# COMMONWEALTH OF PENNSYLVANIA
# TREASURY DEPARTMENT
# TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM

## AUDIT REPORT

## FOR THE FISCAL YEAR ENDED JUNE 30, 2004

**COMMONWEALTH OF PENNSYLVANIA**

# *TREASURY DEPARTMENT*
# *TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM*

**HARRISBURG, PENNSYLVANIA**

**AUDIT REPORT**
**FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

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JACK WAGNER

AUDITOR GENERAL

## BACKGROUND

The Tuition Account Program and College Savings Bond Act of 1992 established Pennsylvania's Tuition Account Program (TAP). The 1992 Act was amended by Act 2000-58 effective August 22, 2000. Act 2000-58 changed the name of the original TAP program to the TAP Guaranteed Savings Program and created a second program, called the TAP Investment Program which is similar to a mutual fund. The TAP Investment Program was implemented on July 17, 2002 and is accounted for as a separate fund. The TAP Investment Program is not included in this report.

The Guaranteed Savings Program (GSP) is administered by the Tuition Account Guaranteed Savings Program Bureau (Bureau), an office within the Pennsylvania State Treasury (Treasury), and provides Commonwealth residents the opportunity to prepay college tuition towards future education expenses at eligible educational institutions. An eligible educational institution is defined as a college, university, vocational or other post-secondary educational institution as defined by the Internal Revenue Code. As of June 30, 2004, 34 Commonwealth-owned and state-related universities and community colleges participate in the Program. In addition, private institutions are eligible, which are defined as any private or out-of-state public institution that is an eligible educational institution.

Additionally, the Act established a 19-member advisory board to "consider, study and review the work of the Tuition Account Guaranteed Savings Program Bureau." The board also advises Treasury upon request and makes recommendations as it deems necessary. Five members are assigned to the board by virtue of their positions - the State Treasurer, the Chairman of the Board of Directors of the Pennsylvania Higher Education Assistance Agency, the Commissioner of Higher Education within the Department of Education, the Chairman of the Council of Higher Education, and the Chancellor of the State System of Higher Education. Of the remaining 14 positions, 4 members are appointed by the President Pro Tempore of the Senate, 4 members are appointed by the Speaker of the House of Representatives and 6 members are appointed by the Governor. The board reports annually to the Governor and to the General Assembly on the status of the Program and the Bureau.

Program assets are maintained in an enterprise fund independent from other state monies and cannot be used by the state for other purposes. The fund is not guaranteed by the full faith and credit of the Commonwealth.

As of June 30, 2004, there were 92,636 accounts in the GSP. During the current audit period. Treasury retained Salomon Smith Barney Inc. as investment and financial advisor and Actuarial Resources Corporation as the actuary to prepare pricing models and provide an assessment of the adequacy of the fund.

The enactment of the federal Economic Growth and Tax Relief Act of 2001, recognized by Section 529 of the Internal Revenue Code, gave the TAP program federal income tax exemption. This Act is to sunset on December 31, 2010.

## Independent Auditor’s Report

The Honorable Robert P. Casey, Jr.
State Treasurer
129 Finance Building
Harrisburg, Pennsylvania 17120

Dear Treasurer Casey:

We have audited the accompanying statement of net assets of the Commonwealth of Pennsylvania State Treasury’s Tuition Account Guaranteed Savings Program as of June 30, 2004, and the related statements of revenues, expenses, and changes in net assets and cash flows for the fiscal year then ended. These financial statements are the responsibility of the Treasury Department’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Commonwealth’s internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Commonwealth’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Tuition Account Guaranteed Savings Program and do not purport to, and do not, present fairly the financial position of the Commonwealth of Pennsylvania as of June 30, 2004, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Treasury Department's Tuition Account Guaranteed Savings Program as of June 30, 2004, and the revenues, expenses, and changes in net assets and its cash flows for the fiscal year then ended, in conformity with accounting principles generally accepted in the United States of America.

Treasury Management's Discussion and Analysis on page 5 is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated February 18, 2005, on our consideration of the Tuition Account Guaranteed Savings Program's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

February 18, 2005

JACK WAGNER
Auditor General

## TREASURY MANAGEMENT'S DISCUSSION AND ANALYSIS

Favorable investment returns for the Tuition Account Guaranteed Savings Program Fund were intrinsic to the growth of the funds' net assets as of June 30, 2004. The market value of net investments (net of securities lending investments) increased to $855.4 million at June 30, 2004, from $610.6 million at June 30, 2003. Investment income increased to $91.5 million in 2004 from $27.4 million in 2003. Net assets increased by $4 million during the fiscal year resulting in total net assets of negative $48 million at June 30, 2004 from negative $52 million at June 30, 2003.

Net liabilities (net of securities lending obligations) for the Tuition Account Guaranteed Savings Program Fund have increased to $906 million in 2004 from $665 million in 2003. Tuition benefits payable increased to $904 million in 2004 from $658 million in 2003.

The investment income contributed to an overall net income of $5 million in 2004 from a net loss of $26 million in 2003. Total revenues increased by $36 million to a total of $298 million in 2004; however total tuition credit purchases decreased to $206.5 million in 2004 from $233.9 million in 2003.

Total expenses for the Tuition Account Guaranteed Savings Program Fund increased by $5 million to $293 million in 2004 from $288 million in 2003. Tuition benefit expense increased to $282 million in 2004 from $278 million in 2003. Actual payments to educational institutions increased to $35.8 million in 2004, from $19.2 million in 2003 as 5,052 beneficiaries used 114,882 credits in 2004 compared to 3,406 beneficiaries using 71,784 credits in 2003.

The fund is now 94.79 percent funded at June 30, 2004, compared to 92.01 percent funded at June 30, 2003. At June 30, 2004, the actuarial accrued liability was $904 million and the value of assets was $857 million, for a difference of $47 million or (5.21%) of liabilities.

Tuition Account Guaranteed Savings Program Fund management maintains its responsibility over internal accounting and administrative controls to ensure that, transactions are executed in accordance with budgetary and financial requirements and that performance measurement information is adequately supported.

**TREASURY DEPARTMENT**
**TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM**
**STATEMENT OF NET ASSETS**
**JUNE 30, 2004**
**(AMOUNTS IN THOUSANDS)**

| | | |
|---|---|---|
| **ASSETS** | | |
| **Current Assets:** | | |
| Cash | $ | 765 |
| Interest receivable | | 2,460 |
| Dividends receivable | | 543 |
| Investments (Notes 2 and 3) | | 321,339 |
| **Total Current Assets** | $ | 325,107 |
| **Noncurrent Assets:** | | |
| Investments (Notes 2 and 3) | | 697,598 |
| **TOTAL ASSETS** | $ | 1,022,705 |
| **LIABILITIES** | | |
| **Current Liabilities:** | | |
| Accounts payable and accrued liabilities | $ | 2,686 |
| Current tuition benefits payable (Notes 2 and 4) | | 79,822 |
| Securities lending obligations | | 163,582 |
| **Total Current Liabilities** | $ | 246,090 |
| **Long-Term Liabilities:** | | |
| Compensated absences | $ | 49 |
| Tuition benefits payable (Notes 2 and 4) | | 824,412 |
| **Total Long-Term Liabilities** | $ | 824,461 |
| **TOTAL LIABILITIES** | $ | 1,070,551 |
| **NET ASSETS** | | |
| Unrestricted | $ | (47,846) |
| **TOTAL NET ASSETS** | $ | (47,846) |

- The notes to the financial statements are an integral part of this statement. -

**TREASURY DEPARTMENT**
**TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM**
**STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS**
**FOR THE FISCAL YEAR ENDED JUNE 30, 2004**
**(AMOUNTS IN THOUSANDS)**

| | |
|---|---|
| **REVENUES:** | |
| Tuition credit purchases | $ 206,511 |
| Investment income | 91,503 |
| Application fees | 228 |
| **TOTAL REVENUES** | $ 298,242 |
| **EXPENSES:** | |
| Tuition benefit expense | $ 281,885 |
| Salaries and other administration expenses | 5,829 |
| Tuition credit refunds | 6,042 |
| **TOTAL EXPENSES** | $ 293,756 |
| **INCREASE IN NET ASSETS** | 4,486 |
| **TOTAL NET ASSETS, JULY 1, 2003** | (52,332) |
| **TOTAL NET ASSETS, JUNE 30, 2004** | $ (47,846) |

- The notes to the financial statements are an integral part of this statement. -

**TREASURY DEPARTMENT**
**TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM**
**STATEMENT OF CASH FLOWS**
**FOR THE FISCAL YEAR ENDED JUNE 30, 2004**
**(AMOUNTS IN THOUSANDS)**

| | | |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Receipts from customers | $ | 205,563 |
| Payments to participants | | (52,476) |
| **NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES** | $ | 153,087 |
| **CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES** | | |
| Net borrowings (repayments) under advances from other funds | | 0 |
| **NET CASH USED FOR NON-CAPITAL FINANCING ACTIVITIES** | | 0 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Purchase of investments | $ | (6,319,704) |
| Proceeds from sale and maturities of investments | | 6,072,042 |
| Investment income | | 17,538 |
| Change in securities lending obligations | | 76,887 |
| **NET CASH USED FOR INVESTING ACTIVITIES** | $ | (153,237) |
| **NET INCREASE (DECREASE) IN CASH** | $ | (150) |
| **CASH AT JULY 1, 2003** | $ | 915 |
| **CASH AT JUNE 30, 2004** | $ | 765 |
| **RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES** | | |
| Operating income | $ | 4,486 |
| Reclassification of investment income | | (91,503) |
| **Change in assets and liabilities:** | | |
| Interest receivable | $ | (1,073) |
| Dividends receivable | | (103) |
| Accounts payable and accrued liabilities | | (4,807) |
| Tuition benefits payable | | 246,093 |
| Compensating absences | | (6) |
| **Total adjustments** | $ | 148,601 |
| **NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES** | $ | 153,087 |

- The notes to the financial statements are an integral part of this statement. -

## NOTE 1 – PROGRAM DESCRIPTION

The TAP Guaranteed Savings Program (GSP) is a prepaid college tuition program designed to provide for the advance purchase of college tuition credits in order to assist Commonwealth residents in funding for future educational expenses. A tuition credit is defined as one-twenty-fourth (1/24) of the tuition for an academic year of tuition at the participating institution. Once enrolled in the GSP, participants may purchase tuition credits as often as they wish. Tuition credit prices are set annually based on an actuarial assessment of current tuition rates, projected tuition inflation, and the earnings of the GSP.

The GSP, accounted for in the TAP Guaranteed Savings Program Fund, is part of the Commonwealth of Pennsylvania's financial reporting entity and is reported as an enterprise fund in the Commonwealth's June 30, 2004 *Comprehensive Annual Financial Report*.

This TAP advisory board was established by The Tuition Account Program and College Savings Bond Act of 1992, and monitors the activity of the GSP. In addition, the GSP retains Salomon Smith Barney as investment and financial advisor and Actuarial Resources Corporation as the actuary.

## NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a. <u>Basis of Accounting and Presentation</u> - The financial statements are prepared on the accrual basis of accounting. Under this basis, revenues are recognized when earned, and expenses are recognized when services and benefits are received.

b. <u>Current Investments</u> - Investments expected to be realized in cash within twelve months are reported as current investments. These investments are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value, which would result from changes in interest rates. Current investments other than repurchase agreements are stated at fair value.

c. <u>Repurchase Agreements</u> - Repurchase agreements are reported at cost because they are non-participating interest-earning investment contracts whose fair value is not significantly affected by the impairment of the credit standing of the issuer or any other factors.

d. <u>Noncurrent Investments</u> - Investments expected to be realized in cash after twelve months are reported as noncurrent investments. Investment debt and equity securities are reported at fair value.

e. <u>Tuition Benefit Payable</u> - Tuition benefits payable represents the current and long-term portions of the actuarially determined present value of future tuition obligations.

f. Investment Income - Investment income includes interest, dividends, realized gains and losses and the change in the fair value of investments during the fiscal year.

## NOTE 3 – DEPOSITS AND INVESTMENTS

Governmental Accounting Standards Board (GASB) Statement No. 3 requires certain disclosures regarding policies and practices with respect to deposits and investments and the credit risk associated with them.

***Deposits***

In accordance with GASB Statement No. 3, deposits are classified into three categories of credit risk, as follows:

Category 1: Insured or collateralized with securities held by the entity or by its agent in the entity's name;

Category 2: Collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name;

Category 3: Collateralized with securities held by the pledging financial institution or by its trust department but not in the entity's name.

The GSP's total deposits of $765 thousand are classified in credit risk Category 1.

***Investments***

In accordance with GASB Statement No. 3, investments are also classified into three categories of credit risk, as follows:

Category 1: Insured or registered, with securities held by the entity or by its agent in the entity's name;

Category 2: Uninsured and unregistered, with securities held by the counter-party's department or agent in the entity's name;

Category 3: Uninsured and unregistered, with securities held by the counter-party or by its trust department or agent but not in the entity's name. (This includes the portion of the carrying amount or any repurchase agreement that exceeds the market value of the underlying securities.)

The following table shows the fair values (in thousands) of the GSP's investments by investment type. All GSP investments are classified in credit risk category 1, except for the Treasury Department Global Pool, mortgage loans, and the securities lending collateral, which are not susceptible to credit risk categorization because securities are not used as evidence of the investment.

| ***Investment Type Description*** | ***Amount*** |
|---|---|
| Repurchase Agreement | $ 27,322 |
| Commercial Paper | 3,000 |
| Municipal Bonds | 178 |
| Mortgage Loans | 12,201 |
| Treasury Department Global Pool | 65,625 |
| Securities Lending Collateral | 163,582 |
| Corporate bonds and notes | 89,860 |
| **Total Other Investments** | $ 361,768 |
| U.S. Treasury Notes | 78,647 |
| **Total U.S. Treasury Government Obligations** | $ 78,647 |
| U.S. Government Agency Obligations | 76,392 |
| **Total U.S. Government Agency Obligations** | $ 76,392 |
| **Total Common and Preferred Stock** | 502,130 |
| **Total Investments** | $1,018,937 |

**Securities Lending Program**

The Fiscal Code provides the Treasury Department with numerous custodial responsibilities; the securities program is an integral part of the custodial function. A contract between the Treasury Department and its custodian, acting as lending agent, provides that the custodian lends securities owned by the GSP to independent brokers, dealers and banks, acting as borrowers.

Lending agreements between the custodian and the borrowers require that the custodian receive collateral from the borrowers in exchange for the securities lent. For securities lent which are not denominated in United States dollars or whose primary trading market is located outside of the United States, the fair value of the collateral received must be at least 105 percent of the fair value of the securities lent. For all other securities lent, the fair value of the collateral received must be at least 102 percent. Securities lent consist of both domestic and foreign equity securities and United States Treasury and foreign debt obligations. Almost all collateral received consists of cash; a very small portion of collateral received consists of letters of credit, United States Treasury, and corporate and/or foreign debt obligations. Collateral is marked to market daily. Additional collateral from borrowers is required if the fair value of the collateral received declines below lending agreement requirements. The lending agent cannot pledge or sell collateral securities received unless the borrower defaults. Accordingly, neither collateral securities received from borrowers nor the related obligations to borrowers are reported.

To the extent that collateral received consists of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the Treasury Department. Either the GSP or the borrower may terminate lending agreements on demand. Lending agreements are typically of very short duration – usually overnight. Therefore, the duration of lending agreements does not generally match the maturities of the investments made with cash collateral. The resulting rate risk is mitigated by the lending agent's ability to reallocate lending agreements among program participants.

The program requires that the lending agent indemnify the Treasury Department for all claims, liabilities and costs resulting from the lending agent's negligence or intentional misconduct. During the fiscal year ended June 30, 2004, there were no failures by any borrower to return securities lent or pay distributions thereon. Also, there were no losses resulting from a lending agent or borrower default and there were no Treasury Department restriction on the amount of the loans that could be made.

At June 30, 2004, there was no Treasury Department credit risk to the borrowers because the fair value of collateral received was greater than the fair value of the securities lent, consistent with the lending agreements outstanding. The carrying amount and fair value of the securities lent was $170.1 million.

## NOTE 4 – TUITION BENEFITS PAYABLE

Tuition benefits payable represents the actuarially determined present value of future tuition obligations. The recognition of current period expenses resulted from the tuition benefits payable increase of $246.1 million from the prior year.

Presented below is the total tuition benefits obligation (in thousands) of the GSP from the actuary's report. The standardized measurement is the actuarial present value (APV) of the future tuition obligation. This valuation method reflects the present value of estimated tuition benefits that will be paid in future years and is adjusted for the effects of projected tuition increases and termination of GSP contracts.

| | |
|---|---|
| **APV of Future Obligations** | |
| Current Tuition Benefits Payable | $ 79,822 |
| Long-Term Tuition Benefit Payable | 798,265 |
| **Total Tuition Benefits Payable** | 878,087 |
| Present Value of Expenses | 26,147 |
| **Total APV of Future Obligations** | $ 904,234 |
| **Assets Available** | 857,068 |

| | |
|---|---|
| **Assets Available as a Percentage of Total:** | |
| Tuition Benefits Payable | 97.60 % |
| APV of Future Obligations | 94.79 % |

Important assumptions used in the actuarial evaluations include the following:

| | |
|---|---|
| Yield on Investments | 7.5% for 3 years, and 8.5% thereafter |
| Asset Allocation | 40% cash & fixed income and 60% equities |

**Tuition Increases:**

| School | Annual Inflation Assumption |
|---|---|
| Pennsylvania Community Colleges | 6.75% |
| Universities of the State System of Higher Education | 7.00% |
| The Pennsylvania State University – All Campuses | 2005/06 – 2007/08 @ 9.75 %, 2008/09 – 2012/13 @ 5.0% 2013/14 – 2022/23 @8.1%, 2023/04 & later @ 7.75% |
| University of Pittsburgh | 2005/06 – 2022/23 @ 7.1% 2023/24 & later @ 7.25% |
| Lincoln University | 5.00% |
| Pennsylvania College of Technology | 7.00% |
| Temple University | 7.25% |
| State Related Average | 8.28% |
| Thaddeus Stevens College | 7.00% |
| PA Private Colleges & Universities | 7.00% |
| Ivy League Universities | 7.00% |

**Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards***

The Honorable Robert P. Casey, Jr.
State Treasurer
129 Finance Building
Harrisburg, PA 17120

We have audited the accompanying statement of net assets of the Commonwealth of Pennsylvania Treasury Department's Tuition Account Guaranteed Savings Program (GSP) as of June 30, 2004, and the related statement of revenues, expenses, and changes in net assets, and statement of cash flows for the fiscal year then ended and have issued our report thereon dated February 18, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Compliance**

As part of obtaining reasonable assurance about whether the GSP financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered Treasury internal control over GSP financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted a matter related to financial reporting which we have reported to management as an Observation in the following section of this report.

This report is intended solely for the information and use of the Treasury Department as manager of the Tuition Account Guaranteed Savings Program and is not intended to be and should not be used by anyone other than this specified party.

February 18, 2005

JACK WAGNER
Auditor General

## TREASURY DEPARTMENT
## TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM

### OBSERVATION – Treasury Should Continually Re-Examine Its Methodology for Evaluating the Actuarial Soundness of the TAP Guaranteed Savings Program Fund

**Comment**

**Prior Year Observation:**

Our audit of TAP for the two fiscal years ended June 30, 2003 and 2002, included observations which expressed concern about the actuarial status of the TAP Guaranteed Savings Program ("TAP GSP" or the "Program") and recommended that Treasury re-examine its methodology for evaluating the actuarial soundness of the TAP GSP Fund (the "Fund"). We also recommended that Treasury continue to evaluate its enrollment policies, program purchase options, and its pricing structure for tuition credits and take necessary steps to ensure that the deficit is eliminated rather than being allowed to persist or grow to levels that threaten the Program's ability to maintain a competitive fee structure in the future.

It should be noted that, although the Program provides a "guarantee" to account holders that tuition credits purchased at today's prices will cover actual per-credit tuition costs at the time a child is ready to attend college, this "guarantee" is not backed by the full faith and credit of the Commonwealth but rather just by the assets of the TAP GSP Fund.

Specifically, we observed that the Fund's assets were $52.4 million and $26.5 million less than the present value of related liabilities as of June 30, 2003 and 2002, respectively. While the Program's actuary concluded that the Fund was still actuarially sound notwithstanding these shortfalls, we noted that his conclusion rested on a changed definition of "actuarial soundness" from that which had been used in earlier years. In those earlier years, the Program's actuary had evaluated actuarial soundness based on a <u>current</u> point-in-time comparison of assets to liabilities. With deficits in the last two years, however, in order to reach the conclusion that the Program remained actuarially sound, the actuary projected that <u>future</u> business at existing rates would generate annual increases in net assets to move the Program from its deficit position to a position where its assets would begin to exceed the present value of its liabilities by June 30, 2006 (based on the actuary's projection as of June 30, 2002) and, as the deficit continued to grow, by June 30, 2010 (based on the actuary's projection as of June 30, 2003).

In addition to questioning the appropriateness of this definitional change, we also expressed concern that the Program actuary's projections appeared optimistic in light of the Program's recent experience. As an example, we noted that the actuary's state fiscal year 2001-02 projections – that new business in state fiscal year 2002-03 and the three succeeding years would generate <u>increases</u> in net assets of $8.6 million annually – departed significantly from the

## TREASURY DEPARTMENT
## TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM

Program's most recent performance in the 2001-02 year, during which it experienced a decrease in net assets of $8 million on new business.

The Fund also experienced a loss of $10.1 million on new business during 2002-03, exceeding even the $8 million loss it had experienced on new business in the prior year. While the Fund's total assets continued to grow with new business during state fiscal year 02-03, its liabilities grew at an even faster rate. Thus, the increase in the Fund's overall size, rather than helping to narrow the deficit, was accompanied by a doubling of the deficit from June 30, 2002 to June 30, 2003. Moreover, not only did the actuarial deficit substantially increase in absolute terms, it also increased in relative terms from 7 percent of total assets at June 30, 2002, to 8.7 percent of total assets at June 30, 2003.

We also pointed out that, if the Program actuary's projections did not materialize, the Program could remain in a position where its liabilities continued to exceed its assets significantly beyond actuarial projections, thus raising concerns about the basis for the actuary's claim that the Program remained actuarially sound.

In its formal management response to our prior-year observations, Treasury stood by its actuarial methodology and its conclusion that the Fund remained actuarially sound. Also, in response to this prior-year experience, TAP management reinstituted "surcharges" or "premiums" for contributions made toward the purchase of tuition credits on or after September 1, 2003. These premiums represent charges to participants over and above actual current tuition rates that would otherwise be applicable to the purchase of future tuition credits. According to TAP management, these premiums would help eliminate an actuarial deficit that persisted through the fiscal year that ended June 30, 2003.

**FYE June 30, 2004:**

The most recent experience of the TAP GSP Program shows that an actuarial fund deficit has persisted throughout the fiscal year ended June 30, 2004, and in fact up through December 31, 2004, as follows:

| As of | TAP GSP Deficit |
|---|---|
| June 30, 2004 | $47.8 million |
| September 30, 2004 | $55.0 million |
| December 31, 2004 | $25.4 million |

We are concerned that the TAP GSP Program has been operating in a persistent deficit condition since the 2001-02 fiscal year, and this shortfall is now continuing into the 2005 year. Although progress has been made toward eliminating the deficit, we continue to question the actuarial

## TREASURY DEPARTMENT
## TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM

soundness of the Fund. This issue must be addressed, as thousands of Pennsylvania families are depending on the health of the Fund in order to provide college educations for their children. Furthermore, other families are evaluating the Fund in order to decide whether to participate in the Program as well.

### Recommendations

- The Treasury Department, working with its actuary, should routinely reassess the viability and appropriateness of its actuarial assumptions and methodology for evaluating the actuarial soundness of the GSP Fund.

- Treasury should evaluate its enrollment policies, program purchase options, and pricing structure for tuition credits and take necessary steps to ensure that the deficit is eliminated as soon as possible, rather than being allowed to persist or grow even further. For the sake of both current and prospective participants in the GSP Program, Treasury should achieve this important task, or at least demonstrate significant progress, by the end of the 2005-06 fiscal year.

### Agency Response

We have reviewed the draft observation entitled Treasury Should Continually Re-Examine Its Methodology for Evaluating the Actuarial Soundness of the TAP Guaranteed Savings Program Fund. This observation resulted from the Department of the Auditor General's audit of the Tuition Account Program's Guaranteed Savings Plan financial statements for the fiscal year ended June 30, 2004.

We concur with your recommendations that Treasury should continue to reassess the actuarial soundness of the Guaranteed Savings Plan and evaluate the program's enrollment policies, program options, and its methodology for setting TAP Credit Rates in order to address the fund deficit that currently exists. We also agree that Treasury should have in place by the end of fiscal year 2005-2006 a plan that strives to deal with the deficit in a systematic, rational and effective manner, recognizing that such plan may call for action on the part of the General Assembly to ensure that the accumulated deficit does not undermine the future viability of the Guaranteed Savings Plan.

In May 2005, the Treasury Department engaged Moody's Investors Service, one of the world's most respected sources for credit ratings, research and risk analysis to analyze the Guaranteed Savings Plan. We will determine what remedial actions, if any, will be taken to strengthen the Guaranteed Savings Plan once we receive Moody's rating opinion and related report.

### Auditors' Conclusion

## TREASURY DEPARTMENT
## TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM

We have reviewed the Agency Response and support Treasury Management's actions to implement the auditors' recommendations as previously stated. We will await the results of Treasury's future evaluations of the fund and continue to closely monitor the GSP in our future audits.

**TREASURY DEPARTMENT**
**TUITION ACCOUNT GUARANTEED SAVINGS PROGRAM**
**AUDIT REPORT DISTRIBUTION LIST**

This report was initially distributed to the following:

Commonwealth of Pennsylvania

The Honorable Edward G. Rendell
Governor

Governor's Office of the Budget

Harvey C. Eckert, Deputy Secretary
Comptroller Operations

Herbert A. Maguire, Director
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