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## Pension Benefit Guaranty Corporation

## Weak Financial Condition Worsened by Serious Internal Control Weaknesses

Statement of
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Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our attempt to audit the Pension Benefit Guaranty Corporation's fiscal year 1990 financial statements. As we reported to the Corporation's Board of Directors in January 1991, we were unable to express an opinion on the fair presentation of the Corporation's financial statements because of serious internal control and systems weaknesses. These weaknesses prevented us from assessing the reliability of the Corporation's method for estimating its liability for future benefit payments to pensioners. Our work also disclosed serious weaknesses with control and collection of premiums and with other accounting controls. In our previous attempts to audit the Corporation's financial statements, we have identified similar problems. The recurring nature of these weaknesses demonstrates an ineffective commitment by the Corporation to establishing and maintaining effective internal controls and sound financial systems.

Corporation management, the Board of Directors, and the Congress need reliable financial statements to effectively manage and oversee the guarantee program and to assess the adequacy of the Corporation's premium levels to meet its long-term obligation to pay future benefits. The Corporation's long-standing control weaknesses, reported $1.8 billion accumulated deficit, and possible future losses for underfunded ongoing pension plans led us to place the Corporation on our list of "high risk" agencies and programs.

Adequate systems and controls are basic to sound financial management. They are especially critical to an entity that is experiencing financial difficulties. Before discussing the three weaknesses we identified, we would like to discuss the Corporation's reported, though unaudited, financial condition and the uncertain financial future it faces. Although the information represents the most recent financial information publicly available, it, nonetheless, reflects the Corporation's unaudited financial condition as of September 30, 1990, and thus is somewhat dated and of uncertain reliability.

## The Corporation's Financial Condition and Uncertain Future

For fiscal year 1990, the Corporation reported an operating loss of more than $780 million which increased its accumulated deficit by more than 75 percent to $1.8 billion. The fiscal year 1990 operating loss was caused by a significant increase in losses for probable future termination of pension plans, investment losses on assets held for benefit payments, and a decline in the expected recovery value of receivables due from sponsors of terminated plans. With $2.6 billion in cash and investments, and annual premium income of approximately $680 million, the reported accumulated deficit does not pose an immediate risk to the Corporation's ability to pay benefits currently due and administrative expenses which, in fiscal year 1990, amounted to approximately $437 million. But it is important to note that future premiums from ongoing pension plans will have to fund the accumulated deficit as well as the continuing cost of the guarantee program.

In addition to the losses already reflected in the fiscal year 1990 financial statements, the Corporation faces significant risk from future plan terminations. At the end of fiscal year 1990, the Corporation reported some $20 billion to $30 billion in plan underfunding, much of which is concentrated in the steel, automotive, and airline industries. The extent of this concentration can be seen in the Corporation's disclosure of the companies responsible for the 50 largest underfunded defined benefit pension plans. Of the $14 billion in underfunding disclosed for the 50 companies, $5 billion (or 35 percent of the total) was attributable to companies in the steel industry, $4.1 billion (or 29 percent) the automotive industry, and $1.5 billion (or 11 percent) the airline industry. The funding status of these plans is of more concern considering that this data was based on information reported as of December 1989. The effects of the current economic downturn on these industries could hinder future employer pension plan contributions.

The most immediate risk to the Corporation from underfunded plans is presented by financially troubled companies in bankruptcy or those close to it. The Corporation's fiscal year 1990 annual report disclosed more than $8 billion in such underfunding. Once again, as this information was developed in support of the fiscal year 1990 financial statements, it does not include the effect of recent events such as the Corporation's decision to seek the termination of PAN AM's pension plans. While the Corporation's fiscal year 1990 financial statements included an estimated loss for the expected PAN AM termination, the Corporation reported last week that it expects additional losses from PAN AM.

Although the Corporation's financial future will be affected by economic trends and particularly by the economic well-being of troubled industries, its financial future will also depend on

-- effective management of the Corporation's pension guaranty programs,

-- effective oversight of private pension plans to detect problems early, and

-- the continued broad-based participation in the guarantee program by pension plan sponsors.

In the event that many of the plans which make up the $20 billion to $30 billion in underfunding terminate in the near future, there would be a serious question as to whether the

Corporation's premium structure could be adjusted to meet the resulting funding needs. Such events could raise the possibility of federal assistance to either the Pension Benefit Guaranty Corporation or to the troubled companies as occurred with the Chrysler Corporation in the late 1970s.

In these troubled times, it is imperative that the Corporation resolve the serious financial system and internal control weaknesses that impair its ability to effectively manage the pension guarantee program.

## Internal Control Weaknesses Affect the Reliability of the Corporation's Estimated Liability for Future Benefits

The Corporation's liability for future benefits dominates its fiscal year 1990 financial statements--the account totals $4.8 billion and is about 95 percent of the Corporation's obligations. This account represents the estimated present value of future benefit payments the Corporation must pay to participants of terminated plans as well as those plans which as of September 30, 1990, were expected to terminate in the near future. Stated in slightly different terms, this account represents the amount of funds (or assets) the Corporation needed, as of September 30, 1990, to prudently invest in order to have sufficient funds in the future to pay required pension benefits to participants over their remaining life expectancies. The reliability of this estimate is essential to sound financial management and to determine where the Corporation stands financially.

The Corporation faces a difficult task in developing reliable estimates of the future benefit liability for the approximately 1,600 terminated pension plans. To precisely calculate the liability for future benefits, the Corporation must first obtain, update, and evaluate data on plan assets and benefit provisions, the financial condition of the plan sponsors and members of their control group (an employer and its affiliated companies), and the individual participants covered by the plan. Historically, this often takes the Corporation as long as 3 to 5 years. When this process is completed, the Corporation's actuaries are able to determine each participant's benefit. This provides a pattern of expected future benefits over a period of years. The Corporation should then be able to calculate a reliable measure of the present value of the future benefit liability using specially designed computer software to calculate for each participant the present value of future benefits as of the date of the financial statements.

The delay inherent in the termination process requires the Corporation to use other techniques to estimate its future benefit liability on plans for which the Corporation has not yet determined the expected pattern of each participant's future benefits. The Corporation developed two alternative techniques which, relying on available plan data, are intended to approximate the calculation performed by the Corporation for individual participants. These techniques are not considered as precise because to varying degrees they rely on less current and less accurate data and arrive at a so-called plan level estimated liability for future benefits rather than developing an estimate for each participant. As of September 30, 1990, about 79 percent of the Corporation's liability for future benefits was determined on this less accurate plan level basis.

It is important to realize that each estimating technique, including that used when the expected pattern of future benefits is known, represents a unique combination of mathematical formulas and assumptions. To express an opinion on the reasonableness of the Corporation's estimated liability we needed to: (1) understand how each technique worked, (2) review the reasonableness of assumptions (such as mortality patterns and the discount rates), (3) review the quality of the participant and/or plan data, and (4) judge how well each technique approximates an individual participant valuation. To audit the Corporation's liability for future benefits, we planned to confirm the validity of the Corporation's technique for producing individual participant valuations, and then use the results to evaluate whether the two alternative techniques used to produce plan-level estimates reasonably approximate the estimates calculated for the individual participants.

However, we were unable to determine the reliability of the Corporation's estimated liability for future benefits.

-- Weaknesses with the Corporation's individual participant technique prevented us from determining that it produced reasonable results. The weaknesses identified included (1) the failure of computer software to measure a liability for certain supplemental benefits applicable to some plans, (2) out-of-date documentation for the computer software, and (3) missing data in the participant data file, such as age and sex. These weaknesses prevented us from forming an opinion on the reliability of individual participant liability estimates and from using the individual participant technique to compare how well the other techniques developed a reasonable estimate.

-- The Corporation had not maintained current supporting material that explained how the individual participant or the plan level estimating techniques worked and why the assumptions used represented the best estimate of the Corporation's anticipated experience. This prevented us from understanding how the techniques worked and from evaluating the appropriateness of assumptions used.

In addition to these weaknesses in supporting and controlling the liability estimating techniques, preliminary comparisons of the relative estimating capabilities of the three techniques, performed by the Corporation on a non-random sample of plans, produced unexplained variations in estimates.

Because it is not possible to express an opinion on the Corporation's financial statements if its principal liability, the liability for future benefits, cannot be audited, we stopped our audit and issued a report on our findings to the Corporation's Board of Directors in January 1991.

## Other Internal Control and Financial System Weaknesses Affect the Reliability of Corporation Financial Statements

Our preliminary work to assess the reliability of other components of the Corporation's financial statements identified two additional areas with serious financial system and internal control weaknesses. These involved the

-- processing and follow-up on premium payments submitted by plan administrators and

-- the general ledger accounting systems and the related accounting procedures used to control the processing and recording of accounting transactions.

## System Weaknesses Inhibit Premium Collection Efforts

Premium income represents the Corporation's primary source of funding for its losses on pension plan terminations as well as its operating expenses. During fiscal year 1990, the Corporation reported premium income of more than $680 million received from ongoing plans. Plan administrators annually determine their premiums by calculating (1) a fixed rate premium on the number of covered participants and (2) if applicable, a variable rate premium based on the level of plan underfunding. To support their calculation, plan administrators are required to report various premium-related information in accordance with Corporation guidance.

In making preliminary inquiries about the Corporation's system for processing and controlling premium-related filing information, we found that the Corporation did not process premium-related information filed by plan administrators for more than 2 years. Because the information was not processed, the Corporation was unable to effectively determine the amount of unpaid premiums and pursue the collection of premiums, interest, and penalties. Not processing the information also affected the reliability of the Corporation's accounting for premium income. The Corporation was not able to process the information because its Premium Processing System, which also serves as the subsidiary accounting system for reporting and controlling premium-related transactions and assets, had not been successfully modified in time to accommodate a change in the Corporation's new premium structure that included a variable rate effective in 1988.

Between August 1988 and September 1990, the Corporation warehoused the data filed by plan administrators on computer tape while it attempted to modify the Premium Processing System to accommodate the processing of the new variable rate data. Without an operating system, the Corporation was unable to perform basic premium processing, collection, and accounting functions and to enforce the premium payment requirements. During the interim the Corporation could not

-- post premium data to appropriate plan history files,

-- process premium data, checking for accuracy and completeness,

-- identify unusual and incorrect data warranting follow-up action,

-- generate automated refund notices or billing notices, and

-- control, summarize, and report premium-related accounting information.

Without a functioning subsidiary accounting system for premiums, the Corporation had to estimate earned premium income and premium receivables for the fiscal year 1990 financial statements. These estimates were developed as an alternative to traditional accounting data produced when premium transactions are processed promptly and accurately in a subsidiary accounting system. It is not known whether, and to what extent, the lack of an effective premium processing system has resulted in the Corporation failing to collect premium income due.

## Accounting Control Weaknesses Limit the Financial Statements Creditability and Place Assets at Risk

The Corporation's accounting operations generally consist of recording, controlling, summarizing, and reporting the financial activity. The operations are essentially broken into two primary funds. The Corporation's revolving fund activity includes premium receipts and subsequent disbursement of these funds to pay operating expenses and the portion of current benefit payments funded by revolving funds. Trust fund activity encompasses the

Corporation's accounting for plan assets acquired after a plan terminates, the related liability for future benefits, and the portion of current benefit payments funded by trusteed assets.

The preparation of reliable financial statements depends to a great extent on sound financial management practices. Sound financial management depends on adequate accounting systems built upon effective internal controls. Effective internal controls provide management with reasonable assurance that (1) obligations and costs comply with applicable laws, (2) assets are safeguarded against waste, loss, and unauthorized use, and (3) revenues and expenses are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over assets.

In obtaining an understanding of the Corporation's accounting and financial reporting functions during fiscal year 1990, we determined that essential elements of the Corporation's accounting system and internal controls were not working during all or part of the fiscal year. The Corporation's trust fund financial activity was not properly controlled by an operating general ledger system for the first 6 months of the fiscal year. In addition, for the entire fiscal year, the Corporation lacked basic accounting procedures needed to properly guide and control the recording of accounting transactions for both the revolving and trust fund activity. These weaknesses represent the continuation of conditions that arose shortly after the Corporation's 1986 decision to abandon the general ledger systems for trust funds and revolving funds even though the replacement system with its accompanying general ledgers was not ready.

As an interim measure, the Corporation began accounting on a manual ad hoc basis until it began partial operations of the new integrated systems, the Financial Accounting and Reporting Systems, in fiscal year 1989. Since January 1986, the ad hoc accounting was performed largely without current operating procedures and without the system and procedural controls associated with an operating system. This condition resulted in inconsistent accounting and created confusion among accounting personnel. The absence of an automated financial system and data base inhibited the preparation and use of summary accounting data to facilitate various control operations such as account reconciliation and interim financial reporting. Without operating general ledger systems, the Corporation relied on undocumented procedures to summarize financial activity in preparing annual financial statements. Finally, even as the various components of the new system became operational during fiscal year 1990, accounting personnel still did not have the guidance needed to accurately and consistently process transactions into the new system.

One effect of these weaknesses surfaced when at the end of fiscal year 1989, the Corporation entered cumulative accounting data into the new general ledger systems in order to generate a set of fiscal year-end general ledger balances. In entering the trust accounting data, the Corporation discovered that in the interim it had not correctly accounted for and controlled over $150 million in trust fund assets. The Corporation adjusted its fiscal year 1989 ending general ledger balances and financial statements to recognize a gain resulting from discovering these assets. However, it was not until fiscal year 1990 that the Corporation reworked and corrected its interim trust accounting data to get accurate balances and confirmed the $150 million fiscal year 1989 adjustment. The lack of an operating general ledger system for trust fund financial activity continued for the first 6 months of fiscal year 1990, after which time, the Corporation began processing periodic trust fund accounting transactions into the new system.

During fiscal year 1990, the weaknesses in systems and controls contributed to the Corporation's inability to

-- systematically reconcile either its accounting data with various internal financial feeder systems or its investment and fund activity with applicable custodian banks and the Department of the Treasury,

-- control its accounts receivable through a subsidiary tracking system which facilitated the billing, monitoring, and collecting of amounts due to the Corporation, and

-- promptly prepare and file reliable external financial reports.

The inoperative trust general ledger system and the absence of adequate accounting procedures needed to guide and control the recording of basic accounting transactions during fiscal year 1990, placed Corporation assets at risk and seriously jeopardized the credibility of its financial statements. Without credible financial statements, the ability of Corporation management and the Congress to manage and oversee the guarantee program is impaired.

## Corporation Plans for Corrective Actions

In response to our January 1991 report, the Corporation has begun efforts designed to develop support for its liability estimating techniques and use of assumptions, to enter missing participant data, and to test how well each of the techniques reasonably estimate the Corporation's liability based on available data.

According to Corporation officials, after the close of fiscal year 1990, the Corporation began limited processing of the warehoused premium data as well as the new premium filing data received since September 1990. However, these officials do not expect to complete other key processing functions on premium filing data received since August 1988 until some time in fiscal year 1992. These include (1) correcting errors in premium data posted to the premium processing system, (2) editing the completeness and accuracy of the variable rate premium and supporting information, and (3) generating automated billing documents for amounts owed for premiums, interest, and penalties. The Corporation faces a substantial task in attempting to complete the processing of all backlogged premium filing information, to resolve the processing problems that can be expected to arise, and to generate billing documents. While the Corporation is working to straighten out the premium processing system, it has begun a separate effort to redesign and simplify the premium processing and accounting functions.

Regarding other accounting operations, Corporation officials advised us that they continue to make substantial progress in implementing the new Financial Accounting and Reporting System. These officials told us that by fiscal year 1992 they expect to be able to process, most, if not all, accounting transactions into the new system in an accurate and timely manner. However, current plans do not provide for development and documentation of basic accounting procedures until some time after the end of fiscal year 1991.

In summary, significant system and control weaknesses in liability estimation, premium, and accounting operations impair the Corporation's ability to

-- reliably account for and control assets acquired through plan termination and premium operations,

-- accurately measure its liabilities for future benefit payments to provide the Congress with a basis for determining if premium levels are adequate to meet its long-term obligations, and

-- reliably report to the Congress and the public on its financial condition using financial information and systems that can withstand independent review and evaluation.

The weaknesses we identified did not arise in fiscal year 1990. On four previous occasions, we have been unable to express an opinion on the financial statements because of serious weaknesses in accounting and internal controls. Only by instituting the financial management reforms needed to resolve the reported weaknesses will the Corporation be able to ensure the collection of premiums due, assess the adequacy of its premium levels to meet future obligations, and reliably report its financial condition.

We believe that the Corporation needs to develop specific corrective action plans, with accompanying milestones, that will address the financial management weaknesses and to monitor and report on its progress to the Congress. We are making specific recommendations to the Corporation dealing with its financial management weaknesses in a report that is nearing completion. Also, we plan to continue to assess the Corporation's progress in improving its internal controls and financial systems and to determine whether its financial statements can be audited.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or members of the Committee may have.