



Fiscal Year 2025



Medicare-
Eligible
Retiree
Health Care
Fund
Audited
Financial
Report

November 14, 2025

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Management's Discussion and Analysis

Department of War Medicare-Eligible Retiree Health Care Fund For the Year Ended September 30, 2025

The Department of War (DoW) Medicare-Eligible Retiree Health Care Fund's (the "Fund" or MERHCF) discussion and analysis provides an overview of the MERHCF's financial activities for the year ended September 30, 2025. Since this information is designed to focus on the Fiscal Year (FY) 2025, resulting changes, and currently known facts, it should be read in conjunction with the MERHCF's principal statements and notes (beginning on page 23).

1. REPORTING ENTITY, MISSION AND MANAGEMENT STRUCTURE

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

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

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

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

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

TRICARE Plans and Programs for Medicare-Eligible Beneficiaries

TRICARE for Life (TFL). The TFL was created as “wrap-around” coverage to Medicare-eligible military retirees by Section 712 of the *Floyd D. Spence National Defense Authorization Act* for FY 2001 (P.L. 106-398). TFL functions as a second payer to Medicare, paying out-of-pocket costs for medical services covered under Medicare for beneficiaries who are entitled to Medicare Part A based on age, disability, or end-stage renal disease. TFL covers Medicare-eligible retirees, including retired guardsmen, reservists, and Medicare-eligible family members and survivors. A beneficiary must be eligible for Medicare Part A and enrolled in Medicare Part B. The Medicare-eligible retirees and family members of the non-DoW Uniformed Services (United States Coast Guard (USCG), Public Health Service (PHS), and National Oceanic and Atmospheric Administration (NOAA)) are also eligible for these benefits. TFL serves as the final payer for Medicare covered benefits, and first payer for TRICARE benefits that are not covered in the Medicare or other health insurance (OHI) programs.

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

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

Designated Provider Program (DPP) formerly Uniformed Services Family Health Plan. (USFHP). Finally, DoW beneficiaries, including Medicare-eligible beneficiaries, in specific locations where DPP, formerly the USFHP, facilities are available, may enroll in capitation rate plans. These plans include institutional and professional services and a pharmacy benefit. The capitation rate is paid by the DoW. Beneficiaries who choose enrollment in these plans are ineligible for care in MTFs

Management's Discussion and Analysis

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

Health Care Purchased from Civilian Providers

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

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

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

For more detailed information about the DHA-CRM purchased care processes and controls, please see “DoW DHA-CRM Management’s Discussion and Analysis for the Year Ended September 30, 2025.”

Computation of Incurred Claims Reserve

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

Health Care Provided in MTFs

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

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

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

DHA has implemented a monthly reconciliation of the Fund by MTF through the deployment of the Financial Management Information System (FMIS) dashboard. The FMIS Dashboard reconciliation process, implemented in FY 2025, is performed monthly and used quarterly for financial reporting to reconcile the MERHCF prospective payments developed within the Distribution Plan to actual earnings for Medicare-eligible retirees healthcare encounters incurred at the DHA MTFs. As of FY 2025, the MERHCF is utilizing a rolling 12-month view to support a monthly variance analysis, which would result in a full reconciliation completed at year-end. The results are uploaded to the FMIS Dashboard for DHA stakeholder review and analysis. Leveraging the reconciliation at year-end, the MERHCF determines whether to book Accounts Receivable (AR) if the prospective distribution exceeds 10% of the assessed workload execution for the current FY. As of FY 2025, Quarter (Q) 3, the reconciliation is also leveraged on a quarterly basis to determine the necessity of an expense and Accounts Payable (AP) accrual in the event of over-execution at the MTF level. FY 2025 is the first FY the MERHCF is performing an overall comparison of the prospective distribution to accumulated execution workload data. MERHCF implemented this process to support monthly tracking of earnings and distributions and to achieve

Management's Discussion and Analysis

data aggregation and interactive reporting, assisting with informed decision-making by DHA stakeholders.

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

The prospective O&M payment for MTF-provided care to Medicare-eligible beneficiaries was \$1.8 billion in FY 2025. While the unit costs of institutional and professional services have risen slightly, utilization of institutional services has continued to decrease while costs related to pharmacy non-ingredient O&M have increased. The prospective payment for MILPERS expenditure for care provided in the MTFs to Medicare-eligible beneficiaries was \$0.5 billion in FY 2025.

2. PERFORMANCE MEASURES

The mission of the Fund is to finance, on an actuarially sound basis, liabilities of the DoW and the uniformed services health care programs for specific Medicare-eligible beneficiaries. There are many ways to measure the funding progress of actuarially determined accrual funds. The ratio of assets in the Fund to the actuarial liability is a commonly used fund ratio. As of September 30, 2025, the Fund had net assets available to pay benefits of \$398.3 billion and an actuarial liability of \$1,013.6 billion (See Note 8 – Federal Employee and Veterans Benefits Payable); the funding ratio was 39.3%. Notwithstanding the effect of other actuarial gains and losses that will occur over time, this ratio is expected to reach 100% once the initial unfunded liability is fully amortized in accordance with a schedule set by the DoW MERHCF Board. The 38-year amortization period for the initial unfunded liability is scheduled to end in FY 2040.

The DoW Annual Performance Report (APR) is the primary document for comprehensive organizational performance reporting. The APR compares actual performance results to the goals, objectives, and outcomes established in the DoW Strategic Plan and Annual Performance Plans and it contains comprehensive, detailed performance reporting and information required by Circular A-11, Part 6. The APR is now part of the SMP (Strategic Management Plan). The APR can be found at <https://dam.defense.gov/Performance-mgmt/>.

The table and variance analysis in the following section presents certain FY 2025 financial statement information for the MERHCF.

3. FINANCIAL STATEMENT ANALYSIS

Financial Data FY 2025

Medicare-Eligible Retiree Health Care Fund	
Analysis of Financial Statements	
for the year ended September 30, 2025	
(\$ In Thousands)	
<u>Balance Sheet</u>	<u>2025</u>
Fund Balance with Treasury	\$131,183
Investments, Net	\$425,258,693
Accounts Receivable, Net	\$534,053
Accounts Payable (Federal)	\$22,878
Other Liabilities	\$30,985
Accounts Payable (Non-Federal)	\$201,713
Liabilities Not Covered by Budgetary Resources ¹	\$616,199,794
Federal Employee and Veterans Benefits Payable	\$1,014,466,033
<u>Statement of Net Cost</u>	
Net Cost of Operations	\$49,580,530
<u>Statement of Budgetary Resources</u>	
Net Amount of Budgetary Resource Obligated for Undelivered Orders ²	\$172,056
Agency Outlays, Net	(\$18,978,684)

¹ Included as a component of the line titled “Federal Employee and Veterans Benefits Payable”

² Included as a component of the “Statement of Budgetary Resources”

Financial Data Variance Analysis

BALANCE SHEET

Fund Balance with Treasury (Note 3)

Fund Balance with Treasury decreased by \$93.7 million (42%) due to a \$93.7 million increase in the total month-end disbursements for September 2025.

Investments (Note 5) **Intragovernmental Securities**

Total Intragovernmental Securities, Net Investments increased \$30.9 billion (7%). This increase is the result of investing annual contributions from the U.S. Treasury and the Uniformed Services (Army, Navy, Air Force, Space Force, Marine Corps, PHS, NOAA, and USCG), net of benefits

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paid. Investment of these funds has a cumulative effect with an expectation invested balances will continue growing to cover future benefits. The amounts not required for current year's benefit payments were invested. The MERHCF purchased \$31 billion in long-term securities in FY 2025.

Accounts Receivable (Note 6)

Accounts Receivable increased \$121.8 million (29.5%). The Retail Refunds program accounts for \$132 million as an increase, or 108.4% of the \$121.8 million increase in net public accounts receivable between 4Q25 and 4Q24. As part of the Retail Refunds internal program quality review, DHA identified that eligible refund claims for drugs dispensed beginning 2021Q1 forward were inadvertently omitted from utilization data and invoices reported to manufacturers. To address this, MERHCF included the prior periods in the 2025Q1 utilization report and have since been including them in current billings.

Accounts Payable (Federal)

Accounts Payable decreased by \$25.5 million (53%). The decrease is due to the Tricare Mail Order Pharmacy (TMOP) Program and is related to timing. For 4Q25, more bills were pushed through interfund causing the accrual to be lower, whereas 4Q24 more bills were held due to reaching the FY24 authority.

Other Liabilities (Note 9)

Other Liabilities increased \$31.0 million (100%). This increase was due to a DHA Direct Care liability being posted for the first time in 3Q25.

Accounts Payable (Non-Federal)

Accounts Payable decreased \$68.8 million (25%) primarily due to the Tricare for Life contract decreased by \$55.4 million. Contractor chose to stop processing claims on 9/24/2025, which was 4 days early and therefore caused non-fed AP to have a decrease in Miscellaneous Healthcare. Also, there were decreases in Retail Pharmacy of \$10.2 million, Overseas of \$1.8 million, MOP of \$0.7 million, and MTF of \$0.7 million.

Liabilities Not Covered by Budgetary Resources (Note 7)

Total Liabilities Not Covered by Budgetary Resources increased \$51 billion (9%). This change is due to an increase of \$80.5 billion in the Federal Employee and Veterans Benefits Payable offset by an increase of \$30.0 billion in net receipts that are available to pay future benefits. Net receipts are comprised of contributions, interest income, and outlays. See Note 8, Federal Employee and Veterans Benefits Payable, for additional information about these changes.

Federal Employee and Veterans Benefits Payable (Note 8)

The present value of the Federal Employee and Veterans Benefits Payable increased \$80.6 billion (8.7%). This resulted from the net effect of an increase of \$41.7 billion due to expected increases (interest cost plus normal cost less benefit outlays), an increase of \$50.5 billion due to changes in key assumptions (mainly due to update the trend assumptions) and a decrease of \$11.8 billion due to actual experience being different from what was assumed (demographic and claims data).

Management's Discussion and Analysis

STATEMENT OF NET COST

Gross Costs decreased \$930.3 million (2.1%) primarily due to a decrease in actuarial expenses applied at fiscal year-end. The largest changes resulting in the decrease to actuarial expenses included a \$10.6 billion decrease to the experience gain liability combined with a \$4.4 billion increase to normal cost liability and a \$4.7 billion increase to the interest cost liability.

Earned Revenue increased \$6.5 billion (17.5%) primarily due to a \$5.5 billion increase in earned revenue from the annual contributions made by Department of the Treasury and the Uniformed Services combined with a \$986 million increase in total interest revenue earned on investments from in FY25.

Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits decreased \$44.4 billion (47%). There was a \$50.5 billion loss in FY25 verses a \$94.9 billion loss in FY24.

Net Cost of Operations decreased \$51.9 billion (51%) due to the \$930.3 million decrease in Gross Costs combined with the \$44.4 billion decrease in Losses/(Gains) from Actuarial Assumption Changes for Military Retirement Benefits and the \$6.5 billion increase in Earned Revenue as described above.

STATEMENT OF BUDGETARY RESOURCES

Undelivered Orders (Note 13)

The Total Budgetary Resources Obligated for Undelivered Orders (UDO) at the End of the Period increased \$116.5 million (209%). The increase in Undelivered Orders/Obligations is primarily due to an increase in obligations of \$108.2 million in Mail Order Pharmacy, \$3.1 million in Retail Pharmacy, and \$5.1 million United States Family Health Plan (USFHP). These increases were primarily due to MERHCF reaching their FY24 authority and no additional authority being granted in FY24. This caused 4Q24 to be very low, whereas 4Q25 represents where MERHCF should be for UDO balances under normal operations.

Budgetary Resources

Appropriations increased \$814.8 million (7%). At the end of the fiscal year, the MERHCF adjusts total budgetary resources to equal total obligations incurred for the fiscal year. MERHCF's obligations are comprised of quarterly distributions to the Medical Treatment Facilities (MTF) and daily payments for Purchased Care/Healthcare, Operations & Maintenance. Fluctuation is normal due to the number of people in the system and medical need from one year to the next.

Total Budgetary Resources increased \$814.8 million (7%) due to the increase in Appropriations.

Status of Budgetary Resources

New Obligations and Upward Adjustments increased \$814.8 million (7%). This is due to the increase in Appropriations. This is primarily due to a \$666.8 million increase in new obligations paid offset by a \$227.7 million increase in undelivered orders. Obligations include quarterly distributions to the MTFs and daily payments for Purchased Care/Healthcare, Operations & Maintenance.

Management's Discussion and Analysis

Outlays, Net

Outlays, net increased \$666.8 million (5%) mainly because of a \$666.8 million increase in total obligations paid. Obligations include quarterly distributions to the MTFs and Daily Payments for purchased care/healthcare, Operations & Maintenance. Distributed offsetting receipts increased \$3.7 billion (13%) mainly due to a \$5 billion increase in earned revenue from the annual contribution made by the Department of the Treasury offset by a \$1.8 million decrease in total interest receipts from September 2025 to September 2024.

Agency outlays, net increased \$3.0 billion (19%) due to the increase in distributed offsetting receipts by the increase in outlays, as explained above.

Assets

Assets of \$425.9 billion, included in the Financial Data FY 2025 table on page 6 and shown in Figure 1, represent amounts that the MERHCF owns and manages. Assets increased by \$30.9 billion during FY 2025. This increase is largely attributable to a net increase in investments of \$30.9 billion. The net increase in investments is related to expected normal growth to cover unfunded portions of future military retirement benefits. Funds not needed to pay current benefits are invested in Treasury securities.

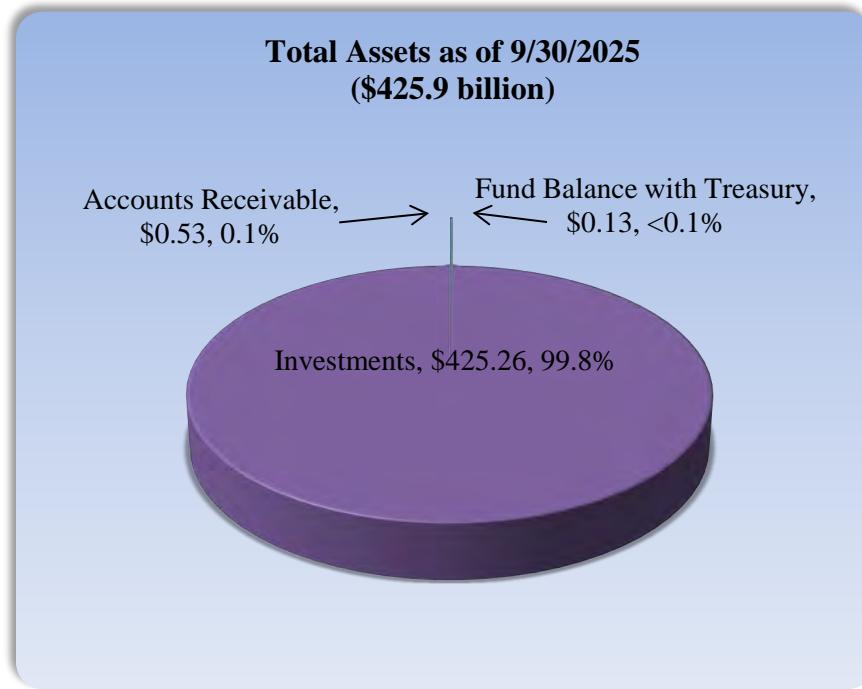


Figure 1

Investments

The Fund receives investment income from a variety of Treasury-based instruments such as bills, notes, bonds, overnight investment certificates, and zero-coupon bonds (ZCB). Treasury bills are short-term securities with maturities of less than one year issued at a discount. Treasury notes are intermediate securities with maturities of one to ten years. The MERHCF did not have any investment in notes at the end of FY 2025 but may invest in notes in the future. Treasury bonds are long-term debt instruments with maturities of greater than ten years. Overnight certificates are interest-based market securities purchased from the Treasury that mature the next business day and accrue interest based on the Federal Reserve Bank of New York survey of reserve repurchase agreement rates. Treasury ZCBs are fixed-principal bonds having maturities of at least five years and purchased at a discount.

Management's Discussion and Analysis

Figure 2 below depicts the par value of investment holdings (includes inflation and interest receivable), net of amortization, as of September 30, 2025.

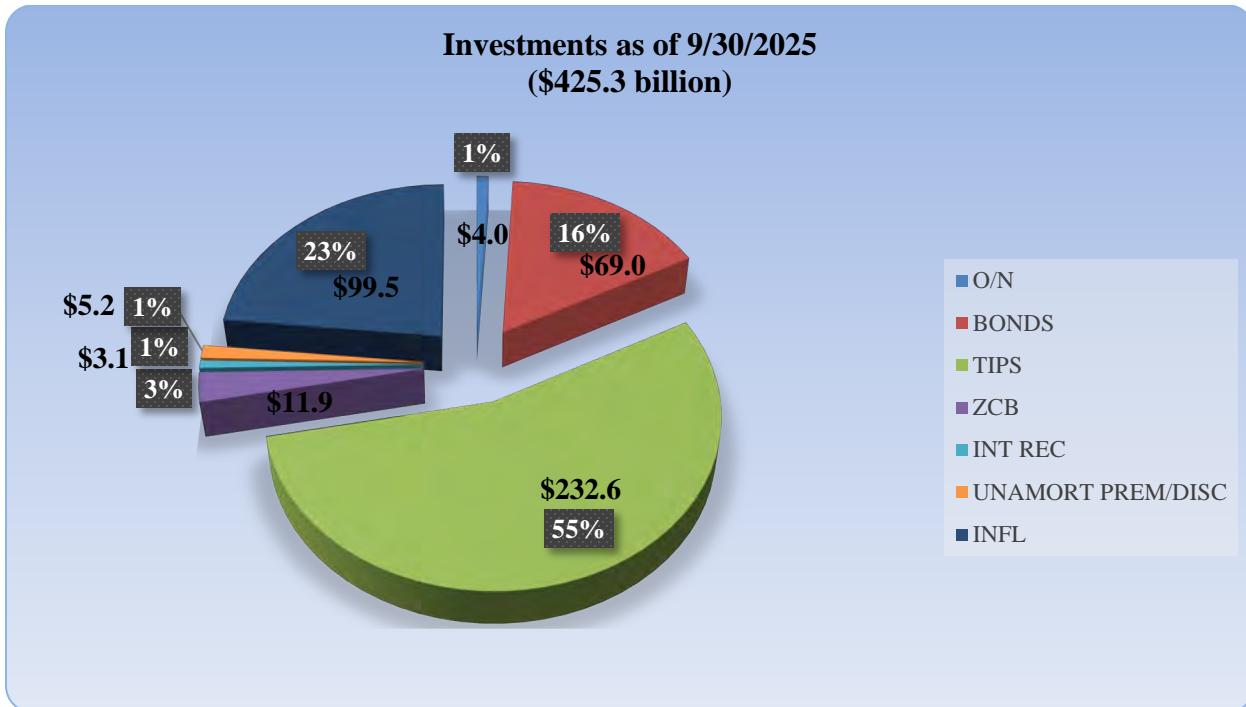


Figure 2

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

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

The Fund receives management oversight from the DoW Investment Board established in September 2003. The members of the Investment Board are the Director, DFAS; the Deputy Chief Financial Officer (DCFO), OUSW(C); and a senior military member from the financial management community. The Investment Board reviews the public law governing the Fund and Treasury guidelines to ensure compliance with statutory authority and broad policy guidance, respectively.

Liabilities

Liabilities of \$1,014.7 billion included in the Financial Data FY 2025 table shown in Figure 3 represent liabilities related to military retirement medical benefits for Medicare-eligible beneficiaries. The liabilities of the MERHCF primarily consist of actuarial liability for future benefit payments. Liabilities increased by \$80.5 billion during FY 2025. This increase is largely attributable to the increase in the actuarial liability.

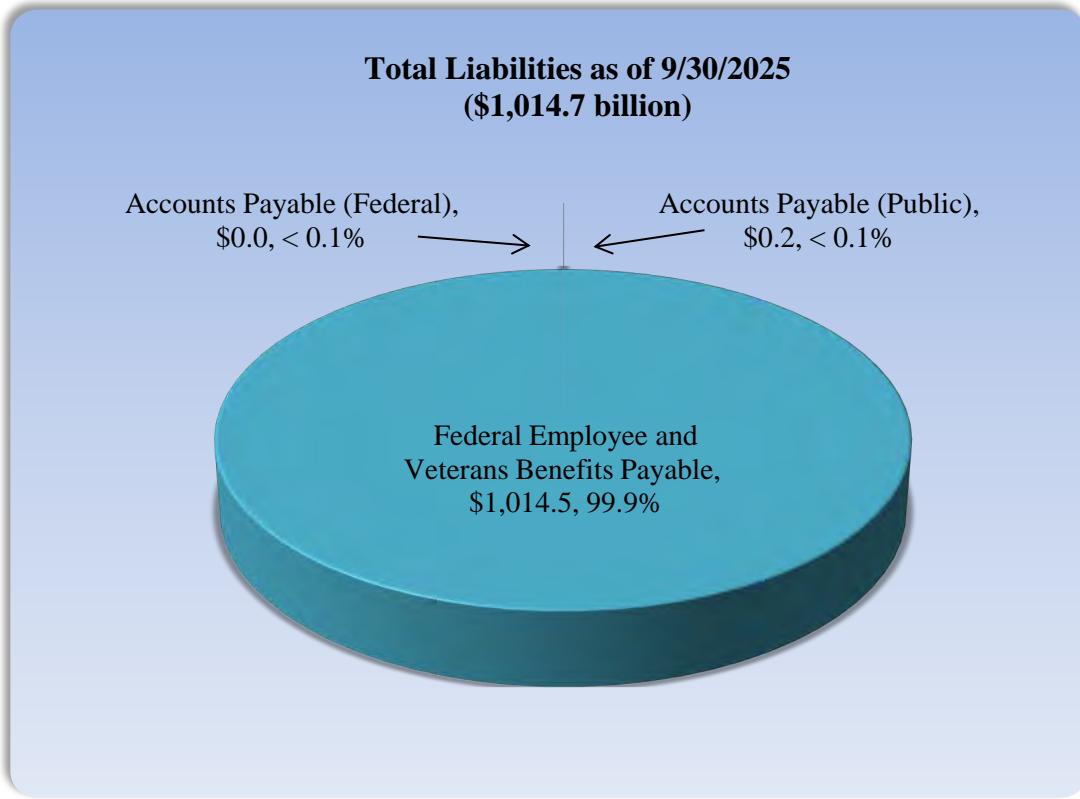


Figure 3

MERHCF Requirements and Funding Plan

In FY 2025, the Fund authorized approximately \$13.8 billion in total health care services, \$11.4 billion to civilian providers for purchased care, \$1.8 billion to MTFs, and \$0.6 billion to Military Service Personnel Accounts, on behalf of Medicare-eligible retirees, retiree dependents, and survivors. Purchased Care end of year MERHCF obligations were \$10.5 billion in FY 2025.

During FY 2025 of the Fund's operation, requirements were funded at the following amounts:

\$ In Billions				
Fiscal Year	Purchased Care	Operations & Maintenance	Military Personnel	Final
2025	\$11.4	\$1.8	\$0.6	\$13.8

MERHCF Revenues and Contributions

The Fund receives income from three sources:

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

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

\$ In Billions			
Fiscal Year	Treasury Unfunded Actuarial Liability (UAL) Payment	Normal Cost Contribution	Interest on Investments
2025	\$14.6	\$11.4	\$17.8

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

4. SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

Management Assurances

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

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

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

The evaluation of internal controls for the statement of assurance extended to every responsibility and activity undertaken by the organizations that execute the MERHCF and applies to program, administrative, and operational controls. The internal control testing follows the Financial Improvement and Audit Readiness (FIAR) Guidance established by the OUSW(C). This process includes the development of process flowcharts and narratives that include the identification of key controls that address FIAR-defined Financial Reporting Objectives, risk assessments associated with those key controls, test plans for those key controls, and reporting of test results based on execution of those test plans. Based on the results of this assessment, the DHA and TFAR are able to provide a qualified statement of assurance that the internal controls over financial reporting as of September 30, 2025 were operating effectively with the exception of the material weakness noted in this section under "Material Weakness 2025."

Federal Financial Management Improvement Act (FFMIA) (PL 104-208). The DHA internal review of the MERHCF also included the effectiveness of the internal controls over the integrated financial management systems for the DHA, MTFs, and the MERHCF financial statement reporting entities. For the MERHCF, the DHA is able to provide a qualified statement of assurance that the internal controls over the integrated financial management system as of June 30, 2025, are in compliance with the Federal Financial Management Improvement Act and OMB Circular A-123 Appendix D with the exception of one system's non-conformance noted in this section under "Material Weakness 2025."

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

Material Weakness 2025

The MERHCF independent auditors noted one material weakness during the FY 2025 Financial Statement Audit that consists of elements from two separate Notices of Findings and Recommendations (NFRs) -- NFR# FIN – 2025-01 (Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls), and NFR # FIN – 2025-03 (Direct Care Cost Completeness and Accuracy).

NFR 2025-01: The MERHCF has not formalized and documented its internal control environment of the FMIS Dashboard reconciliation process, to include the identification and implementation of controls, ensuring the MERHCF achieves financial reporting objectives over Direct Care expenditures.

NFR 2025-03: The MERHCF's FY 2025 quarterly prospective payments resulted in \$2.38 billion in expenses for Direct Care costs as of 30 September 2025. The MERHCF's quarterly distribution methodology and FMIS dashboard reconciliation could not properly validate the completeness and accuracy of Direct Care cost expenditures. The MERHCF was unable to provide sufficient and appropriate audit evidence to demonstrate the completeness and accuracy of distributions made to DHA and the Branch of Service (BoS). Specifically, the MERHCF was unable to provide timely:

- The financial impact of coding errors reported for non-billable encounters, per the *FY 2024 MTF External (Independent) Coding Audit Findings and Recommendations* report
- A formalized accrual methodology and appropriate supporting documentation for the recognition of expenses pertaining to inferred records
- Support for the development of MILPERS payments made to the BoS for Direct Care.

Actions Taken

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

In FY 2025, the MERHCF began implementing significant remediation efforts through the deployment of the FMIS dashboard. The dashboard is leveraged to reconcile MTF earnings, based on accumulated execution workload data, to the quarterly prospective distributions. The workload data is derived from the Military Health System (MHS) Data Repository (MDR), which houses patient encounter records from systems such as MHS GENESIS, Composite Health Care System (CHCS), and Pharmacy Data Warehouse (PDW). The FMIS dashboard process was implemented in FY 2025 and used to adjust financial reporting as of June 30, 2025.

Deployment of MHS GENESIS. The DHA has completed the deployment of MHS' new Electronic Health Record (EHR). The migration to the new EHR will provide the DHA the ability to perform more granular analysis to include itemized patient billing, transactional auditing

Management's Discussion and Analysis

capability, and allow the MERHCF Distribution Calculations and the Monthly Reconciliations to be performed in a more thorough, consistent, and accurate manner.

Information Technology (IT) Significant Deficiency on Access Controls and Segregation of Duties

In FY 2019, the audit identified a significant deficiency pertaining to certain information systems used by the MERHCF. While the deficiency remains in FY 2025, corrective actions are being pursued.

The MERHCF operates or relies on external providers for administration of multiple key financial management systems, including two core accounting systems and the Defense Enrollment Eligibility Reporting System (DEERS). Pharmacy Data Warehouse (PDW) is a centralized data repository used to consolidate, store, and analyze pharmaceutical transaction data across the Military Health System (MHS). DEERS and PDW are administrated by a service organization.

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

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

NFRs identified during the FY 2018 audit were not remediated in a timely manner, which caused repeat findings under the FY 2019 through 2025 audits. However, in FY 2025, there was one NFR which was remediated and closed. Corrective Action Plans (CAPs) established in FY 2019 that failed to be fully implemented in FY 2025 are required to be modified with new completion dates. For specific details please reference the "Independent Auditor's Report on Internal Control over Financial Reporting" included in the Financial Section of this report.

DHA Business Support Directorate - Program Integrity Office

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

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

Management's Discussion and Analysis

- Initiates administrative remedies to enforce provisions of the law, regulation, and policy in the administration of TRICARE program.

5. OTHER MANAGEMENT INFORMATION

Management Initiatives

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

Financial Management Systems Framework

MERHCF Reliance on DHA Financial Systems and Data. The cost of care provided directly in MTFs and medical coding record data used in direct care cost allocations is reported to the MDR by the DHA individual MTFs. The MERHCF direct care funding is executed by the Air Force DHA Component for those facilities that still rely on the financial systems and procedures of the Air Force, or the DHA for the other MTFs that rely on the General Fund Enterprise Business System (GFEBS) financial system. In FY 2025, all MTFs began using the GFEBS financial system.

The material weakness identified in the MERHCF audit is directly related to DHA's financial management systems, data accumulation, and financial reporting deficiencies. MERHCF management has no direct control over DHA financial management systems or data compliance that have not employed GFEBS. The Accounting and Financial Integrity (A&FI) branch of the DHA BSD's Budget & Resource Management continually strives to work with the DHA representatives to improve the MTFs audit readiness by following the FIAR guidance and objectives.

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

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

Management's Discussion and Analysis

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

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

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

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

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

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

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

The table on the following page highlights DoW activity since the inception of the Program. DoW has collected \$20.4 billion to date and continues rigorous collection efforts for both programs.

Management's Discussion and Analysis

TRICARE Retail Pharmacy Refunds Program				
Program To Date (CY 2008-3rd Quarter, CY 2025)	Total	DHP	Non-DoW	MERHCF
SDP -				
Billed	\$12,055,064,704	\$5,484,901,128	\$194,245,297	6,375,918,279
Collected	(11,705,765,259)	(5,294,915,813)	(187,029,323)	(6,223,820,123)
Net	349,299,445	189,985,315	7,215,974	152,098,156
ADP -				
Billed	9,549,902,705	4,428,200,568	160,391,010	4,961,311,127
Collected	(8,714,610,350)	(3,973,940,044)	(143,837,380)	(4,596,832,926)
Net	835,292,355	454,260,524	16,553,630	364,478,201
UDC¹	(3,183,906)	(1,742,004)	(63,559)	(1,378,343)
Total -				
Billed	\$21,604,967,409	\$9,913,101,696	\$354,636,307	\$11,337,229,406
Collected	(20,420,375,609)	(9,268,855,857)	(330,866,703)	(10,820,653,049)
UDC	(3,183,906)	(1,742,004)	(63,559)	(1,378,343)
Net	\$1,181,407,894	\$642,503,835	\$23,706,045	\$515,198,014
Aging -				
Current	\$1,094,341,561	\$601,880,431	\$21,894,500	\$470,566,630
61 Days to 2 Years ²	55,781,614	26,922,035	1,339,859	27,519,720
Over 2 Years	31,284,719	13,701,369	471,686	17,111,664
Total³	\$1,181,407,894	\$642,503,835	\$23,706,045	\$515,198,014

1. Unapplied Collections (UDC) applied to CY25.

2. Pharmacy debt not delinquent until 70 days. 70-day Accounts Receivable aging bucket not available; 61-day aging used instead.

3. 3QCY2025 Estimate added to Billings to reconcile with Accounts Receivable: \$262,114,000 MERHCF; \$347,454,000 DHP & Non-DoD.

TRICARE has a waiver dated September 23, 1996, 10 U.S.C. 1079a, Civilian Health and Medical Program of the Uniformed Services (CHAMPUS): Treatment of Refunds and Other Amounts Collected that states:

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

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

Management's Discussion and Analysis

DHA-CRM in FY 2025 continued to aggressively collect pharmacy refunds for both the SDP and ADP. Through the concerted efforts of DHA-CRM, Pharmacy Operations Division (POD), HCDA, and OGC, DHA-CRM's collection rate has continued to average 97% - 99%.

6. LIMITATIONS ON THE FINANCIAL STATEMENTS

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

DoD Transmittal of Auditor's Opinion

DoD Transmittal of Auditor's Opinion

DoD Transmittal of Auditor's Opinion



OFFICE OF INSPECTOR GENERAL

DEPARTMENT OF DEFENSE

4800 MARK CENTER DRIVE

ALEXANDRIA, VIRGINIA 22350-1500

November 14, 2025

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

SUBJECT: Transmittal of the Independent Auditor's Reports on the DoD
Medicare-Eligible Retiree Health Care Fund Financial Statements and Related
Notes for FY 2025
(Project No. D2025-D000FT-0057.000, Report No. DODIG-2026-011)

We contracted with the independent public accounting firm of Kearney & Company, P.C. (Kearney) to audit the DoD Medicare-Eligible Retiree Health Care Fund (MERHCF) Financial Statements and related notes as of and for the fiscal year ended September 30, 2025. The contract required Kearney to provide a report on internal control over financial reporting and compliance with provisions of applicable laws and regulations, contracts, and grant agreements, and to report on whether the MERHCF's financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996. The contract required Kearney to conduct the audit in accordance with generally accepted government auditing standards (GAGAS); Office of Management and Budget audit guidance; and the Government Accountability Office/Council of the Inspectors General on Integrity and Efficiency, "Financial Audit Manual," Volume 1, June 2025, Volume 2, June 2024, and Volume 3, August 2025. Kearney's Independent Auditor's Reports are attached.

Kearney's audit resulted in a qualified opinion. Kearney could not obtain sufficient appropriate audit evidence to support the costs of direct care provided by DoD-managed military treatment facilities. Kearney concluded that, except for the effects on the financial statements of the amounts related to the MERHCF's direct care costs, the MERHCF's Financial Statements and related notes as of and for the fiscal year ended September 30, 2025, were presented fairly, in all material respects, and in accordance with Generally Accepted Accounting Principles.

DoD Transmittal of Auditor's Opinion

Kearney's separate report, "Independent Auditor's Report on Internal Control Over Financial Reporting," discusses one material weakness related to the MERHCF's internal controls over financial reporting.*

Kearney's additional report, "Independent Auditor's Report on Compliance with Laws, Regulations, Contracts, and Grant Agreements," discusses one instance of noncompliance with provisions of laws and regulations, contracts, and grant agreements. Specifically, Kearney's report describes instances in which the MERHCF did not comply with the Federal Financial Management Improvement Act of 1996.

In connection with the contract, we reviewed Kearney's reports and related documentation and discussed them with Kearney's representatives. Our review, as differentiated from an audit of the financial statements and related notes in accordance with GAGAS, was not intended to enable us to express, and we do not express, an opinion on the MERHCF FY 2025 Financial Statements and related notes. Furthermore, we do not express conclusions on the effectiveness of internal controls over financial reporting, on whether the MERHCF's financial systems substantially complied with Federal Financial Management Improvement Act of 1996 requirements, or on compliance with provisions of applicable laws and regulations, contracts, and grant agreements. Our review disclosed no instances where Kearney did not comply, in all material respects, with GAGAS. Kearney is responsible for the attached November 14, 2025 reports and the conclusions expressed within the reports.

We appreciate the cooperation and assistance received during the audit. If you have any questions, please contact me.



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

Attachments:

As stated

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

Independent Auditor's Report



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INDEPENDENT AUDITOR'S REPORT

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

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF), which comprise the Balance Sheet as of September 30, 2025, the related Statements of Net Cost and Changes in Net Position, and the combined Statement of Budgetary Resources (hereinafter referred to as the "financial statements") for the year then ended, and the related notes to the financial statements.

In our opinion, except for the possible effects of the matter described in the ***Basis for Qualified Opinion*** section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of the MERHCF as of September 30, 2025 and its net cost of operations, changes in net position, and budgetary resources for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Qualified Opinion

We were unable to obtain sufficient appropriate evidential matter to support the costs of Direct Care provided by the Defense Health Agency (DHA)-managed Military Treatment Facilities (MTF). The actuarial liability for Medicare-eligible retiree benefits as of September 30, 2025 includes approximately \$179.4 billion (18% of total) of amounts, reflecting the actuarial present value of the projected Direct Care costs of benefits to be provided by the MTFs to eligible participants in the MERHCF. Additionally, the reported amounts of program revenues and costs, for the year ended September 30, 2025, include approximately \$4.8 billion and \$2.4 billion, respectively, of amounts related to the Direct Care costs.

The MERHCF recognizes expenses based on quarterly prospective payments made to the Defense Health Program (DHP) to support the operations of the MTFs on an ongoing basis as a result of care provided to MERHCF beneficiaries. The MERHCF implemented the Financial Management Information System (FMIS) dashboard to reconcile MTF earnings, based on accumulated patient-level encounter data, to the quarterly prospective distributions made to the DHP. The MERHCF's quarterly distribution methodology and FMIS dashboard reconciliation could not properly validate the completeness and accuracy of Direct Care cost expenditures. The MERHCF also makes quarterly distributions to the Branches of Service (BoS) for Military Personnel (MILPERS) costs related to Direct Care. The MERHCF was unable to provide sufficient and appropriate audit evidence to demonstrate the completeness and accuracy of distributions made to the DHP and the BoS.



We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS); the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 24-02, *Audit Requirements for Federal Financial Statements*. Our responsibilities under those standards are further described in the ***Auditor's Responsibilities for the Audit of the Financial Statements*** section of our report. We are required to be independent of the MERHCF and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for: 1) the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America; 2) the preparation, measurement, and presentation of required supplementary information (RSI) in accordance with U.S. generally accepted accounting principles; 3) the preparation and presentation of other information included in the MERHCF's Agency Financial Report (AFR), as well as ensuring the consistency of that information with the audited financial statements and the RSI; and 4) the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the MERHCF's ability to continue as a going concern for a reasonable period of time beyond the financial statement date.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and, therefore, is not a guarantee that an audit conducted in accordance with GAAS and *Government Auditing Standards* will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on financial statements.

In performing an audit in accordance with GAAS and *Government Auditing Standards*, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit



- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the MERHCF's internal control. Accordingly, no such opinion is expressed
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the MERHCF's ability to continue as a going concern for a reasonable period of time beyond the financial statement date.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Required Supplementary Information

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

Other Information

Management is responsible for the other information included in the AFR. The other information comprises the Summary of Financial Statement Audit and Management Assurances, but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information, and we do not express an opinion or any form of assurance thereon.



In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards* and OMB Bulletin No. 24-02, we have also issued reports, dated November 14, 2025, on our consideration of the MERHCF's internal control over financial reporting and on our tests of the MERHCF's compliance with certain provisions of laws, regulations, contracts, and grant agreements, as well as other matters. The purpose of those reports is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the MERHCF's internal control over financial reporting or on compliance and other matters. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 24-02 in considering the MERHCF's internal control over financial reporting and compliance.

A handwritten signature in blue ink that reads "Kearney & Company".

Alexandria, Virginia
November 14, 2025



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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

We have audited, in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 24-02, *Audit Requirements for Federal Financial Statements*, the financial statements, and the related notes to the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2025, which collectively comprise the MERHCF's financial statements, and we have issued our report thereon dated November 14, 2025.

Report on Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the MERHCF's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the MERHCF's internal control. Accordingly, we do not express an opinion on the effectiveness of the MERHCF's internal control. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 24-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations.

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

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We consider the deficiency in the MERHCF's internal control, as described in the accompanying **Schedule of Findings** as Item I, to be a material weakness.



A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency in the MERHCF's internal control, as described in the accompanying **Schedule of Findings** as Item II, to be a significant deficiency.

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

The Medicare-Eligible Retiree Health Care Fund's Response to Findings

Government Auditing Standards requires the auditor to perform limited procedures on the MERHCF's response to the findings identified in our audit and described in the accompanying **Schedule of Findings**. The MERHCF concurred with the findings identified in our engagement. The MERHCF's response was not subjected to the other auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the response.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and the results of that testing, and not to provide an opinion on the effectiveness of the MERHCF's internal control. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 24-02 in considering the MERHCF's internal control. Accordingly, this report is not suitable for any other purpose.

A handwritten signature in blue ink that reads "Kearney & Company".

Alexandria, Virginia
November 14, 2025



Schedule of Findings

Material Weakness

I. Direct Care Cost (*Modified Repeat Condition*)

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

The MERHCF's prospective payments are made to the DHP in advance of health care provided. Direct Care costs are incurred by the various MTFs managed by the DHA in various locations and are categorized as institutional, professional, and pharmaceutical (Rx) costs. The prospective payments for Direct Care are fixed based on estimated costs for the anticipated Medicare-eligible beneficiary workload, by MTF. The distribution estimates are based on data from the prior two fiscal years (FY). The MERHCF is responsible for developing policies and procedures that validate estimated costs against actual costs. The MERHCF also makes quarterly distributions to the BoS for Military Personnel (MILPERS) costs related to Direct Care.

An update of the corrective actions in progress was provided by MERHCF leadership during the annual Distribution Plan meeting, in addition to subsequent discussions regarding remediation efforts. The MERHCF began implementing significant remediation efforts through the deployment of the Financial Management Information System (FMIS) dashboard. The dashboard is leveraged to reconcile MTF earnings, based on accumulated execution workload data, to the quarterly prospective distributions. The workload data is derived from the Military Health System (MHS) Data Repository (MDR), which houses patient encounter records from systems such as MHS GENESIS, Composite Health Care System (CHCS), and Pharmacy Data Warehouse (PDW). The FMIS dashboard process was implemented in FY 2025 and used to adjust financial reporting as of June 30, 2025.

The reconciliation performed over the first three quarters of FY 2025 workload data resulted in the MERHCF recording an adjustment for the difference between the distribution and accumulated earnings valuation as of June 30, 2025. The reconciliation impacting June 30, 2025 reporting consisted solely of actual workload data. For the reconciliation impacting September 30, 2025 reporting, the MERHCF implemented a process to capture inferred records, in addition to actual workload data. The MERHCF recorded an adjusting journal entry for the actual workload assessed and an accrual for the inferred claims backlog as of September 30, 2025. The inferred records captured within the reconciliation resulting in an accrual are defined as encounters that have occurred as of a specific date but have not completed the coding process.



The reconciliation relies on the medical coding supporting the workload to be accurate. DHA Data Quality Management Control (DQMC) contracts with a third party to perform annual audits over the MTFs' medical coding accuracy in accordance with Department of Defense (DoD) Instructions (DoDI) 6040.40, *MHS DQMC Program*, and 6040.42, *Management Standards for Medical Coding of DoD Health Records*. The most recent DHA external coding audit was performed in FY 2024, representing an audit of medical records that were coded from October 1, 2022 to September 30, 2023. The audit consisted of verifying the coding accuracy of medical encounters by reperforming coding procedures in accordance with industry standards and MHS Coding Guidelines. The report concluded that DHA coding accuracy for inpatient and outpatient encounters did not meet industry standards or established MHS Coding Guidelines.

Condition: The MERHCF's FY 2025 quarterly prospective payments resulted in \$2.38 billion in expenses for Direct Care costs as of September 30, 2025. The MERHCF has not formalized and documented its internal control environment of the FMIS Dashboard reconciliation process, to include the identification and implementation of controls, ensuring the MERHCF achieves financial reporting objectives over Direct Care expenditures. The MERHCF's quarterly distribution methodology and FMIS dashboard reconciliation could not properly validate the completeness and accuracy of Direct Care cost expenditures. The MERHCF was unable to provide sufficient and appropriate audit evidence to demonstrate the completeness and accuracy of distributions made to DHP and the BoS. Specifically, the MERHCF was unable to provide timely:

- The financial impact of coding errors reported for non-billable encounters, per the report, entitled *FY 2024 MTF External (Independent) Coding Audit Findings and Recommendations*
- A formalized accrual methodology and appropriate supporting documentation for the recognition of expenses pertaining to inferred records
- Support for the development of MILPERS payments made to the BoS for Direct Care.

Cause: The MERHCF has not established an effective business process with associated internal controls to properly recognize expenses pertaining to Medicare-eligible beneficiaries who receive care at MTFs. The cost of Direct Care is not initially recorded transactionally at the patient-level. Instead, the cost is recorded prospectively based on prior workload data utilized to calculate an estimated level of effort that is inflated using inflation factors from the President's Budget. The reconciliation process was developed to support the expenses at the patient-level using encounter data. It was implemented for financial reporting purposes as of June 30, 2025 and, therefore, documentation in response to auditor requests remained in development in support of FY 2025 reporting.

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



Recommendations: Kearney & Company, P.C. (Kearney) recommends that the MERHCF perform the following:

1. Design and implement a control environment for the FMIS Dashboard reconciliation, including defined control activities, responsible personnel, and monitoring. All control activities should be properly documented to demonstrate effectiveness and support audit readiness.
2. Prepare and finalize an assessment of the financial impact of coding errors on non-billable encounters pertaining to the MERHCF which impact the FMIS dashboard reconciliation process.
 - a. Consider development of a position paper addressing the coding accuracy rates specific to MERHCF encounters and an associated materiality analysis for the financial impact on the MERHCF.
 - b. Coordinate review of the assessment with the DHA Revenue Cycle Management and Medical Coding offices.
3. Develop and formalize a methodology for monitoring and recording costs associated with inferred records, to include: relevant materiality assessment(s), documented record types for inclusion, assessment of the lag time between patient encounter and completion of coding, and establishment of a process for validating the completeness of the data supporting the determination.
4. Continue utilizing the FMIS dashboard reconciliation process to assess the financial reporting impact of prospective distributions.
5. Include process documentation, methodology, and support for the inputs that contribute to the development of the quarterly MILPERS payments made to the BoS for Direct Care in response to audit requests for the Direct Care Distribution Plan.

* * * * *



Significant Deficiency

II. Information Systems (*Modified Repeat Condition*)

Background: The Medicare-Eligible Retiree Health Care Fund (MERHCF) operates in a complex information system (IS) environment to execute its mission and record transactions timely and accurately. The MERHCF operates or relies on external providers for administration of multiple key financial management systems, including two core accounting systems and multiple financial support systems. The Defense Enrollment Eligibility Reporting System (DEERS) supports key medical benefit payment activities. Pharmacy Data Warehouse (PDW) is a centralized data repository used to consolidate, store, and analyze pharmaceutical transaction data across the Military Health System (MHS). DEERS and PDW are administrated by a service organization. For all key financial management systems, the MERHCF is required, per Department of Defense (DoD) Instruction (DoDI) No. 8510.10, *Risk Management Framework (RMF) for DoD Systems*, Section 2.7, to implement security controls in accordance with National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53, Revision (Rev.) 5, *Security and Privacy Controls for Information Systems and Organizations*.

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

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

Our testing disclosed deficiencies in the following areas:

- Access Controls and Segregation of Duties (SD)
 - Incomplete or not fully implemented policies and procedures for managing and monitoring access to key financial management applications and databases, including third-party systems
 - Incomplete or not fully implemented policies and procedures for the proper SD, including documented business justifications for existing SD conflicts, for key financial management applications
 - Inconsistent implementation of user account recertification to verify the propriety of access to key financial management systems



- Configuration Management
 - Incomplete, inconsistent, or unmaintained documentation of configuration changes for key financial management applications, to support the continuous monitoring of the established baselines.

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

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

Recommendations: Kearney recommends that the MERHCF perform the following:

1. Develop and implement a QC review over the user authorization, user access review, and separations processes, to include procedures to ensure the completeness and accuracy of the access request forms and access listings reviewed.
2. Design and implement controls to mitigate any SD risks identified.
3. Update and implement configuration management procedures to include QC reviews. These reviews should ensure that all authorized changes were properly migrated to the production server and no unauthorized changes were made to the environment.

* * * *



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

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

We have audited, in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 24-02, *Audit Requirements for Federal Financial Statements*, the financial statements, and the related notes to the financial statements of the Medicare-Eligible Retiree Health Care Fund (MERHCF) as of and for the year ended September 30, 2025, which collectively comprise the MERHCF's financial statements, and we have issued our report thereon dated November 14, 2025.

Report on Compliance and Other Matters

As part of obtaining reasonable assurance about whether the MERHCF's financial statements are free from material misstatement, we performed tests of the MERHCF's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts and disclosures, including the provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA). However, providing an opinion on compliance with those provisions was not an objective of our audit; accordingly, we do not express such an opinion. The results of our tests, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 24-02.

The results of our tests of compliance with FFMIA disclosed that the MERHCF's financial management systems did not comply substantially with Section 803(a) requirements related to Federal financial management system requirements, applicable Federal accounting standards, or application of the United States Standard General Ledger at the transaction level, as described in the accompanying **Schedule of Finding** as Item I.

The Medicare-Eligible Retiree Health Care Fund's Response to Finding

Government Auditing Standards requires the auditor to perform limited procedures on the MERHCF's response to the findings identified in our audit and described in the accompanying **Schedule of Finding**. The MERHCF's response to the findings identified in our engagement is described in a separate memorandum attached to this report in the Financial Section of the Agency Financial Report. The MERHCF concurred with the findings identified in our engagement. The MERHCF's response was not subjected to the other auditing procedures



applied in the audit of the financial statements and, accordingly, we express no opinion on the response.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements and the results of that testing, and not to provide an opinion on the effectiveness of the MERHCF's compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* and OMB Bulletin No. 24-02 in considering the MERHCF's compliance. Accordingly, this report is not suitable for any other purpose.

A handwritten signature in blue ink that reads "Kearney & Company".

Alexandria, Virginia
November 14, 2025



Schedule of Finding

Noncompliance and Other Matters

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

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

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

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

Federal Financial Management Systems Requirements

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

Applicable Federal Accounting Standards

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

The financial management systems and Federal accounting standards utilized by the MERHCF, with respect to Direct Care costs, do not fully, efficiently, and effectively support the MERHCF's efforts to:

- Consistently, completely, and accurately record and account for Federal revenues, expenditures, costs, and associated liabilities



- Provide timely and reliable Federal financial management information of appropriate form and content
- Execute all of the above in a way that is consistent with Federal accounting standards and the USSGL.

Standard General Ledger at the Transaction Level

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

* * * *

Principal Statements

The accompanying notes are an integral part of these financial statements

Balance Sheet

Department of War
Medicare-Eligible Retiree Health Care Fund
BALANCE SHEET
As of September 30, 2025
(\$ In Thousands)

	2025
ASSETS (Note 2)	
Intragovernmental:	
Fund Balance with Treasury (Note 3)	\$ 131,183
Investments, Net (Note 5)	<u>425,258,693</u>
Total Intragovernmental	<u>425,389,876</u>
Other than Intragovernmental:	
Cash and Other Monetary Assets (Note 4)	9
Accounts Receivable, Net (Note 6)	<u>534,053</u>
Total Other than Intragovernmental	<u>534,062</u>
TOTAL ASSETS	<u>425,923,938</u>
LIABILITIES (Note 7)	
Intragovernmental:	
Accounts Payable	22,878
Other Liabilities (Notes 9)	<u>30,985</u>
Total Intragovernmental	<u>53,863</u>
Other than Intragovernmental:	
Accounts Payable	201,713
Federal Employee and Veterans Benefits Payable (Note 8)	1,014,466,033
Other Liabilities (Notes 9)	<u>9</u>
Total Other Than Intragovernmental	<u>1,014,667,755</u>
TOTAL LIABILITIES	<u>1,014,721,618</u>
Commitments and Contingencies	
NET POSITION	
Cumulative Results of Operations – Funds Other than Dedicated Collections	<u>(588,797,680)</u>
TOTAL NET POSITION	<u>(588,797,680)</u>
TOTAL LIABILITIES AND NET POSITION	<u>\$ 425,923,938</u>

The accompanying notes are an integral part of these financial statements

Statement of Net Cost

Department of War
Medicare-Eligible Retiree Health Care Fund
STATEMENT OF NET COST
For the Year Ended September 30, 2025
(**\$ In Thousands**)

		2025
Program Costs (Note 11)		
Military Retirement Benefits		
Actuarial Non-Assumption Costs	\$ 0	
Other Program Costs	42,833,958	
Total Gross Costs	<u>42,833,958</u>	
Less: Earned Revenue	<u>(43,783,946)</u>	
Net Military Retirement Benefits Costs	(949,988)	
Losses/(Gains) from Actuarial Assumption Changes (Note 8)	50,530,518	
Net Program Costs Including Assumption Changes	<u>49,580,530</u>	
Net Cost of Operations	<u>\$ 49,580,530</u>	

The accompanying notes are an integral part of these financial statements

Statement of Changes in Net Position

Department of War
Medicare-Eligible Retiree Health Care Fund
STATEMENT OF CHANGES IN NET POSITION
For the Year Ended September 30, 2025
(\$ In Thousands)

	<u>2025</u>
CUMULATIVE RESULTS OF OPERATIONS	
Beginning Balances	\$ (539,217,150)
Imputed Financing	0
Net Cost of Operations (+/-)	<u>49,580,530</u>
Net Change in Cumulative Results of Operations	<u>(49,580,530)</u>
Total Cumulative Results of Operations	<u>(588,797,680)</u>
Net Position	<u>\$ (588,797,680)</u>

The accompanying notes are an integral part of these financial statements

Statement of Budgetary Resources

Department of War
Medicare-Eligible Retiree Health Care Fund
STATEMENT OF BUDGETARY RESOURCES
For the Year Ended September 30, 2025
(\$ In Thousands)

	2025
BUDGETARY RESOURCES	
Unobligated balance from prior year budget authority, net (Note 12)	\$ 0
Appropriations (discretionary and mandatory)	<u>12,974,761</u>
Total Budgetary Resources	<u><u>12,974,761</u></u>
STATUS OF BUDGETARY RESOURCES	
New obligations and upward adjustments (total)	<u>12,974,761</u>
Total Budgetary Resources	<u><u>12,974,761</u></u>
OUTLAYS, NET	
Outlays, net (total) (discretionary and mandatory)	12,952,657
Distributed offsetting receipts (-)	<u>(31,931,340)</u>
Agency Outlays, net (discretionary and mandatory)	<u><u>\$ (18,978,683)</u></u>

The accompanying notes are an integral part of these financial statements

Footnotes to the Principal Statements

DoW MERHCF Footnotes to the Principal Financial Statements

Note 1: Reporting Entity and Summary of Significant Accounting Policies

A. Reporting Entity

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

B. Mission of the Reporting Entity

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

C. Basis of Presentation

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

The MERHCF currently has one auditor-identified financial statement material weakness that is based on two separate Notices of Finding and Recommendation (NFRs). The NFRs are: Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls; and Direct Care Cost Completeness and Accuracy. Details of the material weakness are:

1. Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls:

The MERHCF has not formalized and documented its internal control environment of the FMIS Dashboard reconciliation process, to include the identification and implementation of controls, ensuring the MERHCF achieves financial reporting objectives over Direct Care expenditures.

2. Direct Care Cost Completeness and Accuracy:

The MERHCF's FY 2025 quarterly prospective payments resulted in \$2.38 billion in expenses for Direct Care costs as of 30 September 2025. The MERHCF's quarterly distribution methodology and FMIS dashboard reconciliation could not properly validate the completeness and accuracy of Direct Care cost expenditures. The MERHCF was unable to provide sufficient and appropriate audit evidence to demonstrate the completeness and accuracy of distributions made to DHA and the BoS. Specifically, the MERHCF was unable to provide timely:

- The financial impact of coding errors reported for non-billable encounters, per the FY 2024 MTF External (Independent) Coding Audit Findings and Recommendations report
- A formalized accrual methodology and appropriate supporting documentation for the recognition of expenses pertaining to inferred records
- Support for the development of MILPERS payments made to the BoS for Direct Care.

D. Basis of Accounting

The MERHCF's financial management systems record and report on the accrual basis. Financial and nonfinancial feeder systems and processes are updated from legacy systems to collect and report financial information in accordance with U.S. GAAP.

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

E. Accounting for Intragovernmental and Intergovernmental Activities

Treasury Financial Manual (TFM), Volume I, Part 2, Chapter 4700, provides guidance for reporting and reconciling intragovernmental balances. The MERHCF is able to reconcile balances pertaining to investments in federal securities. For additional information, see Note 11, Disclosures Related to the Statement of Net Cost

F. Non-Entity Assets

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

DoW MERHCF Footnotes to the Principal Financial Statements

G. Fund Balance with Treasury

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

In addition, DFAS and other DoW Agency service centers report to the Treasury by appropriation on interagency transfers, collections received, and disbursements issued. The Treasury records these transactions to the applicable Fund Balance with Treasury (FBWT) account.

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

H. Cash and Other Monetary Assets

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

I. Investments

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

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

J. Accounts Receivable

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

Since the beginning of the Federal Ceiling Price (FCP) Program, professional pharmaceuticals purchased by DoW for MTF pharmacies have been subject to FCPs, as have those under the TRICARE Mail Order Pharmacy (TMOP) program. The MERHCF implemented FCPs for the TRICARE Retail Pharmacy program in compliance with the National Defense Authorization Act for Fiscal Year 2008, §703. The Final Rule was published March 17, 2009, with an effective date of May 26, 2009. The MERHCF applied this rule to all retail prescriptions filled on or after January 27, 2008, unless the DHA, formerly TRICARE Management Activity, granted a waiver to a

DoW MERHCF Footnotes to the Principal Financial Statements

particular manufacturer. Compliance is mandatory and the advantage to the manufacturers is that their drugs will be included on the DoW Uniform Formulary (list of available prescription drugs). The MERHCF will record accounts receivable upon receipt of the calculation from the TRICARE Pharmacy Operations Directorate and will post collections from the manufacturers to the fiscal year of receipt pursuant to Title 10, U.S.C. §1079a.

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

K. Liabilities

Liabilities represent the probable future outflow or other sacrifice of resources as a result of past transactions or events. However, no liability can be paid by the Department absent proper budget authority. Liabilities covered by budgetary resources are appropriated funds for which funding is otherwise available to pay amounts due. The MERHCF Liabilities Not Covered by Budgetary Resources represents the portion of the actuarial liability for health benefits for which current assets are not yet available. These liabilities are reported on Note 7, Liabilities Not Covered by Budgetary Resources.

L. Other Liabilities

Deposit Funds and Suspense Accounts consist of undeposited collections received after the Treasury month-end cutoff. A corresponding liability is created because the MERHCF is not entitled to use the funds until deposited with the Treasury. These undeposited collections are reported on Note 4, Cash and Other Monetary Assets. For additional information, see Note 9, Other Liabilities.

M. Commitments and Contingencies

The MERHCF recognizes contingent liabilities on the Balance Sheet for legal actions where management considers an adverse decision to be probable and the loss amount is reasonably estimable. These legal actions are estimated and disclosed in Note 10, Commitments and Contingencies. However, there are no cases pending with MERHCF meeting the threshold guidance.

N. Federal Employee and Veterans Benefits

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

DoW MERHCF Footnotes to the Principal Financial Statements

8, Federal Employee and Veterans Benefits Payable, and Note 11, Disclosures Related to the Statement of Net Cost, for additional information.

O. Revenues and Other Financing Sources

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

P. Recognition of Expenses

For financial reporting purposes, DoW policy requires the recognition of benefit expenses in the period incurred. Estimates are used in the computation of actuarial liabilities. The current financial management systems for the MERHCF collect and record financial information on the full accrual accounting basis for liabilities and expenses of the fund. The MERHCF Direct Care process calculates their expenses using policies from the FMR, Volume 12, Chapter 16, December 2019.

Q. Budgetary Resources

The purpose of federal budgetary accounting is to control, monitor, and report on funds made available to federal agencies by law and help ensure compliance with the law.

The following budgetary terms are commonly used:

Appropriation is a provision of law (not necessarily in an appropriations act) authorizing the expenditure of funds for a given purpose. Usually, but not always, an appropriation provides budget authority.

Budgetary resources are amounts available to incur obligations in a given year. Budgetary resources consist of new budget authority and unobligated balances of budget authority provided in previous years.

Obligation is a binding agreement that will result in outlays, immediately or in the future. Budgetary resources must be available before obligations can be incurred legally.

Offsetting Collections are payments to the Government that, by law, are credited directly to expenditure accounts and deducted from gross budget authority and outlays of the expenditure account, rather than added to receipts. Usually, offsetting collections are authorized to be spent for the purposes of the account without further action by Congress. They usually result from business-like transactions with the public, including payments from the public in exchange for goods and services, reimbursements for damages, and gifts or donations of money to the Government and from intragovernmental transactions with other Government accounts. The authority to spend collections is a form of budget authority.

DoW MERHCF Footnotes to the Principal Financial Statements

Offsetting receipts are payments to the Government that are credited to offsetting receipt accounts and deducted from gross budget authority and outlays, rather than added to receipts. Usually, they are deducted at the level of the agency and subfunction, but in some cases they are deducted at the level of the Government as a whole. They are not authorized to be credited to expenditure accounts. The legislation that authorizes the offsetting receipts may earmark them for a specific purpose and either appropriate them for expenditures for that purpose or require them to be appropriated in annual appropriations acts before they can be spent. Like offsetting collections, they usually result from business-like transactions with the public, including payments from the public in exchange for goods and services, reimbursements for damages, and gifts or donations of money to the Government, and from intragovernmental transactions with other Government accounts.

Outlays are the liquidation of an obligation that generally takes the form of an electronic funds transfer. Outlays are reported both gross and net of offsetting collections and they are the measure of Government spending.

R. Use of Estimates

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

S. Tax Exempt Status

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

Note 2: Non-Entity Assets

As of September 30,	<u>2025</u>
(\$ In Thousands)	
Total Non-Entity Assets	\$ 0
Total Entity Assets	<u>425,923,938</u>
Total Assets	<u>425,923,938</u>

The MERHCF has stewardship accountability and reporting responsibility for non-entity assets. Non-entity assets consist of assets held by but not available to the MERHCF. These are offset by the MERHCF's liabilities to accurately reflect the MERHCF's net position. Refer to Note 7, Liabilities Not Covered by Budgetary Resources.

Note 3: Fund Balance with Treasury

As of September 30,	<u>2025</u>
(\$ In Thousands)	
Unobligated Balance – Unavailable	\$ 400,232,668

DoW MERHCF Footnotes to the Principal Financial Statements

Obligated Balance not yet Disbursed	396,647
Non-FBWT Budgetary Accounts	<u>(400,498,132)</u>
Total FBWT	\$ <u>131,183</u>

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

Unobligated Balance represents the cumulative amount of budgetary authority set aside to cover future obligations.

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

Non-FBWT budgetary accounts create budget authority and unobligated balances, but do not record to FBWT as there has been no receipt of cash or direct budget authority, such as appropriations. The MERHCF Non-FBWT Budgetary Accounts balance represents investments in Treasury securities that are reflected in the MERHCF's budgetary resources but are not part of the FBWT. Treasury securities provide the MERHCF with budgetary authority and enables the MERHCF to access funds to make future benefit payments or other expenditures. The MERHCF must redeem these securities before they become part of the FBWT.

Note 4: Cash and Other Monetary Assets

As of September 30, (\$ In Thousands)	2025
1. Cash	\$ 9
2. Foreign Currency	0
3. Other Monetary Assets	0
4. Total Cash, Foreign Currency, & Other Monetary Assets	\$ 9

Cash and other monetary assets consist of undeposited collections received after the U.S. Treasury month-end cutoff. A corresponding liability is created because the MERHCF is not entitled to use the funds until deposited with the U.S. Treasury. This liability is reported on Note 9, Other Liabilities.

DoW MERHCF Footnotes to the Principal Financial Statements

Note 5: Investments, Net

As Of September 30,

Amounts for 2025 Balance Sheet Reporting

(\$ In Thousands)	<u>Cost</u>	<u>Amortization Method</u>	<u>Amortized (Premium)/ Discount</u>	<u>Interest Receivable</u>	<u>Investments, Net</u>	<u>Unrealized Gain/(Loss)</u>	<u>Market Value</u>
Intragovernmental Securities							
Nonmarketable, Market-Based							
Nonmarketable, Market-Based	\$ 442,800,319	<u>Effective Interest</u>	\$ (20,645,392)	\$ 3,103,766	\$ 425,258,693	\$ (38,467,983)	\$ 386,790,710
Total	\$ 442,800,319		\$ (20,645,392)	\$ 3,103,766	\$ 425,258,693	\$ (38,467,983)	\$ 386,790,710

The MERHCF invests primarily in non-marketable, market-based Treasury securities. The value of these securities fluctuates in tandem with the selling price of the equivalent marketable security. Securities are purchased with the intent to hold until maturity; thus, balances are not adjusted to market value. See Note 1.I, Investments, for additional information.

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

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

At the semiannual meetings, the Department of War Investment Board approves the strategy for the type of securities purchased by the MERHCF. These securities can include Treasury bills, notes, bonds, inflation-protected securities, overnight certificates, and ZCBs. The Treasury bills are short-term securities with maturities of one year or less and are purchased at a discount. The Treasury notes have maturities of at least one year, but not more than ten years, and are purchased at either a discount or premium. The Treasury bonds are long-term securities with maturities of ten years or more and are purchased at either a discount or premium. The TIPS provide protection against inflation and are purchased at either a discount or premium. The TIPS principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When TIPS mature, the Treasury pays the adjusted principal or original principal, whichever is greater. The TIPS amount includes inflation compensation as well as the par value of the securities. Treasury ZCBs are fixed-principal bonds having maturities of at least five years and are purchased at a discount. Overnight securities are short-

DoW MERHCF Footnotes to the Principal Financial Statements

term securities purchased at face value. They mature the business day after purchase and earn interest at the daily Federal Reserve repurchase agreement rate.

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

COST FY 2025 (\$ in Thousands)	
Notes	\$ 0
Bonds	72,567,830
TIPS	357,251,918
ZCB	8,998,912
Overnights	3,981,659
Total Cost	<u>\$442,800,319</u>

Note 6: Accounts Receivable, Net

As of September 30,
(\$ In Thousands)

	2025		
	Gross Amount Due	Allowance For Estimated Uncollectibles	Accounts Receivable, Net
Nonfederal Receivables (From the Public)	\$ 538,282	\$ (4,229)	\$ 534,053
Total	\$ 538,282	\$ (4,229)	\$ 534,053

Accounts Receivable represent DHA-CRM's claim for payment from other entities. The method used to calculate the percentage for bad debt allowance on the Accounts Receivable balances is determined by taking a 36-month average of the Accounts Receivable balance against the 36-month average on the Write Off balance per each Receivable category. The data from the prior 36-months is used to calculate the percentages for the allowance. DHA-CRM has one specific Accounts Receivable category that follows a different percentage calculation rule, the "Suspended Pharmacy" category. Per a DHA HCFD directive that prevents DHA-CRM's Pharmacy contractor from pursuing collection action against Suspended Pharmacies while under investigation, DHA-CRM uses a 100% Allowance methodology for calculating the debt against the Accounts Receivable balance. Claims with other federal agencies are resolved in accordance with the business rules published in Appendix 5 of TFM, Volume I, Part 2, Chapter 4700.

FASAB issued Technical Bulletin 2020-1, Loss Allowance for Intragovernmental Receivables, which clarified previously issued guidance. An allowance recorded to recognize an intragovernmental receivable at net realizable value on the financial statements does not alter the underlying statutory authority to collect the receivable or the legal obligation of the other intragovernmental entity to pay. For FY 2025 the intragovernmental allowance was calculated using the same methodology as for public receivables. DHA-CRM developed its policy, related

DoW MERHCF Footnotes to the Principal Financial Statements

to the allowance for uncollectible accounts for intragovernmental receivables. Based on several years of experience, DHA-CRM concludes that the net realizable value of its intragovernmental receivables is 100%.

As of September 30, 2025, the total net receivables recorded for the SDP and the ADP were \$651.9 million. The SDP resulted from the implementation of the FCP Program for the TRICARE Retail Pharmacy Refunds Program as required by the FY 2008 NDAA, Section 703. The ADP resulted from voluntary agreements between TRICARE and the pharmaceutical manufacturers providing additional discounts above the SDP.

Note 7: Liabilities Not Covered by Budgetary Resources

As of September 30, (\$ In Thousands)	<u>2025</u>
Other	\$ 30,985
Pension, post-employment, and veterans benefits payable	<u>616,168,809</u>
Total Liabilities Not Covered by Budgetary Resources	<u>616,199,794</u>
Total Liabilities Covered by Budgetary Resources	<u>398,521,815</u>
Total Liabilities Not Requiring Budgetary Resources	9
Total Liabilities	<u>\$ 1,014,721,618</u>

Federal Employee and Veterans Benefits Payable consists of various employee actuarial liabilities not due and payable during the current fiscal year. These liabilities primarily consist of \$616.2 billion in health benefit liabilities. Refer to Note 8, Federal Employee and Veterans Benefits Payable, for additional details and disclosures.

Note 8: Federal Employee and Veterans Benefits Payable

Federal Employee and Veterans Benefits Liability

(\$ In Thousands)			<u>2025</u>		
			<u>(Less: Assets</u>		
			<u>Available to Pay</u>		
<u>Major Program Activities</u>	<u>Present Value of Benefits</u>		<u>Benefits)</u>		
Medicare-Eligible					
Retiree Benefits	\$ 1,013,616,725	\$	(398,297,224)	\$	615,319,501
Other	<u>849,308</u>			0	<u>849,308</u>
Total	<u>1,014,466,033</u>	\$	<u>(398,297,224)</u>	\$	<u>616,168,809</u>

DoW MERHCF Footnotes to the Principal Financial Statements

Change in Actuarial Liability		2025
(\$ In Thousands)		2025
Beginning Actuarial Liability	\$	933,144,879
Plus Expenses:		
Normal Cost		25,965,596
Interest Cost		28,582,663
Experience Losses/(Gains)		(11,802,247)
Other Factors		1
Subtotal: Expenses Before Losses/(Gains) from Actuarial Assumption Changes		<u>42,746,013</u>
Actuarial Losses/(Gains) due to:		
Changes in Trend Assumptions		105,994,863
Changes in Assumptions Other Than Trend		<u>(55,464,345)</u>
Subtotal: Losses/(Gains) from Actuarial Assumption Changes		<u>50,530,518</u>
Total Expenses		<u>93,276,531</u>
Less: Benefit Outlays		<u>12,804,685</u>
Total Changes in Actuarial Liability		<u>80,471,846</u>
Ending Actuarial Liability	\$	<u>1,013,616,725</u>

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

The schedule in the Federal Employee and Veterans Benefits Liability Table reflects two distinct types of liabilities related to Military Retirement and Other Federal Employment Benefits. The line entitled "Medicare-Eligible Retiree Benefits" represents the actuarial (or accrued) liability for future health care benefits provided to Medicare-eligible retired beneficiaries that are not yet incurred, i.e., the present value of future benefits less the present value of future normal costs. The line entitled "Other Factors" represents the incurred-but-not-reported reserve (IBNR), which is an estimate of MERHCF benefits already incurred but not yet reported to DoW.

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

Effective FY 2010, the MERHCF implemented requirements of SFFAS No. 33, which directs that the discount rate, underlying inflation rate, and other economic assumptions be consistent with one

DoW MERHCF Footnotes to the Principal Financial Statements

another. A change in the discount rate may cause other assumptions to change as well. For the September 30, 2025, financial statement valuation, the application of SFFAS No. 33 required DoW OACT to set the long-term inflation (CPI) to be consistent with the underlying Treasury spot rates used in the valuation.

The MERHCF actuarial liability is adjusted at the end of each fiscal year. The 4th Quarter, FY 2025 balance represents the September 30, 2025 amount that will be effective through 3rd Quarter, FY 2026.

Actuarial Cost Method

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

Revenues

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

Assumptions

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

For the FY 2025 financial-statement valuation, the long-term assumptions include a 3.2% discount rate and medical trend rates that were developed using a 3.1% inflation assumption. (For the most recent funding valuation, the long-term assumptions included a 4.50% discount rate and medical trend rates that were developed using a 2.75% inflation assumption.) Note that the term ‘discount rate’ refers to the interest rate used to discount cash flows. The terms ‘interest rate’ and ‘discount rate’ are often used interchangeably in this context.

The difference in the long-term assumptions between funding and financial statement valuations is attributable to SFFAS No. 33. This applicable financial statement standard is described further below. Other assumptions used to calculate the actuarial liabilities, such as mortality and retirement rates, were based on a blend of actual experience and future expectations. Because of reporting deadlines and as permitted by SFFAS No. 33, the current year actuarial liability is rolled forward from the prior year valuation results as reported in DoW OACT’s ‘Valuation of the

DoW MERHCF Footnotes to the Principal Financial Statements

Medicare-Eligible Retiree Health Care Fund' using accepted actuarial methods. Modifications are made as necessary to convert liabilities to a financial statement basis. For purposes of the Fund's financial reporting, this roll-forward process is applied annually.

In calculating the FY 2025 "rolled-forward" actuarial liability, the following assumptions were used:

Discount Rate	3.2%
Inflation	3.1%

Medical Trend (Medicare)	FY 2024 - FY 2025	Ultimate Rate FY 2049
Direct Care Institutional	5.06%	5.10%
Direct Care Professional	6.08%	5.10%
Direct Care Prescription Drugs	9.67%	5.10%
Purchased Care Institutional	4.55%	5.10%
Purchased Care Professional	6.08%	5.10%
Purchased Care Prescription Drugs	11.05%	5.10%
Purchased Care USFHP	6.12%	5.10%

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

The medical cost trend rate assumptions have a significant effect on the amounts reported. For example, if each of the assumed trend rates had increased by one percentage point, the actuarial liability would have increased 33.5%, or approximately \$339.6 billion.

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

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

DoW MERHCF Footnotes to the Principal Financial Statements

DoW complies with SFFAS No. 33, "Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates." The standard requires the separate presentation of gains and losses from changes in long-term assumptions used to estimate liabilities associated with pensions, other retirement and other postemployment benefits. SFFAS No. 33 also provides a standard for selecting the discount rate and valuation date used in estimating these liabilities. SFFAS No. 33, as published on October 14, 2008, by the Federal Accounting Standards Advisory Board (FASAB) requires the use of a yield curve based on marketable U.S. Treasury securities to determine the discount rates used to calculate actuarial liabilities for federal financial statements. Historical experience is the basis for expectations about future trends in marketable U.S. Treasury securities.

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

DoW OACT annually performs two MERHCF valuations. The primary one is for funding purposes, is governed by Chapter 56 of Title 10 U.S.C. and must use methods and assumptions approved by the Board. The other valuation is for financial statement purposes and is governed by FASAB standards. For the September 30, 2025, financial-statement valuation, DoW OACT determined a single equivalent discount rate of 3.2% by using a 10-year average of quarterly zero-coupon Treasury spot rates. These spot rates are based on the U.S. Department of the Treasury – Office of Economic Policy's 10-year Average Yield Curve for Treasury Nominal Coupon Issues (TNC yield curve), which represents average rates from April 1, 2015 through March 31, 2025. The same spot rate data source was used to produce last year's financial statements. In the summer of 2025, the Board approved a discount rate of 4.50% for the September 30, 2024, funding valuation, which differs from the SFFAS No. 33 equivalent rate by 130 basis points. Using the SFFAS No. 33 long-term economic assumptions (as compared to the Board assumptions) increases the MERHCF actuarial liability by 46.2%.

FY 2025 Actuarial Liability for the Uniformed Services

The MERHCF liability includes Medicare liabilities for all Uniformed Services. The approximate breakout of the September 30, 2025, Medicare liability (\$ in thousands) for all Uniformed Services is as follows:

DoW	\$	987,452,092
United States Coast Guard		23,224,337
Public Health Service		2,768,486
National Oceanic and Atmospheric Administration		171,810
Total	\$	1,013,616,725

DoW MERHCF Footnotes to the Principal Financial Statements

FY 2025 Military Service and Other Uniformed Service Contributions

The FY 2025 Military Service and other Uniformed Service contributions to the MERHCF (\$ in thousands) were as follows:

DoW	\$	11,046,305
United States Coast Guard		290,093
Public Health Service		38,018
National Oceanic and Atmospheric Administration		2,412
Total	\$	11,376,828

Market Value of the MERHCF Securities

The market value of the MERHCF nonmarketable, market-based securities as of September 30, 2025, totaled \$386.8 billion. This amount is also reported on Note 5, Investments, Net.

Note 9: Other Liabilities

(\$ in Thousands)	2025
Other Liabilities	\$ 30,985
Total Intragovernmental	<u>30,985</u>
Liability for non-fiduciary deposit funds and undeposited collections	9
Total Other than Intragovernmental	9
Total Other Liabilities	\$ 30,994

The MERHCF's liability for non-fiduciary deposit funds and undeposited collections consist of undeposited collections received after the U.S. Treasury month-end cutoff. These undeposited collections are reported on Note 4, Cash and Other Monetary Assets.

Note 10: Commitments and Contingencies

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

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

Financial statement reporting is limited to disclosure when conditions for liability recognition do not exist but there is at least a reasonable possibility of incurring a loss or additional losses. Examples of loss contingencies include the collectability of receivables, pending or threatened

DoW MERHCF Footnotes to the Principal Financial Statements

litigation, and possible claims and assessments. The MERHCF risk of loss and resultant contingent liabilities arise from pending or threatened litigation or claims and assessments due to events such as medical malpractice; property or environmental damages; and contract disputes.

There is no case or claim pending with the MERHCF that meets materiality thresholds.

Note 11: Disclosures Related to the Statement of Net Cost

(\$ In Thousands)	2025
Military Retirement Benefits	
Gross Cost	\$ 42,833,958
Less: Earned Revenue	(43,783,946)
Losses/(Gains) from Actuarial Assumption Changes	<u>50,530,518</u>
Net Cost of Operations	<u>\$ 49,580,530</u>

The Statement of Net Cost (SNC) represents the net cost of programs and organizations of the MERHCF supported by appropriations or other means. The intent of the SNC is to provide gross and net cost information related to the amount of output or outcome for a given program or organization administered by a responsible reporting entity. The MERHCF's current processes and systems capture costs based on major programs as presented in the schedule above. The DoW is in the process of reviewing available data and developing a cost reporting methodology required by the Statement of Federal Financial Accounting Standards (SFFAS) No. 4, "Managerial Cost Accounting Concepts and Standards for the Federal Government," as amended by SSFAS No. 55, "Amending Inter-Entity Cost Provisions."

The following table displays the MERHCF intragovernmental revenue:

Intragovernmental Earned Revenue for Program Costs

(\$ in Thousands)	2025
Uniformed Services Contributions	\$11,376,829
U.S. Treasury Annual Unfunded Liability Payment	14,569,000
Interest on Investments	<u>17,838,117</u>
Total Intragovernmental Revenue	<u>\$43,783,946</u>

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

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

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Interest on Investments represents the interest income received by the MERHCF for FY 2025.

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

Note 12: Disclosures Related to the Statement of Changes in Net Position

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

(\$ in Thousands)	2025
Appropriations, Statement of Budgetary Resources	\$ 12,974,761
Permanent and Temporary Reductions	0
Trust and Special Fund Receipts	12,974,761
Miscellaneous items	0
Total Reconciling Difference	<u>12,974,761</u>
Appropriations Received, Statement of Changes in Net Position	<u>\$ 0</u>

There was a difference of \$13.0 billion between Appropriations Received on the Statement of Changes in Net Position (SCNP) and Appropriations on the SBR. The MERHCF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with OMB reporting requirements.

Note 13: Disclosures Related to the Statement of Budgetary Resources

Budgetary Resources Obligated for Undelivered Orders

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

(\$ In Thousands)	2025
Intragovernmental	\$ 117,091
Non-Federal	<u>54.965</u>
Total Budgetary Resources Obligated for Undelivered Orders at the End of the Period	<u>\$ 172,056</u>

Permanent Indefinite Appropriations

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

Legal Arrangements Affecting the Use of Unobligated Balances

The MERHCF unobligated balances of budget authority represent (1) the portion of special fund receipts collected in the current fiscal year that exceed the amount needed to pay benefits or other

DoW MERHCF Footnotes to the Principal Financial Statements

valid obligations and (2) the excess of receipts temporarily precluded from obligation by law due to a benefit formula or other limitation. The receipts, however, are assets of the MERHCF and available for obligation as needed in the future.

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

There was a difference of \$13.0 billion between Appropriations on the SCNP and Appropriations on the SBR. The MERHCF records contributions as revenue on the SCNP, while contributions are recorded as Appropriations on the SBR. This is in accordance with OMB reporting requirements. Refer to Note 12, Disclosures Related to the Statement of Changes in Net Position, for more detail.

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

Note 14: Reconciliation of Net Cost to Net Budgetary Outlays

Reconciliation of Net Cost to Net Budgetary Outlays

As of September 30,

(\$ in Thousands)

	<u>2025</u>		
	Federal	Non-Federal	Total
Net Cost of Operations (SNC)	\$ (38,324,062)	\$ 87,904,592	\$ 49,580,530
Components of Net Operating Cost Not Part of the Budgetary Outlays:			
Increase/(Decrease) in Assets:			
Account Receivable, Net	0	121,568	121,568
Securities and Investments	475,777	0	475,777
Other Assets	0	9	9
(Increase)/Decrease in Liabilities:			
Accounts Payable	25,527	68,820	94,347
Federal Employee and Veterans Benefits Payable	0	(80,596,749)	(80,596,749)
Other Liabilities	(30,985)	(9)	(30,994)
Total Components of Net Operating Cost Not Part of Budgetary Outlays	\$ 470,319	\$ (80,406,361)	\$ (79,936,042)
Miscellaneous Items:			
Distributed Offsetting Receipts	(31,931,340)	0	(31,931,340)
Appropriated Receipts for Trust/Special Funds	0	43,308,169	43,308,169
Total Other Reconciling Items	\$ (31,931,340)	\$ 43,308,169	\$ 11,376,829
Total Net Outlays	\$ (69,785,083)	\$ 50,806,400	\$ (18,978,683)
Budgetary Agency Outlays, Net (SBR)			\$ (18,978,683)

DoW MERHCF Footnotes to the Principal Financial Statements

Unreconciled Difference	\$	0
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The Reconciliation of Net Cost to Net Outlays demonstrates the relationship between the MERHCF's Net Cost of Operations, reported on an accrual basis on the Statement of Net Costs, and Net Outlays, reported on a budgetary basis on the Statement of Budgetary Resources. While budgetary and financial (proprietary) accounting are complementary, the reconciliation explains the inherent differences in timing and in the types of information between the two during the reporting period. The accrual basis of financial accounting is intended to provide a picture of the MERHCF's operations and financial position, including information about costs arising from the consumption of assets and the incurrence of liabilities. Budgetary accounting reports on the management of resources and the use and receipt of cash by the MERHCF. Outlays are payments to liquidate an obligation excluding the repayment to the Treasury of debt principal.

In FY 2025, Components of Net Operating Cost Not Part of the Budgetary Outlays includes non-cash charges primarily consisting of \$80.6 billion in changes in Actuarial Health Insurance Liability.

Miscellaneous Reconciling Items includes \$11.4 billion in receipts that are classified as non-distributed offsetting receipts, therefore are not included in the budgetary reports.

Note 15: Subsequent Events

Subsequent events have been evaluated from the balance sheet date through November 14, 2025, which is the date the financial statements were available to be issued. Management determined that there were no other items to disclose as of September 30, 2025.

Other Information

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

SEPTEMBER 30, 2025

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

The DHP included auditor identified weakness in its annual assessment of internal controls from the prior year audit. Specifically, without appropriate documentation of internal controls over the FMIS Dashboard reconciliation process, there is increased risk of the MERHCF inaccurately comparing prospective distribution amounts to actual expense-incurring encounters by MTF. As a result, the MERHCF may be understating or overstating Direct Care expenditures, resulting in overstated or understated expenses in subsequent periods.

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

The timing of the DHP's assessment (dated September 10, 2025) may cause it to differ from the auditor's reported weakness (dated September 30, 2025) for the current fiscal year. In its FY 2025 assessments, the DHP management can provide reasonable assurance, except for direct care related material weakness, the MERHCF Financial Statement Reporting Entity (FSRE) has effective internal controls to support effective and efficient programmatic operations, reliable financial reporting, and is in process of implementing corrective actions to become fully compliant with applicable laws and regulations (FMFIA § 2). The MERHCF FSRE cannot achieve compliance with (FMFIA § 4) for direct care until the DHP has implemented financial systems that comply with (FMFIA § 4).

Except for the one direct care-related material weakness as documented in the DHA's Annual Statement Required Under the FMFIA, dated September 10, 2025, and the above referenced DHP-related FMFIA § 4 weakness, the MERHCF has effective internal controls over financial reporting.

The Status of FY 2025 Audit Findings and Actions Taken tables include a summary of material weakness (FMFIA § 2) and non-conformances (FMFIA § 4), and summary of corrective actions to resolve the material weakness and non-conformances.

Table 1.

Summary of Financial Statement Audit

Audit Opinion	Modified				
Restatement	No				
<hr/>					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Ending Balance
Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls; Direct Care Cost Completeness and Accuracy (Updated Findings from FY 2005)	✓				✓
<i>Total Material Weaknesses</i>	1	0	0	0	1

Table 2.

Summary of Management Assurances

Effectiveness of Internal Control over Financial Reporting (FMFIA § 2)						
Statement of Assurance	Modified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls; Direct Care Cost Completeness and Accuracy (Updated Findings from FY 2005)	✓	0	0	0	0	✓
<i>Total Material Weaknesses</i>	1	0	0	0	0	1
<hr/>						
Effectiveness of Internal Control over Operations (FMFIA § 2)						
Statement of Assurance	Modified					
Material Weaknesses	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Financial Management Information System Dashboard	✓	0	0	0	0	✓

Other Information

Reconciliation Lack of Documentation Evidencing Internal Controls; Direct Care Cost Completeness and Accuracy (Updated Findings from FY 2005)						
<i>Total Material Weaknesses</i>	1	0	0	0	0	1

Conformance with Federal Financial Management System Requirements (FFMIA § 4)						
Statement of Assurance	Purchased Care systems conform to financial management systems requirements: Direct Care Costs systems do not comply with financial management systems requirements.					
Non-Conformances	Beginning Balance	New	Resolved	Consolidated	Reassessed	Ending Balance
Financial Management Information System Dashboard Reconciliation Lack of Documentation Evidencing Internal Controls; Direct Care Cost Completeness and Accuracy (Updated Findings from FY 2005)	✓					✓
<i>Total non-conformances</i>	1	0	0	0	0	1

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

Exhibit 2--PIIA Reporting Details September 30, 2025**PAYMENT INTEGRITY**

In accordance with the Payment Integrity Information Act of 2019 and Appendix B of the Office of Management and Budget Bulletin No. 24-02 issued July 29, 2024, “Audit Requirements for Federal Financial Statements”, DoW reports payment integrity information at the agency-wide level in the consolidated DoW Agency Financial Report. For detailed reporting on DoW payment integrity, refer to the Other Information section of the consolidated DoW (Audited Financial Report) AFR at: <https://comptroller.war.gov/ODCFO/afr2025.aspx>.