

*A*udit  
*R*eport



DOD MILITARY RETIREMENT HEALTH BENEFITS LIABILITY  
FOR FY 1997

Report No. 99-010

October 13, 1998

Office of the Inspector General  
Department of Defense

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### **Acronyms**

CFO	Chief Financial Officers
MTF	Military Treatment Facilities
OMB	Office of Management and Budget
SFFAS	Statement of Federal Financial Accounting Standard
USD(C)	Under Secretary of Defense (Comptroller)



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
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ARLINGTON, VIRGINIA 22202

October 13, 1998

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (COMPTROLLER)  
UNDER SECRETARY OF DEFENSE (PERSONNEL AND  
READINESS)

SUBJECT: Audit Report on DoD Military Retirement Health Benefits Liability for  
FY 1997 (Report No. 99-010)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report. This audit was performed in response to the Chief Financial Officers Act of 1990 and the Federal Financial Management Act of 1994.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. Although the Under Secretary of Defense (Comptroller) only partially concurred, we consider its comments responsive. Therefore, additional comments are not required. The Under Secretary of Defense (Personnel and Readiness) comments were partially responsive. We request that the Under Secretary of Defense (Personnel and Readiness) provide additional comments indicating estimated completion dates for agree-upon actions by November 13, 1998.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Charles J. Richardson at (703) 604-9582 (DSN 664-9582), (e-mail [crichardson@dodig.osd.mil](mailto:crichardson@dodig.osd.mil)) or Mr. Joe E. Richardson at (703) 604-9511 (DSN 664-9511), (e-mail [jrichardson@dodig.osd.mil](mailto:jrichardson@dodig.osd.mil)). See Appendix C for the report distribution. The audit team members are listed on the inside back cover.

A handwritten signature in black ink that reads "Robert J. Lieberman".

Robert J. Lieberman  
Assistant Inspector General  
for Auditing



## Office of the Inspector General, DoD

Report No. 99-010  
(Project No. 8FA-2009)

October 13, 1998

### DoD Military Retirement Health Benefits Liability for FY 1997

#### Executive Summary

**Introduction.** The audit was performed in compliance with the Chief Financial Officers Act of 1990 (Public Law 101-576) and the Federal Financial Management Act of 1994 (Public Law 103-356). Public Law 103-356 requires DoD and other Government agencies to prepare consolidated financial statements for FY 1996 and each succeeding year. Military retirement health benefits are post-retirement benefits that DoD provides to military retirees and other eligible beneficiaries through private sector health care providers and DoD military treatment facilities. The DoD-wide consolidated financial statements for FY 1997 reported total assets of \$1.3 trillion, total liabilities of \$948.8 billion, and a total net position of \$381.4 billion. The DoD military retirement health benefits, an unfunded liability estimated at \$218 billion, were included in total liabilities. This report is the first in a series of reports addressing selected accounts of the DoD-wide consolidated financial statements for FY 1997 and beyond.

**Audit Objectives.** The objective of the audit was to assess the reliability and completeness of the data used to calculate the actuarial valuation of retiree medical benefits for the Military. We also reviewed related management controls.

**Results of Audit.** The DoD reported a \$218 billion unfunded liability for military retirement health benefits liability, a material item on the Government-wide financial statements, as well as on the DoD-wide consolidated financial statements, for FY 1997. The Office of the Actuary, DoD, was unable to provide current and complete information to the contractor responsible for calculating the military retirement health benefits liability. Also, the Office of the Actuary, DoD, did not adjust the \$218 billion liability calculation to reflect the cost impact of TRICARE, a new DoD healthcare program. Additionally, Note 19, "Pensions and Other Actuarial Liabilities," for the DoD consolidated FY 1997 financial statements did not adequately reflect the data assumptions that the contractor used to calculate the liability. As a result, the actuarial estimate for FY 1997 was unreliable, and unless changes are made, the estimate for FY 1998 and beyond will also be unreliable. This problem constitutes a significant impediment to clean audit opinions on both the DoD and Government-wide financial statements. See Part I for a discussion of the audit results and Appendix A for details of the review of the management control program.

**Summary of Recommendations.** We recommend that the Under Secretary of Defense (Comptroller) provide written instructions to the Office of the Actuary, DoD, on an annual basis regarding the information needed to satisfy the Office of Management and Budget and DoD financial statement requirements. In addition, we recommend that the Under Secretary of Defense (Personnel and Readiness) direct the development of a documented integrated process for computing the unfunded military retirement health benefits liability.

**Management Comments.** The Under Secretary of Defense (Personnel and Readiness) generally concurred with the finding and provided clarifying comments and examples of initiatives to improve the completeness and the quality of the data used to calculate the military retirement health benefits liability. Specific initiatives to improve the completeness and the quality of the data to be used to calculate the military retirement include the collection of outpatient data from all 105 MTF and the collection of TRICARE claims data. Also, the Under Secretary of Defense (Personnel and Readiness) will certify the data for general accuracy and reliability. In addition, starting with the FY 1998 financial statements, the Office of the Actuary, DoD will provide information about the health-care trend assumptions used in the calculation of the individual components of expense to be included in the appropriate notes to the financial statements.

The Under Secretary of Defense (Comptroller) partially concurred with the recommendation to provide written instructions to the Office of the Actuary, DoD, regarding the need to satisfy the Office of Management and Budget and DoD financial statement requirements. The Under Secretary proposed that the guidance needed to satisfy financial statement requirements on pensions and other retirement benefits be included in the DoD Financial Management Regulation, rather than providing specific written guidance to the Office of the Actuary, DoD.

The Under Secretary of Defense (Personnel and Readiness) generally concurred with the recommendation to direct the development of a documented integrated process for computing an estimate of the military retirement health benefits liability. However, the Under Secretary of Defense (Personnel and Readiness) proposed that the recommendation be changed to delineate the roles and responsibilities involved in this process. See Part I for a discussion of management comments and Part III for the complete text of management comments.

**Audit Response.** The Under Secretary of Defense (Comptroller) proposed alternative corrective actions which satisfy the intent of the recommendation. Therefore, we consider the comments responsive.

The Under Secretary of Defense (Personnel and Readiness) comments were partially responsive. The additional detail proposed by the Under Secretary of Defense (Personnel and Readiness) can be specified in guidance given to the various involved offices. We request that the Under Secretary of Defense (Personnel and Readiness) provide additional comments by November 13, 1998 indicating specific actions planned or taken and either the planned or actual completion dates of those actions.

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## **Part I - Audit Results**

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## Audit Background

**Requirements for Financial Statements.** Public Law 101-576, "The Chief Financial Officers (CFO) Act of 1990," as amended by Public Law 103-356, "The Federal Financial Management Act of 1994," requires DoD and other Government agencies to prepare consolidated financial statements for FY 1996 and each succeeding year.

**Requirements for Financial Statement Audits.** Under the CFO Act of 1990, the Inspector General, DoD, is responsible for the audit of the financial statements of DoD. The General Accounting Office is responsible for the audit of the consolidated financial statements of the U.S. Government.

**Office of Management and Budget Form and Content Guidance.** Office of Management and Budget (OMB) Bulletin No. 97-01, "Form and Content of Agency Financial Statements," October 16, 1996, provides general and specific guidance to agencies of the Government on the preparation of financial statements. OMB Bulletin No. 97-01 established guidance for reporting pensions, other retirement benefits, and other post-employment benefits. DoD other retirement benefits include all retirement benefits other than pension plan benefits. Retirement benefits represent a significant portion of other retirement benefits in the Federal Government. OMB Bulletin No. 97-01 further states that entities that are responsible for accounting for "other retirement benefits" should calculate and report the liabilities and related expenses in accordance with the Statement of Federal Financial Accounting Standard (SFFAS) No. 5, "Accounting for Liabilities of the Federal Government," September 1995. An unfunded liability for military retirement health benefits had not been reported on previous DoD consolidated financial statements.

**Materiality of Liability.** FY 1997 was the first year that the unfunded liability for the DoD military retirees' medical health benefits was reported on the DoD-wide consolidated financial statements. The \$218 billion unfunded liability was 23 percent of the \$948.8 billion of liabilities included on the DoD-wide financial statements and 14 percent of the estimated \$1.6 trillion of the net cost of operations of the Federal Government. Thus, the DoD military retirement medical health benefits liability is material to the Federal Government and DoD-wide financial statements.

**Armed Forces Medical Care.** United States Code Annotated, Title 10 Armed Forces, "Chapter 55-Medical and Dental Care," requires DoD to provide a uniform program of medical and dental care for uniform services members and certain former members of those services and for their dependents

**Military Treatment Facilities "Family" and Systems.** DoD military treatment facilities (MTF) are DoD hospitals and clinics. A hospital and related clinics are classified as an MTF "family." In FY 1997, DoD had 105 MTF families. The Composite Health Care System is a comprehensive medical information system that DoD developed to provide automated support to its military treatment

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facilities. The Composite Health Care System is composed of nine integrated modules that facilitate the collection and input of data at the point of medical care.

**Contract and Actuarial Technical Support.** The Office of the Actuary, DoD, is responsible for applying theories and techniques of actuarial science to DoD compensation systems, the largest of which is the military retirement system. The Office of the Actuary, DoD, prepares an annual actuarial valuation of the liabilities of the DoD Military Retirement Trust Fund, from which military retirement benefits are paid. Also, the Office of the Actuary, DoD, is responsible for the valuation of the military retirement health benefits liability. On September 30, 1994, the Defense Supply Service-Washington awarded a contract to Milliman and Robertson, Inc. (the contractor), an actuary and consultant firm, to assist in calculating an estimate of the unfunded liability for the military post-retirement health care benefits. The contract calls for the contractor to provide technical support for FY 1996 (basic contract) and for four additional option periods.

The contractor calculated the \$218 billion estimate for the FY 1998 military retirement health benefits liability based on the same data that were used to compute the FY 1997 liability estimate. However, the liability estimate increased for the following reasons:

- The claims cost data used to develop the \$218 billion estimate were projected an extra year to October 1, 1997, using the medical trend assumption of 2.5 percent for FYs 94 through 95 from the FY 1997 report
- The \$218 billion estimate was based on a method of spreading cost over years of service rather than as a level percentage of payrolls. Spreading cost over years of service is the method specified in SFFAS No. 5

## **Audit Objectives**

The objective of the audit was to assess the reliability and completeness of the data used to calculate the actuarial valuation of retiree medical benefits for the Military. We also reviewed related management controls. Appendix A discusses the audit scope and methodology and our review of the management control program.

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## **Developing Estimates for the Military Retirement Health Benefits Liability**

The Office of the Actuary, DoD, was unable to provide current and complete information to the contractor responsible for calculating the military retirement health benefits liability. Also, the Office of the Actuary, DoD, did not adjust the \$218 billion liability calculation for TRICARE, a new DoD healthcare program. Additionally, Note 19, "Pensions and Other Actuarial Liabilities," for the DoD consolidated FY 1997 financial statements did not adequately reflect the data and assumptions that the contractor used to calculate the liability. Those conditions occurred because the Under Secretary of Defense (Comptroller) did not give timely instructions to the Office of the Actuary and other DoD organizations for preparing financial statements and the related notes to the financial statements. As a result, the \$218 billion estimate for FY 1997 was unreliable, and unless the Office of the Actuary, DoD, makes changes to ensure that the military retirement health benefits liability calculation is based on complete and current data, the estimate for FY 1998 and beyond will also be unreliable. Also, because the military retirement health benefits liability is material to the DoD and Government-wide financial statements, unreliable and unaudit data on subsequent liability calculations will prevent the rendering of clean audit opinions on both statements.

### **DoD Chief Financial Officer Responsibilities**

The Office of the Under Secretary of Defense (Comptroller) (USD[C]), as the CFO for DoD, is responsible for overseeing the preparation of the DoD-wide financial statements. That responsibility includes the development of guidance for the form and content of DoD financial statements, including a determination of the specific account balances for DoD to report in the consolidated financial statements.

### **Description of Liability**

The \$218 billion unfunded liability is the DoD estimate of the cost as of September 30, 1997 (net present value), to provide future medical health benefits that have been earned to date by current and future military retirees, their dependents and survivors. Appendix B shows the unfunded liability, in 5-year increments, over the next 99 years.

## Information Used to Calculate the Military Retirement Health Benefits Liability

The Office of the Actuary, DoD, did not provide current and complete information to the contractor responsible for calculating the \$218 billion military retirement health benefits liability. Specifically:

- the contractor did not receive the most current claims and participant data,
- the contractor reported that normal cost percentages and unfunded actuarial liabilities were uncertain because large portions of data were unavailable, and
- the MTF outpatient cost may not be demographically representative.

The contractor identified those deficiencies in a report on the "Analysis of the U.S. Military's Projected Retiree Medical Liabilities for Fiscal Year 1998," March 24, 1998. Also, the contractor used budget, rather than actual costs, to compute MTF outpatient cost. Finally, the contractor relied on the data that the Office of the Actuary, DoD, provided without verification.

**Claims and Participant Data.** The Office of the Actuary, DoD, did not provide the most current outpatient information to the contractor. The contractor received information through FY 1994 but did not receive FYs 1995 and 1996 outpatient information. The Office of the Actuary, DoD, was responsible for obtaining claims, participant, and other types of data that the contractor used to calculate an estimate of the unfunded liability for the military retirement health benefits liability. The claims data (cost) and participant data were used to create an average claim cost per participant for the different age and beneficiary categories considered in the calculations. The average claim cost included cost segments derived from data obtained from the Civilian Health and Medical Program of the Uniformed Services, MTF-inpatient care and outpatient care. Participant data are data regarding the beneficiaries, such as the beneficiaries' age, sex, and marital status.

**Normal Cost Percentages.** The contractor reported that the normal cost percentages and unfunded actuarial liabilities were uncertain because large portions of the claims data were not readily available. The contractor determined a level-percent-of-pay that could be expected to pay for projected benefits at retirement for a new entrant into the medical plan. The level percent developed was called the "normal cost percent." The product of the level percent and estimated payroll was the "normal cost." The difference between the actuarial liability and the funds accumulated as of the same date was referred to as the "unfunded actuarial liability." Finally, the contractor stated that the claim cost per participant could vary widely from year to year until the data are complete.

**MTF Outpatient Data.** The MTF outpatient cost may not be demographically representative because the Office of the Actuary, DoD, could not provide the contractor with all claims data for the calculation of the FY 1997 unfunded military retirement health benefits liability.

## Developing Estimates for the Military Retirement Health Benefits Liability

The contractor identified and expressed concerns regarding the following outpatient data limitations:

“Age breakdown data were available on an outpatient basis for only 15 out of 121 (12 percent) military treatment facility families. The total estimated military treatment facility outpatient cost for retirees, dependents, and survivors may not be representative because the 12 percent of the military treatment facilities families with available data broken down by age represent a small portion of the total outpatient facilities.”

The contractor developed an estimated average cost of providing outpatient care in MTFs to eligible beneficiaries by selective age categories, as part of the overall process of developing an estimate of the \$218 billion liability. However, the Office of the Actuary, DoD, was able to obtain useable data from only 15 out of 121 MTF families (12 percent). The contractor used the data from 12 percent of the MTF families to calculate a “MTF-wide” average cost of providing outpatient care to eligible beneficiaries by selective age categories.

As a result of obtaining data from a limited number of MTF families, the contractor reported:

“Because the 15 MTFs with available data broken down by age represents a small portion of the total outpatient facilities, the sample may not be representative of the total MTF outpatient cost for retirees, dependents, and survivors.”

Therefore, data that the Office of the Actuary, DoD, obtained from the 15 MTFs that had implemented the Composite Health Care System were not statistically selected and may not be demographically representative. That methodology introduced an unquantifiable error.

**Budget Data Not Supported.** SFFAS No. 5 requires DoD to calculate and report its estimated liability for providing health care benefits to military retirees and their beneficiaries. DoD relied on budget information to calculate its \$218 billion liability, instead of relying on the required cost data. Although budget data indicates funds obligated during a period, they are not equivalent to full cost data. According to both, the Office of the Actuary, DoD, and the contractor, the current cost of providing health care is very significant to the liability calculation. The actuaries stated that if costs are understated or overstated by a percentage point, the liability would be understated or overstated by approximately the same percentage. Therefore, the use of budget data could significantly impair the ability of DoD to determine the unfunded liability.

**Contractor Relied on Data Without Verification.** Because the contractor had no contractual requirements for data collection, the contractor relied, without validation, upon claims and expenses, participant data, and economic assumptions that the Office of the Actuary, DoD, provided to complete the calculations. Wherever possible, the contractor used the identical actuarial methods and assumptions that the Office of the Actuary, DoD, provided to complete the calculations. However, the contractor performed overall reasonableness checks on

the data they received. Wherever possible and appropriate, the contractor used judgment with respect to the assumptions and the methods that were required for the calculations when the Office of the Actuary, DoD, could provide no guidance or when the data were insufficient.

## **TRICARE-Specific Health-Care Trends**

The Office of the Actuary, DoD, did not provide DoD-specific health-care trend assumptions for the contractor to consider in its calculations. SFFAS No. 5 requires the use of a health-care cost-trend assumption that is consistent with Medicare projections or other authoritative sources appropriate for the population that the plan covers. The contractor recognized that DoD is undergoing a transition into a new program called TRICARE, which will change the delivery system of health care. However, the contractor's valuation made no explicit adjustments for the cost impact that TRICARE will have on the military retirement health benefits liability. TRICARE replaced the Civilian Health and Medical Program of the Uniformed Services. TRICARE is the military equivalent of a health insurance program, run by DoD, for active duty dependents, military retirees, and other eligible beneficiaries. TRICARE offers beneficiaries the following three methods of receiving healthcare:

- a health maintenance organization system that offers significantly reduced cost,
- a preferred provider network that offers lower cost if the preferred provider is used for care, and
- a standard plan that allows the beneficiaries to choose any health care provider.

## **Adequacy of Financial Statement Disclosures**

The disclosure information that supports Note 19, "Pensions and Other Actuarial Liabilities," of the DoD consolidated financial statements was incomplete. Specifically, the disclosure information did not adequately reflect the assumptions that the contractor used to calculate the liability and did not identify the individual components of expense for the period.

**Footnote Disclosure Requirements.** OMB Bulletin No 97-01 states that financial statement footnotes are integral parts of the statements that contain disclosure requirements and other information. Also, Bulletin No 97-01 provides guidance on the type of information to be disclosed in the footnotes. Specifically, OMB Bulletin No. 97-01, Note 13, "Pensions, Other Retirement Benefits, and Other Post-Employment Benefits," states that entities that are responsible for administering pensions, other retirement benefits, and other post-employment benefits should calculate those liabilities and related expenses in accordance with SFFAS No 5. SFFAS No 5 requires the use of a health-care cost-trend

## **Developing Estimates for the Military Retirement Health Benefits Liability**

assumption that is consistent with Medicare projections or other authoritative sources appropriate for the population covered by the plan. Note 13 established the following minimum disclosure requirements for pensions and other retirement benefits:

- the assumptions used to calculate the liability and
- separate disclosure of the individual components of expense for the period.

**Disclosure in Note 19.** The disclosures required by OMB Bulletin No. 97-01 were reported in Note 19, "Pensions and Other Actuarial Liabilities," for the DoD-wide consolidated financial statements. However, the information contained in Note 19 did not satisfy the minimum disclosures because the USD(C) did not adequately inform the potential users of the financial statements of the general and specific assumptions that were used to calculate the military retirement health benefits liability.

Specifically, Note 19 was inadequate because it did not provide the potential users of the financial statements with any substantive information about the health-care trend assumptions used in the calculations, as required by SFFAS No. 5. Also, Note 19 did not disclose the applicable individual components of expense. The individual components of expense may include some or all of the following elements.

- normal cost,
- interest on the liability for the period,
- prior and past service cost from plan amendments during the period,
- gains or losses from a change in the medical rate assumption, and
- other actuarial gains or losses during the period

## **Timeliness of Instructions for Preparing Financial Statements**

The USD(C) did not give timely instructions to the Office of the Actuary, DoD and other DoD organizations for preparing financial statements and the related notes to the financial statements. Specifically, the USD(C) did not

- initiate the financial statement requirements determination process until 1997, which did not give the Office of the Actuary, DoD, time to obtain a reliable estimate;
- include the Office of the Assistant Secretary of Defense (Health Affairs) in the requirements determination process; and

## Developing Estimates for the Military Retirement Health Benefits Liability

- develop a process for communicating the need for proper accounting estimates and disclosure information with the Defense Finance and Accounting Service Indianapolis Center.

**Initiation of Financial Statement Requirements.** The USD(C) did not assign responsibility to the Office of the Actuary, DoD, to obtain a reliable estimate of the military retirement health benefits liability for use in the financial statements until 1997. As a result, the Office of the Actuary, DoD, was not officially informed of the requirement to calculate an estimate of the military retirement health benefits liability to be reported on the DoD-wide consolidated financial statements until FY 1997.

**Consulting With DoD Health Affairs Experts.** The Assistant Secretary of Defense (Health Affairs) is responsible for exercising authority, direction, and control over the medical personnel, facilities, programs, and funding as they relate to medical programs and DoD health and medical resources. The USD(C) procedures did not include the Office of the Assistant Secretary of Defense (Health Affairs) in the requirement determination process to assess the effects of health-related policies, trends, and assumptions on the data provided to the contractor. As a result, the contractor's calculations do not include health-care cost-trend assumptions such as the transition to the TRICARE program.

**Process for Developing Proper Accounting Estimates.** The process, was incomplete for communicating the requirements for proper accounting estimates and disclosure information specifically, for the military retirement health benefits liability, between the USD(C); Defense Finance and Accounting Service Indianapolis Center; the Assistant Secretary of Defense (Health Affairs); and the Office of the Actuary, DoD. The process did not include the need for proper accounting estimates and for an adequate review and approval of the accounting estimates. USD(C) provided form and content guidance in DoD Financial Management Regulation, Volume 6, but did not provide specific written instructions regarding the preparation and presentation of the health benefits liability estimate to the Office of the Actuary. In addition, the USD(C) has coordinated with the Under Secretary of Defense (Personnel and Readiness) regarding its responsibility for establishing procedures for the computation of the military retirement health benefits liability estimate by using the USD(C) guidance for implementing SFFAS No. 5, "Accounting for Liabilities of the Federal Government," September 1995. The development of an integrated process should include procedures for the review and approval of the estimated liability by the USD(C) and the Assistant Secretary of Defense (Health Affairs)

## **Ongoing and Planned Efforts to Improve Liability Estimates**

Because the unfunded military retirement health benefits liability is material to the DoD and to the Government-wide financial statements, in December 1997 the Inspector General, DoD, and the General Accounting Office initiated efforts to improve the process for obtaining liability estimates. A Military Retirement Health Benefits Working Group, composed of representatives from the USD(C), the Assistant Secretary of Defense (Health Affairs), the Office of the Actuary, DoD;

## **Developing Estimates for the Military Retirement Health Benefits Liability**

the Inspector General, DoD; and the General Accounting Office have held a series of meetings to address the concerns of the contractor in regard to incomplete and unreliable patient data. The Inspector General, DoD, will perform financial management audits to address the quality of the data provided to the contractor, and the General Accounting Office will assess the impact of specific data elements in the actuarial model. The General Accounting Office, with the assistance of an independent contractor, planned or initiated efforts to improve the reliability of the estimate, including the following:

- reviewing the actuarial model of DoD for post-retirement health-care benefits to identify key data elements, assumptions, and other factors in the model;
- identifying the data elements, assumptions, and other factors within the actuarial model that have a significant impact on the liability valuation amount; and
- determining the impact of changes in the data elements, assumptions, and other factors on the liability valuation amount (sensitivity analysis).

### **Management Comments on the Finding**

The Under Secretary of Defense (Personnel and Readiness) generally concurred with the finding and provided clarifying comments and examples of initiatives to improved the completeness and the quality of the data used to calculate the military retirement health benefits liability. Specific initiatives to improve the completeness and the quality of the data to be used to calculate the military retirement include the collection outpatient data from all 105 MTF and the collection of TRICARE claims data. Also, the Under Secretary of Defense (Personnel and Readiness) will certify the data for general accuracy and reliability. In addition, starting with the FY 1998 financial statements, the Office of the Actuary, DoD will provide information about the health-care trend assumptions used in the calculation the individual components of expense to be included in the appropriate notes to the financial statements

## **Recommendations, Management Comments, and Audit Response**

**1. We recommend that the Under Secretary of Defense (Comptroller) provide written instructions to the Office of the Actuary, DoD, on an annual basis regarding the information needed to satisfy the Office of Management and Budget and DoD financial statement requirements.**

**Under Secretary of Defense (Comptroller) Management Comments** The Under Secretary of Defense (Comptroller) partially concurred, stating that the guidance on pensions and other retirement benefits needed to satisfy financial statement requirements will be published in the DoD Financial Management Regulation scheduled for publication by August 1998.

**Audit Response.** The proposed corrective action is responsive. The proposed corrective action to publish the pension and other retirements benefits guidance needed to satisfy financial statement requirements in the DoD Financial Management Regulation satisfies the intent of the recommendation

**2. We recommend that the Under Secretary of Defense (Personnel and Readiness) direct the development of a documented integrated process for computing an approximate actual cost of the military retirement health benefits liability.**

**Under Secretary of Defense (Personnel and Readiness) Management Comments.** The Under Secretary of Defense (Personnel and Readiness) generally concurred with the recommendation to direct the development of a documented integrated process for computing an approximate actual cost of the military retirement health benefits liability. However, the Under Secretary of Defense (Personnel and Readiness) proposed that the recommendation be changed to clearly delineate the roles and responsibilities involved in this process

**Audit Response.** The Under Secretary of Defense (Personnel and Readiness) comments were partially responsive. The additional detail proposed by the Under Secretary of Defense (Personnel and Readiness) can be specified in guidance given to the various involved offices. We request, however, that the Under Secretary of Defense (Personnel and Readiness) identify specific actions taken or planned in response to agreed-upon recommendation and provide the completion dates of the actions. Therefore, we request that the Under Secretary of Defense (Personnel and Readiness) provide additional comments to the final report by November 13, 1998



## **Part II - Additional Information**

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# Appendix A. Audit Process

## Scope and Methodology

We reviewed the data supporting the \$218 billion projection of the U.S. military retirement health benefits liability reported by the contractor, an actuarial and consulting firm hired by the Office of the Actuary, DoD. As a result of an agreement between the Inspector General, DoD, and the General Accounting Office, we agreed to:

- focus on obtaining an understanding of the military retirement health benefits liability,
- consider the use of the work of specialists, and
- identify the data that the Office of the Actuary, DoD, provided to the contractor and that the contractor used in the calculation of the military retirement health benefits liability

Our audit concentrated on obtaining an understanding of the processes and procedures used to develop the estimate of the liability. Specifically, we conducted interviews with personnel from the offices of the USD(C); Assistant Secretary of Defense (Health Affairs); Actuary, DoD; and contract support personnel to obtain an understanding of the staff's specific responsibilities. We also reviewed the FY 1997 DoD-wide consolidated financial statements to evaluate whether reporting and disclosure requirements were consistent with the OMB Bulletin No. 97-01 form and contents guidance.

**Limitations to Audit Scope.** We could not identify a complete and auditable data universe because a significant portion of the claims and participant data were not available. Therefore, we did not conduct tests to assess the reliability and completeness of the data used to calculate the actuarial valuation of retiree medical benefits.

**DoD-Wide Corporate-Level Government Performance and Results Act Goals.** In response to the Government Performance and Results Act, the Department of Defense has established 6 DoD-wide corporate-level performance objectives and 14 goals for meeting these objectives. This report pertains to the achievement of the following objectives and goals.

**Objective:** fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas **(DoD-6)**

**DoD Functional Area Reform Goals.** Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area and goal:

**Financial Management Objective:** Strengthen internal controls.

**Goal:** Improve compliance with the Federal Managers' Financial Integrity Act. (FM-5.3)

**General Accounting Office High Risk Area.** The General Accounting Office has identified several high risk areas in the Department of Defense. This report provides coverage of the Defense Financial Management high risk area.

**Use of Computer-Processed Data.** We used computer-processed data that the Office of the Actuary, DoD, and contract support personnel used to calculate the military retirement health benefits liability. We did not validate the reliability of the management systems because we limited our use of the data to obtain an understanding of the procedures that the Office of the Actuary, DoD, used to calculate the liability. However, not validating the reliability of data did not affect the results of this audit

**Audit Type, Dates, and Standards.** We performed this financial-related audit from October 1997 through May 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. We included tests of management controls considered necessary.

**Contacts During the Audit.** We visited or contacted organizations within DoD. Further details are available on request

**Summary of Prior Coverage.** No audit reports have been issued during the last 5 years on the military retirement health benefits liability.

## Management Control Program

DoD Directive 5010.38, "Management Control Program," August 26, 1996, requires DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of those controls

**Scope of Review of Management Control Program.** We did not review management controls related to the accumulation of relevant, complete, and reliable data on which the estimate of the unfunded military retirement health benefits liability was based. We did not review those controls because a significant portion of the claims and participant data were not available for review. We reviewed the adequacy management controls for the communication of the need for proper accounting estimates and for the preparation of the accounting estimate by qualified personnel. Also, we reviewed the USD(C) FY 1997 Annual Statement of Assurance and management's self-evaluation applicable to controls over establishing a process for identifying and preparing accounting estimates.

**Adequacy of Management Controls.** We identified material management control weaknesses, as defined by DoD Directive 5010.38. The USD(C) management controls did not ensure that the financial statement requirements

## Appendix A. Audit Process

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determination process was initiated in time to obtain a reliable accounting estimate. The recommendations in this report, if implemented, will improve the accuracy of the estimate for the military retirement health benefits liability reported to DFAS Indianapolis Center for inclusion in the Statement of Financial Position for future years. A copy of this report will be provided to the senior Under Secretary of Defense (Personnel and Readiness) and DFAS officials responsible for management controls.

**Adequacy of Management's Self-Evaluation.** In their self-evaluation, USD(C) officials did not identify the specific material management control weaknesses identified by the audit because the USD(C) evaluation covered a much broader area.

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## Appendix B. Net Present Value of the Unfunded Actuarial Estimate for the Military Retirement Health Benefits Liability

(Present value is today's value of payments to be made in the future )

<u>Projection Period</u>	<u>Liability (in millions)*</u>
1998 through 2002	\$ 14,347.81
2003 through 2007	27,308.55
2008 through 2012	32,442.34
2013 through 2017	32,764.50
2018 through 2022	28,775.05
2023 through 2027	23,603.73
2028 through 2032	18,568.26
2033 through 2037	13,985.34
2038 through 2042	9,952.11
2043 through 2047	6,742.94
2048 through 2052	4,367.43
2053 through 2057	2,617.40
2058 through 2062	1,427.89
2063 through 2067	697.37
2068 through 2072	294.26
2073 through 2077	102.98
2078 through 2082	28.48
2083 through 2087	5.98
2088 through 2092	0.79
2093 through 2097	0.03
<b>Total</b>	<b>\$218,033.26</b>

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\* Data rounded to millions.

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## **Appendix C. 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)  
Assistant Secretary of Defense (Health Affairs)  
Office of the Actuary, DoD  
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

### **Other Defense Organizations**

Director, Defense Finance and Accounting Service  
Director, Defense Finance and Accounting Service Indianapolis Center  
Director, Defense Logistics Agency  
Director, Washington Headquarters Services  
Director for Budget and Finance, Washington Headquarters Services

## **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



## **Part III-Management Comments**

# Under Secretary of Defense (Comptroller) Comments



COMPTROLLER

UNDER SECRETARY OF DEFENSE  
1100 DEFENSE PENTAGON  
WASHINGTON, DC 20301-1100



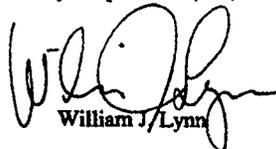
AUG 31 1998

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,  
OFFICE OF THE INSPECTOR GENERAL OF THE  
DEPARTMENT OF DEFENSE

SUBJECT: Audit Report on DoD Military Retirement Health Benefits Liability for FY 1997  
(Project No. 8FA-2009)

This memorandum is in response to your request for comments on the subject draft audit report. This office generally concurs with the recommendation. Attached are detailed comments on the recommendation. This office appreciates the opportunity to comment on the draft audit report.

The point of contact for this matter is Mr. Charles Crichley. He may be reached by e-mail: [crichlec@osd.pentagon.mil](mailto:crichlec@osd.pentagon.mil) or by telephone at (703) 693-6505 (DSN 227-6505).

  
William J. Lynn

Attachment

**OFFICE OF THE UNDER SECRETARY OF DEFENSE (COMPTROLLER)**

**"Audit Report on DoD Military Retirement Health Benefits Liability for FY 1997"  
(Project No. 8FA-2009)**

**RECOMMENDATION**

\*\*\*\*\*

**RECOMMENDATION:** We recommend that the Under Secretary of Defense (Comptroller) provide written instructions to the Office of the Actuary, DoD, on an annual basis regarding the information needed to satisfy the Office of Management and Budget and DoD financial statement requirements.

**OUSDC(C) RESPONSE:** Partially Concur. Actions are underway to ensure that the "DoD Financial Management Regulation" coverage on pensions and other retirement benefits is fully consistent with the accounting standards in Statement of Federal Financial Accounting Standards No. 5. The revised guidance, scheduled for publication by fourth quarter 1998, will consider the required actuarial methodology and the accounting requirements for administrative and employer entities.

The FY 1998 Form and Content guidance for the "DoD Financial Management Regulation" is scheduled for publication by August 1998. The Statement of Federal Financial Accounting Standards No. 5, pension and other retirement benefits financial statement presentation and disclosure requirements are enumerated therein.

The Office of the DoD Actuary has identified milestones and the resources needed to achieve compliant benefit calculations and reporting by FY 1999. The Defense Finance and Accounting Service and the Office of the DoD Actuary have established the relationship needed to ensure the timely communication of accounting and financial statement disclosure information.

The actions underway are intended to remedy the deficiencies disclosed by the audit, and should obviate the need for annual written instructions to the Office of the DoD Actuary. Timely updates of the "DoD Financial Management Regulation" will be used to communicate any new financial statement requirements.

Attachment

# Under Secretary of Defense (Personnel and Readiness) Comments



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



AUG 28 1998

MEMORANDUM FOR DIRECTOR, FINANCE AND ACCOUNTING DIRECTORATE,  
OFFICE OF THE INSPECTOR GENERAL OF THE DEPARTMENT  
OF DEFENSE

SUBJECT: Audit Report on DoD Military Retirement Health Benefits Liability for FY 1997  
(Project No. 8FA-2009)

This memorandum is in response to your request for comments on the subject draft audit report. This office generally concurs with the second "recommendation for corrective action," but suggests specifying the P&R organizations responsible for the work. Attached is the revised recommendation and this office's detailed comments on the report's audit findings.

The point of contact for this matter is Mr. Chris Doyle. He may be reached by phone at (703) 696-7407 (DSN 226-7407) or e-mailed at [doylecn@osd.pentagon.mil](mailto:doylecn@osd.pentagon.mil).

Jeanne B. Fites  
Deputy Under Secretary of Defense  
Program Integration

Attachments:  
As stated



**DRAFT OF PROPOSED AUDIT REPORT**

**DoD Military Retirement Health Benefits Liability for FY 1997  
(Project No. 8FA-2009)**

General Comments

In general, P&R concurs with the draft audit report on the "DoD Military Retirement Health Benefits Liability for FY 1997." We understand the importance of a clean audit opinion on the Consolidated Government-wide financial statements and will work to correct the weaknesses identified by auditors in the calculation of the FY 1997 liability for post-retirement health care.

**RECOMMENDATION:** The Office of the Department of Defense Inspector General recommended that the Under Secretary of Defense for Personnel and Readiness direct the development of a documented integrated process for computing an approximate actual cost of the military retirement health benefits liability

**DoD RESPONSE:** Partially concur. Both the Office of the Actuary and Health Affairs report to the Under Secretary of Defense for Personnel and Readiness. However, the development of a documented integrated process for computing the liability is under the purview of the Office of the Actuary. Health Affairs and TMA will assist the Office of the Actuary by providing and interpreting source data for the calculation. Therefore, we propose that the recommendation be revised to clearly delineate the roles and responsibilities of the offices involved in this process. Our proposed change is stated below.

**We recommend that the Under Secretary of Defense for Personnel and Readiness direct the Office of the Actuary to develop a documented integrated process for computing the military retirement health benefits liability. Health Affairs and TRICARE Management Activity will provide and interpret the source data for the computation.**

Our specific responses to the audit findings in the report follow.

## Under Secretary of Defense (Personnel and Readiness) Comments

1. **Audit finding:** The Office of the Actuary did not provide current information to the Contractor responsible for calculating the \$218 billion Military Retirement Health Benefits Liability (p. 5). Specifically, the Contractor did not receive the most current claims and participant data. The Contractor received information through FY 1994, but did not receive FY's 1995 and 1996 information.

**Response:** The data contractor, Logistics Management Institute (LMI) is in the process of collecting health benefit claims, participant, and other relevant data from the years FY 1995-1997 and will provide that information to the Contractor for use in determining the FY 1998 Military Retirement Health Benefits Liability. The Office of the Actuary or LMI will collect similar data from FY 1998 to use in determining the FY 1999 Military Retirement Health Benefits Liability

2. **Audit finding:** The Office of the Actuary did not provide complete information to the Contractor responsible for calculating the \$218 billion Military Retirement Health Benefits Liability (p. 5). Specifically, the Military Treatment Facility (MTF) outpatient cost may not be demographically representative. The Contractor noted:

"Age breakdown data were available on an outpatient basis for only 15 out of 121 (12 percent) military treatment facilities. The total estimated military treatment facility outpatient cost for retirees, dependents, and survivors may not be representative..."

**Response:** The Composite Health Care System has now been implemented in all 105 MTFs. Accordingly, the Office of the Actuary has requested outpatient data from all 105 MTFs, and LMI is in the process of collecting the data for FY 1997. The data will be provided to the Contractor for use in determining the FY 1998 Military Retirement Health Benefits Liability. The Office of the Actuary or LMI will collect similar data from FY 1998 for use in determining the FY 1999 Military Retirement Health Benefits Liability.

3. **Audit finding:** DoD relied on budget information to calculate its \$218 billion liability, instead of relying on the required cost data (p. 6).

**Response:** With the concurrence of the previous DoD Deputy Comptroller and Health Affairs, LMI uses past actual DoD budget obligations as the basis for calculating MTF patient-level costs. The only other source of cost data is the Medical Expense Performance Reporting System (MEPRS). In the past, the previous DoD Deputy Comptroller and Health Affairs recommended against using MEPRS costs because they cannot be traced back to Congressional appropriations for auditing purposes.

Based on direction from the previous DoD Deputy Comptroller, LMI developed MTF cost data from a set of Program Eight - Medical program elements. The actual program elements were selected in 1991 by the previous Deputy Comptroller after consultation with LMI and OASD (HA). LMI uses the MEPRS data to adjust the budget Military Personnel and Operations and Maintenance obligations for non-health care costs and to determine the relative proportion of inpatient and outpatient costs. Additionally, because of the annual fluctuations in Military Construction and Other Procurement appropriation obligations, a 10-year moving average of

annual obligations is used. This was determined to be the most appropriate estimate of these costs.

MEPRS and other systems within Health Affairs continue to evolve and improve to meet the challenges of a very dynamic health care environment. The Office of the Actuary and LMI will continue to work with Health Affairs to assess the appropriateness and feasibility of using MEPRS cost data in the future. If all parties involved assess MEPRS cost data as sufficiently reliable and superior to budget obligations data for purposes of this calculation, LMI will develop a data collection plan and the Contractor will formulate a methodology for using MEPRS cost data in calculating the Military Retirement Health Benefits Liability

**4. Audit finding:** Because the Contractor had no contractual requirements for data collection, the Contractor relied, without validation, upon claims and expenses, participant data, and economic assumptions provided by the Office of the Actuary to complete the calculations (p. 6)

**Response:** The Under Secretary of Defense (Personnel & Readiness) will certify to the general accuracy, reliability, and comprehensiveness of the data collected. The Contractor will continue to make overall consistency data checks.

The Military Retirement Health Benefits Liability will be generally based on the economic assumptions that are used in the retirement benefit valuation. The Contractor will make all other health care trend assumptions.

**5. Audit finding:** The health care valuation made no explicit adjustments for the cost impact that TRICARE will have on the Military Retirement Health Benefits Liability (p. 7)

**Response:** Since the TRICARE program had not been fully implemented for a full year prior to the last data collection phase, a full year of actual experience data did not exist regarding the cost impact of that program on the Military Retirement Health Benefits Liability. As a result, at that time any adjustment thereon would have been purely speculative. Now that sufficient experience data exists, such an adjustment can and will, as appropriate, be made by the Contractor. LMI is in the process of collecting TRICARE claims data from FY 1997 to use in determining the FY 1998 Military Retirement Health Benefits Liability. The same procedure will be followed in the FY 1999 valuation.

**6. Audit finding:** Note 19 failed to disclose substantive information about the health-care trend assumptions used in the calculation of the Military Retirement Health Benefits Liability (p. 8).

**Response:** Starting with the FY 1998 financial statements, Note 19 will contain this information.

**7. Audit finding:** Note 19 failed to disclose the following applicable individual components of expense: normal cost, interest on the liability for the period, prior and past service cost from plan amendments during the period, gains or losses from a change in the medical rate assumption, and other actuarial gains or losses during the period (p. 8).

**Under Secretary of Defense (Personnel and Readiness) Comments**

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**Response:** Starting with the FY 1998 financial statements, Note 19 will contain this information.

## **Audit Team Members**

The Finance and Accounting Directorate, Office of the Assistant Inspector General for Auditing, DoD, produced this report.

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