FISCAL YEAR 2009

MILITARY RETIREMENT FUND

AUDITED FINANCIAL STATEMENTS

November 6, 2009

DOD
MILITARY RETIREMENT FUND
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DOD MILITARY RETIREMENT FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

For the Years Ended September 30, 2009 and 2008

Description of the Reporting Entity

The reporting entity is the Department of Defense (DOD) Military Retirement Fund (MRF or the Fund). The military retirement system provides benefits for retirement from active duty and from the reserves, disability retirement benefits, and optional survivor coverage. The mission of the MRF is to accumulate funds in order to finance on an actuarially sound basis the liabilities of the DOD under military retirement and survivor benefit programs.

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

The Fund was established by Public Law 98-94 (currently Chapter 74 of Title 10, U.S.C.). This law also established an independent three-member the DOD Retirement Board of Actuaries (the Board) appointed by the President. Public Law 110-181 eliminated the Retirement Board and the Education Benefits Board, and created a new single DOD Board of Actuaries appointed by the Secretary of Defense. Board duties with respect to the Retirement and Education Benefits Funds are the same, and the new law expands the Board's responsibilities to include oversight of any other Fund the Secretary of Defense deems necessary. The Board is required to review valuations of the military retirement system to determine the method of amortizing unfunded liabilities, 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 provides all technical and administrative support to the Board.

In Fiscal Year (FY) 2009, the Fund paid out approximately $50 billion in benefits to military retirees and survivors. In FY 2008, the Fund paid out approximately $46 billion in benefits to military retirees and survivors. In addition to staff members of the OUSD (C) and the OUSD (P&R), hundreds of individuals at the DFAS Pay Centers are involved in making the benefit payments. However, the discrete administrative costs of supporting the Fund's activities are not determinable and are therefore not reflected in the Fund's financial statements.

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt per Public Law 108-136; and investment income. During FY 2009, the Fund received approximately $18 billion in normal cost payments, a $55 billion Treasury payment, and approximately $3 billion in investment income, net of premium/discount amortization and accrued inflation compensation. During FY 2008, the Fund received approximately $16 billion in normal cost payments, a $49 billion Treasury payment, and approximately $16 billion in investment income, net of premium/discount amortization and accrued inflation compensation.

Summary

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Homeland Security), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and

Atmospheric Administration (administered by the Department of Commerce). Only those members in plans administered by the DOD are included in this report, except in cases where Coast Guard data is shown for informational purposes.

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

There are three distinct non-disability benefit formulas related to three populations within the military retirement system. 1) Final Pay: Military personnel who first became members of a uniformed service before September 8, 1980, have retired pay equal to final basic pay times a multiplier. The multiplier is equal to 2.5 percent times years of service. 2) High-3: If the retiree first became a member of a uniformed service on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of final basic pay. 3) Career Status Bonus (CSB)/Redux: Members who first became a member of a uniformed service on or after August 1, 1986, may choose between a High-3 and CSB/Redux retirement. Those who elect CSB/Redux receive the CSB outlined below, also have retired pay computed on a base of the average of their highest 36 months of basic pay, but are subject to a multiplier penalty if they retire with less than 30 years of service; however, at age 62, their retired pay is recomputed without the penalty. Members make their election during the fifteenth year of service and may receive the CSB of $30,000 in either a lump-sum or installments. Those who elect CSB/Redux must remain continuously on active duty until they complete 20 years of active duty service or forfeit a portion of the $30,000.

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

Non-Disability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to the Service Secretary approval. The military retiree receives immediate retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of a uniformed service before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5 percent) times (years of service, rounded down to the nearest month). Members first entering a uniformed service on or after August 1, 1986, who elect CSB/Redux and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40 percent (50 percent minus 10 percent). At age 62, the retired pay is recomputed with the penalty removed.

As of September 30, 2009, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2009, non-disability retirees were paid approximately $39.95 billion. Included in this number are 13,011 non-disabled retirees who elected CSB/Redux. As of September 30, 2008, there were approximately 1.47 million non-disability retirees from active duty receiving retired pay. In FY 2008, non-disability retirees were paid approximately $37.17 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the disability is not the result of the member's intentional misconduct or willful neglect, was not incurred during a period of unauthorized absence, and either: (1) the member has at least 20 years of service; or (2) at the time of determination, the disability is at least 30 percent (under a standard schedule of rating disabilities by the Veterans Administration) and one of three additional conditions are met:

- *1st additional condition*. If the disability was incurred:

  (a) prior to January 28, 2008, it must have been incurred after the member had eight 8 years of active service; or

  (b) between January 28, 2008 and October 13, 2008, it must have been incurred after the member had six months or more of active military service and the disability must not have been noted at the time of the member's entrance on active duty (unless compelling evidence or medical judgment is such to warrant a finding that the disability existed before the member's entrance on active duty); or

  (c) effective October 14, 2008, it must have been incurred after the member's entrance on active duty and the disability must not have been noted at the time of the member's entrance on active duty (unless clear and unmistakable evidence demonstrates that the disability existed before the member's entrance on active duty and was not aggravated by active military service).

- *2nd additional condition*. The disability results from active duty.

- *3rd additional condition*. The disability occurred in the line of duty during a time of war or national emergency or after September 14, 1978.

In disability retirement, the member may elect to receive retired pay equal to either (1) the accrued non-disability retirement benefit regardless of eligibility to retire or (2) base pay multiplied by the rated percent of disability (where the disability rating cannot exceed 75 percent). Only the excess of (1) over (2) is subject to federal income taxes if the member had service on or before September 24, 1975. If not a member of a uniformed service on September 24, 1975, disability retired pay is tax-exempt only for those disabilities that are combat or hazardous duty related. Base pay is equal to final basic pay if the retiree first became a member of a uniformed service before September 8, 1980; otherwise, base pay is equal to the average of the highest 36 months of basic pay.

Members whose disabilities may not be permanent are placed on a temporary-disability retired list and receive disability retirement pay just as if they were permanently disabled. However, they must be physically examined every 18 months for any change in disability. A final determination must be made within five years. The temporary disability pay is calculated like the permanent disability retired pay, except that it can be no less than 50 percent of base pay.

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

As of September 30, 2009, there were approximately 91,000 disability retirees receiving retired pay. In FY 2009, disability retirees were paid approximately $1.39 billion. Included in this number are 258 disabled retirees who elected CSB/Redux. As of September 30, 2008, there were approximately 85,000 disability retirees receiving retired pay. In FY 2008, disability retirees were paid approximately $1.28 billion.

Reserve Retirement

Members of the reserves may retire after 20 qualifying years of creditable service. However, reserve retired pay is not payable until age 60 unless the member performs certain types of active duty or active service specified in the National Defense Authorization Act for FY 2008 (P.L. 110-181), in which case the age is reduced below 60 by three months for every 90 days of such service within a fiscal year. However, the age cannot go below 50, and eligibility for retiree health benefits remains at age 60 even if the eligibility age for retired pay is reduced. Retired pay is computed as base pay times 2.5 percent times years of service. If the reservist was first a member of a uniformed service before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the armed services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the highest 36 months computed as if he/she was on active duty for the entire period preceding retired pay commencement. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, one point is awarded for one day of active duty service (e.g. active duty training) or one inactive duty training (IDT) drill attendance. Reservists may perform two IDT periods in one day thereby receiving two retirement points per day. In addition, 15 points are awarded for completion of one year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member generally cannot retire with less than 20 creditable years, although points earned in non-creditable years are used in the retirement calculation. Beginning with years of service that include October 30, 2007, non-active duty points are limited in any year to no more than 130. Lesser limitations have applied in the past.

As of September 30, 2009, there were approximately 341,000 reserve retirees receiving retired pay. In FY 2009, reserve retirees were paid approximately $4.75 billion. As of September 30, 2008, there were approximately 327,000 reserve retirees receiving retired pay. In FY 2008, reserve retirees were paid approximately $4.29 billion.

Survivor Benefits

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

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

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

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

When the plan started in 1972, benefits for those 62 and older were reduced by the constructed amount of Social Security for which the survivor would be eligible based on the member's military pay. In 1985, that reduction formula was changed so all annuitants 62 and over received a reduced flat rate of 35 percent of the member's base. Beginning October 1, 2005, the age 62 reduced rate was phased out in 5 percent

increments. On April 1, 2008, the survivor benefit reduction at age 62 was fully eliminated and the rate of 55 percent of the member's elected base became standard for all survivors, regardless of age.

During FY 1987, the SBP program's treatment of survivor remarriages changed. Prior to the change, a surviving spouse remarrying before age 60 had the survivor annuity suspended. The change lowered the age to 55. If the remarriage ends in divorce or death, the annuity is reinstated.

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

The surviving spouse (or dependent children if there is no surviving spouse or the spouse subsequently dies) of a reservist with fewer than 20 qualifying years of service who dies while performing inactive duty is entitled to a survivor annuity under the Reserve Component Survivor Benefit Program (RCSBP).

SBP annuities are reduced by any Department of Veterans Affairs (VA) survivor benefits (Dependency and Indemnity Compensation (DIC)) and all premiums relating to the reductions are returned to the survivor. The 2008 National Defense Authorization Act enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary Special Survivor Indemnity Allowance (SSIA) that pays a monthly amount ($50 in FY 2009 grading up to $310 in FY 2017) to survivors with a DIC offset. The authority for the allowance ends in 2017. As with retired pay, SBP annuities and premiums are annually increased with cost-of-living adjustments (COLAs). These COLAs are either full or partial CPI increases, depending on the benefit formula covering the member. If a member who elected the CSB dies before age 62, the survivor is subject to partial COLAs and his/her annuity is increased on what would have been the member's 62nd birthday to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. The RCSBP provides annuities to survivors of reservists who die before age 60, provided they attained 20 years of qualified service. The added cost of this coverage is borne completely by reservists through deductions from future retired pay and/or survivor annuities.

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

In the August 26, 2009, Sharp v. United States (82 Fed. Cl. 222 (2008)) U.S. Court of Appeals decision, three SBP widows who remarried after age 57 were granted permission to receive SBP payments unreduced by the amount of their DIC payments. The Veterans Benefits Act of 2003 restored DIC benefits to surviving spouses who choose to remarry after age 57 (Public Law 108-183, Section 101, effective January 1, 2004). Future action by the DOD is currently being assessed.

As of September 30, 2009, there were approximately 291,000 survivors of military members receiving annuity payments. In FY 2009, survivors were paid approximately $3.58 billion. There are 54,000 SSIA beneficiaries who received approximately $35 million (of those, 31,000 beneficiaries, receiving approximately $20 million, have their survivor pay fully offset by DIC, and are not included in the 291,000 survivors). As of September 30, 2008, there were approximately 289,000 survivors of military members receiving annuity payments. In FY 2008, survivors were paid approximately $3.37 billion.

Temporary Early Retirement Authority (TERA)

The National Defense Authorization Act for FY 1993 (P.L. 102-484) granted temporary authority for the military services to offer early retirements to members with more than 15 but less than 20 years of service. This authority expired on September 1, 2002. The retired pay was calculated in the usual way except that there was a reduction of 1 percent for every year below 20 years of service. Part or all of this reduction can

be restored at age 62 if the retired member works in a qualified public service job during the period from the date of retirement to the date on which the retiree would have completed 20 years of service. Unlike members who leave military service before 20 years with Voluntary Separation Incentives or Special Separation Benefits, these early retirees are generally treated like regular military retirees for the purposes of other retirement benefits.

As of September 30, 2009, there were approximately 57,000 TERA retirees receiving retired pay. In FY 2009, TERA retirees were paid approximately $897 million. As of September 30, 2008, there were approximately 56,000 TERA retirees receiving retired pay. In FY 2008, TERA retirees were paid approximately $839 million.

Cost-of-Living Increase

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

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

The benefits of retirees (and their survivors) are increased annually with the full COLA, except for those first entering the armed services on or after August 1, 1986, who elect the $30,000 CSB. Their benefits are increased annually with a partial COLA equal to the full COLA minus 1 percent (except if the full COLA is less than or equal to 1%). A one-time restoral is given to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, retired pay (or the survivor benefit if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with Department of Veterans Affairs Benefits

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

VA benefits also overlap survivor benefits through the DIC program. DIC is payable to survivors of veterans who die from Service-connected causes. Although an SBP annuity must be reduced by the

amount of any DIC benefit, all SBP premiums relating to the reduction in benefits are returned to the survivor. The 2008 National Defense Authorization Act enacted, and the Family Smoking Prevention and Tobacco Control Act of 2009 (P.L. 111-31) revised, a temporary SSIA that pays a monthly amount ($50 in FY 2009, $60 in FY 2010, $70 in FY 2011, $80 in FY 2012, $90 in FY 2013, $150 in FY 2014, $200 in FY 2015, $275 in FY 2016, and $310 in FY 2017) to survivors with a DIC offset; the authority for the allowance ends in 2017.

In the August 26, 2009, Sharp v. United States (82 Fed. Cl. 222 (2008)) U.S. Court of Appeals decision, three SBP widows who remarried after age 57 were granted permission to receive SBP payments unreduced by the amount of their DIC payments. The Veterans Benefits Act of 2003, restored DIC benefits to surviving spouses who chose to remarry after age 57 (Public Law 108-183, Section 101, effective January 1, 2004). Future action by the DOD is currently being assessed.

Interrelationship with Other Federal Service

For military retirement purposes, no credit is given for other federal service, except for TERA and where cross-service transferability is allowed. Military service is generally creditable toward the federal civilian retirement systems if military retired pay is waived. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees). Military retirees may qualify separately for Civil Service retirement and receive concurrent pay from both systems.

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which non-disability retired pay is based and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative, for comparative purposes, of salary levels in the public and private sectors. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) the housing allowance, which varies by grade, location, and dependency status, (3) the subsistence allowance and, (4) the tax advantages accruing to allowances because they are not subject to federal income tax. Basic pay represents approximately 68 percent of RMC for all retirement eligible members. For the 20-year retiree, basic pay is approximately 66 percent of RMC. Consequently, a member retired with 20-years of service and entitled to 50 percent of basic pay, would only receive 33 percent of RMC. For a 30-year retiree, basic pay is approximately 73 percent of RMC and such member would be entitled to 75% of basic pay or 55 percent of RMC. Public Law 109-364 allows members, retired since January 1, 2007, with greater than 30 years of service, to retire with entitlements exceeding 75 percent of basic pay. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

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

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

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

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

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

Significant Changes During FY 2009 And FY 2008

Changes during FY 2009 included the following assumption changes: (1) lowering of the CSB Take Rate election assumption from 25% to 15%, (2) updates to various rates and factors used to project permanently disabled retired pay, and (3) updates to various rates and factors used to project SBP pay. Of these, the lower CSB election assumption was the most significant. The DOD Board of Actuaries approved these new assumptions at their August 2009 meeting.

There were no legislative benefit changes during FY 2009 which impacted the valuation.

Changes during FY 2008 included: (1) Board adoption of a new long-term interest assumption of 5.75%, down from 6%, (2) updated rates and factors used to project non-disability retired pay, which results in a better allocation of full- and part-time costs, (3) an updated mortality improvement trend used to project increasing life expectancies, (4) early reserve retirement, (5) expansion of Concurrent Receipt benefits, and (6) additional monthly allowance for those annuitants subject to DIC offset. Items (1) – (3) are classified as assumption changes and items (4) – (6) are benefit changes. Of these, the lower interest rate (item 1) was the most significant. The DOD Board of Actuaries approved these assumptions at their August 2008 meeting.

Changes for FY 2010

The possible benefit changes with respect to the MRF for FY 2010 include: (1) "Wounded Warrior" bills targeting refinements to the disability retirement systems, (2) SBP/DIC enhancements, (3) Concurrent Receipt enhancements, and (4) enhancements to general retired pay.

Performance Measures

During FY 2009 and 2008, the Fund made monthly disbursements to approximately 2.2 million retirees and annuitants each year.

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for annuitants on the roll is commonly used. Following are the ratios for the last ten years:

a. September 30, 2009 = .380
b. September 30, 2008 = .354
c. September 30, 2007 = .343
d. September 30, 2006 = .328
e. September 30, 2005 = .334
f. September 30, 2004 = .338
g. September 30, 2003 = .351

h. September 30, 2002 = .378
i. September 30, 2001 = .347
j. September 30, 2000 = .354

The effective yield of the Fund during FY 2009 was approximately 1.0%.

Projected Long-Term Health of the Fund

The projected long-term health of the Fund is good due to the fact that it has three different sources of funding. The first two are appropriated funds—one is annual payments from Treasury to amortize the unfunded liability and pay the normal cost of the concurrent receipt benefits, and one is monthly normal cost payments from the Services to pay for the current year's service cost. Both of these can be considered secure sources of funding backed by the "full faith and credit" of the U.S. Government. The investment portion will most likely be an increasing contribution to the Fund as the return on investments increases due to an increasing Fund balance.

Basic pay for FY 2009 was projected to be $56.2 billion. Normal cost payments were projected to be $19.7 billion. The unfunded liability amortization payment was projected to be $51.1 billion. Investment income was projected to be $17.3 billion. Fund disbursements for FY 2009 were projected to be $48.6 billion. Actual amounts for FY 2009 were $50.3 billion. The table below presents a projection of contributions to and disbursements from the Fund. It includes the dollar amounts as a percent of payroll. The Fund is projected to remain solvent over the 20-year projection period.

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

Fiscal Year	Basic Payroll	Normal Cost Payments		Amortization of Unfunded Liability		Investment Income		Fund Disbursements		Fund Balance End of Year	
2010	$58.9	$23.0	(0.390)	$58.6	(0.995)	$19.4	(0.329)	$50.4	(0.856)	$341.9	(5.805)
2011	$59.8	$23.4	(0.391)	$60.8	(1.017)	$22.5	(0.376)	$50.8	(0.849)	$397.7	(6.651)
2012	$61.3	$23.9	(0.390)	$63.1	(1.029)	$25.8	(0.421)	$51.1	(0.834)	$459.5	(7.496)
2013	$62.8	$24.5	(0.390)	$65.5	(1.043)	$29.5	(0.470)	$52.3	(0.833)	$526.7	(8.387)
2014	$64.5	$25.2	(0.391)	$67.9	(1.053)	$33.5	(0.519)	$53.8	(0.834)	$599.6	(9.296)
2015	$66.2	$25.9	(0.391)	$70.5	(1.065)	$37.8	(0.571)	$55.1	(0.832)	$678.6	(10.251)
2016	$68.0	$26.5	(0.390)	$73.1	(1.075)	$42.5	(0.625)	$56.5	(0.831)	$764.3	(11.240)
2017	$69.9	$27.3	(0.391)	$75.9	(1.086)	$47.6	(0.681)	$57.9	(0.828)	$857.0	(12.260)
2018	$71.7	$28.0	(0.391)	$78.7	(1.098)	$53.0	(0.739)	$59.6	(0.831)	$957.2	(13.350)
2019	$74.2	$28.9	(0.389)	$81.6	(1.100)	$58.9	(0.794)	$61.6	(0.830)	$1,065.1	(14.354)
2020	$76.8	$29.9	(0.389)	$84.7	(1.103)	$65.3	(0.850)	$63.7	(0.829)	$1,181.3	(15.382)
2021	$79.4	$31.0	(0.390)	$87.9	(1.107)	$72.1	(0.908)	$65.9	(0.830)	$1,306.3	(16.452)
2022	$82.1	$32.0	(0.390)	$91.2	(1.111)	$79.5	(0.968)	$68.2	(0.831)	$1,440.9	(17.551)
2023	$84.9	$33.1	(0.390)	$94.6	(1.114)	$87.4	(1.029)	$70.5	(0.830)	$1,585.5	(18.675)
2024	$87.8	$34.2	(0.390)	$98.1	(1.117)	$95.9	(1.092)	$72.9	(0.830)	$1,740.8	(19.827)
2025	$90.7	$35.4	(0.390)	$101.8	(1.122)	$105.0	(1.158)	$75.4	(0.831)	$1,907.5	(21.031)
2026	$93.9	$36.6	(0.390)	$130.9	(1.394)	$116.2	(1.237)	$77.9	(0.830)	$2,113.4	(22.507)
2027	$97.3	$37.9	(0.390)	$11.0	(0.113)	$121.1	(1.245)	$80.3	(0.825)	$2,203.1	(22.642)
2028	$100.8	$39.3	(0.390)	$11.4	(0.113)	$126.3	(1.253)	$83.1	(0.824)	$2,296.9	(22.787)
2029	$104.5	$40.7	(0.389)	$11.8	(0.113)	$131.7	(1.260)	$86.0	(0.823)	$2,395.1	(22.920)

NOTE: The above projections assume a long-term 5.75% interest rate each year. The projections will vary in the short-term depending on the actual economic experience.

Expected Problems

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

Type of Investments

The Fund receives income from three sources: monthly normal cost payments from the Services to pay for the current year's service cost; annual payments from Treasury to amortize the unfunded liability and pay for the increase in the normal cost attributable to Concurrent Receipt; and investment income.

The Fund receives investment income from a variety of Treasury-based instruments such as bills, notes, bonds and overnight investment certificates. Treasury bills are short-term securities with maturities of less than one year issued at a discount. Treasury notes are intermediate securities with maturities of one to ten years. Treasury bonds are long-term debt instruments with maturities of greater than ten years. Overnight certificates are interest-based market securities purchased from the Treasury that mature the next business

day and accrue interest based on the Federal Reserve Bank of New York survey of Reserve repurchase agreement rates.

The Fund also invests in 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 CPI by adjusting the CPI at issuance to the current CPI; as inflation increases, so does the principal amount and the coupon.

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

The Fund receives management oversight from the DOD Investment Board established in September 2003. The members of the Investment Board are the Director, DFAS, the Deputy Chief Financial Officer, OUSD (C) and a senior military member, currently the Vice Chief of Naval Operations. The Investment Board meets twice each fiscal year to consider investment objectives, policies, performance and strategies with the goal of maximizing the Fund's investment income. The Board reviews the Fund's Law and Department of Treasury guidelines to ensure that the Fund complies with broad policy guidance and public law. At the September 30, 2008 meeting, the Investment Board approved a revised Investment Strategy that replaced the duration matching strategy with a ladder approach for investments and reiterated the "hold to maturity" policy.

Anticipated Changes Between the Expected and Actual Investment Rate of Return

The recent volatility in interest rates, the volatility in equity markets, the increasing deficit, the volatility in the markets with regard to energy prices, the state of international conflict, and the economic downturn indicate that there might be strong U.S. fiscal control and monetary policy in the future. This would necessitate increased borrowing by the U.S. Government for the foreseeable future and there may therefore be a greater opportunity to purchase treasury market securities at higher rates of interest. Conversely, uneasy equity markets tend to push participants toward government securities causing downward pressure on the interest rates. Modern corporate financial theory also suggests that non-federal government firms may tend to increase pension plan investments in government securities. It is unknown where the equilibrium will settle. An investment strategy has been developed to shift toward TIPS to hedge against any future inflation to increase the profitability of the Fund over time.

Recent TIPS performance cannot be measured by analyzing each individual year in isolation. Excessive inflation, due to soaring energy costs in FY 2008, led to higher than anticipated investment income.

A correction was expected in FY 2009, but the extreme economic volatility lead to an equally opposing correction on the low end. It is suspected that the energy market has entered a less volatile regime, which will ultimately lead to a stabilization of the TIPS investment income.

The purpose of holding TIPS is to hedge against annual retiree COLAs. A zero COLA is expected for FY 2010 for which the hedge, TIPS, show little investment income for FY 2009. This is analogous to the 5.8% COLA seen in FY 2009 for which the hedge, TIPS, produced an all-time high investment income and the highest since FY 2001.

Financial Data

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

Military Retirement Fund

Analysis of Financial Statements
For the Years Ended September 30, 2009 and 2008
($ in Thousands)

Statements of Net Assets	**2009**	**2008**	**Difference** Increase/(Decrease)
Fund Balance with Treasury - Sufficiency of funds available to cover estimated disbursements	$20,488	$17,515	$2,973 17%
Investments - Revenue from Treasury Payments Service Contribution, and Interest	$278,346,954	$253,046,615	$25,300,339 10%
Account Receivable, Net amounts, including both inter- and intra-governmental - Continued emphasis placed on collecting these amounts	$31,897	$24,513	$7,384 30%
Other Liabilities - Custodial Liability due to Treasury	$1,714	$1,622	$92 6%
Military Retirement Benefit Liabilities - Updated non-disability rates and factors	$1,177,154,851	$1,154,108,091	$23,046,760 2%
Cumulative Results of Operations - Difference is the increase of the total liability over total assets, of which Actuarial Liability increased by $125.3 billion and total assets increased by $34.8 billion.	($898,757,412)	($901,021,262)	$2,263,850 0.25%
Statements of Net Costs Gross Cost of Operations - Higher Actuarial Liability in FY 08 due to the lowering of the long-term interest rate	$73,003,916	$171,077,638	-$98,073,722 -57%
Statements of Budgetary Resources Distributed Offsetting Receipts - Unfunded liability amortization payment (FY 08) from Treasury	$51,125,000	$46,187,000	$4,938,000 11%

Management Assurances

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of The MRF Management Discussion and Analysis, the DOD, and not the MRF, represents the legislative definition of an Agency. Beginning with fiscal year 2006, as directed in Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, Appendix A, *Internal Control over Financial Reporting*, the 24 CFO Act agencies (including the 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 assurance statement. The OUSD (C) issued

guidelines to the Heads of DOD Components, including the MRF, as to how to support this DOD reporting requirement. The MRF management complied with the required guidelines for the MRF.

In its FY 2009 assessments, the MRF management assessed that the MRF (as an OMB-designated Financial Statement Reporting Entity (FSRE)) has effective internal controls to support effective and efficient programmatic operations and reliable financial reporting. In FY 2009, the MRF management implemented corrective actions to become substantially compliant with applicable laws and regulations (FMFIA § 2). Although the current financial management systems conform to financial systems requirements as of year end, the system that was in place for the majority of the year was non-compliant (FMFIA § 4).

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

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

The DOD's risk assessments for military retirement addressed the effectiveness of internal controls in place to prevent improper payments (such as prepayment reviews) as well as system weaknesses identified internally or by outside audit activities. While the DOD's improper payment percentages are extremely low, numerous pre- and post-payment controls further minimize and eliminate improper payments. The DOD uses random sampling methods designed to meet or exceed the OMB requirement of annual estimates of improper payments with a 90% confidence interval (plus or minus 2.5%).

Payments to deceased retirees continue to be the highest risk for improper payments in military retired pay. Based on FY 2008 reviews, the DOD projected approximately $44 million in improper payments for this program, with almost the entire amount paid to deceased retirees. This represents an overpayment rate of 0.12% of the estimated $36 billion in annual military retirement payments. In certain situations, payment to deceased retirees is unavoidable due to payment cycle dates and the fact that notifying a payroll activity is not likely to be the first action for next-of-kin at the time of a retiree's passing. A review of confirmed payments to deceased retirees in FY 2008 indicated that the DOD recovered 96% of the overpayment amounts within 60 days, demonstrating the effectiveness of controls within the retired pay system once a retiree's death confirmation is received and processed for final disposition.

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

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

The DOD has the information and infrastructure needed to reduce improper payments. The DOD also is implementing a Business Activity Monitoring service which will employ the latest technology to increase the efficiency and effectiveness of improper payment detection efforts for commercial pay.

MRF faces statutory or regulatory barriers limiting corrective actions. The barriers include: (1) the Retired and Annuitant Pay service contract and (2) the Federal Acquisition Regulation.

In January 2002, the DFAS awarded the Retired and Annuitant Pay service operations to a contractor. Although most functions remained unchanged from when the Government performed these functions, there are now contractual limits to the Government's involvement in the day-to-day operations of Retired and Annuitant Pay. The Continuing Government Activity Office was formed to oversee this contract; however, the Government can no longer direct how the work is accomplished. To bring about an operational change, both the Government and the contractor must agree on how to effect and fund the change. The Federal Acquisition Regulation requires a contract modification for any scope change to the current contract.

The DOD conducts monthly random reviews of the confirmed deceased accounts. The sampling methodology for the population subset that includes those payments for members who are not deceased, but are in an active retiree/annuitant status, have not been subjected to statistical sampling. While it is believed the greatest risk for improper payments is associated with the deceased accounts, the active retiree/annuitant payments represent a significant amount of monthly payments and errors in these payments are possible. The approach to the sampling methodology and testing for active retiree/annuitants accounts is being reviewed to ensure full compliance with the intent of IPIA.

Limitations of the Financial Statements

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

DOD
MILITARY RETIREMENT
FUND

PRINCIPAL STATEMENTS

Department of Defense
Military Retirement Fund
BALANCE SHEETS
September 30, 2009 and 2008
(In Thousands)

		2009		2008
ASSETS				
Intra-governmental:				
Fund Balance with Treasury (Notes 2 & 3)	$	20,488	$	17,515
Investments (Note 4)		278,346,954		253,046,615
Accounts Receivable, Net (Note 5)		0		0
Total Intra-governmental Assets	$	278,367,442	$	253,064,130
Accounts Receivable, Net (Note 5)		31,897		24,513
TOTAL ASSETS	$	278,399,339	$	253,088,643
LIABILITIES				
Intra-governmental:				
Accounts Payable	$	0	$	0
Other Liabilities (Notes 6 & 7)		1,714		1,622
Total Intra-governmental Liabilities	$	1,714	$	1,622
Military Retirement Benefit Liabilities (Note 9)	$	1,177,154,851	$	1,154,108,091
Other Liabilities (Notes 6 & 7)		186		192
TOTAL LIABILITIES	$	1,177,156,751	$	1,154,109,905
NET POSITION				
Cumulative Results of Operations - Earmarked Funds	$	(898,757,412)	$	(901,021,262)
TOTAL NET POSITION	$	(898,757,412)	$	(901,021,262)
TOTAL LIABILITIES AND NET POSITION	$	278,399,339	$	253,088,643

The accompanying notes are an integral part of these statements.

Department of Defense
Military Retirement Fund
STATEMENTS OF NET COST
For the Years Ended September 30, 2009 and 2008
(In Thousands)

		2009		2008
PROGRAM COSTS				
Gross Costs (Note 10)	$	73,003,916	$	171,077,638
Less: Earned Revenue (Note 10)		(75,267,766)		(80,659,528)
Net Program Costs	$	(2,263,850)	$	90,418,110
NET COST OF OPERATIONS	$	(2,263,850)	$	90,418,110

The accompanying notes are an integral part of these statements.

Department of Defense
Military Retirement Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2009 and 2008
(In Thousands)

		2009		2008
CUMULATIVE RESULTS OF OPERATIONS				
Beginning Balances	$	(901,021,262)	$	(810,603,152)
Net Cost of Operations (+/-)		(2,263,850)		90,418,110
Net Change	$	2,263,850	$	(90,418,110)
Cumulative Results of Operations	$	(898,757,412)	$	(901,021,262)
Net Position (Note 12)	$	(898,757,412)	$	(901,021,262)

The accompanying notes are an integral part of these statements.

Department of Defense
Military Retirement Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2009 and 2008
(In Thousands)

		2009		2008
Budgetary Resources (Note 13)				
Unobligated Balance, brought forward, October 1	$	0	$	0
Budget Authority:				
Appropriation		75,145,332		80,751,005
Subtotal	$	75,145,332	$	80,751,005
Temporarily not available pursuant to Public Law		(24,841,369)		(35,102,235)
Total Budgetary Resources	$	50,303,963	$	45,648,770
Status of Budgetary Resources				
Obligations Incurred:				
Direct	$	50,303,963	$	45,648,770
Subtotal	$	50,303,963	$	45,648,770
Unobligated Balance:				
Exempt from apportionment	$	0	$	0
Subtotal	$	0	$	0
Unobligated balance not available		0		0
Total Status of Budgetary Resources	$	50,303,963	$	45,648,770
Change in Obligated Balance:				
Obligated balance, net:				
Unpaid obligations, brought forward, October 1	$	3,359,247	$	3,530,196
Total unpaid obligated balance, net		3,359,247		3,530,196
Obligations incurred net (+/-)	$	50,303,963		45,648,770
Less: Gross outlays	$	(49,964,454)	$	(45,819,719)
Obligated balance, net, end of period				
Unpaid obligations		3,698,756	$	3,359,247
Total unpaid obligated balance, net, end of period	$	3,698,756	$	3,359,247
Net Outlays:				
Gross outlays	$	49,964,454	$	45,819,719
Less: Distributed offsetting receipts		(51,125,000)		(46,187,000)
Net Outlays	$	(1,160,546)	$	(367,281)

The accompanying notes are an integral part of these statements.

DOD
MILITARY RETIREMENT
FUND

NOTES
TO THE
PRINCIPAL STATEMENTS

DOD MILITARY RETIREMENT FUND

NOTES TO THE PRINCIPAL STATEMENTS

NOTE 1. SIGNIFICANT ACCOUNTING POLICIES

A. Basis of Presentation. These financial statements have been prepared to report the financial position and results of operations for the MRF, as required by the Chief Financial Officers Act of 1990, expanded by the Government Management Reform Act of 1994, and other appropriate legislation. The financial statements have been prepared from the books and records of the MRF in accordance with the DOD Financial Management Regulation; the OMB Circular A-136, *Financial Reporting Requirements*; and, to the extent possible, generally accepted accounting principles (U.S. GAAP). The accompanying financial statements account for all resources for which the MRF is responsible unless otherwise noted.

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

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

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

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

D. Basis of Accounting. The MRF's financial management systems 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 U.S. GAAP.

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

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

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

G. Accounting for Intra-governmental Activities. Preparation of reliable financial statements requires the elimination of transactions occurring among entities within the DOD or between two or more federal agencies. Seller entities within the DOD provide summary seller-side balances for revenue, accounts receivable, and unearned revenue to the buyer-side internal the DOD accounting offices. In most cases, the buyer-side records are adjusted to agree with the DOD seller-side balances. Intra-DOD balances are then eliminated. The MRF is able to reconcile its records and no adjustments are needed. The DOD is developing long-term system improvements to ensure accurate Intra-governmental information, to include sufficient up-front edits and controls, eliminating the need for after-the-fact reconciliations.

The U.S. Treasury Financial Management Service is responsible for eliminating transactions between the DOD and other federal agencies. The *Treasury Financial Manual*, Part 2 - Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government*, and the U.S. Treasury's *Federal Intra-governmental Transactions Accounting Policy Guide*, provide guidance for reporting and reconciling Intra-governmental balances. The MRF is able to reconcile balances pertaining to investments in federal securities.

The DOD's proportionate share of public debt and related expenses of the Federal Government is not included. The Federal Government does not apportion debt and its related costs to federal agencies. The DOD's financial statements, therefore, do not report any portion of the public debt or interest thereon, nor do the statements report the source of public financing whether from issuance of debt or tax revenues.

H. Funds with the U.S. Treasury. The MRF's monetary resources are maintained in the U.S. Treasury accounts. The disbursing offices of DFAS, the Military Departments, and other Federal Government financial service centers process the majority of the MRF's cash collections, disbursements, and adjustments worldwide. Each disbursing station prepares monthly reports that provide information to the U.S. Treasury on check issues, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS sites submit reports by appropriation to the U.S. Treasury on interagency transfers, collections received, and disbursements issued. The U.S. Treasury records these transactions to the applicable fund balance with treasury (FBWT) account. The MRF-recorded balance in FBWT account and U.S. Treasury's FBWT accounts must balance monthly.

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

I. Accounts Receivable. Accounts receivable from other federal entities or from the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon analysis of collection experience by the MRF during the previous three years. The DOD does not recognize an allowance for estimated uncollectible amounts from other federal agencies. Claims against other federal agencies are to be resolved between the agencies in accordance with dispute resolution procedures defined in the Intra-governmental Business Rules published in the Treasury Financial Manual at http://www.fms.treas.gov/tfm/vol1/07-03.pdf.

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

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

K. Contingencies and Other Liabilities. The Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*, as amended by SFFAS No. 12, *Recognition of*

Contingent Liabilities Arising from Litigation, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The MRF recognizes contingent liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated.

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

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

M. Unexpended Obligations. Unexpended obligations represent the amount of earned and accrued pension and annuity benefits reported as accounts payable. The balance of unexpended obligation appears immediately before net outlays in the Statement of Budgetary Resources (SBR) and is referred to as "Total, unpaid obligated balances, net, end of period."

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

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

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

NOTE 2. NON-ENTITY ASSETS

($ In Thousands)		FY 2009		FY 2008
Accounts Receivable	$	1,714	$	1,622
Total Non-Entity Assets	$	1,714	$	1,622
Total Entity Assets		278,397,625		253,087,021
Total Assets	$	278,399,339	$	253,088,643

Non-entity assets are assets for which the MRF maintains stewardship accountability and reporting responsibility, but are not available for the MRF's normal operations.

Nonfederal Assets, Accounts Receivable, represent the amounts of interest, penalties, and administrative charges that are collected by the MRF on behalf of the U.S. Treasury. Once collected, these amounts are transferred to the appropriate U.S. Treasury receipt account. This amount is offset by a corresponding liability reported in Note 7, Other Liabilities. It is also reported on Note 6, Liabilities Not Covered by Budgetary Resources, for 4th Quarter,

FY 2008. Effective 2nd Quarter, FY 2009, the custodial liabilities for the MRF are reported as covered by budgetary resources since the related asset exists and no congressional action is necessary for its use.

NOTE 3. FUND BALANCE WITH TREASURY (FBWT)

($ In Thousands)	FY 2009	FY 2008
Fund Balance:		
Total Trust Funds	$ 20,488	$ 17,515
Status of Fund Balance with Treasury:		
Unobligated Balance - Unavailable	$ 271,798,080	$ 246,956,712
Obligated Balance not yet Disbursed	3,698,756	3,359,247
Non-Budgetary FBWT	(275,476,348)	(250,298,444)
Total	$ 20,488	$ 17,515

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

Unobligated Balance represents the cumulative amount of budgetary authority that has not been set aside to cover outstanding obligations. Certain unobligated balances are restricted for future use and are not apportioned for current use. These unobligated balances, which are classified as available or unavailable, are related to trust fund accounts, which are restricted by the public laws that established the funds. These balances become available subsequently without further congressional action.

Obligated Balance not yet Disbursed represents funds that have been obligated for goods that have not been received or services that have not been performed, and goods and services that have been delivered/received but not yet paid. The MRF balance represents benefits payable on October 1, 2009.

Non-FBWT Budgetary Accounts represent adjustments to budgetary accounts that do not affect FBWT. The MRF balance represents investment accounts that reduce the Status of FBWT.

NOTE 4. INVESTMENTS

($ In Thousands)	FY 2009				
	Cost	Amortization Method	Amortized (Premium) /Discount	Investments, Net	Market Value Disclosure
Intra-governmental Securities, Non-Marketable, Market-based	$ 281,250,305	Effective Interest	$ (5,773,956)	$ 275,476,349	$ 283,292,576
Subtotal	$ 281,250,305		$ (5,773,956)	$ 275,476,349	$ 283,292,576
Accrued Interest	2,870,605			2,870,605	2,870,605
Total Investments	$ 284,120,910		$ (5,773,956)	$ 278,346,954	$ 286,163,181

($ In Thousands)	FY 2008				
	Cost	Amortization Method	Amortized (Premium) /Discount	Investments, Net	Market Value Disclosure
Intra-governmental Securities, Non-Marketable, Market-based	$ 255,722,202	Effective Interest	$ (5,423,758)	$ 250,298,444	$ 240,912,686
Subtotal	$ 255,722,202		$ (5,423,758)	$ 250,298,444	$ 240,912,686
Accrued Interest	2,748,171			2,748,171	2,748,171
Total Investments	$ 258,470,373		$ (5,423,758)	$ 253,046,615	$ 243,660,857

Total Intra-governmental Securities, Net Investments increased $25.3 billion (10%). This increase is primarily the result of investing annual contributions from the U.S. Treasury, net of current disbursements for benefits paid. The increase in the annual investment of these funds has a cumulative effect with an expectation that invested balances will continue growing to cover future benefits. The MRF purchased $32.1 billion in long-term securities during FY 2009. These purchases were offset by a $4.0 billion decrease in inflation compensation.

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. The cash generated from earmarked funds are deposited in the U.S. Treasury, which uses the cash for general Government purposes. The U.S. Treasury securities are issued to the earmarked funds as evidence of its receipts and are an asset to the Military Retirement Fund (MRF) and a liability to the U.S. Treasury. Since the MRF and the U.S. Treasury are both parts of the Federal Government, these assets and liabilities offset each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Government-wide financial statements. The U.S. Treasury securities provide the MRF with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the MRF requires redemption of these securities to make expenditures, the Government finances the securities out of accumulated cash balances by raising taxes or other receipts, borrowing from the public, repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all other expenditures.

The following tables displays the cost of the U.S. Treasury Securities referenced above.

($ In Thousands)

SECURITIES	COST FY 2009	COST FY 2008
Notes	$ 41,635,067	$ 50,905,963
Bonds	2,805,625	1,347,938
TIPS	225,032,819	200,004,938
Overnights	11,776,794	3,463,363
Totals	$ 281,250,305	$ 255,722,202

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

At the semiannual meetings, the DOD Investment Board approves the strategy for the type of securities purchased by the MRF. These securities can include U.S. Treasury bills, notes, bonds, inflation-protected securities, and overnight certificates. The U.S. Treasury bills are short-term securities with maturities of 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. TIPS provide protection against inflation and are purchased at either a discount or premium. The TIPS principal increases with inflation and decreases with deflation, as measured by the CPI. When a TIPS matures, 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.

NOTE 5. ACCOUNTS RECEIVABLE

($ In Thousands)	FY 2009		
	Gross Amount Due	Allowance for Estimated Uncollectible	Net Amount Due
Entity Receivables:			
With the Public	$ 33,441	$ (1,544)	$ 31,897
Intra-governmental	0	0	0
Total Receivables	$ 33,441	$ (1,544)	$ 31,897

($ In Thousands)	FY 2008		
	Gross Amount Due	Allowance for Estimated Uncollectible	Net Amount Due
Entity Receivables:			
With the Public	$ 29,911	$ (5,398)	$ 24,513
Intra-governmental	0	0	0
Total Receivables	$ 29,911	$ (5,398)	$ 24,513

Nonfederal Accounts Receivable increased by $7.4 million (30%). The contributing factors to this increase are a $3.9 million decrease in the allowance for loss on accounts receivable and a $3.5 million increase in current receivables.

In 3rd Quarter FY 2009, the MRF changed procedures in calculating the allowance. The MRF began to apply a percentage to the delinquent accounts receivable balance to obtain the allowance amount. The percentage was calculated using historical data relating to write-offs as a percentage of delinquent receivables. In the past, the percentages were based on outdated trend values; whereas the current percentage is calculated on the most recent 3 years. The allowance is an offset to receivables; therefore, when the allowance decreases the net receivable value increases.

The $3.5 million increase results primarily from the FY 2009 increase in the annual cost of living adjustment. This increase represents additional receivables from overpayments to the beneficiaries for which they were not entitled.

NOTE 6. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

($ In Thousands)

	FY 2009	FY 2008
Intra-governmental Liabilities:		
Other	$ 1,714	$ 1,622
Total Intra-governmental Liabilities	$ 1,714	$ 1,622
Non-Federal Liabilities:		
Military Retirement Benefit Liability (Note 9)	$ 901,658,014	$ 903,792,133
Other	186	192
Total Non-Federal Liabilities	$ 901,658,200	$ 903,792,325
Total Liabilities Not Covered by Budgetary Resources	$ 901,658,200	$ 903,793,947
Total Liabilities Covered by Budgetary Resources	275,498,551	250,315,958
Total Liabilities	$ 1,177,156,751	$ 1,154,109,905

The MRF Liabilities Not Covered by Budgetary Resources represents the difference between the actuarial liability for future benefit payments and the current assets of the MRF.

The Intra-governmental Other Liabilities represent a custodial liability for the MRF for 4th Quarter, FY 2008, and are comprised of interest, penalties, and administrative charges to be collected on behalf of the U.S. Treasury. This amount is also reported on Note 2, Non-Entity Assets, and Note 7, Other Liabilities. Effective 2nd Quarter, FY 2009, the custodial liabilities for the MRF are reported as covered by budgetary resources since the related asset exists and no congressional action is necessary for its use to liquidate the liability.

The Military Retirement Benefit Liability amount represents unfunded actuarial liabilities for pension benefits. Refer to Note 9, Military Retirement Benefit Liabilities, for additional details and disclosures.

Nonfederal Other Liabilities represent contingent liabilities payable by the Department of Defense for estimated death payments. These liabilities cover the retiree benefits not paid by the Department of Veterans Affairs during the month of death. This amount is also reported on Note 7, Other Liabilities, and Note 8, Commitments and Contingencies.

NOTE 7. OTHER LIABILITIES

($ In Thousands)	FY 2009	FY 2008
Intra-governmental:		
Custodial Liabilities	$ 1,714	$ 1,622
Total Intra-governmental Other Liabilities	$ 1,714	$ 1,622
Non-Federal:		
Contingent Liabilities	$ 186	$ 192
Total Non-Federal Other Liabilities	$ 186	$ 192
Total Other Liabilities	$ 1,900	$ 1,814

Intra-governmental Custodial Liabilities represent a liability for the Military Retirement Fund comprised of interest, penalties, and administrative charges to be collected on behalf of U.S. Treasury. This amount is also reported as a nonfederal accounts receivable on Note 2, Non-Entity Assets.

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

NOTE 8. COMMITMENTS AND CONTINGENCIES

Currently there are no known contingent liabilities pending legal action.

The Military Retirement Fund has an estimated contingent liability of $186.1 thousand that is measurable and probable and, therefore, has been recorded in the accounting records. These liabilities cover the retiree benefits not paid by the Department of Veterans Affairs during the month of death. This amount is also reported on Note 7, Other Liabilities.

NOTE 9. MILITARY RETIREMENT BENEFIT LIABILITIES

($ In Thousands)

	FY 2009			
Major Program Activities	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Military Retirement Pensions Actuarial Liability	$ 1,173,456,095	5.75%	$ (271,798,080)	$ 901,658,015
Benefits Due and Payable	3,698,756		(3,698,756)	0
Rounding	0		0	(1)
Total:	$ 1,177,154,851		$ (275,496,836)	$ 901,658,014

	FY 2008			
Major Program Activities	Present Value of Benefits	Assumed Interest Rate (%)	(Less: Assets Available to Pay Benefits)	Unfunded Liabilities
Military Retirement Pensions Actuarial Liability	$ 1,150,748,844	5.75%	$ (246,956,711)	$ 903,792,133
Benefits Due and Payable	3,359,247		(3,359,247)	0
Total:	$ 1,154,108,091		$ (250,315,958)	$ 903,792,133

The Total Military Retirement and Other Federal Employment Benefits increased $23.0 billion (2%) primarily due to the increase in the actuarial liability. The primary driver of this increase is the expected increase in the actuarial liability of $37.6 billion associated with growth due to normal cost and interest cost reduced by liability released through benefit payments. The remaining increase relates to three key assumption changes: 1) lower

CSB take rate resulting in a $3.6 billion increase due to higher future retirement benefits; 2) updated SBP/offset factors resulting in a $3.1 billion increase; and 3) new permanent disability retiree rates resulting in a $1.1 billion increase. These increases were offset by a $23.1 billion decrease in actuarial experience from military pay and cost of living adjustments.

The Military Retirement Fund (MRF) accumulates funds used to pay pensions to retired military personnel and annuities to their survivors. The Military Retirement System is a single-employer, defined benefit plan.

The schedules above reflect two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled "Military Retirement Pensions Actuarial Liability" represent actuarial liability for future pension benefits not yet incurred. The line entitled "Benefits Due and Payable" represent retirement benefits that are due and payable on the first day of the next reporting period.

Actuarial Cost Method

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

Projected Revenues

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

Assumptions

The long-term economic assumptions for each valuation are set by the Board. The long- term assumptions for both the FY 2008 and FY 2009 valuations were 5.75 percent interest, 3.0 percent CPI, and 3.75 percent salary increase. The long-term interest assumption represents the assumed long-run yield of Fund assets. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on actual experience. Because of reporting deadlines, the current year actuarial present value of projected plan benefits is rolled forward from the prior year valuation results as reported in the DOD Office of the Actuary '*Valuation of the Military Retirement System'* using accepted actuarial methods. In calculating the FY 2009 roll-forward amount, the following assumptions were used:

	Inflation	Salary	Interest
Fiscal Year 2009	5.8% (actual)	3.9 % (actual)	5.75 %
Fiscal Year 2010	0.0% (estimated)	3.4% (estimated)	5.75%
Long-Term	3.0%	3.75%	5.75%

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

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

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

NOTE 10. DISCLOSURES RELATED TO THE STATEMENTS OF NET COST

($ In Thousands)	FY 2009	FY 2008
Intra-governmental Costs	$ 0	$ 0
Public Costs	73,003,916	171,077,638
Total Costs	$ 73,003,916	$ 171,077,638
Intra-governmental Earned Revenue	$ (75,267,766)	$ (80,659,528)
Public Earned Revenue	0	0
Total Earned Revenue	$ (75,267,766)	$ (80,659,528)
Net Cost of Operations	$ (2,263,850)	$ 90,418,110

Total Costs decreased $92.7 billion (103%) primarily due to the changes to the actuarial liability affecting current year costs. The September 30, 2008, increase in liability was $125.3 billion compared to FY 2009 increase of $22.7 billion. Factors impacting the change are discussed in Note 9, Military Retirement Benefit Liabilities.

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

Intra-governmental 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.

Intra-governmental earned revenue is comprised primarily of the following:

Intra-governmental Earned Revenues for Program Costs

($ In Thousands)	FY 2009	FY 2008
1. Military Service Contributions as a Percentage of Base Pay	$ 17,542,736	$ 16,138,795
2. Annual Treasury Unfunded Liability Payment	51,125,000	46,187,000
3. Annual Treasury Normal Cost Payment	3,745,000	2,776,000
4. Interest on Investments	2,855,030	15,518,902
5. Gain on Disposition of Investments	0	38,831
Total	$ 75,267,766	$ 80,659,528

NOTE 11. BENEFIT PROGRAM EXPENSE

($ In Thousands)	FY 2009	FY 2008
1. Service Cost	$ 22,505,083	$ 18,914,714
2. Period Interest on the Benefit Liability	65,608,846	60,727,879
3. Prior (or past) Service Cost	332,088	8,057,970
4. Period Actuarial (Gains) or Losses	(15,236,158)	83,410,778
5. Total Benefit Program Expense	$ 73,209,859	$ 171,111,341

The benefit expenses provide components of the change in the actuarial liability from September 30, 2008, to September 30, 2009. The September 30, 2009, actuarial liability is calculated using the components of benefit expenses as well as the expected benefit payments during FY 2009. The September 30, 2009, actuarial liability is equal to the September 30, 2008, liability plus the total benefit program expense minus the expected benefit payments. For FY 2009, Prior Service Cost (Line 3) is primarily due to the increase in the Dependency and Indemnity Coverage allowance for survivors enacted in Public Law (P.L.) 111-31, whereas for FY 2008 a large component related to early reserve retirement provisions enacted in P.L. 110-181. The FY 2009 Period Actuarial (Gains) or Losses (Line 4) is largely impacted by a lower than expected cost of living adjustment anticipated in January 2010, whereas in FY 2008 it was largely impacted by a new (lower) long-term interest rate assumption of 5.75% compared to the prior assumption of 6%.

NOTE 12. DISCLOSURES RELATED TO THE STATEMENTS OF CHANGES IN NET POSITION

There was a difference of $75.1 billion between Appropriations Received on the Statement of Changes in Net Position and Appropriations Received on the SBR. This difference is due to Trust Receipts included in the Appropriations Received line of the SBR but excluded from the Statement of Changes in Net Position. Refer to Note 13, Disclosures Related to the Statements of Budgetary Resources, for additional details.

NOTE 13. DISCLOSURES RELATED TO THE STATEMENTS OF BUDGETARY RESOURCES

Total Budgetary Resources increased $4.7 billion (10%) as a result of a $10.3 billion increase in the change to Receipts and Appropriations Temporarily Precluded from Obligation offset by a $5.6 billion decrease in revenue. Receipts and Appropriations Temporarily Precluded from Obligation increased $10.3 billion primarily due to the change from FY 2008 to FY 2009 in the revenue-exceeding-expenses calculation. The $5.6 billion decrease in revenue is due to a $12.7 billion decrease in interest earned as a result of deflation and lower interest rates due to current economic conditions offset by a $7.3 billion increase in contributions received from the Treasury and the Services ($4.9 billion increase in the Treasury contribution and a $2.4 increase in the Normal Cost Contribution and Service contributions).

Net Outlays decreased $0.8 billion (216%) due to a $4.9 billion increase in the U.S. Treasury contribution for the amortization of the unfunded liability offset by a $4.1 billion increase in disbursements. The amortization payment is based on the unfunded liability amortization schedule established by the DOD Board of Actuaries.

The Military Retirement Fund (MRF) reported $50.3 billion of direct obligations that are exempt from apportionment.

The SBR includes intra-entity transactions because the statements are presented as combined.

The MRF's unobligated balances of budget authority represent the portion of trust 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 the MRF and are available for obligation as needed in the future.

There was a difference of $75.1 billion between appropriations on the Statements of Changes in Net Position (SCNP) and appropriations received on the SBR. This difference represents current receipts, immediately available for obligation, reported as exchange revenue on the Statement of Net Cost and included in appropriations on the SBR.

NOTE 14. RECONCILIATION OF NET COST OF OPERATIONS TO BUDGET

($ In Thousands)		FY 2009		FY 2008
Resources Used To Finance Activities:				
Budgetary Resources Obligated				
Obligations incurred	$	50,303,963	$	45,648,770
Less: Offsetting receipts (-)		(51,125,000)		(46,187,000)
Net obligations	$	(821,037)	$	(538,230)
Other Resources	$	0	$	0
Total resources used to finance activities	$	(821,037)	$	(538,230)
Components of The Net Cost Of Operations That Will Not Require Or Generate Resources In The Current Period:				
Components Requiring or Generating Resources in Future Periods - Other	$	22,707,244	$	125,428,353
Total Components of net cost of operations that will require or generate resources in future periods	$	22,707,244	$	125,428,353
Components nor Requiring or Generating Resources – Other				
Revaluation of assets or liabilities (+/-)	$	0	$	(38,831)
Other (+/-)				
Trust Fund Exchange Revenue		(24,142,766)		(34,433,697)
Other		(7,291)		515
Total components of net cost of operations that will not require or generate resources	$	(24,150,057)	$	(34,472,013)
Total components of net cost of operations that will not require or generate resources in the current period	$	(1,442,813)	$	90,956,340
NET COST OF OPERATIONS	$	(2,263,850)	$	90,418,110

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; and Net Obligations.

Components Requiring or Generating Resources in Future Period – Other displays the change in the actuarial liability of $22.7 billion for FY 2009 and $125.4 billion for FY 2008.

Components not Requiring or Generating Resources – Other displays the change in accounts receivable since the beginning of both FY 2008 and FY 2009. These amounts represent refunds receivable and changes in bad debt for erroneous payments to military retirees or their survivors.

The MRF reported $901.7 billion in pension liabilities that are not covered by budgetary resources as of September 30, 2009. These liabilities represent amounts for which the MRF has no assets available, nor are these liabilities due and payable, in the current fiscal year. Refer to Note 9, Military Retirement Benefit Liabilities, for additional details and disclosures.

NOTE 15. OTHER DISCLOSURES

FY 2009 Change in the MRF Actuarial Liability

The net pension expense for the change in the actuarial accrued liability from September 30, 2008 to September 30, 2009 is developed in Table 1 below:

Table 1: Change in Actuarial Liability

($ In Thousands)	FY 2009	FY 2008
A. Beginning of Year Accrued Liability	$ 1,150,748,844	$ 1,025,320,486
B. Normal Cost Liability	22,505,083	18,914,714
C. Plan Amendment Liability	332,088	8,057,970
D. Assumption Change Liability	7,821,688	60,075,022
E. Benefit Outlays	(50,502,608)	(45,682,983)
F. Interest on Pension Liability	65,608,846	60,727,879
G. Actuarial Loss (Gain)	(23,057,846)	23,335,756
H. End-of-Year Accrued Liability	$ 1,173,456,095	$ 1,150,748,844
I. Net Change in Actuarial Liabilities	$ 22,707,251	$ 125,428,358

Each year the accrued liability is expected to increase with the normal cost (Line B), decrease with benefit outlays (Line E), and increase with the interest cost (Line F) resulting in an expected increase of $37.6 billion in the accrued liability during FY 2009.

The September 30, 2009, accrued liability includes changes due to (1) assumptions, (2) benefit changes, and (3) experience. The new assumptions include a lower CSB take rate, updated permanent disability retiree rates, and updated SBP/offset factors. The net effect of these new assumptions is an increase in the September 30, 2009, accrued liability of $7.8 billion, shown on Line D ($3.6 billion of this increase is due to the lower CSB take rate, $1.1 billion is due to the new permanent disability retiree rates, and $3.1 billion is due to the updated SBP/offset factors). The change in retirement benefits for FY 2009 includes the Dependency and Indemnity Coverage Supplement increase enacted in P.L. 111-31. The effect of this benefit change is $0.3 billion, shown on Line C. The change in the accrued liability due to the net experience gain of $23.1 billion, shown on line G, reflects the new population on which the September 30, 2009, roll-forward is based, as well as other economic experience being different from that assumed ($23.6 billion of this decrease is due to a lower than expected cost of living adjustment and across-the-board salary increase for January 2010).

The end-of-year accrued liability (Line H) is the sum of lines A through G; the net change in the actuarial liability from the prior year (Line I) is the sum of lines B through G.

Treasury Contributions

The October 1 contribution from the U.S. Treasury, determined in accordance with methods and assumptions approved by the Board, increased $5.9 billion (from $49.0 billion in FY 2008 to $54.9 billion in FY 2009).

Reasons for the change include an expected increase inherent in the Board's unfunded liability amortization methodology ($1.7 billion), new assumptions approved by the Board at the August 2007 meeting, ($2.9 billion), and an increase due to the funding requirements of P.L. 108-136 ($1.0 billion).

Military Services Contributions

The contributions from the Military Services are the product of basic pay and Normal Cost Percentages (NCPs) determined in accordance with the methodology set by the Board. Basic pay generally increases each year, and on January 1, 2009, there was a 3.9% across-the-board basic pay increase. The Board set the NCPs for FY 2009 in its March 2008 letter, amending those set in the August 2007 public meeting: 29.4% (full-time) and 21.1% (part-time). The Board set the NCPs for FY 2010 in its August 2008 letter: 32.3% (full-time) and 24.5% (part-time).

Market Value of Investments

The market value of investments in the MRF's nonmarketable market-based securities as of September 30, 2009, totaled $286.2 billion.

NOTE 16. SUBSEQUENT EVENT

No material events or transactions have occurred subsequent to September 30, 2009, that have not been properly recorded in the financial statements or disclosed in the notes. Also, there have been no changes to internal control subsequent to September 30, 2009, or other factors that might significantly affect the effectiveness of internal control.

DOD MILITARY RETIREMENT FUND

OTHER ACCOMPANYING INFORMATION

MILITARY RETIREMENT SYSTEM
ACTUARIAL STATUS INFORMATION
SEPTEMBER 30, 2009 AND 2008

($ In Thousands)

			FY 2009 [1]		FY 2008
1	Present value of future benefits				
	a. Annuitants now on roll	$	719,698,159	$	714,145,466
	b. Non-retired reservists		162,345,352		158,725,870
	c. Active duty personnel [2]		480,769,055		455,777,087
	d. Total	$	1,362,812,566	$	1,328,648,423
2	Present value of future normal cost contributions	$	189,356,471	$	177,899,579
3	Actuarial accrued liability	$	1,173,456,095	$	1,150,748,844
4	Assets [3]	$	271,798,080	$	246,956,711
5	Unfunded accrued liability	$	901,658,015	$	903,792,133

[1] Rolled forward from September 30, 2008.

[2] The future benefits of active duty personnel who are projected to retire as reservists are counted on line 1-b.

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

DOD MILITARY RETIREMENT FUND

INDEPENDENT AUDITORS' REPORTS

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

November 9, 2009

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

SUBJECT: Endorsement of the Unqualified Opinion on the FY 2009 DOD Military Retirement Fund Financial Statements (Report No. D-2010-007)

The requirement for audited Federal Government financial statements was established by the Chief Financial Officers Act of 1990 (Public Law 101-576), as amended by the Government Management Reform Act of 1994 (Public Law 103-356). The Office of Management and Budget (OMB) Bulletin No. 07-04, "Audit Requirements for Federal Financial Statements," as amended,* requires audited financial statements for the DOD Military Retirement Fund. We contracted with Acuity Consulting, Inc. (Acuity Consulting), to perform the FY 2009 Military Retirement Fund audit.

Unqualified Audit Opinion

We agree with the Acuity Consulting unqualified opinion dated November 6, 2009. Acuity Consulting reported that the Military Retirement Fund's Financial Statements as of and for the years ended September 30, 2009 and 2008, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Report on Internal Control

We also agree with the Acuity Consulting Report on Internal Control Over Financial Reporting and on Compliance and Other Matters. Acuity Consulting, in planning and performing its audit, considered the Military Retirement Fund's internal control over financial reporting as a basis for designing audit procedures but not for expressing an opinion on its effectiveness. In the Report on Internal Control, Acuity Consulting cites two significant deficiencies relating to the Military Retirement Fund internal control over financial reporting.

- **Data Used to Pay Retirees and Annuitants**. Data provided by the Military Services to Defense Finance and Accounting Service (DFAS) Cleveland that are used to process and pay retirees and annuitants are not complete or properly supported. DFAS Cleveland relies upon certain data maintained electronically by the Military Services. The electronic data are transmitted to DFAS Cleveland to establish a retiree account and to determine the appropriate benefit payment. However, the Military Retirement Fund does not have policies or procedures in place to require that the Military Services provide

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

additional supporting data. Specifically, DFAS Cleveland does not require the submission of all supporting documents maintained by the Military Services. Although Acuity Consulting did not identify any instances of incorrect payments during the audit, the lack of complete and adequately supported payee files increases the risk that incorrect data might be used in calculating retiree pay.

- **Calculation of Retirement Benefits.** Acuity Consulting identified instances in which the High-3 method for retirement benefits was not properly calculated. The High-3 method is used for all personnel who enter or who have entered a Military Service after September 8, 1980; it will become the predominant method used for retirement benefit calculations as personnel retire in the coming years. DFAS Cleveland should develop and implement a plan to validate the initial High-3 calculation for members receiving benefit payments, and for identifying and correcting the pay for any members who are receiving improper payments.

Compliance and Other Matters

We agree with the Acuity Consulting Report on Compliance and Other Matters. Acuity Consulting performed tests to determine whether management administered the Military Retirement Fund in compliance with certain provisions of laws and regulations. Acuity Consulting cited three instances of noncompliance for this report.

- **Improper Payments Information Act (IPIA) of 2002.** Review of the Military Retirement Fund's compliance with IPIA identified instances of noncompliance for Military Retirement Fund payments. Specifically, through monthly reviews of payments made to deceased members, DFAS found instances of wrongful payments. Errors are also possible in active retiree and annuitant monthly payments, which have not been subjected to the same review process. Payments made to active retirees and annuitants should be subjected to the same rigor of review to ensure compliance. DFAS reports detailed information on the number and dollar amounts of improper payments it finds to the Office of the Under Secretary of Defense (Comptroller).

- **OMB Circular A-130.** An assessment of required system documentation for the newly implemented Trust Fund Reporting System (TFRS) identified that it is not compliant with OMB Circular A-130, "Management of Federal Information Resources." Because disclosure of detailed information about electronic data processing weaknesses may further compromise controls, no further details are being provided here. Instead, the specifics will be presented in a separate, limited distribution report on other control deficiencies involving the Military Retirement Fund's internal control over financial reporting and other matters identified.

- **Federal Financial Management Improvement Act (FFMIA).** For the first 11 months of FY 2009, the legacy Trust Fund Accounting System (TFAS) was still in place as the official system of record. TFAS was not transaction-based, could not produce a usable transaction log, and did not provide budgetary accounting functionality. As such, TFAS was in substantial noncompliance with the requirements of FFMIA. However, the new

TFRS general ledger accounting system, put in place September 1, 2009, should now address these issues of noncompliance with FFMIA.

Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts. OMB Bulletin No. 07-04, as amended, requires that auditors report test results if they identify noncompliance with certain provisions of laws and regulations.

Audit Responsibilities

We were responsible for obtaining reasonable assurance that the basic financial statements of the Military Retirement Fund were presented fairly and free of material misstatement, in conformity with accounting principles generally accepted in the United States of America.

To fulfill our responsibilities for oversight of the Acuity Consulting audit work, we complied with the following: the U.S. Government Accountability Office, "Government Auditing Standards"; OMB Bulletin 07-04; and the Government Accountability Office/President's Council on Integrity and Efficiency "Financial Audit Manual." Specifically, we evaluated the nature, timing, and extent of the work; monitored progress throughout the audit; reviewed documentation prepared by Acuity Consulting; met with Acuity Consulting partners and staff members; reviewed the key judgments; met with officials of the Military Retirement Fund; performed independent tests of the accounting records; and performed other procedures appropriate to the circumstances.

Acuity Consulting formed its opinion on the Basic Financial Statements taken as a whole. Acuity Consulting did not audit the Required Supplementary Information and did not express an opinion on it because that information is not part of the Basic Financial Statements.

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

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INDEPENDENT AUDITORS' REPORT

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

Introduction

We have audited the balance sheets of the Department of Defense Military Retirement Fund (the Fund) as of September 30, 2009 and 2008, as well as the related statements of net cost, changes in net position, and budgetary resources (the financial statements) for the years then ended. The objective of our audit was to express an opinion on the fair presentation of the financial statements as of September 30, 2009 and 2008. In connection with our audits, we also considered the Fund's internal controls over financial reporting and tested the Fund's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

As stated in our opinion of the financial statements, we found that the Fund's financial statements as of and for the years ended September 30, 2009 and 2008, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal controls would not necessarily disclose all significant deficiencies in the internal control over financial reporting that might be significant deficiencies under standards issued by the American Institute of Certified Public Accountants (AICPA) and Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*. During the year ended September 30, 2009, the old system, the Trust Fund Accounting System (TFAS), was in place as the official system of record for the majority of FY 2009. The TFAS is not transaction-based, cannot produce a usable transaction log and does not provide budgetary accounting functionality. As such, TFAS was in substantial noncompliance with the requirements of the Federal Financial Management Improvement Act (FFMIA). However, close to year end, September 1, 2009, a new general ledger accounting system, the Trust Fund Reporting System (TFRS), was implemented to address compliance with the FFMIA in future years. The results of our tests of compliance with certain provisions of laws and regulations disclosed three instances of noncompliance required to be reported herein under *Government Auditing Standards,* issued by the Comptroller General of the United States and OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements.*

1. Improper Payments Information Act (IPIA) of 2002
2. OMB Circular A-130, *Management of Federal Information Resources*
3. Federal Financial Management Improvement Act (FFMIA)

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

INDEPENDENT AUDITORS' REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the Department of Defense ("DOD") Military Retirement Fund (MRF or the "Fund") as of September 30, 2009 and 2008, and the related statements of net cost, changes in net position, and budgetary resources for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the DOD Military Retirement Fund as of September 30, 2009 and 2008, and its net cost of operations, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated November 6, 2009 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be considered in assessing the results of our audits.

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED UPON THE AUDIT PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

We have audited the financial statements of the DOD MRF as of and for the years ended September 30, 2009 and 2008, and have issued our report thereon dated November 6, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and the requirements of OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

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

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

A *material weakness* is a significant deficiency, or a combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the financial statements will not be prevented, or detected. This material weakness definition aligns with the same material weakness definition used by management to prepare an agency's FMFIA assurance statement.

A *significant deficiency* is a deficiency in internal control, or a combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. The term "significant deficiency" replaces the former term "reportable condition." This "significant deficiency" definition aligns with the "reportable condition" definition used by management to prepare an agency's FMFIA assurance statement.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting, described below that we consider to be significant deficiencies in internal control over financial reporting. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

We considered the matters discussed in the following paragraphs to be *significant deficiencies.*

1. Data provided by the Services to Defense Finance and Accounting Service – Cleveland (DFAS-CL) used to process and pay retirees and annuitants is not consistently complete or properly supported. Our testing revealed that adequate supporting documentation was not available for 13.75% of the items tested. DFAS-CL relies upon certain data maintained electronically by the Services. This electronic data is transmitted to DFAS-CL to establish a retiree account and to determine the appropriate benefit payment. The Fund does not have policies or procedures in place to demand that the Services provide accurate and complete data. Additionally, DFAS-CL does not require the submission of all supporting documents (either scanned images of the original documents or hardcopy original documents) maintained by the Services. The lack of complete and adequately supported payee files increases the risk that incorrect data might be used in calculating retiree pay. No instances of incorrect payments were identified in our fieldwork.

2. Our audit procedures also identified instances where the High-3 method for retirement benefits was not properly calculated. The High-3 method is used for all personnel who entered the service after September 8, 1980 and will become the predominant method used for retirement benefit calculations in the future. DFAS-CL should develop and implement a plan to validate the initial High-3 calculation for members receiving benefit payments, identifying and correcting the pay for any members who are receiving improper payments.

Compliance and Other Matters

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

1. Review of the Fund's compliance with the Improper Payments Information Act (IPIA) of 2002 to identify and reduce erroneous payments, determined non-compliance with a significant portion of the MRF payments. Specifically, IPIA testing for the MRF includes a statistical review of payments to deceased members, as well as a separate statistical review of active retiree/annuitant payments every month. While the sampling methodology was appropriately applied for the review of payments to deceased members, the statistical review of the active retiree/annuitant payments was not appropriately applied. For example, only 85 of the 250 statistically selected sample accounts were reviewed each month, skewing the projected error. While it is believed the greatest risk for improper payments is associated with payments made to deceased members, the active retiree/annuitant payments represent a significant amount of monthly payments and errors in these payments are possible. Thus, payments made to active retirees and annuitants should be subjected to the same rigor of review to ensure compliance with the IPIA.

2. Assessment of required system documentation for the TFRS identified it is not compliant with the OMB Circular A-130, *Management of Federal Information Resources.* Because disclosure of detailed information about electronic data processing (EDP) weaknesses may further compromise controls, we are providing no further details here. Instead, as requested by the Office of Inspector General, the specifics will be presented in a separate, limited distribution report concerning other control deficiencies involving the Fund's internal control over financial reporting and other matters that we identified during our audit.

3. For the majority of the year ended September 30, 2009, the old system, the TFAS, was in place as the official system of record. The TFAS is not transaction-based, cannot produce a usable transaction log and does not provide budgetary accounting functionality. As such, the TFAS was in substantial noncompliance with the requirements of FFMIA. However, close to year end, September 1, 2009, a new general ledger accounting system, the TFRS, was implemented to address compliance with the FFMIA in future years.

Views of Responsible Officials

We provided a draft of this report to representatives of the Inspector General of the Department of Defense, the Audit Committee, and the management of the Fund, who then provided us with comments, which we incorporated as appropriate. The Audit Committee and the management of the Fund expressed their continuing commitment to address the deficiencies identified in this report.

Distribution

This report is intended solely for the information and use of the Inspector General of the Department of Defense, the Audit Committee and management of the Fund, other Defense Organizations, the Office of Management and Budget, the Government Accountability Office, and the United States Congress and is not intended to be and should not be used by anyone other than these specified parties.

Acuity Consulting, Inc.

November 6, 2009