



Fiscal Year 2021

Medicare-Eligible Retiree Health Care Fund Audited Financial Report



November 8, 2021

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Management's Discussion and Analysis

Department of Defense Medicare-Eligible Retiree Health Care Fund For the Year Ended September 30, 2021

The Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund's (the "Fund" or MERHCF) discussion and analysis provides an overview of the MERHCF's financial activities for the fiscal year (FY) ended September 30, 2021. Since this information is designed to focus on the current year's activities, resulting changes, and currently known facts, it should be read in conjunction with the MERHCF's principal statements and notes (beginning on page 23).

1. REPORTING ENTITY, MISSION AND MANAGEMENT STRUCTURE

Reporting Entity and Mission. The reporting entity is the MERHCF. The "mission" of the MERHCF, administered by the Secretary of the Treasury, is to accumulate funds in order to finance, on an actuarially sound basis, liabilities of DoD under uniformed services health care programs for specific Medicare-eligible beneficiaries, as designated by Sections 1111 through 1117 of Title 10, U. S. Code. The FY 2001 National Defense Authorization Act (NDAA) directed the establishment of the MERHCF to pay for Medicare-eligible retiree health care beginning on October 1, 2002. Prior to this date, care for Medicare-eligible beneficiaries was financed through annual Congressional appropriations for the Military Health System (MHS) (including the Defense Health Program [DHP] and Military Pay appropriations). The Fund covers Medicare-eligible beneficiaries, regardless of age. In the context of the Fund, hereafter the term "Medicare-eligible beneficiaries" is used to refer to Medicare-eligible beneficiaries who are related to retirees (i.e., retirees themselves, dependents of retirees, and survivors).

Board of Actuaries. The 2001 NDAA also established an independent three-member DoD Medicare-Eligible Retiree Health Care Board of Actuaries (MERHCF Board) appointed by the Secretary of Defense. The MERHCF Board approves the methods and assumptions used to calculate the per capita normal cost rates and the U.S. Treasury contribution. The MERHCF Board is required to review the actuarial status of the Fund, to report annually to the Secretary of Defense, and to report to the President and the Congress on the status of the Fund at least every four years. The DoD Office of the Actuary (OACT), under the Defense Human Resources Activity, provides all technical and administrative support to the Board and is essential in providing the actuarial assessments regarding contributions to the Fund and calculations of the actuarial liability as well as impacts of either current or proposed future retiree program changes. The OACT operates in accordance with the provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in the DoD Financial Management Regulation (FMR), Volume 12, Chapter 16, dated December 2019.

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

establishment. Within DoD the Office of the Under Secretary of Defense for Personnel and Readiness through the Office of the Assistant Secretary of Defense for Health Affairs (OASD (HA)), the DHA has as one of its missions the operational oversight of the MHS, including management of the Fund. The DHA management responsibilities include accounting for, documenting, and projecting annual budget distribution requirements (purchased care claims, demands, and military treatment facilities (MTFs) prospective payments for anticipated care provided in the direct care system), oversight of claims processors, monitoring/management of the Payment Integrity Information Act (PIIA) of 2019, and preparation of financial statements and footnotes.

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

TRICARE Plans and Programs for Medicare-Eligible Beneficiaries

TRICARE for Life (TFL). The TFL was created as “wrap-around” coverage to Medicare-eligible military retirees by Section 712 of the *Floyd D. Spence National Defense Authorization Act* for FY2001 (P.L. 106-398). TFL functions as a second payer to Medicare, paying out-of-pocket costs for medical services covered under Medicare for beneficiaries who are entitled to Medicare Part A based on age, disability, or end-stage renal disease. TFL covers Medicare-eligible retirees, including retired guardsmen, reservists, and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The Medicare-eligible retirees and family members of the non-DoD Uniformed Services (Coast Guard, Public Health Service (PHS), and National Oceanic and Atmospheric Administration (NOAA)) are also eligible for these benefits. TFL serves as the final payer for Medicare covered benefits, and first payer for TRICARE benefits that are not covered in the Medicare or other health insurance (OHI) programs.

TRICARE Pharmacy Program: The TRICARE Pharmacy Program authorizes eligible beneficiaries to obtain low-cost prescription medications from the TRICARE Mail Order Pharmacy (TMOP) and TRICARE civilian pharmacies (network and non-network). Beneficiaries may also continue to use military hospital and clinic pharmacies at no charge.

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

Designated Provider Program (DPP) formerly Uniformed Services Family Health Plan. (USFHP). Finally, DoD beneficiaries, including Medicare-eligible beneficiaries, in specific locations where DPP, formerly the USFHP, facilities are available, may enroll in capitation rate plans. These plans include inpatient and outpatient services and a pharmacy benefit. The capitation rate is paid by

DoD. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs as well as for benefits under the TFL (or other TRICARE plans) and Pharmacy programs. Prior to August 20, 2012, USFHP enrollees were not required to participate in Medicare. Beginning October 2012, a military retiree (or eligible family member) who becomes eligible for Medicare due to age may not enroll or stay enrolled in the USFHP, unless the military retiree (or eligible family member) was enrolled in the plan prior to September 30, 2012.

Health Care Purchased from Civilian Providers

Purchased Care. In accordance with DoD 7000.14-R, *Financial Management Regulation*, Volume 12, Chapter 16, the DHA Contract Resource Management (CRM) reports daily obligations to the Fund for health care purchased from civilian providers or “purchased care”. Daily claims are validated by the voucher edit procedures required by the TRICARE/Civilian Health and Medical Program of the Uniformed Services (CHAMPUS) *Automated Data Processing Manual* 6010.50-M, dated May 1999, to ensure that only costs attributable to Medicare-eligible beneficiaries are included in payments drawn from the Fund.

The DHA uses a TRICARE Dual Eligible Fiscal Intermediary Contract (TDEFIC) awarded to Wisconsin Physician Services for purposes of processing all claims supported by the Fund, regardless of the geographic region in which care was received. Dual eligibility refers to health care users who are both Uniformed Services beneficiaries (retired, dependents of retired, and survivors) and Medicare-eligible beneficiaries. Having a single fiscal intermediary to process all dual-eligible claims ensures greater confidence in uniformity and consistency of claims adjudication.

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

For more detailed information about the DHA CRM purchased care processes and controls, please see the “DoD DHA CRM Management's Discussion and Analysis for the Years Ended September 30, 2021 and 2020.”

Computation of Incurred Claims Reserve

The actuarial determination of the Fund's liability for Incurred But Not Reported (IBNR) claims for purchased care relies on data files provided by the DHA, through the MHS Data Repository (MDR), to the OACT. The IBNR is determined quarterly, using claims triangles that represent paid claims in the month they were incurred. For pharmacy IBNR, OACT relies on a paid claims report that summarizes amount paid by date incurred. Standard actuarial methods are used to compute the IBNR, including the development of month-to-month completion factors, IBNR smoothing techniques, as well as analysis and research of patterns, trends, and anomalies. Separate

MERHCF accounting reports with line item detail are also used to estimate the outstanding administration costs associated with IBNR claims.

Health Care Provided in MTFs

Direct Care. The Fund develops prospective payment amounts for health care estimated to be provided directly in MTFs (Direct Care) to Medicare-eligible beneficiaries based on DoD policy established in the FMR, Volume 12, Chapter 16, December 2019. The prospective payment amounts are calculated for each MTF and include both Military Personnel (MILPERS) and DHP Operations and Maintenance (O&M) costs.

The prospective payment amounts are based on costs reported by the MTF's Medical Expense and Performance Reporting System (MEPRS) and patient encounter data for the most recent FY for which data is complete at the time the calculations are prepared. The DHA develops, in coordination with the Military Departments and Office of the Under Secretary of Defense (Comptroller) (OUSD(C)), MTF-specific rates in accordance with the FMR, Volume 12, Chapter 16. MEPRS cost data is recorded separately for MILPERS and O&M components per clinical workload. These amounts are inflated to the year of execution using budget data provided by the Military Services, and standard Office of Management and Budget (OMB) Consumer Price Index-Urban Medical inflation rates listed in the President's Budget applicable to those years. MEPRS data is recorded and maintained by the Military Services in accordance with DHA 6010.13, Vol 1, *Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities, Business Rules*, dated 27 September 2018, and DHA 6010.13, Vol 2, *Medical Expense and Performance Reporting System for Fixed Military Medical and Dental Treatment Facilities, Uniform Chart of Accounts*, dated 27 September 2018.

OUSD(C) transfers the MERHCF funds quarterly for the MTF prospective payments (based on the DHA-calculated annual total direct care program amounts) to the Military Services for MILPERS costs and to the DHA for DHP O&M costs. The DHA, in turn, distributes DHP O&M funds to the Service Medical Activities (SMA) of the Army, Navy, Air Force, and National Capital Region – Medical Directorate for execution. OUSD(C) includes financial authority in the DHP expense operating budget to finance the annual financial plan requirement of the prospective payment.

The Trust Fund Manager has implemented a monthly reconciliation of the Fund by Medical Treatment Facility (MTF). The reconciliation is performed using a rolling 12 months of data extracted from the MHS Data Repository/MHS MART. The 12 months dataset includes the most recent complete month of the current FY and the 11 months preceding it. A threshold of -10% variance has been established as the critical point at which action must be taken. The variance is monitored throughout the fiscal year. At the end of the fiscal year, if the threshold is breached, the Trust Fund Manager will establish an accounts receivable on the MERHCF end-of-year balance sheet for the amount in excess of 10%, ensure the SMA end-of-year balance sheet reflects an accounts payable for the same amount and then collect that amount from the DHP prior year un-obligated funds. In the first quarter of the following fiscal year, the Trust Fund Manager zeros out the end-of-year accounts receivable and SMA zeros out their accounts payable. Additionally, at the close of each year, any variance up to the 10% threshold will be recorded on the MERHCF Balance Sheet as an "advance" asset.

The Financial Management Chairperson (FMC) who oversees the daily management of the MERHCF, in consultation with the Uniform Business Office (UBO) program management staff, who monitor MTF accounts receivable activities, decided the threshold should be consistent with that of the U.S. Coast Guard prospective payment program and that the threshold for that program is 10%

The prospective O&M payment for MTF-provided care to Medicare-eligible beneficiaries was \$2.0 billion in FY 2021 and \$1.9 billion in FY 2020. While the unit costs of inpatient and outpatient services have risen slightly, utilization of inpatient services has continued to decrease while costs related to pharmacy non-ingredient O&M have increased. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries was \$0.6 billion and \$0.5 billion in FYs 2021 and 2020 respectively.

2. PERFORMANCE MEASURES

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoD and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2021, the Fund had net assets available to pay benefits of \$283.8 billion and an actuarial liability of \$609.4 billion (See Note 13 – Federal Employee and Veteran Benefits Payable); the funding ratio was 46.6%. As of September 30, 2020, the Fund had net assets available to pay benefits of \$262.9 billion and an actuarial liability of \$576.1 billion; the funding ratio was 45.6%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the DoD Board of Actuaries. The 38-year amortization period for the initial unfunded liability is scheduled to end in FY 2040.

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

3. FINANCIAL STATEMENT ANALYSIS

Comparative Financial Data

Medicare-Eligible Retiree Health Care Fund				
Analysis of Financial Statements				
for the years ended September 30, 2021 and 2020				
(\$ In Thousands)				
Balance Sheet	2021	2020	Difference Increase/ (Decrease)	% Change
Fund Balance with Treasury	\$161,069	\$68,929	\$92,140	134%
Cash and Other Monetary Assets	\$28	\$1,485	(\$1,457)	(98%)
Investments, Intragovernmental Securities	\$311,943,891	\$290,249,914	\$21,693,977	7%
Accounts Receivable	\$448,349	\$306,250	\$142,099	46%
Other Assets	\$60,000	\$0	\$60,000	100%
Accounts Payable (Federal)	\$22,832	\$196,228	(\$173,396)	(88%)
Accounts Payable (Nonfederal)	\$180,381	\$169,451	\$10,930	6%
Liabilities Not Covered by Budgetary Resources ¹	\$325,601,586	\$313,196,742	\$12,404,844	4%
Federal Employee and Veteran Benefits Payable	\$610,073,793	\$576,714,516	\$33,359,277	6%
Other Liabilities	\$28	\$1,485	(\$1,457)	(98%)
Statement of Net Cost				
Net Cost of Operations	\$11,208,595	(\$8,944,213)	\$20,152,808	(225%)
Statement of Budgetary Resources				
Net Amount of Budgetary Resources Obligated for Undelivered Orders	\$209,944	\$129,550	\$80,394	62%
Agency Outlays, Net	(\$12,366,130)	(\$3,908,348)	(\$8,457,782)	216%

¹ included as a component of the line titled "Federal Employee and Veteran Benefits Payable"

Comparative Financial Data Variance Analysis

BALANCE SHEET

Fund Balance with Treasury (Note 3)

Fund Balance with Treasury increased \$92.1 million (134%) due to an increase of \$167.9 million in the total final month-end disbursements for September 2021 versus September 2020 offset by a \$260 million increase in the September end of month holdback estimated to cover final month-end disbursements. Each month, a holdback amount is estimated based on the current month to date DHA disbursements versus the average monthly disbursement over the past 12 months.

Cash and Other Monetary Assets (Note 4)

Cash and Other Monetary Assets decreased \$1.5 million (98%) because of a \$1.5 million decrease in undeposited collections from September 2021 to September 2020. The decrease is due to

accounting not receiving a check from a Pharmaceutical Manufacturer under the Pharmacy Retail Refund Program before month-end but after the U.S. Treasury month-end cutoff. When a check is received, a corresponding liability is recorded because MERHCF is not entitled to the funds until deposited with the U.S. Treasury.

Investments - Intragovernmental Securities (Note 5)

Total Intragovernmental Securities, Net Investments increased \$21.7 billion (7%). This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Marine Corps, U.S. Public Health Service, NOAA, and U.S. Coast Guard), net of benefits paid. Investment of these funds has a cumulative effect with an expectation invested balances will continue growing to cover future benefits. The amounts not required for current year benefit payments were reinvested. The MERHCF purchased \$16.1 billion in long-term securities in FY 2021. In addition, there was an \$11.6 billion increase in inflation earned on Treasury Inflation Protected Securities (TIPS) from September 2021 to September 2020 offset by maturities in third and fourth quarters that decreased investments in long-term securities by \$7.9 billion.

Accounts Receivable, Net (Note 6)

Accounts Receivable increased \$142.1 million (46%). This increase is primarily due to a \$127.8 million increase in the Office of General Counsel (OGC) Administered Debt cases for Pharmacies. The remaining difference is mainly due to a \$14.7 million increase in net receivables recorded for Pharmacy Refund Programs due to increased billing for refunds from drug manufacturers offset by a \$947.2 thousand decrease in TRICARE Mail Order Pharmacy (TMOP) receivables.

Other Assets (Note 10)

Other Assets increased \$60 million (100%) due to a \$60 million reimbursement to the MERHCF from the DHA. Due to Coronavirus Disease 2019 (COVID-19), there was a significant decrease in MERHCF eligible care in FY21 causing a variance between the amount distributed to the MTFs and the amount the MTFs earned. MERHCF Business Rules require a reimbursement to the trust fund if there is a negative variance that exceeds 10%. In FY21, the variance was 13%. The \$60 million is the 3% variance required reimbursement to the MERHCF.

Accounts Payable (Federal)

Accounts Payable decreased \$173.4 million (88%) due to a decrease of \$173.4 million in the TRICARE program due to the implementation of the Defense Logistics Agency (DLA) Interfund Billing Process. Under this process, the disbursement to DLA is accomplished within the same month as the billings. Under the old process, the disbursement through Intra-Governmental Payment and Collection (IPAC) was not performed until the following month.

Accounts Payable (Non-Federal)

Accounts Payable increased \$10.9 million (6%). The increase in the Non-Fed Accounts Payable is primarily due to an \$11.5 million increase in drug cost under the Retail Pharmacy program. This increase is due to beneficiaries choosing to fill their prescriptions through retail pharmacies instead of the Military Treatment Facilities.

Liabilities Not Covered by Budgetary Resources (Note 11)

Total Liabilities Not Covered by Budgetary Resources increased \$12.4 billion (4%). This change is due to an increase of \$33.4 billion in the Federal Employee and Veteran Benefits Payable offset by an increase of \$21 billion in net receipts that are available to pay future benefits. Net receipts are comprised of contributions, interest income, and outlays. See Note 13, Federal Employee and Veteran Benefits Payable, for additional information about these changes.

Federal Employee and Veteran Benefits Payable (Note 13)

The present value of the Federal Employee and Veteran Benefits Payable increased \$33.4 billion (6%). This resulted primarily from the net effect of an increase of \$20.2 billion due to expected increases (interest and normal costs less benefit outlays), an increase of \$41.8 billion due to changes in key assumptions, and a decrease of \$28.8 billion due to actual experience being different from what was assumed (demographic and claims data). The remaining difference is attributable to estimated liabilities for medical claims incurred but not reported.

Other Liabilities (Note 15)

Other Liabilities decreased \$1.5 million (98%) because of a \$1.5 million decrease in undeposited collections from September 2021 to September 2020. The decrease is due to accounting not receiving a check from a Pharmaceutical Manufacturer under the Pharmacy Retail Refund Program before month-end but after the U.S. Treasury month-end cutoff. When a check is received, a corresponding liability is recorded because MERHCF is not entitled to the funds until deposited with the U.S. Treasury.

STATEMENT OF NET COST (Note 19)

Gross Costs decreased \$23.8 billion (91%) primarily due to an increase in actuarial expenses applied at fiscal year-end. The largest changes include a \$22.9 billion increase to the experience gain liability and a \$1.1 billion decrease to interest cost liability.

Earned Revenue increased \$10.6 billion (47%) primarily due to a \$9.7 billion increase in interest revenue from the inflation component of Treasury Inflation Protected Securities (TIPS) from September 2021 to September 2020 combined with a \$918 million increase in earned revenue from the annual contributions made by Department of the Treasury and the Uniformed Services.

Losses/Gains from Actuarial Assumption Changes for Military Retirement Benefits decreased \$54.6 billion (427%). There was a \$12.8 billion gain in FY20 but a \$41.8 billion loss in FY21.

Net Cost of Operations decreased \$20.2 billion (225%) due to the \$54.6 billion decrease in Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits offset by the \$23.8 billion decrease in Gross Costs and the \$10.6 billion increase in Earned Revenue as described above.

STATEMENT OF BUDGETARY RESOURCES (Note 21)

Undelivered Orders

The Total Budgetary Resources Obligated for Undelivered Orders at the End of the Period increased \$80.4 million (62%) primarily due to a \$60 million reimbursement to the MERHCF from the DHA. Due to COVID-19, there was a significant decrease in MERHCF eligible care costs in

Management's Discussion And Analysis

FY21 causing a variance between the amount distributed to the MTFs and the amount the MTFs earned. MERHCF Business Rules require a reimbursement to the trust fund if there is a negative variance that exceeds 10%. In FY21, the variance was 13%. The \$60 million is the 3% variance required reimbursement to the MERHCF. The remaining difference is due to a \$20.4 million increase in undelivered orders mainly from an \$8.5 million increase in funding for TMOP, a \$4.2 million increase in Retail Pharmacy, and a \$6.5 million increase in Miscellaneous Health Care Contracts.

Budgetary Resources

Appropriations/Total Budgetary Resources increased \$449.8 million (4%). At the end of the fiscal year, the MERHCF adjusts total budgetary resources to equal total obligations incurred for the fiscal year. MERHCF's obligations are comprised of quarterly distributions to the Medical Treatment Facilities and Daily Payments for purchased care/healthcare, Operations & Maintenance. Fluctuation is normal due to the number of people in the system and medical need from one year to the next.

Status of Budgetary Resources

New Obligations and Upward Adjustments increased \$449.8 million (4%). This increase is primarily due to a \$626.6 million increase in total obligations paid offset by a \$162.5 million decrease in accounts payable. Obligations include quarterly distributions to the Medical Treatment Facilities and Daily Payments for purchased care/healthcare, Operations & Maintenance. (Also, see accounts payable explanations above).

Outlays, net

Outlays, net increased \$626.6 million (6%) because of a \$626.6 million increase in total obligations paid. Obligations include quarterly distributions to the Medical Treatment Facilities and Daily Payments for purchased care/healthcare, Operations & Maintenance.

Distributed offsetting receipts increased \$9.1 billion (63%) primarily due to a \$9.7 billion increase in interest revenue from the inflation component of Treasury Inflation Protected Securities (TIPS) from September 2021 to September 2020.

Agency outlays, net, increased \$8.5 billion (216%) due to the increase in distributed offsetting receipts offset by the increase in outlays, as explained above.

Assets

Assets of \$312.6 billion, included in the Comparative Financial Data table on page 6 and shown in Figure 1, represent amounts that the MERHCF owns and manages. Assets increased by \$22 billion during FY 2021. This increase is largely attributable to a net increase in investments of \$21.7 billion. The net increase in investments is related to expected normal growth to cover unfunded portions of future military retirement benefits. Funds not needed to pay current benefits are invested in U.S. Treasury securities.

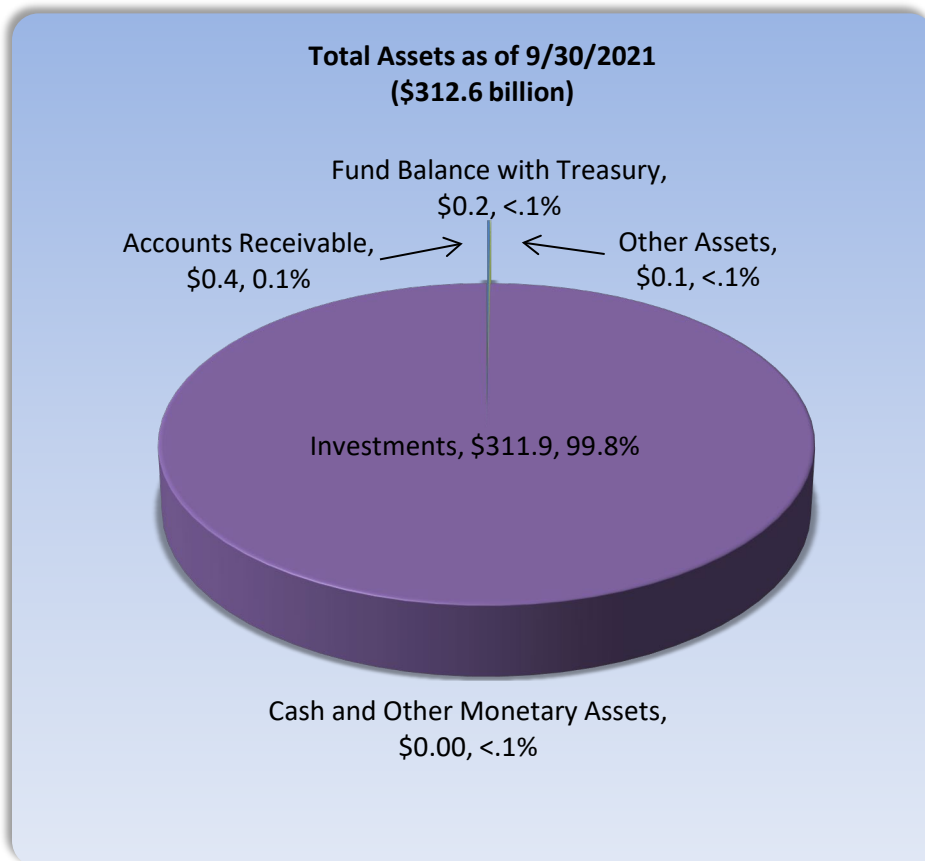


Figure 1

Investments

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

Figure 2 below depicts the par value of investment holdings (includes inflation and interest receivable), net of amortization, as of September 30, 2021.

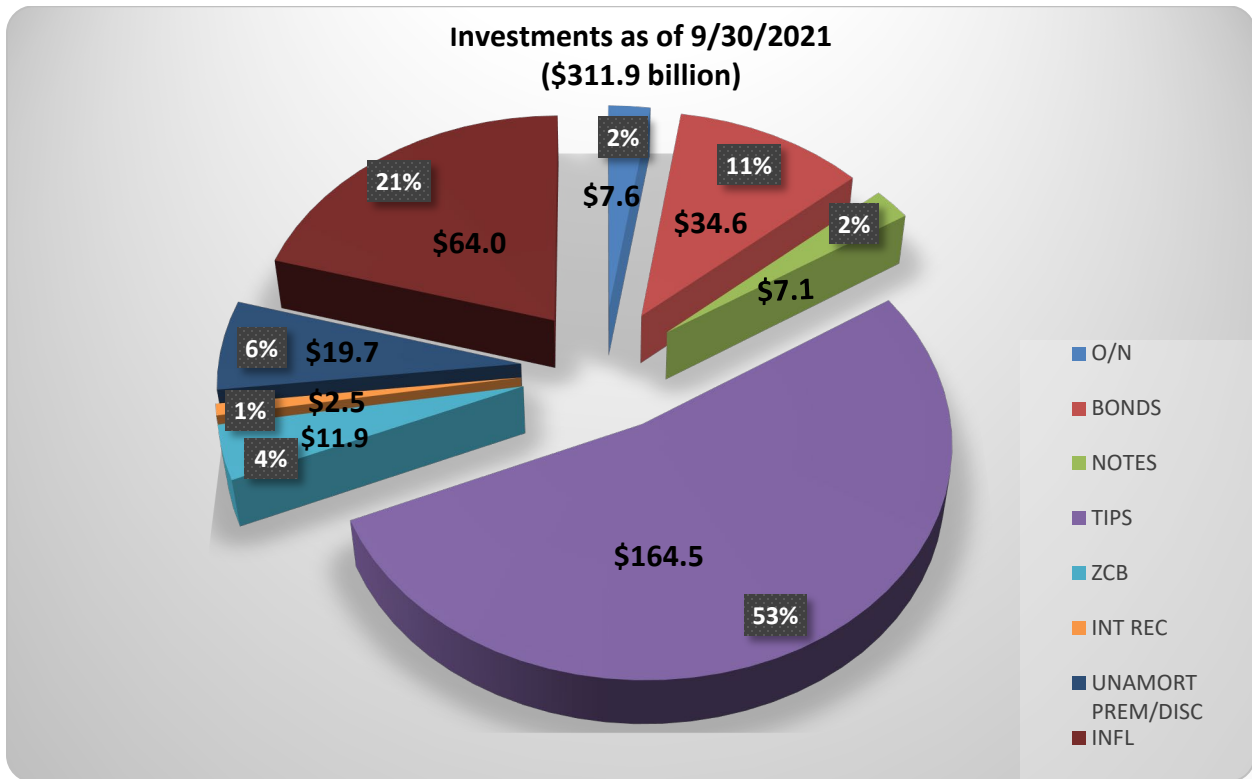


Figure 2

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

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

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

Liabilities

Liabilities of \$610.3 billion included in the Comparative Financial Data table and shown in Figure 3 represent liabilities related to military retirement medical benefits for Medicare-eligible beneficiaries. The liabilities of the MERHCF primarily consist of actuarial liability for future benefit payments. Liabilities increased by \$33.2 billion during FY 2021. This increase is largely attributable to the increase in the actuarial liability.

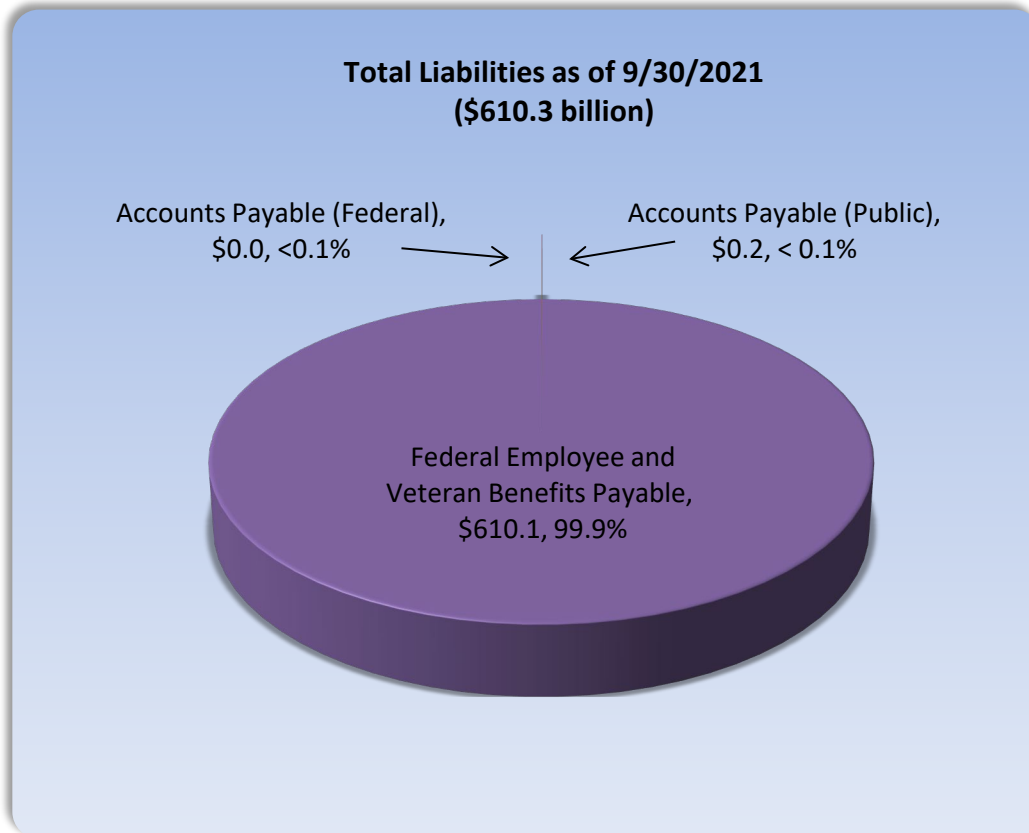


Figure 3

MERHCF Requirements and Funding Plan

In FY 2021 and FY 2020 respectively, the Fund authorized approximately \$11.3 billion and \$10.7 billion in total health care services, \$8.7 billion and \$8.3 billion to civilian providers for purchased care, \$2.0 billion and \$1.9 billion to MTFs, and \$0.6 billion and \$0.5 billion to Military Service Personnel Accounts, on behalf of Medicare-eligible retirees, retiree dependents, and survivors. Purchased Care end of year MERHCF obligations were \$8.5 billion and \$8.2 billion in FY 2021 and FY 2020 respectively.

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

\$ In Billions				
Fiscal Year	Purchased Care	Operations & Maintenance	Military Personnel	Final
2021	\$8.7	\$2.0	\$0.6	\$11.3
2020	\$8.3	\$1.9	\$0.5	\$10.7

MERHCF Revenues and Contributions

The Fund receives income from three sources:

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

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

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2021	\$7.0	\$8.6	\$17.4
2020	\$6.6	\$8.1	\$7.7

Amounts contributed to the MERHCF by the DoD, other uniformed services, and the U. S. Treasury must be based on determinations by the OACT under methods and assumptions approved by the MERHCF Board in accordance with applicable provisions of Sections 1111 through 1117 of Title 10, U.S. Code and DoD policy established in the FMR, Volume 12, Chapter 16, December 2019.

4. SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

Management Assurances

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

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

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

The evaluation of internal controls for the statement of assurance extended to every responsibility and activity undertaken by the organizations that execute the MERHCF and applies to program, administrative, and operational controls. The internal control testing follows the Financial Improvement and Audit Readiness (FIAR) Guidance established by the OUSD(C). This process includes the development of process flowcharts and narratives that include the identification of key controls that address FIAR-defined Financial Reporting Objectives, risk assessments associated with those key controls, test plans for those key controls, and reporting of test results based on execution of those test plans. Based on the results of this assessment, the DHA and TFAR are able to provide a qualified statement of assurance that the internal controls over financial reporting as of June 30, 2021 were operating effectively with the exception of the material weakness noted in this section under "Material Weakness 2021."

Federal Financial Management Improvement Act (FFMIA) (PL 104-208). The DHA internal review of the MERHCF also included the effectiveness of the internal controls over the integrated financial management systems for the DHA, SMA, and the MERHCF financial statement reporting entities. For the MERHCF, the DHA is able to provide a qualified statement of assurance that the internal controls over the integrated financial management system as of September 30, 2021, are in compliance with the Federal Financial Management Improvement Act and OMB Circular A-123 Appendix D with the exception of one systems non-conformance noted in this section under "Material Weakness 2021."

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

Material Weakness 2021

The MERHCF independent auditors noted one material weakness during the FY 2021 Financial Statement Audit.

NFR# FIN – 2021-02 Direct Care Costs Data Accumulation

The MERHCF's FY 2021 quarterly prospective payments included \$1.96 billion in expenses for direct care costs for the period ending 30 June 2021. Health care cost data from the MTFs provided for the direct care cost estimation process used in the prospective payment is aggregated or derived from information in both financial and non-financial systems within the DHP. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the MERHCF does not have a formalized process in place to track health care encounters for MERHCF beneficiaries for accounting purposes, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to the DHP in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

There is also insufficient evidence that appropriate and consistent cut-off accounting activity CUI Medicare-Eligible Retiree Health Care Fund (MERHCF) Fiscal Year (FY) 2021 Financial Statement Audit Notice of Findings and Recommendations (NFR) NFR Number: FIN-2021-02 30 September 2021 2 CUI occurs at the MTF level associated with care provided to MERHCF beneficiaries. The MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care. Additionally, the MERHCF performs an annual retrospective reconciliation, using a 12-month running average process established in FY 2020, of the MTF patient workload data for purposes of comparing the two-year historical data used in the prospective payment methodology to the actual patient workload realized in the year of payment. The results of the reconciliations are used for the purpose of determining if any significant transfer of funds should be returned to the MERHCF, as well as to adjust the prospective payment methodology, as may be warranted.

Direct Care Cost Accumulation

At issue with the conditions of unaudited, non-accrual based MTF level data and the lack of Standard Financial Information Structure (SFIS) compliant accounting systems is the fact that direct health care costs provide input to the development of the actuarially determined long-term health care liability of the MERHCF, as well as the determination of amounts contributed by the branches of military service for active duty participants. The actuarial liability for direct care related to Medicare-eligible retiree benefits as of September 30, 2021 and 2020 is approximately \$134.3 billion (22% of total) and \$136.5 billion (24% of total), respectively, which reflects the actuarial present value of the projected direct-care costs of benefits to be provided by MTFs to the MERHCF beneficiaries.

Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2021, include approximately \$3.6 billion and \$2.6 billion, respectively, and for the year ended September 30, 2020, include approximately \$3.7 billion and \$2.4 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are based on cost allocation methods using data extracted from various Service-specific financial, personnel, and workload systems within DoD as well as patient encounter data. With respect to the extracted data, the MTFs do not have OMB Circular A-123 Appendix D, FFMIA compliant, transaction-based accounting systems and cannot report the costs of an individual patient's care.

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

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

While inpatient and ambulatory encounter costs are weighted at the MTF level as described above, MTF outpatient pharmacy costs represent the largest cost driver for the direct care portion of the actuarial liability. The reconciliation tasks performed by DHA management's support contractor have also assessed and documented the operation of Pharmacy Data Transaction Service, data to support both the prospective payment and calculation of the actuarial liability. The MERHCF Rate Summary Analysis is a process by which the DHA determines the annual prospective payment to the individual MTFs for the coverage of the pharmaceutical ingredient costs associated with dispensing to Medicare-eligible retirees. The ingredient costs for pharmaceuticals dispensed for Medicare-eligible retirees at MTFs are calculated based on the Prime Vendor invoices for all continental United States (CONUS) based facilities for the National Drug Codes within their Generic Sequence Numbers based on a weighted average basis of the average acquisition cost (the price paid by the MTF for the pharmaceutical product) during the relevant FY.

The prospective payments made to the MTFs have, in the past, been reconciled with actual workload activity after the close of the FY. The results of the reconciliation were used to adjust projections of MTF workload levels and costs for the future prospective payment distribution plan. The results of the reconciliation were not used to make adjustments to the current prospective

payment distribution plan either during execution year activities or to a specific distribution subsequent to the close of the FY's operation.

Issues with the prospective payment process include non-accrual based expenditures, auditability of the SMAs' validation and reconciliation of the financial data prior to its input into the MEPRS cost allocation process, archiving MEPRS data at the close of each month, and reconciling in a timely manner the FY prospective payment plan.

Actions Taken

Since FY 2003, when the Fund was established, the MERHCF management has attempted to resolve auditor-identified material weakness through the development of key milestone initiatives. These initiatives were established and managed by the DHA leadership and intended to serve as work-around solutions because the MERHCF management cannot address the Military Services financial systems' or MTF-level data deficiencies. The material weakness is associated with the computation of that portion of the MERHCF health care liability involving the care provided to Medicare-eligible beneficiaries in the MTFs.

In an effort to address issues identified within NFR FIN-2020-2, the Trust Fund Manager has implemented a monthly reconciliation of the Fund by Medical Treatment Facility (MTF). This process is executed using the same data elements involved in producing the MERHCF Annual Level of Effort (LOE) workbook provided to the Trust Fund Manager by Leidos. The reconciliation is performed by using a rolling 12 months of data extracted from the MHS Data Repository/MHS MART. The 12 months dataset includes the most recent complete month of the current FY and the 11 months preceding it. A threshold of -10% variance has been established as the critical point at which action must be taken. The variance is monitored throughout the fiscal year. At the end of the fiscal year, if the threshold is breached, the Trust Fund Manager will establish an accounts receivable on the MERHCF end-of-year balance sheet for the amount in excess of 10%, ensure the SMA end-of-year balance sheet reflects an accounts payable for the same amount and then collect that amount from the DHP prior year un-obligated funds. In the first quarter of the following fiscal year, the Trust Fund Manager zeros out the end-of-year accounts receivable and SMA zeros out their accounts payable. Additionally, at the close of each year, any variance up to the 10% threshold will be recorded on the MERHCF Balance Sheet as an "advance" asset.

The reconciliation is completed on or around the 21st of each month. The most current data available is approximately 60 days in arrears. This process is the most comprehensive approach available to project future trends in MERHCF earnings and allows the Trust Fund Manager the latitude to make proactive decisions regarding the management of the Fund.

Deployment of MHS GENESIS. The DHA has initiated the deployment of the MHS' new Electronic Health Record (EHR). The migration to the new EHR will provide the DHA the ability to perform more granular analysis to include itemized patient billing and transactional auditing capability. In theory this will allow the MERHCF Distribution Calculations and the Monthly Reconciliations to be performed in a more thorough, consistent and accurate manner.

There are risks associated with the deployment of MHS GENESIS that have yet to be mitigated. MHS GENESIS was not designed to interface with the Expense Assignment System (EASIV) that is used by the MEPRS, the MHS' standardized cost accounting system. This has caused a substantial data blackout and prevented accurate cost accounting across the enterprise. At the beginning of FY20, there were four Parent Defense Medical Information System Identifier (DMIS IDs) and multiple Child DMIS IDs using MHS GENESIS. In FY21 six more Parent DMIS IDs and Child DMIS IDs received MHS GENESIS. As more of the MHS transitions from the legacy system to MHS GENESIS, the enterprise faces an unprecedented lack of reliable data for planning, tracking and decision making purposes to include the distribution and reconciliation of the MERHCF.

Information Technology (IT) Significant Deficiency on Access Controls and Configuration Management

In FY 2019, the audit identified a significant deficiency pertaining to certain Information Systems used by the MERHCF. While the deficiency remains in FY 2021, corrective actions are being pursued.

The MERHCF operates or relies on external providers for administration of multiple key financial management systems, including two core accounting systems and multiple financial support systems. The Defense Manpower Data Center (DMDC) Core Infrastructure (dCore), Defense Enrollment Eligibility Reporting System (DEERS), and Naval Postgraduate School (NPS) Mainframe support key medical benefit payment activities. dCore, DEERS and NPS mainframe systems are administrated by the DMDC.

The audit identified the MERHCF, through the support systems of DMDC, has several deficiencies in the design and operating effectiveness of internal controls related to key financial support systems and service organization systems. While the audit noted that no single control deficiency meets the level of a significant deficiency, in combination, the deficiencies noted were elevated to a significant deficiency due to the pervasiveness of the weaknesses throughout the information system environment, the MERHCF's reliance on these systems for financial reporting, and the nature of the deficiencies repeating from the prior year.

Without effective controls throughout the information system environment, the risk of unauthorized access and information system changes increases, thereby increasing the risk to the systems and the data confidentiality, integrity, and availability.

The MERHCF and DMDC agreed with the audit findings received. Notices of Findings and Recommendations (NFRs) identified during the FY 2018 audit were not remediated in a timely manner which caused repeat findings under the FY 2019, 2020 and 2021 audits. Corrective Action Plans (CAPs) established in FY 2019 that failed to be fully implemented are required to be modified with new completion dates. For specific details please reference the "Independent Auditor's Report on Internal Control over Financial Reporting" included in the Financial Section of this report.

DHA Business Support Directorate - Program Integrity Office

The DHA Business Support Directorate (BSD) - Program Integrity Office manages anti-fraud and abuse activities for the DHA to protect benefit dollars and safeguard eligible beneficiaries. Program Integrity responsibilities include:

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

5. OTHER MANAGEMENT INFORMATION

Management Initiatives

All Retiree Fund Proposals. As mentioned in the December 2013 (as well as December 2005 and 2009) *Report to the President and Congress on the Department of Defense Medicare-Eligible Retiree Health Care Fund* submitted by the OACT, a significant portion of military retiree health benefits are not covered by the MERHCF. Benefits for retirees who are not yet Medicare-eligible are a significant cost because of the young age at which many military members retire, and because the program pays for the full cost of their health care (whereas under the Medicare-eligible program, a large portion is paid by Medicare). The OACT noted that both the private sector and public sector (states and municipalities follow Government Accounting Standards Board Statements No. 43 and 45) account for both pre-Medicare and post-Medicare retiree health benefits on an advance accrual basis. The MERHCF Board believes that consideration should be given to extend the Fund to cover all retiree health care costs, so that the budgetary treatment of pre-Medicare retiree health costs would be similar to the treatment of Medicare-eligible retiree costs, and all of the economic efficiencies and proper incentives promoted by the Fund would reflect the full cost to DoD of future retiree benefit entitlements being earned by military members' current service. The MERHCF management agrees with the OACT recommendation.

Financial Management Systems Framework

MERHCF Reliance on SMA Financial Systems and Data. The cost of care provided directly in MTFs and medical coding record data used in direct care cost allocations is reported to the MDR by the SMA individual MTFs. The MERHCF direct care funding is executed by the Navy and Air Force SMA Components for those facilities that still rely on the financial systems and procedures of their parent Line Services, or the DHA for Army and limited Navy MTFs that now rely on the General Fund Enterprise Business System (GFEBS) financial system.

The one material weakness identified in the MERHCF audit is directly related to the SMAs' financial management systems, data accumulation, and financial reporting deficiencies. MERHCF management has no direct control over SMA financial management systems or data compliance

that have not employed GFEBs. The Accounting and Financial Integrity (A&FI) branch of the DHA BSD's Budget & Resource Management continually strives to work with the SMA representatives to improve the SMA audit readiness by following the FIAR guidance and objectives.

In FY 2015, the SMA underwent an examination of the Statement of Budgetary Activity and received an adverse opinion. Since 2018, the SMA has been under audit of its financial statements. From the audit and the resulting issuance of NFRs, SMA officials are able to better develop corrective action plans to ultimately address discrepancies and prepare for additional SMA audits.

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

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

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

The initial rule, published in the Code of Federal Regulations (C.F.R.) at 32 C.F.R. 199.21(q), subjected the TRICARE retail pharmacy program to pricing standards known as FCP by prohibiting pharmaceutical manufacturers from receiving more than the FCPs for pharmaceuticals purchased by DoD for the TRICARE retail pharmacy program.

The OGC requested waiver/compromise authority from DoJ, received it, and has resolved all pending waiver/compromise requests applicable to the "Retro Period" (January 2008 through June 2009) based upon the provisions of 32 C.F.R. §199.11.

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

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

- ADP #1 (Program 009) - WAC (% of Wholesale Acquisition Cost): The manufacturer's list price for the drug to wholesalers or direct purchasers in the United States, not including prompt pay or other discounts, rebates or reductions in price, as reported in wholesale price guides or other publications of drug pricing data.
- ADP #2 (Program 010) – (FCP - additional discount): The maximum price the manufacturer can charge for a Federal Supply Schedule (FSS) listed drug to the Big 4 -

Management's Discussion And Analysis

VA, DoD, PHS, and the Coast Guard; calculated annually by VA using Non-FAMP and other data submitted by the manufacturer.

The table on the following page highlights DoD activity since the inception of the Program. DoD has collected \$14.7 billion to date and continues rigorous collection efforts for both programs.

TRICARE Retail Pharmacy Refunds Program

Program To Date (CY 2008-3rd Quarter, CY 2021)	Total	DHP	Non-DoD	MERHCF
SDP				
Billed	\$9,452,854,133	\$4,246,469,019	\$147,235,395	\$5,059,149,719
Collected	(\$9,141,562,110)	(\$4,111,775,908)	(\$141,823,855)	(\$4,887,962,347)
Net	\$311,292,023	\$134,693,111	\$5,411,540	\$171,187,372
ADP				
Billed	\$5,732,596,066	\$2,569,896,985	\$90,159,323	\$3,072,539,758
Collected	(\$5,514,764,723)	(\$2,475,414,694)	(\$86,552,241)	(\$2,952,797,788)
Net	\$217,831,343	\$94,482,291	\$3,607,082	\$119,741,970
UDC ¹	(\$174,671)	(\$74,393)	(\$2,846)	(\$97,432)
Total				
Billed	\$15,185,450,199	\$6,816,366,004	\$237,394,718	\$8,131,689,477
Collected	(\$14,656,326,833)	(\$6,587,190,602)	(\$228,376,096)	(\$7,840,760,135)
UDC	(\$174,671)	(\$74,393)	(\$2,846)	(\$97,432)
Net	\$528,948,695	\$229,101,009	\$9,015,776	\$290,831,910
Aging				
Current	\$496,271,865	\$215,148,790	\$8,173,600	\$272,949,475
61 Days to 2 Years ²	\$4,038,775	\$1,370,900	\$413,682	\$2,254,193
Over 2 Years	\$28,638,055	\$12,581,319	\$428,494	\$15,628,242
Total³	\$528,948,695	\$229,101,009	\$9,015,776	\$290,831,910

1. Unapplied Collections (UDC) applied to CY21.

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

3. 3QCY2021 Estimate added to Billings to reconcile with A/R: \$137,682,000 MERHCF; \$112,649,000 DHP & Non-DoD.

TRICARE has a waiver dated September 23, 1996, 10 U.S.C. 1079a, *CHAMPUS: Treatment of Refunds and Other Amounts Collected* that states:

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

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

The DHA-CRM in FY 2021 continued to aggressively collect pharmacy refunds for both the SDP and ADP. Through the concerted efforts of DHA-CRM, Pharmacy Operations Division (POD), HCDA, and OGC, DHA-CRM's collection rate has continued to average 97% - 99%.

6. LIMITATIONS ON THE FINANCIAL STATEMENTS

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

Principal Statements

The accompanying notes are an integral part of these financial statements

Balance Sheets

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
BALANCE SHEETS
As of September 30, 2021 and 2020
(\$ In Thousands)**

	2021	2020
ASSETS		
Intragovernmental:		
Fund Balance with Treasury (Note 3)	\$ 161,069	\$ 68,929
Investments, Net (Note 5)	311,943,891	290,249,914
Other Assets (Note 10)	60,000	0
Total Intragovernmental	312,164,960	290,318,843
Other than Intragovernmental/With the Public:		
Cash and Other Monetary Assets (Note 4)	28	1,485
Accounts Receivable, Net (Note 6)	448,349	306,250
Total Other than Intragovernmental/With the Public	448,377	307,735
TOTAL ASSETS	\$ 312,613,337	\$ 290,626,578
LIABILITIES		
Intragovernmental:		
Accounts Payable	\$ 22,832	\$ 196,228
Total Intragovernmental	22,832	196,228
Other than Intragovernmental/With the Public:		
Accounts Payable	180,381	169,451
Federal Employee and Veteran Benefits Payable (Notes 11 and 13)	610,073,793	576,714,516
Other Liabilities (Note 15)	28	1,485
Total Other Than Intragovernmental/With the Public	610,254,202	576,885,452
TOTAL LIABILITIES	\$ 610,277,034	\$ 577,081,680
Commitments and Contingencies (Note 17)		
NET POSITION		
Cumulative Results of Operations – Funds from Other than Dedicated Collections	\$ (297,663,697)	\$ (286,455,102)
TOTAL NET POSITION	(297,663,697)	(286,455,102)
TOTAL LIABILITIES AND NET POSITION	\$ 312,613,337	\$ 290,626,578

The accompanying notes are an integral part of these financial statements

Statements of Net Cost

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF NET COST
For the Years Ended September 30, 2021 and 2020
(\$ In Thousands)**

	2021	2020
Gross Program Costs		
Military Retirement Benefits		
Actuarial Non-Assumption Costs	\$ (8,512,931)	\$ 15,713,925
Other Program Costs	10,898,806	10,511,093
Total Gross Costs	\$ 2,385,875	\$ 26,225,018
Less: Earned Revenue	(32,982,794)	(22,367,191)
Net Military Retirement Benefits Costs	\$ (30,596,919)	\$ 3,857,827
(Gain)/Loss on Actuarial Assumption Changes (Note 13)	\$ 41,805,514	\$ (12,802,040)
Net Program Costs Including Assumption Changes	\$ 11,208,595	\$ (8,944,213)
Net Cost of Operations	\$ 11,208,595	\$ (8,944,213)

The accompanying notes are an integral part of these financial statements

Statements of Changes in Net Position

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF CHANGES IN NET POSITION
For the Years Ended September 30, 2021 and 2020
(\$ In Thousands)**

CUMULATIVE RESULTS OF OPERATIONS	<u>2021</u>	<u>2020</u>
Beginning Balances	\$ (286,455,102)	\$ (295,399,315)
Net Cost of Operations (+/-)	<u>11,208,595</u>	<u>(8,944,213)</u>
Net Change	<u>(11,208,595)</u>	<u>8,944,213</u>
Cumulative Results of Operations	<u>(297,663,697)</u>	<u>(286,455,102)</u>
Net Position	<u><u>\$ (297,663,697)</u></u>	<u><u>\$ (286,455,102)</u></u>

The accompanying notes are an integral part of these financial statements

Statements of Budgetary Resources

**Department of Defense
Medicare-Eligible Retiree Health Care Fund
STATEMENTS OF BUDGETARY RESOURCES
For the Years Ended September 30, 2021 and 2020
(\$ In Thousands)**

	2021	2020
BUDGETARY RESOURCES		
Appropriations (discretionary and mandatory)	\$ 11,054,605	\$ 10,604,783
Total Budgetary Resources	\$ 11,054,605	\$ 10,604,783
STATUS OF BUDGETARY RESOURCES		
New obligations and upward adjustments (total)	\$ 11,054,605	\$ 10,604,783
Total Budgetary Resources	\$ 11,054,605	\$ 10,604,783
OUTLAYS, NET		
Outlays, net (total) (discretionary and mandatory)	11,196,676	10,570,066
Distributed offsetting receipts (-)	(23,562,806)	(14,478,414)
Agency Outlays, net (discretionary and mandatory)	\$ (12,366,130)	\$ (3,908,348)

The accompanying notes are an integral part of these financial statements

Footnotes to the Principal Statements

Note 1. Significant Accounting Policies

A. Reporting Entity

The Department of Defense (Department or DoD) includes the Office of the Secretary of Defense (OSD), Joint Chiefs of Staff (JCS), DoD Office of the Inspector General (DoD OIG), Military Departments, Defense Agencies, DoD Field Activities, and Combatant Commands, which are considered, and may be referred to as, DoD Components. The Military Departments consist of the Departments of the Army, the Navy (of which the Marine Corps is a component), and the Air Force. The MERHCF is a component of the Department's reporting entity for the purposes of consolidated/combined financial statements.

B. Mission of the Reporting Entity

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

C. Basis of Presentation

The financial statements have been prepared to report the financial position and results of the MERHCF operations, as required by the Chief Financial Officers Act of 1990, as amended and expanded by the Government Management Reform Act of 1994 and other applicable legislation. To the extent possible, the financial statements have been prepared from the accounting records of the MERHCF in accordance with the formats prescribed by Office of Management and Budget (OMB) Circular No. A-136, Financial Reporting Requirements, and in accordance with GAAP for federal entities as prescribed by the Federal Accounting Standards Advisory Board (FASAB). The financial statements account for all resources for which the MERHCF is responsible, unless otherwise noted. Accounting standards allow certain presentations and disclosures to be modified, if needed, to prevent the disclosure of classified information.

The MERHCF currently has one auditor-identified financial statement material weakness: Direct Care Costs Data Accumulation. Health care cost data from the MTFs provided for the direct care cost estimation process is aggregated or derived from information in both financial and non-financial systems within the DHA SMAs. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the health care encounters for MERHCF beneficiaries are not tracked for accounting purposes in financial general ledger systems, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to SMAs in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

DoD MERHCF Footnotes to the Principal Financial Statements

There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. As of FY 2021, the MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care.

Finally, there is insufficient evidence effective controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs, which is a significant factor in the allocation process for assigning costs to the MTFs.

D. Basis of Accounting

The MERHCF's financial management systems record and report on the accrual basis. Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with 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 MERHCF is largely derived from budgetary transactions (obligations, disbursements, and collections) and proprietary transactions (assets and liabilities) and accruals made for major items such as accounts receivable, accounts payable, and health care liabilities.

E. Accounting for Intragovernmental and Intergovernmental Activities

Treasury Financial Manual (Treasury), Volume I, Part 2, Chapter 4700, provides guidance for reporting and reconciling intragovernmental balances. The MERHCF is able to reconcile balances pertaining to investments in federal securities.

F. Non-Entity Assets

Non-entity assets are not available for use in the MERHCF's normal operations. The MERHCF has stewardship accountability and reporting responsibility for non-entity assets. An example of a non-entity asset is the amount of interest, penalties, and administrative charges to be collected by the MERHCF on behalf of the U.S. Treasury. For additional information, see Note 2, Non-Entity Assets.

G. Fund Balance with Treasury

The MERHCF's monetary resources of collections and disbursements are maintained in U.S. Treasury accounts. The disbursing offices of the DFAS and other Defense Agency financial service centers process the majority of the MERHCF's cash collections, disbursements, and adjustments worldwide. Each disbursing station reports to the U.S. Treasury on checks issued, electronic fund transfers, interagency transfers, and deposits.

In addition, DFAS and other DoD Agency service centers report to the U.S. Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The U.S.

DoD MERHCF Footnotes to the Principal Financial Statements

Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account.

The U.S. Treasury allows the MERHCF to be fully invested; therefore, FBWT may be zero at various times during the fiscal year. Controls are in place to prevent abnormal balances at the U.S. Treasury. For additional information, see Note 3, Fund Balance with Treasury.

H. Cash and Other Monetary Assets

Cash is the total of cash resources under the control of the DoD, including coins, paper currency, negotiable instruments, and amounts held for deposit in banks and other financial institutions. The MERHCF transacts all business in U.S. dollars. For additional information, see Note 4, Cash and Other Monetary Assets.

I. Investments and Related Interest

The MERHCF reports investments in Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized over the term of the investments using the effective interest rate method. The MERHCF's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The MERHCF invests in nonmarketable, market-based Treasury securities issued to federal agencies by the Treasury's Bureau of Fiscal Service. These securities are not traded on any financial exchange but are priced consistently with publicly traded Treasury securities. The MERHCF receives interest semiannually from the U.S. Treasury on the value of these securities. For additional information, see Note 5, Investments and Related Interest.

J. Accounts Receivable

Accounts receivable from other federal entities or the public include accounts receivable, claims receivable, and refunds receivable. Allowances for uncollectible accounts due from the public are based upon factors such as aging of accounts receivable, debtor's ability to pay, and payment history.

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

DoD MERHCF Footnotes to the Principal Financial Statements

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

TRICARE has a waiver dated September 23, 1996, 10 USC 1079a, Champus: Treatment of Refunds and Other Amounts Collected that states: “All refunds and other amounts collected in the administration of the Civilian Health and medical Program of the Uniformed Services shall be credited to the appropriation available for that program for the fiscal year in which the refund or amount is collected.” Thus, TRICARE records all collections/refunds into the current year and decreases budgetary disbursements for the current year. The refunds collected are not treated as offsetting collections. For additional information, see Note 6, Accounts Receivable, Net.

K. Direct Loans and Loan Guarantees

Not Applicable.

L. Inventories and Related Property

Not Applicable.

M. General Property, Plant and Equipment

Not Applicable.

N. Other Assets

Advances and Prepayments are made in contemplation of the future performance of services, receipt of goods, incurrence of expenditures, or receipt of other assets, excluding those made as Outstanding Contract Financing Payments. The MERHCF’s advances and prepayments represent the amount of reimbursement to the MERHCF from the DHA due to a variance between the amount distributed to the MTFs and the amount the MTFs earned. Due to COVID-19, there was a significant decrease in MERHCF eligible care in FY21 and MERHCF Business Rules require a reimbursement to the trust fund if there is a negative variance that exceeds 10%. In FY21, the variance was 13% requiring a 3%, \$60 million, reimbursement to the MERHCF. This reimbursement is reported on Note 10, Other Assets.

O. Leases

Not Applicable.

P. Liabilities

Liabilities represent the probable future outflow or other sacrifice of resources as a result of past transactions or events. However, no liability can be paid by the Department absent proper budget authority. Liabilities covered by budgetary resources are appropriated funds for which funding is otherwise available to pay amounts due. The MERHCF Liabilities Not Covered by Budgetary Resources represents the portion of the actuarial liability for health benefits for which current assets are not yet available. These liabilities are reported on Note 11, Liabilities Not Covered by Budgetary Resources.

Q. Environmental and Disposal Liabilities

Not Applicable.

R. Other Liabilities

Deposit Funds and Suspense Accounts consist of undeposited collections received after the U.S. Treasury month-end cutoff. A corresponding liability is created because the MERHCF is not entitled to use the funds until deposited with the U.S. Treasury. These undeposited collections are reported on Note 4, Cash and Other Monetary Assets. For additional information, see Note 15, Other Liabilities.

S. Commitments and Contingencies

The MERHCF recognizes contingent liabilities on the Balance Sheet for legal actions where management considers an adverse decision to be probable and the loss amount is reasonably estimable. These legal actions are estimated and disclosed in Note 17, Commitments and Contingencies. However, there are cases where amounts have not been accrued or disclosed because the likelihood of an adverse decision is considered remote or the amount of potential loss cannot be estimated.

There are two cases or claims pending with the DHA meeting the threshold guidance. For additional information, see Note 17, Commitments and Contingencies.

T. Military and Civilian Retirement Benefits

The DoD applies the Statement of Federal Financial Accounting Standards (SFFAS) No. 33, Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates, in selecting the discount rate and valuation date used in estimating Military Retirement Benefit actuarial liabilities. In addition, gains and losses from changes in long-term assumptions used to estimate the actuarial liability are presented separately on the Statement of Net Cost. Refer to Note 13, Federal Employee and Veteran Benefits Payable, and Note 19, Disclosures Related to the Statement of Net Cost, for additional information.

U. Revenues and Other Financing Sources

Using methods and assumptions approved by the DoD MERHCF Board of Actuaries, the DoD Office of the Actuary determines the amount of the contributions to the MERHCF. The contribution consists of two parts: a U.S. Treasury warrant for the amortization payment of the original unfunded liability and an annual contribution from each Uniformed Service: Army, Navy, Air Force, Marine Corps, U.S. Coast Guard, Public Health Service, and National Oceanic and Atmospheric Administration. Funds from the contributions that exceed the amounts required to pay current year expenses are invested in long-term securities. These investments and their associated interest revenues will be used to cover future liabilities of the MERHCF.

V. Recognition of Expenses

For financial reporting purposes, DoD policy requires the recognition of benefit expenses in the period incurred. Estimates are used in the computation of actuarial liabilities. The current financial management systems for the MERHCF collect and record financial information on the full accrual accounting basis for liabilities and expenses of the fund.

W. Treaties for Use of Foreign Bases

Not Applicable.

X. Use of Estimates

The MERHCF's management makes assumptions and reasonable estimates in the preparation of financial statements based on current conditions, which may affect the reported amounts. Actual results could differ materially from the estimated amounts. Significant estimates include actuarial liabilities for military retirement.

Y. Parent-Child Reporting

Not Applicable.

Z. Transactions with Foreign Governments and International Organizations

Not Applicable.

AA. Fiduciary Activities

Not Applicable.

BB. Tax Exempt Status

As an agency of the federal government, the MERHCF is exempt from all income taxes imposed by any governing body whether it is a federal, state, commonwealth, local, or foreign government.

CC. Standardized Balance Sheet and Related Footnotes - Comparative Year Presentation

The format of the Balance Sheet has changed to reflect more detail for certain line items, as required for all significant reporting entities by OMB Circular A-136. This change does not affect totals for assets, liabilities, or net position and is intended to allow readers of this Report to see how the amounts shown on the DoD-wide Balance Sheet are reflected on the Government-wide Balance Sheet, thereby supporting the preparation and audit of the Financial Report of the United States Government. The presentation of the fiscal year 2020 Balance Sheet and the related footnotes was modified to be consistent with the fiscal year 2021 presentation. The mapping of the U.S. Standard General Ledger (USSGL), in combination with their attributes, to particular Balance Sheet lines and footnotes is directed by the guidance published periodically under Treasury Financial Manual, USSGL Bulletins, Section V: Crosswalks to Standard External Reports For FY 2021 Governmentwide Treasury Account Symbol (GTAS) Reporting. The footnotes affected by the modified presentation are Note 6, Accounts Receivable, Net; Note 10, Other Assets; Note 13, Federal Employee and Veteran Benefits Payable, and Note 15, Other Liabilities.

DoD MERHCF Footnotes to the Principal Financial Statements

Note 2. Non-Entity Assets

As of September 30	<u>2021</u>	<u>2020</u>
(\$ In Thousands)		
Total Non-Entity Assets	\$ 0	\$ 0
Total Entity Assets	<u>312,613,337</u>	<u>290,626,578</u>
Total Assets	<u>\$ 312,613,337</u>	<u>\$ 290,626,578</u>

Information Related to Nonentity Assets

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

Note 3. Fund Balance with Treasury

As of September 30	<u>2021</u>	<u>2020</u>
(\$ In Thousands)		
Unobligated Balance – Unavailable	\$ 284,820,265	\$ 263,689,915
Obligated Balance not yet Disbursed	353,158	495,229
Non-FBWT Budgetary Accounts	<u>(285,012,354)</u>	<u>(264,116,215)</u>
Total FBWT	<u>\$ 161,069</u>	<u>\$ 68,929</u>

The Status of FBWT, as presented in Table 3, reflects the reconciliation between the budgetary resources supporting FBWT (largely consisting of Unobligated Balance and Obligated Balance Not Yet Disbursed) and those resources provided by other means. The Total FBWT reported on the Balance Sheet reflects the budgetary authority remaining for disbursements against current or future obligations.

Unobligated Balance is classified as available or unavailable and represents the cumulative amount of budgetary authority set aside to cover future obligations. The available balance consists primarily of the unexpired, unobligated balance that has been apportioned and available for new obligations. The unavailable balance consists primarily of funds invested in U.S. Treasury securities and are temporarily precluded from obligation by law. The unobligated balance for the MERHCF is restricted for use by the public law establishing the fund and becomes available without further congressional action.

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

DoD MERHCF Footnotes to the Principal Financial Statements

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

Note 4. Cash and Other Monetary Assets

As of September 30		<u>2021</u>		<u>2020</u>
(\$ In Thousands)				
Cash	\$	28	\$	1,485
Total Cash and Other Monetary Assets	\$	<u>28</u>	\$	<u>1,485</u>

Cash and other monetary assets consist of undeposited collections received after the U.S. Treasury month-end cutoff. A corresponding liability is created because the MERHCF is not entitled to use the funds until deposited with the U.S. Treasury. This liability is reported on Note 15, Other Liabilities.

Note 5. Investments and Related Interest

(\$ In Thousands)	Amounts for 2021 Balance Sheet Reporting					
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/Discount</u>	<u>Interest Receivable</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities						
Nonmarketable, Market-Based	\$ 328,169,852	Effective Interest	\$ (18,761,499)	\$ 2,535,538	\$ 311,943,891	\$ 376,709,278
Total	\$ 328,169,852		\$ (18,761,499)	\$ 2,535,538	\$ 311,943,891	\$ 376,709,278

(\$ In Thousands)	Amounts for 2020 Balance Sheet Reporting					
	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/Discount</u>	<u>Interest Receivable</u>	<u>Investments, Net</u>	<u>Market Value Disclosure</u>
Intragovernmental Securities						
Nonmarketable, Market-Based	\$ 305,586,803	Effective Interest	\$ (17,785,713)	\$ 2,448,824	\$ 290,249,914	\$ 363,974,111
Total	\$ 305,586,803		\$ (17,785,713)	\$ 2,448,824	\$ 290,249,914	\$ 363,974,111

Information Regarding Investments and Related Interest

The MERHCF invests primarily in nonmarketable, market-based U.S. Treasury securities. The value of these securities fluctuates in tandem with the selling price of the equivalent marketable security. Securities are purchased with the intent to hold until maturity; thus, balances are not adjusted to market value.

The U.S. Treasury securities were issued to trust and special funds legally authorized to invest funds with Treasury and are an asset to the MERHCF and a liability to the U.S. Treasury. The

DoD MERHCF Footnotes to the Principal Financial Statements

Federal Government does not set aside assets to pay future benefits or other expenditures associated with these funds. Cash generated from investments is deposited in the U.S. Treasury and is used for general Government purposes. Since the MERHCF and the U.S. Treasury are both part of the Federal Government, these assets and liabilities offset each other from the standpoint of the Federal Government as a whole. For this reason, they do not represent an asset or a liability in the U.S. Governmentwide financial statements.

The U.S. Treasury securities provide the MERHCF with authority to access funds to make future benefit payments or other expenditures. When the MERHCF requires redemption of securities to make expenditures, the Federal Government will meet the requirement by using accumulated cash balances, raising taxes or other receipts, borrowing from the public or repaying less debt, or curtailing other expenditures. The Federal Government uses the same method to finance all of its other expenditures.

At the semiannual meetings, the Department of Defense Investment Board approves the strategy for the type of securities purchased by the MERHCF. These securities can include U.S. Treasury bills, notes, bonds, inflation-protected securities, overnight certificates, and zero-coupon bonds. The U.S. Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. The U.S. Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at either a discount or premium. The floating rate note (FRN) matured in January 2020. The U.S. Treasury bonds are long-term securities with maturities of ten years or more and are purchased at either a discount or premium. The TIPS provide protection against inflation and are purchased at either a discount or premium. The TIPS principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When TIPS mature, the U.S. Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the securities. Overnight securities are short-term securities purchased at face value. They mature the business day after purchase and earn interest at the daily Federal Reserve repurchase agreement rate. U.S. Treasury zero-coupon bonds (ZCB) are fixed-principal bonds having maturities of at least five years and are purchased at a discount.

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

	COST FY 2021		COST FY 2020
	(in millions)		(in millions)
Notes	\$7,478	Notes	\$10,968
Bonds	43,924	Bonds	46,169
TIPS	260,155	TIPS	234,584
ZCB	8,999	ZCB	8,999
Overnights	<u>7,614</u>	Overnights	<u>4,867</u>
Total Cost	<u>\$328,170</u>	Total Cost	<u>\$305,587</u>

DoD MERHCF Footnotes to the Principal Financial Statements

Note 6. Accounts Receivable, Net

As of September 30
(\$ In Thousands)

	2021		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ 455,618	\$ (7,269)	\$ 448,349
Total Accounts Receivable	\$ <u>455,618</u>	\$ <u>(7,269)</u>	\$ <u>448,349</u>

(\$ In Thousands)

	2020		
	<u>Gross Amount Due</u>	<u>Allowance For Estimated Uncollectibles</u>	<u>Accounts Receivable, Net</u>
Nonfederal Receivables (From the Public)	\$ 310,100	\$ (3,850)	\$ 306,250
Total Accounts Receivable	\$ <u>310,100</u>	\$ <u>(3,850)</u>	\$ <u>306,250</u>

Information Related to Accounts Receivable

Accounts receivable represent the MERHCF's claim for payment from other entities. Allowances for uncollectible accounts due from the public are calculated based on a percentage determined by taking a 12-month average of the accounts receivable balance against a 12-month average on the write off balance. An exception to this methodology exists for the Suspended Pharmacy receivables where 100% methodology is used. Claims with other federal agencies are resolved in accordance with the business rules published in Appendix 5 of Treasury Financial Manual, Volume I, Part 2, Chapter 4700.

As of September 30, 2021, the total net receivables recorded for the pharmaceutical Standard Discount Program (SDP) were \$163.5 million. This program resulted from the implementation of the Federal Ceiling Program for the TRICARE Retail Pharmacy Program as required by the FY 2008 National Defense Authorization Act, Section 703.

Also recorded are net receivables of \$110.9 million originating from the TRICARE Additional Discount Program (ADP), a voluntary additional discount from pharmaceutical manufacturers for preferred products.

Note 7. Loan Receivable, Net and Loan Guarantee Liabilities

Not Applicable.

Note 8. Inventory and Related Property, Net

Not Applicable.

DoD MERHCF Footnotes to the Principal Financial Statements

Note 9. General PP&E, Net

Not Applicable.

Note 10. Other Assets

As of September 30 (\$ In Thousands)	<u>2021</u>	<u>2020</u>
Advances and Prepayments	\$ 60,000	\$ 0
Total Other Assets	<u>\$ 60,000</u>	<u>\$ 0</u>

Advances and Prepayments are made in contemplation of the future performance of services, receipt of goods, incurrence of expenditures, or receipt of other assets, excluding those made as Outstanding Contract Financing Payments. The MERHCF's advances and prepayments represent the amount of reimbursement to the MERHCF from the DHA due to a variance between the amount distributed to the MTFs and the amount the MTFs earned. Due to COVID-19, there was a significant decrease in MERHCF eligible care in FY21 and MERHCF Business Rules require a reimbursement to the trust fund if there is a negative variance that exceeds 10%. In FY21, the variance was 13%. The \$60 million reflected above is the 3% variance required reimbursement to the MERHCF.

Note 11. Liabilities Not Covered by Budgetary Resources

As of September 30 (\$ In Thousands)	<u>2021</u>	<u>2020</u>
Federal Employee and Veteran Benefits Payable (Note 13)	\$ <u>325,601,586</u>	\$ <u>313,196,742</u>
Total Liabilities Not Covered by Budgetary Resources	<u>325,601,586</u>	<u>313,196,742</u>
Total Liabilities Covered by Budgetary Resources	<u>284,675,448</u>	<u>263,884,938</u>
Total Liabilities	<u>\$ 610,277,034</u>	<u>\$ 577,081,680</u>

The MERHCF Liabilities Not Covered by Budgetary Resources represents the portion of the actuarial liability for health benefits for which current assets are not yet available. Refer to Note 13, Federal Employee and Veteran Benefits Payable, for additional details and disclosures.

Note 12. Federal Debt and Interest Payable

Not Applicable.

DoD MERHCF Footnotes to the Principal Financial Statements

Note 13. Federal Employee and Veteran Benefits Payable

(\$ In Thousands)		2021		
<u>Major Program</u> <u>Activities</u>	<u>Present Value</u> <u>of Benefits</u>	<u>(Less: Assets</u> <u>Available to Pay</u> <u>Benefits)</u>	<u>Unfunded</u> <u>Liabilities</u>	
Medicare-Eligible Retiree Benefits	\$ 609,423,615	\$ (283,822,028)	\$ 325,601,587	
Other	650,178	(650,178)	0	
Total	\$ 610,073,793	\$ (284,472,206)	\$ 325,601,587	

(\$ In Thousands)		2020		
<u>Major Program</u> <u>Activities</u>	<u>Present Value</u> <u>of Benefits</u>	<u>(Less: Assets</u> <u>Available to Pay</u> <u>Benefits)</u>	<u>Unfunded</u> <u>Liabilities</u>	
Medicare-Eligible Retiree Benefits	\$ 576,131,032	\$ (262,934,290)	\$ 313,196,742	
Other	583,484	(583,484)	0	
Total	\$ 576,714,516	\$ (263,517,774)	\$ 313,196,742	

Change in Actuarial Liability

(\$ In Thousands)	FY 2021	FY 2020
Beginning Actuarial Liability	\$ 576,131,032	\$ 573,219,147
Plus Expenses:		
Normal Cost	12,385,464	12,250,249
Interest Cost	19,234,948	20,301,646
Plan Amendments	0	0
Experience (Gain)/Loss	(28,762,502)	(5,899,175)
Other factors	0	0
Subtotal: Expenses before (Gain)/Loss from Actuarial Assumption Changes	2,857,910	26,652,720
Actuarial (Gain)/Loss due to:		
Changes in trend assumptions	8,419,468	(39,577,511)
Changes in assumptions other than trend	33,386,046	26,775,471
Subtotal: (Gain)/Loss from Actuarial Assumption Changes	41,805,514	(12,802,040)
Total Expenses	\$ 44,663,424	13,850,680
Less Benefit Outlays	(11,370,841)	(10,938,795)
Total Changes in Actuarial Liability	\$ 33,292,583	\$ 2,911,885
Ending Actuarial Liability	\$ 609,423,615	\$ 576,131,032

DoD MERHCF Footnotes to the Principal Financial Statements

Information Related to Federal Employee and Veteran Benefits Payable

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

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

This schedule also computes "unfunded liabilities", i.e. liabilities not covered by budgetary resources. The assets presented in this schedule differ from those reported on the balance sheet. The balance sheet assets consist primarily of investments, the value of which is based on the fully amortized cost or "book value" of the securities (see Note 5, Investments and Related Interest). The value of assets available to pay benefits presented in the above schedule is based on available budgetary funding. The difference between investments and assets available to pay benefits is the premium on U.S. Treasury Securities. At the time of purchase, budgetary funding is reduced by the premium on U.S. securities because the premium on securities is no longer a budgetary resource.

Effective FY 2010, the MERHCF implemented requirements of SFFAS No. 33, which directs that the discount rate, underlying inflation rate, and other economic assumptions be consistent with one another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2021, financial statement valuation, the application of SFFAS No. 33 required DoD OACT to set the long-term inflation (CPI) to be consistent with the underlying Treasury spot rates used in the valuation.

The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2021 balance represents the September 30, 2021 amount that will be effective through 3rd Quarter, FY 2022.

Actuarial Cost Method

As prescribed by law, the MERHCF is funded using the Aggregate Entry-Age Normal (AEAN) cost method. Per SFFAS No. 5, AEAN is also used to compute the actuarial liabilities reported herein. AEAN is a method whereby projected retiree medical plan costs are spread over the projected service of a new entrant cohort.

Revenues

The MERHCF receives revenues from three sources: interest earnings on MERHCF assets, Uniformed Services normal cost contributions, and a U.S. Treasury contribution. The normal cost contributions are paid annually, at the beginning of the fiscal year, by the U.S. Treasury from

DoD MERHCF Footnotes to the Principal Financial Statements

amounts appropriated to the Military Services and are calculated at the approved full-time and part-time per capita rates times the budgeted full-time and part-time force strengths, respectively. The contribution from the U.S. Treasury is also paid into the MERHCF annually, at the beginning of each fiscal year, and represents the amortization of the unfunded liability for service performed before October 1, 2002, as well as the amortization of subsequent actuarial gains and losses. The DoD Medicare-Eligible Retiree Health Care Board of Actuaries (the Board) approves the methods and assumptions used to calculate the per capita normal cost rates and the U.S. Treasury contribution, and the Secretary of Defense directs the Secretary of Treasury to make the payments.

Assumptions

The Board sets the long-term assumptions for each valuation performed for funding purposes. Prior to FY 2010, the same long term assumptions were used for the financial-statement valuations. The distinction between the two different valuations is discussed in the following pages.

For the FY 2021 financial-statement valuation, the long-term assumptions include a 3.0% discount rate and medical trend rates that were developed using a 1.6% inflation assumption. (For the most recent funding valuation, the long-term assumptions included a 4.50% discount rate and medical trend rates that were developed using a 2.75% inflation assumption.) Note that the term 'discount rate' refers to the interest rate used to discount cash flows. The terms 'interest rate' and 'discount rate' are often used interchangeably in this context.

For the FY 2020 financial-statement valuation, the long-term assumptions included a 3.3% discount rate and medical trend rates that were developed using a 1.6% inflation assumption. (For the most recent funding valuation at the time of the FY 2020 financial statements, the long-term assumptions included a 4.75% discount rate and medical trend rates that were developed using a 2.75% inflation assumption.)

The difference in the long-term assumptions between funding and financial statement valuations is attributable to SFFAS No. 33. This applicable financial statement standard is described further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on a blend of actual experience and future expectations. Because of reporting deadlines and as permitted by SFFAS No. 33, the current year actuarial liability is rolled forward from the prior year valuation results as reported in DoD OACT's 'Valuation of the Medicare-Eligible Retiree Health Care Fund' using accepted actuarial methods. Modifications are made as necessary to convert liabilities to a financial-statement basis. For purposes of the Fund's financial reporting, this roll-forward process is applied annually.

In calculating the FY 2021 "rolled-forward" actuarial liability, the following assumptions were used:

Discount Rate	3.0%
Inflation	1.6%

DoD MERHCF Footnotes to the Principal Financial Statements

<u>Medical Trend (Medicare)</u>	<u>FY 2020 - FY 2021</u>	<u>Ultimate Rate FY 2045</u>
Direct Care Inpatient	6.08%	3.60%
Direct Care Outpatient	9.55%	3.60%
Direct Care Prescription Drugs	-2.10%	3.60%
Purchased Care Inpatient	6.08%	3.60%
Purchased Care Outpatient	9.55%	3.60%
Purchased Care Prescription Drugs	2.93%	3.60%
Purchased Care USFHP	7.38%	3.60%

After a 25-year select period, an ultimate trend rate is assumed for all future projection years.

The medical cost trend rate assumptions have a significant effect on the amounts reported. For example, if each of the assumed trend rates had increased by one percentage point, the actuarial liability would have increased 28.8%, or approximately \$175.5 billion.

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

The initial unfunded liability of the program was amortized over a 50-year period through the FY 2012 payment. At its August 2012 and July 2017 meetings, the Board decided to decrease the period over which the initial unfunded liability is fully amortized by 5 years and 7 years, respectively. The reason for the shorter amortization period is to ensure that the annual amortization payment covers, at a minimum, the interest growth on the initial unfunded liability. The last payment on the initial unfunded liability is expected to be made October 1, 2039. In addition, at its July 2017 meeting, the Board reduced the amortization period for all actuarial gains and losses from 30 years to 20 years. Chapter 56 of Title 10, United State Code (U.S.C.), requires that the Board approve the methods and assumptions used to (1) compute actuarial costs and liabilities, (2) amortize the initial unfunded liability, and (3) amortize all actuarial gains and losses. The Board is a Federal Advisory Committee appointed by the Secretary of Defense.

DoD complies with SFFAS No. 33, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates." The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement and other postemployment benefits. SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities. SFFAS No. 33, as published on October 14, 2008, by the Federal Accounting Standards Advisory

DoD MERHCF Footnotes to the Principal Financial Statements

Board (FASAB) requires the use of a yield curve based on marketable U.S. Treasury securities to determine the discount rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable U.S. Treasury securities.

The statement is effective for periods beginning after September 30, 2009, and applies to information provided in general purpose federal financial statements. It does not affect statutory or other special-purpose reports, such as pension or Other Retirement Benefit reports. SFFAS No. 33 requires a minimum of five periodic rates for the yield curve input and consistency in the number of historical rates used from period to period. It permits the use of a single average discount rate if the resulting present value is not materially different from what would be obtained using the yield curve.

DoD OACT annually performs two MERHCF valuations. The primary one is for funding purposes, is governed by Chapter 56 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other valuation is for financial statement purposes and is governed by FASAB standards. For the September 30, 2021, financial-statement valuation, DoD OACT determined a single equivalent discount rate of 3.0% by using a 10-year average of quarterly zero coupon Treasury spot rates. These spot rates are based on the U.S. Department of the Treasury – Office of Economic Policy’s 10-year Average Yield Curve for Treasury Nominal Coupon Issues (TNC yield curve), which represents average rates from April 1, 2011 through March 31, 2021. The same spot rate data source was used to produce last year’s financial statements. In the summer of 2021, the Board approved a discount rate of 4.50% for the September 30, 2020, funding valuation, which differs from the SFFAS No. 33 equivalent rate by 150 basis points. Using the SFFAS No. 33 long-term economic assumptions (as compared to the Board assumptions) increases the MERHCF actuarial liability by 23.8%.

FY 2021 Actuarial Liability for the Uniformed Services

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2021, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoD	\$	594,625,348
U.S. Coast Guard		13,157,262
Public Health Service		1,543,868
National Oceanic and Atmospheric Administration		<u>97,137</u>
Total	\$	<u><u>609,423,615</u></u>

FY 2021 Military Service and Other Uniformed Service Contributions

The FY 2021 Military Service and other Uniformed Service contributions to the MERHCF (\$ in thousands) were as follows:

DoD MERHCF Footnotes to the Principal Financial Statements

DoD	\$	8,375,811
U.S. Coast Guard		214,864
Public Health Service		29,883
National Oceanic and Atmospheric Administration		1,591
Total	\$	<u>8,622,149</u>

Market Value of the MERHCF Securities

The market value of the MERHCF nonmarketable, market-based securities as of September 30, 2021, totaled \$376.7 billion. This amount is also reported on Note 5, Investments and Related Interest.

Note 14. Environmental and Disposal Liabilities

Not Applicable.

Note 15. Other Liabilities

As of September 30 (\$ In Thousands)	2021	2020
Deposit Funds and Suspense Accounts	\$ 28	\$ 1,485
Total Other Liabilities	\$ 28	\$ 1,485

Deposit Funds and Suspense Accounts consist of undeposited collections received after the U.S. Treasury month-end cutoff. These undeposited collections are reported on Note 4, Cash and Other Monetary Assets.

Note 16. Leases

Not Applicable.

Note 17. Commitments and Contingencies

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

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectability of receivables, pending or threatened litigation, and possible claims and assessments. The MERHCF risk of loss and resultant contingent

DoD MERHCF Footnotes to the Principal Financial Statements

liabilities arise from pending or threatened litigation or claims and assessments due to events such as medical malpractice; property or environmental damages; and contract disputes.

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

There are two cases or claims pending with the MERHCF disclosed below:

INGHAM REGIONAL MEDICAL CENTER v. SECRETARY OF DEFENSE CHARLES HAGEL (U.S. DISTRICT COURT FOR THE DISTRICT OF COLUMBIA).

This class action suit was filed on behalf of every U.S. hospital that provided outpatient services to TRICARE beneficiaries between August 1, 2003, and December 31, 2009.

Nature of Matter: Class action, but not certified, alleging DoD, in reaching a resolution of hospital outpatient radiology claims, entered into contracts with the named plaintiffs. Plaintiffs' First Amended Complaint was filed on November 17, 2014. The Amended Complaint alleges breach of express contract, breach of implied contract, mutual mistake, breach of the covenant of good faith and fair dealing, and violations of a statutory mandate under the TRICARE statute. The suit alleges 5,200 hospitals were underpaid for outpatient procedures. Based on the pleadings, the amount sought is estimated as up to \$2.3 billion.

Progress of Case to Date: On March 22, 2016, the Court of Federal Claims issued its decision granting the Government's Motion to Dismiss Plaintiffs' Amended Complaint. Plaintiffs appealed to the Court of Appeals for the Federal Circuit. On November 3, 2017, the Court of Appeals reversed the dismissal of Ingham's breach of contract claim and remanded the case to the trial court for further proceedings. On March 20, 2018, the Government filed its Answer. Discovery has since closed, and multiple motions including Plaintiffs' motion for class certification are pending before the Court.

The Government's Response or Planned Response: The Government anticipates filing a motion for summary judgment.

The likelihood of unfavorable outcome is remote.

BIO-MEDICAL APPLICATIONS OF GEORGIA, INC., et al. v. U.S., COURT OF FEDERAL CLAIMS, NO. 19-947

Nature of Matter: Plaintiffs challenge the DHA's payment methodology for End Stage Renal Disease dialysis treatments at freestanding dialysis facilities. Plaintiffs filed the Complaint on June

DoD MERHCF Footnotes to the Principal Financial Statements

28, 2019. The Complaint alleges breach of contract, breach of the covenant of good faith and fair dealings, and violations of a money-mandating regulation.

Progress of The Case to Date: On April 16, 2020, in an oral ruling, the Court of Federal Claims granted the Government’s Motion to Dismiss in part and dismissed Counts II (breach of contract) and III (breach of the covenant of good faith and fair dealings). The Government filed its Answer on July 8, 2020, and discovery is ongoing.

The Government’s Response or Planned Response: The parties will complete discovery in January 2022.

The likelihood of unfavorable outcome is reasonably possible. The estimated range of potential loss is currently unknown.

Note 18. Funds from Dedicated Collections

Not Applicable.

Note 19. Disclosures Related to the Statements of Net Cost

(\$ In Thousands)	2021	2020
Military Retirement Benefits		
Gross Cost	\$ 2,385,875	\$ 26,225,018
Less: Earned Revenue	<u>(32,982,794)</u>	<u>(22,367,191)</u>
(Gain)/Loss on Actuarial Assumption Changes	<u>41,805,514</u>	<u>(12,802,040)</u>
Net Cost of Operations	\$ <u>11,208,595</u>	\$ <u>(8,944,213)</u>

Information Related to the Statement of Net Cost

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the MERHCF 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. The MERHCF’s current processes and systems capture costs based on appropriations groups as presented in the schedule above. The DoD is in the process of reviewing available data and developing a cost reporting methodology required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, “Managerial Cost Accounting Concepts and Standards for the Federal Government,” as amended by SFFAS No. 55, “Amending Inter-Entity Cost Provisions.”

The following table displays the MERHCF intragovernmental revenue:

DoD MERHCF Footnotes to the Principal Financial Statements

Intragovernmental Earned Revenue for Program Costs

(\$ in Billions)	<u>FY 2021</u>	<u>FY 2020</u>
1. Uniformed Services Contributions	\$ 8.6	\$ 8.1
2. U.S. Treasury Annual Unfunded Liability Payment	7.0	6.6
3. Interest on Investments	<u>17.4</u>	<u>7.7</u>
4. Total Intragovernmental Revenue	<u>\$ 33.0</u>	<u>\$ 22.4</u>

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

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

Interest on Investments represents the interest income received by the MERHCF for FYs 2021 and 2020.

The MERHCF's costs are reported in accordance with SFFAS No. 33, Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates. The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement benefits and other postemployment benefits on the SNC.

Note 20. Disclosures Related to the Statement of Changes in Net Position

Reconciliation of Appropriations on the Statement of Budgetary Resources to Appropriations Received on the Statement of Changes in Net Position

(\$ in Thousands)	<u>2021</u>	<u>2020</u>
Appropriations, Statement of Budgetary Resources (SBR)	\$ 11,054,605	\$ 10,604,783
Permanent and Temporary Reductions	0	0
Trust and Special Fund Receipts	11,054,605	10,604,783
Miscellaneous items	<u>0</u>	<u>0</u>
Total Reconciling Difference	<u>11,054,605</u>	<u>10,604,783</u>
Appropriations Received, Statement of Changes in Net Position	<u>\$ 0</u>	<u>\$ 0</u>

There was a difference of \$11.1 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations on the SBR. The MERHCF records

DoD MERHCF Footnotes to the Principal Financial Statements

contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with OMB reporting requirements.

Note 21. Disclosures Related to the Statement of Budgetary Resources

Budgetary Resources Obligated for Undelivered Orders

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

(\$ In Thousands)	<u>2021</u>	<u>2020</u>
Intragovernmental		
Unpaid	\$ 41,040	\$ 46,078
Prepaid/Advanced	60,000	0
Total Intragovernmental	<u>101,040</u>	<u>46,078</u>
Non-Federal	\$ 108,904	\$ 83,472
Total Budgetary Resources Obligated for Undelivered Orders at the End of the Period	<u>\$ 209,944</u>	<u>\$ 129,550</u>

Refer to Note 10, Other Assets, for additional details regarding Prepaid/Advanced.

Permanent Indefinite Appropriations

Public Law 106-398, The Floyd D. Spence NDAA for FY 2001, provided and authorized the MERHCF a permanent, indefinite appropriation.

Legal Arrangements Affecting the Use of Unobligated Balances

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

Explanation of Differences between the SBR and the Budget of the U.S. Government

There was a difference of \$11.1 billion between Appropriations on the Statement of Changes in Net Position (SCNP) and Appropriations on the SBR. The MERHCF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with OMB reporting requirements. Refer to Note 20, Disclosures Related to the Statement of Changes in Net Position, for additional details.

There are no material differences between amounts reported on the SBR and the SF 133, Report on Budget Execution.

DoD MERHCF Footnotes to the Principal Financial Statements

Note 22. Disclosures Related to Incidental Custodial Collections

Not Applicable.

Note 23. Fiduciary Activities

Not Applicable.

Note 24. Reconciliation of Net Cost to Net Outlays

Reconciliation of the Net Cost of Operations to Net Outlays

As of September 30 (\$ in Thousands)	2021		
	Federal	Non-Federal	Total
Net Cost of Operations (SNC)	\$ (28,418,970)	\$ 39,627,565	\$ 11,208,595
Components of Net Cost That Are Not Part of Net Outlays:			
Increase/(decrease) in assets:			
Account receivable, net	0	(3,419)	(3,419)
Other assets	60,000	144,061	204,061
(Increase)/decrease in liabilities:			
Accounts payable	173,396	(10,930)	162,466
Federal employee and veteran benefit payable	0	(33,359,277)	(33,359,277)
Other liabilities	0	1,457	1,457
Total Components of Net Cost That Are Not Part of Net Outlays	\$ 233,396	\$ (33,228,108)	\$ (32,994,712)
Miscellaneous Reconciling Items:			
Distributed offsetting receipts	86,714	0	86,714
Other	9,333,273	0	9,333,273
Total Other Reconciling Items	\$ 9,419,987	\$ 0	\$ 9,419,987
Total Net Outlays	\$ (18,765,587)	\$ 6,399,457	\$ (12,366,130)
Agency Outlays, Net (Statement of Budgetary Resources)			\$ (12,366,130)
Unreconciled Difference			\$ 0

DoD MERHCF Footnotes to the Principal Financial Statements

Reconciliation of the Net Cost of Operations to Net Outlays

As of September 30 (\$ in Thousands)	2020		
	Federal	Non-Federal	Total
Net Cost of Operations (SNC)	\$ (17,960,985)	\$ 9,016,772	\$ (8,944,213)
Components of Net Cost That Are Not Part of Net Outlays:			
Increase/(decrease) in assets:			
Account receivable, net	0	3,086	3,086
Other assets	0	37,575	37,575
(Increase)/decrease in liabilities:			
Accounts payable	(22,045)	(2,967)	(25,012)
Federal employee and veteran benefit payable	0	(2,867,098)	(2,867,098)
Other liabilities	0	(1,463)	(1,463)
Total Components of Net Cost That Are Not Part of Net Outlays	\$ (22,045)	\$ (2,830,867)	\$ (2,852,912)
Miscellaneous Reconciling Items:			
Distributed offsetting receipts	4,693	0	4,693
Other	7,884,084	0	7,884,084
Total Other Reconciling Items	\$ 7,888,777	\$ 0	\$ 7,888,777
Total Net Outlays	\$ (10,094,253)	\$ 6,185,905	\$ (3,908,348)
Agency Outlays, Net (Statement of Budgetary Resources)			\$ (3,908,348)
Unreconciled Difference			\$ 0

The Reconciliation of Net Cost to Net Outlays demonstrates the relationship between the MERHCF's Net Cost of Operations, reported on an accrual basis on the Statement of Net Costs, and Net Outlays, reported on a budgetary basis on the Statement of Budgetary Resources. While budgetary and financial accounting are complementary, the reconciliation explains the inherent differences in timing and in the types of information between the two during the reporting period. The accrual basis of financial accounting is intended to provide a picture of the MERHCF's

DoD MERHCF Footnotes to the Principal Financial Statements

operations and financial position, including information about costs arising from the consumption of assets and the incurrence of liabilities. Budgetary accounting reports on the management of resources and the use and receipt of cash by the MERHCF. Outlays are payments to liquidate an obligation, other than the repayment to the Treasury of debt principal.

The FY 2020 reconciliation was modified to conform to the FY 2021 presentation.

In FY 2021, Components of Net Cost Not Part of Net Outlays includes non-cash charges primarily consisting of \$33.4 billion in changes in Actuarial Health Insurance Liability and \$60 million in Other Assets due to a reimbursement to the MERHCF from the DHA. Refer to Note 10, Other Assets, for additional details.

Miscellaneous Reconciling Items includes \$9.3 billion in receipts that are classified as non-distributed offsetting receipts, therefore are not included in the budgetary reports.

Note 25. Public-Private Partnerships

Not Applicable.

Note 26. Disclosure Entities and Related Parties

Not Applicable.

Note 27. Security Assistance Accounts

Not Applicable.

Note 28. Restatements

Not Applicable.

Note 29. COVID-19 Activity

Not Applicable.

Note 30. Subsequent Events

Subsequent events have been evaluated from the balance sheet date through November 8, 2021, which is the date the financial statements were available to be issued. Management determined that there were no other items to disclose as of September 30, 2021.

Note 31. Restatement of Financial Statement Line Items for Financial Report Compilation Process

Not Applicable.

Note 32. Other Disclosures

The actuarial liability for direct care related to Medicare-eligible retiree benefits as of September 30, 2021 and 2020 is approximately \$134.3 billion (22% of total) and \$136.5 billion (24% of total), respectively, which reflects the actuarial present value of the projected direct-care costs of benefits to be provided by MTFs to the MERHCF beneficiaries. Additionally, the reported amounts of program revenues and cost for the year ended September 30, 2021, include approximately \$3.6 billion and \$2.6 billion, respectively, and for the year ended September 30, 2020, include approximately \$3.7 billion and \$2.4 billion, respectively, of amounts related to direct care costs. Such MTF-related amounts of direct-care costs are based on cost allocation methods using data extracted from various Service-specific financial, personnel, and workload systems within DoD as well as patient encounter data. With respect to the extracted data, the MTFs do not have OMB Circular A-123 Appendix D, FFMIA compliant, transaction-based accounting systems and cannot report the costs of an individual patient's care.

Other Information

Exhibit 1--Summary of Financial Statement Audit and Management Assurances**SEPTEMBER 30, 2021**

Agencies are required to provide certain assurances as to the status and effectiveness of the internal controls and financial management systems that support the preparation of the financial statements. In the context of the MERHCF Management Discussion and Analysis, DoD, and not the MERHCF, represents the legislative definition of an Agency. Beginning with FY 2006, as directed in OMB Circular A-123, Management's Responsibility for Internal Control, Appendix A, Internal Control Over Financial Reporting, the 24 CFO Act agencies (includes DoD), are required to provide a separate assessment of the effectiveness of the internal controls over financial reporting as a subset of the overall FMFIA assurance statement. OUSD(C) issued guidelines to the leadership of DoD Components, including the MERHCF, as to how to support this DoD reporting requirement. The DHA management complied with the required guidelines for the MERHCF.

The DHA includes auditor identified weakness in its annual assessment of internal controls from the prior year audit. Specifically, the MTFs do not currently have compliant, transaction-based accounting systems that apply common and consistent business rules in a manner envisioned by the DoD's planned Standard Financial Information Structure (SFIS). There is insufficient evidence that adequate controls exist and have been implemented to ensure the completeness, validity, documentation and cut-off of the costs reported. Additionally, there is insufficient evidence that adequate controls exist and have been implemented to ensure the timeliness and accuracy of the medical record coding processes at the MTFs. Further, the healthcare cost data from the MTFs provided for the estimation process are aggregated or derived from information in both financial and non-financial systems within the branches of military services that have not been audited. The MTF-level data is based on budget execution processes, rather than accrual-based accounting. There is insufficient evidence that appropriate and consistent cutoff of accounting activity occurs at the MTF level. The timing of the DHA's assessment (dated October 4, 2021) may cause it to differ from the auditor's reported weakness (dated September 2021) for the current FY. In its FY 2021 assessments, the DHA management can provide reasonable assurance, except for direct care related material weakness, the MERCHCF Financial Statement Reporting Entity (FSRE) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). The MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the Services have implemented financial systems that comply with (FMFIA § 4).

Except for the one direct care-related material weakness as documented in the DHA's Annual Statement Required Under the FMFIA, dated October 4, 2021, and the above referenced Service-related FMFIA § 4 weakness, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2021 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weakness and non-conformances.

Table 1.
Summary of Financial Statement Audit

Audit Opinion	Modified				
Restatement	No				
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Lack of Direct Care Costs Data Accumulation Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from FY 2005)	✓				✓
<i>Total Material Weaknesses</i>	1	0	0	0	1

Table 2.
Summary of Management Assurances

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Modified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of Direct Care Costs Data Accumulation Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from FY 2005)	✓	0	0	0	0	✓
<i>Total Material Weaknesses</i>	1	0	0	0	0	1
Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	Modified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of Direct Care Costs Data Accumulation Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and	✓	0	0	0	0	✓

Other Information

Updated Finding from FY 2005)						
<i>Total Material Weaknesses</i>	1	0	0	0	0	1

Conformance with Federal Financial Management System Requirements (FMFIA § 4)						
Statement of Assurance	Purchased Care systems conform to financial management systems requirements: Direct Care Costs systems do not comply with financial management systems requirements.					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Lack of Direct Care Costs Data Accumulation Compliant, Transaction-based Accounting Systems for Direct-care Costs (Carried Forward and Updated Finding from FY 2005)	✓					✓
<i>Total non-conformances</i>	1	0	0	0	0	1

Compliance with Section 803(a) of the Federal Financial Management Improvement Act (FFMIA)		
	Agency	Auditor
1. Federal Financial Management System Requirements	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems
2. Applicable Federal Accounting Standards	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems
3. USSGL at Transaction Level	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems	No lack of compliance noted for purchased care systems; lack of compliance noted for direct care systems

Exhibit 2--PIIA Reporting Details September 30, 2021

PAYMENT INTEGRITY

In accordance with the Payment Integrity Information Act of 2019 and Appendix B of the Office of Management and Budget Bulletin No. 21-04 issued June 2021, “Audit Requirements for Federal Financial Statements”, DoD reports payment integrity information at the agency-wide level in the consolidated DoD Agency Financial Report. For detailed reporting on DoD payment integrity, refer to the Other Information section of the consolidated DoD AFR at: <https://comptroller.defense.gov/ODCFO/afr2021.aspx>.

DoD Transmittal of Auditor's Opinion

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DoD Transmittal of Auditor's Opinion



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
4800 MARK CENTER DRIVE
ALEXANDRIA, VIRGINIA 22304-1500

November 8, 2021

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

SUBJECT: Transmittal of the Independent Auditor's Reports on the DoD Medicare-
Eligible Retiree Health Care Fund Financial Statements and Related Notes
for FY 2021 and FY 2020 (Project No. D2021-D000FT-0076.000,
Report No. DODIG-2022-016)

We contracted with the independent public accounting firm of Kearney & Company to audit the DoD Medicare-Eligible Retiree Health Care Fund (MERHCF) Financial Statements and related notes as of and for the fiscal years ended September 30, 2021, and 2020. The contract required Kearney & Company to provide a report on internal control over financial reporting and compliance with provisions of applicable laws and regulations, contracts, and grant agreements, and to report on whether the MERHCF's financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996. The contract required Kearney & Company to conduct the audit in accordance with generally accepted government auditing standards (GAGAS); Office of Management and Budget audit guidance; and the Government Accountability Office/Council of the Inspectors General on Integrity and Efficiency, "Financial Audit Manual," June 2018, Volume 1 (Updated, April 2020), Volume 2 (Updated, March 2021), and Volume 3 (Updated, September 2021). Kearney & Company's Independent Auditor's Reports are attached.

Kearney & Company's audit resulted in a qualified opinion. Kearney & Company could not obtain sufficient, appropriate audit evidence to support the costs of direct care provided by DoD-managed military treatment facilities. Kearney & Company concluded that, except for the effects on the financial statements of the amounts related to the MERHCF's direct care costs, the MERHCF FY 2021 and FY 2020 Financial Statements and related notes as of and for the fiscal years ended September 30, 2021,

DoD Transmittal of Auditor's Opinion

and 2020, are presented fairly in all material respects, in accordance with Generally Accepted Accounting Principles.

Kearney & Company's separate report, "Independent Auditor's Report on Internal Control Over Financial Reporting," discusses one material weakness related to the MERHCF's internal controls over financial reporting.* Specifically, Kearney & Company's report concluded that the health care cost data from the military treatment facilities provided for the direct care cost estimation process were based on budget execution processes and not accrual-based accounting.

Kearney & Company's additional report, "Independent Auditor's Report on Compliance With Laws, Regulations, Contracts, and Grant Agreements," discusses one instance of noncompliance with provisions of applicable laws and regulations, contracts, and grant agreements. Specifically, Kearney & Company's report describes that the MERHCF's financial management systems did not substantially comply with the Federal Financial Management Improvement Act of 1996.

In connection with the contract, we reviewed Kearney & Company's reports and related documentation and discussed them with Kearney & Company's representatives. Our review, as differentiated from an audit of the financial statements and related notes in accordance with GAGAS, was not intended to enable us to express, and we do not express, an opinion on the MERHCF FY 2021 and FY 2020 Financial Statements and related notes. Furthermore, we do not express conclusions on the effectiveness of internal control over financial reporting, on whether the MERHCF's financial systems substantially complied with Federal Financial Management Improvement Act of 1996 requirements, or on compliance with provisions of applicable laws and regulations, contracts, and grant agreements. Our review disclosed no instances where Kearney & Company did not comply, in all material respects, with GAGAS. Kearney & Company is responsible for the attached November 8, 2021 reports, and the conclusions expressed within the reports.

* A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting that results in a reasonable possibility that management will not prevent, or detect and correct, a material misstatement in the financial statements in a timely manner.

DoD Transmittal of Auditor's Opinion

We appreciate the cooperation and assistance received during the audit. Please direct questions to me.



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

Attachments:
As stated

Independent Auditor's Report



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INDEPENDENT AUDITOR'S REPORT

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the Department of Defense

Report on the Financial Statements

We have audited the accompanying financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), which comprise the balance sheets as of September 30, 2021 and 2020, the related statements of net cost and changes in net position, and the combined statements of budgetary resources (hereinafter referred to as the "financial statements") for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our 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 Office of Management and Budget (OMB) Bulletin No. 21-04, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 21-04 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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



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

Basis for Qualified Opinion

We were unable to obtain sufficient, appropriate evidential matter to support the costs of direct care provided by the Department of Defense (DoD)-managed Military Treatment Facilities (MTF). As discussed in Note 13 to the financial statements, the actuarial liability for Medicare-eligible retiree benefits as of September 30, 2021 and 2020 includes approximately \$134.3 billion (22% of total) and \$136.5 billion (24% of total), respectively, of amounts reflecting the actuarial present value of the projected direct care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and costs, for the year ended September 30, 2021, include approximately \$3.6 billion and \$2.6 billion, respectively, and, for the year ended September 30, 2020, include approximately \$3.7 billion and \$2.4 billion, respectively, of amounts related to the direct care costs.

The MERHCF recognizes expenses based on quarterly prospective payments made to the Defense Health Program (DHP) to support the operations of the MTFs on an ongoing basis as a result of care provided to MERHCF beneficiaries. The MERHCF recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards. The prospective payments for direct care are based on estimated costs for the anticipated number of patients that will use an MTF to receive health care. The MERHCF does not have a formalized process in place to track health care encounters for MERHCF beneficiaries for accounting purposes, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. We were unable to obtain sufficient evidence as to the direct care component of the reported amounts in the accompanying financial statements for Medicare-eligible retiree beneficiaries by performing other audit procedures. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the effects of the matter described in the "Basis for Qualified Opinion" section above, the financial statements referred to above present fairly, in all material respects, the financial position of the MERHCF as of September 30, 2021 and 2020, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the United States of America.



Other Matters

Required Supplementary Information

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

Other Information

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



Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards* and OMB Bulletin No. 21-04, we have also issued reports, dated November 8, 2021, on our consideration of the MERHCF's internal control over financial reporting and on our tests of the MERHCF's compliance with provisions of applicable laws, regulations, contracts, and grant agreements, as well as other matters for the year ended September 30, 2021. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 21-04 and should be considered in assessing the results of our audits.

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

Alexandria, Virginia
November 8, 2021



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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the
Department of Defense

We have audited, in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 21-04, *Audit Requirements for Federal Financial Statements*, the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2021, and the related notes to the financial statements, which collectively comprise the MERHCF's financial statements, and we have issued our report thereon dated November 8, 2021.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the MERHCF's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the MERHCF's internal control. Accordingly, we do not express an opinion on the effectiveness of the MERHCF's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 21-04. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

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

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.



We consider the deficiencies described in the accompanying Schedule of Findings to be a material weakness and a significant deficiency.

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

The MERHCF's Response to Findings

The MERHCF's response to the findings identified in our audit is described in Management's Discussion and Analysis (MD&A) of the Agency Financial Report (AFR). The MERHCF's response was not subjected to the auditing procedures applied in the audit of the financial statements; accordingly, we express no opinion on it. Kearney will issue a Management Letter to communicate deficiencies in internal control or instances of noncompliance noted during the audit to management and those charged with governance.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of the MERHCF's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 21-04 in considering the entity's internal control. Accordingly, this communication is not suitable for any other purpose.

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

Alexandria, Virginia
November 8, 2021



Schedule of Findings

Material Weakness

I. Military Treatment Facility – Direct Care Costs Data Accumulation (*Repeat Condition*)

Background: The costs of health care services provided directly by the Department of Defense (DoD) in Military Treatment Facilities (MTF) (i.e., direct care costs) for the Medicare-Eligible Retiree Health Care Fund (MERHCF) beneficiaries represent significant input to the development of the actuarially determined health care liabilities of the MERHCF, as well as the determination of amounts contributed to the MERHCF by the branches of military service for active duty participants. In addition, the MERHCF recognizes expenses based on quarterly prospective payments made to the Defense Health Program (DHP) to support the operations of the MTFs on an ongoing basis as a result of care provided to MERHCF beneficiaries.

Direct care costs are incurred by the multitude of the MTFs managed by the Defense Health Agency (DHA) and Service Medical Activity (SMA) Components of the DHP in various locations. The prospective payments for direct care are fixed based on estimated costs for the anticipated number of patients who will rely on an MTF to receive health care. The anticipated number of patients is based on the actual workload two years prior to the budget execution year. The MERHCF is responsible for developing policies and procedures that validate estimated costs against actual costs.

Condition: The MERHCF's fiscal year (FY) 2021 quarterly prospective payments included \$1.96 billion in expenses for direct care costs for the period ended June 30, 2021. Health care cost data from the MTFs provided for the direct care cost estimation process used in the prospective payment is aggregated or derived from information in both financial and non-financial systems within the DHP. The MTF-level data is based on budget execution processes rather than accrual-based accounting. While activity-based costing techniques are used to estimate program costs related to the MTFs, the costs being allocated cannot be related to specific appropriations. In addition, the MERHCF does not have a formalized process in place to track health care encounters for MERHCF beneficiaries for accounting purposes, resulting in no transactional patient-level data to support the direct care costs recognized by the MERHCF. The MERHCF prospective payments are made to the DHP in advance of health care provided. The MERHCF, however, recognizes the payments as expenses upon the transfer of funds, which is not in compliance with Federal accounting standards.

There is also insufficient evidence that appropriate and consistent cut-off accounting activity occurs at the MTF level associated with care provided to MERHCF beneficiaries. The MERHCF had not yet implemented appropriate and sufficient levels of management control and reconciliation processes to ensure the adequacy and completeness of the data required for its financial reporting and actuarial valuation processes associated with direct care. Additionally, the MERHCF performs an annual retrospective reconciliation, using a 12-month running average process established in FY 2020, of the MTF patient workload data for purposes of comparing the



two-year historical data used in the prospective payment methodology to the actual patient workload realized in the year of payment. The results of the reconciliations are used for the purpose of determining if any significant transfer of funds should be returned to the MERHCF, as well as to adjust the prospective payment methodology, as may be warranted.

Cause: MTFs are not currently performing patient-level accounting for MERHCF beneficiaries, and MTF health care encounters for MERHCF beneficiaries are not tracked for billing purposes. The DHP has not established an effective business process with associated internal controls to properly recognize revenue based on care provided from actual activity occurring in the current FY. Rather, the cost of direct care provided to MERHCF beneficiaries for FY 2021, with the exception of the pharmacy ingredient cost, is fixed based on estimated costs for the anticipated number of MERHCF beneficiaries that will rely on an MTF to receive health care. The anticipated number of patients is based on the actual workload two years prior to the budget execution year, as well as the monthly reconciliation (implemented in FY 2020), and the annual reconciliation process of the two-year lookback is not performed timely to record adjustments which may be deemed necessary.

Effect: The MTF-level data is based on budget execution processes rather than accrual-based accounting. The MERHCF is unable to provide sufficient evidence supporting the completeness, validity, and appropriateness and consistent cut-off of accounting activity occurring at the MTF level associated with health care provided to MERHCF beneficiaries. The MERHCF financial statements may contain misstatements associated with Accounts Receivable (AR), Accounts Payable (AP), and Advances to Others on the Balance Sheet, as well as the Expense line on the Statement of Net Cost.

Recommendations: Kearney & Company, P.C. (Kearney) recommends that the MERHCF implement the necessary management control and reconciliation processes to support the direct care costs with actual patient workload data from the current FY. Kearney understands that the MERHCF is considering a change to record the prospective payment as a non-expenditure transfer. Upon finalization of its position, the MERHCF should document that the proposed accounting treatment is compliant with applicable Federal accounting standards and the United States Standard General Ledger (USSGL) guidance from the Department of the Treasury (Treasury).

Currently as recorded, Kearney recommends that the MERHCF perform the following:

1. Formalize expenditure recognition procedures to align with actual care provided in the current FY, as applicable for care provided by the DHP MTFs. Expenses recognized should be supported by transactional activity recorded in the general ledger (GL) system or in a supporting subsidiary system:
 - a. Prospective payments disbursed should be recorded as advances in accordance with USSGL guidance from the Treasury. Reference should be made to the recommended accounting treatment issued by the Defense Audit Remediation Working Group (DARWG) Research and Recommendation Paper, *MERHCF Transfer of Budgetary Resources to DHP*. Distribution payments made in excess of



- billings during the FY should be reflected as assets of the MERHCF at year-end.
- b. Patient care received by MERHCF beneficiaries should be tracked and monitored for expense recognition purposes using available information systems, as appropriate (e.g., Composite Health Care System [CHCS], Armed Forces Billing And Collection Utilization Solution [ABACUS], Military Health System [MHS] Data Repository [MDR]). The MERHCF should continue implementation and formalization of the MERHCF 12-month rolling average reconciliation analysis against the prospective payment at the beginning of the FY to validate the expenses recognized in the current year (i.e., appropriate expense recognition and periodic drawdown of advances). This supporting prospective payment analysis should be formalized quarterly and provided to the appropriate accounting personnel for consideration of adjusting accounting entries, as necessary.
 - c. Patient care encounters used in the quarterly prospective payment analysis should be maintained for audit trail purposes. Completeness of the patient care encounter data used in the quarterly analysis should be verified and documented.
 - d. Prospective payments provided in excess of actual care received should be recognized as an asset at year-end.
2. Implement verification testing over the contractor provided data to confirm accuracy.
 3. Provide cost accounting analytics for MTFs with MHS GENESIS.
 4. Through coordination with the DHP, develop a Memorandum of Understanding (MOU) for care provided to MERHCF beneficiaries at MTFs in support of the prospective payment validation discussed above. The MOU should establish necessary data and/or support requirements from the DHP for MERHCF accounting personnel to be able to perform the required quarterly validation for the prospective payments.

* * * * *



Significant Deficiency

II. Information Systems (*Repeat Condition*)

Background: The MERHCF operates in a complex information system environment to execute its mission and record transactions timely and accurately. The MERHCF operates or relies on external providers for administration of multiple key financial management systems, including two core accounting systems and multiple financial support systems. The Defense Manpower Data Center (DMDC) Core (dCore), Defense Enrollment Eligibility Reporting System (DEERS), and DMDC Mainframe systems support key medical benefit payment activities. A service organization administers the dCore, DEERS, and the DMDC Mainframe systems.

Because of the sensitive nature of the MERHCF's information system environment, Kearney does not present specific details related to the systems, conditions, or criteria discussed within this significant deficiency. We provided those details separately to the MERHCF's management and relevant stakeholders through Notices of Findings and Recommendations (NFR).

Condition: The MERHCF, through the support systems of its service organization, has several deficiencies in the design and operating effectiveness of internal controls related to key financial support systems and service organization systems. While no single control deficiency meets the level of a significant deficiency, in combination, these deficiencies elevate to a significant deficiency due to the pervasiveness of the weaknesses throughout the information system environment, the MERHCF's reliance on these systems for financial reporting, and the nature of the deficiencies repeating from the prior year.

Our testing disclosed deficiencies in the following areas:

- Security Management
 - A key financial management system did not update core Risk Management Framework (RMF) documents following significant changes to the system environment
- Access Controls and Segregation of Duties
 - Incomplete or not fully implemented policies and procedures for managing and monitoring access to key financial management applications and databases, including third-party systems
 - Incomplete or not fully implemented policies and procedures for the proper segregation of duties, including documented business justifications for existing segregation of duties conflicts, for key financial management applications
 - Inconsistent implementation of user account recertification to verify the propriety of access to key financial management systems
 - Inconsistent logging and monitoring of activity for key financial management systems



- Configuration Management
 - Incomplete, inconsistent, or unmaintained documentation of configuration changes for key financial management applications, including an incomplete listing of changes implemented into the production environment.

Cause: The deficiencies are a result of multiple circumstances, including previous deferral of key information system environment improvement projects related to audit logging, lack of integration between business and information technology (IT) stakeholders, incomplete or inconsistent implementation of policies and procedures, ineffective quality control (QC) processes to ensure personnel responsible for key information system controls followed documented procedures, and competing organizational priorities.

Effect: Without effective controls throughout the information system environment, the risk of unauthorized access and information system changes increases, thereby increasing the risk to the systems and the data confidentiality, integrity, and availability.

Recommendations: Kearney recommends that the MERHCF perform the following:

1. Implement monitoring activities to ensure compliance with DoD Instruction (DoDI) 8510.01, National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53, and NIST SP 800-37 RMF's document update requirements.
2. Develop and implement a QC review over the user authorization and user access review processes, to include procedures to ensure the completeness and accuracy of the access request forms and access listings reviewed.
3. Design and implement controls to mitigate any segregation of duty risks identified.
4. Continue to perform information system environment improvement projects related to audit logging.
5. Update and implement configuration management procedures to include QC reviews. These reviews should ensure that all changes follow a defined and controlled process, including maintaining appropriate supporting documentation from initial change request through implementation into the production environment.

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APPENDIX A: STATUS OF PRIOR-YEAR DEFICIENCIES

In the *Independent Auditor's Report on Internal Control over Financial Reporting* included in the audit report on the Medicare-Eligible Retiree Health Care Fund's (MERHCF) fiscal year (FY) 2020 financial statements (DODIG-2021-008, November 2020), we noted several issues that were related to internal control over financial reporting. The status of the FY 2020 internal control findings is summarized in **Error! Reference source not found.**

Exhibit 1: Status of Prior-Year Findings

Control Deficiency	FY 2020 Status	FY 2021 Status
Military Treatment Facility (MTF) – Direct Care Costs Data Accumulation	Material Weakness	Material Weakness
Information Technology (IT)	Significant Deficiency	Significant Deficiency



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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANT AGREEMENTS

To the Assistant Secretary of Defense for Health Affairs and Inspector General of the Department of Defense

We have audited, in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 21-04, *Audit Requirements for Federal Financial Statements*, the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2021, and the related notes to the financial statements, which collectively comprise the MERHCF's financial statements, and we have issued our report thereon dated November 8, 2021.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the MERHCF's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA). We limited our tests of compliance to these provisions and did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the MERHCF. However, providing an opinion on compliance with those provisions was not an objective of our audit; accordingly, we do not express such an opinion. The results of our tests, exclusive of those referred to in the FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 21-04.

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

The MERHCF's Response to Findings

The MERHCF's response to the findings identified in our audit is described in Management's Discussion and Analysis (MD&A) of the Agency Financial Report (AFR). The MERHCF's response was not subjected to the auditing procedures applied in our audit of the financial statements; accordingly, we express no opinion on it.



Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 21-04 in considering the entity's compliance. Accordingly, this communication is not suitable for any other purpose.

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Alexandria, Virginia

November 8, 2021



Schedule of Findings

Noncompliance and Other Matters

I. Federal Financial Management Improvement Act of 1996 Noncompliance (*Repeat Condition*)

The Federal Financial Management Improvement Act of 1996 (FFMIA) requires that an entity's overall financial management systems environment operate, process, and report data in a meaningful manner to support business decisions. Compliance with FFMIA is achieved through substantial compliance with the following three Section 803(a) requirements:

- Federal financial management system requirements
- Applicable Federal accounting standards
- United States Standard General Ledger (USSGL) at the transaction level.

The effects of the material weakness reported in the accompanying *Report on Internal Control over Financial Reporting*, with respect to direct care cost data accumulation, indicate substantial noncompliance with the requirements of Section 803(a) of FFMIA.

Federal Financial Management Systems Requirements

FFMIA requires reliable financial reporting, including the availability of timely and accurate financial information, and maintaining internal control over financial reporting and financial system security. The matters described in the "Basis for Qualified Opinion" section in the accompanying *Independent Auditor's Report*, as well as the material weakness reported in the accompanying *Report on Internal Control over Financial Reporting*, represent noncompliance with the requirement for reliable financial reporting, with respect to direct care costs.

Applicable Federal Accounting Standards

With respect to direct care costs, the Medicare-Eligible Retiree Health Care Fund (MERHCF) is not in compliance with the requirements necessary to meet internal and external reporting mandates. This includes the requirement that agency management systems maintain data to support reporting in accordance with Generally Accepted Accounting Principles (GAAP) for financial statements to be prepared in accordance with the form and content rules prescribed by the Office of Management and Budget (OMB) and reporting requirements prescribed by the Department of the Treasury (Treasury).



The financial management systems utilized by the MERHCF, with respect to direct care costs, do not fully, efficiently, and effectively support the MERHCF's efforts to:

- Consistently, completely, and accurately record and account for Federal revenues, expenditures, and costs
- Provide timely and reliable Federal financial management information of appropriate form and content
- Execute all of the above in a way that is consistent with Federal accounting standards and the USSGL.

Standard General Ledger at the Transaction Level

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

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