DEPARTMENT GRANT APPEALS BOARD
THE DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE

DATE: February 7, 1975

Re: State of Connecticut, Docket No. 9.
Decision No. 8

This is an appeal pursuant to 45 CFR Part 16 from the action of Mr. Henry Kirschenmann, Jr., for the Department of Health, Education, and Welfare on September 13, 1973 in sustaining the exceptions taken by the Department of Health, Education, and Welfare Audit Agency in its audit Report No. 30136-01 dated May 23, 1973, relative to the practice of the State of Connecticut charging Federal programs for employees retirement contributions at an actuarial rate greater than the rate charged State programs. This decision is made on the basis of the documents submitted to the Board and an informal hearing held in Washington, D.C., on September 5, 1974. The undersigned members of the Grant Appeals Board have been designated as a panel of three for the disposition of the instant case.

Background

The pre-negotiation review of the Consolidated State-wide Cost Allocation Plan for the State of Connecticut by the Regional Audit Director identified several unresolved problems for the fiscal year ending June 30, 1970. The problems were summarized in Mr. Edward A. Parigian's memorandum dated January 27, 1970. Item 3 of the memorandum discussed fringe benefits and indicated that the "salary and wage amounts used in the various cost analyses used for allocation purposes were increased by 18.06%." The memorandum indicated that only 3.28% of the 18.06% was substantiated, and that the 13.36% difference represented an increase in pension costs that results from an actuarial study of State pension benefits made by an actuarial firm. The actuarial study was not reviewed at that time by the auditors.

On May 23, 1973, the Regional Audit Director issued Health, Education, and Welfare Audit No. 30136-01. The audit reviewed State-wide cost allocation plans, provisionally approved by the Office of Grants Administration Policy (OGAP) for the four years ending June 30, 1973. The audit concluded (page 5) that the actuarial contributions to the State Employees Retirement Fund by the State for the fiscal years 1972 and 1973 were 6.69% and 7.805% respectively below the percentage rates provisionally approved by Health, Education, and Welfare. The report indicated that "those States using the higher rates

are, in fact, claiming excessive reimbursement under Federally-supported programs" (page 5).

The State of Connecticut took exception to the findings claiming that (1) the accounting principal of accrued liabilities was well established; (2) that OMB Circular A-87 provides for accrual accounting; (3) that A-87 also provides that the cost of personal services includes all costs, paid or accrued; (4) that the "22.3% retirement adder" was developed by a competent actuarial firm; (5) that the State has an unconditional obligation ultimately to pay the retirement benefits; and (6) that the relation of the State to its employees is usually long-range and the accrued liability for pension benefits is eventually paid.

On September 13, 1973, the Division of Cost Policy and Negotiation, HEW, by memorandum substained the HEW auditors in the exceptions taken "to the practice of assessing Federal programs at a rate in excess of State programs," as well as the depositing of funds received for such differences in accounts other than the retirement fund. The basis for the disallowance was: (1) The action was inconsistent with OMB Circular A-87, particularly Section C.1.d which calls for consistent accounting treatment between all Federally assisted programs, as well as other activities so charged. (2) The definition of cost was improperly interpreted by the State--more specifically, that it must be necessary to "liquidate the legal liability of the State arising from the conduct of the Federal programs." (3) That there was a question as to whether the State had incurred any legal, enforceable liability to its employees. (4) That it "was almost a universal practice of States and other organizations performing under Federal Grants to fund employee retirement at an actuarially determined rate.

On October 16, 1973, the State of Connecticut by letter pursuant to 45 CFR-16 (38 FR 9906, dated April 20, 1973) appealed the decision of Mr. Henry G. Kirschenmann, Jr., Director, Division of Cost Policy and Negotiation, HEW.

On September 5, 1974, after several delays, an informal hearing was conducted in Washington, D.C. Mr. Wendell Gates, Assistant Attorney General, represented the State of Connecticut and Mr. Henry G. Kirschenmann, Jr., represented the Department of Health, Education, and Welfare. The participants to the hearing were given 30 days from the receipt of the transcript to submit final briefs on their positions. The State of Connecticut and the Department of Health, Education, and Welfare submitted final positions during the time periods indicated.

Discussion

During fiscal years 1972 and 1973 the State of Connecticut claimed and was paid for by the United States Government, the cost of deferred retirement benefits in excess of the rates charged itself and paid into the retirement fund for all State employees. The Federal Government paid to the State of Connecticut 13.36% and 22.3% respectively of the salaries of State employees engaged in Federal programs while the State charged itself 6.69% and 7.8% for the fiscal years 1972 and 1973. In addition, the State did not deposit the entire amounts so received from the Federal Government in its retirement fund.

In fiscal year 1972 the State discarded its "pay-as-you-go" funding system and changed to a system funded on an "actuarial reserve basis." The State employed an actuary to determine various alternative actuarial methodologies. From these the State recommended an alternative whereby the State would contribute annually over a 15 year period increasing percentages of the sum of the system normal cost plus the amount necessary for a 40 year amortization of its unfunded liability. In the 15th year and subsequent the State would contribute the system's normal cost plus the amount needed to amortize the unfunded liability. However, the legislature passed Public Act 666 which left the decision of post-FY 1986 funding to the discretion of the State's retirement commission. While the State legislature selected the least costly alternative of financing, the State Commissioner of Finance and Control selected a more costly approach to charge the Federal Government. In so doing the State argues that the higher figure represents the true "costs" of its retirement system.

The State alleges that the extent to which the State elects to fund this "cost" though actual contributions (cash payments by the State) to the retirement fund is irrelevant and "has no effect on the figures which express the cost of the retirement plan" (appeal document-page 10). The State also alleges that it is not required to place the entire Federal retirement payment in its retirement fund. In fact it states that the non-use of funds paid to the State for retirement "costs" by the retirement fund is "not an important consideration" (appeal document-page 20). Finally, the State contends OMB Circular A-87 permits Federal recognition and payment of "accrued costs."

The Government's position is that, with respect to retirement benefits provided under a plan which is funded on an actuarial reserve basis, allowable "retirement cost" for purposes of Federal grants and contracts is determined by a State's actual contribution to its retirement fund, so long as that contribution is reasonable. The reasonableness of a State's contribution depends in part upon the actuarial cost method and the actuarial tables and assumptions used by the actuary in developing the plan's funding scheme, and the treatment of the plan's unfunded liability. It is the Government's view, therefore, that, if the 6.69% and 7.8% contribution rates applicable to the State of Connecticut during FY 1972 and FY 1973 were reasonable, they should have been applied as well to the Federal Government. To the extent Federal "retirement" payments in those years exceeded the sums which would have been paid had those rates been applied to the Government, the payments represented unallowable costs.

The State relies strongly on the principles outlined in OMB Circular A-87, primarily the concept of "accrued liabilities," arguing that nothing in A-87 precludes the claims which they have made.

In summary, OMB Circular A-87 provides:

(1) The cost must be approved or authorized by documentary evidence, or consent prior to incurring specific costs.

(2) The cost must be acceptable to the Federal Government as a discharge of the grantee accountability.

(3) The cost must be consistent with policies, regulations and procedures that apply both to Federally assisted and other activities.

(4) The cost must be accorded consistent treatment.

(5) The cost must be distributed equitably to grant programs and to other activities.

A step-by-step review of the process indicates that the State of Connecticut has not met the provisions of OMB Circular A-87 in that:

The Federal Government did not finally approve"by documentary evidence or consent" the State's Consolidated State-wide Cost Allocation Plan as alleged by the State. The Department's letters of August 2, 1971, and

September 28, 1972, under Section III, General - Part A, Limitations (1) indicate "that no costs other than those incurred by the State were incurred on its State-wide cost allocation plan proposal and that such costs are legal obligations of the State, and (2) that similar types of costs have been accorded consistent treatment. None of the provisions listed above have been complied with by the State of Connecticut.

(1) The State has not incurred the expenses represented by the totals charged the Federal Government for FY 1972 and FY 1973. The State only incurred as to legal obligations that rate of cash payments made to the retirement fund for other State employees. It is difficult to understand how the State has incurred a cost in excess of the rate that it has charged itself--namely 6.69% for FY 1972 and 7.8% for FY 1973.

(2) The State has not incurred a legal obligation for the excess rates. The State contends that the retirement costs which it fails to fund, and elects to accrue, represent a "legal liability of the State" (appeal document, page 27). An entitlement to retirement benefits which an employee may accrue over the years does not represent a legal liability of the State. The State is free to reduce or terminate such benefits as it sees fit. To the extent that the State could be liable for such future benefits, its liability is, at best, a contingent one.

(3) The State has not accorded consistent treatment of similar costs. While the Federal Government in FY 1972 paid 13.36% of employee salaries as its share of retirement benefits, the State contributed to the Retirement Fund only 6.6% of employee salaries. In other words, the State did not contribute in excess of the 6.6% rate for its own non-Federally funded State employees, but it has claimed and received payment from the Federal Government (but not paid the cash into the retirement fund) at the rate of 13.36%.

The State's argument and its use of the concept of "accrued costs" should also be fully recognized. Under Connecticut's theory a State has complete discretion in devising alternative funding schemes, in selecting the approach under which the "costs" will be measured, and in selecting another approach under which

it will actually fund the plan. One approach can then be used for reimbursement to the State under Federal grants even though the State selects quite another, less costly, approach under which its financial disbursements are determined. This theory permits a State to define the "cost" of its retirement plan over a short period and to charge the Federal Government on the basis of this approach. However, the State can at the same time choose an entirely different and, at least initially, less costly approach under which it will contribute to its retirement fund. The "difference" is treated as "accrued costs." The Board finds that this methodology discriminates against the Federal Government and does not find that OMB Circular A-87 or any other Government regulation, instruction, or interpretation, supports such an approach.

Decision

The appeal is disallowed in full.

/s/ Francis D. Degeorge, Panel Chairman

/s/ William T. Van Orman

/s/ Thomas E. Malone