DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

AUG 1 1994

TO: The Secretary
Through: DS ____
COS ____
ES ____

FROM: Inspector General

SUBJECT: Audit of State of California's Pension Fund--INFORMATION MEMORANDUM

PURPOSE

The purpose of this information memorandum is to advise that we plan to issue to the State of California a final audit report on its pension plan within 10 days from the date of this memorandum. Because of the financial difficulties in the State and the significance of the audit findings, we anticipate contacts from State officials, as well as congressional and media interest.

INFORMATION TEXT

The State of California passed legislation (Assembly Bill 702, effective July 1, 1991) to reduce its projected $14 billion State budget deficit by eliminating certain pension benefits and related reserves from its public pension system. These reserves total about $2.0 billion. The plan to distribute the excess reserve fund called for $1.3 billion to be allocated to all employers (other than the State agency) that participated in the retirement system (i.e., cities, counties, schools, and local districts). Through legislative amendments, the remaining $816 million was to be distributed to the State general fund, thus excluding Federal reimbursement of an estimated $111 million.

This action violates basic cost principles under the Office of Management and Budget (OMB) Circular A-87. The OMB Circular A-87 requires that all participating Federal programs should receive an equitable share of the cost reductions resulting from the use of the reverted pension funds.

We recommend that the Government receive its fair share of cost reductions related to this legislation, which is estimated at about $111 million. The estimated cost reductions will be shared with all Federal agencies providing financial assistance to the State of California. The Office of the General Counsel and the Assistant Secretary for Management and Budget have reviewed this issue and have concurred with the audit conclusions.

The State responded that the disposition of the pension reserves was mandated by State law to provide resources for employer contributions that were paid by the General Fund. Thus, the State contends, there was no reduction of State costs nor basis for a Federal share. However, under the cost principles of OMB Circular A-87, when the Federal Government fully participates in funding the pension system and pays its fair share of employer costs, it is entitled to an equitable share in any benefits realized by the employers.

June G Brown

June Gibbs Brown

Attachment

Tab A:
Final Report of Audit of State of
California's Pension Fund

cc:
Kenneth S. Apfel
Assistant Secretary for
Management and Budget

Harriet Rabb
General Counsel

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

AUDIT OF STATE OF CALIFORNIA'S PENSION FUND

JUNE GIBBS BROWN
Inspector General

AUGUST 1994
A-09-92-00116

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Washington, D.C. 20201

CIN: A-09-92-00116

AUG - 1 1994

Russell Gould, Director
Department of Finance
State of California
State Capitol
Sacramento, California 95814

Dear Mr. Gould:

This report provides the results of our audit of the use of pension reserves to reduce California's budget deficit. We found that the State did not credit Federal programs with a proportionate share when excess pension funds were used to pay for State operations. The State's action resulted from a legislative amendment which allowed the State to use $816 million of $2 billion of excess pension reserves to reduce State pension costs paid from the General Fund. As a result, the State's pension costs were reduced without a reduction of the share charged to Federal programs. This practice violates Federal rules contained in the Office of Management and Budget (OMB) Circular A-87.

The OMB Circular A-87, Cost Principles for State and Local Governments, requires that expenditures claimed for reimbursement under Federal programs be reduced by any credits which offset or reduce expenditures. The California Public Employees Retirement System (PERS) allocated approximately $727 million of the $2 billion to State agencies while the remainder was allocated to other employers who participated in PERS. Subsequently, an additional $89 million in investment earnings was included by PERS in the amount allocated to the State, for a total of $816 million. We estimate that the Federal Government should receive a credit of $111 million for its share of the State's reduction in pension costs. However, the entire $816 million of excess pension funds was used to reduce the State's employer pension costs paid by the General Fund.

We recommend that the State credit the Federal Government with a proportionate share of the reserves used to offset the General Fund retirement contributions.

The State responded that the disposition of the pension reserves was mandated by State law to provide resources for employer contributions that were paid by the General

Fund. Thus, the State contends, there was no reduction of State costs nor basis for a Federal share. However, while there may have been no <u>reduction</u> in State contributions, the State legislative enactments provided that the State's General Fund should receive the sole benefit of the excess pension reserves, contrary to the applicable Federal cost principles that would require both the State and Federal Governments to share equitably from the reserves. The State's response is included as Appendix B.

BACKGROUND

The Federal Government participates in and makes contributions to State pension funds through the Statewide Cost Allocation Plan, which is submitted annually by the State and approved by the Department of Health and Human Services (HHS), Division of Cost Allocation. The Federal Government contributes to the costs of operating the State's pension plan; therefore, any transactions that divert funds from the pension plan for operating expenses must include a credit to the Federal Government for its fair share.

The PERS is a statutorily created body which administers and pays retirement benefits. The membership includes employees of the State, nonteaching school employees, and employees of various local agencies.

Both the employees and the employing agencies contribute to PERS. Although the employees' contributions are fixed and constant, this is not true of the employers' contributions. Employers are required to contribute the remaining amounts necessary to fund the benefits for their members, using the actuarial basis recommended by the actuaries and actuarial consultants of PERS and adopted by the PERS' Board of Administration (Board).

The Federal Government shares in the direct and indirect costs of employer pension contributions through payments made under Federal grants and contracts administered by State and local agencies.

<u>Creation of New Reserves</u>

In 1982 the California Legislature authorized the payment of additional benefits to retired PERS members. Instead of paying these additional benefits from the existing retirement fund (i.e., the source of other PERS benefits), two new special reserve accounts, the Investment Dividend Disbursement Account (IDDA) and the Extraordinary Performance Dividend Account (EPDA), were created for the new additional benefits. These new accounts were funded by investment earnings that exceeded the annual rates approved by the Board for crediting the employees' retirement accounts.

The IDDA/EPDA reserves were established to fund supplemental cost-of-living adjustments not included in employees' current pension plans. However, these reserves were not included as pension assets in calculating the employer contribution rate. Employees had no vested right to the reserves and payments were subject to the discretion of the Board and the availability of funds. Although there were some payments to retirees, the reserves grew significantly because the pension fund realized investment rates of return in excess of the crediting rates specified by the Board.

Deficit Reduction

To help reduce a projected $14 billion State budget deficit for the fiscal year (FY) ended June 30, 1992, the California Legislature passed Assembly Bill (AB) 702 on June 30, 1991. The State Legislature voted to repeal the additional benefits created under the 1982 legislation and to eliminate the IDDA/EPDA reserves which funded those extra benefits. The Legislature directed that the reserves be used to reduce employer contributions to PERS until the funds were exhausted. The legislation resulted in savings to the State by using IDDA/EPDA reserves instead of the General Fund to pay the employer pension costs.

In implementing AB 702, California State agencies were allocated approximately $727 million of the $2 billion. The remainder of $1.3 billion was allocated to other employers that participated in the retirement system (i.e., cities, counties, schools and other local districts). The PERS determined the amount of reserves attributed to each employer. Employers used their portion of the reserves to offset pension contribution costs. As indicated by PERS instructions to participating employers, the reduction of employer contributions should benefit all fund sources (to include the Federal Government). Thus, each fund source would be credited for the full amount of its pension contributions until the employer's share of IDDA/EPDA reserves was eliminated.

Amendment to Benefit State Funds Only

The law was amended by AB 1922 on June 11, 1992, to clarify the legislative intent that, for the portion of IDDA/EPDA reserves allocated to State agencies, only the General Fund was to benefit from the savings realized by the reduction of employer contributions. The State increased the savings realized by the General Fund by denying offsets to some other fund sources, including Federal.

Beginning July 1, 1991, the State used the $727 million to offset State employer pension costs. Subsequently, an additional $89 million in investment earnings was included by PERS in the amount allocated to the State, for a total of $816 million.

SCOPE

Our audit was conducted in accordance with generally accepted government auditing standards. The objective of our audit was to determine the impact on Federal programs resulting from AB 702 and AB 1922. To accomplish our objective, we studied the legislation and applicable criteria, reviewed actuarial studies and financial statements, and discussed the issues with key State and Federal officials. To verify how the reversion of the IDDA/EPDA funds was implemented and to determine the resulting impact on Federal programs, we reviewed selected accounting transactions at the State Department of Social Services (as an example of a major recipient of Federal funds), the State Controller's Office (SCO), and PERS.

We estimated the Federal share of the offset for retirement contributions using the ratio of Federal to total costs of State operations. The estimate was based on recorded costs for FY 1992, as reported in the Governor's Budget for FY 1994.

We relied on audit work done by the California Auditor General's Office (currently the State Auditor, Bureau of State Audits), which audits the California statewide financial statements on an annual basis. The audit includes a review of the Department of Finance and the preparation of the Budget. The audit also includes a reconciliation of the amounts presented in the Budget with the financial statements. Because the audit for FY 1992 had not been completed, we reviewed previous single audit reports to determine if the State Auditor had reported any material weaknesses in internal controls or compliance applicable to our audit objective.

The PERS is audited annually by independent auditors. We relied on the work done by the auditors for the acceptability of the amount reported as the balance of IDDA/EPDA reserves.

FINDINGS AND RECOMMENDATIONS

The State of California did not credit Federal programs with a proportionate share of the $816 million in IDDA/EPDA reserves used for State operations. The costs that otherwise would have been paid by the General Fund were reduced by the funds from IDDA/EPDA reserves. However, the State did not reduce the costs that were paid by some other funding sources, including Federal programs. We estimate, based on a methodology agreed to in a previous audit of the State of California, that a proportionate Federal share of these costs is $111 million.

Implementation of Pension Offsets

Under normal procedures, employers' pension costs are recorded by State agencies and the Federal share is subsequently claimed for reimbursement. The total amount of the employer pension costs is transferred to PERS by SCO. This transfer is funded by the General Fund and other fund sources, including Federal. However, under AB 1922, instead of transferring funds from the General Fund to PERS, the pension costs for the State were paid from IDDA/EPDA reserves.

These reserves were used to offset the employer's pension costs beginning July 1, 1991. Although the individual State agencies recorded the entire amount of the pension costs in their accounting records, the amount that should have been paid by the General Fund was paid from IDDA/EPDA reserves. In effect, the State did not have an "out-of-pocket expenditure" for the pension costs, even though the agencies' records show that such costs had been incurred.

During FY 1992, the State used $532 million of the $816 million in IDDA/EPDA reserves to offset pension costs incurred by the General Fund. The State used the remaining reserves to reduce pension costs for FY 1993.

Pension Costs Charged to Federal Programs

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 OMB Circular A-87.

The OMB Circular A-87 clearly provides that to be allowable, costs must be "... net of all applicable credits" (Attachment A, paragraph C.1.g). The "applicable credits," as noted above, are defined as receipts which "...offset or reduce expense items allocable to grants as direct or indirect costs" (Attachment A, paragraph C.3.a). Also, for the Federal Government to accept costs claimed by States for reimbursement under Federal programs, the Government must be treated fairly and equitably. A basic principle to ensure fairness is that such costs must be "... accorded consistent treatment through application of generally accepted accounting principles appropriate to the circumstances" (Attachment A, paragraph C.1.e).

The employer pension costs incurred by the General Fund for State FYs 1992 and 1993 were offset by IDDA/EPDA funds. However, employer pension costs reimbursed by Federal funds were not reduced and the full amount of the pension costs allocable to Federal programs was claimed for Federal reimbursement. As a result, the employer pension costs incurred by the General Fund were being eliminated while the Federal Government was charged the full pension cost for employees working on Federal programs. Thus, Federal programs were charged in a manner inconsistent with the State programs.

Estimate of Federal Share

We estimated that the Federal Government should be credited for $111 million of IDDA/EPDA reserves used to offset employer contributions. The calculation of the Federal share was based on the ratio of Federal to total State operating costs. The calculation is presented in Appendix A.

Our estimate of the Federal share was based on a methodology developed during a prior audit ("Refund of the Public Employees' Contingency Reserve Funds Under Section 4.20 of the Budget Acts of 1984 and 1985," State of California, CIN: A-09-86-60465, issued April 12, 1988). That audit involved a credit due to the Federal Government from a refund of a contingency reserve fund established to pay the costs of providing health benefits to retirees covered by PERS. The audit questioned the Federal share of refunds given to State agencies but not used to reduce the amount of pension costs claimed for Federal reimbursement for FYs 1984 and 1985. The State agreed to an adjustment based on the methodology.

The methodology was also used in a review by the Division of Cost Allocation, Region IX, HHS. The review related to a contingency reserve for deficiencies and involved calculating the Federal share of the reserve using costs reported for FYs 1981 and 1982. The State agreed to make the adjustment by transferring the reserve for deficiencies to the regular reserves to be used to compute future employer pension contribution rates.

RECOMMENDATION

We recommend that the State credit the Federal Government for a proportionate share of the pension costs reduced by IDDA/EPDA reserves. We estimate that the Federal share is $111 million. Additionally, we recommend that the State provide necessary documentation to the appropriate Federal cognizant agencies to ensure that the Federal Government receives its fair share of the cost reductions resulting from the use of reverted pension funds.

In a letter dated June 15, 1994, the California Department of Finance stated that the Federal Government was not entitled to receive credit for any part of IDDA/EPDA funds. Their response is summarized below and included in full as Appendix B.

<u>State Response</u>

The State law authorized the use of IDDA/EPDA reserves specifically to fund the General Fund portion of the contribution to PERS. The law clarified the legislative intent that the authority to use the reserves did not extend to any other fund source, including the Federal Government.

<u>Auditor Comments</u>

We recognize that California's legislature enacted bills that authorized the use of IDDA/EPDA reserves in the manner found by our audit. However, whatever the purpose of these enactments, under the Supremacy Clause of the U.S. Constitution, such State statutory law is preempted by the controlling Federal law or regulations. OMB Circular A-87, incorporated into Federal regulations at 45 CFR §§ 74.171 and 92.22, is applicable to all grants with State and Local governments. The Circular provides that, to be allowable, costs must be accorded consistent treatment and that they be net of all applicable credits.

State Response

The State was not granted a reduction or rebate on employer pension contributions owed to PERS. The State paid its contributions using the funds in IDDA/EPDA reserves instead of the General Fund. Therefore, the Federal Government is not entitled to receive any of IDDA/EPDA funds.

Auditor Comments

We do not dispute that the State paid its 1991-92 General Fund contribution with IDDA/EPDA resources and that the State received no "reduction or rebate" on its General Fund contribution. However, since the IDDA/EPDA reserves were, in effect, created with both Federal and State contributions, both the Federal and State Governments were entitled to share in those reserves when the reserve funds were eliminated. But, under the California statues, the IDDA/EPDA reserves were used to reduce only the State contributions, with no reduction whatsoever to Federal contributions. The costs were thus not accorded consistent treatment and the favored treatment of the State funds constituted an applicable credit.

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Final determination 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), Office of Inspector General, Office of Audit Services' reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein 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 Common Identification Number A-09-92-00116 in all correspondence relating to this report.

Sincerely yours,

June G Brown

June Gibbs Brown
Inspector General

Direct Reply to HHS Action Official:

David Low, Director
Division of Cost Allocation, HHS
50 United Nations Plaza, Room 304
San Francisco, CA 94102

APPENDICES

SUMMARY OF FEDERAL SHARE

	Total Amount Allocated	Federal Share Percentage	Federal Share
State Agencies	$809,709,799	13.10	$106,071,984
University of California (UC) Laboratories	4,337,571	100.00	4,337,571
UC Other	2,498,543	29.33	732,823
	$816,545,913		$111,142,378

Note: The State used $532 million of IDDA/EPDA reserves to offset State employer pension costs for FY 1992. No offset was made, however, for UC costs. We used actual UC employer pension costs for FY 1992 to determine the amount that should have been allocated for UC to offset employer contributions.

STATE OF CALIFORNIA PETE WILSON, *Governor*

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR
STATE CAPITOL, ROOM 1145
SACRAMENTO, CA 95814-4998

June 15, 1994

Lawrence Frelot
Regional Inspector General for Audit Services
Office of Audit Services
Department of Health & Human Services
Region IX
50 United Nations Plaza
San Francisco, CA 94102

Re: Audit of State of California's Pension Fund
CIN: A-09-92-00116

Dear Mr. Frelot:

This is in response to your request for comment by the Department of Finance, on the above referenced draft report dated April 13, 1994.

In the Audit, you request the Department to provide written comments regarding your findings. Specifically, your audit recommends that the federal government receive $111 million from the liquidation of the Investment Dividend Disbursement Account and the Extraordinary Performance Dividend Account (IDDA/EPDA) within the Public Employees' Retirement Fund.

Chapter 83, Statutes of 1991 (AB 702), as amended by Chapter 91, Statutes of 1992 (AB 1922), authorized the State to fund the General Fund portion of its retirement contribution to the Public Employees' Retirement System (PERS) with the balances available in the IDDA/EPDA accounts at the time they were eliminated. The same authority, however, was not extended to any other fund including federal funds. Consequently, use of IDDA/EPDA funds to pay for federal employer contributions would be in direct violation of State law and legislative intent.

It should also be noted that the State was not granted a reduction or rebate on the General Fund employer retirement contribution owed to PERS for 1991-92; instead, the State paid its 1991-92 General Fund contribution, as required, with IDDA/EPDA resources in accordance with the statutes cited above. Consequently, the presumption that the State General Fund was relieved or did not pay a retirement contribution in 1991-92 is incorrect. For these reasons, there is no basis in fact or in law for the federal government to receive any IDDA/EPDA funding.

Thank you for the opportunity to respond to your draft report. Please contact Vincent P. Brown, Assistant Program Budget Manager, or William Young, Principal Program Budget Manager, at 445-3274 if you have questions or need additional information.

Sincerely,

Russell S. Gould

RUSSELL S. GOULD
Director