



Fiscal Year 2013

Medicare- Eligible Retiree Health Care Fund Audited Financial Statements



December 9, 2013

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Management's Discussion and Analysis

Department of Defense Medicare-Eligible Retiree Health Care Fund For the Year Ended September 30, 2013

The Department of Defense Medicare-Eligible Retiree Health Care Fund's (MERHCF) Management Discussion and Analysis provides an overview of MERHCF's financial activities for the fiscal year ended September 30, 2013. Since this information is designed to focus on the current year's activities, resulting changes, and currently known facts, it should be read in conjunction with the MERHCF's principal statements and notes (beginning on page 23).

1. REPORTING ENTITY, MISSION AND MANAGEMENT STRUCTURE

Reporting Entity and Mission. The reporting entity is the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the "Fund" or MERHCF). The "mission" of the MERHCF, administered by the Secretary of the Treasury, is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of DoD under uniformed services health care programs for specific Medicare-eligible beneficiaries, as designated by Sections 1111 through 1117 of Title 10, U. S. Code. 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 the Military Health System (MHS) (including the Defense Health Program [DHP] and Military Pay appropriations). 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).

Board of Actuaries. The 2001 NDAA also established an independent three-member DoD Medicare-Eligible Retiree Health Care Board of Actuaries (MERHCF Board) appointed by the Secretary of Defense. The MERHCF Board approves the methods and assumptions used to calculate the per capita normal cost rates and the U.S. Treasury contribution. Details about the methods and assumptions used in the calculation of the FY 2013 actuarial liability are reported in the MERHCF Board of Actuaries minutes of the August 2, 2013 meeting and are available upon request. The MERHCF 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), under the Defense Human Resources Activity, provides all technical and administrative support to the Board and is essential in providing the actuarial assessments regarding contributions to the Fund and calculations of the actuarial liability as well as impacts of either current or proposed future retiree program changes. The DoD OACT operates in accordance with the provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in Department of Defense Instruction 6070.02 (DoDI 6070.02), "Department of Defense Medicare Eligible Retiree Health Care Fund Operations," July 19, 2002.

TRICARE Management Activity (TMA). Within DoD the Office of the Under Secretary of Defense (OUSD) for Personnel and Readiness (P&R) through the Office of the Assistant Secretary of Defense for Health Affairs, TMA has as one of its missions the operational oversight of the Military Health System (MHS), including management of the Fund. TMA management responsibilities include accounting for, documenting, and projecting annual budget distribution requirements (purchased care claims, demands, and military treatment facilities (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.

Defense Health Agency (DHA) Establishment. A change in reporting entity for FY 2014 was made effective October 1, 2013 to establish the Defense Health Agency and disestablish the TRICARE Management Activity (TMA). The DoD Directive 5136.13, "Defense Health Agency," dated September 30, 2013, transfers appropriate TMA functions to the DHA. Any reference in law, rule, regulation, or issuance to TMA will be deemed to be a reference to DHA, unless otherwise specified by the Secretary of Defense. There is no financial reporting change to the MERHCF because of the DHA establishment.

Defense Finance and Accounting Service (DFAS). The DFAS Trust Fund Accounting and Reporting (TFAR) division provides accounting and investment services for the Fund. The Investment Fund Manager is responsible for investing cash balances of MERHCF not required to meet current expenditures. Investments are limited to Market-Based U.S. Government Special Securities issued by the U. S. Treasury and are made in accordance with the provisions of Sections 1111 to 1117 of Title 10, U.S. Code.

TRICARE Plans and Programs for Medicare-Eligible Beneficiaries

TRICARE for Life (TFL). The TFL was created as "wrap-around" coverage to Medicare-eligible military retirees by Section 712 of the *Floyd D. Spence National Defense Authorization Act* for FY2001 (P.L. 106-398). TFL functions as a second payer to Medicare, paying out-of-pocket costs for medical services covered under Medicare for beneficiaries who are entitled to Medicare Part A based on age, disability, or end-stage renal disease (ESRD). TFL covers Medicare-eligible retirees, including retired guardsmen, 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.

TRICARE Pharmacy Program. The TRICARE Pharmacy Program authorizes eligible beneficiaries to obtain low-cost prescription medications from the TRICARE Mail Order Pharmacy (TMOP) and TRICARE civilian pharmacies (network and non-network). Beneficiaries may also continue to use military hospital and clinic pharmacies at no charge. The FY 2013 NDAA requires TRICARE to increase copayments on brand name and non-formulary medications that are not filled at military clinics or hospitals. There is no increase to copayments

for generic medications. New copayments for prescription drugs covered by TRICARE went into effect February 1, 2013.

TRICARE Plus. TRICARE Plus is an MTF primary care enrollment program that is offered at selected local MTF. All beneficiaries eligible for care in MTF (except those enrolled in [TRICARE Prime](#), a civilian Health Maintenance Office (HMO), or Medicare can seek enrollment for primary care at MTF where enrollment capacity exists. Non-enrollment in TRICARE Plus does not affect [TFL](#) benefits or other existing programs.

Designated Provider Program (DPP) formerly Uniformed Services Family Health Plan (USFHP). Finally, DoD beneficiaries, including Medicare-eligible beneficiaries, in specific locations where DPP, formerly the USFHP, 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 for benefits under the TFL (or other TRICARE plans) and Pharmacy programs. Prior to August 20, 2012, USFHP enrollees were not required to participate in Medicare. Beginning October 2012, a military retiree (or eligible family member) who becomes eligible for Medicare due to age may not enroll or stay enrolled in the USFHP, unless the military retiree (or eligible family member) was enrolled in the plan since September 30, 2012.

Health Care Purchased from Civilian Providers

Purchased Care. In accordance the MERHCF DoDI 6070.2, July 2002, the TMA Contract and Resource Management (CRM) reports daily obligations to the Fund for health care purchased from civilian providers or “purchased care”. 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.

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.

Purchased Care through DPP. 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.

For more detailed information about TMA CRM purchased care processes and controls, please see the "DoD TMA CRM Management's Discussion and Analysis for the Years Ended September 30, 2013 and 2012."

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care relies on data files provided by TMA, through the Military Health System Data Repository (MDR), to the OACT. The IBNR is determined quarterly, using claims triangles that represent paid claims in the month they were incurred. For pharmacy IBNR, OACT relies on a paid claims report that summarizes amount paid by date incurred. Standard actuarial methods are used to compute the IBNR, including the development of month-to-month completion factors, IBNR smoothing techniques, as well as analysis and research of patterns, trends, and anomalies. Separate MERHCF accounting reports with line item detail are also used to estimate the outstanding administration costs associated with claims incurred but not reported.

Health Care Provided in Military Treatment Facilities (MTFs)

Direct Care. TMA develops prospective payment amounts for health care estimated to be provided directly in MTFs (Direct Care) to Medicare-eligible beneficiaries based on DoD policy established in the MERHCF DoDI 6070.02, July 2002. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and DHP Operations and Maintenance (O&M) costs.

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 the MERHCF DoDI 6070.02, 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 budget data provided by the Military Services, 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) transfers MERHCF funds quarterly for the MTF prospective payments (based on the TMA calculated annual total direct care program amounts) to the Military Services for MILPERS costs and to TMA for DHP O&M costs. TMA, in turn, distributes DHP O&M funds to the Service Medical Activities (SMA) of the Army, Navy and Air Force 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 the MERHCF DoDI 6070.02, July 19, 2002.

The prospective O&M payment for MTF provided care to Medicare-eligible beneficiaries was \$1.4 billion and \$1.3 billion in FY 2013 and 2012, respectively. While the unit costs of inpatient and outpatient services have risen slightly, utilization of inpatient services has continued to decrease while costs related to pharmacy non-ingredient O&M have increased. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries was \$0.5 billion in FY 2013 and \$0.5 billion in FY 2012.

DODI and DOD FMR Updates for MERHCF

Due to the DHA establishment effective October 1, 2013, and the need to reflect current responsibilities, policy and procedures for existing business process application, the MERHCF DoDI 6070.02, July 19, 2002 and DoD 7000.14-R, *Financial Management Regulation*, Volume 12, Chapter 16 paragraphs on *Accounting for MERHCF Accruals and Investments* is currently under coordination for update with OUSD P&R and OUSD(C) offices respectively.

2. 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, 2013, the Fund had net assets available to pay benefits of \$187 billion and an actuarial liability of \$502.4 billion (See Note 9 – Military Retirement and Other Employment Benefits); the funding ratio was 37.2%. 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%. 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.

The table and variance analysis in the following section presents certain comparative financial statement information for the MERHCF.

3. FINANCIAL STATEMENT ANALYSIS

Comparative Financial Data

Medicare-Eligible Retiree Health Care Fund				
Analysis of Financial Statements				
for the years ended September 30, 2013 and 2012				
(\$ In Thousands)				
<u>Consolidated Balance Sheets</u>	<u>2013</u>	<u>2012</u>	<u>Difference</u> Increase/ (Decrease)	<u>%</u> <u>Change</u>
Investments (Intra-Governmental Securities) - Revenue from Treasury payments and Service contributions excess to current year health care benefit payments is invested in Treasury securities	\$216,976,919	\$203,341,522	\$13,635,397	7%
Accounts Receivable, Net - A/R associated with Standard Discount Program (SDP)	\$506,342	\$ 1,004,281	(\$497,939)	(50%)
Liabilities Not Covered by Budgetary Resources - Represents difference between actuarial liability for future benefit payments and current assets	\$315,435,698	\$358,077,554	(\$42,641,856)	(12%)
Accounts Payable (Non-Federal)	\$688,838	\$418,559	\$270,279	65%
Military Retirement and Other Federal Employment Benefits - Represents actuarial liability of future health care benefit and Incurred But Not Reported (IBNR) liability	\$503,017,319	\$533,392,364	(\$30,375,045)	(6%)
<u>Statements of Net Cost</u>				
Net Costs of Operations - Changes in computation of actuarial health care liability are the major contributor to changes in net costs of operation	(\$43,256,775)	(\$16,814,228)	(\$26,442,547)	(157%)
<u>Statements of Budgetary Resources</u>				
Undelivered orders	\$81,376	\$38,291	\$43,085	112%

Comparative Financial Data Variance Analysis**BALANCE SHEET****Investments (Note 3)
Intragovernmental Securities**

Total Intragovernmental Securities, Net Investments increased \$13.6 billion (7%). 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 \$10.4 billion in long-term securities during FY 2013.

Accounts Receivable, Net (Note 4)

Accounts Receivable, Public, decreased \$497.9 million (50%) of which \$490.5 million was from the TRICARE Retail Pharmacy Refunds Program. The decrease in the TRICARE Retail Pharmacy Refunds Program is due to refunds recorded in the 2nd Quarter, FY 2012 covering January 2008 - June 2009 resulting from the implementation of Federal Ceiling Prices (FCP) as required by the FY 2008 NDAA, §703 that were substantially collected as of September 30, 2013. The appropriate allowances were recorded to reduce the receivables to net realizable value.

Liabilities Not Covered by Budgetary Resources (Note 6)

Total Liabilities Not Covered by Budgetary Resources decreased \$42.6 billion (12%). This change is primarily attributable to a \$30.4 billion decrease from changes in the underlying benefit plan, actuarial assumptions, experience, and expectations used to calculate the unfunded liability. See Note 9, Military Retirement and Other Federal Employment Benefits, for additional information about these changes.

Accounts Payable (Nonfederal) (Note 7)

Accounts Payable, Nonfederal increased \$270.3 million (65%). The increase is the result of a combination of higher utilization by the DoD Medicare-eligible beneficiaries and an increase in pharmaceutical expenses. Payables increased \$147.4 million in the Mail Order Program and \$137.8 million in the TRICARE Retail Pharmacy Program."

Military Retirement and Other Federal Employment Benefits (Note 9)

The present value of total Military Retirement and Other Federal Employment Benefits liability decreased \$30.4 billion (6%). This resulted from decreases of \$43.6 billion from plan amendments, \$9.6 billion due to actual experience being different from what was assumed (demographic and claims data), and \$3.9 billion due to changes in key assumptions. These were offset by an expected increase of \$26.7 billion due to interest and normal costs, less benefit outlays.

STATEMENT OF NET COST (Note 10)

Net Cost of Operations decreased \$26.4 billion (157%) due primarily to a decrease of \$30.4 billion from gains due to changes in the underlying benefit plan, actuarial assumptions, experience, and expectations used to calculate the unfunded liability. The decrease from benefit plan amendments is primarily due to a new plan change, effective February 1, 2013, that resulted in certain retail and mail order pharmacy copay increases and a mandatory mail order pilot for members of TRICARE For Life. The effect of this benefit change on the actuarial liability is a decrease to future funded expenses. See Note 9, Military Retirement and Other Federal Employment Benefits for additional details.

STATEMENT OF BUDGETARY RESOURCES (SBR) (Note 12)

The Net Amount of Budgetary Resources Obligated for Undelivered Orders increased \$43.1 million. This was primarily the result of 1) a \$14.4 million increase in TRICARE Dual Eligible Fiscal Intermediary Contracts, recorded twice in FY 2013 in error and subsequently corrected in October 2013, 2) a \$13.4 million increase in obligations for the U.S. Family Health Plan, and 3) a \$13.0 million increase in the Mail Order Pharmacy funding obligations recorded in FY 2013 to correct a prior year error.

Assets

Assets of \$217.7 billion, included in the Comparative Financial Data table above, and shown in Figure 1, represent amounts that the MERHCF owns and manages. Assets increased by \$13.1 billion during FY 2013. This increase is largely attributable to purchasing new investments of \$19 billion with funds received from the U.S. Treasury payments, Service contributions, and interest receipts. 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.

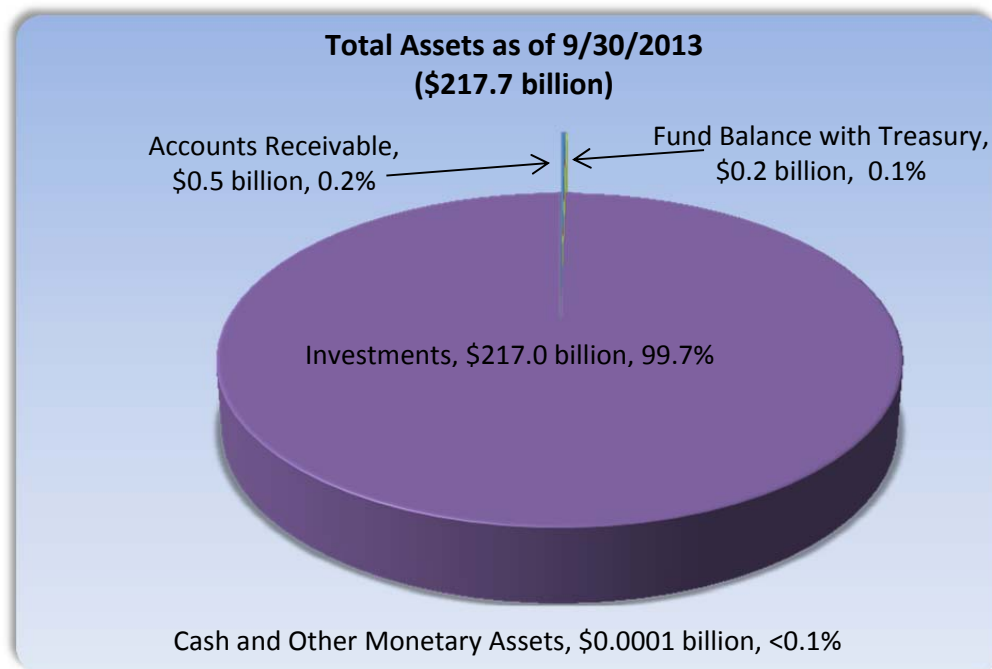


Figure 1

Investments

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.

Figure 2 below depicts the par value of investment holdings (includes inflation and interest receivable), net of amortization, as of September 30, 2013.

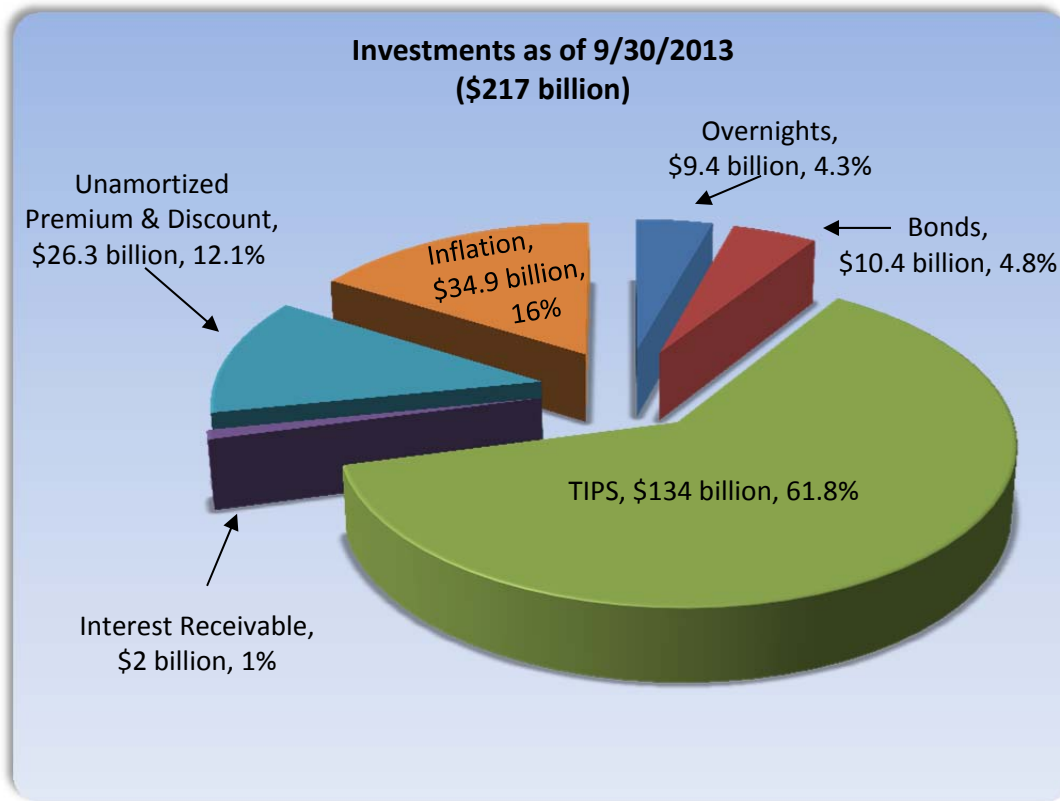


Figure 2

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.

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

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

No accounts of the Fund have been excluded from the Fund’s financial statements. The significant increase in investments interest revenue between FY 2013 and FY 2012 is due primarily to the favorable economic conditions during FY 2013.

Liabilities

Liabilities of \$503.8 billion included in the Comparative Financial Data table and shown in Figure 3 represent liabilities related to military retirement medical benefits for Medicare-eligible beneficiaries. The liabilities of the MERHCF primarily consist of actuarial liability for future benefit payments. Liabilities decreased by \$30.1 billion during FY 2013. This decrease is largely attributable to the decrease in the actuarial liability.

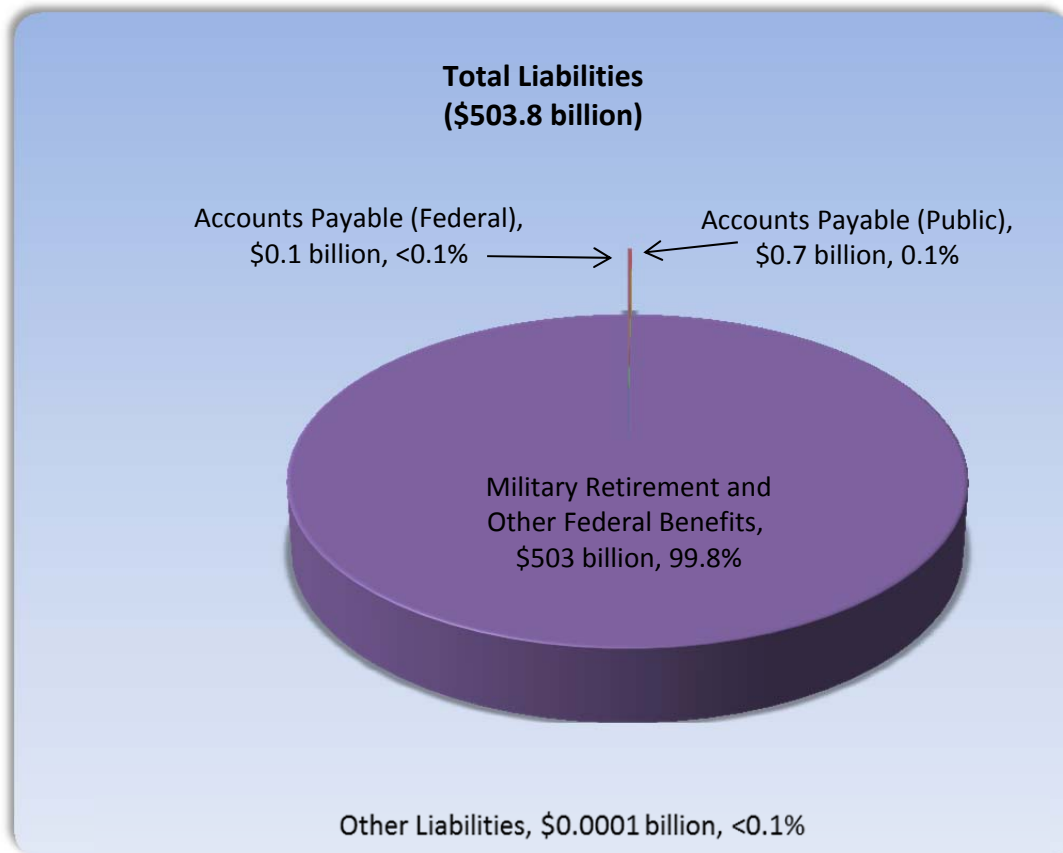


Figure 3

MERHCF Requirements and Funding Plan

In FY 2013 and FY 2012 respectively, the Fund authorized approximately \$9.5 billion and \$9.8 billion in total health care services, \$7.6 billion and \$8.0 billion to civilian providers, \$1.4 billion and \$1.3 billion to MTFs, and \$0.5 billion and \$0.5 billion to Military Service Personnel Accounts, on behalf of Medicare-eligible retirees, retiree dependents, and survivors. Purchased Care end of year MERHCF obligations were \$6.8 billion and \$7.0 billion in FY 2013 and FY 2012 respectively.

Management's Discussion And Analysis

During the last two years of the Fund's operation, requirements were funded at the following amounts:

\$ In Billions				
Fiscal Year	Purchased Care	Operations & Maintenance	Military Personnel	Final
2013	\$7.6	\$1.4	\$0.5	\$9.5
2012	\$8.0	\$1.3	\$0.5	\$9.8

MERHCF Revenues and Contributions

The Fund receives income from three sources:

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

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

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2013	\$6.1	\$8.5	\$7.2
2012	\$6.7	\$11.1	\$6.3

Amounts contributed to MERHCF by the DoD, other uniformed services, and the U. S. Treasury must be based on determinations by the OACT under methods and assumptions approved by the DoD MERHCF Board in accordance with applicable provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in the MERHCF DoDI 6070.02, July, 2002.

4. SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

Management Assurances

Federal Managers' Financial Integrity Act (FMFIA). The Federal Managers' Financial Integrity Act (FMFIA) requires executive branch agencies to provide annual assurance statements regarding systems of accounting and administrative control. Accounting and administrative controls include program, operational and administrative areas, as well as accounting and financial management.

OMB Circular A-123 is the government-wide implementation guidance for FMFIA. TMA conducted its assessment of the effectiveness of internal controls over financial reporting in accordance with OMB Circular A-123, and Appendix A, Internal Control over Financial Reporting. The OMB guidance in Appendix A establishes a strengthened management process for assessing internal control over financial reporting and requires an additional and separate annual statement of assurance specifically addressing the effectiveness of internal control over financial reporting. The objectives of the systems of internal controls of MERHCF are to provide reasonable assurance of:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

The evaluation of internal controls for the statement of assurance extended to every responsibility and activity undertaken by the organizations that execute the MERHCF and applies to program, administrative, and operational controls. The internal control testing follows the Financial Improvement and Audit Readiness (FIAR) Guidance established by the DoD OUSD (C). This process includes the development of process flowcharts and narratives that include the identification of key controls that address FIAR-defined Financial Reporting Objectives, risk assessments associated with those key controls, test plans for those key controls, and reporting of test results based on execution of those test plans. Based on the results of this assessment, the TMA is able to provide a qualified statement of assurance that the internal controls over financial reporting as of June 30, 2013 were operating effectively with the exception of the material weakness noted in this section under "Material Weaknesses 2013."

Federal Financial Management Improvement Act (FFMIA) (PL 104-208). The TMA internal review of MERHCF also included the effectiveness of the internal controls over the integrated financial management systems for TMA, SMA and MERHCF financial statement reporting entities. For MERHCF, TMA is able to provide a qualified statement of assurance that the internal controls over the integrated financial management system as of June 30, 2013, are in compliance with the Federal Financial Management Improvement Act and OMB Circular A-127 with the exception of one systems non-conformance noted in this section under "Material Weaknesses 2013."

Please see Exhibits 1 and 2 in the Other Information section for additional details on management assurances and a discussion of controls and reporting on improper payments.

Material Weaknesses 2013

The MERHCF independent auditors noted two material weaknesses during the FY 2013 Financial Statement Audit.

1. Lack of U.S. Standard General Ledger (USSGL) Compliant, Transaction-based Accounting Systems for Direct Care Costs. 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 (SFIS). While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated to MTFs cannot be related to specific appropriations. Thus, there is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, documentation 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 process.
2. MTF Direct Care Costs Data Accumulation. 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 branches of military 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 FY 2013, 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.

Direct Care Cost Accumulation

At issue with the conditions of unaudited, non-accrual based MTF level data and the lack of SFIS compliant accounting systems is the fact that direct health care costs provide input to the development of the actuarially determined long-term health care liability of MERHCF, as well as the determination of amounts contributed by the branches of military service for active duty participants. The actuarial liability for direct care related to Medicare-eligible retiree benefits as of September 30, 2013 and 2012 is approximately \$79.8 billion (16% of total) and \$77.3 billion (15% 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, 2013, include approximately \$2.3 billion and \$1.8 billion, respectively, and for the year ended September 30, 2012, include approximately \$2.7 billion and \$1.7 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are based on cost allocation methods using data extracted from various Service-specific financial, personnel, and workload systems within DoD as well as patient encounter data. With respect to the extracted data, the 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 non-accrual based expenditures, auditability of the SMAs validation and reconciliation of the 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-around solutions because MERHCF management cannot address the Military Services financial systems' or MTF-level data 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.

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 OACT 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 Uniformed 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 standards of practice as well as satisfy accounting, Government Accountability Office (GAO), and Congressional standards. Data on which the new model will be developed must be collected over time for several fiscal years with appropriate adjustments. The annual Medicare data collected from the Center for Medicare and Medicaid Services (CMS) by the DHA and OACT contains medical claims detail data on over 2.2 million 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 2017. 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.

TMA Program Integrity Office

The TMA Program Integrity manages anti-fraud and abuse activities for TMA to protect benefit dollars and safeguard eligible beneficiaries. Program Integrity responsibilities include:

- Central coordinating office for allegations of fraud and abuse within the TRICARE Program.
- Develops and executes anti-fraud/abuse policies and procedures.
- Monitors and provides oversight of contractor program integrity activities.
- Develops cases for criminal fraud/abuse prosecutions and civil fraud/abuse lawsuits.
- Coordinates investigative activities and exchanges information with the Department of Justice, law enforcement agencies, federal agencies, and state agencies.
- Initiates administrative remedies to enforce provisions of the law, regulation and policy in the administration of TRICARE program.

5. OTHER MANAGEMENT INFORMATION

Management Initiatives

All Retiree Fund Proposal. As mentioned in the December 2009 (as well as December 2005) *Report to the President and Congress on the Department of Defense Medicare-Eligible Retiree Health Care Fund* submitted by the DoD OACT, a significant portion of military retiree health benefits are not covered by the MERHCF. Benefits for retirees who are not yet Medicare-eligible are a significant cost because of the young age at which many military members retire, and because the program pays for the full cost of their health care (whereas under the Medicare-eligible program, a large portion is paid by Medicare). The DoD OACT noted that both the private sector and public sector (states and municipalities follow Government Accounting Standards Board Statements No. 43 and 45) account for both pre-Medicare and post-Medicare retiree health benefits on an advance accrual basis. The MERHCF Board believes that consideration should be given to extend the Fund to cover all retiree health care costs, so that the budgetary treatment of pre-Medicare retiree health costs would be similar to the treatment of Medicare-eligible retiree costs, and all of the economic efficiencies and proper incentives promoted by the Fund would reflect the full cost to DoD of future retiree benefit entitlements being earned by military members' current service. MERHCF management agreed with the DoD OACT recommendation and submitted a legislative change proposal this year during the program review cycle that would implement this recommendation. While this legislative change proposal has not yet been adopted, MERHCF management believes that the proposal will be reconsidered by the Department in the coming fiscal year.

Consistent Cost Basis for MERHCF Retiree Benefit. Effective for FY 2013, MERHCF management worked with the TMA and DoD Offices of General Counsel (OGC) and OUSD(C) representatives to implement the MERHCF Board's second recommendation to restrict the MERHCF's financial responsibility for direct care costs to cover only the cost of providing health care benefits to retirees. For the MERHCF financial statements, the direct care data is adjusted by DoD to include an allocation of operating costs associated with personnel, operations and maintenance of the MTFs that are paid from the Fund. The application of the consistent cost basis eliminated the additional costs allocated to cover military construction (MILCON), Other Procurement (PROC) for capitalized equipment, and medical research, development, testing, and evaluation (RDTE) that were accounted for on the SMA financial statements for the Army, Navy and Air Force medical components, as part of their statement's postretirement health care liability, but are not paid from the Fund because they are covered in the Defense Health Program annual appropriations for active duty requirements. This change to a consistent cost basis for the MERHCF retiree benefit did not impact the MERHCF financial statements but reduced the amount of long-term health care liability, (including the amount previously attributed to MILCON, RDTE and PROC for MERHCF retirees), recorded on the SMA financial statements.

Financial Management Systems Framework

MERHCF Reliance on SMA Financial Systems and Data. The cost of care provided directly in MTFs and medical coding record data used in direct care cost allocations is reported to the MHS Data Repository, (a.k.a. the MDR) by the Army Medical Command (SMA-Army), Navy Bureau of Medicine and Surgery (SMA-Navy), and Air Force Medical Service (SMA-AF). The MERHCF direct care funding is executed by the three SMA Components, each of which relies on the financial systems and procedures of its parent Line Service.

The two material weaknesses identified in the MERHCF audit are directly related to the SMAs' financial management systems, data accumulation, and financial reporting deficiencies. MERHCF management has no direct control over SMA financial management system or data compliance. TMA Management Control division (DHA Business Support-Accounting and Financial Integrity branch) continually strives to work with the SMA Representatives to improve the SMA audit readiness by following the FIAR guidance and objectives. TMA has worked with SMA Representatives to accomplish the following in support of DoD audit readiness objectives:

- OUSD(C) validation that the TMA and SMA Financial Statement Reporting Entities are audit ready for Wave 1 (Appropriations Received) of the FIAR Guidance.
- Continued dialogue with OUSD(C) FIAR Office on audit readiness for key assessable units for Wave 2 (Statement of Budgetary Resources) of the FIAR Guidance. These assessable units include Civilian Pay, Contract/Vendor Pay, and Financial Reporting.
- Supported OUSD(C)-directed mock audits on Appropriations Received, Civilian Pay, Contract Pay, and Financial Reporting, as required.
- Continued Federal Information Systems Compliance Audit Manual (FISCAM) testing of the owner controls for TMA-owned systems material to financial statements, including Defense Medical Logistics Standard Support (DMLSS), Composite Health Care System (CHCS), Third Party Outpatient Collection System (TPOCS), and Coding Compliance Editor (CCE).

Retail Pharmacy Refund Program (Standard Discount Program)

TRICARE Standard Discount Program (SDP). The SDP (Program 006) is a Standard or Minimum Refund, formerly known as Mandatory Agreements Retail Refunds (MARR), on a Section 703 Covered Drug. It is by law equal to the difference between Non-Federal Average Manufacturer Price (Non-FAMP) and Federal Ceiling Price (FCP) ($FCP = 76\% \times \text{Non-FAMP}$).

The NDAA for FY 2008 (NDAA-08), §703 enacted 10 U.S.C. 1074g(f) which mandated all covered TRICARE Retail Pharmacy Network prescriptions filled on or after January 28, 2008, be subject to FCP.

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 FCP by prohibiting pharmaceutical manufacturers from receiving more than the FCPs for pharmaceuticals purchased by DoD for the TRICARE retail pharmacy program.

Prior to September 2012 DHA had not demanded payment for refunds arising before the date of its Final Rule implementing NDAA-08. Consequently because DHA had not completed billing

all FCP refund debt, DoD 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.

Based on auditable, supportable calculations, CRM and 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. The DHA completed recalculations for the final two quarters of CY 2009 and the first three quarters of CY 2010 in FY 2013. Substantial collections have been received for all billed quarters mentioned above, with the exception of CY 2010 quarter 3 and CY 2013 quarters 2 and 3. The CY 2010 quarter 3 billings are not due until October 2013; and CY 2013 quarters 2 and 3 are not due until October 2013 and January 2014, respectively. (See **TRICARE Retail Pharmacy Refunds Program** table on page 21).

The DoD OGC addressed waiver/compromise requests for billed quarters except for those manufacturers with pre-statute voluntary refund agreements. As of September 30, 2013 all but five waiver/compromise requests have been resolved. The DoD OGC requested waiver/compromise authority from the Department of Justice (DOJ) and is waiting for the response. All waiver/compromise requests are given due consideration based upon the provisions of 32 C.F.R. §199.11.

The DHA started the transfer of delinquent debt files to the DoD OGC for legal validation and subsequent referral to the U. S. Treasury or the DOJ in FY 2013. The DHA believes that the delinquent debts should be consistently calculated, accurate, and final before transferring to the U.S. Treasury and/or the DOJ.

TRICARE Additional Discount Programs (ADP). The DHA 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:

- 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 Veteran's Affairs (VA) using Non-FAMP and other data submitted by the manufacturer.

Management's Discussion And Analysis

The table below highlights DoD CY activity since the inception of the programs. DoD has collected \$6.8 billion to date and is working to collect the remaining \$1.1 billion.

TRICARE Retail Pharmacy Refunds Program				
Program To Date (CY 2008 3rd Quarter - CY 2013)	Total	DHP	Other Uniformed Services	MERHCF
SDP:				
Billed	\$4,904,513,415	\$2,129,047,583	\$66,288,166	\$2,709,177,666
Collected	(4,244,438,902)	(1,838,147,914)	(57,052,449)	(2,349,238,539)
Net	660,074,513	290,899,669	9,235,717	359,939,127
ADP:				
Billed	2,886,553,799	1,251,568,596	41,084,530	1,593,900,673
Collected	(2,204,206,336)	(951,899,203)	(31,060,271)	(1,221,246,862)
Net	682,347,463	299,669,393	10,024,258	372,653,811
UDC ^{1, 2, 3}	(269,628,224)	(113,356,912)	(3,760,432)	(152,510,880)
Total:				
Billed ⁵	\$7,791,067,214	\$3,380,616,180	\$107,372,695	\$4,303,078,339
Collected	(6,448,645,238)	(2,790,047,117)	(88,112,720)	(3,570,485,401)
UDC	(269,628,224)	(113,356,912)	(3,760,432)	(152,510,880)
Total Net	\$1,072,793,752	\$477,212,151	\$15,499,543	\$580,082,058
Aging:				
Current	\$471,104,194	\$215,740,134	\$7,461,393	\$247,902,668
61 Days to 2 Years ⁴	504,365,794	219,355,966	7,124,540	277,885,288
Over 2 Years	97,323,764	42,116,052	913,610	54,294,102
Total Net	\$1,072,793,752	\$477,212,151	\$15,499,543	\$580,082,058

1. UDC are unidentified collections; waiting on payment detail from manufacturers.

2. UDC distributed between calendar years in proportion with the Total Billings.

3. UDC does not include overpayments of collections: \$25,514,097 MERHCF; \$19,525,747 DHP & Non-DoD.

4. Pharmacy debt not delinquent until 70 days. 70-day A/R aging bucket not available; 61-day aging used instead.

5. 3Q2013 Estimate added to Billings to reconcile with A/R: \$114,479,000 MERHCF; \$97,519,000 DHP & Non-DoD.

TRICARE has a waiver dated September 23, 1996, 10 USC 1079a, *Champus: Treatment of Refunds and Other Amounts Collected* that states:

“All refunds and other amounts collected in the administration of the Civilian Health and medical Program of the Uniformed Services shall be credited to the appropriation available for that program for the fiscal year in which the refund or amount is collected.”

Thus TRICARE records all collections/refunds into the current year and decreases budgetary disbursements for the current year. The refunds collected are not treated as offsetting collections.

6. LIMITATIONS ON 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.

Principal Statements

The accompanying notes are an integral part of these financial statements.

Balance Sheets

Department of Defense
Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30, 2013 and 2012

(\$ In Thousands)	2013	2012 (Restated)
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 2)	\$ 173,942	\$ 162,254
Investments (Note 3)	<u>216,976,919</u>	<u>203,341,522</u>
Total Intragovernmental Assets	217,150,861	203,503,776
Accounts Receivable, Net (Note 4)	506,342	1,004,281
Cash and Other Monetary Assets (Note 5)	<u>101</u>	<u>2,312</u>
TOTAL ASSETS	\$ <u>217,657,304</u>	\$ <u>204,510,369</u>
LIABILITIES		
Intragovernmental:		
Accounts Payable (Note 7)	\$ <u>131,409</u>	\$ <u>134,273</u>
Total Intragovernmental Liabilities	131,409	134,273
Accounts Payable (Note 7)	688,838	418,559
Military Retirement and Other Federal Employment Benefits (Notes 6 and 9)	503,017,319	533,392,364
Other Liabilities (Note 8)	<u>101</u>	<u>2,312</u>
TOTAL LIABILITIES	<u>503,837,667</u>	<u>533,947,508</u>
NET POSITION		
Cumulative Results of Operations	<u>(286,180,363)</u>	<u>(329,437,139)</u>
TOTAL NET POSITION	\$ <u>(286,180,363)</u>	\$ <u>(329,437,139)</u>
TOTAL LIABILITIES AND NET POSITION	\$ <u>217,657,304</u>	\$ <u>204,510,369</u>

The accompanying notes are an integral part of these financial statements.

Statements of Net Cost

Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF NET COST
For the Years Ended September 30, 2013 and 2012

(\$ In Thousands)	<u>2013</u>	<u>2012</u> (Restated)
Program Costs		
Actuarial Non-Assumption Costs	\$ (26,493,695)	\$ (12,007,182)
Other Program Costs	8,987,502	8,190,897
Less: Earned Revenue	<u>(21,862,550)</u>	<u>(24,118,686)</u>
Net costs before (Gain)/Loss on Actuarial Assumption Changes (Note 9)	\$ <u>(39,368,743)</u>	\$ <u>(27,934,971)</u>
(Gain)/Loss on Actuarial Assumption Changes	\$ <u>(3,888,033)</u>	\$ <u>11,120,744</u>
Net Cost of Operations	\$ <u>(43,256,776)</u>	\$ <u>(16,814,227)</u>

The accompanying notes are an integral part of these financial statements.

Statements of Changes in Net Position

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2013 and 2012**

(\$ In Thousands)	2013	2012 (Restated)
CUMULATIVE RESULTS OF OPERATIONS	<u>2013</u>	<u>2012</u> <u>(Restated)</u>
Beginning Balances	\$ (329,437,139)	\$ (346,251,366)
Net Cost of Operations (+/-)	<u>(43,256,776)</u>	<u>(16,814,227)</u>
Net Change	43,256,776	16,814,227
Cumulative Results of Operations	(286,180,363)	(329,437,139)
Net Position	\$ <u>(286,180,363)</u>	\$ <u>(329,437,139)</u>

The accompanying notes are an integral part of these financial statements.

Statements of Budgetary Resources

Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2013 and 2012

(\$ In Thousands)	2013	2012 (Restated)
BUDGETARY RESOURCES		
Appropriations (discretionary and mandatory)	\$ 8,525,966	\$ 8,736,416
Spending Authority from offsetting collections	128,528	0
Total Budgetary Resources	\$ 8,654,494	\$ 8,736,416
 STATUS OF BUDGETARY RESOURCES		
Obligations Incurred	\$ 8,654,494	\$ 8,736,416
Total Budgetary Resources	\$ 8,654,494	\$ 8,736,416
 CHANGE IN OBLIGATED BALANCE		
Unpaid obligations:		
Unpaid obligations, brought forward, Oct 1	\$ 591,123	\$ 522,848
Obligations incurred	8,654,494	8,736,416
Outlays (gross) (-)	(8,343,994)	(8,668,141)
Obligated balance, end of year	\$ 901,623	\$ 591,123
Memorandum (non-add) entries:		
Obligated balance, start of year	\$ 591,123	\$ 522,848
Obligated balance, end of year	\$ 901,623	\$ 591,123
 BUDGET AUTHORITY AND OUTLAYS, NET		
Budget Authority, gross (discretionary and mandatory)	\$ 8,654,494	\$ 8,736,416
Offsetting collections (discretionary and mandatory)(-)	(128,528)	0
Budget Authority, net (discretionary and mandatory)	\$ 8,525,966	\$ 8,736,416
 Outlays, gross (discretionary and mandatory)	\$ 8,343,994	\$ 8,668,141
Offsetting collections (discretionary and mandatory)(-)	(128,528)	0
Outlays, net (discretionary and mandatory)	8,215,466	8,668,141
Distributed offsetting receipts(-)	(12,265,230)	(12,896,403)
Agency Outlays, net (discretionary and mandatory)	\$ (4,049,764)	\$ (4,228,262)

The accompanying notes are an integral part of these financial statements.

Notes to the Principal Statements

Note 1. Significant Accounting Policies

A. Basis of Presentation

These financial statements have been prepared to report the financial position and results of operations for the Medicare-Eligible Retiree Health Care Fund (MERHCF), as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared using the books and records of MERHCF in accordance with U.S. generally accepted accounting principles (USGAAP) promulgated by the Federal Accounting Standards Advisory Board (FASAB); the Office of Management and Budget (OMB) 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 (FY) 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 B.

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.

E. Revenues and Other Financing Sources

Using methods and assumptions approved by the DoD MERHCF Board of Actuaries, the DoD Office of the Actuary (OACT) 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. 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 5, 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 will record 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.

TRICARE has a waiver dated September 23, 1996, 10 USC 1079a, Champus: Treatment of Refunds and Other Amounts Collected that states:

“All refunds and other amounts collected in the administration of the Civilian Health and medical Program of the Uniformed Services shall be credited to the appropriation available for that program for the fiscal year in which the refund or amount is collected.”

Thus TRICARE records all collections/refunds into the current year and decreases budgetary disbursements for the current year. The refunds collected are not treated as offsetting collections.

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 Fiscal Service. These securities are not traded on any financial exchange but are priced consistently with publicly traded U.S. Treasury securities. 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.

There is one case that resurfaced after September 30, 2013 that requires disclosure. It did not meet the reporting threshold of the Department, but meets the disclosure threshold for the MERHCF financial statements. Information pertaining to the case is disclosed in the Commitments and Contingencies disclosure in Note 14.

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. Refer to Note 9, Military Retirement and Other Federal Employment Benefits, and Note 10, General Disclosures Related to the Statement of Net Cost, for additional information.

O. Significant Events

Change in Accounting Principle. During FY 2013, the MERHCF implemented Statement of Federal Financial Accounting Standards (SFFAS) No. 43: Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked Funds. SFFAS 43 provides clarifying language to be used by reporting entities when classifying funds and provides additional reporting alternatives for financial statement presentation and note disclosure. Refer to Note 11, Disclosures on Statement of Changes in Net Position and Note 16, Restatements, for additional information.

Sequestration of Accrual Contributions. Per consultation from OMB's Budget Review Division (BRD) and DoD OGC, OMB concluded that the Public Health Service (and National Oceanic and Atmospheric Administration) contributions to the DoD account were sequestered, per the March 1, 2013, Sequestration Report to Congress. The NOAA amount sequestered was less than the \$500,000 threshold in the report, so those funds were not adjusted. During July, 2013, the Public Health Service annual normal cost contribution of \$29,061,800.00 was reduced by the sequestered amount for the MERHCF accrual account of \$1,453,090.00. The contribution amounts approved by the MERHCF Board were reduced by the rescinded amount resulting in effect to a net contribution by PHS of \$27,608,710.00.

P. Reclassifications

Certain fiscal year 2012 amounts in the Statement of Budgetary Resources have been reclassified to conform to the fiscal year 2013 presentation.

Note 2. Fund Balance with Treasury

(\$ In Thousands)	2013	2012
Fund Balance		
Total Special Funds	\$ <u>173,942</u>	\$ <u>162,254</u>
Status of Fund Balance with Treasury		
Unobligated Balance – Unavailable	187,581,621	175,314,810
Obligated Balance not yet Disbursed	901,623	591,123
Non-FBWT Budgetary Accounts	<u>(188,309,302)</u>	<u>(175,743,679)</u>
Total	\$ <u>173,942</u>	\$ <u>162,254</u>

The Status of Fund Balance with Treasury (FBWT) reflects the budgetary resources to support the FBWT and is the 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-FBWT Budgetary Account balance reduces the status of FBWT and consists primarily of investments in U.S. Treasury securities.

Note 3. Investments

(\$ In Thousands)		2013			
	<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>223,228,685</u>	Effective Interest	\$ <u>(8,291,660)</u>	\$ <u>214,937,025</u>	\$ <u>242,383,021</u>
Subtotal	223,228,685		(8,291,660)	214,937,025	242,383,021
Interest Receivable	<u>2,039,894</u>		<u>0</u>	<u>2,039,894</u>	<u>2,039,894</u>
Total Investments	\$ <u>225,268,579</u>		\$ <u>(8,291,660)</u>	\$ <u>216,976,919</u>	\$ <u>244,422,915</u>

(\$ In Thousands)		2012			
	<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>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>

The cash generated from investments is deposited in the U.S. Treasury, which uses the cash for general government purposes. The U.S. Treasury securities are issued to the MERHCF 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. government-wide financial statements.

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

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

At the semiannual meetings, the DoD 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 amount 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.

(\$ in thousands)		COST FY 2013	COST FY 2012
Notes	\$	0	Notes \$ 3,986,875
Bonds		14,728,223	Bonds 12,376,504
TIPS		199,130,599	TIPS 184,831,221
Overnights		<u>9,369,863</u>	Overnights <u>6,598,969</u>
Total Cost		<u>\$223,228,685</u>	Total Cost <u>\$207,793,569</u>

Note 4. Accounts Receivable

(\$ In Thousands)

	2013		
	<u>Gross Amount Due</u>	<u>Allowance for Estimated Uncollectible Amounts</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ <u>545,861</u>	\$ <u>(39,519)</u>	\$ <u>506,342</u>
Total Accounts Receivable	\$ <u>545,861</u>	\$ <u>(39,519)</u>	\$ <u>506,342</u>

(\$ In Thousands)

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

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. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience. Claims with other federal agencies are resolved in accordance with the Intragovernmental Business Rules.

Note 5. Cash and Other Monetary Assets

(\$ In Thousands)

	<u>2013</u>	<u>2012</u>
Cash	\$ 101	\$ 2,312
Other Monetary Assets	0	0
Total Cash and Other Monetary Assets	\$ <u>101</u>	\$ <u>2,312</u>

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 6. Liabilities Not Covered by Budgetary Resources

(\$ In Thousands)	2013	2012
Nonfederal Liabilities:		
Military Retirement and		
Other Federal Employment Benefits (Note 9)	\$ <u>315,435,698</u>	\$ <u>358,077,554</u>
Total Nonfederal Liabilities	<u>315,435,698</u>	<u>358,077,554</u>
 Total Liabilities Not Covered by Budgetary Resources	 315,435,698	 358,077,554
Total Liabilities Covered by Budgetary Resources	<u>188,401,969</u>	<u>175,869,954</u>
 Total Liabilities	 \$ <u>503,837,667</u>	 \$ <u>533,947,508</u>

The MERHCF Liabilities Not Covered by Budgetary Resources represents the portion of the actuarial liability for post-retirement 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)	2013	2012
Intragovernmental Payables	\$ <u>131,409</u>	\$ <u>134,273</u>
Nonfederal Payables (to the Public)	<u>688,838</u>	<u>418,559</u>
Total Accounts Payable	\$ <u>820,247</u>	\$ <u>552,832</u>

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)	2013	2012
Deposit Funds and Suspense Accounts	\$ <u>101</u>	\$ <u>2,312</u>

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

Note 9. Military Retirement and Other Federal Employment Benefits

(\$ In Thousands)	FY 2013		
<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 Health Benefits	\$ 502,399,494	\$ (186,963,796)	\$ 315,435,698
Other	<u>617,825</u>	<u>(617,825)</u>	<u>0</u>
Total	\$ <u>503,017,319</u>	\$ <u>(187,581,621)</u>	\$ <u>315,435,698</u>

(\$ 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 Health Benefits	\$ 532,781,222	\$ (174,703,668)	\$ 358,077,554
Other	<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>

Change in Actuarial Liability

(\$ In Thousands)

	FY 2013	FY 2012
Beginning Actuarial Liability	\$ 532,781,222	\$ 533,667,660
Plus Expenses:		
Normal Cost	11,496,638	10,958,301
Interest Cost	24,817,738	26,457,418
Plan Amendments	(43,560,859)	(33,269,895)
Experience (Gain)/Loss	(9,615,311)	(6,682,447)
Other factors	1	1
Subtotal: Expenses before (Gain)/Loss from Actuarial Assumption Changes	(16,861,793)	(2,536,622)
Actuarial (Gain)/Loss due to:		
Changes in trend assumptions	(24,355,038)	(14,673,866)
Changes in assumption other than trend	20,467,005	25,794,610
Subtotal: (Gain)/Loss from Actuarial Assumption Changes	(3,888,033)	11,120,744
Total Expenses	\$ (20,749,826)	\$ 8,584,122
Less Benefit Outlays	9,631,902	9,470,560
Total Changes in Actuarial Liability	\$ (30,381,728)	\$ (886,438)
Ending Actuarial Liability	\$ 502,399,494	\$ 532,781,222

Information Related to Military Retirement and Other Federal Employment Benefits Liability

The MERHCF accumulates funds to pay for health care programs for Department of Defense (DoD) and other Uniformed Services Medicare-eligible retirees and their Medicare-eligible dependents and survivors.

The schedules in the first two tables above reflect two distinct types of liabilities related to Military Retirement and Other Federal Benefits liability. The line entitled “Medicare-Eligible Retiree Health 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 “Other” represents the incurred-but-not-reported reserve amount which is an estimate of benefits already incurred but not yet reported to DoD.

This schedule also computes “unfunded liabilities”, i.e. liabilities not covered by budgetary resources. The assets presented in this schedule differ from those reported on the balance sheet. The balance sheet assets consist primarily of investments, the value of which is based on the fully amortized cost or “book value” of the securities (see Note 3, Investments). The value of assets available to pay benefits presented in the above schedule is based on available budgetary funding. The difference between investments and assets available to pay benefits is the premium on U.S. Treasury Securities. At the time of purchase budgetary funding is reduced by the

premium on U.S. securities because the premium on securities is no longer a budgetary resource at the time of purchase.

The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2013 balance represents the September 30, 2013 amount that will be effective through 3rd Quarter of FY 2014.

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.

Revenues

The MERHCF receives revenues from three sources: interest earnings on MERHCF assets, Uniformed Services normal cost contributions, and a 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 the MERHCF annually, 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 2013 financial-statement valuation, the long-term assumptions include a 4.4% discount rate and medical trend rates that were developed using a 2.4% inflation assumption. (For the most recent 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 2012 financial-statement valuation, the long-term assumptions included a 4.6% discount rate and medical trend rates that were developed using a 2.6% inflation assumption. (For the most recent funding valuation at the time of the FY 2012 financial statements, 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 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 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 OACT's 'Valuation of the Medicare-Eligible Retiree Health Care Fund' using accepted actuarial methods. Adjustments are made as necessary to put liabilities on a financial-statement basis. In the selection of the valuation date, SFFAS No. 33 allows for the roll-forward of actuarial liabilities from the prior year valuation results. In calculating the FY 2013 'rolled-forward' actuarial liability, the following assumptions were used:

Discount Rate	4.4%
Inflation	2.4%

<u>Medical Trend</u>	<u>FY 2012 - FY 2013</u>	<u>Ultimate Rate 2037</u>
Medicare Inpatient (Direct Care)	0.13%	5.15%
Medicare Inpatient (Purchased Care)	2.13%	5.15%
Medicare Outpatient (Direct Care)	2.13%	5.15%
Medicare Outpatient (Purchased Care)	3.13%	5.15%
Medicare Prescriptions (Direct Care)	0.00%	5.15%
Medicare Prescriptions (Purchased Care)	4.54%	5.15%
Medicare USFHP (Purchased Care)	3.14%	5.15%

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 would have increased 28.6%, or approximately \$143.7 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, 2013, financial-statement valuation, OACT determined an SFFAS No. 33 equivalent discount rate of 4.4% by using quarterly zero coupon Treasury spot rates (a series published by the Office of Thrift Supervision through December 31, 2011, and U.S. Treasury-Office of Economic Policy thereafter) from June 30, 2003, through March 31, 2013. In the summer of 2013, the Board approved a discount rate of 5.75% for the September 30, 2012, funding valuation, which differs from the SFFAS equivalent rate by 135 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, 2013, financial-statement valuation, use of the SFFAS 33 single equivalent discount rate required OACT to change the long-term inflation and medical trend rate assumptions to be consistent with the underlying Treasury spot rates used in the valuation. Using the SFFAS No. 33 long-term economic assumptions increases the MERHCF actuarial liability by 26.9%.

Plan Amendments

The liability also reflects two new plan amendments. The first plan change, (as enacted in the 2013 National Defense Authorization Act), resulted in certain retail and mail order pharmacy copay increases, effective February 1, 2013, and a mandatory mail order pilot for members of TRICARE For Life. The effect of this benefit change on the actuarial liability is a decrease of \$45.3 billion. The second plan change, effective retroactively to June 26, 2013, is the addition of coverage for same sex spouses. The effect of this plan change on the actuarial liability is an increase of \$1.8 billion.

FY 2013 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, 2013, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$ 490,795,134
Coast Guard	10,331,252
Public Health Service	1,197,071
National Oceanic and Atmospheric Administration	<u>76,037</u>
Total	\$ <u>502,399,494</u>

FY 2013 Military Service and Other Uniformed Services Contributions

The FY 2013 Military Service and other Uniformed Services contributions to MERHCF (\$ in thousands) were as follows:

DoD	\$ 8,296,906
Coast Guard	201,610
Public Health Service	27,609
National Oceanic and Atmospheric Administration	<u>1,422</u>
Total	\$ <u>8,527,547</u>

Market Value of MERHCF's Securities

The market value of MERHCF's nonmarketable, market-based securities as of September 30, 2013, totaled \$244.4 billion. This amount is also reported on Note 3, Investments.

Note 10. Disclosures Related to the Statements of Net Cost

(\$ In Thousands)	2013	2012
Gross Costs		
Intragovernmental Costs	\$ 2,904,669	\$ 2,900,279
Public Costs		
Actuarial Non-Assumption costs	(26,493,695)	(12,007,182)
Other Program Costs	6,082,833	5,290,618
Total Costs	(17,506,193)	(3,816,285)
Earned Revenue		
Intragovernmental Revenue	(21,862,550)	(24,118,686)
Total Revenue	(21,862,550)	(24,118,686)
Losses/(Gains) from Actuarial Assumption		
Changes for Military Retirement Benefits	(3,888,033)	11,120,744
Net Cost of Operations	\$ (43,256,776)	\$ (16,814,227)

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 2013</u>	<u>FY 2012</u>
Uniformed Services Contributions	\$8,527,547	\$11,144,771
U.S. Treasury Annual Unfunded Liability Payment	6,142,000	6,716,000
Interest on Investments	7,193,003	6,257,915
Total Intragovernmental Revenue	<u>\$21,862,550</u>	<u>\$24,118,686</u>

Uniformed Service Contributions. Uniformed Service Contributions represent the amount contributed by the U.S. 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 U.S. 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. Interest on investments represents the interest income received by the MERHCF for FYs 2013 and 2012.

The MERHCF complies with 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 standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement benefits, and other postemployment benefits on the SNC. The SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities. The DoD Office of the Actuary changed long-term inflation and salary increase assumptions to be consistent with the underlying Treasury spot rates used in the valuation.

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

There was a difference of \$8.5 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations 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.

Funds From Dedicated Collections. Effective with FY 2013 reporting, MERCHF has implemented “Statement of Federal Financial Accounting Standards (SFFAS) No. 43: *Funds from Dedicated Collections: Amending SFFAS 27, Identifying and Reporting Earmarked Funds*.” Based on this implementation, MERHCF no longer reports “Earmarked” funds as previously required by SFFAS 27. Refer to Note 16, Restatements, for additional details.

Note 12. Disclosures Related to the Statement of Budgetary Resources

The Medicare-Eligible Retiree Health Care Fund (MERHCF) reported \$8.7 billion in direct, Category B obligations. Category B obligations are apportioned funds that relate to a specific project or program.

Undelivered Orders at the End of Period.

(\$ in Thousands)	2013	2012
Net Amount of Budgetary Resources Obligated for Undelivered Orders at the End of the Period	\$ <u>81,376</u>	\$ <u>38,291</u>

Permanent, Indefinite Appropriation. 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 mission of the MERHCF, administered by the Secretary of the Treasury, is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of DoD under uniformed services health care programs for specific Medicare-eligible beneficiaries. The MERHCF accounts are “no-year” accounts. Funds may be merged with and used for the same purpose as the appropriations they are transferred to (MILPERS and O&M) in accordance with the provisions of the public law.

The Statement of Budgetary Resources (SBR) includes intra-entity transactions because the statements are presented as combined.

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 \$8.5 billion between appropriations on the Statement of Changes in Net Position (SCNP) and appropriations on the SBR. The MERHCF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with Office of Management and Budget reporting requirements.

Note 13. Reconciliation of Net Cost of Operations to Budget

(\$ in Thousands)	2013	2012
Resources Used to Finance Activities:		
Budgetary Resources Obligated—Obligations incurred	\$ 8,654,494	\$ 8,736,416
Less: Spending authority from offsetting collections/recoveries	(128,528)	0
Less: Offsetting receipts (-)	<u>(12,265,230)</u>	<u>(12,896,403)</u>
Net obligations	(3,739,264)	(4,159,987)
 Total resources used to finance activities	 <u>(3,739,264)</u>	 <u>(4,159,987)</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 (-)	(43,085)	61,921
Resources that fund expenses recognized in prior Periods (-)	<u>(30,375,045)</u>	<u>(987,580)</u>
Budgetary offsetting collections and receipts that do not affect Net Cost of Operations	<u>(58,589)</u>	<u>(77,512)</u>
 Total resources used to finance items not part of the Net Cost of Operations	 <u>(30,476,719)</u>	 <u>(1,003,171)</u>
 Total resources used to finance the Net Cost of Operations	 <u>(34,215,983)</u>	 <u>(5,163,158)</u>
Components Requiring or Generating Resources in Future Period Other (+/-)	0	0
Components not Requiring or Generating Resources		
Trust Fund Exchange Revenue	(9,538,730)	(11,144,771)
Other	<u>497,937</u>	<u>(506,298)</u>
 Total components of Net Cost of Operations that will not Require or Generate Resources in the current period	 <u>(9,040,793)</u>	 <u>(11,651,069)</u>
 Net Cost of Operations	 \$ <u>(43,256,776)</u>	 \$ <u>(16,814,227)</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.

Spending authority from offsetting collections – 10 U.S.C. Chapter 56 §1113(c) authorizes transfers back to MERHCF up to two years after end of the fiscal year of the original transfer. TMA conducts an execution review of MERHCF expenses and patient encounter data to determine the direct care MTF level of effort (LOE) for the fiscal year. The prospective payment amounts paid to each Service Medical Activity (SMA) for that fiscal year are compared to the allocated expenses and actual workload LOE calculated for the same time period. Any material excess payment amounts identified in the execution reviews are returned to the MERHCF. Returns for the FY 2011 reconciliation must be completed by September 30, 2013. The amount returned to MERHCF in Q4 FY 2013 for the FY 2011 LOE reconciliation was \$128.5M (\$125M SMA-Army, \$3.5M SMA-Air Force). No amounts were returned for the FY 2010 reconciliation (due not later than September 30, 2012) because there was no material amount for return identified in that fiscal year's reconciliation.

Components Requiring or Generating Resources in Future Period – Other displays the change in the FY 2013 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 and Other Federal Employment Benefits for additional details.

Components not Requiring or Generating Resources – Other displays the changes in accounts receivables since the beginning of both FY 2012 and FY 2013. 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 2012 and FY 2013. These bad debts occurred because erroneous payments made to MERHCF beneficiaries or to nonfederal providers of medical services were not repaid.

Note 14. Commitments and Contingencies

The SFFAS No. 5, “Accounting for Liabilities of the Federal Government,” as amended by SFFAS No. 12, “Recognition of Contingent Liabilities Arising from Litigation,” defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. 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. Examples of loss contingencies include the collectability of receivables, pending or threatened litigation, and possible claims and assessments. The MERHCF’s risk of loss and resultant contingent liabilities arise from pending or threatened litigation or claims and assessments due to events such as medical malpractice; property or environmental damages; and contract disputes.

The MERHCF is a party in legal actions related to claims for contractual bid protests. We are not aware of any contingent liabilities for legal actions. Amounts disclosed for litigation claims and assessments are fully supportable and agree with MERHCF’s legal representation letters and management summary schedule.

There is one case or claim pending with the MERHCF (and TMA CRM) that meets the MERHCF threshold guidance of an amount being claimed at or exceeding \$2.1 million or multiple cases or claims arising out of a single action, incident or factual circumstances where, in the aggregate, the amount claimed is or exceeds \$4.2 million.

Ingham Regional Medical Center v. Secretary of Defense Charles Hagel (US District Court for the District of Columbia). This class action suit was filed on behalf of every U.S. hospital that provided outpatient services to TRICARE beneficiaries between August 1, 2003, and December 31, 2009. This case is related to an earlier settlement with respect to radiology payments. In this action, plaintiffs allege that the radiology settlement was based on a flawed study conducted by Kennell and Associates (Kennell). Plaintiffs claim that Kennell originally calculated plaintiffs were due \$98 million, when in fact they were due \$215.6 million (a difference of \$117.6 million). Moreover, plaintiffs disagree with Kennell’s study that all other outpatient hospital services had been paid consistent with Medicare standards. Instead, they claim that Kennell’s calculations were incorrect for outpatient diagnostic services, laboratory services and rehabilitation services. As a result, plaintiffs claim DoD breached the agreement by accepting Kennell’s calculations and that the plaintiffs and DoD committed a mutual mistake in reaching the agreement based on those calculations. The lawsuit was voluntarily dismissed by plaintiffs, after the Department of Justice filed its brief in support of a motion to dismiss. In a claim for money damages, the jurisdiction of federal district courts is limited to a maximum of \$10,000. On October 21, 2013, Ingham Regional Medical Center filed suit in the Court of Federal Claims. The named defendant is the United States. MERHCF is unable to express an opinion concerning the likely outcome of this case at this time.

Note 15. Subsequent Events

Defense Health Agency Establishment.

A change in reporting entity for FY 2014 was made effective October 1, 2013 to establish the Defense Health Agency and disestablish the TRICARE Management Activity (TMA). TMA had as one of its missions the operational oversight of the Military Health System (MHS), including management of the MERHCF. TMA management responsibilities for MERHCF included accounting for, documenting, and projecting annual budget distribution requirements (purchased care claims, demands, and military treatment facilities (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 DoD Directive 5136.13, "Defense Health Agency," dated September 30, 2013, transfers appropriate TMA functions to the DHA. Any reference in law, rule, regulation, or issuance to TMA will be deemed to be a reference to DHA, unless otherwise specified by the Secretary of Defense. There should be no financial reporting change to the MERHCF because of the DHA establishment.

Note 16. Restatements

During FY 2013, the Medicare-Eligible Retiree Health Care Fund (MERHCF) implemented Statement of Federal Financial Accounting Standards (SFFAS) 43, *Funds from Dedicated Collections: Amending SFFAS 27, Identifying and Reporting Earmarked Funds*. SFFAS 43 provides clarifying language when classifying funds and additional reporting alternatives for financial statement presentation and note disclosure. As required by the implementation guidance of SFFAS 43, MERHCF restated its prior year financial statements. The restatement is not related to a misstatement in the FY 2012 financial statements and had no dollar value impact to any MERHCF balance; the restatement removed the "Funds from Dedicated Collections" (formerly "Earmarked Funds") attribute from all MERHCF USSGL account balances and related financial statement and footnote presentations. Refer to Note 11, Disclosures on Statement of Changes in Net Position for additional information.

Note 17. Other Disclosures

The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2013 and 2012, includes approximately \$79.8 billion (15.9% of total) and \$77.3 billion (14.5% of total), respectively, of amounts reflecting the actuarial present value of the projected direct-care costs of future benefits that will be provided in the MTFs to eligible MERHCF participants. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2013, include approximately \$2.3 billion and \$1.8 billion, respectively, and 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. 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 Information

Exhibit 1--Summary of Financial Statement Audit and Management Assurances

SEPTEMBER 30, 2013

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 2013, TMA's assessment may differ from the auditor's reported weaknesses for the current FY, which are reported as of September 2013. In its FY 2013 assessments, TMA management assessed that, except for direct care related material weaknesses, the MERCHCF 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 May 2013, 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 August 13, 2013, and the above referenced Service-related FMFIA § 4 weakness, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2013 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	Yes				
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)	✓				✓
Total Material Weaknesses	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	Re-assessed	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 Material Weaknesses	1	0	0	0	0	1

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 in Table 2 and Table 3 combines the two reported Direct Care material weaknesses identified by the independent auditor in the audit of the FY 2013 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 2013 MERHCF audit.

Exhibit 2--IPIA Reporting Details September 30, 2013

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 2013 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 1.5% 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.

The Department through TRICARE Management Activity (TMA) has contracted with an External Independent Contractor (EIC) to provide an independent, impartial review of reimbursement methodologies and claims processing procedures used by TRICARE’s purchased care contractors. The EIC manually reviews randomly-sampled medical, active duty dental and pharmacy claims documentation and re-adjudicates processed claims submitted by the purchased care contractors to detect errors. Additionally, a risk assessment by program managers is completed annually by TMA based on the evaluation of the quarterly and semi-annual claim reviews performed by the EIC or other compliance reviews.

Over the years, these audits and reviews have consistently have reported an error rate that is significantly 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 2012 results reflect an improper payment rate of 0.15%; FY 2013 results reflect an improper payment rate of 0.33%. 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 2012 ¹			FY 2013 ¹			FY 2014 Estimated			FY 2015 Estimated			FY 2016 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	\$20.5	0.33	\$67.7	\$21.2	2	\$424	\$21.9	2	\$438	\$22.7	2	\$454
1 TMA Contract improper payments and recoveries are reported 12 months in arrears to accommodate its 100 percent post-payment review.														

1. The final payment error rates for FY 2012 and FY 2013 audit results are 0.15% (\$31.3M) and 0.33% (\$67.7M) respectively, which are less than the contract performance standard of 2% (\$418M for FY 2012 and \$410M for FY 2013) used in the FY 2012 and FY 2013 AFR calculations. The error rate in FY 2014 and beyond is a conservative estimate based on the 2% contract performance standard.

2. The FY 2012 and FY 2013 reports on outlays include all benefit dollars for contracts and programs as described in the FY 2013 Improper Payment AFR Report including the TRICARE Dual Eligible Fiscal Intermediary Contract and TRICARE Pharmacy program. Fee-for-service claims are considered susceptible to improper payments as payment is made based upon an individual claim submitted by a provider or beneficiary certifying services were provided as billed. Administrative or change order costs are not included, as those costs do not fall into the definition of areas susceptible to improper payments.

3. The following Military Health System Contract/Programs are reviewed under DoD Audit and are not included in the improper payment computations for FY 2012 and FY 2013 reports on outlays:

- Designated Providers (Uniformed Services Family Health Plan (USFHP) including Pharmacy). The TMA Risk Assessment for this contract is identified as a low risk. The USFHP is a Government-contract health plan that offers the TRICARE Prime benefit to uniformed services beneficiaries, to include those individuals over age 65, residing in the geographic service areas of a USFHP-DP and eligible to receive medical and pharmacy care. The Risk Assessment is based on annual Payment Reconciliation, Price and Policy Compliance audits conducted by the Defense Contract Audit Agency (DCAA). TRICARE pays a set amount to the contractor 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 DCAA 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) and TRICARE Retiree Dental Program (TRDP). The contractor reviewed in the FY 2012 audit results (and reported in FY 2013) was MetLife while the TRDP contractor was Delta Dental of California. TMA Risk Assessment for this contract has been Low Risk. The Risk Assessment for the TDP and TRDP programs is based on annual beneficiary eligibility audits conducted by the Defense Contract Audit Agency (DCAA).
 - 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 Contiguous United States (CONUS). In Outside Contiguous United States (OCONUS) locations, the Government pays Command Sponsored enrollee's 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 charge for covered services, less applicable cost shares.

- The TRDP contract offers a worldwide dental benefit to eligible retired service members and their family members, retired National Guard or Reserve members and their family members, Medal of Honor Recipients and their families and survivors of deceased active or retired service members. Like the TDP, the TRDP is a premium-based program; OCONUS coverage is available to eligible beneficiaries under the Enhanced-Overseas TRDP; the contractor is at risk for 100% of claims payment in CONUS and OCONUS.

Independent Auditor's Opinion



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

December 9, 2013

**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 2013 Basic Financial Statements (Report No. DODIG-2014-021)**

We contracted with the independent certified public accounting firm of Kearney & Company to audit the financial statements of the DoD Medicare-Eligible Retiree Health Care Fund (MERHCF) as of September 30, 2013, and 2012, and for the years 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, it was unable to obtain sufficient, competent evidence that DoD-managed Military Treatment Facilities had compliant, transaction-based accounting systems to support the costs of direct care provided. 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, 2013, and 2012, 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 also 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 December 9, 2013, 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 cursive script that reads "Lorin T. Venable".

Lorin T. Venable, CPA
Assistant Inspector General
Financial Management and Reporting

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

Report on the Financial Statements

We have audited the accompanying financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), which comprise the balance sheets as of September 30, 2013 and 2012, the related statements of net cost and changes in net position, and the statements of budgetary resources (hereinafter referred to as the "financial statements") for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America. This includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. 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. 14-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness

of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified 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 17 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2013 and 2012 includes approximately \$79.8B (15.9% of the total) and \$77.3B (14.5% of the total), respectively, of amounts reflecting the actuarial present value of the projected direct care costs of MTF-provided benefits to eligible participants in MERHCF. Additionally, the reported amounts of program revenues and costs related to direct care were approximately \$2.3B and \$1.8B, respectively, for the year ended September 30, 2013, and approximately \$2.7B and \$1.7B, respectively, for the year ended September 30, 2012.

Such MTF-related amounts of direct care costs are estimated by MERHCF's actuaries using data extracted from various service-specific financial, personnel, and workload systems within the DoD. With respect to the extracted data, the MTFs do not currently maintain compliant, transaction-based accounting systems. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, 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 audit procedures.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section above, the financial statements referred to above present fairly, in all material respects, the financial position of MERHCF as of September 30, 2013 and 2012, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

As discussed in Notes 1 and Note 16 to the financial statements, MERHCF has restated its financial statements as of September 30, 2012 to comply with Statement of Federal Financial Accounting Standards (SFFAS) No. 43, *Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked*

Funds, reporting requirements. Our opinion is not modified with respect to this matter. The change in accounting principle provides clarifying language in classifying funds from dedicated collections (formerly “earmarked funds”) and reporting alternatives for financial statement presentation.

Other Reporting Responsibilities

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management’s Discussion and Analysis (hereinafter referred to as the “required supplementary information”) be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by OMB and the Federal Accounting Standards Advisory Board (FASAB), who consider it to be an essential part of financial reporting for placing the 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 it for consistency with management’s responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the 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.

Other Information

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The Summary of Financial Statement Audit and Management Assurances, and Improper Payments Information Act Reporting as of September 30, 2013 are presented for the purpose of additional analysis and are not required parts of the financial statements. Such information was not subject to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Independent Auditor’s Report on Internal Control over Financial Reporting and Compliance with Applicable Provisions of Laws, Regulations, Contracts, and Grant Agreements

In accordance with *Government Auditing Standards* and OMB Bulletin No. 14-02, we have also issued a report, dated December 9, 2013, 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, contracts and grant agreements; and other matters for the year ended September 30, 2013. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance and other matters. That report is an integral part of an audit performed in accordance with *Government Auditing*



Standards and OMB Bulletin No. 14-02, and in considering MERHCF's internal control over financial reporting and compliance.

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

Alexandria, Virginia
December 9, 2013

**INDEPENDENT AUDITOR’S REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND COMPLIANCE WITH APPLICABLE PROVISIONS
OF LAWS, REGULATIONS, CONTRACTS, AND GRANT AGREEMENTS**

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 financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), which comprise the balance sheet as of September 30, 2013, the related statements of net cost and changes in net position, and the statement of budgetary resources for the year then ended (hereinafter referred to as the “financial statements”), and have issued our report thereon dated December 9, 2013. 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. 14-02, *Audit Requirements for Federal Financial Statements*.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered MERHCF’s internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of MERHCF’s internal control. Accordingly, we do not express an opinion on the effectiveness of MERHCF’s internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 14-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers’ Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies; therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying Schedule of Findings, 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 deficiencies described in the accompanying Schedule of Findings to be material weaknesses.

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

We noted certain additional matters involving internal control over financial reporting that we will report to MERHCF's management in a separate letter.

Compliance with Applicable Provisions of Laws, Regulations, Contracts, and Grant Agreements

As part of obtaining reasonable assurance about whether MERHCF's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 14-02, including the provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions and did not test compliance with all laws, regulations, contracts and grant agreements applicable to MERHCF. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests, exclusive of those referred to in the FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, or OMB Bulletin No. 14-02.

The results of our tests of compliance with FFMIA disclosed that MERHCF's financial management systems did not substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, or application of the United States Standard General Ledger (USSGL) at the transaction level, as described in the accompanying Schedule of Findings.

MERHCF's Response to Findings

MERHCF's management has provided its response to our findings in the Management's Discussion and Analysis section of the Agency Financial Report. MERHCF's response was not subjected to the auditing procedures applied in our audit of the financial statements and accordingly, we do not express an opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of

the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin 14-02 in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Alexandria, Virginia
December 9, 2013

Schedule of Findings

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 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, 2013, includes approximately \$79.8B (15.9% 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, 2013 include approximately \$2.3B and \$1.8B, respectively, of amounts related to direct care.

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 (SFIS). Although activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, 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.

As a result, 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 accounting principles generally accepted in the United States of America.

Kearney & Company, P.C. (Kearney) was unable to determine the impact of this finding, as the MTFs do not currently have compliant, transaction-based accounting systems; therefore, they do

not apply common and consistent business rules in the manner envisioned by DoD's planned SFIS.

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 has not been audited. The MTF-level data is based on budget execution processes rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the MTF level. During fiscal year (FY) 2013, MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of data required for its financial reporting and actuarial valuation processes.

We noted that MERHCF performs annual retrospective reconciliation reviews of MTF level-of-effort data to compare 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 to determine prospective budgetary requirements to support the MTFs' operations, as required by the DoD Instructions.

Kearney was unable to determine the effect of this finding, as the MTF-level data is based on budget execution processes rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cut-off of accounting activity occurs at the MTF level.

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 effort.

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 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 non-financial systems that support the Military Health System's (MHS) operations, such as the "systems of record" for MERHCF, that are 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 and procedures mentioned above among the Office of the Chief Actuary, Defense Health Agency, DoD Office of Health Affairs, and Defense Finance and Accounting Service
- Design, test, and implement reconciliation processes to ensure 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.

Noncompliance and Other Matters

I. FFMIA Noncompliance

Federal Financial Management Systems 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. This includes the requirement for financial statements to be prepared in accordance with the form and content rules prescribed by OMB, reporting requirements prescribed by the Department of the Treasury, and the requirement to monitor the financial management system to ensure the integrity of 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:

- Provide reliable and timely financial information for managing current operations

- Prepare financial statements and other required financial and budget reports using information generated by the financial management systems
- Account for assets reliably so they can be properly protected from loss, misappropriation, and/or destruction
- Execute 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.

Recommendation:

Please see the recommendations associated with material weaknesses numbers I and II.