



Fiscal Year 2012

Medicare-Eligible Retiree Health Care Fund Audited Financial Statements



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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, 2012 and 2011

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 MERHCF 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 (the Board) 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 2012 and FY 2011 respectively, the Fund authorized approximately \$9.8 billion and \$9.5 billion in total health care services, \$8.0 billion and \$7.7 billion to civilian providers, \$1.3 billion and \$1.4 billion to MTFs, and \$0.5 billion and \$0.4 billion to Military Service Personnel Accounts, 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
2012	\$8.0	\$1.3	\$0.5	\$9.8
2011	\$7.7	\$1.4	\$0.4	\$9.5

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 in the following amounts:

MERHCF Funding Sources

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2012	\$6.7	\$11.1	\$6.3
2011	\$9.8	\$11.3	\$9.2

No accounts of the Fund have been excluded from the Fund's financial statements. The significant decrease in investments interest realized between FY 2011 and FY 2012 is due primarily to the unfavorable economic conditions during FY 2012.

Medicare-Eligible Retiree Health Care Plan of Benefits

TRICARE for Life (TFL) covers Medicare-eligible retirees, 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. TFL 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.

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.

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. Beginning October 2012, a military retiree (or eligible family member) who becomes eligible for Medicare due to age may not enroll in or stay enrolled in the US Family Health Plan, unless the military retiree (or eligible family member) was enrolled in the plan on September 30, 2012.

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/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 2012 and FY 2011 were approximately \$7.0 billion and \$6.9 billion respectively.

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 2012 was \$1.3 billion and \$1.4 billion in FY 2011. 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 \$0.5 billion in FY 2012 and \$0.4 billion in FY 2011.

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, 2012, the Fund had net assets available to pay benefits of \$174.7 billion and an

actuarial liability of \$532.8 billion; the funding ratio was 32.8%. As of September 30, 2011, the Fund had net assets available to pay benefits of \$184.9 billion and an actuarial liability of \$533.7 billion; the funding ratio was 34.6%. 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 45-year amortization period for the initial unfunded liability is scheduled to end in FY 2047.

Investments

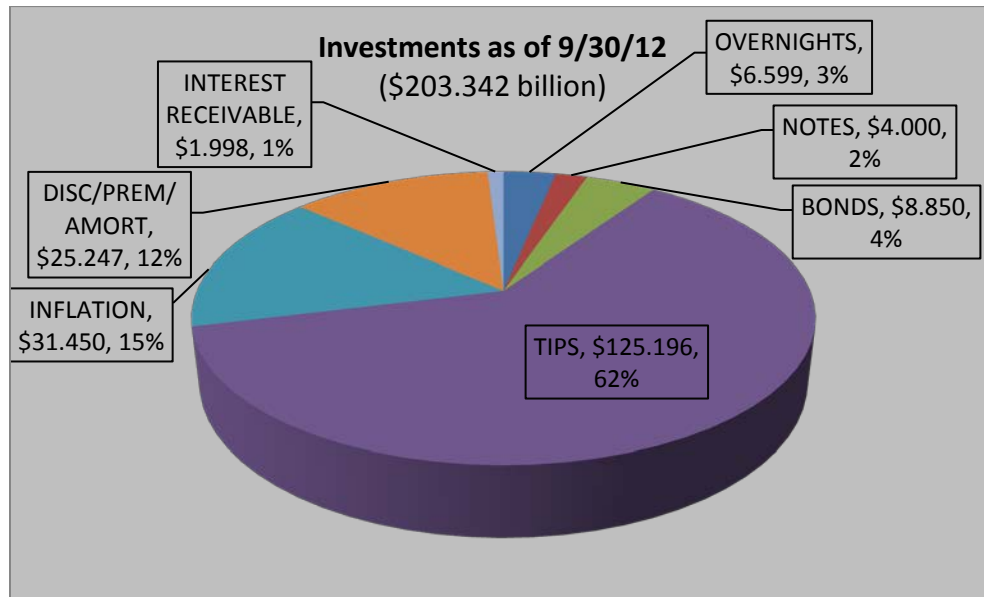


Figure 1

Figure 1 depicts the par value (plus inflation and interest receivable) of investment holdings as of September 30, 2012.

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 semi-annual interest.

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, DFAS; the Deputy Chief Financial Officer, OUSD(C); 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 Audit Findings

The MERHCF independent auditors noted two material weaknesses during the FY 2011 Financial Statement Audit. These material weaknesses were noted as repeat findings during the FY 2012 Financial Statement Audit.

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.
2. 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 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.

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, 2012 and 2011 is approximately \$77.3 billion (15% of total) and \$73.6 billion (14% 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, 2012, include approximately \$2.7 billion and \$1.7 billion, respectively, and for the year ended September 30, 2011, include approximately \$2.8 billion and \$1.8 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

Management's Discussion and Analysis

MTFs do not have OMB 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 Comprehensive Ambulatory/Professional Encounter Record System (CAPERS) reported in the MHS Data Repository. The SIDRs and CAPERS 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 CAPERS 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 CAPERS 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)

TRICARE Standard Discount Program (SDP) formerly known as Mandatory Agreements Retail Refunds (MARR)

Section 703 of the National Defense Authorization Act (NDAA) for Fiscal Year 2008 enacted 10 U.S.C. 1074g(f) which mandated all covered TRICARE Retail Pharmacy Network prescriptions filled on or after January 28, 2008, are subject to Federal Ceiling Prices (FCP).

A pending appeal by the Coalition for Common Sense in Government Procurement is currently before the United States Court of Appeals for the District of Columbia Circuit (Court of Appeals). This case was closed out in the FY 2011 interim legal representation letter because in the legal opinion of the TMA/OGC, it does not represent a money claim and if the plaintiff succeeded, the result would be additional rule-making. A trade association on behalf of pharmaceutical manufacturers initially sought to enjoin DoD from enforcing a rule implementing 10 U.S.C. § 1074g(f) enacted in Section 703 of the NDAA for Fiscal Year 2008, Pub. L. 110-181. The initial rule, published in the Code of Federal Regulations at 32 C.F.R. 199.21(q), subjected the TRICARE retail pharmacy program to pricing standards known as Federal Ceiling Prices (FCP) by prohibiting pharmaceutical manufacturers from receiving more than the FCPs for pharmaceuticals purchased by DoD for the TRICARE retail pharmacy program. In

November 2009, the District Court for the District of Columbia remanded the matter to DoD to consider the effective date of the published rule (i.e., whether it would be made effective as of the effective date of the statute (January 28, 2008)). DoD's rule-making determined the effective date would still be January 28, 2008. The District Court upheld the final rule. Now that the District Court has ruled in favor of the Government, the TMA Office of General Counsel views plaintiff's chances of succeeding on appeal as being remote. If plaintiff did succeed, there would still be no money damages and an unfavorable result would be a remand for further rule-making.

Prior to September 2012, the TRICARE Management Activity (TMA) had not demanded payment for refunds arising before the date of its original Final Rule implementing NDAA-08. Consequently, OGC was not able to finalize resolution of the waiver/compromise requests submitted by pharmaceutical manufacturers for the period January 29, 2008 through September 30, 2012.

MERHCF issued demand letters in September 2012 to the pharmaceutical manufacturers for refunds due for Calendar Year (CY) 2008 and the first two quarters of CY 2009.

Accompanying those demand letters, excepting the letters for those manufacturers with pre-statute voluntary refund agreements, were letters from OGC denying the majority of waiver/compromise requests. Special, individual letters accompanied the demand letters to the sixteen manufacturers with pre-statute voluntary agreements.

For consistency, TMA will begin recalculations for the 3rd and 4th quarters of CY 2009 and all subsequent quarters for CY 2010 and CY 2011 in FY 2013. Accompanying the demand letters for the recalculations will be the appropriate waiver/compromise resolution letters from OGC.

TMA will begin the transfer of delinquent debt files to the OGC for legal validation and subsequent referral to the U.S. Department of Treasury or the Department of Justice in FY 2013 upon completion of the recalculations and subsequent reconciliations. TMA believes that the delinquent debts should be consistently calculated, accurate and final before transferring to the U.S. Department of Treasury and/or the Department of Justice.

In FY 2011, MERHCF received a total of \$691.8 million in pharmacy retail network refunds under the SDP program. In FY 2012, receipts totaled \$496.5 million, representing 55% of total SDP collections received.

TRICARE Additional Discount Program (ADP) formerly known as Voluntary Agreements Retail Rebates (VARR)

TMA initiated a new retail pharmacy rebate program during the 2nd Quarter, FY 2007, ADP, formerly known as Voluntary Agreements Retail Rebates (VARR). Manufacturers may offer rebates to the DoD for pharmaceutical agents dispensed through the TRICARE Retail pharmacy network. The Uniform Formulary VARR (UF-VARR) is contingent upon pharmaceutical agents being included on the 1st (generic drugs) or 2nd (formulary brand drugs) tiers of the DoD Uniform Formulary. There are two types of additional discounts in addition to the SDP:

- SDP - (Program 006) - Standard or Minimum Refund (SDP) on a Section 703 Covered Drug is by law equal to the difference between Non-FAMP (Non-Federal Average Manufacturer Price) and FCP (Federal Ceiling Price = 76% x Non-FAMP).
- ADP #1 (Program 009) - WAC (% of Wholesale Acquisition Cost): The manufacturer's list price for the drug to wholesalers or direct purchasers in the United States, not including prompt pay or other discounts, rebates or reductions in price, as reported in wholesale price guides or other publications of drug pricing data.
- ADP #2 (Program 010) – (FCP - additional discount): The maximum price the manufacturer can charge for a Federal Supply Schedule (FSS) listed drug to the Big 4 -- VA, DoD, PHS, and the Coast Guard; calculated annually by VA using Non-FAMP and other data submitted by the manufacturer.

In FY 2011 MERHCF received a total of \$301.3 million in pharmacy retail network rebates under both ADP programs. In FY 2012, receipts from both programs were \$319.6 million, representing 55% of total ADP collections received.

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.

Management's Discussion and Analysis

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 2012 and FY 2011, 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, 2012 and 2011				
(\$ In Thousands)				
<u>Consolidated Balance Sheets</u>	<u>2012</u>	<u>2011</u>	<u>Difference</u> Increase/ (Decrease)	<u>%</u> <u>Change</u>
Fund Balance with Treasury	\$162,254	\$227,170	(\$64,916)	(29 %)
Investments (Intra-Governmental Securities) - Revenue from Treasury payments and Service contributions excess to current year health care benefit payments is invested in Treasury securities	\$203,341,522	\$187,826,062	\$15,515,460	8 %
Accounts Receivable, Net A/R associated with Standard Discount Program (SDP)	\$ 1,004,281	\$497,982	\$506,299	102%
Liabilities Not Covered by Budgetary Resources - Represents difference between actuarial liability for future benefit payments and current assets	\$358,077,554	\$348,753,354	\$9,324,200	3%
Accounts Payable (Intra-governmental)	\$134,273	\$101,275	\$32,998	33 %
Accounts Payable (Non-Federal)	\$418,559	\$321,360	\$97,199	30 %
Military Retirement and Other Federal Employment Benefits - Represents actuarial liability of future health care benefit and Incurred But Not Reported (IBNR) liability	\$533,392,364	\$534,379,945	(\$987,581)	(.18%)
<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	(\$16,814,227)	(\$60,761,227)	\$43,946,999	72%
<u>Statements of Budgetary Resources</u>				
Undelivered orders	\$38,291	\$100,212	(\$61,921)	(62%)
Net Outlays	(\$4,228,262)	(\$10,203,340)	5,975,078	59%

Assets

Assets of \$204.5 billion, included in the previous table and shown in Figure 2, represent amounts that the MERHCF owns and manages. Assets increased \$15.9 billion at the end of FY 2012. This increase is largely attributable to purchasing new investments of \$15.5 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 invested in U.S. Treasury securities.

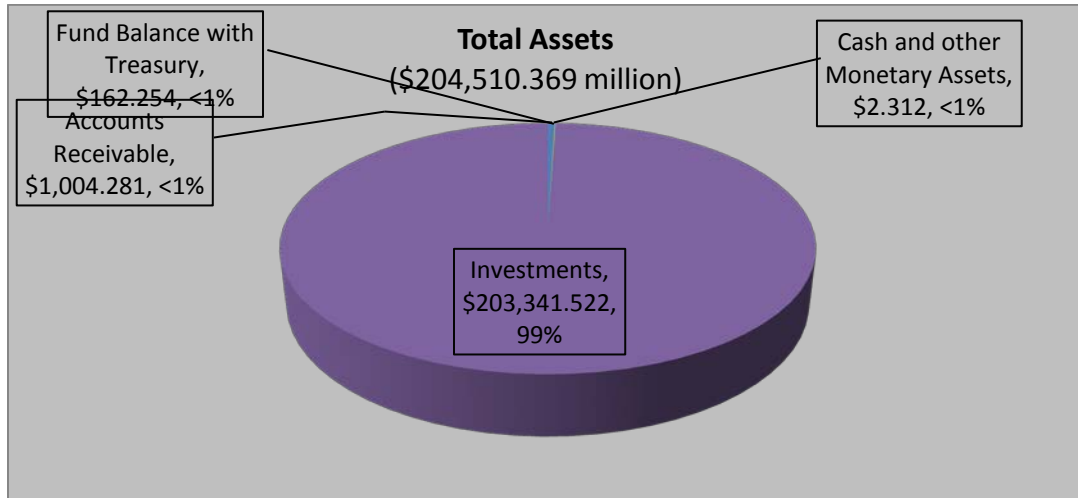


Figure 2

Liabilities

Liabilities of \$533.9 billion shown in Figure 3 represent liabilities related to military retirement medical benefits for Medicare-eligible beneficiaries. The liabilities of the MERHCF primarily consist of an actuarial liability for future benefit payments. Liabilities decreased \$0.9 billion at the end of FY 2012. This decrease is largely attributable to the decrease in the actuarial liability.

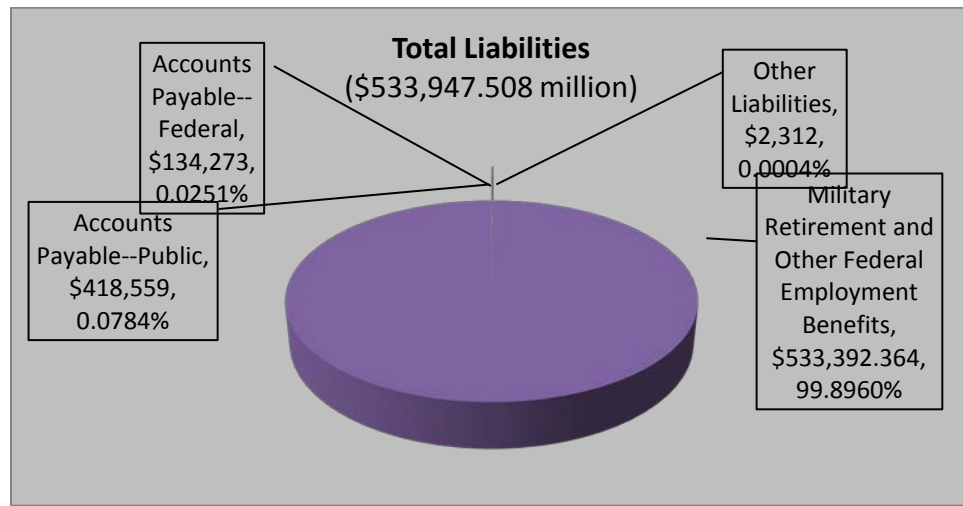


Figure 3

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 no systemic weakness concerning accounts receivable due from pharmaceutical manufacturers' refunds for drugs dispensed from retail pharmacies.

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

Balance Sheets

Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30, 2012 and 2011

(\$ In Thousands)	2012	2011
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$ 162,254	\$ 227,170
Investments (Note 3)	<u>203,341,522</u>	<u>187,826,062</u>
Total Intragovernmental Assets	203,503,776	188,053,232
Cash and Other Monetary Assets (Note 4)	2,312	0
Accounts Receivable, Net (Note 5)	<u>1,004,281</u>	<u>497,982</u>
TOTAL ASSETS	\$ <u>204,510,369</u>	\$ <u>188,551,214</u>
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 7)	\$ <u>134,273</u>	\$ <u>101,275</u>
Total Intragovernmental Liabilities	134,273	101,275
Accounts Payable (Note 7)	418,559	321,360
Military Retirement Benefit Liabilities (Notes 5 and 9)	533,392,364	534,379,945
Other Liabilities (Note 8)	<u>2,312</u>	<u>0</u>
TOTAL LIABILITIES	<u>533,947,508</u>	<u>534,802,580</u>
COMMITMENTS AND CONTINGENCIES		
NET POSITION		
Cumulative Results of Operations - Earmarked Funds	<u>(329,437,139)</u>	<u>(346,251,366)</u>
TOTAL NET POSITION	\$ <u>(329,437,139)</u>	\$ <u>(346,251,366)</u>
TOTAL LIABILITIES AND NET POSITION	\$ <u>204,510,369</u>	\$ <u>188,551,214</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, 2012 and 2011

(\$ In Thousands)	<u>2012</u>	<u>2011</u>
Program Costs		
Actuarial Non Assumption Costs	\$ (12,007,182)	\$ 9,996,535
Other Program Costs	8,190,897	8,820,043
(Less: Earned Revenue)	<u>(24,118,686)</u>	<u>(30,253,771)</u>
Net Cost before Losses/(Gains) from Actuarial Assumption Changes	\$ <u>(27,934,971)</u>	\$ <u>(11,437,193)</u>
Losses/(Gains) from Actuarial Assumption Changes	\$ <u>11,120,744</u>	\$ <u>(49,324,034)</u>
Net Cost of Operations	\$ <u>(16,814,227)</u>	\$ <u>(60,761,227)</u>

Statements of Changes in Net Position

The accompanying notes are an integral part of these statements

**Department of Defense
Uniformed Services Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2012 and 2011**

(\$ In Thousands)	<u>2012</u>	<u>2011</u>
CUMULATIVE RESULTS OF OPERATIONS		
Beginning Balances	\$ (346,251,366)	\$ (407,012,593)
Net Cost of Operations (+/-)	<u>(16,814,227)</u>	<u>(60,761,227)</u>
Net Change	16,814,227	60,761,227
Cumulative Results of Operations	(329,437,139)	(346,251,366)
Net Position	\$ <u>(329,437,139)</u>	\$ <u>(346,251,366)</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, 2012 and 2011

(\$ In Thousands)	2012	2011
BUDGETARY RESOURCES		
Appropriations (discretionary and mandatory)	\$ 8,736,416	\$ 8,755,948
Total Budgetary Resources	\$ 8,736,416	\$ 8,755,948
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred	\$ 8,736,416	\$ 8,755,948
Total Budgetary Resources	\$ 8,736,416	\$ 8,755,948
CHANGE IN OBLIGATED BALANCE		
Obligated balance, start of year (net), as adjusted	\$ 522,848	\$ 366,924
Obligations incurred	8,736,416	8,755,948
Outlays (net) (-)	(8,668,141)	(8,600,024)
Obligated balance, end of year	\$ 591,123	\$ 522,848
BUDGET AUTHORITY AND OUTLAYS, NET		
Budget Authority, net (discretionary and mandatory)	\$ 8,736,416	\$ 8,755,948
Outlays, net (discretionary and mandatory)	\$ 8,668,141	\$ 8,600,024
Distributed offsetting receipts (-)	(12,896,403)	(18,803,364)
Agency Outlays, net (discretionary and mandatory)	\$ (4,228,262)	\$ (10,203,340)

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 or the Fund), 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.

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. 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. The underlying data for the MERHCF is largely derived from budgetary transactions (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. Some of the trial balances may reflect known abnormal balances resulting largely from business and system processes. Disclosures of abnormal balances are made in the applicable footnotes, but only to the extent that the abnormal balances are evident.

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 financial information on the full accrual accounting basis for liabilities and expenses of the fund.

G. Accounting for Intragovernmental Activities

The Treasury Financial Manual Part 2 – *Chapter 4700, Agency Reporting Requirements for the Financial Report of the United States Government*, provides guidance for reporting and reconciling intragovernmental balances. The MERHCF is able to reconcile balances pertaining to investments in federal securities.

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 Defense 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 to the U.S. Treasury account monthly, 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. Cash and Other Monetary Assets

Cash is the total of cash resources under the control of DoD which includes coin, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. The MERHCF transacts all business in U.S. dollars. See Note 4, Cash and Other Monetary Assets, for further information and disclosures.

J. 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 records accounts receivable upon receipt of the calculation from the TRICARE Pharmacy Operations Directorate and will post collections from the manufacturers to the fiscal year of receipt pursuant to Title 10, U.S.C. §1079a.

K. 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.

L. 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.

M. 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.

N. Military Retirement and Other Federal Employment Benefits

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. During FY 2012, certain costs within the FY 2011 "Losses/(Gains) from Actuarial Assumption Changes" balance on the Statement of Net Cost was reclassified to agree with the FY 2012 presentation. Refer to Note 17, Military Retirement and Other Federal Employment Benefits, and Note 18, General Disclosures Related to the Statement of Net Cost, for additional information.

O. Significant Events

The Office of Management and Budget (OMB), the Treasury Financial Management Service, the Treasury Bureau of the Public Debt (BPD), the Office of the Under Secretary of Defense (Comptroller), and Enterprise Solutions and Standards, DFAS agreed to budgetary reporting

changes related to the purchase of premiums and amortization of premiums and discounts for Treasury securities. OMB requested these changes be made in order for DoD reporting to be consistent with the reporting of other Federal agencies.

This change reduced the available funding for the MERHCF by the premiums purchased, the amortization of these premiums, and the amortization of the discounts. In the past, budgetary funding was not affected at the time of purchase for a premium. However, the budgetary funding was reduced monthly by the amortization of premiums and increased by the amortization of discounts. Beginning August 1, 2012, the budgetary funding was reduced by premium at time of purchase. The budgetary funding will be increased by the discount at time of maturity. This change affects the Statement of Budgetary Resources. See Note 12, Disclosures to the Statement of Budgetary Resources for more information.

P. Reclassification

Certain fiscal year 2011 amounts have been reclassified to conform to the fiscal year 2012 presentation.

Note 2. Fund Balance with Treasury

(\$ In Thousands)	<u>2012</u>	<u>2011</u>
Fund Balance		
Total Special Funds	\$ <u>162,254</u>	\$ <u>227,170</u>

Status of Fund Balance with Treasury

Unobligated Balance – Unavailable	175,314,810	185,626,591
Obligated Balance not yet Disbursed	591,123	522,847
Non-Budgetary FBWT Accounts	<u>(175,743,679)</u>	<u>(185,922,268)</u>
Total	\$ <u>162,254</u>	\$ <u>227,170</u>

The Fund Balance with Treasury (FBWT) decreased \$64.9 million (29%) due to a \$176.9 million change in the final month-end disbursements in September 2012 versus September 2011. This was offset by a \$112.0 million increase in the monthly holdback estimated to cover final month-end disbursements. The monthly holdback is calculated based on the current month to date disbursements versus the average monthly disbursement over the past 12 months.

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)	<u>2012</u>				
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium) / Discount</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>

Notes to the Principal Statements

Intragovernmental Securities					
Nonmarketable, Market-Based	\$ <u>207,793,569</u>	Effective Interest	\$ <u>(6,433,352)</u>	\$ <u>201,360,217</u>	\$ <u>262,831,262</u>
Subtotal	207,793,569		(6,433,352)	201,360,217	262,831,262
Interest Receivable	<u>1,981,305</u>		<u>0</u>	<u>1,981,305</u>	<u>1,981,305</u>
Total Investments	\$ <u>209,774,874</u>		\$ <u>(6,433,352)</u>	\$ <u>203,341,522</u>	\$ <u>264,812,567</u>

(\$ 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>

Total Intragovernmental Securities, Net Investments, for MERHCF increased \$15.5 billion (8%). 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 \$19.3 billion in long-term securities during FY 2012.

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 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.

Notes to the Principal Statements

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.

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

<u>COST FY 2012</u>		<u>COST FY 2011</u>	
(in thousands)		(in thousands)	
Notes	\$3,986,875	Notes	\$3,986,875
Bonds	12,376,504	Bonds	10,515,160
TIPS	184,831,221	TIPS	170,645,069
Overnights	<u>6,598,969</u>	Overnights	<u>5,911,555</u>
Total Cost	<u>\$207,793,569</u>	Total Cost	<u>\$191,058,659</u>

Note 4. Cash and Other Monetary Assets

(\$ In Thousands)	2012	2011
Cash	\$ 2,312	\$ 0
Other Monetary Assets	0	0
Total Cash and Other Monetary Assets	\$ 2,312	\$ 0

Cash consists of undeposited collections received after the U.S Treasury month-end cutoff. A corresponding liability is created because MERHCF is not entitled to use the funds until deposited with the U.S. Treasury.

Note 5. Accounts Receivable

(\$ In Thousands)	2012		
	<u>Gross Amount</u> <u>Due</u>	<u>Allowance For</u> <u>Estimated</u> <u>Uncollectibles</u>	<u>Accounts</u> <u>Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ 1,085,624	\$ (81,343)	\$ 1,004,281
Total Accounts Receivable	\$ 1,085,624	\$ (81,343)	\$ 1,004,281

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

Accounts Receivable, Public, increased \$506.3 million (102%). This increase is primarily due to \$483.4 million (net) for the January 2008 - June 2009 receivables resulting from the implementation of the Federal Ceiling Price (FCP) Program for the TRICARE Retail Pharmacy Program as required by the FY 2008 National Defense Authorization Act (NDAA), Section 703. Actual billing calculations for these six quarters were prepared and recorded during FY 2012, as was allowed by a favorable court ruling in October of FY 2012. In FY 2011, MERHCF could not determine a reasonable estimate for the amounts owed as of September 30, 2011, and therefore disclosed a contingent gain surrounding the January 2008 – June 2009 receivables, in accordance with SFFAS No. 12, “Recognition of Contingent Liabilities Arising from Litigation.”

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, 2012, the total net receivables, recorded for the FCP Program for the TRICARE Retail Pharmacy Program were \$786.3 million.

Note 6. Liabilities Not Covered by Budgetary Resources

(\$ In Thousands)	2012	2011
Nonfederal Liabilities		
Military Retirement Benefits Liabilities (Note 8)	\$ <u>358,077,554</u>	\$ <u>348,753,354</u>
Total Nonfederal Liabilities	<u>358,077,554</u>	<u>348,753,354</u>
Total Liabilities Not Covered by Budgetary Resources	358,077,554	348,753,354
Total Liabilities Covered by Budgetary Resources	<u>175,869,954</u>	<u>186,049,226</u>
Total Liabilities	\$ <u>533,947,508</u>	\$ <u>534,802,580</u>

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 9, Military Retirement and Other Federal Employment Benefits, for additional details and disclosures.

Note 7. Accounts Payable

(\$ In Thousands)	2012	2011
Intragovernmental Payables	\$ 134,273	\$ 101,275
Nonfederal Payables (to the Public)	<u>418,559</u>	<u>321,360</u>
Total Accounts Payable	\$ <u>552,832</u>	\$ <u>422,635</u>

Intragovernmental Payables increased \$33.0 million (33%) primarily due to increased Mail Order Pharmacy Program activity caused by the timing of the bills received from the Defense Logistics Agency and the change in usage of the mail order program by beneficiaries.

Nonfederal Payables (to the Public) increased \$97.2 million (30%). This change is primarily due to an \$83.3 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 and the timing of the last healthcare claims cycle processed at the end of the fiscal year.

Accounts Payable includes 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 8. Other Liabilities

(\$ In Thousands)	2012	2011
Deposit Funds and Suspense Accounts	\$ <u>2,312</u>	\$ <u>0</u>

Other Liabilities consist of undeposited collections received after the U.S Treasury month-end cutoff.

Note 9. Military Retirement Benefit Liabilities

(\$ In Thousands)	FY 2012		
<u>Major Program Activities</u>	<u>Present Value of Benefits</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Medicare-Eligible Retiree Benefits	\$ 532,781,222	\$ (174,703,668)	\$ 358,077,554
Benefits Due and Payable	<u>611,142</u>	<u>(611,142)</u>	<u>0</u>
Total	\$ <u>533,392,364</u>	\$ <u>(175,314,810)</u>	\$ <u>358,077,554</u>

(\$ In Thousands)	FY 2011		
<u>Major Program Activities</u>	<u>Present Value of Benefits</u>	<u>(Less: Assets Available to Pay Benefits)</u>	<u>Unfunded Liabilities</u>
Medicare-Eligible Retiree Benefits	\$ 533,667,660	\$ (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>

Notes to the Principal Statements

Change in Actuarial Liability (\$ In Thousands)	<u>FY 2012</u>	<u>FY 2011</u>
Beginning Actuarial Liability	\$ 533,667,660	572,995,159
Plus Expenses:		
Normal Cost	10,958,301	12,127,505
Interest Cost	26,457,418	29,022,624
Plan Amendments	(33,269,895)	(12,807,919)
Experience Losses (Gains)	(6,682,447)	(8,889,969)
Other factors	<u>1</u>	<u>0</u>
Subtotal: Expenses before Losses (Gains) from Actuarial Assumption Changes	(2,536,622)	19,452,241
Actuarial losses/ (gains)/ due to		
Changes in trend assumptions	(14,673,866)	(68,961,084)
Changes in assumptions other than trend	<u>25,794,610</u>	<u>19,637,050</u>
Subtotal: Losses (Gains) from Actuarial Assumption Changes	<u>11,120,744</u>	<u>(49,324,034)</u>
Total Expenses	<u>\$ 8,584,122</u>	<u>(29,871,793)</u>
Less Benefit Outlays	<u>9,470,560</u>	<u>9,455,706</u>
Total Changes in Actuarial Liability	<u>\$ (886,438)</u>	<u>(39,327,499)</u>
Ending Actuarial Liability	<u>\$ 532,781,222</u>	<u>533,667,660</u>

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 schedules in the first two tables above reflect two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled "Medicare-Eligible Retiree Benefits" represents the actuarial (or accrued) liability for future health care benefits that are not yet incurred, i.e., the present value of future benefits less the present value of future normal costs. The line entitled "Benefits Due and Payable" represents the incurred-but-not-reported reserve amount which is an estimate of benefits already incurred but not yet reported to DoD.

These tables also compute so-called "unfunded liabilities." The assets used in this formula are different than those that appear on the balance sheet. Assets on the balance sheet are discussed in Note 4 - Investments, and are based on the fully amortized cost of the securities. The above asset figures represent the assets available to pay benefits, and are based on the par value cost of the securities. The fact that different asset bases are used in two different parts of the same financial statements highlights that there is no singular, exact "unfunded liability." The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2012 balance represents the September 30, 2012, amount.

Actuarial Cost Method

As dictated by law, the 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 methods and assumptions used to calculate 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.

For the FY 2012 financial-statement valuation, the long-term assumptions include a 4.6% discount rate and medical trend rates that were developed using a 2.6% inflation assumption. (For the FY 2012 funding valuation, the long-term assumptions included a 5.75% discount rate and medical trend rates that were developed using a 3.0% inflation assumption.) Note that the term 'discount rate' refers to the interest rate used to discount cash flows. The terms 'interest rate' and 'discount rate' are often used interchangeably in this context.

For the FY 2011 financial-statement valuation, the long-term assumptions included a 4.9% discount rate and medical trend rates that were developed using a 2.5% inflation assumption. (For the FY 2012 funding valuation, the long-term assumptions included a 5.75% discount rate and medical trend rates that were developed using a 3.0% inflation assumption.)

The difference in the long-term assumptions between funding and financial statement valuations is attributable to the Statement of Federal Financial Accounting Standards No. 33 (SFFAS No. 33). The standard is discussed further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial 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

Notes to the Principal Statements

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 No. 33 allows for the roll-forward of actuarial liabilities from the prior year valuation results. In calculating the FY 2012 "rolled-forward" actuarial liability, the following assumptions were used:

Discount Rate	4.6%
Inflation	2.6%

<u>Medical Trend</u>	<u>FY 2011 - FY 2012</u>	<u>Ultimate Rate 2036</u>
Medicare Inpatient (Direct Care)	1.60%	5.35%
Medicare Inpatient (Purchased Care)	3.60%	5.35%
Medicare Outpatient (Direct Care)	2.26%	5.35%
Medicare Outpatient (Purchased Care)	3.26%	5.35%
Medicare Prescriptions (Direct Care)	0.00%	5.35%
Medicare Prescriptions (Purchased Care)	4.44%	5.35%
Medicare USFHP (Purchased Care)	3.83%	5.35%

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 \$154.7 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 initial unfunded liability of the program was amortized over a 50-year period through the FY 2012 payment. At its August 2012 meeting, the Board decided to decrease the period over which the initial unfunded liability is fully amortized by 5 years. Therefore, starting with the FY 2013 payment, the initial unfunded liability is being amortized over a 45-year period, with the last payment expected to be made October 1, 2046. All subsequent gains and losses experienced by the system are amortized over a 30-year period. Chapter 56 of Title 10, United State Code (U.S.C.), requires that the Board approve the methods and assumptions used to (1) compute actuarial costs and liabilities, (2) amortize the initial unfunded liability, and (3) amortize all actuarial gains and losses. The Board is a Federal Advisory Committee appointed by the Secretary of Defense.

SFFAS No. 33, as published on October 14, 2008, by the Federal Accounting Standards Advisory Board (FASAB), requires the use of a yield curve based on marketable U.S. Treasury

securities to determine the 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 No. 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, 2012, financial-statement valuation, OACT determined an SFFAS No. 33 equivalent discount rate of 4.6% by using quarterly zero coupon Treasury spot rates (as published by the Office of Thrift Supervision) from June 30, 2002, through March 31, 2012, with an approximation for the March 31, 2012 rates due to discontinuation of the published series. In the summer of 2012, the Board approved a discount rate of 5.75% for the September 30, 2011, funding valuation, which differs from the SFFAS equivalent rate by 115 basis points.

SFFAS No. 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, 2012, financial-statement valuation, use of the SFFAS No. 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 No. 33 long-term economic assumptions increases the MERHCF actuarial liability by 24.1%.

Plan Amendment

The liability also reflects a new plan amendment. The benefit change, effective October 1, 2012, is a change in the eligibility rules for the US Family Health Plan. Per Sec. 708 of P.L. 112-81, after September 30, 2012, a military retiree (or eligible family member) who becomes eligible for Medicare due to age may not enroll in or stay enrolled in the US Family Health Plan, unless the military retiree (or eligible family member) was enrolled in the plan on September 30, 2012. The effect of this benefit change on the actuarial liability is (\$33.3) billion.

FY 2012 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, 2012, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$ 520,650,288
Coast Guard	10,832,163
Public Health Service	1,220,224
National Oceanic and Atmospheric Administration	<u>78,547</u>
Total	\$ <u>532,781,222</u>

FY 2012 Military Service and Other Uniformed Service Contributions

The FY 2012 Military Service and other Uniformed Service contributions to MERHCF (\$ in thousands) were as follows:

DoD	\$ 10,845,107
Coast Guard	261,871
Public Health Service	35,991
National Oceanic and Atmospheric Administration	<u>1,802</u>
Total	\$ <u>11,144,771</u>

Market Value of MERHCF's Securities

The market value of MERHCF's nonmarketable, market-based securities as of September 30, 2012, totaled \$264.8 billion. This amount is also reported on Note 3, Investments and Related Interest.

Note 10. Disclosures Related to the Statements of Net Cost

(\$ In Thousands)	2012	2011
Gross Costs		
Intragovernmental Costs	\$ 2,900,279	\$ 2,772,992
Public Costs		
Actuarial Non Assumption costs	(12,007,182)	9,996,535
Other Program Costs	<u>5,290,618</u>	<u>6,047,051</u>
Total Costs	(3,816,285)	18,816,578
Earned Revenue		
Intragovernmental Revenue	<u>(24,118,686)</u>	<u>(30,253,771)</u>
Total Revenue	<u>(24,118,686)</u>	<u>(30,253,771)</u>
Losses/(Gains) from Actuarial Assumption		
Changes for Military Retirement Benefits	<u>11,120,744</u>	(49,324,034)
Net Cost of Operations	\$ <u>(16,814,227)</u>	\$ <u>(60,761,227)</u>

Notes to the Principal Statements

The Net Cost of Operations decreased \$43.9 billion (72%) primarily due to \$38.4 billion decrease in the annual change to the actuarial liability. (See Note 9, Military Retirement Benefit Liabilities).

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 non 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 due to changes in assumptions 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 2012</u>	<u>FY 2011</u>
Uniformed Services Contributions	\$11,144,771	\$11,315,433
U.S. Treasury Annual Unfunded Liability Payment	6,716,000	9,785,000
Interest on Investments	<u>6,257,915</u>	<u>9,153,338</u>
Total Intragovernmental Revenue	<u>\$24,118,686</u>	<u>\$30,253,771</u>

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.

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.

Interest on Investments represents the interest income received by the MERHCF for FYs 2012 and 2011.

In FY 2011, based on 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", the DoD included all costs associated with the change in the actuarial liabilities for military retirement in "Losses/(Gains) from Actuarial Assumption Changes". During FY 2012, the Department of Treasury and the Government

Notes to the Principal Statements

Accountability Office provided additional guidance which specified only trend and other assumption changes should be recorded as "Losses/(Gains) from Actuarial Assumption Changes". To ensure comparability, certain FY 2011 costs have been reclassified on the Statement of Net Cost to conform to the current year presentation.

Note 11. Disclosures Related to the Statements of Changes in Net Position

There was a difference of \$8.7 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 12, Disclosures Related to the Statement of Budgetary Resources, for additional details.

Note 12. Disclosures Related to the Statements of Budgetary Resources

(\$ in Thousands)	<u>2012</u>	<u>2011</u>
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ <u>38,291</u>	<u>100,212</u>

The MERHCF reported \$8.7 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 \$8.7 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.

During FY 2012, MERHCF changed from an accrual basis of accounting to a cash basis of accounting for budgetary reporting, in compliance with the Office of Management and Budget (OMB). The OMB, the Treasury Financial Management Service, the Treasury Bureau of the Public Debt (BPD), the Office of the Under Secretary of Defense (Comptroller), and Enterprise Solutions and Standards, DFAS agreed to budgetary reporting changes related to the purchase of premiums and amortization of premiums and discounts for Treasury securities. OMB requested these changes be made in order for DoD reporting to be consistent with the reporting of other Federal agencies.

This change reduced the available funding for the MERHCF by the premiums purchased, the amortization of these premiums, and the amortization of the discounts. In the past, budgetary

Notes to the Principal Statements

funding was not affected at the time of purchase for a premium. However, the budgetary funding was reduced monthly by the amortization of premiums and increased by the amortization of discounts. Beginning August 1, 2012, the budgetary funding was reduced by premium at time of purchase. The budgetary funding will be increased by the discount at time of maturity.

Note 13. Reconciliation of Net Cost of Operations to Budget

(\$ in Thousands)	2012	2011
Resources Used to Finance Activities:		
Budgetary Resources Obligated—Obligations incurred	\$ 8,736,416	\$ 8,755,948
Less: Offsetting receipts (-)	<u>(12,896,403)</u>	<u>(18,803,364)</u>
Net obligations	(4,159,987)	(10,047,416)
Total resources used to finance activities	<u>(4,159,987)</u>	<u>(10,047,416)</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 (-)	61,921	(36,979)
Resources that fund expenses recognized in prior Periods (-)	<u>(987,580)</u>	<u>(39,327,500)</u>
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	<u>(77,512)</u>	<u>(134,974)</u>
Total resources used to finance items not part of the Net Cost of Operations	<u>(1,003,171)</u>	<u>(39,499,453)</u>
Total resources used to finance the Net Cost of Operations	<u>(5,163,158)</u>	<u>(49,546,869)</u>
Components Requiring or Generating Resources in Future Period Other (+/-)	<u>0</u>	<u>36,134</u>
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	(11,144,771)	(11,315,433)
Other	<u>(506,298)</u>	<u>64,941</u>
Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	<u>(11,651,069)</u>	<u>(11,214,358)</u>
Net Cost of Operations	\$ <u>(16,814,227)</u>	\$ <u>(60,761,227)</u>

The following note schedule lines are presented as combined instead of consolidated due to intra-agency budgetary transactions not being eliminated:

- Obligations Incurred.
- Obligations Net of Offsetting Collections and Recoveries.
- Less: Offsetting Receipts.
- Net Obligations.
- Undelivered Orders.

Components Requiring or Generating Resources in Future Period - Other displays the change in the FY 2011 incurred-but-not-reported (IBNR) reserve amounts. The IBNR amount represents an estimate of medical benefits already incurred but not yet reported to the DoD. Refer to Note 9, Military Retirement Benefit liabilities for additional details.

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables since the beginning of both FY 2011 and FY 2012. These changes represent refunds receivable for (1) amounts due from drug manufacturers as required by the FCP 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. This line also includes the changes in bad debts for FY 2011 and FY 2012. These bad debts occurred because erroneous payments made to MERHCF beneficiaries or to nonfederal providers of medical services were not repaid.

Note 14. Earmarked Funds

	2012	2011
<u>BALANCE SHEETS</u>		
<u>ASSETS</u>		
Fund balance with Treasury	\$ 162,254	\$ 227,170
Investments	203,341,522	187,826,062
Accounts and Interest Receivable	1,004,281	497,982
Other assets	<u>2,312</u>	<u>0</u>
Total Assets	\$ <u>204,510,369</u>	\$ <u>188,551,214</u>
<u>LIABILITIES and NET POSITION</u>		
Military Retirement Benefits and Other Federal Employment Benefits	\$ 533,392,364	\$ 534,379,945
Other Liabilities	555,144	422,635
Total Liabilities	\$ <u>533,947,508</u>	\$ <u>534,802,580</u>
Cumulative Results of Operations	<u>(329,437,139)</u>	<u>(346,251,366)</u>
Total Liabilities and Net Position	\$ <u>204,510,369</u>	\$ <u>188,551,214</u>
<u>STATEMENTS OF NET COST</u>		
Actuarial Non Assumption Changes	\$ (12,007,182)	\$ 9,996,535
Other Program Costs	8,190,897	8,820,043
Less Earned Revenue	(24,118,686)	(30,253,771)
Losses/(Gains) from Actuarial Assumption Changes	11,120,744	49,324,034
Net Cost of Operations	\$ <u>(16,814,227)</u>	\$ <u>(60,761,227)</u>
<u>STATEMENTS OF CHANGES IN NET POSITION</u>		
Net Position Beginning of the Period	\$ (346,251,366)	\$ (407,012,593)
Net Cost of Operations	<u>(16,814,227)</u>	<u>(60,761,227)</u>
Change in Net Position	\$ 16,814,227	\$ 60,761,227
Net Position End of the Period	\$ <u>(329,437,139)</u>	\$ <u>(346,251,366)</u>

The MERHCF receives its funding as an earmarked special fund and uses these resources to execute its mission and report on resource usage.

Note 15. Other Disclosures

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2012 and 2011, includes approximately \$77.3 billion (15% of total) and \$73.6 billion (14% 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, 2012, include approximately \$2.7 billion and \$1.7 billion, respectively, and 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. 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--Summary of Financial Statement Audit and Management Assurances

SEPTEMBER 30, 2012

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 2012, TMA's assessment may differ from the auditor's reported weaknesses for the current FY, which are reported as of September 2012. In its FY 2012 assessments, TMA management assessed that, except for direct care related material weaknesses, 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 July 2012, indicates a FY 2017 timeline for the Services to achieve (FMFIA § 4) compliance.

Except for the two direct care-related material weaknesses, as documented in TMA's Annual Statement Required Under the FMFIA dated July 12, 2012, and the above referenced Service-related FMFIA § 4 weakness, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2012 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.

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)	✓				✓
<i>Total Material Weaknesses</i>	2	0	0	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>	2	0	1	0	0	1

***MERHCF includes auditor-identified weaknesses in its annual assessment of internal controls from the prior year audit. Due to the timing of MERHCFs FY 2011 assessment which reported during June 2011, MERHCF’s assessment may differ from the auditor’s reported weaknesses for the same period 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 2012 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 2012 MERHCF audit.

Exhibit 2--IPIA Reporting Details September 30, 2012

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 2011 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.

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 2010 results reflect an improper payment rate of 0.24%; FY 2011 results reflect an improper payment rate of 0.15%. 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 2011			FY 2012			FY 2013 Estimated			FY 2014 Estimated			FY 2015 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)
\$20.9	0.15	\$31.3	\$20.3	2	\$407	\$20.6	2	\$413	\$21.6	2	\$432	\$23.2	2	\$463

1. The outlays increased from \$12.6B in FY 2010 to \$20.9B in FY 2011 due to newly scheduled audits of the TRICARE Pharmacy (TPHARM) Program, Active Duty Dental Program (ADDP), and the TRICARE Overseas Contract (TOP), that were excluded from audit in FY 2010.
2. The final payment error rate for FY 2011 is 0.15% (\$31.3M), which is less than the contract performance standard of 2% (\$418M) used in the FY 2011 AFR calculation. The error rate in FY 2012 and beyond is a conservative estimate based on the 2% contract performance standard.
3. The FY 2011 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.

4. The FY 2011 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.
- Special Supplemental Food Program for Women, Infants, and Children Overseas (WIC Overseas Program). Under the WIC Overseas Program specific TRICARE beneficiaries – pregnant women, breastfeeding women, postpartum women, infants, and children are provided supplemental foods and nutrition education when active duty families meet certain income thresholds. WIC serves as an adjunct to good health care during critical times of growth and development, in order to prevent the occurrence of health problems, including drug and other substance abuse, and to improve the health status of program participants. The benefit is similar to the benefits provided under the U.S. Department of Agriculture (USDA) administered Women, Infant, and Children (WIC) Program within the U.S.

TRICARE Dental Program (TDP). The contractor in FY 2011 was United Concordia Companies, Inc. TMA Risk Assessment for this contract has been Low Risk. The TDP contract offers a worldwide dental benefit to eligible family members of active duty service members and Selected Reserve and Individual Ready Reserve sponsors and their eligible family members. The TDP is a premium based program with the Government contributing a portion of the premium for certain plan types. The Contractor is at risk for 100% of the claims payment risk in the CONUS. In OCONUS locations, the Government pays Command Sponsored enrollees, cost shares for all covered services other than orthodontics, prosthodontics and other restorative care. The contractor is at risk on OCONUS claims for the allowable portion of the billed charges for covered services, less applicable cost shares.

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Independent Auditor's Report

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INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22350-1500

November 7, 2012

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

**SUBJECT: Independent Auditor's Report on the DoD Medicare-Eligible Retiree Health Care
Fund FY 2012 Basic Financial Statements (Report No. DODIG-2013-016)**

We contracted with the independent certified public accounting firm of Kearney & Company to audit the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), as of September 30, 2012, and for the year then ended, and provide a report on internal controls over financial reporting and compliance with laws and regulations. The contract required that Kearney & Company conduct the audit in accordance with U.S. generally accepted government auditing standards, Office of Management and Budget audit guidance, and the Government Accountability Office/President's Council on Integrity and Efficiency, "Financial Audit Manual," July 2008.

Kearney & Company's audit resulted in a qualified opinion. According to Kearney & Company, DoD-managed Military Treatment Facilities did not have compliant, transaction-based accounting systems. It issued a qualified opinion because it was unable to obtain sufficient, competent, evidential matter in accordance with OMB Circular A-127, "Financial Management Systems," January 9, 2009, and was unable to apply other auditing procedures to support the costs of direct care provided by the Military Treatment Facilities. Kearney & Company reported that except for the effects on the financial statements of the amounts related to MERHCF's direct care costs, the financial statements presented fairly, in all material respects, the financial position of MERHCF, as of September 30, 2012 and 2011, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The report discusses two material weaknesses related to the MERHCF internal controls over financial reporting. The results of the audit are presented in the attached report.

We reviewed Kearney & Company's report and related documentation and discussed audit results with Kearney & Company representatives. Our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the MERHCF financial statements, conclusions about the effectiveness of internal controls, conclusions on whether the MERHCF financial management systems substantially comply with the "Federal Financial Management Improvement Act of 1996," or conclusions on compliance with laws and regulations. Kearney & Company is responsible for the attached auditor's report, dated November 7, 2012, and the conclusions expressed in the report. However, our review disclosed no instances where Kearney

& Company did not comply, in all material respects, with U.S. generally accepted government auditing standards.

We appreciate the courtesies extended to the staff. Please direct questions to me at (703) 601-5945 (DSN 329-5945).

A handwritten signature in black ink that reads "Lorin T. Venable". The signature is written in a cursive style with a light grey rectangular background behind it.

Lorin T. Venable, CPA
Acting Assistant Inspector General
DoD Payments and Accounting Operations

Attachment:
As stated

INDEPENDENT AUDITOR'S REPORT

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, 2012 and 2011, and the related statements of net cost, changes in net position, and budgetary resources (hereinafter referred to as the "financial statements") 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; 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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, 2012 and 2011 includes approximately \$77.3 billion (15% of the total) and \$73.6 billion (14% 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 \$2.7 billion and \$1.7 billion, respectively, for the year ended September 30, 2012, and approximately \$2.8 billion and \$1.8 billion, respectively, for the year ended September 30, 2011.

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 the 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 performing 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 present fairly, in all material respects, the financial position of the Fund as of September 30, 2012 and 2011, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis be presented to supplement the basic financial statements. Such information, although not part of the basic financial statements, is required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board, who considers it to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. Other Accompanying Information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

In accordance with *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended, we have also issued reports, dated November 7, 2012, on our consideration of MERHCF's internal control over financial reporting and on our tests of MERHCF's compliance with certain provisions of laws, regulations, and other matters for the year ended September 30, 2012. 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, Virginia
November 7, 2012

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, 2012, and have issued our report thereon dated November 7, 2012. Except as discussed in our report, we conducted our audit 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. The management of MERHCF is responsible for establishing, maintaining, and assessing internal control related to financial reporting and compliance, 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 deficiencies, 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.

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

Material Weaknesses

I. Lack of United States Standard General Ledger Compliant, Transaction-Based Accounting Systems for Direct Care Costs (Repeat Condition)

As defined in OMB Circular A-127, *Financial Management Systems*, "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 Government 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."

MERHCF's actuarial liability for Medicare-eligible retiree benefits, as of September 30, 2012, includes approximately \$77.3 billion (15% of the total) of amounts reflecting the actuarial present value of the projected direct care costs of benefits to be provided by the Department of Defense (DoD)-managed Military Treatment Facilities (MTF) to eligible participants in MERHCF. Additionally, the reported amounts of program revenues and costs for the year ended September 30, 2012 include approximately \$2.7 billion and \$1.7 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 presentation of the direct care costs in conformity with GAAP.

Recommendation:

Kearney recommends that MERHCF continue to work on its corrective action plan to revise DoD Instruction Number 6070.2, *Department of Defense Medicare Eligible Retiree Health Care Fund Operations*, to reflect the use of per capita rates to calculate the annual update of the direct care portion of the health care liability and determine the annual distribution to the MTFs.

II. Direct Care Cost Data Accumulation (Repeat Condition)

The costs of health care provided directly by the DoD for MERHCF participants and beneficiaries represent significant input to the development of the actuarially-determined health care liabilities of MERHCF, and the determination of amounts contributed by the services for their active duty participants. These costs are incurred in the MTFs, which are 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 cutoff of accounting activity occurs at the MTF level. During fiscal year (FY) 2012, 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 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 the DoD Instructions.

Recommendation:

Kearney recommends that MERHCF implement the necessary management control and reconciliation processes with respect to direct care and the design of improved financial management information systems as part of the overall DoD business transformation efforts.

Additionally, Kearney recommends that MERHCF perform the following:

- Continue its ongoing efforts to develop, test, and implement appropriate and sufficient management control and reconciliation processes as soon as possible to ensure that the health care cost data from the MTFs is adequate and complete for use in MERHCF's financial reporting and actuarial valuation processes
- Identify all systems that support MERHCF's financial reporting and actuarial valuation processes, including such non-financial systems that support the Military Health System's (MHS) operations, such as the "systems of record" for MERHCF, to be subject to appropriate and sufficient management and internal control
- Reassess all processes and procedures for the accumulation, validation, and documentation of direct care costs and encounter data to be used in the valuation process
- Formalize and coordinate these processes among the Office of the Actuary (OOA), TRICARE Management Activity (TMA), the DoD Office of Health Affairs, and Defense Finance and Accounting Service (DFAS)
- Design, test, and implement reconciliation processes to ensure that direct care costs utilized for prospective estimates are reconciled to the amounts reported in the financial accounting systems, and are adjusted for actual data on a timely basis. Such reconciliations should be implemented to encompass direct care cost data recorded on the accrual basis of accounting, rather than solely based on the budget execution process anticipated by the existing DoD Instructions.

During the audit, we noted certain other matters that we will report to MERHCF's management in a separate letter.

MERHCF's management has provided its response to our findings in the Management's Discussion and Analysis section of the Agency Financial Report. We did not audit management's response and, accordingly, we do not express an opinion on it.

* * * * *

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



Alexandria, Virginia
November 7, 2012

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, 2012, and have issued our report thereon dated November 7, 2012. 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, that we determined were applicable. 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. 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 no instances of noncompliance exclusive of FFMIA, or other matters that are required to be reported upon under *Government Auditing Standards* and OMB Bulletin No. 07-04, as amended. However, the material weaknesses identified in our Independent Auditor's Report on Internal Control, dated November 7, 2012, with respect to internal control over financial reporting, indicate that MERHCF is not fully compliant with the requirements of OMB Circulars A-123, *Management's Responsibility for Internal Control*, and A-127, *Financial Management Systems*, and the Federal Managers' Financial Integrity Act of 1982 (FMFIA).

Under FFMIA, we are required to report whether MERHCF's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Standard General Ledger (USSGL) at the transaction level. We noted certain instances, described below, in which MERHCF's financial management systems and related controls did not substantially comply with certain Federal system requirements, Federal accounting standards, and the USSGL at the transaction level.



Federal Financial Management System Requirements

MERHCF’s financial management system, with respect to direct care costs, does not meet the requirements of an integrated financial management system, as defined in OMB Circular A-127.

Applicable Federal Accounting Standards

With respect to direct care costs, 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 the financial data.

The financial management systems utilized by MERHCF, with respect to direct care costs, 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.

Standard General Ledger at the Transaction Level

While the general ledger system utilized by MERHCF is compliant with the USSGL, with respect to direct care costs, it is not transaction-based.

MERHCF’s management has provided its response to our findings in the Management’s Discussion and Analysis section of the Agency Financial Report. We did not audit management’s response and, accordingly, we do not express an opinion on it.

* * * * *

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



Alexandria, Virginia
November 7, 2012