DEPARTMENT OF HEALTH & HUMAN SERVICES Office of Inspector General

Washington, D.C. 20201

MAY 13 2004

TO: Philip Simard
Director
Division of Cost Allocation
Program Support Center

FROM: Dara Corrigan
Acting Principal Deputy Inspector General

SUBJECT: Audit of the Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System (A-04-02-00011)

Attached is an advance copy of our final audit report on the reasonableness of pension charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System (the retirement fund). The report will be issued to the State within 5 business days. We initiated this audit because previous reviews of retirement funds in other States disclosed that the Federal Government did not always receive its equitable share when surplus State pension funds were withdrawn, transferred to other State funds, or used to cover State expenses. In addition, news articles reported that North Carolina had used the employers' share of pension fund contributions to assist in balancing the State's budget.

Our audit was designed to assess whether North Carolina appropriately claimed reimbursement from the Federal Government for expenses related to the retirement fund. Specifically, our audit objectives were to determine whether North Carolina (1) credited the Federal Government for its share of any reductions or redirection of retirement fund contributions and (2) based retirement fund contribution rates on actuarially determined estimates. Our audit covered the period July 1, 1999 through June 30, 2002.

With respect to our first objective regarding reductions or redirection of retirement fund contributions, our review revealed that North Carolina did not comply with Federal cost principles because it claimed reimbursement from federally funded programs for retirement contributions that the State did not fund. With respect to our second objective, North Carolina based retirement fund contributions on actuarially determined estimates as required by the Office of Management and Budget (OMB) Circular A-87. The State's actuary determined the annual required contribution in accordance with the parameters established in Governmental Accounting Standards Board (GASB) Statements 25 and 27.

Recommendation

We recommend that North Carolina refund $7,827,275 (Federal share), plus accrued interest, for unfunded retirement contributions.[1]

In its response to our draft report, North Carolina stated that its partial funding of the required contribution in December 2001 was sufficient to cover the Federal share of the retirement funds initially escrowed to balance the State's budget.

We do not believe that North Carolina is entitled to be reimbursed for the $127.4 million ($7.8 million Federal share) because the State has not funded this amount. Reimbursing the State would result in an inconsistent treatment of Federal and State costs and would not be in accordance with Federal cost principles. Specifically, OMB Circular A-87, Attachment A, C.1.e., requires that in order to be allowable, the cost must "Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit." Therefore, we continue to recommend that North Carolina refund $7.8 million plus accrued interest for the Federal share of unfunded retirement contributions.

Please send us your final management decision, including any action plan, as appropriate, within 60 days. If you have any questions or comments about this report, please do not hesitate to call me or have your staff contact Donald L. Dille, Assistant Inspector General for Grants and Internal Activities, at (202) 619-1175 or through e-mail at ddille@oig.hhs.gov. To facilitate identification, please refer to report number A-04-02-00011 in all correspondence.

Attachments

[1] In the draft report, we stated that the Federal share was $7,271,755. Based on additional information, we adjusted the Federal share to $7,827,275.

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Office of Inspector General
Office of Audit Services

REGION IV
61 Forsyth Street, S.W., Suite 3T41
Atlanta, Georgia 30303

MAY 14 2004

Report Number: A-04-02-00011

Richard H. Moore
State Treasurer
North Carolina Department of State Treasurer
325 North Salisbury Street
Raleigh, North Carolina 27603-1385

Dear Mr. Moore:

Enclosed are two copies of the Department of Health and Human Services (HHS), Office of Inspector General (OIG) report entitled "Audit of the Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System." A copy of this report will be forwarded to the action official noted below for review and any action deemed necessary.

Final determinations as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG reports issued to the Department's grantees and contractors are made available to members of the press and general public to the extent the information is not subject to exemptions in the Act which the Department chooses to exercise (see 45 CFR Part 5).

To facilitate identification, please refer to report number A-04-02-00011 in all correspondence.

Sincerely,

Charles J. Curtis

Charles J. Curtis
Regional Inspector General
for Audit Services, Region IV

Enclosures - as stated

Direct Reply to HHS Action Official:

Mr. William Logan
Director, Mid-Atlantic Office
Division of Cost Allocation
U.S. Department of Health and Human Services
Wilbur Cohen Building, Room 1067
330 Independence Avenue, S.W.
Washington, D.C. 20201

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF THE REASONABLENESS OF PENSION CHARGES TO THE FEDERAL GOVERNMENT FOR THE NORTH CAROLINA TEACHERS' AND STATE EMPLOYEES' RETIREMENT SYSTEM

MAY 2004
A-04-02-00011

EXECUTIVE SUMMARY

BACKGROUND

The Federal Government contributes to States' public employee retirement systems based on approved statewide cost allocation agreements subject to Office of Management and Budget (OMB) Circular A-87, "Cost Principles for State, Local, and Indian Tribal Governments."

OBJECTIVES

Our audit was designed to assess whether North Carolina appropriately claimed reimbursement from the Federal Government for expenses related to the Teachers' and State Employees' Retirement System (retirement fund). Specifically, our audit objectives were to determine whether North Carolina (1) credited the Federal Government for its share of any reductions or redirection of retirement fund contributions and (2) based retirement fund contribution rates on actuarially determined estimates. Our audit covered the period July 1, 1999 through June 30, 2002.

SUMMARY OF FINDINGS

With respect to our first objective regarding reductions or redirection of retirement fund contributions, our review revealed that North Carolina did not comply with Federal cost principles because it claimed reimbursement from federally funded programs for retirement contributions that the State did not fund. With respect to our second objective, North Carolina based retirement fund contributions on actuarially determined estimates as required by OMB Circular A-87. The State's actuary determined the annual required contribution in accordance with the parameters established in Governmental Accounting Standards Board (GASB) Statements 25 and 27.

Federal Share of Retirement Fund Contributions

North Carolina improperly claimed reimbursement from federally funded programs for retirement fund contributions that it did not make. For the period February 1, 2001 through June 30, 2001, North Carolina's contribution should have been $208.4 million ($12.8 million Federal share) when, in fact, it had deposited only $81 million ($5 million Federal share). Although North Carolina claimed reimbursement for the full amount of the actuarially determined contribution, $127.4 million ($7.8 million Federal share) remained unfunded.

Under Federal cost principles, States are not entitled to seek reimbursement from the Federal Government until pension costs are funded by the State. Specifically, OMB Circular A-87, Attachment B, section 11.e.(2), states in part: "Pension costs . . . are allowable for a given fiscal year <u>if they are funded</u> for that year or within six months after the end of that year . . . ." (Emphasis added.)

Other Matter: Actuarial Surplus

Retirement fund assets exceeded actuarial accrued liabilities by $4.4 billion ($315 million Federal share) on December 31, 2001.[1] An actuarial surplus existed because investment income from retirement fund assets exceeded actuarial estimates and the State changed its asset valuation methodology, which resulted in actuarial surpluses from December 1998 through 2001.

North Carolina has taken steps to address the actuarial surplus, including reducing future employer contribution rates, granting cost-of-living increases to retirees, and reducing the assumed return on investment rate. However, it should periodically reassess the contribution rates to ensure actuarial balance.

Recommendation

We recommend that North Carolina refund $7,827,275 (Federal share), plus accrued interest, for unfunded retirement contributions.[2]

In its response to our draft report, North Carolina stated that its partial funding of the required contribution in December 2001 was sufficient to cover the Federal share of the retirement funds initially escrowed to balance the State's budget.

We do not believe that North Carolina is entitled to be reimbursed for the $127.4 million (Federal share $7.8 million) because the State has not funded this amount. Reimbursing the State would result in an inconsistent treatment of Federal and State costs and would not be in accordance with Federal cost principles. Specifically, OMB Circular A-87, Attachment A, C.1.e., requires that in order to be allowable, the cost must "Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit."

The State's written comments and the Office of Inspector General's (OIG) response are summarized after the Recommendation section of this report. The complete text of the State's comments is included in Appendix B.

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[1] At the time our draft report was issued, plan assets exceeded actuarial accrued liabilities (on December 31, 2001) by $4.4 billion ($315 million Federal share). According to the State's actuarial report for the year ended December 31, 2002, plan assets exceeded actuarial accrued liabilities by $3.4 billion ($241 million Federal share).

[2] In the draft report, we stated that the Federal share was $7,271,755. Based on additional information, we adjusted the Federal share to $7,827,275.

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ACKNOWLEDGMENTS

INTRODUCTION

BACKGROUND

Federal Participation in Public Employee Retirement Systems

The Federal Government participates in and makes contributions to State public employee retirement systems in accordance with the Statewide Cost Allocation Agreements that are submitted by the State and approved by the U.S. Department of Health and Human Services, Division of Cost Allocation.

Employees and their employing agencies contribute to public employee retirement systems. The basis for these contributions can be computed using either a pay-as-you-go method or an acceptable actuarial cost method in accordance with established written policies of the governmental unit. Pension costs charged to Federal programs are subject to cost principles contained in Federal regulations. For State and local governments, the cost principles governing allowable costs to Federal programs are set forth in the OMB Circular A-87, "Cost Principles for State, Local and Indian Tribal Governments." The current reporting and accounting requirements are set forth in GASB Statement Number 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans," and Number 27, "Accounting for Pensions by State and Local Governmental Employers."

Because the Federal Government contributes to the costs of operating a State's public employee retirement system, any transactions that divert funds from the public employee retirement system for nonpension-related operating expenses must include the return of an equitable share to the Federal Government. Failure to compensate the Federal Government for its share of any pension refunds, offsets, or diversions to other State activities would violate OMB Circular A-87, based on the inconsistent treatment of Federal programs.

North Carolina Retirement Systems

The Department of State Treasurer, Retirement Systems' Division, administers the statutory retirement plans that cover North Carolina public employees. The North Carolina retirement systems had assets of $55.7 billion as of December 31, 2001. North Carolina currently has the 13th largest pension plan and the 9th largest public pension plan in the United States.

The Teachers' and State Employees' Retirement System (the retirement fund), a defined benefit pension plan, is one of four retirement systems administered by the Retirement Systems' Division. Created by the North Carolina General Assembly in 1941, the retirement fund has the most assets ($44.1 billion as of December 31, 2001) and largest membership of the retirement systems administered by the Division. The retirement fund provides benefits to most of the full-time teachers and State employees in all public school systems, universities, departments, institutions, and agencies of the State.

Two boards of trustees govern the retirement systems. The State Treasurer is ex-officio chairman of each board. The retirement fund board is composed of 14 members, including active employees, retirees, and public members. The Local Governmental Employees' Retirement System, while legally separate, is composed of the same 14 members plus 3 members representing local governments. The retirement fund is operated on the basis of the calendar year, from January 1 to December 31, rather than on the basis of the State's fiscal year (FY), which runs from July 1 to June 30.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

The objectives of our review were to determine whether North Carolina (1) credited the Federal Government for its share of any reductions or redirection of retirement fund contributions and (2) based contribution rates to the retirement fund on actuarially determined estimates.

Scope

Our audit covered the period July 1, 1999 through June 30, 2002. We did not test the financial statements of the retirement fund. To the extent possible, we relied on the work of the North Carolina Office of the State Auditor. For this audit, we relied on the 1999, 2000, and 2001 Comprehensive Annual Financial Reports for North Carolina, which were audited by the North Carolina Office of the State Auditor and given an unqualified opinion. In addition, we relied on the calculations of the actuarial firm of Buck Consultants, which attested to performing an actuarial valuation of the retirement fund in accordance with the parameters of GASB Statements 25 and 27.

Methodology

To accomplish our audit objectives, we:

- reviewed applicable regulations and standards including OMB Circular A-87 and GASB Statements 25 and 27;

- met with officials from the North Carolina Department of the State Treasurer to discuss the structure of the retirement fund and the policies and procedures for the retirement fund and investment program;

- met with officials from the Office of the State Controller and the State Budget Office to obtain information that confirmed that the unfunded employers' retirement contributions were transferred to a reserve account;

- met with North Carolina's principal actuary from Buck Consultants, the actuarial firm for the State's Retirement Systems since the retirement fund's creation in 1941;

- obtained and analyzed salaries and employers' contributions to the retirement fund for State FYs 2000 through 2002 to determine the Federal share of retirement fund contributions;

- reviewed the actuarial reports and the unaudited balance sheet for the retirement fund to determine the reasonableness of the retirement fund's fund balance as of December 2001; and

- calculated the Federal share of the retirement fund contributions the State did not make and the Federal share of the retirement fund surplus (see Appendix A).

We conducted our audit in accordance with generally accepted government auditing standards. Fieldwork was performed at the Department of the State Treasurer and the Office of the State Controller, Raleigh, North Carolina.

FINDINGS AND RECOMMENDATION

With respect to our first objective regarding reductions or redirection of retirement fund contributions, our review revealed that North Carolina did not comply with Federal cost principles because it claimed reimbursement from federally funded programs for retirement contributions that the State did not make. With respect to our second objective, North Carolina based retirement fund contributions on actuarially determined estimates as required by OMB Circular A-87. The State's actuary determined the annual required contribution in accordance with the parameters established in GASB Statements 25 and 27.

FEDERAL SHARE OF RETIREMENT FUND CONTRIBUTIONS

For the period February 1 through June 30, 2001, North Carolina claimed reimbursement from federally funded programs for retirement contributions totaling $127.4 million ($7.8 million Federal share) that were unfunded.

Under Federal cost principles, States are not entitled to seek reimbursement from the Federal Government until pension costs are funded by the State. However, under certain circumstances, States are allowed to fund their pension costs after the end of a given fiscal year without penalty. OMB Circular A-87, Attachment B, section 11.e.(2), states:

> Pension costs . . . are allowable for a given fiscal year <u>if they are funded</u> for that year within six months after the end of that year. Costs funded after the six month period (or a later period agreed to by the cognizant agency) are allowable in the year funded. The cognizant agency may agree to an extension of the six month period if an appropriate adjustment is made to compensate for the timing of the charges to the Federal Government and related Federal reimbursement and the governmental unit's contribution to the pension fund. (Emphasis added.)

As part of an effort to balance the State's FY 2001 budget, the Governor of North Carolina signed Executive Order Number 3, dated February 8, 2001. This executive order directed the Office of the State Controller to escrow the employers' contributions for all State-funded retirement systems into a special reserve as established by the Office of State Budget, Planning, and Management. Consequently, that office established Budget Code 19941 entitled "General Fund Reserve."

As of June 30, 2001, the State had escrowed $212.5 million of employers' contributions applicable to three of the State's retirement systems. The portion of the escrowed employers' contributions for the retirement fund at issue in this report totaled $208.4 million.

In December 2001, the State deposited $81 million (38.87 percent) of the $208.4 million into the retirement fund. This $81 million was deposited within the allowable 6-month period. However, the remaining $127.4 million (61.13 percent) was still owed to the retirement fund as of September 30, 2003.

On January 4, 2002, the Governor signed House Bill 231, enacted as Session Law 2001-513. This law stated the "intent of the General Assembly" to appropriate funds to reimburse the retirement fund. The law further stated that the payments would be made over a 5-year period beginning July 1, 2003, "subject to the availability of funds."[3]

OTHER MATTER: ACTUARIAL SURPLUS

Even though the annual required contributions were determined using the GASB parameters, an actuarial surplus existed. On December 31, 2001, plan assets exceeded actuarial accrued liabilities by $4.4 billion ($315 million Federal share). Retirement fund assets exceeded actuarially determined liabilities because actual results from retirement fund operations deviated from actuarial estimates and the legislature changed the asset valuation methodology in September 2001.

The actuarial liability is that portion of the actuarial present value of projected benefits that will not be paid by future employer normal costs or member contributions. The difference between this liability and funds accumulated as of the same date is referred to as the unfunded actuarial accrued liability. If the difference is negative, the excess of the funds accumulated over the liabilities may be referred to as the surplus. As can be seen from the table below, the retirement fund had a surplus in 1998 and the surplus increased in both percentage and dollar amount for the next 2 years.

Table 1: Schedule of Retirement Fund Surplus 1998-2001

(Dollars in Thousands)

	12/31/1998	**12/31/1999**	**12/31/2000**	**12/31/2001**
Actuarial Accrued Liability	$30,354,222	$32,787,108	$35,248,770	$37,713,663
Actuarial Value of Assets	$31,847,438	$36,119,259	$39,773,747	$42,104,086
Unfunded Actuarial Accrued Liability	($1,493,216)	($3,332,151)	($4,524,977)	($4,390,423)
Funded Ratio	**104.92%**	**110.16%**	**112.84%**	**111.64%**

Any funded ratio above 100 percent represents a surplus of assets over liabilities. This means that the retirement fund is ahead of schedule in funding benefits that have not yet accrued.

[3] State officials told us that on October 1, 2003, North Carolina repaid $10 million of the $127.4 million unfunded balance.

North Carolina has taken several steps to address the retirement fund surplus:

- The legislature reduced employer contributions from 8.15 percent for FY 2000 to 5.33 percent for FY 2001, 1.97 percent for FY 2002, and 0 percent for FY 2003.

- The retirement fund granted cost-of-living increases to retirees for FYs 1998 to 2003. Also, in the 2004/2005 biennial budget, the retirement fund's Board of Trustees recommended a 2-percent cost-of-living increase for retirees and an increase in the retirement formula for calculating an employee's annuity from 1.82 to 1.83 percent.

- The Board of Trustees reduced the retirement fund's interest rate assumption to 7.375 percent for the December 1997 valuation and further reduced the assumption to 7.25 percent for the December 1998 through 2001 valuations.

North Carolina should periodically reassess the contribution rates to ensure actuarial balance.

RECOMMENDATION

We recommend that the State refund $7,827,275 (Federal share), plus accrued interest, for the retirement fund contributions that were not made during FY 2001.

State's Comments—Federal Share of Retirement Fund Contributions

In written comments to the draft report, State officials disagreed with the OIG's recommendation to refund $7,827,275 (Federal share), plus accrued interest, for the retirement fund contributions that were not made. According to State officials, the Federal share was subsequently deposited into the retirement fund and the State did not use any Federal funds to balance the State budget. State officials also said that the State is committed to repaying, over a 5-year period, the entire sum, plus interest that was used to balance the State budget. To that end, the State's 2003-2005 biennial budget includes a $10 million appropriation in the first year to begin the repayment. According to State officials, the Governor and the Assembly will determine the level of contributions available each year for the remaining 4 years.

OIG's Response—Federal Share of Retirement Fund Contributions

The State's position that all Federal funds that were initially withheld from the retirement fund were subsequently deposited into the retirement fund is not consistent with OMB Circular A-87's requirement of consistent treatment between State and Federal programs.

The State's accounting of the unfunded employer contributions (shown in Table 2 below) consisted of a computerized spreadsheet maintained by the Office of the State Controller. The spreadsheet shows that of the $212.5 million unfunded contributions, $12.8 million (6.02 percent) applied to Federal programs. In our opinion, it follows logically that of the $82.6 million returned to the fund, 6.02 percent or $5 million was for Federal programs.

The difference--$7.8 million--was neither deposited to the fund nor used to offset expenditures claimed to the Federal programs.

However, as shown in Tables 2 and 3, the State maintains that it could allocate the returned contributions to employer categories disproportionately to the source of the contribution.

Table 2: Unfunded Employer Contributions

Office of the State Controller's Categories	Unfunded Employers' Contributions	Percentage of Total Unfunded Contributions
Federal	$12,804,311	6.02%
Local	30,669,757	14.43
Highway	11,695,650	5.50
Special Revenue	2,337,641	1.10
General Fund	143,349,712	67.45
Institution	6,280,792	2.96
Other	5,404,685	2.54
Total	**$212,542,548**[4]	**100%**

Table 3: Employer Contributions Returned to the Retirement Systems Per State Methodology

Office of the State Controller's Categories	Unfunded Contributions Returned to Retirement Systems	Percentage of Total Unfunded Contributions Returned
Federal	$12,804,311	100%
Local	30,669,757	100
Highway	11,695,650	100
Special Revenue	2,337,641	100
General Fund	13,420,066	9.36
Institution	6,280,792	100
Other	5,404,685	100
Total	**$82,612,902**[5]	**38.87%**

OMB Circular A-87 requires consistent treatment. OMB Circular A-87, Attachment A, C. Basic Guidelines, Sections C.1.e., contains one of the factors affecting the allowability of costs. According to Section C.1.e., to be allowable under Federal awards, costs must

[4] The $212.5 million represents $208.4 applicable to the retirement fund, $3.8 million applicable to the Consolidated Judicial Retirement System, and $0.3 million applicable to the Legislative Retirement System.

[5] The $82.6 million represents $81 million applicable to the retirement fund, $1.5 million applicable to the Consolidated Judicial Retirement System, and $133,000 applicable to the Legislative Retirement System.

"Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit." To be consistent, the State's refund should be credited to all participants in the retirement system proportionately. Of the $212.5 million of total retirement systems contributions that the State did not fund, 67 percent represented general fund monies, 6 percent represented Federal monies, and 27 percent represented other nongeneral fund monies. In contrast, the State asserted that 9 percent of the general fund monies, 100 percent of the Federal monies, and 100 percent of nongeneral fund monies were returned to the retirement systems.

Federal cost principles also require that the State not only incur a cost, but also use the monies for the purposes intended. In this case, North Carolina did not fund the Federal share of $127.4 million in retirement fund contributions used to assist in balancing the State's budget. When North Carolina actually deposits the unfunded contributions into the retirement systems, the State may be entitled to seek Federal reimbursement for an equitable share of those pension costs.

APPENDICES

CALCULATION OF FEDERAL PARTICIPATION

The following methods were used to determine the Federal portion of unfunded employer contributions and the Federal portion of the retirement fund's surplus.

Federal Share of Retirement Fund Contributions

To determine the Federal share of the contributions that were not made to the retirement fund, we obtained reports from the Office of the State Controller. These reports showed the Office of the State Controller's compilation of the employers' pension contributions by funding source for the period February through June 2001. The funding sources included State agencies and boards, universities, community colleges, and local education agencies.

We made appropriate adjustments in the Office of the State Controller reports based on information we obtained from the North Carolina Accounting System, the State's Department of Health and Human Services, university controllers, and the Department of Public Instruction. Finally, we reduced the total Federal portion of employer contributions by the percentage (38.87) of total funds the State returned to the retirement fund in December 2001.

Federal Share of the Retirement Fund's Surplus

To obtain the Federal participation rate for the retirement fund, we used a weighted average participation rate for State agencies, universities, and local education agencies. We excluded community colleges from the computation of the Federal share of the surplus because their contribution to the retirement fund's surplus did not materially affect the Federal participation rate.

To develop the rate, we obtained the North Carolina Accounting System reports from the Office of the State Controller for State FYs 2000 through 2002 and obtained Federal salaries from the universities. For university employees, we excluded the salaries of temporary employees and employees under the universities' optional retirement system.

For State FYs 2000 through 2002, we calculated a 3-year average of Federal salaries separately for State agencies, universities, and local education agencies, and weighted the results in proportion to the respective groups' retirement fund salaries. The resulting Federal participation rate was 7.17 percent. Using this percentage, we estimated that the Federal portion of the $4.4 billion retirement fund surplus was $315 million.

STATE OF NORTH CAROLINA
DEPARTMENT OF STATE TREASURER
RETIREMENT SYSTEMS DIVISION

RICHARD H. MOORE
TREASURER

MICHAEL WILLIAMSON
DEPUTY TREASURER

RECEIVED

JUL 1 5 2003

Office of Audit Svcs.

July 15, 2003

Via Facsimile Transmittal 404.562.7795
and by Federal Express

Mr. Charles J. Curtis
Regional Inspector General
Office of Inspector General
Office of Audit Services, Region IV
U.S. Department of Health and Human Services
61 Forsyth Street, SW, Suite 3T41
Atlanta, Georgia 30303-8909

RE: Response to Draft Audit Report Number A-04-02-00011, ***Audit of the Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System*****, dated April 29, 2003**

Dear Mr. Curtis:

The North Carolina Department of the State Treasurer hereby submits our formal response to the Office of Inspector General's *Audit of the Reasonableness of the Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System*. We have included comments on each of the audit report's findings as well as additional information and documentation.

<u>Federal Share of Diverted Pension Contributions</u>

In February 2001, Governor Mike Easley issued Executive Order No. 3 escrowing the State's contributions to the Teachers' and State Employees' Retirement System (TSERS) for the remainder of that fiscal year, diverting these funds to the General Fund to balance the State's budget. The Department of State Treasurer, in conjunction with the Office of State Controller, maintains that the State of North Carolina used the necessary accounting processes to ensure that the State appropriately segregated and properly accounted for any Federal funds involved in the 2001 escrow. Furthermore, the State

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deposited the identified Federal funds into TSERS and used no funds to balance the budget. The State holds that the initial funds the State repaid to the Retirement System made the Federal Government whole with regard to any Federal funds that were included in the initial $209 million escrow. In fact, this was the State's absolute first priority in repaying the escrowed funds. Finally, the State committed to repaying the entire sum used to balance the budget plus interest, and has demonstrated the first step in that repayment as the State's recently ratified 2003-04 budget includes $10 million toward the repayment of the remaining escrowed funds.

Throughout this process, the State has followed generally accepted accounting principles (GAAP), consulted with Federal experts to ensure Federal compliance, and has not harmed Federal programs or Federal recipients. The State therefore believes the OIG audit finding that the State did not appropriately credit the Federal Government for its share of the escrowed TSERS pension fund contributions should be withdrawn and the declaration that the State pay $7,271,755, plus accrued interest, for the pension fund contributions that were not made to TSERS should be abated.

The State's formal response to the OIG audit report includes the attached memorandum from the Office of State Controller.

<u>TSERS Contribution Rate and Actuarial "Surplus"</u>

The 2001 TSERS actuarial valuation indicates that the plan assets exceeded accrued liabilities by $4.39 billion. Based on this figure, the OIG audit concluded that the State overcharged the Federal Government for pension fund contributions. For the following reasons, the State entirely disagrees with this OIG audit finding.

- As noted in the audit, "contribution rates to the TSERS were based on actuarially determined estimates." These contribution rates also reflect the fact that the actuarial value of assets exceeds the accrued liability. Because the plan has excess assets and uses an amortization period of nine years, as mandated by State law, this results in a lower contribution than would otherwise be required if the plan used a longer amortization period.
- The results of the actuarial valuations for the years 1998-2001 illustrate that both the Federal and State contributions have already been lowered and therefore the Federal Government was not overcharged, but given a credit based on actuarially determined contributions. Finally, the $4.4 billion negative unfunded liability or "surplus" was primarily a by-product of extraordinary investment performance over the past 15 years, and, with a nine-year amortization period, TSERS is being highly aggressive in lowering the so-called "surplus." A pension fund will either have an unfunded liability or a negative unfunded liability, where plan assets exceed accrued liabilities, and given the fact that for over 50 years, from 1941 to 1997, TSERS had an unfunded liability, it is quite logical that a "surplus" over 4 years is reasonable.
- As noted in the audit report, a portion of the actuarial "surplus" arose from the change in the basis for recognizing market fluctuations in asset values in FY 2000 and 2001. Governmental Accounting Standards Board (GASB) rules stipulate that such changes should be amortized over a period of not less than

10 years. The OMB Circular A-87 indicates that "Pension costs calculated using an actuarial cost-based method recognized by GAAP are allowable for a given fiscal year if they are funded for that year within six months after the end of that year." Since GAAP precluded a more rapid recognition than 10-year amortization of the portion of the plan assets that exceeded liabilities arising from the changes in the asset valuation method, it is unreasonable to expect the Retirement System to take less than 4 years to eliminate this amount.

The State's formal response on this issue includes the attached letter from TSERS' consulting actuary. Also included in the State's formal response are concurring letters from the actuarial firms of Milliman USA and Gabriel, Roeder, Smith & Company. Based on the entirety of the response provided on this issue, the State believes that the OIG audit finding that the State overcharged the Federal Government for pension fund contributions is inaccurate and that it should be repealed.

The State recognizes its responsibility to use Federal funds for their intended purpose and to charge the Federal Government appropriate pension fund contribution rates. In fact, we take this responsibility seriously. Similarly, we also recognize our fiduciary responsibility to fully fund the retirement benefits of the teachers and state employees who serve the State. To this end, as confirmed by not only our consulting actuary but two other leading actuarial firms who work with other public retirement systems across the country, we have made and will continue to make every effort to prudently manage both Federal and State funds.

Sincerely yours,

Richard H Moore

Richard Moore
State Treasurer

cc: Michael Williamson, Deputy Treasurer
David McCoy, State Budget Officer
Robert Powell, State Controller
Wesley Ray, Deputy State Auditor

State of North Carolina
Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

July 3, 2003

MEMORANDUM

TO: Michael Williamson
Deputy State Treasurer

FROM: Robert L. Powell
State Controller

SUBJECT: OIG Audit on Withheld Retirement Contributions

The purpose of this document is to respond to the audit conducted by the Office of the Inspector General on funds budgeted in the 2000-01 state fiscal year for employer retirement contributions of employees funded with federal funds, non-federal funds, and general fund resources of the State of North Carolina. This audit was completed on April 29, 2003 and was presented to the State of North Carolina on May 8, 2003. This response is intended to represent the facts which were provided to the audit team in the conduct of its audit and the position of the State of North Carolina regarding this specific audit finding.

Upon taking office in January, 2001, Governor Michael Easley determined that the State was experiencing a revenue shortfall that would require the invoking of his constitutional authority to manage. Accordingly, on February 8, 2001 as part of Executive Order No. 3 (EO3) which invoked this authority, the Governor directed that all budgeted employer share of retirement contributions be placed in a restrictive reserve to be governed by EO3 until the June 30 close of the 2000-01 fiscal year. This directive included the employer share of the retirement contributions for state positions funded from any source including positions funded in whole or in part by state, local or federal resources. Subsequent to this directive, a reserve was established in the Office of the State Controller entitled EO3 Reserve and all funds from the Governor's directive were placed in this reserve and held to balance the budget for the 2000-01 fiscal year.

In the process of accumulating these funds into EO3 Reserve, agencies were directed to submit a breakdown of the funding source for the employer retirement contributions between general funds, federal funds, local funds, or other non-general fund sources. This information was maintained in the OSC and has been provided to the audit team. For the period beginning on February 8 and continuing through June 30, 2001, the total funds deposited to the EO3 Reserve from employer retirement contributions was $212.5 million. These funds were segregated and identified as $144.9 million general fund and $67.6 million in non-general fund sources which includes federal and local funds. At the time these funds were being accumulated and segregated,

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it was not possible to determine if the Governor would need the total EO3 Reserve to balance the budget. OSC had as its focus to insure that all non-general fund sources were being separately accounted for and could be properly dispersed upon direction from the Governor. During this time, we also discussed with our federal consultant, DMG Maximus, the appropriate treatment of federal funds. We were advised that the procedures being used were acceptable to insure that federal funds were not being used to balance the state budget.

At the close of the 2000-01 fiscal year, the OSC was directed by the Governor to continue to hold these retirement funds in EO3 Reserve pending the adoption of the 2001-03 budget by the General Assembly. On October 3, 2001, Governor Easley determined that $129.9 million of EO3 retirement funds would be needed for budget purposes and the balance of $82.6 million could be returned to the appropriate sources. However, at that time, the books of the State had been closed and the federal grants from which these funds had been received had also been closed for the applicable year. To reopen those grants at that time was not practical nor feasible and no longer was an option for the State. We again contacted DMG Maximus and were advised that the best course of action was to submit the non-general fund resources to the Retirement System consistent with the original expenditure expectation. Additionally, we should secure a commitment from the General Assembly to pay the general fund amount to the Retirement System, with interest, as soon as possible. Accordingly, on December 7, 2001 Governor Easley directed that the balance of the EO3 Reserve ($82.6 million) be remitted to the Retirement System. Furthermore, with the adoption of Session Law 2001-513, Section 21, the North Carolina General Assembly enacted legislation declaring intent to appropriate to the Retirement System $129.9 million over a five-year period including applicable interest beginning July 1, 2003. The ratified North Carolina State Budget for the 2003-05 biennium includes a $10 million appropriation in the first year to begin that contribution to the Retirement System. We are advised that the Governor and the Assembly will determine the level of contributions available each year for the remaining four years.

To summarize, the State of North Carolina has demonstrated the necessary accounting processes to insure that funds involved in this incident be segregated and properly accounted for. The State has deposited the identified federal funds into the State Retirement System and has used no federal funds to balance the budget. Finally, the State has committed to paying to the System the entire sum used to balance the budget plus interest, and has demonstrated the first step in that repayment. In process of this action, we have followed generally accepted accounting principles, consulted with federal experts to insure federal compliance, and have not harmed federal programs or federal recipients. We therefore believe the audit findings in the OIG audit report should be rescinded and the declaration of payment be abated.

cc: John Corne

BUCK CONSULTANTS
A Mellon Financial Company

200 Galleria Parkway NW, Suite 1900
Atlanta, Georgia 30339-5945

July 14, 2003

VIA FAX AND UPS

Mr. Richard H. Moore
State Treasurer
Department of State Treasurer
325 North Salisbury Street
Raleigh, NC 27603-1385

We have reviewed the actuarial issues addressed in the April 2003 draft report "Audit of the Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees Retirement System" prepared by the Office of Inspector General and have the following comments.

Page 1 and 4 both state that one of the objectives of the audit was to determine whether "contribution rates to the TSERS were based on actuarially determined estimates". Page 5 indicates you acknowledge, "contribution rates to the TSERS were based on actuarially determined estimates."

Page 2 states that OIG is recommending, "federal programs do not continue to be overcharged". Neither the federal program nor the state has been overcharged. The contribution rates have been determined reflecting the fact that the actuarial value of assets exceeds the accrued liability. Because the plan has excess assets and uses an amortization period of nine years, as mandated by state law, this results in a lower contribution than would otherwise be required if a longer amortization period were used. The following summary indicates the results of the previous four valuations (1998-2001) and illustrates the impact of the excess assets on the contribution rates. It also illustrates that both the federal and state contribution has already been lowered and therefore neither were overcharged.

There are two contribution rates that have to be determined during a pension plan valuation. The first is the normal rate which is the contribution required to fund the accrual of additional benefits in the upcoming year. If a plan were always 100% funded the normal rate would be the required contribution since no increases are required to pay off a positive unfunded accrued liability or no decreases are required to absorb and lower a negative unfunded accrued liability. The normal rate can increase or decrease from year to year due to changes in the plan's benefit structure, changes in actuarial assumptions and demographic changes in the population of the plan. The second rate is the contribution required for the unfunded accrued liability. These two contribution rates are added together to determine the total contribution rate required.

The amount paid by the employee is set by statute at 6% and the employer must pay the remaining amount. If the unfunded accrued liability is positive the total rate will be higher than the normal rate. If, as is the recent case with TSERS, the unfunded accrued liability is negative, the total rate is less than the normal rate reflecting the credit for the excess assets.

The normal rate determined by the December 31, 1998 valuation was 12.83% of which 6% was to be paid by the employees and 6.83% was to be paid by the employer. However TSERS had an unfunded accrued liability of ($1.5) billion. Therefore, the employers' required contribution was reduced from 6.83% to 5.33% to reflect the nine-year amortization of the negative unfunded accrued liability. This resulted in a reduction in the employer contribution of approximately $120 million based on a payroll of $8 billion. Using the federal share of 7.17% as calculated on page 10 of your report, the federal share of this credit due to a negative unfunded accrued liability was $8,604,000.

The normal rate determined by the December 31, 1999 valuation was 12.90% of which 6% was to be paid by the employees and 6.90% was to be paid by the employer. However TSERS had an unfunded accrued liability of ($3.3) billion. Therefore, the employers' required contribution was reduced from 6.90% to 1.97% to reflect the nine-year amortization of the negative unfunded accrued liability. This resulted in a reduction in the employer contribution of approximately $419 million based on a payroll of $8.5 billion. Using the federal share of 7.17% as calculated on page 10 of your report, the federal share of this credit due to a negative unfunded accrued liability was $30,046,000.

The normal rate determined by the December 31, 2000 valuation was 12.70% of which 6% was to be paid by the employees and 6.70% was to be paid by the employer. However TSERS had an unfunded accrued liability of ($4.5) billion. Therefore, the employers' required contribution was reduced from 6.70% to 0.00% to reflect the nine-year amortization of the negative unfunded accrued liability. This resulted in a reduction in the employer contribution of approximately $603 million based on a payroll of $9 billion. Using the federal share of 7.17% as calculated on page 10 of your report, the federal share of this credit due to a negative unfunded accrued liability was $43,235,000.

The normal rate determined by the December 31, 2001 valuation was 12.77% of which 6% is to be paid by the employees and 6.77% is to be paid by the employer. However TSERS had an unfunded accrued liability of ($4.4) billion. Therefore, the employers required contribution was reduced from 6.77% to 0.00% to reflect the nine-year amortization of the negative unfunded accrued liability. This will result in a reduction in the employer contribution of approximately $643 million based on a payroll of $9.5 billion. Using the federal share of 7.17% as calculated on page 10 of your report, the federal share of this credit due to a negative unfunded accrued liability was $46,114,000.

As was previously illustrated the federal program was not overcharged, but given a credit based on actuarially determined contributions. This credit over just the last four years is nearly $128 million. For as long as the plan has a negative unfunded accrued liability both the state and the federal program will continue to share in the credit in the form of contributions lower than the normal rate. However, as the negative unfunded accrued liability approaches zero the contributions required would increase.

On Page 2 of your report, you recommend that if the actuarial surplus continues that future contributions should be reduced. For as long as the plan has a negative unfunded accrued liability both the state and the federal program will share in a reduction of future contributions.

The OMB Circular A-87 states that a cost is reasonable reflecting such factors as "sound business practice...and Federal, State and other laws and regulations." All of our contributions have been determined in accordance with Federal and state laws, GASB, ERISA and sound business practices. In addition, A-87 goes on to state, "pension costs calculated using as actuarial cost- based method recognized by GAAP are allowable". Again all the contributions meet this requirement.

Page 7 states that it is unreasonable to "continue a large surplus over 4 years". This statement is incorrect. The current surpluses have primarily been a by-product of extraordinary equity performance over the past 15 years. It has been shown above, the TSERS is being aggressive in lowering the surplus. Also since a plan will either be in a deficit or surplus and given the fact that for over 50 years from 1941 to 1997 TSERS was in a deficit position it is seems quite logical that a surplus over 4 years is reasonable.

If you have any questions, please call me at (770) 916-4113.

Sincerely,

Edward A. Macdonald
Principal, Consulting Actuary

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July 9, 2003

Richard Moore
State Treasurer
North Carolina Department of State Treasurer
325 N. Salisbury Street
Raleigh, NC 27603-1385

Dear Treasurer Moore:

You asked me to review the draft response from Buck Consultants to the Audit of the Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System prepared by the Office of Inspector General of the Department of Health and Human Services. I have done so and have summarized my thoughts below. I based on my review on the draft audit report and the annual valuation of the Teachers' and State Employees' Retirement System of North Carolina prepared as of December 31, 2001.

I agree with the observations made by Buck Consultants in their response regarding the contribution rates. In particular, both the Federal Government as well as other contributing employers into the Retirement System should have been contributing the full normal rate to fund the additional benefits earned by members each year. To the extent that the employer required contribution rate was set below that amount on account of the actuarial surplus in the system, all employers, including the Federal Government, have been receiving a share of that actuarial surplus as a reduction against future contributions. (Evidently, such reductions have been applied in determining the employer required contribution rate since the December 31, 1998 actuarial valuation.) Thus, the Retirement System has been reducing contributions for several years on account of the actuarial surplus, just as the Office of Inspector General recommends.

I also agree with Buck Consultants' objection to the Inspector General's assertion "it is not reasonable to continue a large surplus over four years." Generally accepted actuarial practice is to amortize unfunded actuarial liabilities or actuarial surpluses over extended time periods of up to 30 years. This is done for a variety of reasons, including the fact that actuaries recognize that actual experience in any single year may differ significantly from the long-term assumption even though, over time, actual experience can be expected to average close to that assumption. For example, as the Inspector General noted, while the actuarially assumed rate of return on investments was 7.25%, the actual average return on investments over the three years ending June, 2000 was

12.78%, and the system had a negative return of -2.44% and -4.34% in the following two fiscal years. Thus the average return over the entire five-year period was 6.3%. The year-to-year fluctuations were significant, but the longer-term average was fairly close to the assumed rate. Actuaries have developed widely used practices such as (a) smoothing the recognition of market fluctuations in the value of plan assets and (b) amortizing unfunded liabilities or surpluses over long time periods to avoid large fluctuations in contribution rates from year to year due to such temporary fluctuations in actuarial experience.

It is also worth highlighting that, as noted by the Inspector General, a portion of the actuarial surplus arose from the change in the formula for recognizing market fluctuations in asset values in FY 2000 and 2001. Governmental Accounting Standards Board rules stipulate that such changes in the method to determine the actuarial value of assets should be amortized over a period of not less than 10 years. The OMB circular indicates that "Pension costs calculated using an actuarial cost-based method recognized by GAAP are allowable for a given fiscal year if they are funded for that year within six months after the end of that year." Since GAAP precluded a more rapid recognition than 10-year amortization of the portion of the surplus arising from the changes in the asset valuation method, it seems inappropriate to criticize the Retirement System or its actuary for taking more than 4 years to eliminate the surplus – GAAP precluded such a rapid amortization of a large portion of the surplus.

In performing this analysis, we relied on information provided by the Teachers' and State Employees' Retirement System of North Carolina. We have not audited or verified this data and other information. Such a review was beyond the scope of our assignment. If the underlying data or information is inaccurate or incomplete, the results of our analysis may likewise be inaccurate or incomplete.

I hope the above comments are of assistance to you and the Retirement System. Please let me know if you have any questions or if I can provide any additional information.

Sincerely,

William A. Reimert, FSA

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GABRIEL, ROEDER, SMITH & COMPANY
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July 11, 2003

Mr. Richard H. Moore
State Treasurer
North Carolina Department of State Treasurer
325 N. Salisbury Street
Raleigh, NC 22706-01385

Dear Treasurer Moore:

Subject: Comments on OIG Audit of TSERS Contributions

Gabriel, Roeder, Smith & Company has been requested to review certain material provided to us by the Teachers' and State Employees' Retirement System of North Carolina (TSERS). This material is with respect to the "Audit of The Reasonableness of Pension Charges to the Federal Government for the North Carolina Teachers' and State Employees' Retirement System" as provided by the Office of Inspector General (OIG).

The OIG audit asserts that certain contributions made by the Federal Government with respect to federally funded programs whose employees are covered under TSERS have been over-charged and that the Federal Government is due a reduction of approximately $314.8 million in its payments.

Gabriel, Roeder, Smith is one of the leading actuarial and benefit consulting firms in the United States in providing actuarial and benefit consulting services to state retirement systems. The biography of the below-signed actuary is attached to this letter.

In conducting our analysis, we have reviewed the audit report of the OIG, the actuarial valuation report prepared as of December 31, 2001, and the response to the audit as prepared by the Systems' actuary, Buck Consultants. In our opinion, the OIG has reached an erroneous conclusion in its assertion that the Federal Government is entitled to a refund or a reduction in future contributions in the amount of $314.8 million. In our opinion the Federal Government has in no way been "over-charged" with respect to TSERS. To the contrary, it is our opinion that both the Federal Government and the State of North Carolina have enjoyed significant reductions in their contributions to TSERS over the last several fiscal years as a result of better-than-expected investment performance during the decade of the 1990s.

Based on our review of the actuarial valuation report as of December 31, 2001, it is our opinion that contribution rates for the retirement system have been appropriately calculated under acceptable actuarial standards and methods. We have also reviewed the comments provided by the Systems' actuary Buck Consultants, with respect to the OIG audit report. We are in full concurrence with the conclusions and observations provided by those comments.

The comments by Buck Consultants and the results of the annual actuarial valuations clearly show that both the State and the Federal Government have received substantial reductions in their contribution requirements over the last several years attributable directly to the funding surplus of TSERS.

Prior to the period of time at which TSERS became fully funded, the employer contribution rate paid by the State and the Federal Government to TSERS ranged from 7.78% of pay to as high as 9.35% of pay during the 1990s. Once the System became fully funded as disclosed by the 1998 actuarial valuation, the employer contribution rate began to decline rapidly. The decline in the employer contribution rate was directly attributable to the credit that both the Federal Government and the State received in their contribution requirement due to the funding surplus. As the funding surplus became larger, the credit to the employer contribution requirement has also become larger. The mechanism for these contributions is described in Buck's letter.

Therefore the assertion by the OIG audit report that the Federal Government has over-paid TSERS or that it has received no benefit from and no recognition of the funding surplus is erroneous. The Federal Government has, in fact, enjoyed substantial reductions in its contribution requirements to TSERS by virtue of the funding surpluses.

In our opinion, the calculation of all contribution rates applicable to TSERS has been performed according to reasonable actuarial standards of practice, and these rates are appropriate actuarially determined rates. They have also been calculated in full compliance with GASB 25 and GASB 27. These calculations have fully reflected significant reductions in the contribution requirements directly attributable to the funding surpluses.

Therefore, in our opinion, there has been no "over-charging" of the Federal Government and no funds are due the Federal Government.

If you should have any questions concerning our comments, please contact us.

Sincerely,

W Michael Carter

Gabriel, Roeder, Smith & Company
W. Michael Carter, FSA
Senior Consultant

nlb

Attachment

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ACKNOWLEDGMENTS

This report was prepared under the direction of Charles J. Curtis, Regional Inspector General for Audit Services. Other principal Office of Audit Services staff who contributed included:

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