Audit Report

INTERNAL CONTROLS AND COMPLIANCE WITH LAWS AND REGULATIONS FOR THE DOD MILITARY RETIREMENT TRUST FUND FINANCIAL STATEMENTS FOR FY 1997

Report No. 98-171

June 30, 1998

Office of the Inspector General
Department of Defense

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Acronyms

DFAS	Defense Finance and Accounting Service
DRAS	Defense Retiree and Annuitant Pay System
FFMIA	Federal Financial Management Improvement Act
IG	Inspector General
OMB	Office of Management and Budget
SBP	Survivor Benefit Program

INSPECTOR GENERAL
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June 30, 1998

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

SUBJECT: Audit Report on Internal Controls and Compliance With Laws and Regulations for the DoD Military Retirement Trust Fund Financial Statements for FY 1997 (Report No. 98-171)

We are providing this audit report for your information and use. The Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspector General and prescribes the responsibility of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations.

On June 4, 1998, we issued an unqualified audit opinion on the FY 1997 DoD Military Retirement Trust Fund Financial Statements. We identified no internal control weaknesses or instances of noncompliance with laws and regulations that materially affect the financial statements. However, we found certain internal control weaknesses and noncompliances that were not material to the financial statements, but merit management attention. Management was cooperative and has taken actions to resolve the weaknesses. Part I includes separate sections on internal controls and compliance with laws and regulations. Part II provides relevant appendixes for management use. Appendix D includes the FY 1997 Financial Statements of the Military Retirement Trust Fund.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. David F. Vincent at (703) 604-9110 (DSN 664-9110) or e-mail DVincent@dodig.osd.mil, or Mr. Thomas J. Winter at (703) 604-9134 (DSN 664-9134) or e-mail TWinter@dodig.osd.mil. If management requests, we will provide a formal briefing on the audit results. See Appendix G for the report distribution. A list of audit team members is on the inside back cover.

Robert J. Lieberman
Assistant Inspector General
for Auditing

Office of the Inspector General, DoD

Report No. 98-171 **June 30, 1998**
(Project No. 7FH-2039.01)

Internal Controls and Compliance With Laws and Regulations for the DoD Military Retirement Trust Fund Financial Statements for FY 1997

Executive Summary

Introduction. Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994, requires an annual audit of the financial statements of the DoD Military Retirement Trust Fund (the Fund). The Fund's financial statements for FY 1997 reported total assets of $143 billion, investments of $139 billion, and a future funding requirement of $501 billion. The Fund manager is the Deputy Under Secretary of Defense (Program Integration) who reports to the Under Secretary of Defense (Personnel and Readiness). The Defense Finance and Accounting Service (DFAS) administers the Fund from the DFAS Cleveland Center, Cleveland, Ohio, and the DFAS Denver Center, Denver, Colorado. The Fund manager and DFAS management are responsible for establishing internal controls and for compliance with laws and regulations.

Audit Objectives. The overall objective of our audit was to determine whether the Fund's Financial Statements for FY 1997 were presented fairly and in accordance with Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. In addition, we assessed the internal controls and compliance with laws and regulations related to the financial statements. See Appendix A for a discussion of the audit scope and methodology.

Unqualified Opinion. On June 4, 1998, we issued an unqualified opinion on the Fund's Financial Statements for FY 1997. In our opinion, the Principal Statements, including the Notes to the Principal Statements, present fairly, in all material respects, the assets, liabilities, and net financial position of the Fund for FY 1997, and the results of operations and changes in net position, in accordance with DoD accounting policies and procedures and generally accepted accounting principles. Appendix C of this report includes our opinion and Appendix D includes the Fund's Financial Statements for FY 1997.

Change in Accounting Method. In FY 1997, the Fund changed its method of accounting for the actuarial liability to comply with the Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995.

Internal Controls. Overall, management has established sound internal controls over the Fund's activities. Internal controls ensure that financial statements are not materially misstated and that management complies with laws and regulations.

laws and regulations. However, management reported one uncorrected material internal control weakness at the DFAS Cleveland Center as defined by DoD Directive 5010.38, "Management Control Program," August 26, 1996. The DFAS Cleveland Center had reported the weakness in its FY 1995 Annual Statement of Assurance, stating that data in the retired pay system had not been reconciled with data in the Military Departments' personnel systems. Corrective action will be completed in FY 1998.

We reviewed over 600 military personnel files to test the accuracy of source documents used to determine the Fund's liability. The delay in acquiring data, as well as the extensive coordination and evaluation, contributed to the delay in rendering the financial statement opinion. In addition, we did not receive a legal representation letter until April 8, 1998, which also hindered our ability to issue reports.

Our statistical sample of data on 4.3 million participants, which includes military retirees, survivor annuitants, active-duty and reserve personnel, showed that the Actuarial Accrued Liability was overstated by $4.5 billion and understated by an estimated $2.6 billion, for an estimated net overstatement of $1.9 billion out of a reported $641.7 billion. The overstatement is not material to the Fund's financial statements. The Actuary confirmed that the overstatement is the result of a systemic error in the database and an error in the input file used to project survivor benefits. The Actuary has taken action to resolve the systemic error, and will correct the input file error.

We recomputed payments to retirees and survivor annuitants and did not identify any systemic problems in the Defense Retiree and Annuitant Pay System. We also followed up on a reportable condition concerning the erroneous calculation of the high-3 average base pay years for retirees. Because the reportable condition is the result of not applying the provisions, no systemic problem exists that affects our opinion. Our work also showed that the financial management system used to compile the Fund's FY 1997 Financial Statements did not meet the requirements of the Federal Financial Management Improvement Act of 1996 because of nonintegration and lack of compliance with the U.S. Government Standard General Ledger. Finally, we conducted a separate audit on computer application controls over the Defense Retiree and Annuitant Pay System and determined that existing errors would not materially affect the Fund's Financial Statements.

Compliance With Laws and Regulations. We reviewed compliance with laws and regulations pertaining to the accuracy of the financial statements. Our tests did not disclose any material noncompliance affecting the financial statements. Except for the noncompliances described above, management complied in all respects with the laws and regulations we reviewed. With respect to items not tested, nothing came to our attention that caused us to believe that the Fund had not complied, in all material respects, with applicable laws and regulations. Part I.B. is our report on compliance with laws and regulations. Part II, Appendix F, lists the laws and regulations we reviewed.

Management Comments. We provided a draft of this report on June 12, 1998. Because this report contains no findings or recommendations, formal written comments were not required, and no formal comments were received. Therefore, we are publishing this report in final form.

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I. - Audit Results

Audit Background

Introduction. This audit was performed as part of our effort to meet the requirements of Public Law 101-576, the "Chief Financial Officers Act of 1990," November 15, 1990, as amended by Public Law 103-356, the "Federal Financial Management Act of 1994," October 13, 1994. The legislation requires financial statement audits by the Inspectors General and prescribes the responsibility of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. Management is responsible for establishing and maintaining an internal control structure and for complying with laws and regulations applicable to DoD financial accounting and reporting. Our responsibility is to render an opinion on the financial statements, and to determine whether internal controls are adequate and whether the entity complied with laws and regulations.

Accounting Principles. The Military Retirement Trust Fund (the Fund) Financial Statements for FYs 1997 and 1996 were to be prepared in accordance with the Office of Management and Budget (OMB) Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as modified by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. Footnote 1 of the Fund's Financial Statements for FYs 1997 and 1996 discusses the significant accounting policies used in preparing the financial statements.

Change in Accounting Method. In FY 1997, the Fund changed its method of accounting for the actuarial liability as described in Note 1 of the financial statements. Actuarial liability will be reported as of the end of the fiscal year, using the "projected benefit obligation" cost method. This change is in accordance with the Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995.

Unqualified Audit Opinion. On June 4, 1998, we issued an unqualified opinion on the Fund's Financial Statements for FY 1997. In our opinion, the Principal Statements, including the Notes to the Principal Statements, present fairly, in all material respects, the assets, liabilities, and net financial position of the Fund for FYs 1997 and 1996, and the results of operations and changes in net position for FYs 1997 and 1996, in accordance with the accounting principles described in Part II, Appendix A. Part II of our report includes the audit opinion and financial statements.

Fund Administration. In April 1995, DFAS consolidated the military retiree and annuity pay systems and operations into the Defense Retiree and Annuitant Pay System (DRAS) at the DFAS Cleveland Center, Cleveland, Ohio, and the DFAS Denver Center, Denver, Colorado. The DFAS Cleveland Center establishes and maintains retiree accounts, and the DFAS Denver Center establishes and maintains survivor annuitant accounts. The DRAS is the standard DoD system that gathers, stores, and processes data required to generate and account for payroll for all DoD military retirees, former spouses of these retirees, and survivor benefit plan annuitants. The DoD Office of the Actuary (the Actuary) determines the funding requirements for the Fund. Based on those requirements, the Investment Trust Fund Directorate, Accounting Deputate, DFAS, monitors the contributions that the Military Departments and the U.S. Treasury make to the Fund and invests those contributions in market-based U.S. securities.

Audit Objectives

The overall objective of our audit was to determine whether the FY 1997 financial statements of the Fund are presented fairly and in accordance with OMB Bulletin No. 94-01, as modified by OMB Bulletin No. 97-01. We also evaluated internal controls and compliance with laws and regulations as they relate to the financial statements. Part II, Appendix A, gives the audit scope and methodology, standards, and accounting principles.

Part I. A. - Review of Internal Controls

Introduction

Audit Responsibilities. The audit objective was to determine whether controls over transactions supporting the accounts in the Fund's FY 1997 Financial Statements were adequate to ensure that the accounts were free of material error. In planning and performing our audit of the Fund for the year ended September 30, 1997, we evaluated the established internal controls. The purposes of this evaluation were to:

- determine our auditing procedures for rendering an opinion on the financial statements; and

- determine whether an internal control structure had been established.

That determination included obtaining an understanding of the internal control policies and procedures, as well as assessing the level of control risk relevant to all significant cycles, classes of transactions, and account balances. For those significant control policies and procedures that had been properly designed and placed in operation, we performed sufficient tests to provide reasonable assurance that the controls were effective and working as designed. For areas where internal controls were determined to be weak, we performed tests to determine the level of assurance that could be placed on those controls.

Management Responsibilities. As the Chief Financial Officer, the Under Secretary of Defense (Comptroller) oversees all financial management activities for DoD programs and operations, including the accounting functions of DFAS. The Military Departments, Defense agencies, and DoD field activities are responsible for managing their operations. Establishing and maintaining internal controls appropriate to the entity is an important management responsibility. The objectives of internal controls are to provide management with reasonable, not absolute, assurance that:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets;

- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, and misappropriation; and

- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and with any laws and regulations that OMB, DoD, or the Inspector General (IG), DoD, have identified as being significant and for which compliance can be objectively measured and evaluated.

Internal Control Elements. The purpose of our review was to evaluate the internal controls and issue a report on the results. The three elements of controls are the control environment, accounting and related systems, and control procedures. The control environment is the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include management's philosophy and operating style, the entity's organizational structure, and personnel policies and practices. The control environment reflects the overall attitude, awareness, and actions of management concerning the importance of controls and the emphasis placed on them by the entity. Accounting and related systems are the methods and records established to identify, assemble, analyze, classify, record, and report on the entity's transactions and to maintain accountability for the related assets and liabilities. Control procedures are the policies and procedures, in addition to the control environment and the accounting and related systems, which management has established to provide reasonable assurance that specific objectives will be achieved.

Reportable Conditions

Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls that, in our judgment, could adversely affect the organization's ability to effectively control and manage its resources and to ensure reliable and accurate financial information for use in managing and evaluating operational performance. A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that errors or irregularities could occur. Such errors would be in amounts that would be material to the statements being audited, or material to a performance measure or aggregation of related performance measures, and would not be detected in a timely manner by employees in the normal course of performing their functions. Our consideration of internal controls would not necessarily disclose all reportable conditions and would not necessarily disclose all reportable conditions that are material weaknesses.

Management Acknowledgment of Reportable Conditions. In the FY 1997 Annual Statement of Assurance, DFAS reported one uncorrected material internal control weakness for the Fund. DFAS had initially reported the weakness in its FY 1995 Annual Statement of Assurance. The weakness related to reconciling the retired pay system to the Services' Military Department personnel systems.

Weakness in Personnel Systems. The DFAS Cleveland Center had reported that data in the DRAS had not been reconciled with the Military Department personnel systems. Reconciliations would assist in resolving errors in data elements and in identifying fraudulent or erroneous accounts. In the FY 1997 Annual Statement of Assurance, the DFAS Cleveland Center reported the reconciliation weakness as an uncorrected material internal control weakness to be corrected in FY 1998. During FYs 1996 and 1997, the DFAS Cleveland Center submitted personnel data on retirees to the Army, the Air Force, and the Marine Corps for reconciliation with the personnel systems. In FY 1997, the DFAS Cleveland Center submitted retiree data to the Navy for reconciliation with the Navy personnel system. In discussions with DFAS Cleveland Center personnel, we determined that the DFAS Cleveland Center's corrective action was adequate and should correct the weakness when fully implemented. In future audits, we will continue to monitor the status of this material weakness and its effect on the Fund's Financial Statements.

This is a material weakness, as defined by DoD Directive 5010.40, "Management Control (MC) Program Procedures," August 28, 1996. This weakness is reportable under DoD Directive 5010.38, "Management Control Program," August 26, 1996, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993. However, the weakness did not materially affect the Fund's FY 1997 Financial Statements. During our review of internal controls at the DFAS Cleveland Center and our recomputation of the payments made by the Fund to 60 retirees and 60 annuitants, we did not identify any significant errors in the DRAS data indicating that the material internal control weakness, as reported in the DFAS Cleveland Center's FY 1997 Annual Statement of Assurance, materially affected the Fund's FY 1997 Financial Statements.

Computer Application Controls. A separate IG, DoD, "Audit of Selected Application Controls Over the Defense Retiree and Annuitant Pay System," (Project No. 8FG-5010), is being conducted to evaluate application controls over the DRAS and ensure that the system produces authorized, accurate, complete, and reliable data. The preliminary results of this audit show that unauthorized activity could occur and may not be detected in a timely manner in order to prevent misstatements in the Fund's Financial Statements. However, tests of the Fund's management controls did not detect material misstatements. The preliminary results of this audit and the following procedures and controls lead us to believe that data from the DRAS are reliable.

- DFAS is developing procedures to detect the existence of invalid retiree pay accounts by matching pay and personnel records for retiree pay.

- In 386 cases tested, the existence of edit and validation controls was evident.

The following additional tests strengthen our belief that no systemic problems exist in the Fund that would cause a material misstatement.

- Recomputation of retiree and annuitant monthly payments on over 700 individuals, from FY 1991 to FY 1992 and from FY 1995 to FY 1997, did not reveal any systemic problems.

- In Operation Mongoose, a fraud detection project, auditors visited nine foreign countries to verify the existence of retired military and civilian DoD employees and their surviving dependents who were receiving payments. Based on the reviews, pay accounts were suspended from November 1996 through June 1997. As of August 1997, 85 to 95 percent of the suspended accounts had been reactivated. The DFAS Cleveland Center did not identify any material internal control weaknesses based on those reviews.

- The DFAS Cleveland Center compiles daily and monthly exception reports to identify unusual payments.

- Reconciliations between records of the Department of Veterans Affairs and retiree records in the DRAS are performed annually to verify that payment and death notification data from the Department of Veterans Affairs are properly reported in the DRAS.

- Reconciliations between Social Security Administration records and retiree records on the DRAS are performed quarterly to identify retirees who are believed to be deceased.

- Comparisons between the DRAS and the active-duty military pay system are performed monthly to identify individuals who receive both retired and active-duty pay.

Overstatement in Actuarial Accrued Liability. The participant data used by the Actuary to forecast the $641.7 billion Actuarial Accrued Liability, and the effect on Other Expenses ($15.9 billion for the Fund's FY 1997 Financial Statements), were generally accurate. However, our opinion was not affected by the net estimated overstatement of $1.9 billion because our materiality threshold for the Actuarial Accrued Liability was $6.4 billion. The net overstatement of $1.9 billion was derived from

- a complete actuarial review of retiree records to arrive at the overstatement of $4.5 billion, and

- a projection by the IG, DoD, statistician for an estimated understatement of $2.6 billion.

Actuarial Overstatement. The Actuary's complete evaluation of the retiree database identified a $4.5 billion overstatement related to the retiree Survivors Benefit Program (SBP) election. The SBP provides annuities to the retirees' spouses and families on the retirees' death. The $4.5 billion overstatement has two causes, as indicated below.

- The data input file to the computer module for the Actuarial liability projection caused an overstatement of $2.6 billion. This overstatement occurred because the input file included potential survivors who did not exist. The error occurred because the input file mistakenly assumed that retirees with survivor benefits who had lost a spouse beneficiary (e.g., through death) still had an eligible spouse. The input file is controlled by the Actuary, and action is under way to correct the problem.

- The additional $1.9 billion overstatement was caused by coding errors when retirees declined SBP coverage at retirement. The database shows an eligible beneficiary although no beneficiary coverage was elected, causing the Actuary to incorrectly project a future liability.

We determined that the Actuary received incorrect SBP codes for retirees who declined coverage or who no longer had an eligible spouse beneficiary. We did not determine whether the coding errors occurred at the DFAS Cleveland

Center or the Defense Manpower Data Center. The coding errors occurred during the data transfer, causing the Actuary to receive inaccurate data. The Actuary took immediate action to establish a Memorandum of Understanding between the three parties to identify and resolve the problem. Based on the supporting documents we reviewed at the DFAS Cleveland Center, we concluded that SBP coverage was properly recorded in DRAS. The DRAS accurately reported that retirees had declined coverage or had no beneficiary currently eligible for SBP. Because of the application error in the data input file used by the Actuary and the coding errors in the SBP election, the Actuary's data input file erroneously classified the following as having spouses:

- retirees who declined coverage, and
- retirees who no longer had eligible beneficiaries.

As a result, the model inappropriately forecasted larger future benefits, causing the total overstatement of $4.5 billion.

Statistical Understatement. The IG, DoD, statistician projected an estimated Accrued Liability understatement of $2.6 billion, based on errors that we identified in the statistical sample of 600 individuals eligible for payments from the Fund. The $2.6 billion represents the IG, DoD, statistician's projection to the entire universe of 4.3 million Fund participants. We determined that those errors were not attributable to any systemic error and did not have a material effect on the financial statements. Appendix A discusses the statistical sample.

Statistical Internal Control Assessment. We considered the IG, DoD, statistician's results to assess the adequacy of internal controls over the participants data and conclude we can rely on the controls. As specified in Appendix A, the statistical sample showed that an estimated 8.1 percent of the sample items contained at least one error in a data element, and an estimated 7.5 percent contained a data element that was unsupported. If a record contained both an unsupported and an error item, the item was counted only as an error, providing a conservative approach to the results. The statistical results indicate that moderate reliance can be placed on the controls to ensure the accuracy of the data reported for each element. Although the sample results indicated that only moderate reliance could be placed on the controls, the statistical estimate of the dollar effect of those errors on the actuarial liability reported on the Fund's financial statements was not material, even though the controls were assessed at the level of moderate risk.

The errors in the data elements do not have a material effect on the actuarial liability because the projection module uses a hierarchy of data elements to estimate the actuarial liability and many of the elements have no or only a negligible impact on the actuarial liability. As a result, the frequency of data element errors is mitigated and does not adversely effect the estimate. We determined that those errors were not attributable to any systemic error and did not have a material effect on the estimate of the actuarial liability. As a result, the errors did not indicate a material management control weakness.

We also considered the following factors in our assessment of internal controls.

- The results of our substantive tests for this year and prior year's did not disclose any material misstatements in the Fund's Financial Statements.

- An unsupported item is not automatically wrong. During our data collection, we found that accurate support was available for data elements, but not expeditiously in some cases. We considered the cost and benefit to further reduce the unsupported items identified at the 7.5 percent level. We conclude that the benefit to reduce the percentage would not be cost effective or warranted based on the expected results.

- Many of the errors we did identify had no material effect on the financial statements. In the majority of data errors, the Actuary determined that there was no dollar impact on the liability. We would expect that many of the 8.1 percent errors would have similar results.

Based on the above factors, we conclude internal controls are adequate to prevent a material misstatement of the Fund's Financial Statements.

Corrective Action. We determined that the Actuary has taken the action necessary to establish a Memorandum of Understanding between the DFAS Cleveland Center and the Defense Manpower Data Center to identify and correct the problem; we did not determine where the problem originates. In addition, the Actuary has acknowledged the problem with the input file to the computer projection module for participants in suspended beneficiary status, and has agreed to modify the system. Future audits of the Fund will follow up on the results of this corrective action.

Computations of Payments. During the FY 1997 audit, we recomputed 60 retiree and 60 annuitant payments made to individuals by DFAS Centers, using the same methodology as in prior audits. We did not identify any systemic errors. We followed up on a reportable condition from FY 1996 concerning the calculation of the high-3 average base pay years for retirees. The high-3 average base pay calculation applies only to individuals who entered the Service after 1980. We determined that the FY 1996 errors were caused by inappropriate application of the saved-pay provisions of 10 U.S.C. 1401a(e), as repealed by the "DoD Authorization Act, FY 84," section 921, on September 24, 1983. The saved-pay provisions allow a one-time review to determine which calculation of retirement pay is most advantageous to the Service member. The DFAS Cleveland Center determined that saved pay provisions were not applied in all cases. Since a limited number of Service members are affected and DFAS has identified the problem, we concluded that no systemic problem existed that would materially affect the financial statements.

Debt Collection Techniques. In prior audit reports, we identified weaknesses in the debt collection process at the DFAS Cleveland and Denver Centers. We did not follow up on the previously reported weaknesses because the amounts involved were well below the materiality threshold. Public Law 97-365, the

"Debt Collection Act of 1982" October 25, 1982, authorized Federal agencies to assess interest, penalties, and administrative charges on debts. Public Law 104-134, the "Debt Collection Improvement Act of 1996," April 26, 1996, transferred old debts to the Department of the Treasury for collection. We continue to monitor the corrective actions initiated by DFAS.

Summary

Overall, internal controls for the Fund were working as designed. Although we identified a control weakness in the system used to project the actuarial accrued liability, internal controls were adequate and effective and identified any potential problems that could materially affect the financial statements. We are not making a recommendation concerning the systemic problem with the actuarial accrued liability because the Actuary has taken action to establish a Memorandum of Understanding with the DFAS Cleveland Center and the Defense Manpower Data Center to identify and correct this problem. The Actuary is also modifying the input file to the projection module.

Part I. B. - Review of Compliance With Laws and Regulations

Introduction

We evaluated the Fund's FY 1997 Financial Statements for material instances of noncompliance with laws and regulations for FY 1997. Our purpose was not to render an opinion on overall compliance with laws and regulations. The Deputy Under Secretary of Defense (Comptroller), the Deputy Under Secretary of Defense (Program Integration), and the Director, DFAS, are responsible for ensuring compliance with laws and regulations applicable to the Fund. As part of obtaining reasonable assurance on whether the financial statements are free of material misstatements, we tested compliance with the laws and regulations listed in Appendix F. Such tests are required by the Chief Financial Officers Act of 1990, as amended by the Federal Financial Management Act of 1994.

Reportable Conditions

Material instances of noncompliance are failures to follow requirements, laws, or regulations that would cause us to conclude that the aggregation of the misstatements resulting from those failures is either material to the financial statements, or that the sensitivity of the matter would cause others to perceive it as significant.

Title 31, U.S.C. 3512, "Federal Financial Management Improvement Act of 1996." On September 9, 1997, OMB issued a memorandum, "Implementation Guidance for the Federal Financial Management Improvement Act of 1996" (the FFMIA). The FFMIA requires Federal agencies to implement and maintain financial management systems that comply substantially with Federal requirements for financial management systems, applicable Federal accounting standards, and the U.S. Government Standard General Ledger at the transaction level. The FFMIA also requires that we report on agency compliance with these requirements, which are well-established in the following Federal policy documents.

- OMB Circular No. A-127, "Financial Management Systems," July 23, 1993, establishes Government policy for developing, evaluating, and reporting on financial management systems. It requires that financial management systems provide complete, reliable, consistent, timely, and useful information. To achieve this goal, DoD and other Federal agencies must establish and maintain a single, integrated financial management system using the U.S. Government Standard General Ledger.

- OMB Circular No. A-134, "Financial Accounting Principles and Standards," May 20, 1993, establishes policies and procedures for approving and publishing financial accounting principles and standards. It also establishes the policies that Executive agencies and OMB are to follow in seeking and providing interpretations and other advice related to the standards.

- The Joint Financial Management Improvement Program is a cooperative undertaking of the OMB, the Department of the Treasury, and the Office of Personnel Management, working with each other and with operating agencies to improve financial management throughout the Government. The Joint Financial Management Improvement Program has published a series of "Federal Financial Management System Requirements."

- The "Core Financial System Requirements," September 1995, which are a part of the Joint Financial Management Improvement Program "Federal Financial Management System Requirements," establish standard requirements for the foundation modules of an agency's integrated financial management system. These requirements state that a financial management system must support the partnership between program and financial managers and assure the integrity of information for decisionmaking and measuring performance.

As part of our audit to obtain reasonable assurance about whether the Fund's FY 1997 Financial Statements were free of material misstatement, we performed tests of compliance with certain provisions of laws and regulations when noncompliance with these laws and regulations could have a direct and material effect on the financial statements. We also tested compliance with certain other laws and regulations specified in OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, as modified by OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998. In planning and performing our tests of compliance, we considered the implementation guidance issued by OMB on September 9, 1997, relating to the FFMIA.

Federal Financial Management Improvement Act of 1996. Under the FFMIA and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, as modified by OMB Bulletin No. 98-04, "Addendum to OMB Bulletin No. 93-06," January 16, 1998, our work disclosed that financial management systems did not fully comply with Federal requirements for integrated financial management systems and the U.S. Government Standard General Ledger at the transaction level. The financial management systems used to compile figures for three line items (Contributions, Investments and Disbursements) on the Fund's FY 1997 Financial Statements were not integrated or transaction-based. In addition, the Fund's accounting system's general ledger used to compile the financial statements was not transaction-based or derived from an integrated financial management system. However, the noncompliance with the FFMIA did not affect the reliability of the data in the Fund's financial statements. Finally, the Trust Fund Accounting System used to compile the FY 1997 Military Retirement Trust Fund Financial Statements, which is compliant with the U.S. Standard General Ledger, obtains data from the Centralized Expenditure/Reimbursement Process system and the General Accounting and Finance System. These two feeder systems are partially compliant with the requirements of the U.S. Government Standard General Ledger.

Legal Representation Letter. Management did not fully comply with the Federal Financial Management Act of 1994, which required the submission of audited financial statements to OMB by March 1, 1998. For the auditors to render an unqualified opinion, the financial statements must be supported by a legal representation letter. The Fund's management provided us with a legal representation letter on April 8, 1998; therefore, we could not fulfill the requirements of the OMB guidance. However, the late receipt of the legal representation letter and our inability to fulfill OMB guidance did not prevent us from issuing an unqualified opinion. We are rendering this unqualified opinion based on our review of the Principal Statements and the Notes to the Principal Statements of the Military Retirement Trust Fund for FY 1997.

Compliance Issues. The results of our tests indicate that, with respect to the items tested, the Fund complied in all material respects with the provisions referred to above. With respect to items not tested, nothing came to our attention that caused us to believe that the DoD Components operating the Fund had not complied, in all material respects, with the provisions identified above.

Part II. - Additional Information

Appendix A. Audit Process

Scope

Statements Reviewed. We examined the Principal Statements and the Notes to the Principal Statements of the Fund for FYs 1996 and 1997. The Principal Statements include the Statement of Financial Position and the Statement of Operations and Changes in Net Position. Also included are the Footnotes, Overview, and Supplemental Information. Our opinion is based on the Principal Statements dated February 27, 1998.

Sample of Participant Data. To comply with the audit and accounting guide issued by the American Institute of Certified Public Accountants, "Audit of Employee Benefit Plans," May 1, 1996, we evaluated participant data. The Actuary uses the participant data to estimate the actuarial accrued liability for the Fund. We used a statistical sample of 600 participants to test the validity of the data, for 4.3 million individuals, including retirees, survivors, reservists, and active-duty personnel. Because participants' records were stored in many locations throughout the United States, obtaining data for the sample required several months of extensive effort. The additional time required to collect and evaluate the data was a reason for delay in issuing this report and the audit opinion.

Accounting Principles. Accounting principles and standards for the Federal Government are under development. The Federal Accounting Standards Advisory Board was established to recommend Federal accounting standards to three officials for approval. Those three officials are the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States. The Director, OMB, and the Comptroller General issue standards agreed on by the three officials. To date, seven Accounting Standards and two Accounting Concepts have been published in final form. Accounting Standard No. 8 has been approved by the Federal Accounting Standards Advisory Board, but must be reviewed before it is issued. In addition, the Federal Accounting Standards Advisory Board issued an exposure draft, "Amendments to Accounting for Property, Plant, and Equipment," February 13, 1998, proposing amendments to Accounting Standards No. 6 and No. 8. These standards and concepts constitute generally accepted accounting principles for the Federal Government. OMB Bulletin No. 94-01, as supplemented by OMB Bulletin No. 97-01, incorporates these standards and concepts and should be used by Federal agencies to prepare financial statements. The following table lists the "Statements of Federal Financial Accounting Standards and Concepts."

Statements of Federal Financial Accounting Standards and Concepts

Accounting Standards and Concepts	Title	Status	Fiscal Year Effective
Standard No. 1	Accounting for Selected Assets and Liabilities, March 30, 1993	Final	1994
Standard No. 2	Accounting for Direct Loans and Loan Guarantees, August 23, 1993	Final	1994
Standard No. 3	Accounting for Inventory and Related Property, October 27, 1993	Final	1994
Standard No. 4	Managerial Cost Accounting Concepts and Standards for the Federal Government, July 31, 1995	Final	1998
Standard No. 5	Accounting for Liabilities of the Federal Government, December 20, 1995	Final	1997
Standard No. 6	Accounting for Property, Plant, and Equipment, November 30, 1995	Final*	1998
Standard No. 7	Accounting for Revenue and Other Financing Sources, May 10, 1996	Final	1998
Standard No. 8	Supplementary Stewardship Reporting, June 11, 1996	Approved*	
Concept No. 1	Objectives of Federal Financial Reporting, September 2, 1993	Final	
Concept No. 2	Entity and Display, June 6, 1995	Final	

*The Federal Accounting Standards Advisory Board has issued an exposure draft, "Amendments to Accounting for Property, Plant, and Equipment," February 13, 1998. The exposure draft contains proposed amendments to Standards No. 6 and No. 8.

Through FY 1997, agencies were required to follow the hierarchy of accounting principles outlined in OMB Bulletin No. 94-01, as supplemented by OMB Bulletin No. 97-01. The FY 1997 hierarchy includes:

- standards agreed to and published by the Director, OMB; the Secretary of the Treasury; and the Comptroller General of the United States;
- requirements for the form and content of financial statements outlined in OMB Bulletin No. 94-01, as modified by OMB Bulletin No. 97-01;
- accounting standards contained in agency accounting policy, procedures, or other guidance as of March 29, 1991; and
- accounting principles published by other authoritative sources.

Review of Internal Controls. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements, including the accompanying notes. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statements. We reviewed aspects of the Fund's internal controls and obtained an understanding of the internal control policies and procedures related to accounting systems, Fund Balance With Treasury, accounts receivable, accounts payable, pensions and other actuarial liabilities, revenues, expenses, and the preparation of the financial statements. Specifically, we recomputed retiree and annuitant pay; evaluated participants data; tested Investments and Contributions to the Fund; and tested internal controls. We followed up on internal control weaknesses, identified during the audit of the Fund for FY 1996, regarding retiree payment computations and the debt collection issues. Our consideration of the internal controls would not necessarily disclose all matters that might be reportable conditions, and would not necessarily disclose all reportable conditions that are also considered material weaknesses.

Review of Compliance With Laws and Regulations. Compliance with laws and regulations is the responsibility of Fund managers and DFAS managers. To obtain reasonable assurance that the Fund's FY 1997 Financial Statements were free of material misstatements, we reviewed compliance with laws and regulations that may directly affect the financial statements, and with other laws and regulations designated by OMB and DoD. Appendix F lists the laws and regulations we reviewed.

Methodology

Auditing Standards. We conducted this financial statement audit in accordance with generally accepted Government auditing standards issued by the Comptroller General of the United States as implemented by the IG, DoD, and OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993, as supplemented. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the principal statements are free of material misstatements. We relied on the guidelines suggested by the General Accounting Office and our professional judgment in assessing the materiality of matters affecting the fair presentation of the financial statements and related internal control weaknesses.

Computer-Processed Data. To achieve our audit objective, we relied on computer-processed data. To evaluate selected application controls over the DRAS, a separate IG, DoD project, Project No. 8FG-5010, was conducted. The audit results did not identify unauthorized activity, but will recommend implementing controls to increase managers' confidence in the authorization, accuracy, completeness, and reliability of retiree payments. By comparing retiree and annuitant data in the DRAS to source documents, we determined that the DRAS data were valid and accurate. By recomputing the pay based on source documents, we also determined that the DRAS accurately computed the monthly gross pay for those retirees and annuitants. The sample of participant data was selected from the database that the Defense Manpower Data Center provided to the Actuary in order to estimate the actuarial accrued liability.

The Defense Manpower Data Center obtained the data from the Military Department active duty and reserve personnel systems and the DRAS. To recompute, on a test basis, the FY 1997 contributions that the Military Departments were required to make to the Fund, we relied on the base pay data in the Military Department pay systems. We accepted the base pay amounts as reported in the pay systems; we did not test the systems. We also reconciled the contributions, as reported by the Military Departments, to the Fund's FY 1997 Financial Statements.

Audit Period and Locations. The audit was conducted from June 1997 through March 1998 at DFAS, Arlington, Virginia; the DFAS Cleveland Center, Cleveland, Ohio; the DFAS Denver Center, Denver, Colorado; and the National Personnel Records Center, St. Louis, Missouri.

Representation Letters. On January 21, 1998, we received a management representation letter from the Office of the Under Secretary of Defense (Personnel and Readiness), regarding the Fund's FY 1997 Financial Statements. The letter stated that the Office of the Under Secretary of Defense (Personnel and Readiness) had made available all records and had either represented or disclosed all facts related to or affecting the Fund's Financial Statements for FY 1997. The Office of the Under Secretary of Defense (Personnel and Readiness) had nothing to disclose that would preclude the issuing of an unqualified opinion. On April 8, 1998, we received a legal representation letter from the General Counsel, DFAS. The legal representation letter stated that there were no known or pending legal matters affecting the Fund. Part II, Appendix E, contains the management and legal representation letters.

Contacts During the Audit. We visited or contacted individuals and organizations within the DoD and the National Personnel Records Center, St. Louis, Missouri. Further details are available on request.

Statistical Sampling Methodology

Sampling Purposes. In support of this Chief Financial Officer Act audit, the purposes of the statistical sampling were to provide quantitative evidence for two audit determinations: the fair representation of the dollar value of the Pensions and Other Actuarial Liabilities line [5 b(4)] of the Fund's FY 1997 Financial Statements, and the adequacy of internal controls for this line. For the determination of fair representation, we statistically estimated the total net dollar misstatement of the reported value for the line. To assess the adequacy of internal controls, we statistically estimated the overall percentage of individuals with erroneous information in their records and, separately, the overall percentage with unsupported information in their records.

Sampling Frame. The frame for our statistical sampling included 4,256,832 individuals' records with a total reported value, as of September 30, 1997, of $641.9 billion for Pensions and Other Actuarial Liabilities. These individuals comprised four subpopulations:

- Retirees, 1,654,386 individuals, $408.6 billion;
- Survivors, 224,385 individuals, $18.1 billion;
- Reservists, 854,830 individuals, $21.8 billion; and
- Active Duty, 1,523,231 individuals, $193.4 billion.

Measures. The net dollar misstatement for an individual's record was defined as the difference between the accrued liability for the individual, calculated using the information in the individual's record, and the corrected accrued liability for the individual. Corrections were made for any errors found in the record. These corrected values were calculated and provided by the Actuary. No dollar changes were made for unsupported information. The percentage of individuals with errors in their records was based on errors found in one or more of the critical fields, as defined by the Actuary. If no documentation was available for one of the critical fields, the record was counted as unsupported. A record with both errors and unsupported fields was counted as an error, but was not counted as unsupported.

Sampling Design. We used a stratified sampling design for this audit. The universe was divided into 4 subpopulations with 12 strata, 1 stratum for each of the Military Departments for the Retiree and Survivor subpopulations, and officer and enlisted strata for the Reserves and Active Duty subpopulations. The sample size selections and population sizes for each stratum are listed below:

Stratum	Sample Size	Population Size
Retirees - Army	70	555,499
Retirees - Navy	60	416,909
Retirees - Marine Corps	20	84,049
Retirees - Air Force	80	597,929
Survivors - Army	20	96,367
Survivors - Navy	20	56,570
Survivors - Marine Corps	20	8,087
Survivors -Air Force	20	63,361
Reserves - Officer	20	130,992
Reserves - Enlisted	90	723,838
Active-Duty - Officer	20	244,618
Active-Duty Enlisted	160	1,278,613

The sampled records were selected randomly within each stratum.

Sample Results. We derived the following statistical estimates of misstatement dollar values from our sample data:

95-Percent Confidence Intervals

	Lower Bound	Point Estimate	Upper Bound
Net Misstatement (excluding SBP)	- $6.237 billion	- $2.613 billion	$1.011 billion
SBP (100-percent review by Actuary)		$4.529 billion	
Total Net Misstatement	- $1.708 billion	$1.916 billion	$5.540 billion

We are 95-percent confident that the total net dollar misstatement of the liability in our sampling frame is from $1.708 billion understated to $5.540 billion overstated. The point estimate of the misstatement's dollar value is the statistically best unbiased single value estimator of the true dollar misstatement for Pensions and Other Actuarial Liabilities.

The Actuary reviewed 100 percent of the retirees with SBP elections after the auditors found a problem with the procedures for using this information in the calculation of the liability. The Actuary provided the auditors with the corrected liability. This was treated as a census stratum, and the results were added to the estimate for the net misstatement (excluding the SBP) to determine the total net misstatement.

We also generated the following statistical estimates of misstatement percentages from our sample data:

95-Percent Confidence Intervals

	Lower Bound	Point Estimate	Upper Bound
Records With Errors	5.7 percent	8.1 percent	10.4 percent
Records With Unsupported Data	5.4 percent	7.5 percent	9.6 percent

We are 95-percent confident that from 5.7 percent to 10.4 percent of the records in our sampling frame contain one or more errors. Also, we are 95-percent confident that from 5.4 percent to 9.6 percent of the records in our sampling frame contain one or more unsupported data elements. The point estimates of these misstatement percentages are the statistically best unbiased single value estimators of the true misstatement percentages for the records with errors and the unsupported records, respectively. (See pages 10 and 11 of this report for an assessment of the statistical results and our conclusion that internal controls over the Fund were adequate to prevent a material misstatement.)

Appendix B. Prior Audit Reports

IG, DoD, Report No. 97-177, "Internal Controls and Compliance With Laws and Regulations for the DoD Military Retirement Trust Fund Financial Statements for FY 1996," June 25, 1997. We issued an unqualified opinion on the Fund's FY 1996 Financial Statements. Two internal control weaknesses identified in the FY 1995 audit required followup in FY 1996. The Fund managers had corrected the internal control weakness concerning whether the DFAS Cleveland Center was paying retirees from the correct appropriation. The other internal control weakness, related to debt collection at the DFAS Cleveland and Denver Centers, had not been corrected. Also, in its FY 1996 Annual Statement of Assurance, the DFAS Cleveland Center reported one uncorrected and one corrected material internal control weakness. The material internal control weakness regarding the appointment of trustees for mentally incompetent Air Force retirees has been corrected. The other material internal control weaknesses, regarding data in the retired pay system that had not been reconciled with data in the Services' personnel systems, was scheduled to be corrected in FY 1997. DFAS has extended the implementation to FY 1998. No recommendations were made in this report.

IG, DoD, Report No. 96-169, "Internal Controls and Compliance With Laws and Regulations for the DoD Military Retirement Trust Fund Financial Statements for FY 1996," June 19, 1996. We issued an unqualified opinion on the Fund's FY 1995 Financial Statements. During the audit, we identified internal control weaknesses in debt collection techniques at the DFAS Cleveland and Denver Centers and whether retiree disbursements at the DFAS Cleveland Center were made from the correct appropriation. During our audit of the Fund's FY 1996 Financial Statements, we did followup work to determine whether the DFAS Centers had corrected these weaknesses. We reported that the DFAS Cleveland and Denver Centers were not charging interest on all retiree and annuitant debts. The DFAS Cleveland Center had corrected the internal control weaknesses regarding whether disbursements to retirees were made from the proper appropriations. During the audit of the Fund's FY 1995 Financial Statements, we found that internal control weaknesses existed at the DFAS Cleveland Center regarding whether disbursements were made from the correct appropriation for Service members who retired under Public Law 102-484, the "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992, which gives the Services temporary early retirement authority to offer early retirements to members with more than 15 but less than 20 years of service. In the audit of the Fund's FY 1996 Financial Statements, we determined that the DFAS Cleveland Center had corrected the retiree payments that were disbursed from the incorrect appropriation. No recommendations were made in this report.

IG, DoD, Report No. 98-098, "Selected General Controls Over the Retiree and Casualty Pay Subsystem at the Defense Finance and Accounting Service Cleveland Center," March 30, 1998. This was an audit of general and application controls of the DRAS. The auditors identified procedures that DFAS has implemented for developing and modifying software, separation of duties, monitoring the use of software, and establishing procedures to prevent disruptions in service. Additional controls are needed for monitoring and updating the security program, limiting access to the subsystem, and providing for continuity of operations. We recommended that the Director, DFAS Cleveland Center, update security documents, monitor access to the Subsystems, and establish improved controls over the security of the Subsystems. The Deputy Director, DFAS Cleveland Center concurred with the recommendations.

General Accounting Office Report No. AIMD-97-128 (OSD Case No. 1411), "Review of the Military Retirement Trust Fund's Actuarial Model and Related Computer Controls," September 9, 1997. The objective of the audit was to review the actuarial assumptions, methods, systems, and related controls used by the Actuary to calculate the Fund's pension liability and annual actuarial activity for the financial statements and other reporting purposes. Based on the procedures performed and the results obtained, we conclude that the methodology and actuarial assumptions used by the Actuary to calculate the FY 1996 pension liability and the annual actuarial activity for the Fund are reasonable and reliable. GAO recommended that the DoD Office of the Actuary improve its actuarial process and Electronic Data Processing General Controls. The DoD Office of the Actuary concurred with the recommendations.

Appendix C. Audit Opinion

This appendix (a total of 3 pages) consists of the Audit Opinion on the FY 1997 Financial Statements of the Military Retirement Trust Fund.

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

June 4, 1997

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

SUBJECT: Audit Opinion on the DoD Military Retirement Trust Fund Financial Statements for FY 1997 (Project No. 7FH-2039)

The Chief Financial Officers (CFO) Act of 1990, as amended by the Federal Financial Management Act of 1994, requires financial statement audits by the Inspectors General and prescribes the responsibility of management and the auditors for the financial statements, internal controls, and compliance with laws and regulations. Management is responsible for establishing and maintaining internal controls and for complying with laws and regulations applicable to the Military Retirement Trust Fund (the Fund). Our responsibility is to render an opinion on the financial statements based on our audit, and to determine whether internal controls are adequate and whether the entity complied with laws and regulations.

Unqualified Audit Opinion. In our opinion, the Principal Statements, including the Notes to the Principal Statements, present fairly, in all material respects, the assets, liabilities, and net financial position of the DoD Military Retirement Trust Fund for FYs 1997 and 1996, and the results of operations and changes in net position for FYs 1997 and 1996, in conformity with the accounting principles described below.

Change in Accounting Method. In FY 1997, the Fund changed its method of accounting for the actuarial liability as described in Note 1 of the financial statements. This liability will now be reported as of the end of the fiscal year using the "projected benefit obligation" cost method. This change is in accordance with the Office of Management and Budget (OMB) Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government," December 20, 1995.

Accounting Principles. The Military Retirement Trust Fund Financial Statements for FYs 1997 and 1996 were to be prepared in accordance with OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993, as supplemented by OMB Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996. These bulletins incorporate the Statements of Federal Financial Accounting Concepts and Standards recommended by the Federal Accounting Standards Advisory Board, which are approved by the Secretary of the Treasury; the Director, OMB; and the Comptroller General of the United States. Footnote 1 of the Military Retirement Trust Fund Financial Statements for FY 1997 discusses the significant accounting policies that the Fund followed in preparing the financial statements.

Scope. We have audited the Principal Statements and Notes to the Principal Statements of the Military Retirement Trust Fund for FYs 1997 and 1996. The Principal Statements include the Statement of Financial Position and the Statement of Operations and Changes in Net Position.

An audit includes examining, on a test basis, evidence supporting amounts and disclosures in those statements. An audit also includes assessing the accounting principles used and significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Our audit would not necessarily disclose all internal control and compliance conditions that might be considered material weaknesses. Reportable internal control and compliance conditions are summarized in this report and will be further addressed in our report on internal controls and compliance with laws and regulations.

In auditing the FY 1997 Military Retirement Trust Fund Financial Statements, we reviewed over 600 military personnel files to determine whether the data used by the DoD Office of the Actuary to determine the annual funding liability were accurate and could be relied on. Obtaining data on over 600 military personnel required coordination with numerous contact points in DoD. The delay in acquiring the data, as well as the extensive coordination and evaluation of the data, contributed to the delay in rendering the final opinion. In addition, on January 6, 1998, we requested that a legal representation letter be sent to us no later than January 23, 1998. The General Counsel of DoD provided a legal representation letter dated April 8, 1998, which also hindered our ability to render the opinion.

Internal Controls. We reviewed the Fund's internal controls and obtained an understanding of the internal control policies and procedures. The internal controls consist of the overall control environment, accounting systems, and control procedures, and should provide reasonable assurance that accounting data are accumulated, recorded, and reported properly by management and that assets are safeguarded. We performed applicable tests to determine whether the internal controls were effective and working as designed. The actuarial accrued liability was overstated by $4.5 billion and understated by $2.4 billion, for a net overstatement of $2.1 billion. The overstatement was caused by coding errors in the survivor benefit data and an application error in the projection module used by the DoD Office of the Actuary. Statisticians in the Office of the Assistant Inspector General for Auditing, DoD, calculated the understatement from errors that we identified during the review of participant data. The overstatement is not material to the Fund's financial statements.

Internal controls were effective in accounting for and managing resources, ensuring compliance with laws and regulations, and ensuring that the financial statements are free of material misstatements. However, in its FY 1997 Annual Statement of Assurance, the Defense Finance and Accounting Service (DFAS) Cleveland Center reported an uncorrected material weakness: data in the retired pay system were not reconciled to the Military Department personnel systems. The weakness was first reported in the Annual Statements of Assurance for FYs 1995 and 1996 and is scheduled to be corrected in FY 1998. We agree with DFAS Cleveland that this is a material weakness; however, our tests did not identify any adverse effects on the financial statements caused by this weakness. In future audits, we will continue to monitor the status of the weakness and its effects on the Fund's financial statements.

During audits of the Fund's financial statements for FYs 1995 and 1996, we noted instances of noncompliance in the area of debt collection. These weaknesses are not material to the financial statements. We continue to monitor the corrective actions initiated by DFAS to implement the Debt Collection Act of 1982 and the Debt Collection Improvement Act of 1996.

Compliance With Laws and Regulations. We reviewed compliance with laws and regulations pertaining to the accuracy of the financial statements. Noncompliance with laws and regulations is a reportable condition if the noncompliance could result in material misstatements in the financial statements, or if the sensitivity of the matter would cause anyone to perceive the noncompliance as significant. Under the Federal Financial Management Improvement Act of 1996 and OMB Bulletin No. 93-06, Addendum 1, "Audit Requirements for Federal Financial Statements," January 16, 1998, our work disclosed that financial management systems did not fully comply with Federal requirements for integrated financial management systems and the U.S. Government Standard General Ledger at the transaction level. However, the noncompliance with the Federal Financial Management Improvement Act of 1996 did not affect the reliability of the data in the Fund's financial statements.

David K. Steensma

David K. Steensma
Deputy Assistant Inspector General
for Auditing

Appendix D. Financial Statements

This appendix (a total of 38 pages) consists of the FY 1997 Financial Statements of the *Military Retirement Trust Fund.

Department Of Defense Military Retirement Trust Fund

Chief Financial Officer Annual Financial Statement FY 1997

February 27,1998

DoD MILITARY RETIREMENT TRUST FUND

OVERVIEW

SUMMARY OF THE MILITARY RETIREMENT SYSTEM

As of September 30, 1997

Overview

The military retirement system applies to members of the Army, Navy, Marine Corps, and Air Force. However, most of the provisions also apply to retirement systems for members of the Coast Guard (administered by the Department of Transportation), officers of the Public Health Service (administered by the Department of Health and Human Services), and officers of the National Oceanic and Atmospheric Administration (administered by the Department of Commerce). Those not in plans administered by the Department of Defense are not included in this valuation.

The system is a funded, noncontributory defined benefit plan that includes nondisability retired pay, disability retired pay, retired pay for reserve service, and survivor annuity programs. The Service Secretaries approve immediate nondisability retired pay at any age with credit of at least 20 years of active-duty service. Reserve retirees must be 60 years old with 20 creditable years of service before retired pay commences. There is no vesting before retirement.

There are three distinct nondisability benefit formulas related to three populations within the military retirement system. Military personnel who first became members of the Armed Services before September 8, 1980 have retired pay equal to (terminal basic pay) times (a multiplier). The multiplier is equal to (2.5 percent) times (years of service) and is limited to 75 percent. If the retiree first became a member of the Armed Services on or after September 8, 1980, the average of the highest 36 months of basic pay is used instead of terminal basic pay. Members first entering the Armed Services on or after August 1, 1986 are subject to a penalty if they retire with less than 30 years of service; at age 62, their retired pay is recomputed without the penalty.

Retiree and survivor benefits are automatically adjusted annually to protect the purchasing power of initial retired pay. The benefits associated with members first entering the Armed Services before August 1, 1986 are adjusted by the percentage increase in the average Consumer Price Index (CPI). This is commonly referred to as full CPI protection. Benefits associated with members entering on or after August 1, 1986 are annually increased by the percentage change in the CPI minus 1 percent. At the military member's age 62, the benefits are restored to the amount that would have been payable had full CPI protection been in effect. This restoral is in combination with that described in the previous paragraph. However, after this restoral, partial indexing (CPI minus 1 percent) continues annually for life.

Nondisability Retirement From Active Service

The current system allows voluntary retirement upon completion of at least 20 years of service at any age, subject to Service Secretary approval. The military retiree receives immediate retired pay calculated as (base pay) times (a multiplier). Base pay is equal to terminal basic pay if the retiree first became a member of the Armed Services before September 8, 1980. It is equal to the average of the highest 36 months of basic pay for all other members. The multiplier is equal to (2.5 percent) times (years of service, rounded down to the nearest month) and is limited to 75 percent. Members first entering the Armed Services on or after August 1, 1986, and who retire with less than 30 years of service receive a temporary penalty until age 62. The penalty reduces the multiplier by one percentage point for each full year of service under 30. For example, the multiplier for a 20-year retiree would be 40 percent (50 percent minus 10 percent). At age 62, the retired pay is recomputed with the penalty removed.

In FY97, 1.31 million nondisability retirees from active duty were paid $24.94 billion.

Disability Retirement

A disabled military member is entitled to disability retired pay if the disability is at least 30 percent (under a standard schedule of rating disabilities by the Veterans Administration) and either (1) the member has eight years of service; (2) the disability results from active duty; or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

In disability retirement, the member receives retired pay equal to the larger of (1) the accrued nondisability retirement benefit, or (2) base pay multiplied by the rated percent of disability. The benefit cannot be more than 75 percent of base pay. Only the excess of (1) over (2) is subject to Federal income taxes. Base pay is equal to terminal basic pay if the retiree first became a member of the Armed Services before September 8, 1980. If the retiree first entered the Services on or after September 8, 1980, base pay is equal to the average of the highest 36 months of basic pay.

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

In FY97, 116,000 disability retirees were paid $1.46 billion.

Reserve Retirement

Members of the reserves may retire after 20 years of creditable service, the last eight of which must be in a reserve component. However, reserve retired pay is not payable until age 60. Retired pay is computed as (base pay) times (2.5 percent) times (years of service). If the reservist was first a member of the Armed Services before September 8, 1980, base pay is defined as the active duty basic pay in effect for the retiree's grade and years of service at the time that retired pay begins. If the reservist first became a member of the Armed Services on or after September 8, 1980, base pay is the average basic pay for the member's grade in the last three years that he/she was a member of the Armed Services. The years of service are determined by using a point system, where 360 points convert to a year of service. Typically, a point is awarded for a day of service or a drill attendance, with 15 points being awarded for a year's membership in a reserve component. A creditable year of service is one in which the member earned at least 50 points. A member cannot retire without 20 creditable years, although points earned in non-creditable years are used in the retirement calculation.

In FY97, 221,000 reserve retirees were paid $2.22 billion.

Survivor Benefits

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

On September 21, 1972, RSFPP was replaced by the Survivor Benefit Plan (SBP) for new retirees. RSFPP still covers those servicemen retired before 1972 who did not convert to the new plan and still pays survivor annuities.

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

The SBP survivor annuity is initially 55 percent of the member's base amount. The base amount is elected by the member, but cannot be less than $300 or more than the member's full retired pay. If a penalty for service under 30 years is included in the calculation of retired pay, the maximum base amount is equal to the full retired pay without the penalty.

The spouse's annuity is considered a two-tier benefit because, at age 62, the annuity is reduced to 35 percent of the base amount. Prior to the enactment of the two-tier benefit, survivor annuities were integrated with Social Security. SBP participants and active and reserve personnel with at least 20 years of service on October 1, 1985 were grandfathered into the two-tier system. Their survivors will be given the higher of the two annuities at age 62.

During FY87 the SBP program's treatment of survivor remarriages changed. Prior to the change, a surviving spouse remarrying before age 60 had the survivor annuity suspended. The change lowered the age to 55. (If the remarriage ends in divorce or death, the annuity is reinstated.)

Beginning in April 1992, retirees with base amounts equal to full retired pay could also elect a supplemental annuity for their surviving spouses after age 62, in increments of 5 percent of the base amount, up to a maximum 20 percent benefit. (The cost of this supplemental SBP benefit is borne by retirees in the form of a reduction in retired pay over and above the usual 6.5 percent reduction for SBP.)

Members who die on active duty with over 20 years of service are assumed to have retired on the day they died and to have elected full SBP coverage for spouses and/or children.

SBP annuities are reduced by any VA survivor benefits and all premiums relating to the reductions are returned to the survivor. Additionally, SBP annuities are annually increased with cost-of-living adjustments (COLAs). These COLAs may be based on full or partial CPI increases, depending on when the member first entered the Armed Services. If the member dies before age 62 and the survivor is subject to partial COLAs, the survivor's annuity is increased (on the member's 62nd birthday) to the amount that would have been payable had full COLAs been in effect. Partial COLAs continue annually thereafter.

For reserve retirees, the same set of retired pay reductions applies for survivor coverage after a reservist turns 60 and begins to receive retired pay. A second set of optional reductions, under the Reserve Component Survivor Benefit Plan, provides annuities to survivors of reservists who die before age 60, but after attaining 20 years of service. The added cost of this coverage is borne completely by reservists through deductions from retired pay and survivor annuities.

In FY97, 223,000 surviving families were paid $1.62 billion.

Temporary Early Retirement Authority (TERA)

The National Defense Authorization Act for FY93 (P.L. 102-484) grants temporary authority for the military services to offer early retirements to members with more than 15 but less than 20 years of service. The retired pay is calculated in the usual way except that there is a reduction of 1 percent for every year below 20 years of service. Part or all of this reduction can be restored at age 62 if the retired member works in a qualified public service job during the period from the date of retirement to the date on which the retiree would have completed 20 years of service. Unlike members who leave military service before 20 years with voluntary separation incentives or special separation benefits, these early retirees are treated like regular military retirees for the purposes of other retirement fringe benefits. This authority is scheduled to expireat the end of FY99.

As of September 30, 1997, there were 48,000 TERA retirees receiving retired pay at an annual rate of $561 million.

Cost-of-Living Increases

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

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

The benefits of retirees (and their survivors) first entering the Armed Services before August 1, 1986 are annually increased with the full COLA; all other benefits are annually increased with a "partial" COLA. The partial COLA is the full COLA minus 1 percent. A one-time restoral is given to a partial COLA recipient on the first day of the month after the retiree's 62nd birthday. At this time, the retiree benefit (or survivor benefit if the retiree is deceased) is increased to the amount that would have been payable had full COLAs been in effect. Annual partial COLAs continue after this restoral.

Relationship with VA Benefits

The Department of Veterans Affairs (VA) provides compensation for Service-connected and certain non-Service-connected disabilities. These VA benefits can be in place of (or in combination with) DoD retired pay, but they are not additive. Since VA benefits are exempt from Federal income taxes, it is sometimes to the advantage of a member to elect them.

Veterans Administration benefits also overlap survivor benefits through the Dependency and Indemnity Compensation (DIC) program. DIC is payable to survivors of veterans who died from Service-connected causes. Although an SBP annuity must be reduced by the amount of any DIC benefit, all SBP premiums relating to the reduction in benefit are returned to the survivor.

Interrelationship with Other Federal Service

For retirement purposes, no credit is given for other Federal service, except where cross-service transferability is allowed. Military service is generally creditable toward the Federal civilian retirement systems if military retired pay is waived. However, a deposit (equal to a percentage of post-1956 basic pay) must be made to the Civil Service Retirement Fund in order to receive credit. Military service is not generally creditable under both systems (but is for reservists and certain disability retirees). Retired regular officers employed by the Federal Government lose a substantial portion of their retired pay while so employed, and all retired members are subject to a combined ceiling equivalent to Level V of the Executive Schedule. The ceiling does not apply to those who had retired before October 13, 1978 (or were under age 60 and eligible for Reserve retirement on that date) and were continuously employed by the Federal Government since that date.

Relationship of Retired Pay to Military Compensation

Basic pay is the only element of military compensation upon which retired pay is computed and entitlement is determined. Basic pay is the principal element of military compensation that all members receive, but it is not representative, for comparative purposes, of salary levels in the public and private sectors. Reasonable comparisons can be made to regular military compensation (RMC). RMC is the sum of (1) basic pay, (2) cash or in kind allowances (the housing allowance, which varies by grade, location, and dependency status, and a subsistence allowance) and (3) the tax advantages accruing to allowances because they are not subject to Federal income tax. Basic pay represents approximately 72 percent of RMC for all retirement eligibles. For the 20-year retiree, basic pay is approximately 69 percent of RMC. Consequently, a 20-year retiree may be entitled to 50 percent of basic pay, but only 35 percent of RMC. For a 30-year retiree, the corresponding entitlements are 75 percent of basic pay, but only 56 percent of RMC. These relationships should be considered when military retired pay is compared to compensation under other retirement systems.

Social Security Benefits

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

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

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

Members of the military are also required to pay the Hospital Insurance (HI) payroll tax, with the Federal Government contributing the matching employer contribution. Medicare eligibility occurs at age 65, or earlier if the employee is disabled. Entitlement to Medicare terminates entitlement to benefits under the Civilian Health and Medical Program of the Uniformed Services (CHAMPUS), although eligibility continues for medical care in military facilities on a space available basis.

Performance Measures

While there are many ways to measure the funding progress of a pension plan, the ratio of assets in the fund to the present value of future benefits for annuitants on the roll is commonly used. Here is what this ratio has been for the last twelve years:

a. September 30, 1997 = .32200
b. September 30, 1996 = .31314
c. September 30, 1995 = .30375
d. September 30, 1994 = .30306
e. September 30, 1993 = .28314
f. September 30, 1992 = .27018
g. September 30, 1991 = .25127
h. September 30, 1990 = .21878
i. September 30, 1989 = .19549
j. September 30, 1988 = .16211
k. September 30, 1987 = .11431
l. September 30, 1986 = .07187

Limitations of the Financial Statements

These financial statements have been prepared to report the financial position and results of operations for the Military Retirement Trust Fund pursuant to the requirements of the Chief Financial Officers Act of 1990. While the statements have been prepared from the books and records of the Military Retirement Trust Fund in accordance with the formats prescribed by the Office of Management and Budget, the statements are different from the financial statements used to monitor and control budgetary resources that are prepared from the same books and records. These statements should be read with the realization that they are for a Federal entity, that unfunded liabilities reported in the financial statements can not be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by DoD.

DoD MILITARY RETIREMENT TRUST FUND

PRINCIPAL STATEMENTS

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Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1997
(Thousands)

ASSETS	1997	1996
1. Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balances with Treasury (Note 2)	$4,645	$57,869
(2) Investments, Net (Note 4)	139,014,269	131,065,203
(3) Accounts Receivable, Net (Note 5)	0	0
(4) Interest Receivable	4,228,139	4,200,579
(5) Advances and Prepayments	0	0
(6) Other Federal (Intragovernmental) (Note 6)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Investments,Net (Note 4)	0	0
(2) Accounts Receivable, Net (Note 5)	24,969	12,253
(3) Credit Program Receivables/ Related Foreclosed Property, Net (Note 7)	0	0
(4) Interest Receivable, Net	0	0
(5) Advances and Prepayments	0	0
(6) Other Non-Federal (Governmental) (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Inventory, Net (Note 8)	0	0
e. Work in Process (Note 9)	0	0
f. Operating Materials/Supplies, Net (Note 10)	0	0
g. Stockpile Materials, Net (Note 11)	0	0
h. Seized Property (Note 12)	0	0
i. Forfeited Property, Net (Note 13)	0	0
j. Goods Held Under Price Support and Stabilization Programs, Net (Note 14)	0	0
k. Property, Plant and Equipment, Net (Note 15)	0	0
l. War Reserves	0	0
m. Other Entity Assets	0	0
n. Total Entity Assets	$143,272,022	$135,335,904
2. Non-Entity Assets:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Fund Balance with Treasury (Note 2)	$0	$0
(2) Accounts Receivable, Net (Note 5)	0	0
(3) Interest Receivable, Net	0	0
(4) Other (Note 6)	0	0

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1997
(Thousands)

ASSETS, Continued	1997	1996
2. Non-Entity Assets		
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Receivable, Net (Note 5)	$0	$0
(2) Interest Receivable, Net	0	0
(3) Other (Note 6)	0	0
c. Cash and Other Monetary Assets (Note 3)	0	0
d. Other Non-Entity Assets	0	0
e. Total Non-Entity Assets	0	0
3. Total Assets	$143,272,022	$135,335,904
LIABILITIES		
4. Liabilities Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$0	$0
(2) Interest Payable	0	0
(3) Debt (Note 16)	0	0
(4) Other Federal (Intragovernmental) Liabilities (Note 17)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	2,631,053	2,548,044
(2) Accrued Payroll and Benefits		
(a) Salaries and Wages	0	0
(b) Annual Accrued Leave	0	0
(c) Severance Pay and Separation Allowance	0	0
(3) Interest Payable	0	0
(4) Liabilities for Loan Guarantees (Note 7)	0	0
(5) Lease Liabilities (Note 18)	0	0
(6) Pensions and Other Actuarial Liabilities (Note 19)	140,640,969	132,787,860
(7) Other Non-Federal (Governmental) Liabilities (Note 17)	0	0
c. Total Liabilities Covered by Budgetary Resources	$143,272,022	$135,335,904

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
Statement of Financial Position
as of September 30, 1997
(Thousands)

LIABILITIES, Continued	1997	1996
5. Liabilities Not Covered by Budgetary Resources:		
a. Transactions with Federal (Intragovernmental) Entities:		
(1) Accounts Payable	$0	$0
(2) Debt (Note 16)	0	0
(3) Other Federal (Intragovernmental) Liabilities (Note 17)	0	0
b. Transactions with Non-Federal (Governmental) Entities:		
(1) Accounts Payable	0	0
(2) Debt (Note 16)	0	0
(3) Lease Liabilities (Note 18)	0	0
(4) Pensions and Other Actuarial Liabilities (Note 19)	501,074,103	414,912,140
(5) Other Non-Federal (Governmental) Liabilities (Note 17)	118	110
c. Total Liabilities Not Covered by Budgetary Resources	$501,074,221	$414,912,250
6. Total Liabilities	$644,346,243	$550,248,154
NET POSITION (Note 20)		
7. Balances:		
a. Unexpended Appropriations	$0	$0
b. Invested Capital	0	0
c. Cumulative Results of Operations	0	0
d. Other	0	0
e. Future Funding Requirements	(501,074,221)	(414,912,250)
f. Total Net Position	($501,074,221)	($414,912,250)
8. Total Liabilities and Net Position	$143,272,022	$135,335,904

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
Statement of Operations and Changes in Net Position
For Period Ended September 30, 1997
(Thousands)

	1997	1996
REVENUES AND FINANCING SOURCES		
1. Appropriated Capital Used	$0	$0
2. Revenues from Sales of Goods and Services		
a. To the Public	0	0
b. Intragovernmental	0	0
3. Interest and Penalties, Non-Federal	0	0
4. Interest, Federal	11,859,066	11,280,558
5. Taxes (Note 21)	0	0
6. Other Revenues and Financing Sources (Note 22)	26,252,570	21,873,163
7. Less: Taxes and Receipts Transferred to the Treasury or Other Agencies	0	0
8. Total Revenues and Financing Sources	$38,111,636	$33,153,721
EXPENSES		
9. Program or Operating Expenses (Note 23)	$30,258,527	$28,991,489
10. Cost of Goods Sold (Note 24)		
a. To the Public	0	0
b. Intragovernmental	0	0
11. Depreciation and Amortization	0	0
12. Bad Debts and Write-offs	0	0
13. Interest		
a. Federal Financing Bank/Treasury Borrowing	0	0
b. Federal Securities	0	0
c. Other	0	0
14. Other Expenses (Note 25)	15,943,199	18,600,000
15. Total Expenses	$46,201,726	$47,591,489
16. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses Before Extraordinary Items	($8,090,090)	($14,437,768)
17. Plus (Minus) Extraordinary Items (Note 26)	(8)	(7)
18. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	($8,090,098)	($14,437,775)

The accompanying notes are an integral part of these statements.

Department of Defense
DoD Military Retirement Fund
Statement of Operations and Changes in Net Position
For Period Ended September 30, 1997
(Thousands)

EXPENSES, Continued	1997	1996
19. Net Position, Beginning Balance, as Previously Stated	($414,912,250)	($407,169,291)
20. Adjustments (Note 27)	(78,071,873)	6,694,816
21. Net Position, Beginning Balance, as Restated	($492,984,123)	($400,474,475)
22. Excess (Shortage) of Revenues and Financing Sources Over Total Expenses	(8,090,098)	(14,437,775)
23. Plus (Minus) Non Operating Changes (Note 28)	0	0
24. Net Position, Ending Balance	($501,074,221)	($414,912,250)

The accompanying notes are an integral part of these statements.

The accompanying notes are an integral part of these statements.

DoD MILITARY RETIREMENT TRUST FUND

FOOTNOTES TO THE PRINCIPAL STATEMENTS

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NOTES TO THE DoD MILITARY RETIREMENT FUND PRINCIPAL STATEMENTS AS OF SEPTEMBER 30, 1997

Note 1. Significant Accounting Policies:

A. The DoD Military Retirement Fund was authorized by PL98-94 for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs. These financial statements have been prepared to report the financial position and results of operations of the Department of Defense Military Retirement Fund, as required by the Chief Financial Officers (CFO) Act of 1990, and other appropriate legislation. They have beenprepared from the books and records of the Defense Finance and Accounting Service Accounting Deputate Investment Trust Directorate (DFAS-HQ/AE). These financial statements are presented on the accrual basis of accounting in accordance with the requirements ofthe Office of Management and Budget Bulletin No. 94-01, "Form and Content of Agency Financial Statements", and subsequent issues.

The program is funded by:
(1) Annual unfunded liability payment from Treasury
(2) Monthly Service contributions as a percentage of base pay
(3) Interest on investments.

B. Accounting Method Used to Present Actuarial Liability Starting in FY 1997, the Military Retirement Trust Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year. This is a change from prior year reporting, which presented the beginning-of-year liability. This figure is approximate because of the lengthy time required to develop an accurate end-of-year actuarial estimate and the accelerated deadlines for these financial statements.

Actuarial Cost Method: Starting in FY 1997, the Military Retirement Trust Fund financial statements present the actuarial liability as of the end of the fiscal year using the "projected benefit obligation" (PBO) cost method required by the Office of Management and Budget (OMB) Statement of Federal Financial Accounting Standards No. 5 "Accounting for Liabilities of the Federal Government." This is a change from prior year reporting, which presented the accumulated benefit obligation, which assumes no future salary increases.

Note 2. Fund Balances with Treasury (in thousands):

A. Fund and Account Balances:

	Entity Assets: Trust Funds	Revolving Funds	Appropriated Funds	Other Fund Types	Total
Unobligated Balance Available:					
Available	$4,645	$0	$0	$0	$4,645
Restricted	0	0	0	0	0
Reserve For Anticipated Resources	0	0	0	0	0
Obligated (but not expensed)	0	0	0	0	0
Unfunded Contract Authority	0	0	0	0	0
Unused Borrowing Authority	0	0	0	0	0
Treasury Balance	$4,645	$0	$0	$0	$4,645

B. Other Information: Securities are redeemed to cover expenses.

Note 3. Cash, Foreign Currency and Other Monetary Assets (in thousands): Not applicable

Note 4. Investments, Net (in thousands):

	(1) Cost	(2) Market Value	(3) Amortization Method	(4) Amortized Premium/ (Discount)	(5) Investments Net
A. Intragovernmental Securities:					
(1) Marketable	$0	$0		$0	$0
(2) Non-Marketable Par Value	0	0		0	0
(3) Non-Marketable Market Based	145,479,816	157,029,135	Effective	(6,465,547)	139,014,269
Subtotal	$145,479,816	$157,029,135	Interest	($6,465,547)	$139,014,269
B. Governmental Securities:					
(1) Not applicable	$0	$0		$0	$0
Subtotal	$0	$0		$0	$0
Total	$145,479,816	$157,029,135		($6,465,547)	$139,014,269

C. Other Information: The method used to determine amount amortized, book value of investments, as of September 30, 1997, currently held and related yield on investments conforms to the prevailing practice in the financial community. The calculated yields match up with yields in published security tables of U.S. Treasury securities.

Note 5. Accounts Receivable, Net (in thousands):

	(1) Gross Amount Due	(2) Allowance For Estimated Uncollectibles	(3) Allowance Method Used (see below)	(4) Net Amount Due
A. Entity Receivables:				
Intragovernmental	$0	$0		$0
Governmental	24,969	0		24,969
B. Non-Entity Receivables:				
Intragovernmental	$0	$0		$0
Governmental	0	0		0

C. Other Information: Accounts Receivable represent Refunds Receivable of overpayments of benefits.

Note 6. Other Federal (Intragovernmental) and Non-Federal (Governmental) Assets (in thousands): Not applicable

Note 7. Loans and Loan Guarantees, Non-Federal Borrowers (in thousands): Not applicable

Note 8. Inventory, Net (in thousands): Not applicable

Note 9. Work in Process (in thousands): Not applicable

Note 10. Operating Materials and Supplies (OM&S), Net (in thousands): Not applicable

Note 11. Stockpile Materials, Net (in thousands): Not applicable

Note 12. Seized Property (in thousands): Not applicable

Note 13. Forfeited Property, Net (in thousands): Not applicable

Note 14. Goods Held Under Price Support and Stabilization Programs, Net (in thousands): Not applicable

Note 15. Property, Plant, and Equipment, Net (in thousands): Not applicable

Note 16. Debt (in thousands): Not applicable

Note 17. Other Liabilities (in thousands):

A. Other Liabilities Covered by Budgetary Resources Not applicable

B. Other Information: Not applicable

C. Other Liabilities Not Covered by Budgetary Resources:

	Non-Current Liability	Current Liability	Total
1. Intragovernmental:			
(a) Canceled Budget Authority	$0	$0	$0
Total	$0	$0	$0

	Non-Current Liability	Current Liability	Total
2. Governmental:			
(a) Canceled Budget Authority	$0	$0	$0
(b) Death Payment Contingency	118	0	118
Total	$118	$0	$118

D. Other Information: Not applicable

Note 18. Leases (in thousands): Not applicable

Note 19. Pensions and Other Actuarial Liabilities (in thousands):

	(1) Actuarial Accrued Liability	(2) Assumed Interest Rate(%)	(3) Assets Available to Pay Benefits	(4) Unfunded Actuarial Liability
A. Pension and Health Plans:	$641,715,072	6.5	$140,640,969	$501,074,103
B. Insurance/Annuity Programs:				
C. Other: Not applicable				
D. Total Lines A+B+C:	$641,715,072		$140,640,969	$501,074,103

E. Other Information: The Military Retirement System is a single-employer plan. It is a defined benefit plan. Administrative costs are not borne by the plan. The actuarial cost method used is the aggregate entry-age-normal. Projected revenues, as authorized by PL98-94, are to be paid into the Fund at the beginning of each fiscal year by the Secretary of the Treasury as certified by the Secretary of Defense. This permanent, indefinite appropriation, determined by the Board of

Actuaries, represents the amortization of the unfunded liability for service performed prior to October 1, 1984. Along with the 6.5% assumed annual interest rate, the long-term annual Consumer Price Index is assumed to be 3.5% and the annual basic pay increase is assumed to be 4.0%. Other assumptions, such as mortality and retirement rates, are based on actual experience.

Accounting Method Used to Present Actuarial Liability Starting in FY 1997, the Military Retirement Trust Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year. This is a change from prior year reporting, which presented the beginning-of-year liability. This figure is approximate because of the lengthy time required to develop an accurate end-of-year actuarial estimate and the accelerated deadlines for these financial statements.

Actuarial Cost Method: Starting in FY 1997, the Military Retirement Trust Fund financial statements present the actuarial liability as of the end of the fiscal year using the "projected benefit obligation" (PBO) cost method required by the Office of Management and Budget (OMB) Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government." This is a change from prior year reporting, which presented the accumulated benefit obligation, which assumes no future salary increases.

Note 20. Net Position (in thousands):

	Revolving Funds	Trust Funds	Appropriated Funds	Total
A. Unexpended Appropriations:				
(1) Unobligated,				
a. Available	$0	$0	$0	$0
b. Unavailable	0	0	0	0
(2) Undelivered Orders	0	0	0	0
B. Invested Capital	0	0	0	0
C. Cumulative Results of Operations	0	0	0	0
D. Other	0	0	0	0
E. Future Funding Requirements	0	(501,074,221)	0	(501,074,221)
F. Total	$0	($501,074,221)	$0	($501,074,221)

G. Other Information: The future funding requirement is the amount of the unfunded portion of the DoD Military Retirement Trust fund actuarial liability.

Note 21. Taxes (in thousands): Not applicable

Note 22. Other Revenues and Financing Sources (in thousands):

A. Other Revenues and Financing Sources:

	1997	1996
(1) Normal Cost Contribution from Services	$ 11,101,570	$11,174,163
(2) Unfunded Liability Payment from Treasury	15,151,000	10,699,000
Total	$26,252,570	$21,873,163

B. Other Information: Not applicable

Note 23. Program or Operating Expenses (in thousands):

	1997	1996
A. Operating Expenses by Object Classification:	$0	$0
(1) Personal Services and Benefits	0	0
(2) Travel and Transportation	0	0
(3) Rental, Communication and Utilities	0	0
(4) Printing and Reproduction	0	0
(5) Contractual Services	0	0
(6) Supplies and Materials	0	0
(7) Equipment not Capitalized	0	0
(8) Grants, Subsidies and Contributions	0	0
(9) Insurance Claims and Indemnities	30,258,527	28,991,489
(10) Other (describe):	0	0
(11) Total Expenses by Object Class	$30,258,527	$28,991,489

B. Operating Expenses by Program: Not applicable

Note 24. Cost of Goods Sold (in thousands): Not applicable

Note 25. Other Expenses (in thousands):

	1997	1996
A. Other Expenses:		
(1) Change in Actuarial Liability for period	$15,943,199	$18,600,000
Total	$15,943,199	$18,600,000

Other Information: Starting in FY 1997, the Military Retirement Trust Fund financial statements present the actuarial liability as of the end of the fiscal year using the "projected benefit obligation" (PBO) cost method required by the OMB Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government." This is a change from prior year reporting, which presented the beginning-of-the-year accumulated benefit obligation, which assumes no future salary increases. The above figure for 1997 represents the change in the end-of year PBO from FY 1996 to FY 1997.

Note 26. Extraordinary Items (in thousands):

	1997
A. Extraordinary Items:	
(1) Death Payment Contingency - (Increase) - Decrease	($8)
Total	($8)

Note 27. Prior Period Adjustments (in thousands):

	1997
A: Prior Period Adjustments:	
(1) Change in Actuarial Liability	($78,071,873)
Total	($78,071,873)

B. Other Information: The FY 1996 actuarial liability using the ABO method was $547.7 billion. The above figure represents the change in going from ABO to PBO for 1996.

Note 28. Non-Operating Changes (in thousands): Not applicable

Note 29. Intrafund Eliminations (in thousands):

Schedule A: Sales within the General Fund by transactions Sales or services rendered) relative to the DoD Component. Not Applicable

Schedule B: The selling Working Capital Fund (WCF) Component will report intrafund transactions (sales or services) within the WCF Component. Not Applicable

Schedule C: Sales and services between the DoD Military Retirement Trust Fund and other DoD reporting entities by transactions and according to general ledger amounts for accounts receivable, revenues, unearned revenues, and collections. It is presumed that an equal amount of accounts payable, expenses, advances, and disbursements have been entered on the accounting records of the purchasing activity.

Seller Activity	Column A	Column B	Column C	Column D
	Accounts Receivable	Revenue	Unearned Revenue	Collections
DoD Military Retirement Trust Fund	N/A	$26,252,570	N/A	$26,252,570
Total		$26,252,570		$26,252,570

Customer Activity:	Column A	Column B	Column C	Column D
	Accounts Payable	Expenses	Advances	Disbursements
Department of the Army (T.I. 21)	N/A	$3,974,471	N/A	$3,974,471
Department of the Navy (T.I. 17)	N/A	4,034,921	N/A	4,034,921
Department of the Air Force (T.I. 57)	N/A	3,092,178	N/A	3,092,178
Other Defense Organizations (97*0040)	N/A	15,151,000	N/A	15,151,000
Total	N/A	$26,252,570	N/A	$26,252,570

Other Information: $11,101,570 are collections from the Military Personnel accounts of the Military Services and $15,151,000 are funds appropriated to account, Payments to Military Retirement Fund, Defense and subsequently transferred to the Military Retirement Fund.

Schedule D: Sales or services between the DoD Military Retirement Trust Fund and other U.S. Government reporting entities by transactions and according to general ledger amounts for accounts receivable, revenues, unearned revenues, and collections. It is presumed that an equal amount of accounts payable, expenses, advances, and disbursements have been entered on the accounting records of the purchasing activity.

Seller Activity	Column A	Column B	Column C	Column D
	Accounts Receivable	Revenue	Unearned Revenue	Collections
DoD Military Retirement Trust Fund	$4,228,139	$11,807,681	N/A	$11,807,681
Total	$4,228,139	$11,807,681	N/A	$11,807,681

Customer Activity:	Column A	Column B	Column C	Column D
	Accounts Payable	Expenses	Advances	Disbursements
Department of the Treasury (T.I. 20)	$4,228,139	$11,807,681	N/A	$11,807,681
Total	$4,228,139	$11,807,681	N/A	$11,807,681

Other Information: $4,228,139 is Accrued Interest Receivable on U.S. Treasury Notes and Bonds held by the DoD Military Retirement Fund.
For securities purchased on October 1, 1986 and subsequent, discount and premium are amortized through account 97X8097.2 Earnings on Investments. The amortization of discount and premium for securities purchased prior to October 1, 1986 is reported to Treasury by changing the Preclosing Unexpended Balance for account 97X8097.941 on report FMS 2108. Gains and loses on securities sold are also reported through account 97X8097.2. $11,920,116 was reported to account 97X8097.2 and (112,435) was reported via FMS 2108, which equals $11,807,681 as reported above.

On the Statement of Operations and Changes in Net Position, Line 4 Interest, Federal shows an amount of $11,859,066. This amount was determined as follows:

Interest collected (cash)	$13,076,320
Amortized Premium	(1,300,403)
Amortized Discount	31,760
Gain on sale	4
Subtotal	$11,807,681
Increase in Accrued Interest Receivable	51,385
	$11,859,066

Note 30. Contingencies (in thousands): Not applicable

Note 31. Other Disclosures (in thousands):

Net Pension Expense: The net pension expense for the actuarial accrued liability is developed in the table below.

A. Beginning-of-Year Accrued Liability	$625,771,873
B. Normal Cost Liability	11,101,570
C. Plan Amendment Liability	0
D. Benefit Outlays	(30,258,527)
E. Interest on Pension Liability (A, B, C, and D)	40,052,570
F. Actuarial Loss (Gain)	(4,952,414)
G. End-of-Year Accrued Liability (A+B+C+D+E+F)	$641,715,072
H. Net Pension Expense (B+C+D+E+F)	$15,943,199

Other Information: The interest on the pension liability (Line E) is calculated as a full year of interest on the beginning-of-year accrued liability (Line A) and a half year of interest on the normal cost liability and the benefit outlays (Line B and Line D).

DoD MILITARY RETIREMENT TRUST FUND

SUPPLEMENTAL INFORMATION

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TABLE 1

DEPARTMENT OF DEFENSE
MILITARY RETIREMENT FUND
STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS
($ in thousands)

	For the Plan Year Ended: Sept 30, 1996	Sept 30, 1997
Assets		
Investments, at fair market value, U.S. Government securities [1]	$146,294,217	$157,029,135
Accounts receivable		
Accrued interest [2]	$4,200,580	$4,228,139
Due from Military Retirees or their Survivors	$12,253	$24,969
Cash	$57,869	$4,645
Total Assets	$150,564,919	$161,286,888
Accounts Payable	($2,548,044)	($2,631,053)
Total Assets Available for Benefits	$148,016,875	$158,655,835

[1] Fair market value of securities has been measured by quoted prices (bid price) in the active U.S. Government securities market. Bid price used represents the over-the-counter quotations as of 4 p.m. Eastern time, as reported in the Wall Street Journal on October 1.

[2] Includes accrued interest receivable (including interest purchased).

TABLE 2

MILITARY RETIREMENT FUND
STATEMENT OF CHANGES IN NET ASSETS
AVAILABLE FOR BENEFITS
($ in thousands)

	For the Plan Year Ended: Sept 30,1996	Sept 30,1997
Net assets available for benefits at beginning of plan year	$148,658,870	$148,016,875
Investment income		
Interest	$12,502,872	$13,127,704
Net appreciation (depreciation) in fair market value of investment [1]	($6,026,543)	$1,517,213
Contributions		
From services	$11,174,164	$11,101,570
Appropriation to amortize unfunded liability	$10,699,000	$15,151,000
Total additions	$28,349,493	$40,897,487
Benefits paid to participants [2]	$28,991,489	$30,258,527
Net assets available for benefits at end of plan year	$148,016,875	$158,655,835

[1] Investments bought, sold and held during the plan year ended September 30 appreciated (depreciated) in value as follows:

	PY 1996	PY 1997
Appreciated (depreciated) fair value over book value	($4,804,228)	$2,785,852
Amortized discount	151,912	31,760
Amortized premium	(1,374,227)	(1,300,403)
Gain (loss) on sale	0	4
	($6,026,543)	$1,517,213

[2] The statement has been adjusted to show benefits paid to participants on an accrual basis.

	PY 1996	PY 1997
Benefits paid on cash basis	$28,831,111	$30,188,234
Increase in liability for benefits due at end of year	160,378	70,293
Benefits paid on accrual basis	$28,991,489	$30,258,527

TABLE 3

MILITARY RETIREMENT SYSTEM
ACTUARIAL STATUS INFORMATION
AS OF SEPTEMBER 30, 1997 [1,2]
($ in billions)

	For the Plan Year Ended: Sept 30, 1996	Sept 30, 1997
1. Present value of Accumulated Plan Benefits		
a. Actuarial present value of vested benefits		
I. Participants currently receiving payments	$431.3	n/a
II. Other vested participants	$55.1	n/a
b. Total vested	$486.4	n/a
c. Actuarial present value of non-vested benefits	$61.3	n/a
d. Total actuarial present value of accumulated plan benefits	$547.7	n/a
2. Present value of future benefits		
a. Annuitants now on roll	n/a	$426.5
b. Non-retired reservists	n/a	$24.0
c. Active duty personnel [3]	n/a	$271.1
d. Total	n/a	$721.6
3. Present value of future normal cost contributions	n/a	$79.9
4. Actuarial accrued liability	n/a	$641.7
5. Assets [4, 5]	$151.0	$140.6
6. Excess of accumulated benefits over assets	$396.7	n/a
7. Unfunded accrued liability	n/a	$501.1

FOOTNOTES FOR TABLE 3

1. Starting in FY 1997, the Military Retirement Trust Fund financial statements present the unfunded actuarial liability determined as of the end of the fiscal year.

2. Starting in FY 1997, the Military Retirement Trust Fund financial statements present the actuarial liability as of the end of the fiscal year using the "projected benefit obligation" cost method required by the Office of Management and Budget (OMB) Statement of Federal Financial Accounting Standards No. 5, "Accounting for Liabilities of the Federal Government."

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

4. Total assets are reported for 9/30/96 because the liability for benefit payments due is included in the actuarial present value of benefits for participants currently receiving payments.

5. The assets available to pay benefits is reported for 9/30/97 and is determined using the amortized cost method (book value) of valuation.

Appendix E. Management and Legal Representation Letters

This appendix (a total of 5 pages) consists of the management and legal representation letters for the Military Retirement Trust Fund Financial Statements for FY 1997.

THE OFFICE OF THE UNDER SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, DC 20301-4000

JAN 21 1998

PERSONNEL AND
READINESS

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING

SUBJECT: Management Assurance Concerning Military Retirement Trust Fund Financial Statements for FY 1997

This is in regard to your audit of the Military Retirement Trust Fund Financial Statements (Project No. 7FH-2039) as of September 30, 1997. In order to allow you to express an opinion on the fair presentation of the financial statements and on conformity with generally accepted actuarial and accounting principles, I confirm to the best of my knowledge and belief the following representations made to you during your audit:

- Personnel and Readiness (hereafter referred to as we) is responsible for the fair presentation of the Fund's financial statements in conformity with generally accepted actuarial and accounting principles.

- We have made available to you all financial records and related data, including the minutes to the Board of Actuaries meetings.

- We can provide reasonable assurance that the accounting and non-accounting systems used to produce the financial statements are reliable.

- We have no plans or intentions that would materially affect the carrying value or classification of assets and liabilities.

- There have been no irregularities involving:

  a) management or employees who have significant roles in the internal control structure; or

  b) other employees that could have a material effect on the financial statements.

- We have received no communications from regulatory agencies or auditors concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

- There are no material transactions that have not been properly recorded in the accounting records and reflected in the financial statements.

• The Military Retirement Trust Fund has satisfactory title to all assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged.

• There are no violations, or possible violations of laws or regulations whose effects should be disclosed in the financial statements.

• There are no unasserted claims or assessments about which our legal representative have advised us and which should be disclosed.

• There are no gain and loss contingencies which should be disclosed.

• No events have occurred after the balance sheet date which we are aware of and which should be disclosed or adjusted for the financial statements.

• We can attest to the accuracy of the various account balances provided to the Defense Finance and Accounting Service by the Services and used by us to prepare the financial statements.

• All adjustments made to account balances by our activity or the Defense Finance and Accounting Service are fully documented and were made in accordance with applicable accounting standards.

Jeanne B. Fites

Jeanne B. Fites
Deputy Under Secretary of Defense
Program Integration

GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
1600 DEFENSE PENTAGON
WASHINGTON, D. C. 20301-1600

GENERAL COUNSEL

April 8, 1998

MEMORANDUM FOR THE ASSISTANT INSPECTOR GENERAL FOR AUDITING DEPARTMENT OF DEFENSE

SUBJECT: LEGAL REPRESENTATION LETTER FOR AUDITORS CONCERNING THE DEPARTMENT OF DEFENSE FISCAL YEAR 1997 MILITARY RETIREMENT TRUST FUND FINANCIAL STATEMENTS

REFERENCES:

(a) Deputy Under Secretary of Defense (Program Integration) OUSD(P&R) Memorandum dated February 9, 1998, Subject: Inspector General, Department of Defense, Audit of the Military Trust Fund Financial Statements for FY 1997

(b) Statement of Federal Financial Accounting Standard No. 5, "Accounting for Contingencies," December 1995

(c) American Bar Association Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975)

This memorandum responds to reference (a) which requests that my office provide a legal representation letter for the Military Retirement Trust Fund for the fiscal year ended September 30, 1997 and from the period September 30, 1997 through February 27, 1998.

As General Counsel of the Department of Defense, I advise you as follows in connection with your examination of the Military Retirement Trust Fund concerning matters that existed as of September 30, 1997 and from the period September 30, 1997 through February 27, 1998.

As General Counsel of the Department of Defense, I have supervisory authority with respect to claims and litigation made against the Department of Defense and its Agencies, including the Military Retirement Trust Fund. In such capacity, I or one of the lawyers over whom I exercise supervision, would have reviewed litigation and claims threatened or asserted involving the Military Retirement Trust Fund.

Known Claims, Litigation, and Assessments

Subject to the foregoing, and to the last paragraph of this memorandum, I advise you that, as of September 30, 1997 and from the period September 30, 1997 through February 27, 1998, neither I nor any of the lawyers over whom I exercise general supervision have given substantive attention to, or represented, the Military Retirement Trust Fund in connection with any known litigation, claim, or assessment of $100 million or more made against the Fund.

Unasserted Claims and Assessments

Information is also requested concerning unasserted claims and assessments which this office considers probable of assertion and, if asserted, would have a reasonable possibility of an unfavorable outcome. I have interpreted this request to refer to unasserted claims and assessments which, if asserted, have a reasonable possibility of resulting in a material unfavorable outcome where materiality is defined as $100 million or more.

Subject to the last paragraph of this memorandum, I advise you that neither I nor any of the lawyers over whom I exercise legal supervision have given substantive attention to, or represented the Military Retirement Trust Fund in connection with any unasserted claims or assessments which, if asserted, would constitute a material loss contingency within the scope of clause (a) of Paragraph 5 of reference (c).

Representation Concerning Disclosure

Subject to the last paragraph of this memorandum, and consistent with the last sentence of Paragraph 6 of reference (c), this will confirm that whenever, in the course of performing legal services for the Department of Defense, its Agencies or Field Activities with respect to a matter recognized to involve an unasserted possible material claim or assessment against the Military Retirement Trust Fund that may call for financial statement disclosure, I or one of the lawyers over whom I exercise general legal supervision have formed a professional conclusion that the Department must disclose, or consider disclosure, concerning such possible claim or assessment, the lawyer forming such professional conclusion will so advise the Department and will consult with the Department's financial managers concerning the question of such disclosure and the applicable requirements of reference (b).

Limitation on This Response

This response is limited by, and made in accordance with, the ABA Statement of Policy Regarding Lawyer's Responses to Auditors' Requests for Information (December 1975) (reference (c)). Without limiting the generality of the foregoing, the limitations set forth in such

Statement on the scope and use of this response (paragraphs 2 and 7)) are specifically incorporated herein by reference, and any description herein of any "loss contingencies" is qualified in its entirety by Paragraph 5 of reference (c) and the accompanying Commentary (which is an integral part of this Statement). In addition, we do not interpret reference (a) to require or authorize the release of information subject to the attorney-client privilege or the work product doctrine, and in responding to reference (a) we have provided no information subject to that privilege or doctrine. Moreover, the information set forth herein is as of March 30, 1998, and covers matters that existed as of September 30, 1997 and for the period September 30, 1997 to February 27, 1998, and I expressly disclaim any undertaking to advise you of changes which may be brought to my attention or to the attention of the lawyers over whom I exercise general legal supervision after March 30, 1998.

Judith Miller

Judith A. Miller

Appendix F. Laws and Regulations Reviewed

Subtitle III, Financial Management, Title 31, United States Code, including the requirements for accounting and accounting systems and information in 31 U.S.C., 3511, 3512, 1513, and 3514, and financial statement requirements in 31 U.S.C. 3515.

Subtitle A, General Military Law, Title 10, United States Code, Armed Forces (as amended through December 1, 1994), chapter 74, "Department of Defense Military Retirement Fund," March 1995

Public Law 104-208, "Federal Financial Management Improvement Act of 1996," October 1, 1996

Public Law 104-134, "Debt Collection Improvement Act of 1996," April 12, 1996

Public Law 103-356, "Government Management Reform Act of 1994," October 13, 1994 "Federal Financial Management Act of 1994"

Public Law 103-337, "Department of Defense Authorization Act of 1995," October 5, 1994

Public Law 103-62, "Government Performance and Results Act of 1993," August 3, 1993

Public Law 102-484, "National Defense Authorization Act for Fiscal Year 1993," October 23, 1992

Public Law 101-576, "Chief Financial Officers Act of 1990," November 15, 1990

Public Law 99-177, "Public Debt Limit-Balanced Budget and Emergency Deficit Control Act of 1985"

Public Law 98-369, "Deficit Reduction Act of 1984," July 18, 1984

Public Law 98-94, "Department of Defense Authorization Act of 1984," September 24, 1983

Public Law 97-365, "Debt Collection Act of 1982," October 25, 1982

Public Law 97-255 "Federal Managers Financial Integrity Act of 1982," September 8, 1982

Public Law 96-513 "Personnel Management Act of 1981," December 12, 1980

OMB Circular No. A-123, Revised, "Management Accountability and Control," June 21, 1995

OMB Bulletin No. 94-01, "Form and Content of Agency Financial Statements," November 16, 1993

OMB Bulletin No. 93-06, "Audit Requirements for Federal Financial Statements," January 8, 1993

OMB "Statement of Federal Financial Accounting Standards and Concepts"

Department of the Treasury, "Treasury Financial Manual," June 12, 1990

DoD Directive 5010.38, "Management Control Program," August 26, 1996

DoD Directive 7200.1, "Administrative Control of Appropriations," May 4, 1995

Joint Financial Management Improvement Program "Core Financial System Requirements," September 1995 (part of the "Federal Financial Management System Requirements")

DoD 7000.14-R, "DoD Financial Management Regulation," volume 1, "General Financial Management Information, Systems, and Requirements," May 1993

DoD 7000.14-R, "DoD Financial Management Regulation," volume 5, "Disbursing Policy and Procedures," December 1993

DoD 7000.14-R, "DoD Financial Management Regulation," volume 6, "Reporting Policy and Procedures," February 1996

DoD 7000.14-R, "DoD Financial Management Regulation," volume 7B, "Military Pay Policy and Procedures for Retired Pay," June 1995

DoD 7000.14-R, "DoD Financial Management Regulation," volume 14, "Administrative Control of Funds and Antideficiency Act Violations," August 1995

DoD 7000.14-R, "DoD Financial Management Regulation," volume 15, "Security Assistance Policy and Procedures," March 1993

Appendix G. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
  Deputy Chief Financial Officer
  Deputy Comptroller (Program/Budget)
Under Secretary of Defense (Personnel and Readiness)
  Deputy Under Secretary of Defense (Program Integration)
  Director, Defense Manpower Data Center
  Chief Actuary, DoD Office of the Actuary
Assistant Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Auditor General, Department of the Navy

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Department of the Air Force

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Finance and Accounting Service
Director, Defense Logistics Agency

Non-Defense Federal Organizations and Individuals

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division, General Accounting Office

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on Government Management, Information, and Technology, Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal Justice, Committee on Government Reform and Oversight
House Committee on National Security

Audit Team Members

This report was prepared by the Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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