or discounts are amortized over the term of the investment using the effective interest rate method. The MRF's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, there is no provision for unrealized gains or losses on these securities.

The MRF invests in nonmarketable, market-based U.S. Treasury securities which are issued to federal agencies by the U. S. Treasury, Bureau of the Public Debt. These securities mirror marketable securities traded in the Government securities market, but are not publicly traded. The MRF receives interest semiannually from the U.S. Treasury on the value of these securities.

K. Contingencies and Other Liabilities. The SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The MRF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. The MRF reports death payment contingencies that result from DoD's responsibility to cover retiree benefits not paid by the VA during the month of death.

L. Net Position. Net position consists of cumulative results of operations. Cumulative results of operations represent the net of expenses, losses, and financing sources (including appropriations, revenue, and gains) since inception.

M. Undistributed Disbursements and Collections. Undistributed disbursements and collections represent the difference between disbursements and collections matched at the transaction level to a specific obligation, payable, or receivable in the source systems and those reported by the U.S. Treasury. The MRF has no undistributed disbursements or collections.

N. Military Retirement and Other Federal Employment Benefits. The Department applies SFFAS No. 33, *"Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates"*, in selecting the discount rate and valuation date used in estimating actuarial liabilities. In addition, gains and losses from changes in long-term assumptions used to estimate

Notes to the Principal Statements

the actuarial liability are presented separately on the Statement of Net Cost. Refer to Note 9, Military Retirement Benefit Liabilities, and Note 10, Disclosures Related to the Statements of Net Cost, for additional information.

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

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

NOTE 2. Non-Entity Assets

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|-------------------------|-----------------------|-----------------------|
| Accounts Receivable | 1,680 | 1,819 |
| Total Non-Entity Assets | \$ 1,680 | \$ 1,819 |
| Total Entity Assets | \$ 372,218,413 | \$ 321,747,447 |
| Total Assets | \$ <u>372,220,093</u> | \$ <u>321,749,266</u> |

Nonentity assets are assets for which the MRF maintains stewardship accountability and responsibility to report but are not available for MRF’s operations.

Nonfederal Assets, Accounts Receivable, represent the amount of interest, penalties, and administrative charges to be collected by MRF on behalf of the U.S. Treasury. Once collected, this amount is transferred to the appropriate U.S. Treasury receipt account. This amount is offset by a corresponding custodial liability for MRF reported in Note 7, Other Liabilities.

NOTE 3. Fund Balance With Treasury (FBWT)

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|----------------------|----------------------|
| Fund Balance | | |
| Total Trust Fund Balance | \$ <u>370,337</u> | \$ <u>25,383</u> |
| Status of Fund Balance with Treasury | | |
| Unobligated Balance-Unavailable | \$ 368,236,009 | \$ 314,380,513 |
| Obligated Balance not yet Disbursed | 345,337 | 4,209,938 |
| NonFBWT Budgetary Accounts | <u>(368,211,009)</u> | <u>(318,565,068)</u> |
| Total | \$ <u>370,337</u> | \$ <u>25,383</u> |

Notes to the Principal Statements

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|----------------------|----------------------|
| Fund Balance | | |
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| Obligated Balance not yet Disbursed | 345,337 | 4,209,938 |
| NonFBWT Budgetary Accounts | <u>(368,211,009)</u> | <u>(318,565,068)</u> |
| Total | \$ <u>370,337</u> | \$ <u>25,383</u> |

Fund Balance with Treasury increased \$345.0 million due to the difference between the amount held back for payroll and actual payroll funds disbursed. The 2011 National Defense Authorization Act (NDAA) requires that when the first day of the month falls on a nonbusiness day (weekend/holiday), the payroll must be paid the preceding business day. Since October 1, 2011 fell on a Saturday, the MRF held back a payroll estimate of \$4.3 billion on September 30, 2011; however, funds actually disbursed were \$3.9 billion. The MRF holdback at the end of a quarter is typically \$25.0 million when the first day of the month falls on a business day. See Note 9, Military Retirement Benefit Liabilities, and Disclosures Related To the Statement of Budgetary Resources, Note 13, for additional information about these changes.

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support FBWT and is a reconciliation between budgetary and proprietary accounts. It primarily consists of unobligated and obligated balances. The balances reflect the budgetary authority remaining for disbursement against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. The unavailable balance, which consists primarily of funds that are temporarily precluded from obligation by law, is invested in U.S. Treasury securities. The unobligated balance for the MRF is restricted for use by the public law that established the fund and becomes available without further congressional action.

Obligated Balance not yet Disbursed represents the amount of earned and accrued pension and annuity payments. The MRF balance represents benefits payable on October 1, 2011.

The MRF NonFBWT Budgetary Accounts balance represents investments in U.S. Treasury securities that are reflected in the MRF's budgetary resources, but are not part of the FBWT.

Notes to the Principal Statements

NOTE 4. Investments

| (\$ In Thousands) | | FY 2011 | | | |
|------------------------------|-----------------------|----------------------------|--------------------------------------|------------------------|--------------------------------|
| | <u>Cost</u> | <u>Amortization Method</u> | <u>Amortized (Premium) /Discount</u> | <u>Investments Net</u> | <u>Market Value Disclosure</u> |
| Intragovernmental Securities | | | | | |
| Nonmarketable, Market-Based | \$ 376,420,184 | Effective Interest | \$ (8,209,175) | \$ 368,211,009 | \$ 432,741,430 |
| Subtotal | 376,420,184 | | | 368,211,009 | 432,741,430 |
| Accrued Interest | <u>3,405,272</u> | | | <u>3,405,272</u> | <u>3,405,272</u> |
| Total Investments | \$ <u>379,825,456</u> | | \$ <u>(8,209,175)</u> | \$ <u>371,616,281</u> | \$ <u>436,146,702</u> |

| (\$ In Thousands) | | FY 2010 | | | |
|------------------------------|-----------------------|----------------------------|--------------------------------------|------------------------|--------------------------------|
| | <u>Cost</u> | <u>Amortization Method</u> | <u>Amortized (Premium) /Discount</u> | <u>Investments Net</u> | <u>Market Value Disclosure</u> |
| Intragovernmental Securities | | | | | |
| Nonmarketable, Market-Based | \$ 325,124,664 | Effective Interest | \$ (6,559,596) | \$ 318,565,068 | \$ 351,050,659 |
| Subtotal | 325,124,664 | | (6,559,596) | \$ 318,565,068 | 351,050,659 |
| Accrued Interest | <u>3,121,772</u> | | | <u>3,121,772</u> | <u>3,121,772</u> |
| Total Investments | \$ <u>328,246,436</u> | | \$ <u>(6,559,596)</u> | \$ <u>321,686,840</u> | \$ <u>354,172,431</u> |

Total Intragovernmental Securities, Net Investments increased \$49.9 billion (16%) primarily due to the MRF purchase of \$43.4 billion in long-term securities. The increase is due to normal growth in the MRF from contributions from the U.S. Treasury and the Military Services net of benefits paid. The annual investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover future benefits.

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash generated from earmarked funds is deposited in the U.S. Treasury, which uses the cash for general Government purposes. The U.S. Treasury securities are issued to the earmarked funds as evidence of its receipts and are an asset to the MRF and a liability to the U.S. Treasury. Since MRF and the U.S. Treasury are both parts of the Federal Government, these assets and liabilities offset each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements.

Notes to the Principal Statements

The U.S. Treasury securities provide MRF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When MRF requires redemption of these securities to make expenditures, the Government will finance them from accumulated cash balances, by raising taxes or other receipts, borrowing from the public or repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

The following table displays the cost of the U.S. Treasury Securities.

(\$ In Thousands)

| | FY 2011 COST (\$ in thousands) | FY 2010 COST (\$ in thousands) |
|-------------------|--|--|
| Notes | \$ 21,467,813 | \$ 31,347,154 |
| Bonds | 11,944,969 | 6,427,250 |
| TIPS | 328,755,348 | 273,248,935 |
| Overnights | <u>14,252,054</u> | <u>14,101,325</u> |
| Total Cost | <u>\$376,420,184</u> | <u>\$325,124,664</u> |

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

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

On August 5, 2011, Standard & Poor's (S&P), a nationally recognized statistical rating organization, downgraded the long-term U.S. credit rating to "AA+" (from the highest rating of "AAA"). Acuity Consulting, Inc. evaluated the impact of the credit rating reduction on impairment of the Fund's investment or the requirement to recognize a contingency. Acuity found the Fund has the intent and ability to retain its investments to allow for any anticipated recovery in market value, which has not decreased as a result of the credit rating downgrade. Please refer to the Management Discussion and Analysis, Projected Long-Term Health of the Fund, for additional information.

Notes to the Principal Statements

NOTE 5. Accounts Receivable

| (\$ In Thousands) | FY 2011 | | |
|-------------------------------|-----------------------------|--|---------------------------|
| | <u>Gross Amount Due</u> | <u>Allowance for Estimated Uncollectible</u> | <u>Net Amount Due</u> |
| Intragovernmental Receivables | \$ 186,057 | \$ | \$ 186,057 |
| With the Public | <u>49,603</u> | <u>(2,185)</u> | <u>47,418</u> |
| Total Receivable | \$ <u>235,660</u> | \$ <u>(2,185)</u> | \$ <u>233,475</u> |

| (\$ In Thousands) | FY 2010 | | |
|-------------------------------|-----------------------------|--|---------------------------|
| | <u>Gross Amount Due</u> | <u>Allowance for Estimated Uncollectible</u> | <u>Net Amount Due</u> |
| Intragovernmental Receivables | \$ 0 | \$ | \$ 0 |
| With the Public | <u>38,921</u> | <u>(1,878)</u> | <u>37,043</u> |
| Total Receivable | \$ <u>38,921</u> | \$ <u>(1,878)</u> | \$ <u>37,043</u> |

Intragovernmental Receivables increased by \$186.1 million (100%) due to a late receipt of a Service contribution. The Marine Corps paid their September 2011 contribution on October 4, 2011.

Nonfederal Accounts Receivable increased by \$10.4 million (28%) due to the Special Separation Benefit (SSB) recoupment. The recoupment occurs if the member returns to service and subsequently retires. The SSB recoupment had been put on hold for approximately one and a half years; however, during 3rd Quarter, FY 2011, the hold was removed. The SSB recoupment is a receivable that does not incur interest, administrative fees, penalties, and fines.

The accounts receivable represent the Military Retirement Fund's (MRF) claim for payment from military retirees or their survivors for erroneous amounts previously paid. The MRF only recognizes an allowance for uncollectible amounts from the public. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

NOTE 6. Liabilities Not Covered By Budgetary Resources

| (\$ In Thousands) | FY 2011 | FY 2010 |
|--|-------------------------|-------------------------|
| Nonfederal Liabilities | | |
| Military Retirement Benefits Liability (Note 9) | \$ 992,686,495 | \$ 944,082,476 |
| Other Liabilities | 180 | 181 |
| Total Nonfederal Liabilities | \$ <u>992,686,675</u> | \$ <u>944,082,657</u> |
| Total Liabilities Not Covered by Budgetary Resources | \$ <u>992,686,675</u> | \$ <u>944,082,657</u> |
| Total Liabilities Covered by Budgetary Resources | \$ <u>368,583,027</u> | \$ <u>318,592,270</u> |
| Total Liabilities | \$ <u>1,361,269,702</u> | \$ <u>1,262,674,927</u> |

Notes to the Principal Statements

Total Liabilities Not Covered by Budgetary Resources increased \$48.6 billion (5%). The increase is primarily attributable to the increase in the actuarial liability of \$98.6 billion (see discussion in Military Retirement Benefits and Other Federal Employment Benefits, below) offset by an increase of \$43.4 billion in investments available to pay benefits (explained above). See Note 4, Investments, and Note 9, Military Retirement Benefit Liabilities, for additional information about these changes.

The Military Retirement Fund Liabilities Not Covered by Budgetary Resources amount represents actuarial liabilities for pension benefits for which assets are not yet available. Refer to Note 9, Military Retirement Benefit Liabilities, for additional details and disclosures.

Nonfederal Other Liabilities represent contingent liabilities payable by the Department of Defense for estimated death payments. These liabilities cover the retiree benefits not paid by the Department of Veterans Affairs during the month of death. This amount is also reported on Note 7, Other Liabilities.

NOTE 7. Other Liabilities

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|----------------|----------------|
| Intragovernmental | | |
| Custodial Liabilities | \$ 1,680 | \$ 1,819 |
| Total Intragovernmental Other Liabilities | \$ 1,680 | \$ 1,819 |
| Nonfederal | | |
| Contingent Liabilities | 180 | 181 |
| Total Nonfederal Other Liabilities | \$ 180 | \$ 181 |
| Total Other Liabilities | \$ 1,860 | \$ 2,000 |

Intragovernmental Custodial Liabilities are comprised of interest, penalties, and administrative charges to be collected on behalf of the U.S. Treasury. This amount is also reported as a nonfederal accounts receivable on Note 2, Non-entity Assets.

Nonfederal Other Liabilities represent contingent liabilities payable by DoD for estimated death payments. These liabilities cover the retiree benefits not paid by the VA during the month of death. This amount is also reported on Note 6, Liabilities Not Covered by Budgetary Resources, and on Note 8, Commitments and Contingencies.

NOTE 8. Commitments and Contingencies

Currently there are no known contingent liabilities pending legal action.

The MRF has an estimated contingent liability of \$180 thousand that is measurable and probable and, therefore, has been recorded in the accounting records. These liabilities cover the retiree benefits not paid by the VA during the month of death. This amount is also reported on Note 7, Other Liabilities.

Notes to the Principal Statements

NOTE 9. Military Retirement Benefit Liabilities

(\$ In Thousands)

FY 2011

| <u>Major Program Activities</u> | <u>Present Value of Benefits</u> | <u>Assumed Interest Rate (%)</u> | <u>(Less: Assets Available to Pay Benefits)</u> | <u>Unfunded Liabilities</u> |
|---|----------------------------------|----------------------------------|---|-----------------------------|
| Military Retirement Pension Actuarial Liability | \$ 1,360,922,505 | 4.8% | \$ (368,236,009) | \$ 992,686,496 |
| Other | 345,337 | | (345,337) | 0 |
| Total: | \$ <u>1,361,267,842</u> | | \$ <u>(368,581,346)</u> | \$ <u>992,686,496</u> |

(\$ In Thousands)

FY 2010

| <u>Major Program Activities</u> | <u>Present Value of Benefits</u> | <u>Assumed Interest Rate (%)</u> | <u>(Less: Assets Available to Pay Benefits)</u> | <u>Unfunded Liabilities</u> |
|---|----------------------------------|----------------------------------|---|-----------------------------|
| Military Retirement Pension Actuarial Liability | \$ 1,258,462,989 | 5.0% | \$ (314,380,513) | \$ 944,082,476 |
| Other | 4,209,938 | | (4,209,938) | 0 |
| Total: | \$ <u>1,262,672,927</u> | | \$ <u>(318,590,451)</u> | \$ <u>944,082,476</u> |

The present value of the Military and Retirement and Other Federal Employment Benefits liability increased \$98.6 billion (8%). An increase of \$62.0 billion is primarily due to the lower interest rate and associated changes in the long-term salary increase and inflation assumptions related to requirements prescribed by SFFAS No. 33, updated retiree offset factors, mortality improvement factors, and undoing entitlement-year-based benefit payments. In addition, an increase of \$40.4 billion is for normal cost and interest costs, offset by benefit payments. These increases are offset by a decrease in pension benefits due and payable of \$3.9 billion resulting from the changes in the 2011 National Defense Authorization Act, requiring payment on September 30, 2011 instead of the first business day of October 2011. See Note 3, Fund Balance with Treasury, and Disclosures Related to the Statement of Budgetary Resources, Note 13, for additional information about these changes.

Information Related to Military Retirement and Other Federal Employment Benefits

The MRF accumulates funds used to pay pensions to retired military personnel and annuities to their survivors. The Military Retirement System is a single-employer, defined benefit plan. The schedules above reflect two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled "Military Retirement Pensions" represents the actuarial liability for future pension benefits not yet paid. The line entitled "Other" represents retirement benefits due and payable on the first day of the next reporting period.

Notes to the Principal Statements

Effective FY 2010, MRF implemented requirements of SFFAS No. 33 which directs the interest rate, underlying inflation rates, and other economic assumptions should be consistent with one another. A change in the interest rate may cause other assumptions to change as well. For the September 30, 2011, financial statement valuation, the implementation of the SFFAS equivalent rate required DoD OACT to change the long-term inflation and salary increase assumptions to be consistent with the underlying Treasury spot rates used in the valuation.

The MRF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2011, balance represents the September 30, 2011, amount.

Actuarial Cost Method

As dictated by law, the MRF is funded using the Aggregate Entry-Age Normal Cost method. This is a method whereby projected retirement costs are spread over the projected future salaries of a new-entrant cohort.

Projected Revenues

The MRF receives projected revenues from three sources: interest earnings on MRF assets, monthly contributions from the Military Services, and an annual contribution from the U.S. Treasury. The contribution from the U.S. Treasury is applied to MRF at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed before October 1, 1984, as well as the amortization of subsequent actuarial gains and losses. Starting October 1, 2004, P.L. 108-136 requires a contribution for the normal cost amount for the concurrent receipt provisions under Sections 1413a and 1414 in addition to the unfunded liability amortization payment. The DoD Board of Actuaries (the Board) approves methods and assumptions used to determine the amount for the U.S. Treasury warrant, and the Secretary of Defense directs the Secretary of Treasury to make the payment.

Assumptions

The Board sets the long-term economic assumptions for each valuation performed for funding purposes. Prior to FY 2010, the same long-term assumptions were used for the financial statement valuations. The distinction between the two different valuations is discussed further below. The long-term assumptions for the FY 2010 financial statement valuation were 5.0% interest, 2.4% Consumer Price Index, and 3.6% salary increase. For the FY 2010 funding valuation, the long-term assumptions were 5.75% interest, 3.0% Consumer Price Index, and 3.75% salary increase. For the FY 2011 financial statement valuation, the long-term assumptions were 4.8% interest, 2.5% Consumer Price Index, and 3.3% salary increase. For the FY 2011 funding valuation, the long-term assumptions did not change. (The term “interest” refers to the interest rate used to discount cash flows. The terms “interest rate” and “discount rate” can be used interchangeably.) The difference in the long-term assumptions between and among valuations is attributable to the SFFAS No. 33. The standard is discussed further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward from the prior year valuation results as reported in the OACT report “Valuation of the Military Retirement System” using accepted actuarial methods. Adjustments are made as necessary to put liabilities on a financial statement

Notes to the Principal Statements

basis. In the selection of the valuation date, SFFAS No. 33 allows for actuarial liabilities to be rolled forward from the prior year valuation results. The effects of changes during the year in major factors such as pay raises and cost of living adjustments have been incorporated in the roll-forward adjustment. In calculating the FY 2011 roll-forward amount, the following assumptions were used:

| | <u>Inflation</u> | <u>Salary</u> | <u>Interest</u> |
|------------------|-------------------|------------------|-----------------|
| Fiscal Year 2011 | 0.0 % (actual) | 1.4 % (actual) | 4.8 % |
| Fiscal Year 2012 | 2.8 % (estimated) | 1.6% (estimated) | 4.8 % |
| Long-Term | 2.5% | 3.3 % | 4.8 % |

For purposes of the MRF's financial reporting, this roll-forward process is applied annually. Contributions to MRF are calculated so as to maintain the Fund on an actuarially sound basis. This means that there will be sufficient funds to make all benefit payments to eligible recipients each year and that the asset balance is projected to eventually equal the actuarial liability; i.e., all unfunded liabilities are liquidated. In order to accomplish this objective, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded liability) and any emerging actuarial gains or losses.

The initial unfunded liability of the program was amortized over a 50-year period through the FY 2007 payment. At its August 2007 meeting, the Board decided to decrease the period over which the initial unfunded liability is fully amortized by 8 years. Their decision was made to ensure that, at a minimum, the amortization payment covered the interest on the unfunded actuarial liability. Therefore, starting with the FY 2008 payment, the initial unfunded liability is being amortized over a 42-year period, with the last payment expected to be made October 1, 2025. All subsequent gains and losses experienced by the system are amortized over a 30-year period. Chapter 74 of Title 10, United States Code (USC), requires the Board to approve the methods and assumptions used to (1) compute actuarial costs and liabilities, (2) amortize the initial unfunded liability, and (3) amortize all actuarial gains and losses. The Board is a Federal Advisory Committee appointed by the Secretary of Defense.

The SFFAS No. 33, as published on October 14, 2008, by the Federal Accounting Standards Advisory Board (FASAB), requires the use of a yield curve based on marketable U. S. Treasury securities to determine the interest rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable U. S. Treasury securities.

The statement is effective for periods beginning after September 30, 2009, and applies to information provided in general purpose federal financial statements. It does not affect statutory or other special-purpose reports, such as pension or Other Retirement Benefit reports. It requires a minimum of five periodic rates for the yield curve input and a consistency in the number of historical rates used from period to period. It permits the use of a single average interest rate if the resulting present value is not materially different from what would be obtained using the yield curve.

Notes to the Principal Statements

OACT annually performs two MRF valuations. The primary one is for funding purposes—this valuation is governed by Chapter 74 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other is for financial statement purposes and is governed by FASAB standards. For the September 30, 2011, financial statement valuation, OACT used quarterly zero coupon Treasury spot rates (as published by the Office of Thrift Supervision) from June 30, 2001, to March 31, 2011, (40 quarterly interest rates) to determine an SFFAS equivalent interest rate of 4.8%. In the summer of 2011, the Board approved an interest rate of 5.75% for the September 30, 2011, funding valuation, which differs from the SFFAS equivalent rate by 95 basis points. Using the SFFAS No. 33 long-term economic assumptions increases the MRF actuarial liability by 7%.

Military Services Contributions

The contributions from the Military Services are the product of basic pay and normal cost percentages (NCPs) determined in accordance with the methods and assumptions approved by the Board. Basic pay generally increases each year, and on January 1, 2011, there was a 1.4% across-the-board basic pay increase. The NCPs for FY 2011 were set by the Board in their August 2009 Board Letter: 32.7% (full-time) and 24.4% (part-time). The NCPs for FY 2012 were set by the Board in their July 2010 Board Letter: 34.3% (full-time) and 24.3% (part-time). The above NCPs are based on the Board's funding valuation, not the financial statement valuation (SFFAS No. 33), and are calculated without regard to the concurrent receipt provisions of Sections 1413a and 1414 of Title 10.

Market Value of Investments

The market value of MRF's nonmarketable market-based securities as of September 30, 2011, totaled \$436.1 billion as reflected in Note 4, Investments and Related Interest.

NOTE 10. Disclosures Related to the Statements of Net Cost

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|----------------------------------|-------------------------|------------------------|
| Public Costs | \$ <u>153,446,332</u> | \$ <u>136,097,973</u> |
| Total Costs | \$ 153,446,332 | \$ 136,097,973 |
| Intragovernmental Earned Revenue | <u>(105,322,384)</u> | <u>(93,929,724)</u> |
| Total Earned Revenue | \$ <u>(105,322,384)</u> | \$ <u>(93,929,724)</u> |
| Net Cost of Operations | \$ <u>48,123,948</u> | \$ <u>42,168,249</u> |

Net Cost of Operations increased \$6.0 billion (14%) primarily due to an increase in the change of the actuarial liability for Military Retirement Benefits in the amount of \$17.5 billion. Factors impacting the change are discussed in Note 17, Military Retirement Benefits and Other Federal Employment Benefits. This is offset by an increase in earned revenue due to increases in interest earnings of \$7.6 billion, the annual Treasury contribution of \$2.8 billion, and the employing agency (Military Services) contributions of \$1.0 billion. The increase in the Military Services' contributions is the result of the change in the Normal Cost Percentages, which are updated two years in advance.

Notes to the Principal Statements

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the Federal Government that are supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity.

Intragovernmental costs and revenue represent transactions made between two reporting entities within the Federal Government. Public costs and revenues are exchange transactions made between the reporting entity and a nonfederal entity. Intragovernmental earned revenue is comprised primarily of the following:

Intragovernmental Earned Revenues for Program Costs

| (\$ in Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|-----------------------|----------------------|
| 1. Military Service Contributions as a Percentage of Base Pay | \$ 20,970,253 | \$ 20,376,688 |
| 2. Annual Treasury Unfunded Liability Payment | 61,404,000 | 58,619,000 |
| 3. Annual Treasury Normal Cost Payment | 4,950,000 | 4,516,000 |
| 4. Interest on Investments | <u>17,998,131</u> | <u>10,418,036</u> |
| Total | \$ <u>105,322,384</u> | \$ <u>93,929,724</u> |

NOTE 11. Benefit Program Expense

Benefit Expenses

| (\$ in Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|-----------------------|-----------------------|
| 1. Service Cost | \$ 28,780,469 | \$ 23,932,659 |
| 2. Period Interest on the Benefit Liability | 62,587,412 | 66,965,791 |
| 3. Prior (or Past) Service Cost | 0 | 0 |
| 4. Period Actuarial (Gains) or Losses | <u>62,104,063</u> | <u>44,525,019</u> |
| Total | \$ <u>153,471,944</u> | \$ <u>135,423,469</u> |

The benefit program expense provides components of the change in the actuarial liability from September 30, 2010, to September 30, 2011. The September 30, 2011, actuarial liability is calculated using the components of benefit program expense as well as the expected benefit payments during FY 2011. The September 30, 2011, actuarial liability is equal to the September 30, 2010, liability plus the total benefit program expense minus the expected benefit payments. For FYs 2010 and 2011, there was no Prior Service Cost (Line 3). The FY 2011 Period Actuarial (Gains) or Losses (Line 4) is positively impacted by a change in long-term economic assumptions due to SFFAS No. 33, and positively impacted by a higher than expected cost of living adjustment anticipated in January 2012, and negatively impacted by a lower than expected across-the-board pay table increase, whereas in FY 2010 it was largely impacted by a lower cost of living adjustment in January 2011. In FY 2011 there also is a positive impact due to eliminating the entitlement-year-based benefit payments adjustment.

Notes to the Principal Statements

NOTE 12. Disclosures Related to the Statements of Changes in Net Position

There was a difference of \$104.9 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations on the Statement of Budgetary Resources (SBR). The MRF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with Office of Management and Budget reporting requirements. Refer to Note 13, Disclosures Related to the Statement of Budgetary Resources for further information.

NOTE 13. Disclosures Related to the Statements of Budgetary Resources

Net Outlays increased \$1.5 billion (19%) due to an increase in gross outlays of \$4.2 billion primarily as a result of disbursing \$3.9 billion in payroll on September 30, 2011 instead of October 3, 2011. This is offset by a \$2.8 billion increase in the U.S. Treasury contribution for the amortization of the unfunded liability based on the unfunded liability amortization schedule established by the DoD Board of Actuaries. See Note 3, Fund Balance with Treasury, and Note 9, Military Retirement Benefit Liabilities, for additional information regarding the payroll date change.

The MRF reported \$51.0 billion of direct obligations that are exempt from apportionment. The SBR includes intra-entity transactions because the statements are presented as combined. P.L. 98-94, *The Defense Authorization Act of 1984*, authorized MRF and provided a permanent, indefinite appropriation.

The MRF's unobligated balances of budget authority represent the portion of trust fund receipts collected in the current fiscal year that exceeds (1) the amount needed to pay benefits or other valid obligations and (2) the receipts temporarily precluded from obligation by law. The receipts, however, are assets of MRF and are available for obligation as needed in the future.

There was a difference of \$104.9 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations on the SBR. The MRF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with Office of Management and Budget reporting requirements.

Notes to the Principal Statements

NOTE 14. Reconciliation of Net Cost of Operations to Budget

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|------------------------|-----------------------|
| Resources Used to Finance Activities: | | |
| Budgetary Resources Obligated: | | |
| Obligations incurred | \$ 50,997,330 | \$ 51,096,125 |
| Less: Offsetting receipts (-) | <u>(61,404,000)</u> | <u>(58,619,000)</u> |
| Net obligations | \$ <u>(10,406,670)</u> | \$ <u>(7,522,875)</u> |
| Resources that fund expenses recognized in prior period | (1) | (5) |
| Total resources used to finance the Net Cost of Operations | \$ <u>(10,406,671)</u> | \$ <u>(7,522,880)</u> |
| Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period: | | |
| Components Requiring or Generating Resources in Future Period – Other | <u>102,459,516</u> | <u>85,006,894</u> |
| Components not Requiring or Generating Resources: | \$ <u>102,459,516</u> | \$ <u>85,006,894</u> |
| Other (+/-) | | |
| Trust Fund Exchange Revenue | (43,918,384) | (35,310,724) |
| Other | <u>(10,513)</u> | <u>(5,041)</u> |
| Total Components of Net Cost of Operations that will not Require or Generate Resources | (43,928,897) | (35,315,765) |
| Total components of Net Cost of Operations that will not Require or Generate Resources in the current period | \$ <u>58,530,619</u> | \$ <u>49,691,129</u> |
| Net Cost of Operations | \$ <u>48,123,948</u> | \$ <u>42,168,249</u> |

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

Components not Requiring or Generating Resources – Other displays the change in accounts receivable since the beginning of both FY 2011 and FY 2010. These amounts represent refunds receivable and changes in bad debt for erroneous payments to military retirees or their survivors.

Notes to the Principal Statements

NOTE 15. Earmarked Funds

| | <u>2011</u> | <u>2010</u> |
|--|-------------------------|-------------------------|
| <u>BALANCE SHEET</u> | | |
| <u>ASSETS</u> | | |
| Fund balance with Treasury | \$ 370,337 | \$ 25,383 |
| Investments | 371,616,281 | 321,686,840 |
| Accounts and Interest Receivable | <u>233,475</u> | <u>37,043</u> |
| Total Assets | \$ <u>372,220,093</u> | \$ <u>321,749,266</u> |
| <u>LIABILITIES and NET POSITION</u> | | |
| Military Retirement Benefits and Other Federal Employment Benefits | \$ 1,361,267,842 | \$ 1,262,672,927 |
| Other Liabilities | <u>1,860</u> | <u>2,000</u> |
| Total Liabilities | \$ 1,361,269,702 | \$ 1,262,674,927 |
| Cumulative Results of Operations | <u>(989,049,609)</u> | <u>(940,925,661)</u> |
| Total Liabilities and Net Position | \$ <u>372,220,093</u> | \$ <u>321,749,266</u> |
| <u>STATEMENT OF NET COST</u> | | |
| Program Costs | \$ 153,446,332 | \$ 136,097,973 |
| Less Earned Revenue | <u>(105,322,384)</u> | <u>(93,929,724)</u> |
| Net Program Costs | \$ 48,123,948 | \$ 42,168,249 |
| Net Cost of Operations | \$ <u>48,123,948</u> | \$ <u>42,168,249</u> |
| <u>STATEMENT OF CHANGES IN NET POSITION</u> | | |
| Net Position Beginning of the Period | \$ (940,925,661) | \$ (898,757,412) |
| Net Cost of Operations | <u>48,123,948</u> | <u>42,168,249</u> |
| Change in Net Position | \$ <u>(48,123,948)</u> | \$ <u>(42,168,249)</u> |
| Net Position End of the Period | \$ <u>(989,049,609)</u> | \$ <u>(940,925,661)</u> |

P. L. 98-94, *The Defense Authorization Act of 1984*, established the MRF as a pension program for the payment of pensions to retired military personnel, annuities to eligible survivors, and special compensation for certain disabled retirees. The MRF accumulates funds to finance, on an actuarially sound basis, liabilities of the DoD retirement program. The MRF receives its funding as an earmarked trust fund and uses these resources to execute its mission.

The primary financing sources for MRF are (1) monthly Military Service contributions as a percentage of base pay; (2) an annual warrant from the U.S. Treasury for the unfunded liability and for the concurrent receipt provisions for certain disabled retirees; and (3) interest earned on investments. Using methods and assumptions approved by the DoD Board of Actuaries, the DoD Office of the Actuary calculates the annual payment amounts and percentages. The financing sources are the result of intragovernmental flows. Contributions in excess of the projected current year retiree and annuitant benefits are invested. The investments and associated interest revenue are used to cover future liabilities of MRF.

Notes to the Principal Statements

NOTE 16. Other Disclosures

FY 2011 Change in the MRF Actuarial Liability

The net pension expense for the change in the actuarial accrued liability from September 30, 2010 to September 30, 2011 is developed in the following table.

Table 1: Change in Actuarial Liability

| (\$ In Thousands) | <u>FY 2011</u> | <u>FY 2010</u> |
|---|-----------------------|----------------------|
| Beginning Actuarial Liability | \$ 1,258,462,989 | \$ 1,173,456,095 |
| Normal Cost Liability | 28,780,469 | 23,932,659 |
| Plan Amendment Liability | 0 | 0 |
| Assumption Change Liability | 61,970,175 | 66,642,583 |
| Benefit Outlays | (51,012,426) | (50,416,577) |
| Interest Cost | 62,587,412 | 66,965,791 |
| Actuarial (gains)/losses due to changes in experience | <u>133,886</u> | <u>(22,117,562)</u> |
| Ending Actuarial Liability | \$ 1,360,922,505 | \$ 1,258,462,989 |
| Change in Actuarial Liability | \$ <u>102,459,516</u> | \$ <u>85,006,894</u> |

The September 30, 2011, accrued liability includes changes due to assumptions and experience. The new assumptions include updated retiree offset factors, mortality improvement factors, undoing entitlement-year-based benefit payments, and a lower single equivalent interest rate under SFFAS No. 33 of 4.8%. The net effect of these new assumptions is an increase in the September 30, 2011, accrued liability of \$62.0 billion, shown on Line D (\$53.1 billion of this increase is due to the lower SFFAS No. 33 interest rate and associated changes in the long-term salary increase and inflation assumptions, -\$6.3 billion is due to the updated retiree offset factors, \$10.9 billion is due to the new mortality improvement factors, and \$4.3 billion is due to undoing entitlement-year-based benefit payments). The change in the accrued liability due to the net experience loss of \$133.9 million, shown on line G, reflects the new population on which the September 30, 2011, roll-forward is based, as well as other economic experience being different from that assumed (-\$5.6 billion due to a lower than expected cost of living adjustment and across-the-board salary increase for January 2012, which was offset by \$5.7 billion from new population data).

NOTE 17. Subsequent Event

No material events or transactions have occurred subsequent to September 30, 2011, through November 4, 2011, the date when the financial statements were available to be issued, that have not been properly recorded in the financial statements or disclosed in the notes. Also, there have been no changes to internal control subsequent to September 30, 2011, or other factors that might significantly affect the effectiveness of internal control.