



**Fiscal Year
2011**



Medicare- Eligible Retiree Health Care Fund Audited Financial Statements

November 7, 2011

Report Documentation Page				Form Approved OMB No. 0704-0188	
Public reporting burden for the collection of information is estimated to average 1 hour per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington Headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington VA 22202-4302. Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to a penalty for failing to comply with a collection of information if it does not display a currently valid OMB control number.					
1. REPORT DATE 07 NOV 2011		2. REPORT TYPE		3. DATES COVERED 00-00-2011 to 00-00-2011	
4. TITLE AND SUBTITLE Medicare-Eligible Retiree Health Care Fund Audited Financial Statements. Fiscal Year 2011				5a. CONTRACT NUMBER	
				5b. GRANT NUMBER	
				5c. PROGRAM ELEMENT NUMBER	
6. AUTHOR(S)				5d. PROJECT NUMBER	
				5e. TASK NUMBER	
				5f. WORK UNIT NUMBER	
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Department of Defense Inspector General, 4800 Mark Center Drive, Alexandria, VA, 20350-1500				8. PERFORMING ORGANIZATION REPORT NUMBER	
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)				10. SPONSOR/MONITOR'S ACRONYM(S)	
				11. SPONSOR/MONITOR'S REPORT NUMBER(S)	
12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution unlimited					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT Same as Report (SAR)	18. NUMBER OF PAGES 68	19a. NAME OF RESPONSIBLE PERSON
a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified			

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Management's Discussion and Analysis

Summary of the Department of Defense Uniformed Services Medicare-Eligible Retiree Health Care Fund For the Years Ended September 30, 2011 and 2010

Reporting Entity

The reporting entity is the Department of Defense (DoD) Uniformed Services Medicare-Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The Fiscal Year (FY) 2001 National Defense Authorization Act (NDAA) directed the establishment of the Medicare-Eligible Retiree Health Care Fund to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for space available care in Military Treatment Facilities (MTFs). The Fund covers Medicare-eligible beneficiaries, regardless of age. In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees (i.e., retirees themselves, dependents of retirees, and survivors).

The NDAA also established an independent three-member DoD Medicare-Eligible Retiree Health Care Board of Actuaries appointed by the Secretary of Defense. The Board is required to review the actuarial status of the Fund, to report annually to the Secretary of Defense, and to report to the President and the Congress on the status of the Fund at least every four years. The DoD Office of the Actuary (OACT) provides all technical and administrative support to the Board.

Within DoD, the Office of the Under Secretary of Defense (OUSD) for Personnel and Readiness through the Office of the Assistant Secretary of Defense for Health Affairs, TRICARE Management Activity (TMA), has as one of its missions operational oversight of the Defense TRICARE Health Delivery System, including management of the Fund. TMA management responsibilities include accounting for, documenting, and projecting annual budget distribution requirements (purchased care claims, demands, and MTF prospective payments for anticipated care provided in the direct care system), oversight of claims processors, monitoring/management of the Improper Payments Information Act (IPIA) of 2002, and preparation of financial statements and footnotes. The Defense Finance and Accounting Service (DFAS) provides accounting and investment services for the Fund.

In FY 2011 and FY 2010 respectively, the Fund authorized approximately \$9.5 billion and \$9.1 billion in total health care services, civilian providers \$7.7 billion and \$7.5 billion, MTFs \$1.4 billion and \$1.2 billion, and Military Service Personnel Accounts \$0.4 billion and \$0.4, on behalf of Medicare-eligible retirees, retiree dependents, and survivors.

Final Fiscal Year Requirements and Funding Plan

\$ In Billions				
Fiscal Year	Purchased Care	Operations & Maintenance	Military Personnel	Final
2011	\$7.7	\$1.4	\$0.4	\$9.5
2010	\$7.5	\$1.2	\$0.4	\$9.1

The Fund receives income from three sources:

1. An annual U.S. Treasury payment made on behalf of the Uniformed Services at the beginning of the year based on average budgeted force strengths
2. Annual payments from the U. S. Treasury to amortize the unfunded liability, and
3. Investment income

During the last two years of the Fund's operation, income was received from the above sources at the following amounts:

MERHCF Funding Sources

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2011	\$9.8	\$11.0	\$9.2
2010	\$10.0	\$11.1	\$5.3

No accounts of the Fund have been excluded from the Fund's financial statements. The significant increase in investments interest realized between FY 2011 and FY 2010 is due primarily to improved economic conditions during FY 2011.

Medicare-Eligible Retiree Health Care Plan of Benefits

If beneficiaries age 65 and over cannot obtain care in a MTF, they can receive essentially no charge civilian care through the TRICARE for Life (TFL) program. With this program, TRICARE serves as the final payer for Medicare covered benefits, and first payer for TRICARE benefits that are not covered in the Medicare or Other Health Insurance programs.

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

The TRICARE Pharmacy Program authorizes eligible beneficiaries to obtain low-cost prescription medications from the TRICARE Mail Order Pharmacy (TMOP) and TRICARE network and non-network civilian pharmacies. Beneficiaries may also continue to use military

hospital and clinic pharmacies, at no charge. The pharmacy program is available to Medicare-eligible beneficiaries and their dependent/survivors.

Finally, DoD beneficiaries, including Medicare-eligible beneficiaries, in specific locations where Designated Provider Program (DPP), formerly the Uniformed Services Family Health Plan, facilities are available, may enroll in capitation rate plans. These plans include inpatient and outpatient services and a pharmacy benefit. The capitation rate is paid by DoD. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs as well as benefits under the TFL and Pharmacy programs.

Health Care Purchased from Civilian Providers

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

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

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

At the beginning of each FY, a new Funding Authorization Document (FAD) for the TFL/TRICARE Pharmacy purchased care expenditure limit is provided to the TMA Contract Resource Management (CRM) Division. By agreement with DFAS-IN, disbursement transactions are provided by email the day prior to payment processing. DFAS-IN uses these estimates to ensure sufficient funds are available for payment from the Fund for daily transactions. The final purchased care payments for FY 2011 and FY 2010 were approximately \$7.1 billion.

TMA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services (WPS) for purposes of processing all claims supported by the Fund, regardless of the geographic region in which care was received. Dual eligibility refers to

health care users who are both Uniformed Services beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single fiscal intermediary to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication.

Payment for Health Care Provided in MTFs

TMA annually develops prospective payment amounts for care estimated to be provided in MTFs to Medicare-eligible beneficiaries. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and Defense Health Program (DHP) Operations and Maintenance (O&M) costs. TMA provides a memo to DFAS-IN with the payment amounts by Military Service for MILPERS and DHP O&M that is reported on the Standard Form 1081, Voucher and Schedule of Withdrawals and Credits by DFAS-IN.

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent fiscal year for which data is complete at the time the calculations are prepared. TMA develops, in coordination with the Military Departments and Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), MTF-specific rates in accordance with DoDI 6070.2, dated July 19, 2002. MEPRS cost data are recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using Service-provided budget data, and standard Office of Management and Budget (OMB) Consumer Price Index-Urban (CPI-U) Medical inflation rates listed in the President's Budget applicable to those years. MEPRS data are recorded and maintained by the Military Services in accordance with DoD 6010.13-M, "Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities," dated April 2008.

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

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

The prospective O&M payment for MTF provided care to Medicare-eligible beneficiaries in FY 2011 was \$1.4 billion and \$1.2 billion in FY 2010. While the unit costs of inpatient and outpatient services have risen slightly, utilization of these services has continued to decline at a greater rate. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries was \$0.4 billion in FY 2011 and \$0.4 billion in FY 2010.

Performance Measures

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2011, the Fund had net assets available to pay benefits of \$184.9 billion and an actuarial liability of \$533.70 billion; the funding ratio was 34.6%. As of September 30, 2010, the Fund had net assets available to pay benefits of \$163.6 billion and an actuarial liability of \$573.0 billion; the funding ratio was 28.6 %. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the DoD Board of Actuaries. The 50-year amortization period for the initial unfunded liability is scheduled to end in FY 2052.

Investments

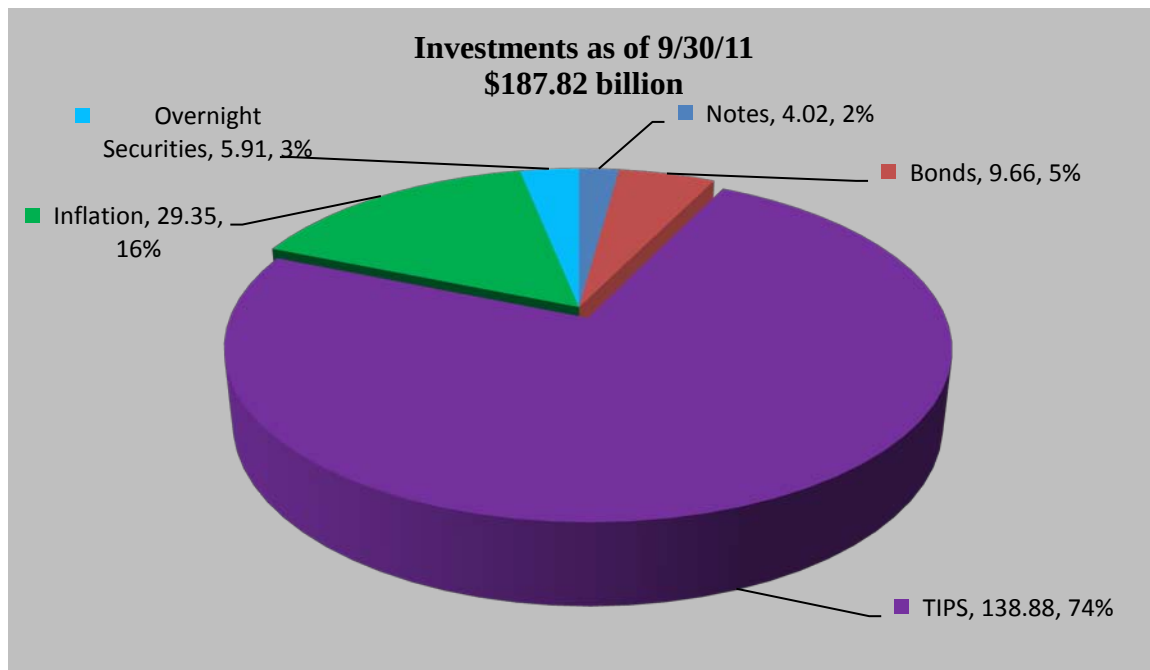


Figure 1

Figure 1 depicts the book value (par plus premium/discount less amortization of premium/discount plus interest receivable) of investment holdings as of September 30, 2011.

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 ten years. U.S Treasury bonds are long-term debt instruments with maturities of greater than ten 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 U.S Treasury Inflation Protected Securities (TIPS), which are indexed for inflation. TIPS are fixed-rate instruments designed to protect against inflation, and the principal amount is indexed to the consumer price index (CPI) by adjusting the CPI at issuance to the current CPI; as inflation increases, so does the principal amount and the coupon.

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

The Fund receives management oversight from the DoD Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service; the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller); and a senior military member, currently the Chief, Army Budget. The Investment Board reviews the Fund's Law and Department of Treasury guidelines to ensure compliance with broad policy guidance and public law.

Status of FY 2010 Audit Findings

The MERHCF independent auditors noted three material weaknesses and one significant deficiency during the FY 2010 Financial Statement Audit. The first three bullets are the material weaknesses, of which the first was new. The last bullet is the significant deficiency, which was also new for FY 2010.

Material Weaknesses 2010

1. Because of the untimely receipt of quarterly refund calculations from the Pharmacy Operations Directorate, MERHCF personnel did not issue demand letters by September 30, 2010 for Accounts Receivable relating to the second and third quarters of FY 2010. Journal entries were recorded on September 30, 2010 for the refunds pertaining to the second and third quarters of FY 2010, as well as an estimate for the fourth quarter of FY 2010 refund calculation.

With no Pharmacy Program second and third quarter demand letters issued before fiscal year's end, the auditor could not confirm Accounts Receivable recorded for the Pharmacy Program as of September 30, 2010. In addition, because of the infancy of the Pharmacy Program, the auditor could not assess the reasonableness of the estimate recorded for the fourth quarter refund amount. The auditor was unable to apply adequate audit procedures to obtain reasonable assurance that the balance was fairly stated.

2. MTF-related amounts of direct care costs are estimated by MERHCF's actuaries and others using data extracted from various Military Service financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs did not have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by the DoD's planned Standard Financial Information Structure.
3. The healthcare cost data from the MTF's provided for the estimation process are aggregated or derived from information in both financial and non-financial systems within the Military Services that have not been audited. The MTF-level data are based on budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cutoff of accounting activity occurs at the MTF level.

Significant Deficiency 2010

1. To participate in the Pharmacy Program, manufacturers must sign an agreement with TRICARE Management Activity, stating that the manufacturer will reimburse the TRICARE Management Activity, in the manner elected on the agreement, for pharmaceutical drug claims covered by the program. This refund is calculated on the data provided by a third-party contractor. The third-party contractor generates the data from paid TRICARE beneficiary pharmacy claims.
2. The auditor noted that no internal control exists at the Pharmacy Operations Directorate for the validation of data provided by the third-party contractor. The Pharmacy Program data is used to calculate the quarterly refund amounts for the program.

Direct Care Costs

At issue with the lack of a patient-level cost accounting system, material weaknesses 1 and 2 above, is the fact the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2011 and 2010 is approximately \$73.6 billion (14% of total) and \$73.2 billion (13% of total), respectively, which reflects the actuarial present value of the projected direct-care costs of benefits to be provided by MTFs to MERHCF beneficiaries.

Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2011, include approximately \$2.8 billion and \$1.8 billion, respectively, and for the year ended September 30, 2010, include approximately \$2.6 billion and \$1.6 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various Service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not have Office of Management and Budget Circular A-127, *Financial Management Systems*, compliant, transaction-based accounting systems and cannot report the costs of an individual patient's care.

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

The average costs per weighted workload unit are then applied to specific care provided to specific patients by reviewing the Standard Inpatient Data Record (SIDR) and Standard Ambulatory Data Record (SADR) reported in the MHS Data Repository. The SIDRs and SADRs are prepared for each patient encounter and contain patient-specific information, to include name, Social Security Number, sponsor or dependent status, and Medicare eligibility. Further, the SIDRs and SADRs reflect the diagnosis and any procedures performed on the patient for that specific encounter. The average costs per weighted workload unit computed in MEPRS is then applied against the specific data contained in the SIDRs and SADRs to determine an average cost for care provided to a specific patient. Estimates of the weighted workload provided to Medicare-eligible beneficiaries are calculated for each MTF based on historical experience. When the weighted workload costs are applied against the projected workload volume for each MTF, a prospective payment distribution plan can be computed for each MTF for the next fiscal year.

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for the actuarial liability. The reconciliation tasks performed by TMA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service, data to support both the prospective payment and calculation of the actuarial liability.

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

Issues with the prospective payment process include validating/reconciling financial data prior to its input into the MEPRS cost allocation process, archiving MEPRS data at the close of each month, and reconciling in a timely manner the fiscal year prospective payment plan.

Actions Taken

Since FY 2003, when the Fund was established, MERHCF management has attempted to resolve auditor-identified material weaknesses through the development of key milestone initiatives. These initiatives were established and managed by TMA leadership and intended to serve as work-arounds to address the Services' financial systems' deficiencies. The material weaknesses are associated with the computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs.

Unfortunately, the milestone initiatives have not produced the desired results in the projected time frame. To mitigate risks associated with these weaknesses, and to initiate appropriate corrective actions, we have developed a revised financial improvement plan with key milestones to incorporate a methodology to use per capita rates to prospectively compensate the Military Services each year for health care provided to Medicare-eligible beneficiaries in DoD MTFs. This methodology will also be used by the Office of the Actuary to compute the MERHCF health care liability. The use of per capita rates will enable the MERHCF to eliminate the need to rely on MTFs for auditable financial information and accurate coding of medical records and, thus, move to an unqualified audit opinion independent of the Military Services' receipt of unqualified audit opinions on their financial statements.

Creating a new model is very complex and resource intensive. The model must comply with actuarial laws and requirements as well as satisfy accounting, Government Accountability Office, and Congressional standards. Data on which the new model will be developed must be collected over time for several fiscal years with appropriate adjustments, as trends dictate. The initial data collected from the Center for Medicare and Medicaid Services by the OACT contained 2.2 million records on Medicare-eligible retirees and dependents. Additional time will be required to collect industry benchmark data, analyze the data, and develop and test the model. After testing, modifications may also be required, therefore, the time table for implementation of the per capita rate methodology is for the close of FY 2013.

Direct care costs developed under this proposed method will still retain the current plan design wherein Medicare does not reimburse DoD for care received in MTFs.

Retail Pharmacy Refund Program (Standard Discount Program)

Section 703 of the National Defense Authorization Act for Fiscal Year 2008, codified as 10 U.S.C. 1074g(f) provides:

(f) Procurement of pharmaceuticals by TRICARE Retail Pharmacy Program. With respect to any prescription filled on or after the date of the enactment of the National Defense Authorization Act for FY 2008 [January 28, 2008], the TRICARE Retail Pharmacy Program shall be treated as an element of the Department of Defense for purposes of the procurement of drugs by Federal agencies under Section 8126 of Title 38 to the extent necessary to ensure that pharmaceuticals paid for by the Department of Defense that are provided by pharmacies under the program to eligible covered beneficiaries under this section are subject to the pricing standards in such Section 8126. The effect of this law is that for all prescriptions filled on or after January 28, 2008, all covered TRICARE Retail Pharmacy Network drug prescriptions are subject to Federal Ceiling Prices (FCPs).

While DoD took steps to implement the Statute, there was a concurrent litigation challenge to the validity of the Final Rule in a case called Coalition for Common Sense in Government Procurement v. U.S., U.S. District Court for the District of Columbia, Civ. No. 08-996 (JDB), 2009 U.S. Dist. LEXIS 110746. The Court issued a decision November 30, 2009. The decision had four major points:

- Although 10 U.S.C. § 1074g(f) requires that FCPs shall apply, the Statute does not specify how they will apply. DoD incorrectly interpreted the Statute as requiring manufacturer refunds, to the exclusion of other possible approaches. DoD must reconsider the implementation of the Statute as a function of its discretionary judgment, rather than only as a legal interpretation. For example, DoD should exercise its discretion to consider “which of the five parties that participate in the retail pharmacy program – manufacturers, wholesalers, network pharmacies, private pharmacy benefit managers, and TRICARE beneficiaries – must bear any costs associated with imposing the Federal Ceiling Prices.”
- While DoD considers whether to readopt the Final Rule as it currently stands or to change it, the Final Rule will remain in effect, as will the manufacturer agreements that cover approximately 99% of TRICARE retail prescriptions. (This is the effect of the Court’s Order that the Final Rule is “remanded without vacatur.”)
- DoD correctly interpreted the Statute as applying Federal Ceiling Prices to all prescriptions filled on or after January 28, 2008.
- The Court ordered DoD to file a status report with the Court no later than March 1, 2010, “documenting its consideration on remand.”

Following the Court order, the Plaintiff, representing the pharmaceutical companies, filed a notice of appeal to the United States Court of Appeals for the District of Columbia Circuit. DoD initiated action to comply with the Court order through a notice in the Federal Register February 9, 2010, inviting additional public comments on the matters addressed by the Court. DoD intends to consider public comments received and to reissue a Final Rule in 2010, consistent with the views expressed by the Court. On February 17, 2010, the government filed a status report with the Court which advised the Court of the February 9, 2010, Federal Register notice. The Status Report also informed the Court that DoD has been receiving payments for pharmaceuticals covered by the Voluntary Uniform Formulary agreements and that a number of manufacturers have requested waivers. In the meantime, the 2009 Final Rule remains in effect. Following the issuance of the 2010 Final Rule, DoD anticipates litigation will continue.

On October 15, 2010, DoD completed reconsideration of the 2009 Final Rule and published its Final Rule at 75 Federal Register 63,383. The DoD elected to retain the requirement that had been challenged by manufacturers: that pharmaceutical manufacturers refund any amounts charged to DoD in excess of Federal Ceiling Prices. The Coalition for Common Sense in Government Procurement appealed to the District Court for the District of Columbia, requesting an injunction. This appeal was pending in FY 2010 and finalized in FY 2011. The court did not grant an injunction.

MERHCF has begun the process to compute amounts potentially owed for the period of January 28, 2008 through June 30, 2009, however much uncertainty remains. The TMA Office of the General Counsel (OGC) will need to review the amounts calculated as owed in conjunction with weighing the legal merits of manufacturer waiver compromises and/or other amounts in dispute. As such, the MERHCF cannot determine a reasonable estimate for the

amounts owed as of September 30, 2011. In light of the uncertainty regarding the amount MERHCF will issue demand letters for, and the likely additional litigation that may result in response to billings for the period in question, Management has concluded the requirements for recognition of exchange transactions, as defined in SFFAS 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling," have not been met. Therefore, a gain contingency exists as it relates to Accounts Receivable relating to the TRICARE Retail Pharmacy Program for prescriptions filled from January 28, 2008 through June 30, 2009. The fund has appropriately disclosed this contingency in Note 7 of the accompanying financial statements.

Additional details relating to the litigation as well as the uncertainty surrounding the amount owed to the MERHCF are provided below.

- The Final Rules also incorporated the regulatory overpayment recovery procedures of 32 C.F.R. §199.11 based upon the Federal Claims Collection Act and related laws for waiver/compromise of overpayment refunds for all such prescriptions. The applicability of §199.11 brings with it a procedure for a manufacturer to request waiver/compromise of a contested refund amount due.
- Resolution of waiver/compromise requests had been in abeyance pending the 2010 regulatory reconsideration. TMA is in the process of calculating refunds for CY 2008 for covered drug prescriptions purchased by TRICARE beneficiaries on or after January 28, 2008.
- Refund calculations must be run sequentially since the Department of Veteran Affairs (DVA) Pricing File (the source prescribed by law for the DoD Master Pricing File) is amended annually each November with changes, additions, deletions, and transfers submitted by the pharmaceutical manufacturers of their Non-Federal Average Manufacturer Price (Non-FAMP). After calculation of the refund amounts for the individual quarters for CY 2008, TMA will proceed with calculations for the first two quarters of CY 2009.
- Upon receipt of final calculations, TMA will issue demand letters for remaining balances and will commence with resolution of all submitted waiver/compromise requests.

The decision was made to issue demand letters for the period subsequent to June 30, 2009.

Additional Discount Program (ADP)

TMA initiated a new retail pharmacy rebate program during the 2nd Quarter, FY 2007, Voluntary Agreements for TRICARE Retail Network Rebates (VARR/ADP). Manufacturers may offer rebates to the DoD for pharmaceutical agents dispensed through the TRICARE Retail pharmacy network.

Collections from SDP and the Additional Discount Program (ADP)

During FY 2011, the MERHCF received a total of \$690.5 million in retail pharmacy SDP refunds and \$300.2 million in retail pharmacy ADP refunds.

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care to the Fund's beneficiaries relies on data files provided by TMA to the OACT. Due to the lack of a fully integrated financial management system to support the DHP, certain data are provided to the OACT from health care operational sources, rather than from the accounting and financial records of claims payment activity.

The TMA/CRM Division in Aurora, Colorado, monitors claims processing activities performed by the TDEFIC fiscal intermediary, WPS, in support of purchased care activities for Medicare-eligible beneficiaries. To better monitor purchased care claims processing and mitigate the potential for an undetected large increase in claims backlogs occurring in the future, MERHCF management has developed a quarterly purchased care claims backlog metric to report to OUSD(C).

Each quarter MERHCF estimates the IBNR purchased care claims liability. IBNR represents health care received by Medicare-eligible beneficiaries for which DoD has not yet received a claim. The purchased care claims processing metric monitors the completeness of the data used for the IBNR liability calculation. The metric is calculated by dividing the liability from claims on hand that is actually used in the IBNR calculation (without any backlogged claims) by the liability that includes any claims backlogged at the time of the IBNR calculation.

By their nature, IBNR calculations need regular and normally distributed data. The data does not have to be 100% complete, but must include a percentage of claims large enough to represent the normal claims universe, and most importantly, the degree of the claims completeness should remain relatively constant over time.

The goal is to ensure the IBNR calculation is based upon no less than 85% of the liability contained on all processed and backlogged claims. It is anticipated that 8% to 12% of available monthly claims will not be included in the IBNR calculation due to the cutoff of processed claims by 10:00 am EST on the last business day of the month. The cutoff was established to ensure IBNR calculations could be completed in time to meet reporting requirements. For FY 2011 and FY 2010, the IBNR calculation included 100% of available monthly claims.

Financial Performance Overview

Financial Data

The following table presents comparative financial statement information for the MERHCF.

Medicare-Eligible Retiree Health Care Fund				
Analysis of Financial Statements				
for the years ended September 30, 2011 and 2010				
(\$ In Thousands)				
<u>Consolidated Balance Sheets</u>	<u>2011</u>	<u>2010</u>	<u>Difference</u> Increase/ (Decrease)	<u>%</u> <u>Change</u>
Fund Balance with Treasury	\$227,170	\$195,962	\$31,208	15.9%
Investments (Intra-Governmental Securities) - Revenue from Treasury payments and Service contributions excess to current year health care benefit payments is invested in Treasury securities	\$187,826,062	\$166,203,523	\$21,622,539	13.0%
Liabilities Not Covered by Budgetary Resources - Represents difference between actuarial liability for future benefit payments and current assets	\$348,753,354	\$409,407,569	(\$60,654,215)	(14.8%)
Accounts Receivable, Net A/R associated with Standard Discount Program (SDP)	\$497,982	\$562,924	(\$64,942)	(11.5%)
Accounts Payable (Intra-governmental)	\$101,275	\$91,603	\$9,672	10.6%
Accounts Payable (Non-Federal)	\$321,360	\$212,089	\$109,271	51.5%
Military Retirement and Other Federal Employment Benefits - Represents actuarial liability of future health care benefit and Incurred But Not Reported (IBNR) liability	\$534,379,945	\$573,671,310	(\$39,291,365)	(6.8%)
<u>Statements of Net Cost</u>				
Net costs of operation - Changes in computation of actuarial health care liability are the major contributor to changes in net costs of operation	(\$60,761,227)	\$45,159,317	(\$105,920,544)	(234.5%)
<u>Statements of Budgetary Resources</u>				
Undelivered orders	\$100,212	\$63,232	\$36,980	58.5%
Net Outlays	(\$10,203,340)	(\$6,691,306)	(\$3,512,033)	52.5%

Assets

Assets of \$188.5 billion, included in the previous table and shown in Figure 2, represent amounts that the MERHCF owns and manages. Assets increased \$21.60 billion at the end of FY 2011. This increase is largely attributable to purchasing new investments of \$18.7 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 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.

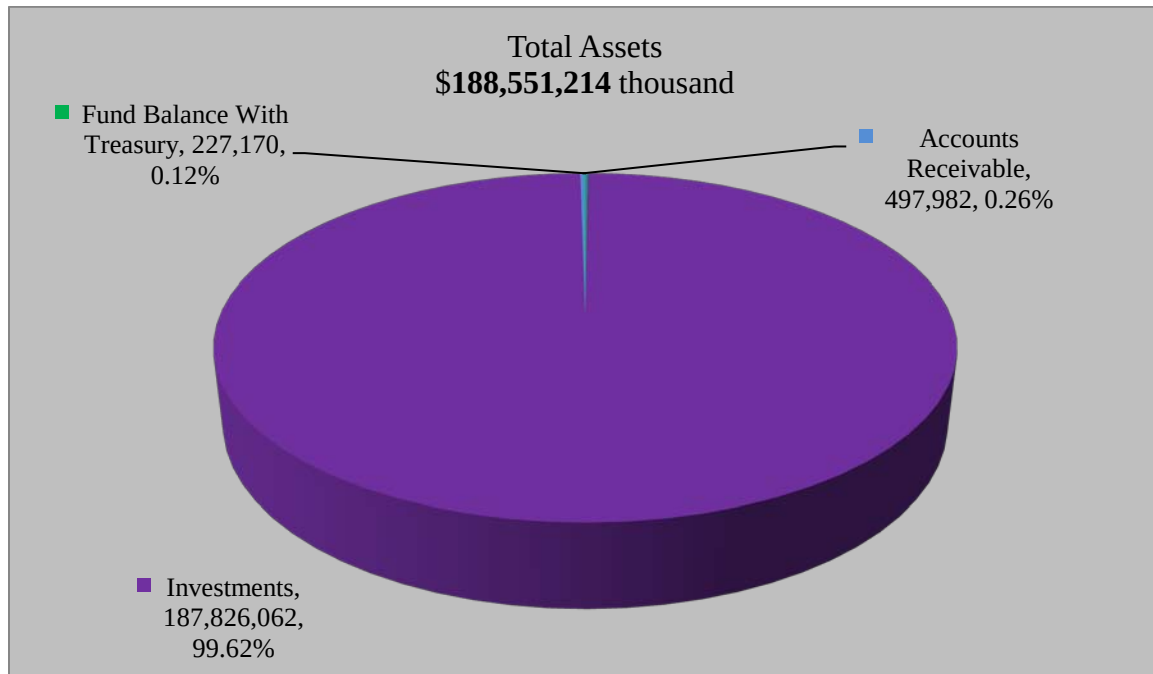


Figure 2

Liabilities

Liabilities of \$534.8 billion included in the previous table and shown in Figure 3 represent liabilities related to military retirement pension benefits. The liabilities of the MERHCF primarily consist of actuarial liability for future benefit payments. Liabilities decreased \$39.2 billion at the end of FY 2011. This increase is largely attributable to the decrease in the actuarial liability calculation.

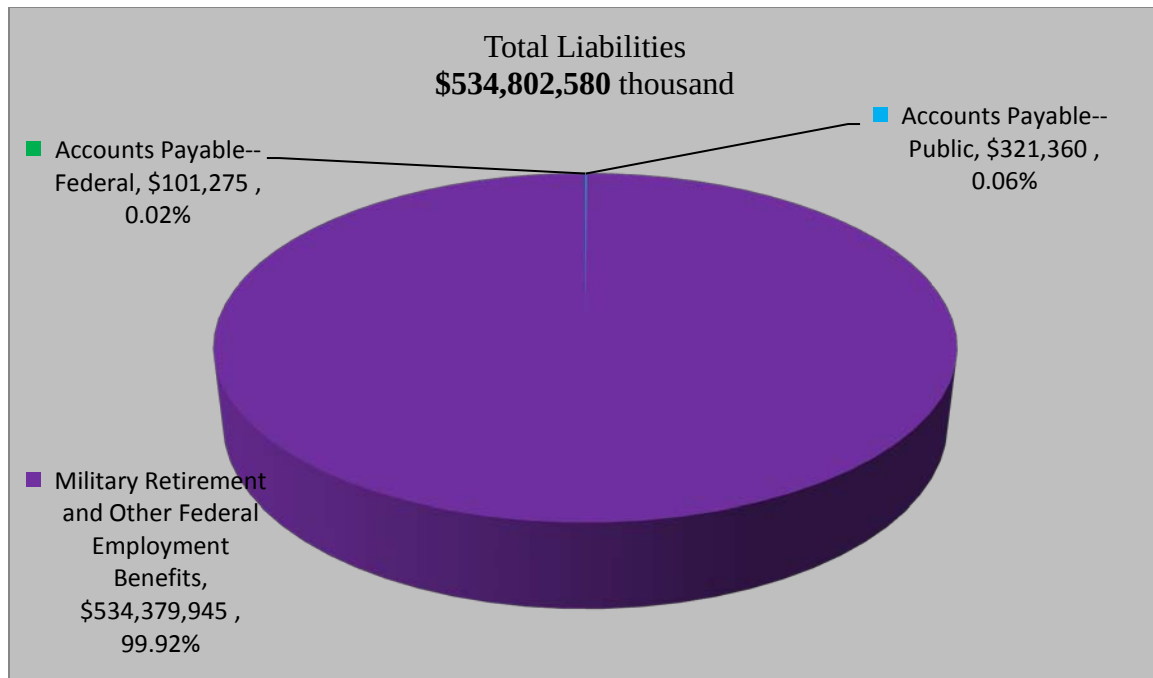


Figure 3

Limitations of the Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations for the MERHCF pursuant to the requirements of the Chief Financial Officers (CFO) Act of 1990. While the statements have been prepared from the books and records of the MERHCF in accordance with the U.S. generally accepted accounting principles (U.S. GAAP) for Federal entities and the formats prescribed by OMB, these statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization they are for a component of the U.S. Government, a sovereign entity.

Internal Controls Over Financial Reporting and On Compliance With Other Matters

During an independent audit of the Fund's financial statements, the auditor identified deficiencies related to the internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of financial statements. Because of these deficiencies, the auditor believes the Fund's financial management system does not meet the requirements of an integrated financial management system as defined in OMB Circular A-127, with respect to consistent internal control over data entry, transaction processing and reporting. Further, the auditors believe the Fund is not in compliance with the system design requirements sufficient to comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and

content prescribed by OMB and reporting requirements prescribed by Treasury, and to monitor the financial management system to ensure integrity of financial data.

The TMA assessments of internal controls identified one new systemic weakness concerning accounts receivable due from pharmaceutical manufacturers' refunds for drugs dispensed from retail pharmacies, which was reflected in the FY 2010 audit opinion and the FY 2011 TMA Statement of Assurance. Note: Due to the timing of the assessment of Internal Controls, which ends as of June 30, compared to audit, which ends as of September 30, there may be inconsistencies as to weaknesses noted. While the IPA noted a Material Weakness in 2010 related to TRICARE Retail Pharmacy Program, in FY 2011 they did not re-issue this finding.

More detailed discussion of the auditors findings on internal controls can be found in the "Independent Auditors' Report on Internal Control" and on "Compliance and Other Matters."

Principal Statements

The accompanying notes are an integral part of these statements

Balance Sheets

**Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30, 2011 and 2010**

(\$ In Thousands)	<u>2011</u>	<u>2010</u>
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$ 227,170	\$ 195,962
Investments (Note 3)	<u>187,826,062</u>	<u>166,203,523</u>
Total Intragovernmental Assets	188,053,232	166,399,485
Accounts Receivable, Net (Note 4)	<u>497,982</u>	<u>562,924</u>
TOTAL ASSETS	\$ <u>188,551,214</u>	\$ <u>166,962,409</u>
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 6)	\$ <u>101,275</u>	\$ <u>91,603</u>
Total Intragovernmental Liabilities	101,275	91,603
Accounts Payable (Note 6)	321,360	212,089
Military Retirement Benefit Liabilities (Notes 5 and 8)	<u>534,379,945</u>	<u>573,671,310</u>
TOTAL LIABILITIES	\$ <u>534,802,580</u>	\$ <u>573,975,002</u>
COMMITMENTS AND CONTINGENCIES (Note 7)		
NET POSITION		
Cumulative Results of Operations - Earmarked Funds	<u>(346,251,366)</u>	<u>(407,012,593)</u>
TOTAL NET POSITION	\$ <u>(346,251,366)</u>	\$ <u>(407,012,593)</u>
TOTAL LIABILITIES AND NET POSITION	\$ <u>188,551,214</u>	\$ <u>166,962,409</u>

The accompanying notes are an integral part of these statements

Statements of Net Cost

Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF NET COST
For the Years ended September 30, 2011 and 2010

(\$ In Thousands)	2011	2010
Program Costs		
Gross Costs (Note 9)	\$ 8,820,043	\$ 8,050,695
(Less: Earned Revenue)	<u>(30,253,771)</u>	<u>(26,420,118)</u>
Net Cost before Losses/(Gains) from Actuarial Assumption Changes	\$ <u>(21,433,728)</u>	\$ <u>(18,369,423)</u>
Losses/(Gains) from Actuarial Assumption Changes	\$ <u>(39,327,499)</u>	\$ <u>63,528,740</u>
Net Cost of Operations	\$ <u>(60,761,227)</u>	\$ <u>45,159,317</u>

The accompanying notes are an integral part of these statements

Statements of Changes in Net Position

**Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2011 and 2010**

(\$ In Thousands)	2011	2010
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (407,012,593)	\$ (361,576,518)
Prior Period Adjustments:		
Corrections of errors (+/-)	<u>0</u>	<u>(276,758)</u>
Beginning balances, as adjusted	(407,012,593)	(361,853,276)
Net Cost of Operations (+/-)	<u>(60,761,227)</u>	<u>45,159,317</u>
Net Change	60,761,227	(45,159,317)
 Cumulative Results of Operations	 (346,251,366)	 (407,012,593)
 Net Position	 \$ <u>(346,251,366)</u>	 \$ <u>(407,012,593)</u>

The accompanying notes are an integral part of these statements

Statements of Budgetary Resources

**Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2011 and 2010**

(\$ In Thousands)	<u>2011</u>	<u>2010</u>
BUDGETARY RESOURCES		
Unobligated balance, brought forward, October 1	\$ 0	\$ 0
Budget authority		
Appropriation	<u>30,118,797</u>	<u>26,215,989</u>
Subtotal	30,118,797	26,215,989
Temporarily not available pursuant to Public Law	(21,362,849)	(17,593,148)
Permanently not available	<u>0</u>	<u>0</u>
Total Budgetary Resources	\$ <u>8,755,948</u>	\$ <u>8,622,841</u>
STATUS OF BUDGETARY RESOURCES		
Obligations incurred:		
Direct	\$ <u>8,755,948</u>	\$ <u>8,622,841</u>
Subtotal	8,755,948	8,622,841
Unobligated balance:		
Subtotal	0	0
Unobligated balance not available	<u>0</u>	<u>0</u>
Total status of budgetary resources	\$ <u>8,755,948</u>	\$ <u>8,622,841</u>
CHANGE IN OBLIGATED BALANCE		
Obligated balance, net		
Unpaid obligations, brought forward, October 1	\$ <u>366,924</u>	\$ <u>173,192</u>
Total unpaid obligated balance, net	366,924	173,192
Obligations incurred, net (+/-)	8,755,948	8,622,841
Gross outlays	(8,600,024)	(8,429,109)
Obligated balance, net, end of period		
Unpaid obligations	<u>0</u>	<u>366,924</u>
Total, unpaid obligated balance, net, end of period	\$ 522,848	\$ 366,924
NET OUTLAYS		
Gross outlays	\$ 8,600,024	\$ 8,429,109
Less: Distributed Offsetting receipts	<u>(18,803,364)</u>	<u>(15,120,415)</u>
Total Outlays	\$ <u>(10,203,340)</u>	\$ <u>(6,691,306)</u>

The accompanying notes are an integral part of these statements

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 Medicare-Eligible Retiree Health Care Fund (MERHCF), 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 using the books and records of MERHCF in accordance with 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 MERHCF is responsible unless otherwise noted.

The MERHCF currently has two auditor-identified financial statement material weaknesses: (1) The DoD-managed Military Treatment Facilities (MTFs) do not have compliant, transaction-based accounting systems that support the costs of direct care provided to MERHCF beneficiaries and (2) the MTF-level health care cost data is based on budget execution processes rather than accrual-based accounting. See Note 4, Accounts Receivable and Note 7, Commitments and Contingencies for further information and disclosures.

B. Mission of the Reporting Entity. The mission of MERHCF is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of health care programs for DoD Military Services and other Uniformed Services. The MERHCF provides benefits for a Medicare-eligible member of a participating Military Service or other Uniformed Service entitled to retired or retainer pay and such member's Medicare-eligible dependents or survivors.

C. Appropriations and Funds. Public Law 106-398, The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001, authorized MERHCF 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 law does not specify an amount of budget authority for the indefinite appropriation; however, the law does specify a variable factor that determines the amount available until expended.

The MERHCF is a special fund. Special fund accounts are used to record government receipts reserved for a specific purpose. Accordingly, the funds in MERHCF are used, in compliance with the law, to provide benefits for the Medicare-eligible beneficiaries listed in paragraph 1B.

Certain trust and special funds may be 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 MERHCF 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 MERHCF's financial management systems record and report on the accrual basis. Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with USGAAP.

The financial statements and supporting trial balances are compiled from the underlying financial data and trial balances. The underlying data for the MERHCF 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, accounts payable, and health care liabilities.

E. Revenues and Other Financing Sources. Using methods and assumptions approved by the DoD MERHCF Board of Actuaries, the DoD Office of the Actuary determines the amount of the contribution to MERHCF. The contribution consists of two parts: a U. S. Treasury warrant for the amortization payment of the original unfunded liability and an annual contribution from each Uniformed Service: Army, Navy, Air Force, Marine Corps, U.S. Coast Guard, Public Health Service, and National Oceanic and Atmospheric Administration. 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 MERHCF.

F. Recognition of Expenses. For financial reporting purposes, DoD policy requires the recognition of benefit expenses for the period incurred. The current financial management systems for MERHCF 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 MERHCF 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 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 MERHCF's monetary resources are maintained in U.S. Treasury accounts. The disbursing offices of the Defense Finance and Accounting Service (DFAS) and other DoD Agency financial service centers process the majority of MERHCF'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 and other DoD Agency service centers 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 MERHCF reconciles monthly with the U.S. Treasury account with no outstanding discrepancies.

The U.S. Treasury allows MERHCF 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; however, internal controls are in place to prevent abnormal balances at the U.S. Treasury.

I. Accounts Receivable. Accounts receivable from other federal entities or the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by fund type. 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.

Since the beginning of the Federal Ceiling Price (FCP) Program, outpatient pharmaceuticals purchased by DoD for medical treatment facility pharmacies have been subject to FCPs, as have those under the TRICARE Mail Order Pharmacy (TMOP) program. The MERHCF implemented FCPs for the TRICARE Retail Pharmacy program in compliance with the National Defense Authorization Act for Fiscal Year 2008, §703. The Final Rule was published March 17, 2009, with an effective date of May 26, 2009. The MERHCF applied this rule to all retail prescriptions filled on or after January 27, 2008, unless the TMA granted a waiver to a particular manufacturer. Compliance is mandatory and the advantage to the manufacturers is that their drugs will be included on the DoD Uniform Formulary (list of available prescription drugs). The MERHCF will record accounts receivable upon receipt of the calculation from the TRICARE Pharmacy Operations Directorate and will post the collections from the manufacturers to the fiscal year of receipt pursuant to Title 10, U.S.C. §1079a.

J. Investments in U.S. Treasury Securities. The MERHCF 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 method. The MERHCF'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 MERHCF 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, but are not publicly traded. The MERHCF 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 MERHCF 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.

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. MRB. The DoD 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 the actuarial liability are presented separately on the Statement of Net Cost. Refer to Note 8, Military Retirement and Other Federal Employment Benefits and Note 9, General Disclosures Related to the Statement of Net Cost, for additional information.

Note 2. Fund Balance with Treasury

(\$ In Thousands)	<u>2011</u>	<u>2010</u>
Fund Balance		
Total Special Funds	\$ <u>227,170</u>	\$ <u>195,962</u>
Status of Fund Balance with Treasury		
Unobligated Balance – Unavailable	185,626,591	164,263,741
Obligated Balance not yet Disbursed	522,847	366,924
Non-Budgetary FBWT Accounts	<u>(185,922,268)</u>	<u>(164,434,703)</u>
Total	\$ <u>227,170</u>	\$ <u>195,962</u>

The Fund Balance with Treasury (FBWT) increased \$31.2 million (16%) due to the increase in the amount held back to cover the final month-end disbursements. This monthly holdback is calculated based on the current month to date disbursements versus the average monthly disbursement over the last 12 months. During FY 2011, final payments reported ranged from \$0 million to \$229.2 million.

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support the 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. Unobligated Balances for the MERHCF are restricted for use by the public law that established the fund and become available without further congressional action.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods and services not received and those received but not paid. The MERHCF balance represents amounts payable to the Defense Logistics Agency (DLA) for purchases of pharmaceuticals, to private contractors waiting for DLA to replenish the pharmaceutical supply, and to private health care providers.

The MERHCF Non-Budgetary FBWT Account balance represents investments in U.S. Treasury securities that are reflected in the MERHCF's budgetary resources, but are not part of the FBWT.

Note 3. Investments

(\$ In Thousands)		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	\$ <u>191,058,659</u>	Effective Interest	\$ <u>(5,136,390)</u>	\$ <u>185,922,269</u>	\$ <u>221,620,502</u>
Subtotal	191,058,659		(5,136,390)	185,922,269	221,620,502
Interest Receivable	<u>1,903,793</u>		<u>0</u>	<u>1,903,793</u>	<u>1,903,793</u>
Total Investments	\$ <u>192,962,452</u>		\$ <u>(5,136,390)</u>	\$ <u>187,826,062</u>	\$ <u>223,524,295</u>

(\$ In Thousands)		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	\$ <u>168,568,946</u>	Effective Interest	\$ <u>(4,134,242)</u>	\$ <u>164,434,704</u>	\$ <u>182,212,125</u>
Subtotal	168,568,946		(4,134,242)	164,434,704	182,212,125
Interest Receivable	<u>1,768,819</u>		<u>0</u>	<u>1,768,819</u>	<u>1,768,819</u>
Total Investments	\$ <u>170,337,765</u>		\$ <u>(4,134,242)</u>	\$ <u>166,203,523</u>	\$ <u>183,980,944</u>

Total Intragovernmental Securities, Net Investments, for MERHCF increased \$21.6 billion (13%). This increase is primarily the result of investing annual contributions from the U.S.

Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. Public Health Service, National Oceanic and Atmospheric Administration, and U.S. Coast Guard) net of benefits paid. Investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover future benefits. The MERHCF purchased \$18.7 billion in long-term securities during FY 2011.

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 Medicare-Eligible Retiree Health Care Fund (MERHCF) and a liability to the U.S. Treasury. Since MERHCF 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. governmentwide financial statements.

The U.S. Treasury securities provide MERHCF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When MERHCF requires redemption of these securities to make expenditures, the federal government finances the securities out of 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 MERHCF purchases and redeems nonmarketable, market-based U.S. Treasury securities that fluctuate in tandem with the current selling price of the equivalent marketable securities on the open market. The MERHCF 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 MERHCF. These securities may 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 1 year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least 1 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 U.S. Treasury Inflation-Protected Securities (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 Consumer Price Index. 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.

Notes to the Principal Statements

The cost of the U.S. Treasury Securities are displayed in the following table.

	COST FY 2011 (in thousands)		COST FY 2010 (in thousands)
Bills	\$ 0	Bills	\$ 0
Notes	3,986,875	Notes	8,170,204
Bonds	10,515,160	Bonds	8,191,910
TIPS	170,645,069	TIPS	146,372,105
Overnights	<u>5,911,555</u>	Overnights	<u>5,834,727</u>
Total Cost	\$ <u>191,058,659</u>	Total Cost	\$ <u>168,568,946</u>

Note 4. Accounts Receivable

(\$ In Thousands)

	2011		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ <u>524,737</u>	\$ <u>(26,755)</u>	\$ <u>497,982</u>
Total Accounts Receivable	\$ <u>524,737</u>	\$ <u>(26,755)</u>	\$ <u>497,982</u>

(\$ In Thousands)

	2010		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ <u>623,303</u>	\$ <u>(60,379)</u>	\$ <u>562,924</u>
Total Accounts Receivable	\$ <u>623,303</u>	\$ <u>(60,379)</u>	\$ <u>562,924</u>

Accounts Receivable, Public, decreased \$64.9 million (12%) primarily due to receiving timelier reimbursements.

The accounts receivable represent the MERHCF's claim for payment from other entities. The MERHCF only recognizes an allowance for uncollectible amounts from the public. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

As of September 30, 2011, the total net receivables, recorded for the pharmaceutical SDP were \$317.8 million and for the ADP were \$171.6 . This program resulted from the implementation of the Federal Ceiling Program for the TRICARE Retail Pharmacy Program as required by the FY 2008 National Defense Authorization Act, Section 703. See Note 7, Commitments and Contingencies for further information and disclosures.

Note 5. Liabilities Not Covered by Budgetary Resources

(\$ In Thousands)	2011	2010
Nonfederal Liabilities		
Military Retirement Benefits Liabilities (Note 8)	\$ 348,753,354	\$ 409,407,569
Total Nonfederal Liabilities	<u>348,753,354</u>	<u>409,407,569</u>
 Total Liabilities Not Covered by Budgetary Resources	 348,753,354	 409,407,569
Total Liabilities Covered by Budgetary Resources	<u>186,049,226</u>	<u>164,567,433</u>
 Total Liabilities	 \$ <u>534,802,580</u>	 \$ <u>573,975,002</u>

Total Liabilities Not Covered by Budgetary Resources decreased \$60.7 billion (15%). This change is primarily attributable to a decrease in the actuarial liability of \$39.3 billion and an increase of \$21.6 billion in investments available to pay benefits. See Note 3, Investments, and Note 8, Military Retirement and Other Federal Employment Benefits, for additional information about these changes.

The MERHCF Liabilities Not Covered by Budgetary Resources represent the portion of the actuarial liability for health benefits for which current assets are not yet available. Refer to Note 8, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Note 6. Accounts Payable

(\$ In Thousands)	2010	2009
Intragovernmental Payables	\$ 101,275	\$ 91,603
Nonfederal Payables (to the Public)	<u>321,360</u>	<u>212,089</u>
Total Accounts Payable	\$ <u>422,635</u>	\$ <u>303,692</u>

Intragovernmental Payables increased \$9.7 million (11%) primarily due to increased Mail Order Pharmacy Program activity.

Nonfederal Payables (to the Public) increased \$109.3 million (52%). This change is primarily due to an \$81.5 million increase in TRICARE Mail Order Pharmacy Program costs. This is the result of a combination of higher utilization by the DoD Medicare-eligible beneficiaries and an increase in pharmaceutical expenses.

Accounts Payable include amounts owed to federal and nonfederal entities for goods and services received by MERHCF.

The MERHCF balance represents amounts payable to the Defense Logistics Agency (DLA) for purchases of pharmaceuticals, to private contractors waiting for DLA to replenish the pharmaceutical supply, and to private health care providers.

Note 7. Commitments and Contingencies

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.

Section 703 of the National Defense Authorization Act for Fiscal Year 2008, codified as 10 U.S.C. 1074g(f) provides:

(f) Procurement of pharmaceuticals by TRICARE Retail Pharmacy Program. With respect to any prescription filled on or after the date of the enactment of the National Defense Authorization Act for Fiscal Year 2008 [January 28, 2008], the TRICARE Retail Pharmacy Program shall be treated as an element of the Department of Defense for purposes of the procurement of drugs by Federal agencies under section 8126 of title 38 to the extent necessary to ensure that pharmaceuticals paid for by the Department of Defense that are provided by pharmacies under the program to eligible covered beneficiaries under this section are subject to the pricing standards in such section 8126. The effect of this law is that for all prescriptions filled on or after January 28, 2008, all covered TRICARE Retail Pharmacy Network drug prescriptions are subject to Federal Ceiling Prices (FCPs).

On October 15, 2010, DoD completed reconsideration of the 2009 Final Rule and published its Final Rule at 75 Federal Register 63,383. The DoD elected to retain the requirement that had been challenged by manufacturers: that pharmaceutical manufacturers refund any amounts charged to DoD that are in excess of the Federal Ceiling Prices. The Coalition for Common Sense in Government Procurement appealed to the District Court for the District of Columbia, requesting an injunction. This appeal was pending in FY 2010 and finalized in FY 2011. The court did not grant an injunction.

MERHCF has begun the process to compute amounts potentially owed for the period of January 28, 2008 and June 30, 2009, however much uncertainty remains. The TMA OGC will need to review the amounts calculated as owed in conjunction with weighing the legal merits of manufacturer waiver compromises and/or other amounts in dispute. As such, the MERHCF cannot determine a reasonable estimate for the amounts owed as of September 30, 2011. In light of the uncertainty regarding the amount MERHCF will issue demand letters for, and the likely additional litigation that may result in response to billings for the period in question, Management has concluded the requirements for recognition of exchange transactions, as defined in SFFAS 7, "Accounting for Revenue and Other Financing Sources and Concepts for Reconciling," have not been met. Therefore, a gain contingency exists as it relates to Accounts Receivable relating to the TRICARE Retail Pharmacy Program for prescriptions filled between January 28, 2008 and June 30, 2009.

Additional details relating to the litigation as well as the uncertainty surrounding the amount owed to the MERHCF are provided below.

Notes to the Principal Statements

- The Final Rules also incorporated the regulatory overpayment recovery procedures of 32 C.F.R. §199.11 based upon the Federal Claims Collection Act and related laws for waiver/compromise of overpayment refunds for all such prescriptions. The applicability of §199.11 brings with it a procedure for a manufacturer to request waiver/compromise of a contested refund amount due.
- Resolution of waiver/compromise requests had been in abeyance pending the 2010 regulatory reconsideration. TMA is in the process of calculating refunds for CY 2008 for covered drug prescriptions purchased by TRICARE beneficiaries on or after January 28, 2008.
- Refund calculations must be run sequentially since the Department of Veteran Affairs (DVA) Pricing File (the source prescribed by law for the DoD Master Pricing File) is amended annually each November with changes, additions, deletions, and transfers submitted by the pharmaceutical manufacturers of their Non-Federal Average Manufacturer Price (Non-FAMP). After calculation of the refund amounts for the individual quarters for CY 2008, TMA will proceed with calculations for the first two quarters of CY 2009.
- Upon receipt of final calculations, TMA will issue demand letters for remaining balances and will commence with resolution of all submitted waiver/compromise requests.

Note 8. 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>	
Medicare-Eligible Retiree Benefits	\$ 533,667,660	5.00%	\$ (184,914,306)	\$ 348,753,354	
Benefits Due and Payable	<u>712,285</u>		<u>(712,285)</u>	<u>0</u>	
Total	\$ <u>534,379,945</u>		\$ <u>(185,626,591)</u>	\$ <u>348,753,354</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>
Medicare-Eligible Retiree Benefits	\$ 572,995,159	5.00%	\$ (163,587,590)	\$ 409,407,569
Benefits Due and Payable	<u>676,151</u>		<u>(676,151)</u>	<u>0</u>
Total	\$ 573,671,310		\$ (164,263,741)	\$ 409,407,569

Change in Actuarial Liability

(\$ In Thousands)	<u>FY 2011</u>	<u>FY 2010</u>
Beginning Actuarial Liability	\$ <u>572,995,159</u>	\$ <u>509,466,419</u>
Normal Cost Liability	12,127,505	10,583,746
Plan Amendment Liability	(12,807,919)	
Benefit Outlays	(9,455,706)	(8,633,903)
Interest Cost	29,022,624	29,658,129
Actuarial (gains)/losses due to changes in experience	(8,889,969)	3,323,196
Actuarial (gains)/losses due to changes in trend assumptions	(68,961,084)	(90,883,699)
Actuarial (gains)/losses due to other factors	<u>19,637,050</u>	<u>119,481,271</u>
Ending Actuarial Liability	\$ <u>533,667,660</u>	\$ <u>572,995,159</u>
Change in Actuarial Liability	\$ <u>(39,327,499)</u>	\$ <u>63,528,740</u>

The Total Military and Retirement and Other Federal Employment Benefits Liability decreased \$39.3 billion (7%). This resulted from a decrease of \$49.3 billion due to changes in key assumptions; a decrease of \$12.8 in the Plan Amendment Liability (beneficiary cost share effective October 1, 2011) and a decrease of \$8.9 billion due to actual experience being different from what was assumed (demographic and claims data) offset by an expected increase of \$31.7 billion due to interest and normal costs less benefit outlays.

The MERHCF accumulates funds to pay for health care programs for DoD and other Uniformed Services Medicare-eligible retirees and their Medicare-eligible dependents or survivors.

The two tables on page 31 display two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. These tables display on the line entitled “Military Medicare-Eligible Retiree Benefits” the actuarial liability for health care benefits that are not yet incurred. They also display on the line entitled “Other” the incurred-but-not-reported reserve amount that represents an estimate of benefits already incurred but not yet reported to DoD.

Actuarial Cost Method

As dictated by law, MERHCF is funded using the Aggregate Entry-Age Normal Cost method. This is a method whereby projected retiree medical plan costs are spread over the projected service of a new entrant cohort.

Projected Revenues

The MERHCF receives projected revenues from three sources: interest earnings on MERHCF assets, annual Uniformed Services normal cost contributions, and an annual U.S. Treasury contribution. The normal cost contributions are paid annually at the beginning of the fiscal year by the U.S. Treasury from amounts appropriated to the Military Services and are calculated at the approved full-time and part-time per capita rates times the budgeted full-time and part-time

force strengths, respectively. The contribution from the U.S. Treasury is also paid into MERHCF at the beginning of each fiscal year and represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses. The DoD Medicare-Eligible Retiree Health Care Board of Actuaries (the Board) approves the per capita normal cost rates and the U.S. Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payments.

Assumptions

The Board sets the long-term 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 included a 5.0% discount rate and medical trend rates that were developed using a 2.4% inflation assumption. For the FY 2011 financial-statement valuation, the long-term assumptions include a 4.9% discount rate and medical trend rates that were developed using a 2.5% inflation assumption. The change in the long-term assumptions is due to compliance with the Statement of Federal Financial Accounting Standards 33 (SFFAS 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 liability is rolled forward from the prior year valuation results as reported in the DoD Office of the Actuary's (OACT's) 'Valuation of the Medicare-Eligible Retiree Health Care Fund' using accepted actuarial methods. Adjustments are made as necessary to put liabilities on a financial-statement basis. In the selection of the valuation date, SFFAS 33 allows for the roll-forward of actuarial liabilities from the prior year valuation results. In calculating the FY 2011 roll-forward amount, the following assumptions were used:

Discount Rate	4.9%	
Inflation	2.5%	
<u>Medical Trend</u>	<u>FY 2010 - FY 2011</u>	<u>Ultimate Rate 2035</u>
Medicare Inpatient (Direct Care)	3.38%	5.25%
Medicare Inpatient (Purchased Care)	4.38%	5.25%
Medicare Outpatient (Direct Care)	3.26%	5.25%
Medicare Outpatient (Purchased Care)	4.26%	5.25%
Medicare Prescriptions (Direct Care)	2.00%	5.25%
Medicare Prescriptions (Purchased Care)	5.82%	5.25%
Medicare USFHP (Purchased Care)	5.67%	5.25%

For purposes of the Fund's financial reporting, this roll-forward process is applied annually.

The medical cost trend rate assumptions have a significant effect on the amounts reported. For example, if each of the assumed trend rates had increased by one percentage point, the actuarial liability benefits would have increased 29.0%, or approximately \$154.1 billion.

Contributions to the MERHCF are calculated to maintain the Fund on an actuarially sound basis. This means there will be sufficient funds to make all benefit payments to eligible recipients each

year, and the Fund balance is projected to eventually equal the actuarial liability; i.e., all unfunded liabilities are liquidated. In order to accomplish this, normal costs are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, amortization payments are calculated to fund liabilities that were present at plan inception (initial unfunded liability) and any emerging actuarial gains or losses.

The SFFAS 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 discount 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.

SFFAS 33 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. SFFAS 33 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 discount rate if the resulting present value is not materially different from what would be obtained using the yield curve.

DoD OACT annually performs two MERHCF valuations. The primary one is for funding purposes—this valuation is governed by Chapter 56 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other valuation 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, through March 31, 2011, (40 quarterly interest rates) to determine an SFFAS 33 equivalent discount rate of 4.9%. In the summer of 2011, the Board approved a discount rate of 5.75% for the September 30, 2010, funding valuation, which differs from the SFFAS equivalent rate by 85 basis points.

SFFAS 33 requires that the discount rate, underlying inflation rates, and other economic assumptions should be consistent with one another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2011, financial-statement valuation, implementation of the SFFAS 33 single equivalent discount rate required OACT to change the long-term inflation and medical trend rate assumptions to be consistent with the underlying Treasury spot rates used in the valuation. Using the SFFAS 33 long-term economic assumptions increases the MERHCF actuarial liability by 14.7%.

Plan Amendment

The liability also reflects a plan amendment. The benefit change, effective October 1, 2011, is the result of a regulation approved by the DoD Pharmacy and Therapeutics Committee, and includes changes to Retail and Mail Order pharmacy co-payments (the beneficiary cost-share). The effect of this benefit change on the actuarial liability is (\$12.8) billion.

FY 2011 Military Service and Other Uniformed Services Actuarial Liability

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2011, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$ 521,780,560
Coast Guard	10,666,248
Public Health Service	1,143,997
National Oceanic and Atmospheric Administration	<u>76,855</u>
Total	\$ <u>533,667,660</u>

FY 2011 Military Service and Other Uniformed Service Contributions

The FY 2011 Military Service and other Uniformed Service contributions to MERHCF (\$ in thousands) were as follows:

DoD	\$ 11,010,191
Coast Guard	265,321
Public Health Service	38,089
National Oceanic and Atmospheric Administration	<u>1,832</u>
Total	\$ <u>11,315,433</u>

Market Value of MERHCF's Securities

The market value of MERHCF's nonmarketable, market-based securities as of September 30, 2011, totaled \$223.5 billion. This amount is also reported on Note 3, Investments and Related Interest.

Note 9. Disclosures Related to the Statements of Net Cost

(\$ In Thousands)	2011	2010
Gross Costs		
Intragovernmental Costs	\$ 2,772,992	\$ 2,400,305
Public Costs	<u>6,047,051</u>	<u>5,650,390</u>
Total Costs	8,820,043	8,050,695
Earned Revenue		
Intragovernmental Revenue	<u>(30,253,771)</u>	<u>(26,420,118)</u>
Total Revenue	<u>(30,253,771)</u>	<u>(26,420,118)</u>
Losses/(Gains) from Actuarial Assumption		
Changes for Military Retirement Benefits	<u>(39,327,499)</u>	<u>63,528,740</u>
Net Cost of Operations	\$ <u>(60,761,227)</u>	\$ <u>45,159,317</u>

The Net Cost of Operations decreased \$105.9 billion (235%) primarily due to \$102.8 billion decrease in the annual change to the actuarial liability. For FY 2011, the actuarial liability decreased \$39.3 billion; conversely, the FY 2010 actuarial liability increased \$63.5 billion.

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the federal government 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 (i.e. MERHCF) or organization administered by a responsible reporting entity.

Intragovernmental costs and revenue are related to 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. Public costs also include actuarial gains and losses on assumption changes for other retirement benefits. Pursuant to 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", effective for fiscal years after September 30, 2009, actuarial gains and losses are presented on Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits line on the Statement of Net Costs.

The following table displays the intragovernmental revenue.

Intragovernmental Earned Revenue for Program Costs

(\$ in Thousands)	<u>FY 2011</u>	<u>FY 2010</u>
1. Uniformed Services Contributions	\$11,315,433	\$11,095,573
2. U.S. Treasury Annual Unfunded Liability Payment	9,785,000	10,006,000
3. Interest on Investments	<u>9,153,338</u>	<u>5,318,545</u>
4. Total Intragovernmental Revenue	<u>\$30,253,771</u>	<u>\$26,420,118</u>

Line 1. Uniformed Service Contributions represent the amount contributed by Treasury on behalf of the Uniformed Services at the beginning of each fiscal year. The contribution rates, which are determined by the DoD Retirement Board of Actuaries, are based on DoD Retirement Board of Actuaries approved per capita normal cost rates and expected average strengths for the Uniformed Services.

Line 2. Annual Treasury Unfunded Liability Payment. This payment represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses.

Line 3. Interest on Investments represents the interest income received by the MERHCF for FYs 2011 and 2010.

Note 10. Disclosure Related to the Statement of Changes in Net Position

There was a difference of \$30.1 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations Received on the Statement of Budgetary Resources (SBR). The MERHCF 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 11, Disclosures Related to the Statement of Budgetary Resources, for additional details.

Note 11. Disclosures Related to the Statement of Budgetary Resources

(\$ in Thousands)	<u>2011</u>	<u>2010</u>
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ <u>100,212</u>	\$ <u>63,232</u>

The Medicare-Eligible Retiree Health Care Fund (MERHCF) reported \$8.8 billion in direct, Category B obligations. Category B obligations are apportioned funds that relate to a specific project or program.

Public Law 106-398, *The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001*, provided and authorized MERHCF a permanent, indefinite appropriation.

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

There was a difference of \$30.1 billion between appropriations on the Statement of Changes in Net Position (SCNP) and appropriations on the SBR. The MERHCF 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.

Note 12. Reconciliation of Net Cost of Operations to Budget

(\$ in Thousands)	2011	2010
Resources Used to Finance Activities:		
Budgetary Resources Obligated—Obligations incurred	\$ 8,755,948	\$ 8,622,841
Less: Offsetting receipts (-)	<u>(18,803,364)</u>	<u>(15,120,415)</u>
Net obligations	(10,047,416)	(6,497,574)
Total resources used to finance activities	<u>(10,047,416)</u>	<u>(6,497,574)</u>
Resources Used to Finance Items not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided:		
Undelivered Orders (-)	(36,979)	(12,935)
Resources that fund expenses recognized in prior Periods (-)	<u>(39,327,500)</u>	<u>(144,215)</u>
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	<u>(134,974)</u>	<u>0</u>
Total resources used to finance items not part of the Net Cost of Operations	<u>(39,499,453)</u>	<u>(157,150)</u>
Total resources used to finance the Net Cost of Operations	<u>(49,546,869)</u>	<u>(6,654,724)</u>
Components Requiring or Generating Resources in Future Period Other (+/-)	36,134	63,528,740
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	(11,315,433)	(11,299,702)
Other	<u>64,941</u>	<u>(414,997)</u>
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	<u>(11,214,358)</u>	<u>51,814,041</u>
Net Cost of Operations	\$ <u>(60,761,227)</u>	\$ <u>45,159,317</u>

Components Requiring or Generating Resources in Future Period – Other displays the change in the FY 2011 the incurred-but-not-reported (IBNR) reserve amounts. The IBNR amount represents an estimate of medical benefits already incurred but not yet reported to the Department of Defense. Refer to Note 17, Military Retirement and Other Federal Employment Benefits. For additional details and disclaimers regarding FY 2011 changes.

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables from FY 2010 to FY 2011. These changes represent refunds receivable for (1) amounts due from drug manufacturers as required by the Federal Ceiling Price program, (2) duplicate or other erroneous MERHCF payments made to contractors for care of the beneficiaries, and (3) copayments from MERHCF beneficiaries for mail order prescriptions. These refunds receivable are recorded as an offset to expenses.

Note 13. Benefit Program Expense

Benefit Program Expense

(\$ in Thousands)		FY 2011	FY 2010
1	Service Cost	\$ 12,127,505	\$ 10,583,746
2	Plan Amendment Liability	(12,807,919)	
3	Period Interest on the Benefit Liability	29,022,624	29,658,129
4	Prior (or Past) Service Cost	0	0
5	Period Actuarial (Gains) or Losses	10,747,081	122,804,467
6	(Gains)/Losses Due to Changes in Medical Trend Assumption	(68,961,084)	(90,883,699)
7	Total	\$ (29,871,793)	\$ 72,162,642

The above table displays the benefit program expense amounts that are considered public costs for the MERHCF.

The Benefit Program Expenses (BPEs) provide 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 BPEs as well as the expected benefit payments during the fiscal year. See Note 8, Military Retirement Benefit Liabilities, for further details about the change in the actuarial liability. The September 30, 2011, actuarial liability is equal to the September 30, 2010, liability plus the total BPEs minus the expected benefit payments. The BPE includes normal (or service) cost, plan amendment liability, interest cost, and gains and losses. It measures the change in the actuarial liability from one year to the next (excluding the impact of benefit payments).

In FY 2011, the Period Actuarial (Gains) or Losses component of BPE (line 5) contributed a net gain (liability decrease), reflecting the net of various gains and losses resulting from experience and changes in assumptions. The (Gains)/Losses Due to Changes in Medical Trend Assumption component of BPE (line 6) produced a gain in FY 2011. Each year, the assumption changes are approved by the MERHCF Board of Actuaries.

Note 14. Earmarked Funds

	<u>2011</u>	<u>2010</u>
<u>BALANCE SHEETS</u>		
<u>ASSETS</u>		
Fund balance with Treasury	\$ 227,170	\$ 195,962
Investments	187,826,062	166,203,523
Accounts and Interest Receivable	<u>497,982</u>	<u>562,924</u>
Total Assets	\$ <u>188,551,214</u>	\$ <u>166,962,409</u>
<u>LIABILITIES and NET POSITION</u>		
Military Retirement Benefits and Other Federal Employment Benefits	\$ 534,379,945	\$ 573,671,310
Other Liabilities	422,635	303,692
Total Liabilities	\$ <u>534,802,580</u>	\$ <u>573,975,002</u>
Cumulative Results of Operations	<u>(346,251,366)</u>	<u>(407,012,593)</u>
Total Liabilities and Net Position	\$ <u>188,551,214</u>	\$ <u>166,962,409</u>
<u>STATEMENTS OF NET COST</u>		
Program Costs	\$ (30,507,456)	\$ 71,579,435
Less Earned Revenue	<u>(30,253,771)</u>	<u>(26,420,118)</u>
Net Program Costs	\$ <u>(60,761,227)</u>	\$ <u>45,159,317</u>
Net Cost of Operations	\$ <u>(60,761,227)</u>	\$ <u>45,159,317</u>
<u>STATEMENTS OF CHANGES IN NET POSITION</u>		
Net Position Beginning of the Period	\$ (407,012,593)	\$ (361,576,518)
Net Cost of Operations	<u>(60,761,227)</u>	<u>45,159,317</u>
Other Financing Sources	<u>0</u>	<u>(276,758)</u>
Change in Net Position	\$ 60,761,227	\$ (45,436,075)
Net Position Beginning of the Period	\$ <u>(346,251,366)</u>	\$ <u>(407,012,593)</u>

Public Law 106-398, *The Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001*, authorized the establishment of the MERHCF. The MERHCF accumulates funds to finance, on an actuarially sound basis, liabilities of the DoD and the Uniformed Services health care programs for specific Medicare-eligible beneficiaries. The MERHCF receives its funding as an earmarked special fund and uses these resources to execute its mission and report on resource usage.

The primary financing sources for MERHCF are (1) an annual unfunded actuarial liability payment from the U.S. Treasury, (2) annual contributions from the Military Services and other Uniformed Services (U.S. Coast Guard, National Oceanic and Atmospheric Administration, and U.S. Public Health), 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

unfunded liability amount, the annual Military Services payment amounts, and the rates for the other Uniformed Services. These financing sources are the result of intragovernmental flows. Contributions in excess of the projected current year health care benefits are invested. These investments and associated revenue are used to cover future liabilities of MERHCF.

Note 15. Other Disclosures

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2011 and 2010, includes approximately \$73.6 billion (14% of total) and \$73.2 billion (13% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2011, include approximately \$2.8 billion and \$1.8 billion, respectively, and for the year ended September 30, 2010, include approximately \$2.9 billion and \$1.7 billion, respectively, of amounts related to the direct-care costs. Such MTF-related amounts of direct-care costs are estimated by the Fund's actuaries using data extracted from various Military Service-specific financial, personnel and workload systems within DoD. With respect to extracted data, the MTFs do not have OMB Circular A-127, compliant, transaction-based accounting systems and, therefore, cannot report the costs of an individual patient's care.

Other Accompanying Information

Exhibit 1--Actuarial Status Information

SEPTEMBER 30, 2011 and 2010

(\$ In Thousands)

	<u>September 30, 2011</u>	<u>September 30, 2010</u>
1 Present value of future benefits		
a. Current inactive	\$328,683,472	\$348,080,024
b. Active duty personnel ¹	\$170,612,841	\$182,308,227
c. Nonretired reservists	<u>\$122,346,807</u>	<u>\$139,775,437</u>
d. Total	\$621,643,120	\$670,163,688
2 Present value of future normal cost contributions	<u>\$(87,975,460)</u>	<u>\$(97,168,529)</u>
3 Actuarial accrued liability	<u>\$533,667,660</u>	<u>\$572,995,159</u>
4 Assets ² (funded accrued liability)	<u>\$184,914,306</u>	<u>\$163,587,590</u>
5 Unfunded accrued liability ³	<u>\$348,753,354</u>	<u>\$409,407,569</u>

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

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

³ The unfunded accrued liability does not include \$712.3 million and \$676.2 million for the estimated incurred-but-not-reported liabilities as of September 30, 2011 and 2010, respectively, as presented in the Balance Sheet as "Benefits Due and Payable" and as discussed in Note 8, "Military Retirement Benefit Liabilities."

Exhibit 2--Summary of Financial Statement Audit and Management Assurances**SEPTEMBER 30, 2011**

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 MERHCF Management Discussion and Analysis, DoD, and not MERHCF, represents the legislative definition of an Agency. Beginning with FY 2006, as directed in OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A, Internal Control Over Financial Reporting, the 24 CFO Act agencies (includes 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. OUSD(C) issued guidelines to the leadership of DoD Components, including MERHCF, as to how to support this DoD reporting requirement. TMA management complied with the required guidelines for MERHCF.

TMA includes auditor identified weaknesses in its annual assessment of internal controls from the prior year audit. Due to the timing of TMA's assessment, which reported during June 2011, TMA's assessment may differ from the auditor's reported weaknesses for the current FY, which are reported as of September 2011. In its FY 2011 assessments, TMA management assessed that, except for direct care related material weaknesses and one material weakness associated with the retail pharmacy refund program, the MERHCF Financial Statement Reporting Entity (FSRE) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Services have implemented financial systems that comply with (FMFIA § 4). The OUSD (C) published Financial Improvement and Audit Readiness Status Report as of June 2011, indicates a FY 2017 timeline for the Services to achieve (FMFIA § 4) compliance. Compliance with (FMFIA § 2) for purchased care should be achieved in FY 2013.

Except for the two direct care-related material weaknesses and one purchased care-related material weakness above, and documented in TMA's Annual Statement Required Under the FMFIA, dated June 29, 2011, and the above referenced Service-related FMFIA § 4 weakness , the MERHCF has effective internal controls over financial reporting.

The Status of FY 2011 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weaknesses and non-conformances.

Other Accompanying Information

Table 1.
Summary of Financial Statement Audit

Audit Opinion	Qualified				
Restatement	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of U.S. Standard General Ledger Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	✓				✓
Direct Care Cost Data Accumulation (Carried Forward and Updated Finding from Fiscal Year FY2005)	✓				✓
Untimely receipt of quarterly purchased care retail pharmacy refund calculations	✓		✓		
<i>Total Material Weaknesses</i>	3	0	1	0	2

Table 2.
Summary of Management Assurances

Effectiveness of Internal Controls over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Qualified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant U.S. Standard General Ledger transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	✓					✓
***Government's inability to submit timely invoices to drug manufacturers for retail pharmacy refunds, prevented the auditor from obtaining appropriate audit evidence to test and evaluate the drug refund accounts receivables.		✓				✓
<i>Total Material Weaknesses</i>	1	1	0	0	0	2

***MERHCF includes auditor-identified weaknesses in its annual assessment of internal controls from the prior year audit. Due to the timing of MERHCF's assessment which reported during June 2011, MERHCF's assessment may differ from the auditor's reported weaknesses for the current FY which are reported as of September 2011.

Table 3.

Conformance with financial management system requirements (FMFIA § 4)

Statement of Assurance	Purchased Care systems conform to financial management systems requirements: Direct Care Costs systems do not comply with financial management systems requirements.					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Independent auditor was unable to obtain sufficient, appropriate audit evidence from currently existing non-compliant U.S. Standard General Ledger transaction-based accounting systems to support the costs of direct care provided by DoD-managed Military Treatment Facilities. (Carried Forward and Updated Finding from Fiscal Year ("FY") 2005)	✓					✓
Total non-conformances	1	0	0	0	0	1

Compliance with Federal Financial Management Improvement Act (FFMIA)		
	Agency	Auditor
Overall Substantial Compliance	No	No
1. Systems Requirements	Yes for Purchased Care; - No for Direct Care	
2. Accounting Standards	Yes for Purchased Care; - No for Direct Care	
3. USSGL at Transaction Level	Yes for Purchased Care; - No for Direct Care	

Note: The above uncorrected weakness combines the two reported Direct Care material weaknesses identified by the independent auditor in the audit of the FY 2011 MERHCF financial statements. Identification and implementation of appropriate corrective actions to resolve this one material weakness will result in successful correction of the two Direct Care material uncorrected weaknesses identified in the FY 2011 MERHCF audit

Exhibit 3--IPIA Reporting Details September 30, 2011**Improper Payments Information Act Reporting**

The Improper Payments Information Act (IPIA) of 2002, as implemented by the 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. The Department’s FY 2010 review did not identify any programs at risk of significant erroneous payments in accordance with OMB criteria (programs with erroneous payments exceeding both \$10 million and 2.5% of program payments).

Risk Assessment

The Department’s risk assessment for Military Health Benefits addressed the effectiveness of internal controls for preventing improper payments (such as prepayment reviews), as well as system weaknesses identified internally or by outside audit activities. While the Department’s improper payment percentages are low, numerous pre- and post-payment controls further minimize and eliminate improper payments.

On a quarterly basis, the Department audits statistically valid samples of health care claims. Over the years, these audits consistently have produced an error rate of less than the 2% performance standard contained in TRICARE contracts. Errors in health care claims processing potentially can be related to improperly submitted claims by providers, as well as a minimal degree of human error expected with handling a large volume of claims under the tight time parameters established by the Prompt Payment Act regulations and the claims processing timeliness performance standard.

Numerous prepayment and post-payment controls are built into the military health benefits’ claims processing system to minimize improper payments. Every claim is adjudicated against this system of checks and balances. One control is the prepayment review required under the contract. The contractor uses this strategy to prevent payment for questionable billing practices. Prepayment review allows for a closer examination of the services rendered and may require the provider to submit medical documentation to support the services billed. In addition, the Department of Defense requires the contractor to have an anti-fraud unit to identify and investigate any pattern of suspicious or potential fraudulent billings. Recoupment from cases identified, combined with proactive case work are additional benefit dollars returned to the Fund.

Statistical Sampling Process

To determine an estimate of the annual amount of improper payments, the Department of Defense uses a statistically valid method of sampling for the managed care support services contracts and the Medicare dual eligibility contractor.

Other Accompanying Information

The Department samples data records for review for claims processed by the Medicare dual eligible contractor quarterly. There are two kinds of payment samples, one for non-denied claims and one for denied claims. For the Medicare dual eligible contract, the non-denied payment sample will be drawn from all records with government payments of \$1 to \$25,000. All records with a government payment of \$25,000 and over will be audited. The denied payment sample will be drawn from all records with a billed amount of \$1 to \$500,000. All records with billed amounts of \$500,000 and over will be audited. The non-denied sample will be stratified at multiple levels within the \$1 to \$25,000 range, and the denied payment sample will be stratified at multiple levels within the \$1 to \$500,000 range.

Corrective Action Plan

The Department's contracts have had payment performance standards for military health benefit claims processing in place for many years. The estimate of 2 percent is based on the contract performance standard. However, actual results have been consistently less than 1 percent. FY 2009 results reflect an improper payment rate of 0.42%; FY 2010 results reflect an improper payment rate of 0.24%. Contractors exceeding the 2% performance standard are subjected to a financial disincentive for erroneous claims payments. In addition, the contractors are financially liable for payment of non-allowable claims. This contractual design, combined with numerous prepayment and post-payment controls, effectively minimizes improper payments and ensures the Government's risk for improper payments in military health benefits is minimized..

Military Health Benefits Program Improper Payment Reporting

FY 2010			FY 2011			FY 2012 Estimated			FY 2013 Estimated			FY 2014 Estimated		
Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)	Outlays (\$B)	IP (%)	IP (\$M)
\$12.6	0.24	\$30.2	\$16.0	2	\$321	\$16.4	2	\$328	\$17.5	2	\$351	\$19.0	2	\$380

1. The final payment error rate for FY 2010 is 0.24% (\$30.2M), which is less than the contract performance standard of 2% (\$249.6M) used in the FY 2010 AFR calculation. The error rate in FY 2011 and beyond is a conservative estimate based on the 2% contract performance standard.

2. The FY 2010 outlays include all benefit dollars subject to the audit process. Fee-for-service claims are considered susceptible to improper payments as payment is made based upon an individual claim submitted by a provider or beneficiary certifying services were provided as billed. Administrative or change order costs are not included, as those costs do not fall into the definition of areas susceptible to improper payments.

3. The FY 2010 outlays do not include:

- The Designated Providers (U.S. Family Health Plan) contracts, through which a set amount is paid for each patient's care on a per member per month basis. The contractor is 100% responsible for improper payments; there is no shared risk with the Government. The Defense Contract Audit Agency conducts reconciliations to validate correct capitated payments for the enrolled population. Government liability is limited to the amount paid to the contractor regardless of the cost of health care services.
- Pharmacy claims (\$6.4 billion). Under the TRICARE Claims Audit Reimbursement Contract (TCARS), which became effective September 1, 2010, auditing of claims processing has begun. Audit findings will be reported for FY 2011 in the Agency Financial Report (AFR) for FY 2012.
- Foreign claims were not included in audit. TRICARE Overseas Program (TOP) auditing commenced in FY 2011. Audit findings will be reported for FY 2011 in the AFR for FY 2012.

DoD Endorsement of Auditors' Opinion



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

November 7, 2011

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)/CHIEF
FINANCIAL OFFICER, DOD
ASSISTANT SECRETARY OF DEFENSE (HEALTH AFFAIRS)
DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE

SUBJECT: Endorsement of the Qualified Opinion on the DoD Medicare-Eligible Retiree Health
Care Fund FY 2011 and FY 2010 Basic Financial Statements (Report No. DODIG-
2012-018)

The Medicare-Eligible Retiree Health Care Fund (MERHCF) was established by Public Law 106-398, "The National Defense Authorization Act for FY 2001." In accordance with Public Law 101-576, "Chief Financial Officers Act of 1990," as amended by Public Law 103-356, "Government Management Reform Act of 1994," agencies are required to submit financial statements for each revolving fund and trust fund. The Under Secretary of Defense (Comptroller)/Chief Financial Officer requires that MERHCF personnel prepare audited financial statements in accordance with DoD Regulation 7000.14-R, "DoD Financial Management Regulation." We contracted with Kearney & Company to perform MERHCF's FY 2011 audit.

Kearney & Company audited the accompanying MERHCF Balance Sheets as of September 30, 2011 and 2010, and the related Statement of Net Cost, Statement of Changes in Net Position, and Statement of Budgetary Resources for the years then ended. These financial statements are the responsibility of MERHCF's management.

Qualified Audit Opinion

We endorse the Kearney & Company qualified opinion dated November 7, 2011. In its opinion, Kearney & Company reported that, except for the amounts related to MERHCF's direct care costs, the financial statements and the accompanying notes present fairly, in all material respects, the financial position of MERHCF as of September 30, 2011 and 2010, and its net cost of operations, changes in net position, and changes in budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP).

Kearney & Company issued a qualified opinion because it was unable to obtain sufficient, competent evidential matter from compliant, transaction-based accounting systems and was unable to apply other auditing procedures to support the costs of direct care provided by the DoD-managed Military Treatment Facilities (MTFs).

Reports on Internal Control and Compliance With Laws and Regulations

Kearney & Company concurrently issued a report on internal control over financial reporting and a report on compliance with laws and regulations as part of the audit of MERHCF's FY 2011 Basic Financial Statements. We endorse these reports.

Internal Control

The Kearney & Company report on internal control concluded that the MERHCF financial management system did not meet the requirements of an integrated financial management system as defined in Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems," October 1, 2009. Kearney & Company also concluded that MERHCF was not in compliance with the system design requirements necessary to comply with internal and external reporting requirements.

Kearney & Company reported the following material weaknesses.¹

- MTF-related amounts of direct care costs are estimated by MERHCF's actuaries and others using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by the DoD's planned Standard Financial Information Structure.
- The health care cost data from the MTFs provided for the estimation process are aggregated or derived from information in both financial and nonfinancial systems within the services that have not been audited. The MTF-level data are based on budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cutoff of accounting activity occurs at the MTF level.

Compliance With Laws and Regulations

Kearney & Company performed tests that disclosed MERHCF personnel did not comply with certain provisions of the following laws and regulations.

- While the general ledger system used by MERHCF is compliant with the U.S. Government Standard General Ledger with respect to direct care costs, it is not transaction-based, nor is it derived from an integrated financial system, as required by the Federal Financial Management Improvement Act of 1996.
- The financial management systems used by MERHCF, with respect to direct care costs, do not substantially comply with the requirements for Federal financial management systems set forth in OMB Circular A-127 in that they do not fully, efficiently, and effectively support MERHCF's efforts to:

¹ 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.

- prepare financial statements and other required financial and budget reports using information generated by the financial management systems;
 - provide reliable and timely financial information for managing current operations;
 - account for assets reliably so they can be properly protected from loss, misappropriation, or destruction; and
 - do all of the above in a way that is consistent with Federal accounting standards and the U.S. Government Standard General Ledger.
- These conditions, in the aggregate, resulted in significant departures from the requirements of OMB Circular A-123, "Management's Responsibility for Internal Control," December 21, 2004, and OMB Circular A-127.

MERHCF personnel did not fully comply with OMB Circular A-123, OMB Circular A-127, the Federal Managers' Financial Integrity Act of 1982, and the Federal Financial Management Improvement Act of 1996. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,² requires that auditors report test results if the financial statements did not comply with certain laws and regulations.

Audit Responsibilities

Kearney & Company was responsible for obtaining reasonable assurance that the basic financial statements were presented fairly and free of material misstatement, in conformity with U.S. GAAP. To fulfill our oversight responsibilities for the contract with Kearney & Company, we complied with U.S. Government Accountability Office (GAO), "Government Auditing Standards"; OMB Bulletin No. 07-04, as amended; and the GAO/PCIE [President's Council on Integrity and Efficiency] "Financial Audit Manual," July 2008. Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; reviewed documentation prepared by Kearney & Company; met with Kearney & Company partners and staff members; met with MERHCF officials; performed independent tests of the accounting records; and performed other procedures appropriate in the circumstances.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 604-8905 (DSN 329-8905).



Amy J. Frontz, CPA
Principal Assistant Inspector General
for Auditing

² OMB Memorandum M-09-33, Technical Amendments to OMB Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," September 23, 2009.

Independent Auditors' Reports

REPORT OF INDEPENDENT AUDITORS

To:

The Under Secretary of Defense (Comptroller)/Chief Financial Officer
The Assistant Secretary of Defense for Health Affairs
The Director of the Defense Finance and Accounting Service
The Inspector General of the Department of Defense

We have audited the accompanying Balance Sheets of the Medicare-Eligible Retiree Health Care Fund (MERHCF or the Fund) as of September 30, 2011 and 2010, and the related Statements of Net Cost, Statements of Changes in Net Position, and Statements of Budgetary Resources for the years then ended. These financial statements are the responsibility of MERHCF's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraphs, we conducted our audits in accordance with auditing standards generally accepted in the United States of America; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated November 10, 2010, we did not express an opinion over the fiscal year (FY) 2010 financial statements because we were unable to apply adequate audit procedures to obtain sufficient, competent evidential matter related to accounts receivable for the TRICARE Retail Pharmacy Program (Pharmacy Program), to obtain reasonable assurance that the Pharmacy Program accounts receivable balance was fairly stated in accordance with Generally Accepted Accounting Principles (GAAP).

In FY 2011, we were able to apply adequate audit procedures to obtain sufficient, competent evidential matter related to accounts receivable for the Pharmacy Program, to obtain reasonable assurance that the Pharmacy Program accounts receivable balance was fairly stated in accordance with GAAP as of September 30, 2010. Accordingly, our present opinion on the FY 2010 financial statements, as presented herein, is different from that expressed in our previous report.

We were unable to obtain sufficient, competent evidential matter from OMB Circular A-127, *Financial Management Systems*, compliant, transaction-based accounting systems to support the costs of direct care provided by the Department of Defense (DoD)-managed Military Treatment Facilities (MTF). As discussed in Note 15 to the financial statements, the actuarial liability for

Medicare-eligible retiree benefits as of September 30, 2011 and 2010 includes approximately \$73.6 billion (14% of the total) and \$73.2 billion (13% of the total), respectively, of amounts reflecting the actuarial present value of the projected direct care costs of benefits to be provided by the MTFs to eligible participants in the Fund. Additionally, the reported amounts of program revenues and costs related to direct care were approximately \$2.8 billion and \$1.8 billion, respectively, for the year ended September 30, 2011, and approximately \$2.6 billion and \$1.6 billion, respectively, for the year ended September 30, 2010.

Such MTF-related amounts of direct care costs are estimated by the Fund's actuaries using data extracted from various service-specific financial, personnel, and workload systems within DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems. While activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording, and cut-off of the costs reported. We were unable to obtain sufficient evidence as to the direct care component of the reported amount of the actuarial liability for Medicare-eligible retiree benefits by other auditing procedures.

In our opinion, except for the effects on the financial statements of the amounts related to the Fund's direct care costs that might have been determined to be necessary had we been able to obtain sufficient evidence regarding the direct care component of the actuarial liability for Medicare-eligible retiree benefits, the financial statements referred to above, including the accompanying notes, present fairly, in all material respects, the financial position of the Fund as of September 30, 2011 and 2010, and its net cost of operations, changes in net position, and changes in budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying "Management's Discussion and Analysis" and "Other Accompanying Information" are not required parts of the basic financial statements. Rather, they are considered supplementary information required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. This supplementary information is the responsibility of the Fund's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information; however, such information was not subjected to the procedures applied in our audits of the basic financial statements. Accordingly, we do not express an opinion on this information.

In accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have also issued reports, dated November 7, 2011, on our consideration of the Fund's internal control over financial reporting and compliance, and on our tests of the Fund's compliance with certain provisions of laws, regulations, and other matters for the year ended September 30, 2011. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance as well as the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance and other matters.



Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, and should be considered in assessing the results of our audits.

A handwritten signature in blue ink that reads "Kearney & Company". The signature is written in a cursive, flowing style.

Alexandria, VA
November 7, 2011

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL

To:

The Under Secretary of Defense (Comptroller)/Chief Financial Officer
The Assistant Secretary of Defense for Health Affairs
The Director of the Defense Finance and Accounting Service
The Inspector General of the Department of Defense

We have audited the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF or the Fund) as of and for the year ended September 30, 2011, and have issued our report dated November 7, 2011. Except as discussed in our report, we conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. The management of MERHCF is responsible for establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) are met.

In planning and performing our work, we considered MERHCF's internal control over financial reporting and compliance by obtaining an understanding of the design effectiveness of MERHCF's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of MERHCF's controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal controls. Accordingly, we do not express an opinion on the effectiveness of MERHCF's internal control over financial reporting and compliance or on management's assertion on internal control included in Management's Discussion and Analysis.

We limited our internal control testing to those controls necessary to achieve the OMB Bulletin No. 07-04, as amended, control objectives that provide reasonable, but not absolute assurance, that: (1) transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP), and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) transactions are executed in compliance with laws governing the use of budget authority, Government-wide policies and laws identified in Appendix E of OMB Bulletin No. 07-04, as amended, and other laws and regulations that could have a direct and material effect on the financial statements. We did not test all internal controls relevant to operating objectives, as broadly defined by FMFIA, such as those controls relevant to ensuring efficient operations.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraphs and was not designed to identify all deficiencies in internal

control that might be significant deficiencies or material weaknesses; therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses. We noted other matters involving internal control and its operations over financial reporting, which have been reported to MERHCF's management in a separate letter dated November 29, 2011.

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 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.

During our audit of MERHCF's financial statements, we identified deficiencies related to internal control over the preparation, analysis, and monitoring of financial information to support the efficient and effective preparation of financial statements. Because of the deficiencies noted, we believe that MERHCF's financial management system does not meet the requirements of an integrated financial management system, as defined in OMB Circular A-127, *Financial Management Systems*. We also believe that MERHCF is not in compliance with the system design requirements necessary to comply with internal and external reporting requirements. These requirements include the requirement for financial statements to be prepared in accordance with the form and content rules prescribed by OMB and reporting requirements prescribed by the Department of the Treasury, as well as the requirement to monitor the financial management system to ensure the integrity of financial data.

As defined in OMB Circular A-127, "A financial management system includes the core financial systems and the financial portions of mixed systems necessary to support financial management, including automated and manual processes, procedures, and controls, data, hardware, software, and support personnel dedicated to the operations and maintenance of system functions." Such financial management systems shall be designed so that "...financial events shall be recorded applying the requirements of the United States Standard General Ledger (USSGL). Application of the USSGL at the transaction level means that each time an approved transaction is recorded in the system, it will generate appropriate general ledger accounts for posting the transaction according to the rules defined in the USSGL guidance."

We consider the following deficiencies in MERHCF's internal control to be material weaknesses.

Material Weaknesses

I. Lack of USSGL Compliant, Transaction-based Accounting Systems for Direct Care Costs

MERHCF's actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2011, includes approximately \$73.6 billion (14% of the total) of amounts reflecting the actuarial

present value of the projected direct care costs of benefits to be provided by Department of Defense (DoD)-managed Military Treatment Facilities (MTF) to eligible participants in MERHCF. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2011 include approximately \$2.8 billion and \$1.8 billion, respectively, of amounts related to the direct care costs.

MTF-related amounts of direct care costs are estimated by MERHCF's actuaries and others using data extracted from various service-specific financial, personnel, and workload systems within the DoD. With respect to extracted data, the MTFs do not currently have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by DoD's planned Standard Financial Information Structure. Although activity-based costing techniques are used to estimate the program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations, and there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, recording, and cut-off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation processes.

Therefore, the procedures in place to determine the allocated costs of direct care provided by the MTFs are inadequate to ensure that the presentation of the direct care costs is in conformity with GAAP.

II. Direct Care Cost Data Accumulation

The costs of health care provided directly by DoD for MERHCF participants and beneficiaries represent significant input to the development of the actuarially-determined health care liabilities of MERHCF, and to the determination of amounts contributed by the services for their active duty participants. These costs are incurred in the MTFs managed by the services in various locations. MERHCF makes prospective payments to the services based on estimates of these direct care costs in order to support the operations of the MTFs on an ongoing basis.

The health care cost data from the MTFs provided for the estimation process is aggregated or derived from information in both financial and non-financial systems within the services that have not been audited. The MTF-level data is based on budget execution processes rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the MTF level. During fiscal year (FY) 2011, MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes.

We noted that MERHCF performs annual retrospective reconciliation reviews of the MTF level-of-effort data for the purpose of comparing the prospective payments provided to the MTFs for the care of MERHCF's participants and beneficiaries versus the results of the budget execution



process. The results of the reconciliations are used in the determination of prospective budgetary requirements to support the MTFs' operations, as required by DoD Instructions.

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This report is intended solely for the information and use of MERHCF management, those charged with governance and others within MERHCF, the Inspector General of the DoD, OMB, the Government Accountability Office, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in blue ink that reads "Kearney & Company". The signature is stylized and cursive.

Alexandria, Virginia
November 7, 2011

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND OTHER MATTERS

To:

The Under Secretary of Defense (Comptroller)/Chief Financial Officer

The Assistant Secretary of Defense for Health Affairs

The Director of the Defense Finance and Accounting Service

The Inspector General of the Department of Defense

We have audited the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF or the Fund) as of and for the year ended September 30, 2011, and have issued our report dated November 7, 2011. Except as discussed in our report, we conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. The management of MERHCF is responsible for compliance with laws and regulations.

As part of obtaining reasonable assurance about whether MERHCF's financial statements are free of material misstatement, we performed tests of MERHCF's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 07-04, as amended. As part of our work, we performed tests of compliance with the Federal Financial Management Improvement Act of 1996 (FFMIA), Section 803(a) requirements. We limited our tests of compliance to these provisions; we did not test compliance with all laws and regulations applicable to MERHCF. We did not test all internal controls relevant to operating objectives, as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA). 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 of compliance described in the preceding paragraph disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, which are summarized below:

- While the general ledger system utilized by MERHCF is compliant with the United States Standard General Ledger (USSGL), with respect to direct care costs, it is not transaction-based, nor is it derived from an integrated financial system, as required by the FFMIA
- The financial management systems utilized by MERHCF, with respect to direct care costs, do not substantially comply with the requirements for Federal financial management systems set forth in OMB Circular A-127, *Financial Management Systems*, in that they do not fully, efficiently, and effectively support MERHCF's efforts to:



- Prepare financial statements and other required financial and budget reports using information generated by the financial management systems
- Provide reliable and timely financial information for managing current operations
- Account for assets reliably so they can be properly protected from loss, misappropriation, and/or destruction
- Do all of the above in a way that is consistent with Federal accounting standards and the USSGL.

These conditions, in the aggregate, result in significant departures from the requirements of OMB Circulars A-123, *Management's Responsibility for Internal Control*, and A-127.

The material weaknesses identified in our Independent Auditor's Report on Internal Control, dated November 7, 2011, with respect to internal control over financial reporting, indicate that MERHCF is not fully compliant with the requirements of OMB Circulars A-123 and A-127, FMFIA, and FFMIA.

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Alexandria, Virginia
November 7, 2011