DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date DEC 31 1996

From June Gibbs Brown
Inspector General
June G Brown

Subject Report on Pension Costs Charged to Federal Programs for Members of the State Teachers Retirement System of Ohio (A-05-96-00071)

To John J. Callahan
Assistant Secretary for
Management and Budget

The attached final report provides you with the results of the Department of Health and Human Services (HHS), Office of Inspector General's report entitled, "Report on Pension Costs Charged to Federal Programs for Members of the State Teachers Retirement System of Ohio". This report is being issued to your Region V Division of Cost Allocation for resolution and negotiation concerning pension costs charged to Federal programs by various entities in the State of Ohio. We are informing you directly because of the significant dollars involved in the proposed resolution--$75 million.

The purpose of the audit was to determine if pension costs charged to grants and contracts were in compliance with Federal regulations, generally accepted accounting principles, and actuarial standards. Our audit covered the period July 1, 1992 through July 31, 1993.

Our audit determined that excessive charges of pension costs to Federal programs resulted from the State's practice of not using surplus pension investment earnings to reduce their unfunded actuarial accrued liability (UAAL), which at the time of our review approximated $8 billion. Instead, the State of Ohio (i) established a $200 million contingency reserve for future retirement benefits and potential retirement liabilities and (ii) transferred $374 million in excess retirement fund earnings to a reserve to support future health care benefits; however, this funding level was not actuarially determined.

The Office of Management and Budget Circular A-87, "Cost Principles for State, Local and Indian Tribal Governments", Attachment B, Section D.2 states that:

> "... contributions to a contingency reserve or any similar provision for unforseen events are unallowable..."

Additionally, generally accepted actuarial principles state that "actuarial gains" should be used as they occur to reduce the pension plan's UAAL. Also, funding of the health care reserve was not in accordance with prescribed actuarial cost methodology.

Our review determined that the elimination of these practices would reduce the pension costs allocable to Federal Government agencies by approximately $75 million in future years.

We are recommending that the Division of Cost Allocation consider these issues in rate negotiations with the State agencies and other entities whose employees participate in the State Teachers Retirement System. Future pension costs allocable to the Federal Government should be reduced by the actuarial gains inappropriately transferred to the contingency and health care reserves.

If you have any questions please call me or have your staff contact John A. Ferris, Assistant Inspector General for Administrations of Children, Family, and Aging Audits, at (202) 619-1175.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

PENSION COSTS CHARGED TO FEDERAL PROGRAMS FOR MEMBERS OF THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO

JUNE GIBBS BROWN
Inspector General

DECEMBER 1996
A-05-96-00071

Memorandum

Date

From Regional Inspector General for Audit Services
Region V

Subject Report on Pension Costs Charged to Federal Programs for Members of the State Teachers Retirement System of Ohio -- Common Identification No. A-05-96-00071

To Merle Schmidt, Director
Division of Cost Allocation
Office of the Assistant Secretary
for Management and Budget
Region VI

Attached are three copies of our final report titled, "Pension Costs Charged to Federal Programs for Members of the State Teachers Retirement System of Ohio (STRS)." This report is issued for your resolution and negotiations concerning pension costs charged to Federal programs by various entities in the State of Ohio. Please safeguard it from unauthorized use. Although we are not issuing this report to STRS or to the State agency, we have no objection to your office providing them with a copy if you wish to do so.

Our audit determined that excessive charges to Federal programs in Ohio result from using pension fund earnings to (i) establish and maintain a contingency reserve to cover possible actuarial deviations and (ii) fund a health care reserve which is not actuarially supported. Since these reserves were not properly considered in determining the Plan's unfunded actuarial accrued liability, there is a potential financial impact of as much as $75 million on Federal programs in Ohio over future years.

Although you generally agreed that the auditor's position is technically correct based on Federal regulations and STRS' non-compliance with certain actuarial and accounting principles, you indicated that you may withhold concurrence based on the fact that the funds maintained in the contingency and health care reserves remain assets of the pension fund and are considered in calculating the contribution rate. We considered your comments and reevaluated our position. We subsequently determined that although the reserves are in fact included as assets in the computation of the unfunded liability and pension contribution rate, these same amounts are also used as an offsetting liability in the calculation. Thus, after discussions with our consulting actuary, we continue to believe that the practices of the Plan do not fully comply with Federal cost principles and applicable actuarial cost methodology.

We request that you provide us with written comments within 60 days from the date of this report regarding any actions taken or planned on our recommendations. Your response should be addressed to: Paul Swanson, Regional Inspector General for Audit Services, 105 West Adams, 23rd Floor, Chicago, Illinois 60068. If you have any questions, please call me or Jim Pervisky, Audit Manager, at (312) 353-2618.

for James W. Pervisky

Paul Swanson

Attachments

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date

From Regional Inspector General for Audit Services
Region V

Subject Report on Pension Costs Charged to Federal Programs for Members of the State Teachers Retirement System of Ohio - - Common Identification No. A-05-96-00071

To Merle Schmidt, Director
Division of Cost Allocation
Office of the Assistant Secretary
for Management and Budget
Region VI

This report provides the results of our audit to assist you in your negotiations concerning pension costs charged to Federal programs for plan members of the State Teachers Retirement System of Ohio (STRS). Our audit of pension costs generally covered the period July 1, 1992 through July 31, 1993. The purpose of the audit was to determine whether pension costs charged to grants and contracts were in compliance with Federal regulations, generally accepted accounting principles (GAAP), and actuarial standards.

Pension contribution rates must conform to cost principles contained in Office of Management and Budget Circular A-87. The rates must be calculated in accordance with generally accepted accounting and actuarial standards and be actuarially determined. We determined that certain practices clearly do not conform with Federal cost reimbursement principles or applicable actuarial cost methodology.

Our audit determined that excessive charges of pension costs to Federal programs result from (i) establishing a contingency reserve to cover liabilities that could result from deviations from actuarial estimates and projections and (ii) using pension fund investment earnings (actuarial gains) to fund a health care reserve instead of to reduce the retirement fund's unfunded liability.

Office of Management and Budget (OMB) Circular A-87 states that contributions to contingency reserves are not allowable charges to Federal programs. The funding of the health care reserve was not in accordance with prescribed actuarial cost methodology, nor was the reserve actuarily determined. Both of these reserves were funded with retirement fund investment earnings which should have been used to reduce the plan's unfunded liability for future retirement benefits. Since amortization of this future liability is a component used in calculating the employer contribution rates, retirement costs charged to Federal programs are overstated. Federal cost principles do not allow reimbursement of increases in employer contributions to a pension plan that result from the maintenance of special reserves which are actuarily unsupported and unjustified.

By using the investment earnings to fund and maintain the two reserves, instead of to reduce the plan's unfunded liability for future retirement benefits, there is a potential future financial impact of approximately $75 million on programs administered by State of Ohio agencies and other entities within the State, including universities and county and local school districts.

We are recommending that the Division of Cost Allocation (DCA) consider these issues in rate negotiations with the State agencies and other entities whose employees participate in STRS. Future pension costs allocable to the Federal government should be reduced by a share of the retirement fund earnings (actuarial gains) inappropriately transferred to the contingency and health care reserves. Effective July 1, 1996, the reserve for future health care benefits must be based on acceptable accounting methodology in accordance with the revised OMB Circular A-87, using either actuarially determined costs or pay-as-you-go financing. The health care reserve maintained during our audit period clearly did not meet either of these criteria.

BACKGROUND

STRS was created by legislative action on May 8, 1919. It is a mandatory retirement plan for teachers and other faculty members employed in the State's public schools. As of July 1, 1993, STRS had about 254,000 active members and 91,000 retirees. Audited financial statements for the year ended June 30, 1993 disclosed that the plan had total assets of more than $25 billion and that pension contributions during 1993 were approximately $1.4 billion. The STRS accumulates assets to provide retirement benefits to members from pension contributions made by the employers and employee members of the plan and from investment earnings on these contributions.

The STRS is administered in accordance with Chapter 3307 of the Ohio Revised Code. The STRS Retirement Board is the governing body with responsibility for administration and management. Contribution rates are established by the Retirement Board and limited by Chapter 3307 of the Revised Code to 14 and 10 percent of covered payroll for employers and employees, respectively. The rates are established based on a valuation by the STRS actuary. During the period covered by this audit, the employer contribution rate was set at 14 percent of covered payroll, and the employee contribution rate was set at 9.25 percent.

SCOPE

Our review was conducted in accordance with generally accepted government auditing standards, except that we limited the scope of our review based on the extent of audit tests performed and results of a comprehensive audit performed by the plan's certified public accountants (CPA). The CPAs offered an unqualified opinion on the plan's financial statements. We reviewed the CPA's supporting working papers.

Our objective was to determine whether pension costs were being accounted for and charged to Federal grants and contracts in accordance with GAAP, actuarial principles and applicable Federal cost reimbursement principles. To accomplish this objective, we reviewed financial and actuarial reports, administrative and State regulations, and accounting and actuarial principles. We performed such other auditing procedures as were considered necessary in the circumstances.

The work performed during our audit addressed areas that are applicable to grants and contracts received by the State of Ohio as well as other Ohio entities. This report is limited to costs charged for employer units which have members covered by STRS.

To determine compliance with actuarial standards, we utilized the contracted services of an independent actuarial consultant provided by the Division of Cost Allocation. In determining the actuarial accrued liability and normal cost for the plan, the consultant found that the plan's actuary had used actuarial methods and assumptions that were generally correct and in accordance with appropriate actuarial principles. The actuarial consultant reviewed the overall reasonableness of the plan's assumptions and projections, and adherence to actuarial guidelines. The consultant was also used to determine the effect of possible audit recommendations related to the use of retirement fund earnings to fund and maintain the reserves. We also provided a copy of our draft report for review and comments by an actuary of the Health Care Financing Administration (HCFA) whose duties include reviewing costs of employee benefit plans that are charged to HCFA and other HHS programs. The HCFA actuary supported the OIG auditor's position on the reserves.

We conducted a limited review of the pension plan's published reports, both financial and actuarial, and certain accounting records. We held interviews with STRS staff and State agency officials. Since retirement contribution rates applicable to programs supported by Federal funds are approved in annual Statewide Cost Allocation Plans, we coordinated our review with the Ohio Office of Budget and Management (OBM) which compiles and negotiates the Cost Allocation Plans. Since the Statewide Cost Allocation Plan requires approval by the Department of Health and Human Services (HHS), we are addressing our report to the HHS Division of Cost Allocation.

The audit period covered by our audit of health care and special reserves was July 1, 1992 to July 31, 1993. The field work was performed at the STRS offices, their CPA's offices, and State of Ohio offices.

RESULTS OF REVIEW

For the period covered by our review, the independent CPA firm rendered an unqualified opinion on the Plan's financial statements. Our review was focused on certain issues that affect pension charges to Federal programs. Except for the issues covered in this report, nothing came to our attention to indicate that the retirement system was not operating in accordance with applicable laws and regulations.

During our review, however, we identified certain practices that do not conform with Federal cost reimbursement principles or applicable actuarial cost methodology, and which can have a significant future impact on pension costs charged to Federal programs. Pension costs allocable to Federal Government agencies would be reduced by as much as $75 million in future years if investment earnings transferred to the STRS Health Care Reserve and Special Reserve are appropriately considered in the calculation of the contribution rates. The cost savings could be achieved by the Federal agencies that provide financial assistance to Ohio State agencies, universities, and county and local school districts. Although any additional expenses associated with actuarily determined health care costs could offset these savings if benefits are maintained at the same levels, there are no offsetting costs attributable to the special reserve that are actuarially supported or justified. Details follow:

Special Reserve

The plan's Unfunded Actuarial Accrued Liability (UAAL) for future retirement benefits was overstated as a result of STRS' decision to maintain a contingency reserve for possible deviations from actuarial estimates and projections. OMB Circular A-87 states that contributions to contingency reserves are not allowable for reimbursement by Federal programs. The effect of maintaining this contingency reserve is that the funds are not properly considered in the calculation of the contribution rate applicable to retirement costs. The amortization of the UAAL is a component of the contribution rate. The plan's UAAL was not reduced by the retirement fund earnings used to establish the reserve. In addition, the amount of funds in the special reserve were considered both an asset and an offsetting liability in the computation of the contribution rate. This results in an overstatement of contributions needed to meet retirement costs of the plan. Charges made to Federal programs which are based on the contribution rates are, therefore, overstated.

The STRS established a reserve of $200 million as of July 1, 1990 to cover additional liabilities that could emerge on account of adverse actuarial experience. This reserve was funded with accumulated net actuarial gains resulting from favorable actuarial experience. For the year ended June 30, 1993, STRS' net actuarial gains were $248 million. Instead of using these gains to reduce the plan's UAAL, STRS transferred $228 million to the existing reserve for adverse actuarial experience, increasing the reserve balance to $366 million as of July 1, 1993, and $20 million to the health care reserve fund. During 1993, reserve funds of $62 million were transferred out of this contingency reserve to finance additional survivor benefits provided by the State Legislature in H.B. 721, as amended in sections of the Ohio Revised Code.

The reserve for adverse actuarial experience was established to provide a hedge in the event investment earnings did not meet actuarial expectations. Adverse actuarial experiences are occurrences outside of those considered by the actuary in projecting pension fund income/expenses. Because this reserve is dependent on future occurrences and any fund balance that might be needed to cover future adverse actuarial experience cannot be determined, we consider this reserve to be a contingency reserve.

These costs are clearly ineligible for Federal reimbursement under OMB Circular A-87. Attachment B, Section D.2 of the Circular states that "...contributions to a contingency reserve or any similar provision for unforeseen events are unallowable...." Although actuarial standards do not prohibit maintaining this type of reserve, the fund assets **must** be considered in the calculation of the plan's contribution rates. However, the balance of funds in this special reserve (including transfers of actuarial gains) is included both as an asset and an offsetting liability in determining the UAAL and the contribution rate.

Accordingly, the $366 million in this special reserve must be used to reduce the UAAL for purposes of computing the pension contribution rates. Assuming that contributions and other variables are held constant, the reduction of $366 million would result in a shortened amortization period. Our contracted actuary calculated that, for purposes of computing the contribution rates, reducing the UAAL by the $366 million would result in a change in the length of the amortization period from 31.5 years to 29.5 years. The financial impact on Federal grants and contracts made to the State of Ohio agencies, universities, and county and local school districts would be approximately $37.6 million over the total amortization period.

In summary, Federal cost principles do not allow reimbursement of increases in employers contributions to a pension plan that result from the maintenance of special reserves which are actuarily unsupported and unjustified. The assets in these reserves must be actuarily determined and fully considered in the calculation of pension contribution rates.

Health Care Reserve

The STRS established a Health Care Premium Stabilization Fund (health care reserve) to support future health care benefits. We found that the funding of the reserve was not in conformance with applicable actuarial cost methods. On July 1, 1992 and July 1, 1993, excess retirement fund earnings of about $354 million and $20 million was transferred to the health care reserve fund to provide additional reserves for future health care benefits. These transfers contributed to a health care fund balance of $750 million as of July 1, 1993. As a result of the transfers, employer contributions and the related charges to Federal programs are overstated. The financial impact on Federal programs during future years is approximately $37.6 million.

The portion of the net actuarial gain transferred to this reserve account was used to finance health care costs and to provide comprehensive health care benefits to retirees and their dependents. The costs of these health care benefits **are not actuarially determined**. Under Ohio law, part of the employer contributions forwarded to STRS are to be used to pay medical costs of the plan. To assist in meeting these costs, the STRS Retirement Board authorized an allocation of employer contributions equal to 2 percent of covered payroll to the health care reserve fund.

The 2 percent allocation of employer contributions for health care benefits was not based on actuarial determinations of costs or supported by actuarial studies, as required. Through December 1990, health care contributions forwarded to STRS significantly exceeded health care expenses. These unexpended contributions, along with the subsequent transfers of pension funds to the health care reserve, resulted in the accumulation of the large fund balances. These balances ($750 million), along with current contributions received by STRS, exceeded the amounts needed to meet current health care costs. For the year ended June 30, 1993, net payments for health care costs were about $187 million, during which time the income from contributions (2 percent of payroll costs) amounted to approximately $116 million, a shortfall of $71 million. OMB Circular A-87 provides that pension costs charged to Federal programs be reasonable and that they be treated consistently through application of GAAP.

The STRS uses the "entry age normal" actuarial cost method for determining its obligation for retirement benefits. Under this method, the present value of each member's expected benefit payable at retirement or death is determined. The amount by which the plan's actuarial accrued liability for the present value of retirement benefits earned by members exceeds the value of assets accumulated in the pension fund is referred to as the UAAL. The UAAL is amortized over a number of years, and the amount amortized becomes a component of the pension contribution rate. The contribution rate is based on the amount of the UAAL amortization and the plan's actuarially determined normal costs.

National Council on Governmental Accounting (NCGA) Statement No. 6 and the Actuarial Standards Board Actuarial Standard of Practice (ASP) No. 4 provide the following definition of entry age normal:

> ...A method under which the actuarial present value of the projected benefits of each individual included in an actuarial valuation is allocated on a level basis over the earnings or service of the individual between entry age and assumed exit age(s). The portion of this actuarial present value allocated to a valuation year is called the normal cost. The portion of this actuarial present value not provided for at a valuation date by the actuarial present value of future normal costs is called the actuarial accrued liability....

The NCGA Statement No. 6 and ASP No. 4 further require **that actuarial gains, as they occur, reduce the unfunded actuarial accrued liability**. However, we found that some of the actuarial gains in July 1992 and July 1993 ($374 million) were used to increase the health care reserves instead of reducing the plan's UAAL. The dollar balance of the health care reserve (including the transfers of actuarial gains) is included as an asset in the determination of the UAAL and the contribution rate. However, a corresponding liability is also included as an offset to the assets of this reserve.

Because $374 million in actuarial gains were transferred to the health care reserves and the reserve balance was considered both an asset and a liability in the calculations, the contribution rate is overstated and the employer contributions needed in future periods will be larger. Since the contribution rate calculation is based, in part, on an amortization of the UAAL which was not reduced by the $374 million in actuarial gains, the rates are overstated and unallowable amounts are claimed for reimbursement under Federal programs. The $374 million should have been used to reduce the plan's UAAL, as required by NCGA Statement No. 6 and ASP No. 4.

According to our actuarial consultant, reducing the health care reserve by the $374 million and applying this amount to the UAAL would shorten the period over which the UAAL would be amortized by approximately two years, from 31.5 years to 29.5 years. Therefore, amortization costs will not be included in the contribution rate during years 29.5 through 31.5.

The financial impact resulting from the shortened amortization period was calculated by multiplying the portion of the employer contribution rate attributable to the amortization of the UAAL (6.6%) times the total annual payroll of STRS participants ($5.7 billion). Based on this calculation, contributions of approximately $376 million each year would eliminate the UAAL over the 31.5 year amortization period. Costs for the two year amortization period associated with years 29.5 through 31.5 amounted to $752 million.

The financial impact on Federal grants and contracts made to State of Ohio agencies, universities, and county and local school districts would be approximately $37.6 million ($752 million times the 5% Federal share) over the amortization period. The Federal share is based on statistics which show that approximately 5 percent of the salaries for STRS participants (State, university, county and local school district employees) are charged to Federal programs. A relatively small percentage of the total is attributable to retirement contributions made on behalf of the State of Ohio agencies. Most of the impact is attributable to contributions made in behalf of the university, county and school district employee participants in STRS.

Revisions to OMB Circular A-87, which generally are effective for state fiscal years beginning on or after September 1, 1995, provide options for either actuarially determined costs or pay-as-you-go financing.

Effective July 1, 1996, if STRS chooses to establish an actuarial cost method for health care benefits, the health care funds remaining after the $374 million is returned to the pension fund may be retained in a reserve for the sole purpose of providing post-retirement benefits to retirees and other eligible beneficiaries. If STRS chooses not to establish an actuarial cost method, it **must** use a pay-as-you-go method under which allowable costs would be limited to actual payments made in behalf of eligible members. Under a pay-as-you-go method of financing, the reserve would not be needed. The balance of the health care reserve must be used to meet future health care costs or be returned to the pension fund, depending on the accounting method elected by STRS to finance health care costs.

Recommendations

We recommend that the HHS Division of Cost Allocation coordinate with the Ohio Office of Budget and Management and STRS to implement the following:

(1) A reduction of pension costs allocable to the Federal Government by:

(a) adjusting the UAAL for the participants' share of the $366 million in the Special Reserve account in the calculation of pension costs, resulting in estimated savings of approximately $37.6 million.

(b) adjusting the UAAL for the participants' share of the $374 million of actuarial gains transferred to the health care reserve in the calculation of pension costs, resulting in estimated savings of approximately $37.6 million.

(2) Adoption of an acceptable accounting method by STRS for future health care benefits, using either actuarially determined costs or pay-as-you-go financing.

(3) Developing methodology for determining appropriate cost adjustments, based on Recommendation No. 1, for all entities that claim pension costs under Federal programs.

(4) Consider entering into an agreement which provides for an appropriate refund to the Federal government in the event that any portion of the special reserve or health care reserve were to revert to the State.

(5) Require an actuarial determination of the participants' health care benefits in computing the employer contribution rate.

STATE AGENCY RESPONSE AND OIG COMMENTS

Our findings and recommendations were discussed with State agency and STRS officials at an exit conference held on March 19, 1996. The State agency, with input from the State Teachers Retirement System, provided a written response to the draft report. The State agency's comments, along with pertinent STRS positions on the reserves, are summarized in the Appendix to this report.

We would appreciate your current views, and the status of actions taken or contemplated on our recommendations, within the next 60 days. Any questions or further comments on any aspect of the report are welcome and should be directed to James W. Pervisky, Audit Manager, at (312) 353-7907. Please address your response to me at: HHS/OIG/Office of Audit Services, 105 W. Adams, 23rd floor, Chicago, Illinois 60603.

for James W. Pervisky

Paul Swanson

cc:
John J. Callahan
Assistant Secretary for
Management and Budget

APPENDIX

STATE AGENCY RESPONSE TO DRAFT REPORT AND OIG COMMENTS

STATE AGENCY COMMENTS

The State agency expressed concern regarding the scope of our review, the findings and recommendations pertaining to the STRS special and health care reserves and the contribution rate. The STRS disagrees with the report recommendations, indicating that they believe certain conclusions in the report are fundamentally wrong.

Scope of Review. In the response, the State agency expresses its concern that the significance of our findings appears to be overstated because the scope of our review includes other entities over which the Office of Budget and Management has no management control or responsibility.

> "...the costs to the Federal government isolated in the report are enhanced by the inclusion of school district, county and university employees - entities over which this office has no management control or responsibility...."

The State agency contends that the Federal savings attributable to those State employees enrolled in STRS who are under its management control is only about $960,000 over 30 years. Because most State employees who work on Federal grants are enrolled in the Public Employees retirement System (PERS), State employees represent only 0.0013% of the total annual payroll of all STRS enrollees.

OIG Comments. We recognize and agree that the State agency has no management control over pension contributions from the non-State agencies. These entities were included in this report to demonstrate the potential effect of the STRS reserves on all Federal programs in the State of Ohio for consideration by the HHS Division of Cost Allocation in resolving the issues and in developing rate agreements with the other entities. It was not feasible for us to expand the scope of our review to address the many city, local, and county school districts, vocational schools, colleges and universities within the State that have STRS enrollees and receive Federal grant funds directly or through the State. Therefore, after receiving the State agency's response, we elected to issue this final report to the Division of Cost Allocation for resolution of the issues since they also affect many other recipients of Federal funding in the State.

The State agency's computation of Federal savings attributable to State employees participating in STRS was based on the effect of a transfer of $740 million of actuarial gains placed in the health care ($374 million) and special reserves ($366 million). The computation, instead, should be based on the savings associated with the two year reduction of the amortization period for the health care reserve ($752 million of savings) and the special reserve ($752 million of savings). On this basis, the Federal savings attributable to the State employees is approximately $1,950,000 ($1.5 billion times 0.0013%). As discussed in the narrative of this report, the estimated savings attributable to all entities in the State is approximately $75 million.

Special Reserves. The State agency refers to the new OMB Circular A-87 which states that the term "contingency reserve" excludes pension plan reserves. Accordingly, they suggest that the reserves at issue are not covered by the prohibition against reimbursement for the cost of contingencies because the reserves constitute part of the pension plan.

OIG Comments. Although the revised OMB Circular A-87 (effective 9/1/95) does state that the term "contingency reserve" excludes pension plan reserves, the reference pertains to pension plan reserves taken as a whole, which by their nature are a contingency for future benefits. It clearly does not pertain to individual components or special contingency reserves within the pension plan, which are actuarily unsupported. Therefore, the provisions regarding contingencies, contained in the prior Circular A-87, in effect during the period of our review, are an appropriate basis for questioning the continued maintenance of the reserve as an exclusion from the calculation of the contribution rate.

Further, the revised OMB Circular states that pension plan costs may be computed using either a pay-as-you-go method or an acceptable actuarial cost method. The STRS uses the Entry Age Normal Actuarial Cost Method. Under this method, the actuarial gains, as they occur, must be used to reduce the Unfunded Actuarial Accrued Liability (UAAL). In contrast to the defined methodology, STRS used a portion of prior actuarial gains to fund the special reserve. This, in effect, causes pension costs to be higher than appropriate.

Health Care Reserve. The State agency response states that the reserve to provide adequate funding for health care benefits is a prudent policy choice on the part of STRS, that it is part of the pension plan, and that it should be reviewed in accordance with the revised OMB Circular A-87, Attachment B, section 11.e. The STRS further states that reference to a document or established standard is needed to support the claim that the funding of the reserve was not in conformance with accounting or actuarial principles. Per STRS, NCGA Statement No. 6 was not GAAP for reporting accrued pension obligations, as it was superseded by GASB Statement No. 5. Additionally, they stated that both will be superseded by GASB No. 26 in June 1996.

OIG Comments. We do not dispute that a reserve for health care benefits is an appropriate policy choice for a pension plan. However, the reserve must be developed and maintained in accordance with applicable guidelines and cost principles for the share that is funded with Federal monies. Guidance provided by several accounting (GASB No. 5, NCGA No. 6) and actuarial (Actuarial Standard of Practice No. 4) standards indicates that, under the actuarial cost method used by STRS, actuarial gains are to be used to reduce the UAAL. However, we found that STRS used a portion of prior actuarial gains ($374 million) to fund the health care reserve.

We agree that Section 11.e. of the revised Circular A-87 should be the basis for health care reserve funding. In that regard, section 11.e supports our finding that pension plan costs, including health care benefits, be computed using a pay-as-you-go method or an acceptable actuarial cost method. It was the Auditor of State, in a 1994 Single Audit Report for the State of Ohio, that classified STRS health care benefits as Other Post-employment Benefits. The Single Audit Report states that the employer contribution for health care benefits is advance-funded, but **not on an actuarially determined basis.** Contributions for health care benefits were not based on actuarial determinations or supported by actuarial studies. The STRS Retirement Board authorized an allocation of contributions equal to 2 percent of covered payroll to the health care reserve fund. As a result, funding of the Health Care Reserve does not comply with either option.

Implementation of a pay-as-you-go basis or actuarially determined cost basis for future health care costs could decrease current funding available for non-health care pension benefits and extend the amortization period of the UAAL if (i) the employer contribution rate remains capped by Ohio law, (ii) the State chooses to offer the same health benefit package, and (iii) the system chooses not to increase employee contribution rates. In any case, the State should select an appropriate funding option for the Health Care Reserve and not use excess retirement fund earnings. The transfer of these earnings to the health care reserve results in higher retirement costs and delays a decision on the level of health care funding and benefit coverage for enrollees that is needed and which the State is willing to pay.

GASB No. 5 provides for the use of three authoritative statements, including NCGA Statement No. 6, as sources of acceptable pension accounting principles pending the issuance of Statements on pension accounting and reporting. We determined that the CPAs who performed the annual audit of STRS financial statements used NCGA Statement No. 6 for valuation of investments and real estate. Although we agree that GASB No. 5 and NCGA No. 6 are to be superseded by the new Standards being promulgated by GASB, these new Standards will not be effective until June 1996 or later. Additionally, we understand that GASB No. 25 and GASB No. 27 will contain authoritative wording that, under the entry age normal cost method, actuarial gains are to be used to reduce the UAAL. Our audit recommendation would still apply.

Contribution Rate. The State agency contends that if the reserves were used to reduce the UAAL of the pension fund, no reduction in the rate would result. A reduction of the UAAL would result in a reduction in the number of years over which the UAAL is amortized. They suggest that this is the same conclusion reached by the HHS consulting actuary. The State agency further contends that requiring a different rate to be computed for Federal programs fails to recognize that the current rate would not change even if the system operated as proposed. The State concludes that the Federal government fairly and equitably gets the benefits it pays for in its contributions to the State's pension systems. Federal programs are treated no differently than state programs for purposes of assessing pension costs.

OIG Comments. Our contracted actuary calculated the effect that a reduction in the health care reserves would have on the amortization period of the UAAL, rather than on the contribution rate, due to the fact that the employer and employee contribution rates were established and fixed by State law. We do not intend to suggest that the amortization period of the UAAL should be reduced <u>and</u> a lower contribution rate be computed. As discussed at the exit conference, we are not recommending that any changes be made in the manner in which STRS is operating its program. Rather, we are recommending that the effect of the reported findings be considered in the calculation of pension costs charged to Federal programs by the various entities in Ohio. Although we agree that the State's charges to Federal programs are in fact consistent with charges to all other programs, the portions of the charges representing the contingency reserve and the transfers to the Health Care Reserve, which are not eligible for reimbursement under Federal cost principles, need to be eliminated from reimbursement claims.

The contribution rates are established by the Retirement Board based, in part, on a valuation of the pension plan liabilities by the STRS actuary. The actuarial valuation is based on a determination of the normal costs and amortization of the UAAL. The use of actuarial gains for purposes other than the reduction of the UAAL results in a lengthened amortization period for the UAAL. As a result, the exclusion of certain actuarial gains from the actuary's calculations will result in the payment of additional retirement contributions in the future and may delay decisions that could effect the current levels of health care benefits and funding the State is willing to pay. The Federal government should not have to share in any additional retirement costs that result from the use of actuarial gains to support the health care reserve and establish the special reserve.