Pension Benefit Guaranty Corporation

Office of Inspector General

Audit Report

Audit of the Pension Benefit Guaranty Corporation's Fiscal Years 2002 and 2001 Financial Statements

Report of Independent Accountants

Report on Internal Control

Report on Compliance With Applicable Laws and Regulations

Pension Benefit Guaranty Corporation's
Fiscal Years 2002 and 2001 Financial Statements
and Notes to the Financial Statements

January 30, 2003

2003-3/23168-2

Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

Office of Inspector General

To the Board of Directors
Pension Benefit Guaranty Corporation

This letter transmits the PricewaterhouseCoopers LLP report on the audit of the Fiscal Years (FYs) 2002 and 2001 financial statements of Single-Employer and Multiemployer Program Funds administered by the Pension Benefit Guaranty Corporation (PBGC). Section 9105 of 31 U.S.C., as amended, requires PBGC's Inspector General or an independent external auditor, as determined by the Inspector General, to audit PBGC's financial statements. This audits is performed in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States.

PricewaterhouseCoopers issued an unqualified opinion on the FYs 2002 and 2001 financial statements of Single-Employer and Multiemployer Program Funds administered by PBGC. In addition, PricewaterhouseCoopers issued two other reports - an unqualified opinion on PBGC management's assertion about the effectiveness of its internal control and a report on PBGC's compliance with laws and regulations.

Two reportable conditions were carried forward from prior financial statement audits. Though audit work during FY 2002 showed that PBGC had made progress in addressing these reportable conditions, it was not sufficient to remove them and they remain:

1. PBGC needs to integrate its financial management systems and enforce its systems development life cycle methodology; and

2. PBGC needs to complete and fully test its plan for maintaining continuity of operations.

In addition, the FY 2002 audit work identified three other reportable conditions:

3. PBGC needs to continue its efforts to implement an effective fully integrated and functional enterprise-wide security program

4. PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable plan terminations.

5. PBGC needs to enhance controls over measurement of asset values for non-commingled assets of trusteed plans, plans pending trusteeship and plans probable for termination.

To fulfill the Inspector General's statutory responsibility, we monitored the quality of PricewaterhouseCoopers' audit work to ensure it was in accordance with *Government Auditing Standards*. Specifically, we:

- reviewed the audit approach and planning;
- evaluated the qualifications and independence of auditors;
- monitored the progress of the audit at key points;
- examined the working papers and reports; and
- performed other procedures that we deemed necessary.

Based on results of our oversight review, we determined that PricewaterhouseCoopers planned, executed, and reported the results of its audit of FYs 2002 and 2001 financial statements of Single-Employer and Multiemployer Program Funds administered by PBGC in accordance with applicable standards. Therefore, we conclude that PricewaterhouseCoopers' audit work provides a reasonable basis on which to render its January 14, 2003 opinion.

Sincerely,

Deborah Stover-Springer
Deputy Inspector General

Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2002 and 2001 Financial Statements

Audit Report 2003-3/23168-2

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
CFND	Corporate Finance and Negotiations Department
COOP	Continuity of Operations Plan
CWG	Contingency Working Group
ERISA	Employee Retirement Income Security Act of 1974
FASD	Facilities and Services Department
FMFIA	Federal Managers' Financial Integrity Act of 1982
FOD	Financial Operations Department
FRS	Financial Reporting System
IOD	Insurance Operations Department
IPVFB	Integrated Present Value of Future Benefits
IRMD	Information Resource Management Department
ISSO	Information Systems Security Officer
JFMIP	Joint Financial Manager's Improvement Program
OIG	Office of Inspector General
OMB	Office of Management and Budget
PA	Performance Accounting
PAS	Premium Accounting System
PBGC	Pension Benefit Guaranty Corporation
PRISM	Participant Records Information Systems Management
SDLC	Systems Development Life Cycle
SLCM	Systems Life Cycle Management
TPL	Trust Plan Ledger

Section I

Report of Independent Accountants

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Report of Independent Accountants

To the Inspector General
Pension Benefit Guaranty Corporation

We have audited the accompanying statements of financial condition of the Single-Employer and Multiemployer Program Funds administered by the Pension Benefit Guaranty Corporation (PBGC) as of September 30, 2002 and 2001, and the related statements of operations and changes in net position and statements of cash flows for the years then ended. These financial statements are the responsibility of PBGC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and *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. 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Single-Employer and Multiemployer Program Funds administered by the PBGC at September 30, 2002 and 2001, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

By law, PBGC's Single-Employer Program Fund (the Fund) must be self-sustaining, and therefore its premiums must be sufficient to cover both its short and long-term obligations. The Fund has been able to meet its short-term benefit obligations, and PBGC internal analyses project that it will be able to do so for the foreseeable future. However, the Fund's statement of financial condition reports a net deficit position (liabilities in excess of assets) of $3.6 billion at September 30, 2002. Losses that are "reasonably possible" as a result of unfunded vested benefits are estimated to be $35.4 billion at September 30, 2002, as discussed in Note 7. The Fund's net position, and long-term viability, could be negatively impacted by losses from plans classified as reasonably possible (or from other plans not yet identified as potential losses) as a result of deteriorating economic conditions, the insolvency of a large plan sponsor or other factors.

Management's discussion and analysis, the Actuarial Valuation and other supplemental information contain a wide range of data, some of which are not directly related to the financial statements. We do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with PBGC officials. Based on this limited work, we found no material inconsistencies with the financial statements.

In addition, in accordance with *Government Auditing Standards*, we have issued reports dated January 14, 2003, on management's assertion about the effectiveness of its internal control and on its compliance with laws and regulations. These reports are integral parts of an audit conducted in accordance with *Government Auditing Standards*, and, in considering the results of the audit, these reports should be read along with the Report of Independent Accountants on the financial statements.

PricewaterhouseCoopers LLP

January 14, 2003

2003-2/23168-1

Section II

Report on Internal Control

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Independent Accountants' Report on Internal Control

To the Inspector General
Pension Benefit Guaranty Corporation

We have examined management's assertion that the Pension Benefit Guaranty Corporation's (PBGC or the Corporation) management controls in effect as of September 30, 2002, provided reasonable assurance that assets were safeguarded from material loss and that transactions were executed in accordance with management's authority and with significant provisions of selected laws and regulations, and furthermore, PBGC management controls provided reasonable assurance that transactions were properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and to maintain accountability for assets among funds based upon criteria contained in the Federal Managers' Financial Integrity Act of 1982 (FMFIA). This assertion is included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of PBGC's fiscal year 2002 Annual Report to the Congress. Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA) and *Government Auditing Standards*, and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that PBGC's management controls in effect as of September 30, 2002 provided reasonable assurance that assets were safeguarded from material loss and that transactions were executed in accordance with management's authority and with significant provisions of selected laws and regulations, and furthermore, PBGC management controls provided reasonable assurance that transactions were properly recorded, processed, and summarized to permit the preparation of the financial statements in accordance with accounting principles generally accepted in the United States of America and to maintain accountability for assets among funds is fairly stated, in all material respects, based upon criteria contained in the FMFIA.

However, we noted certain matters involving internal control and its operation that we consider reportable conditions under auditing standards generally accepted in the United States of America. Reportable conditions involve matters coming to our attention relating to significant deficiencies in

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the design or operation of the internal control that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The reportable conditions we noted were:

(1) PBGC needs to integrate its financial management systems and enforce its systems development life cycle methodology,
(2) PBGC needs to complete and fully test its plan for maintaining continuity of operations,
(3) PBGC needs to continue its efforts to fully implement and enforce departmental compliance with its information security program,
(4) PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable and reasonably possible plan terminations, and
(5) PBGC needs to enhance controls over measurement of asset values for non-commingled assets of trusteed plans, plans pending trusteeship and plans probable for termination.

The specific findings and recommendations underlying these reportable conditions are described in the attached schedule of reportable conditions.

A material weakness is a reportable 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 errors or fraud 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.

Our consideration of internal control would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above and in the attached schedule of reportable conditions are believed to be material weaknesses.

We also noted other matters involving internal control and its operation that we will communicate in a separate letter.

This report is intended solely for the information and use of PBGC's Office of Inspector General, its Board of Directors, the management of PBGC, and the United States Congress, and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

Washington, DC
January 14, 2003

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SCHEDULE OF REPORTABLE CONDITIONS

PricewaterhouseCoopers LLP (PwC) reported the first two reportable conditions in the fiscal year 2001 report on internal control. During fiscal year 2002, PwC assessed the adequacy, effectiveness and efficiency of the corrective actions taken by PBGC Management for these reportable conditions. In addition, the fiscal year 2002 audit work identified three other reportable conditions that are included in this report.

1. Systems Design and Integration

Financial Management Systems Integration

In prior audits of PBGC, we identified a lack of integration of the Corporation's financial management systems, as defined by the Office of Management and Budget's (OMB) Circular A-127, *Financial Management Systems*. The systems that have been identified and included in the definition of significant PBGC financial management systems include: Performance Accounting (PA) system; Trust Plan Ledger (TPL); Financial Reporting System (FRS); Participant Records Information System Management (PRISM); Premium Accounting System (PAS); and Integrated Present Value of Future Benefits (IPVFB).

OMB Circular A-127 states that financial management systems should be designed to provide for effective and efficient interrelationships between systems.

> *The term "single, integrated financial management system" means a unified set of financial systems and the financial portions of mixed systems encompassing the software, hardware, personnel, processes (manual and automated), procedures, controls and data necessary to carry out financial management functions, manage financial operations of the agency and report on the agency's financial status to central agencies, Congress and the public. Unified means that the systems are planned for and managed together, operated in an integrated fashion, and linked together electronically in an efficient and effective manner to provide agency-wide financial system support necessary to carry out the agency's mission and support the agency's financial management needs.*

The Joint Financial Management Improvement Program (JFMIP)'s "Core Financial System Requirements" document, developed for Federal government entities, reinforces the need for integrated financial systems. This document clearly states that:

> *Financial management systems must be designed with effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within systems.*

The JFMIP document lists the following integrated, financial management system attributes:

- Standard data classifications (definition and formats) established and used for recording financial events,

- Common processes used for processing similar kinds of transactions,
- Internal controls over data entry, transaction processing, and reporting applied consistently, and
- A system design that eliminates unnecessary duplication of transaction entry.

In addition, the JFMIP document further states that for the development of any integrated information system, the following elements need to be incorporated:

- The scope of the functions to be supported (processes),
- How data quality will be assured (data stewardship),
- The information to be processed (management information),
- How systems fit together to support the functions (systems architecture), and
- Safeguards needed to ensure the integrity of operations and data (internal control).

To address this reportable condition that has remained unresolved, PBGC, in fiscal year 2001, initiated a workgroup to develop a corrective action plan to comply with OMB Circular A-127. Follow-up testing for fiscal year 2002 indicated that although the workgroup made progress towards the development of the corrective action plan, additional effort is needed to develop and implement this plan across all PBGC departments that are impacted by changes in the core financial systems. As a result, the lack of complete integration continues to impact the Corporation's ability to promptly and efficiently accumulate and summarize information required for internal and external financial reporting. This issue remains open for the fiscal year 2002.

Systems Development Life Cycle (SDLC) Methodology

In prior years, we reported that PBGC had not formalized and implemented an SDLC methodology. We found that although significant improvements were made in developing and documenting the SDLC methodology during fiscal year 2001, the use of this methodology and its corporate-wide acceptance had not been demonstrated as of September 30, 2001 and this issue was carried forward to the fiscal year 2002 report on internal control.

OMB Circular A-127 states, "…agency financial management systems shall conform to existing applicable functional requirements for the design, development, operation, and maintenance of financial management systems." OMB Circular A-127 also addresses requirements with respect to systems documentation, training and user support, maintenance, financial management system improvements, and internal controls related to the systems. In addition, the JFMIP's "Federal Financial Management Systems Requirements" provides guidance on this subject.

Our testing in fiscal year 2002 revealed that PBGC had made progress in developing and formalizing an SDLC methodology. The new methodology is referred to as Systems Life Cycle Management (SLCM). Specifically, it was noted that:

- The methodology contained the necessary elements, such as requirements definition, documentation guidelines and templates, standard tool sets, programming activities, and testing procedures.
- PBGC management signed the policy requiring the usage of the methodology for new projects.

However, our FY 2002 testing results revealed the following deficiencies in the implementation of the new framework:

- There is no enforcement mechanism in place to ensure that new projects and enhancements to existing systems completely follow the SLCM framework.
- There is no formally documented management approval process within SLCM framework for the following:

    - Review of budgetary spending thresholds at each phase of the project development and implementation.
    - Review of compliance with the SLCM at specified project phases.
    - No review or approval by the Information Systems Security Officer (ISSO) of security risks related to implementation of new technologies.

- Several projects have not effectively utilized the SLCM framework or been assigned an SLCM Methodologist, who provides assistance and oversight to departmental management in maintaining compliance with the SLCM methodology and overall project management.
- PBGC management has not developed and distributed a complete corporate-wide change management methodology; therefore, change management procedures are not consistently implemented and followed for system changes to the Insurance Operations Department (IOD) and the Financial Operations Department (FOD) owned applications.

Although significant progress has been achieved, the lack of a fully implemented SDLC methodology has historically impacted, and will continue to impact, data conversion efforts, security administration, user acceptance testing, reports definition, and consistency of systems development initiatives.

Recommendations:

We acknowledge improvements through the efforts of the Corporation in the areas noted above. However, we continue to recommend that PBGC:

- Complete its efforts to integrate its financial management systems, in accordance with OMB Circular A-127 and its Five-Year Management Systems Plan. **(OIG Control Number FOD-268)**

- Follow the formal systems development life cycle methodology on all subsequent systems acquisition or development projects, and require the same of contractors. **(OIG Control Number IRMD-92)**

Based upon the results of our FY 2002 review of the SLCM, we further recommend that PBGC:

- Develop an enforcement mechanism to ensure that projects and their respective departments completely follow the SLCM framework. **(OIG Control Number CTO-3)**

- Update the SLCM framework to include a management approval process to review the following:

    - Budgetary spending thresholds at each phase of the project development and implementation.
    - Compliance with SLCM at specified project phases.
    - Acceptance by the ISSO of the security risks associated with system implementation.

    (OIG Control Number CTO-4)

- Update the PBGC Change Management Manual to include procedures governing the entire change management cycle, rather than limiting the focus to the usage of Peregrine Service Center. This updated manual should require **all** departments and users to consistently follow the same procedures and complete uniform documentation in a timely manner for the release of all changes into production. IRMD Management should establish monitoring procedures to enforce compliance with existing change control policies, procedures, and standards. **(OIG Control Number IRMD-135)**

2. Continuity of Operations

In prior audits, we reported that PBGC had not provided the necessary attention to business continuity issues and had not fully developed and tested a thorough contingency/business continuity plan.

In October 1998, Presidential Decision Directive #67 (PDD 67) was issued requiring all Federal departments and agencies to have a viable Continuity of Operations Plans (COOP) plan in place by October 1999. The following requirements are to be met for every COOP plan developed:

- Must be able to become operational not later than 12 hours after activation.
- Must be capable of sustaining operations for up to 30 days.
- Must be constantly monitored and updated as circumstances and organizations change.
- Must provide plans and procedures for orderly succession under all circumstances.
- Must contain all needed delegations of authority for continued decision making.
- Must identify essential functions, alternative sites, and vital records.
- Must provide for testing, training, and evaluation.

The intent of the COOP plan was not to replace any existing contingency plans, but to act as a unifying concept to integrate the above functions if and when a problem threatens serious disruption to agency operations. The plans should identify such items as emergency communications, chain of command, and delegation of authority.

In addition to PDD 67, OMB Circular A-130, *Management of Federal Information Resources,* requires agencies to establish controls for assuring adequate security for information processed, transmitted, or stored in Federal automated information systems. Appendix III of the Circular emphasizes the importance of developing a plan for restoring critical operations for a Federal agency's information systems environment. It anticipates that there will inevitably be some service interruptions to an entity's system environment. It further states, "Agency plans should assure that there is an ability to recover and provide service sufficient to meet the minimal needs of users of the systems."

In the past three years PBGC has made progress in developing its COOP plan for each department and functional area. PBGC identified the Facilities and Services Department (FASD) as the central point for coordinating PBGC contingency and COOP efforts. This coordination includes the development and testing of plans for hardware, communications, and application recovery.

While the COOP plan, as defined by PDD 67, can be interpreted as a business recovery plan, an overall contingency plan that defines responsibility to declare an emergency situation and coordinate the recovery efforts still needs to be put in place. Although PBGC has improved its documentation of an overall contingency plan and its COOP plans, our fiscal year 2002 testing continues to identify a number of deficiencies that, in our view, would impair PBGC's ability to respond effectively to a disruption in business operations. Furthermore, testing of any existing plan(s) and the recovery process has not taken place as well as a complete identification of mission-critical systems.

Specifically, we continue to note, as we have in past years, the following:

- PBGC did not provide evidence of a formal Business Impact Analysis to identify and validate critical workloads. The process documented by PBGC only identified the systems, not the workloads relative to recovery and processing and did not prioritize the systems and/or associated workloads.

- PBGC updated the existing contingency plan/COOP plan in fiscal year 2001, but did not address the current computing environment at PBGC, to include necessary mission critical systems, including contractor-supported systems, impacting the requirements to complete a recovery process.

- Although PBGC defined a location where a recovery process for computer systems would be initiated, it is still questionable as to how a full recovery, including staff and contractors, would be accomplished within a defined time frame.

- PBGC performed only a partial test of the existing disaster recovery plan in fiscal year 2001. Specifically, PBGC did not completely test critical functions as defined to date and its formal schedule of future tests does not anticipate such a test until fiscal year 2003.

- Specific procedures for restoring operations and applications have not been included as part of the COOP plans or as part of any other recovery plan. Only very high-level responsibilities/actions have been documented.

- Identification of specific critical data files has not been documented. The "Vital Records and Databases" section of each COOP plan lists emergency operating records as well as legal and financial rights records. In this section, the records are documented according to category, description, record type (e.g., paper or electronic), offsite storage location, and maintenance frequency for the records. However, identification of specific critical data files with their relationship to specific applications has begun in FY 2002, but has not been completed and included in any COOP.

- Not all of the COOP plans contain information on alternate facilities. Only some of the department COOP plans list DOL, 1200 K. St., and 1275 K. St. as its alternate sites. Where alternative sites are not appropriate, specific details of the procedures to be followed for staff and contractors affected are not documented. In addition, there is no mention of the Wilmington hot-site or its role in the recovery process in any of the COOP plans.

During additional fiscal year 2002 audit fieldwork, PwC obtained and inspected the department/division COOP plans as well as the Corporate-Wide COOP plan and conducted an inspection of the PBGC hot-site location in Wilmington, Delaware. As a result of the plan inspections we noted that critical operations have been identified and prioritized on a department and division level. Furthermore, Appendix II of the Corporate COOP plan identifies and prioritizes department/division recovery activities. However, there were no detailed procedures for an orderly and structured recovery of operations, and COOP Plans lacked the following pertinent information:

- 29 of 30 COOP plans do not include both alternate facilities location and specific data files.
- 22 of 30 COOP plans include alternate facilities location but no specific data files.
- 26 of 30 COOP plans include specific data files but no alternate facilities location.
- 17 of 30 COOP plans do not include alternate facilities location or specific data files

Through discussions with PBGC staff and management we learned that PBGC is in the process of implementing the computer infrastructure for its hot-site in Wilmington, Delaware. This implementation is scheduled for completion in fiscal year 2003 and FASD plans on testing this computer infrastructure once completed.

Our physical inspection of the Wilmington, DE hot-site revealed that the physical and environmental controls do not limit authorized access to the computer resources and do not provide assurance of the availability of these resources in the event of a disaster, such as a fire.

Although PBGC has taken some positive steps to address its ability to continue performing its required business operations, improvements are still needed to strengthen PBGC's ability to recover from an unanticipated disruption to its service. We believe PBGC remains vulnerable should a disaster or an extended business disruption occur.

Recommendations:

We acknowledge improvements through the efforts of the Corporation in the areas noted above. However, we continue to recommend that PBGC:

- Conduct a Business Impact Analysis to validate all critical workloads. In addition, recovery priorities should be established and documented for mission critical systems. IRMD can serve as the central point for developing these priorities and help facilitate and coordinate the efforts required to complete this process. **(OIG Control Number FASD-112)**

- Update the existing contingency/disaster recovery plan to reflect the current computing environment at PBGC. **(OIG Control Number IRMD-104)**

- Develop detailed procedures for the recovery of PBGC operations. **(OIG Control Number FASD-114)**

- Test the contingency/disaster recovery procedures on a regular basis using sufficiently detailed test plans and scenarios. Review and incorporate test results, as appropriate, in the contingency/disaster recovery plan in a timely manner. **(OIG Control Number FASD-115)**

- Ensure that each department documents specific procedures such as manual/peripheral processing procedures for restoring applications and operations as part of its COOP, including specific references to critical data files required. **(OIG Control Number FASD-117)**

- Include requirements for the use of alternate facilities in each of the COOP plans, if needed, as well as instructions for staff and contractors as to their role in the recovery process and where they would perform their duties. **(OIG Control Number FASD-118)**

As a result of our physical review of the Wilmington, DE hot-site during the FY 2002 testing, we further recommend that PBGC:

- Install physical security and environmental controls to limit unauthorized access to the computing resources and to provide management assurance of the availability of these resources in the event of a disaster. **(OIG Control Number FASD-119)**

3. Enterprise-Wide Information Security Program

PBGC has responded positively to past issues concerning information security and has made progress over the past two years implementing security-related corrective actions such as:

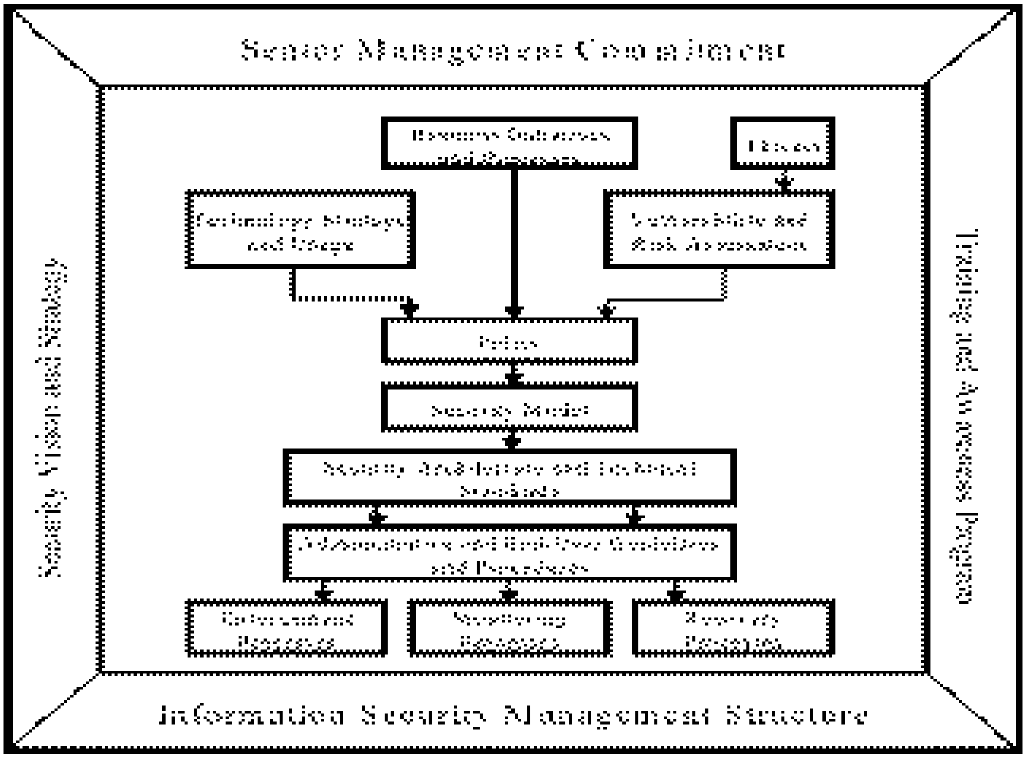
- Developing and implementing a corporate-wide security training and awareness program;
- Hiring an individual, Information Systems Security Officer (ISSO), to be responsible for information security; and
- Developing a number of security-related policies addressing issues from password use to electronic communications to PBGC access and physical security.

However, a review of PBGC's enterprise-wide information security program and standards revealed weaknesses in controls that expose key elements of PBGC's distributed systems and networks to unauthorized access and/or modification of sensitive data. The general areas where exposures occurred included:

- Implementing and maintaining an organizational structure that promotes an effective enterprise-wide information security program including compliance and enforcement with established policies and procedures;
- Monitoring and enforcement controls over system access, security violations and periodic reviews of user access;
- Personnel security such as conducting and maintaining background investigations; and
- Implementation of effective security plans for all PBGC systems as well as proper certification and accreditation of systems for processing.

Exposures existed in these areas primarily because PBGC had not implemented an effective fully integrated and functional enterprise-wide information security program. The following diagram is one representation of a fully integrated and functional enterprise-wide information security program. This diagram incorporates the key system security provisions of OMB Circular A-130, Appendix III, and associated NIST guidelines.

Information Security Framework



As previously mentioned, PBGC has made progress in certain elements of this information security framework. However, the weaknesses we identified show that elements of the framework related to the vulnerability and risk assessment as well as the enforcement and monitoring processes need to be addressed as well as the higher-level focus of vision and strategy, and security management structure. Disclosure of detailed information about these weaknesses might further compromise controls. Rather than provide such details in this report, we present the following examples, which provide an overview of the types of weaknesses we identified.

- *Vulnerability and Risk Assessment* – Not all of PBGC's general support systems and major business systems, such as PRISM, have undergone the accreditation and certification process. There are currently 14 major business application systems as well as 6 general support systems identified. PBGC has implemented procedures to conduct the certification process and risk assessments in its business system design process. During fiscal year 2002, PBGC had completed 2 general support systems and 1 major business application system certification. Additionally, we noted that PBGC Management has not created an overall Security Plan for the Oracle Environment.

- *Enforcement and Monitoring processes* – During an internal network security penetration study, unauthorized access was gained to PBGC network resources without triggering an incident report to the Information Systems Security Officer. In addition, the following issues were identified:

- Although PBGC has developed the PBGC Password Usage Policy, we noted several instances in the processing environments where system password controls were not in compliance with this policy and NISTIR 5153;
- Current procedures require that contractors and employees must undergo background investigations and obtain clearance. As a result of testing this control, we noted exceptions where individuals had been granted access to PBGC systems without the completion of a background investigation. In discussions, PBGC raised the concern that background investigations take too long to be practical in situations where work needs to be performed and access to PBGC systems granted. We noted that there is no interim (suitability) check performed to give PBGC a comfort level sufficient enough to allow an individual to be granted access to its systems during the time period a full investigation is in progress. Additionally, PBGC does not comply with its directive requiring background reinvestigations of PBGC Federal employees and contractors in accordance with OPM regulations.
- PBGC management has not developed procedures requiring the periodic recertification of user access to the general support and major business systems; and
- Application developers have access to the production environment that process PBGC's financially significant applications.

- *Security Management Structure* - The Information Systems Security Officer (ISSO) reports directly to the IRMD Director, rather than the PBGC Chief Technology Officer (CTO). The current reporting relationship does not provide for the necessary independence, as the ISSO is responsible for reviewing the security program established by IRMD. Further complicating the information security organizational structure, the ISSO has been designated as responsible for information security, yet there exists a number of staffing and reporting lines for various security positions throughout PBGC that have no direct reporting relationship to the ISSO.

Until a complete enterprise-wide information security program is implemented and maintained, PBGC's ability to mitigate effectively the risk of unauthorized access to, and /or modification or disclosure of, sensitive PBGC information will be impaired. Unauthorized access to sensitive data can result in the loss of data, loss of other assets, and/or compromised privacy of information associated with PBGC's benefit payment processes and programs. The need for a strong information security program to address threats to the security and integrity of PBGC operations will grow as the corporation continues to implement Internet and Web-based applications to serve the American public.

Recommendations:

We acknowledge improvements specifically relating to the conduct of risk assessments as well as the system certification and accreditation process through the efforts of the Corporation. However, we continue to recommend that PBGC:

- Develop and document specific policies and procedure to perform risk assessment of business systems as required by OMB. **(OIG Control Number CTO-1)**

- Implement the established policies and procedures for completing risk assessments to comply with OMB requirements. **(OIG Control Number CTO-2)**

- Finalize accreditation and certification of systems. **(OIG Control Number IRMD-118)**

We further recommend that PBGC continue its efforts to fully implement and enforce departmental compliance with its information security program by completing the following:

- Assign specific resources to complete the implementation of a fully functional and integrated enterprise-wide information security program, with priority given to implementation and monitoring of technical security standards. **(OIG Control Number CTO-5)**

- Develop enforcement mechanisms to ensure that all departments comply with the enterprise-wide information security program as well as consistently enforce policies and procedures for logical access to information resources that are based on the concepts of "least possible privilege." **(OIG Control Number CTO-6)**

- Implement a process that defines the extent of background check required in order to begin work as well as granting access to its business and support systems until a complete investigation can be completed. **(OIG Control Number HRD-6)**

- Implement procedures requiring periodic background re-investigations in compliance with OPM requirements. **(OIG Control Number HRD-7)**

- Develop, document, approve, and implement a security plan for all key production environments that process PBGC's financial systems that, at a minimum, follows the guidelines and standards prescribed by NIST and OMB. **(OIG Control Number IRMD-136)**

4. Contingent Liabilities

Under Statement of Financial Accounting Standards No. 5, *Accounting for* Contingencies, PBGC is required to identify and measure its estimated liabilities for probable plan terminations. Our audit of these processes revealed weaknesses in controls that could increase the risk of misclassification of plans and misstatement in the financial statements. Considering the increased volume of troubled plans and compressed reporting time frames, PBGC's classification and estimation processes should be more robust and the level of supporting documentation expanded, since it is more difficult for management to be familiar with the specifics of each plan and to be involved in each decision on plan classification.

During our testing of plan classifications, we found the following:

- The criteria for distinguishing between a "high risk" reasonably possible liability and a probable liability is subjective and not clearly defined. The Contingency Working Group (CWG) procedures manual does not include the criteria for classifying a plan as Probable or Reasonably Possible; it refers to the contingency classification form for standard criteria. The procedures manual also does not include any guidance on plans considered "high risk" by PBGC. A "very high risk plan" (one of the criteria available for probable on the contingency classification form) is not defined in the procedures or on the classification form. Also, the procedures do not provide guidance on factors for distinguishing between a "high risk" reasonably possible and a probable. A clear definition would permit analysts and the working group to apply criteria consistently.

- We noted inconsistencies in the contents of the memos that document PBGC's classification of a plan as "high risk" reasonably possible. There is not any specific guidance on how the "high risk" memos should be written or on what information should be included in the memos. When reviewing the "high risk" memos for the reasonably possible plans, there were instances when it was not clearly documented why the plan should not be classified as probable. Instead of including positive evidence for why a plan should be classified as reasonably possible, most memos simply stated, "there is not sufficient evidence that a future plan termination is likely", or the memo included negative evidence that did not support their conclusions for classifying a plan as reasonably possible.

Our findings demonstrate the need for PBGC to develop a standard format for "high risk" memos to include documentation of not only the rationale for why a plan is considered "high risk," but also the basis for conclusions of why the plan is not likely to terminate. If discussions of factors other than those documented in the memos take place informally regarding these plans, the discussion items need to be documented to support the conclusions (either in the memo, additional documentation to the file, or in the minutes to the Contingency Working Group). The memo should include a positive statement that there is a reasonable possibility that the plan could continue and the basis for that conclusion, rather than relying on the fact that perhaps no one has yet discussed the termination of the pension plan. If external data is used (i.e. analysts reports) to form the basis of conclusions, those sources should be cited in the memo, as they add credibility to PBGC's position. A reasonable person should be able to read the supporting documentation and draw the same conclusions.

During testing of the PBGC’s calculations of its contingent liability for reasonably possible plans:

- Errors were noted agreeing amounts on the contingency list to supporting calculations, causing the liability for reasonably possible plan terminations to be misstated in the notes to the financial statements.

- A significant number of input errors into the calculation worksheets used to estimate PBGC's reasonably possible contingent liability were discovered.

Based on our findings, the review of unfunded benefit liability calculations for plans reasonably possible of termination was ineffective. An independent review process should be built into the timeline for preparing the financial statements to allow sufficient review time for discovered errors to be corrected and reviewed prior to the beginning of the year-end audit. The reviewed file should include documentation of the input data and sign-off of any reviews.

Recommendations:

We recommend that PBGC:

Policy

- Document the definition of a probable, including the definition of a “very high risk plan that should be classified as a probable.” **(OIG Control Number CFND-1)**

- Prepare guidance on factors to be considered in assessing whether a “high risk” plan should be classified as a probable or reasonably possible for termination. **(OIG Control Number CFND-2)**

- Develop guidance to enhance the supporting documentation of the rationale and conclusions for classifying high risk plans as probable or reasonably possible for termination. **(OIG Control Number CFND-3)**

- Develop a standard format for “high risk” memos, to include documentation and analysis that supports the conclusion that a plan is “high risk” and its likelihood of termination or reasonably possible of continuation. **(OIG Control Number CFND-4)**

Control Procedures

- Develop a corporate-wide procedures manual for CFND and IOD to follow when generating information to be included in the financial statements. **(OIG Control Number FOD-296)**

- Implement independent review procedures of unfunded benefit liability calculations for contingent liabilities. **(OIG Control Number CFND-5)**

- Reexamine the process for classifying and determining appropriate values of contingent liabilities to meet compressed financial reporting timeframes. **(OIG Control Number CFND-6)**

5. Non-commingled Assets

PBGC's stated accounting policy is to report assets and liabilities at fair value in accordance with the Financial Accounting Standards Board Statement of Financial Accounting Standard No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. Plan assets of terminated trusteed pension plans are held by PBGC's custodian, and asset values are available from the custodian statements. For plan assets not yet commingled with PBGC's trust fund assets (including trusteed plans, plans pending trusteeship and plans probable of termination), PBGC must obtain asset value information from various other sources. Because asset statements are not always available as of September 30, PBGC is required to use available information and estimate asset values for financial reporting purposes.

Given the recent significant changes in market values, and higher volumes of plans not yet trusteed, the risk of misstatement of asset values, net income and net position is increased. In order to ensure that appropriate values are reflected in its financial statements, it is necessary that PBGC have effective policies and procedures in place to obtain and use market information as close to the September 30 financial statement date as possible and have effective techniques to estimate market values in the absence of current market information.

While the Financial Operations Department (FOD) is responsible for recording non-commingled assets in the financial statements, three PBGC departments -- FOD, Insurance Operations Department (IOD) and Corporate Finance and Negotiations Department (CFND) – are involved in the process of obtaining asset statements and determining asset values related to non-commingled assets. IOD or CFND, depending on the size of the plan, is responsible for estimating assets at date of plan termination (DOPT). FOD is responsible for determining non-commingled asset values after DOPT through year-end for plans trusteed or pending trusteeship, and IOD is responsible for estimating the year-end asset values for plans probable for termination.

During our testing of non-commingled assets, we noted a number of instances where PBGC's methods and procedures to value and record non-commingled assets did not fully or consistently address the risk of changes in market values. Specifically, we found the following:

Stale Source Information

- Instances of FOD using asset value source information (when more recent information was available internally) to report asset values for plans pending trusteeship in the year-end financial statements without making any market adjustments.

- Instances of FOD using asset value source information ranging from six months to nine months old to report asset values for trusteed plans in the year-end financial statements without making any market adjustments.

- If updated asset statements are received after September 30 but before financial statement issuance, FOD does not compare estimated year-end asset values to actual values to assess whether values changed significantly.

- Instances of IOD using asset source information ranging from six months to one year three months old to value assets at year-end for plans probable for termination.

Inconsistent Use of Asset Return Assumptions

- Instances where the long-term asset rate of return was used (IOD used these rates to estimate changes in asset values of probable plans between the date of source documentation and year-end); instances where another rate of return was used (CFND selected a zero percent rate of return to value assets of plans pending trusteeship at DOPT); and instances where no rate of return assumption was applied (FOD made no market value adjustments from DOPT to year-end for plans pending trusteeship).

Lack of Written Procedures or Consistent Practices

- Neither CFND nor IOD have written procedures regarding the process of asset valuation.

- FOD has a procedures manual for recording non-commingled assets from DOPT to the date of commingling. However, the procedures have not been updated since 1992 and contain references to systems no longer used by PBGC.

- The FOD procedures do not appear to be consistently followed by the trust accountants as was evident by the lack of consistent process and file documentation by the trust accountants. Although the procedures state the trust accountants are to contact all plan asset custodians upon receiving the plans and follow-up if statements are not received, from the date the cases were assigned to the date the statements were first requested took a month or more for seven of the plans pending trusteeship. In addition, for two of the trusteed plans, the date the statements were requested was not recorded in the case file.

- FOD management has no procedures to review the valuations received from CFND and IOD to determine their reasonableness for inclusion in the year-end financial statements without further market value adjustments. No supporting documentation is attached to the valuation to aid in an assessment of reasonableness.

- No audit trail documentation of the year-end asset values were found in any of the case files maintained by FOD and IOD. When asked in November, the trust accountants could not provide complete audit trail documentation for all cases.

- Of the audit trail documentation provided, we noted that there were a few variances between the source document and what was recorded by FOD, one of which could not be explained. The errors in the plans pending trusteeship occurred when a source document other than the Trusteeship Decision Record (TDR) was used. The TDR lists the asset value as one dollar amount and the supporting documentation used to arrive at that value is not included. In specified circumstances when other viable data sources are not available, the trust accountants have been instructed to record assets assuming a 50-50 allocation between fixed maturity and equity securities, but this is not consistently followed (sometimes the trust accountants record 100% as fixed maturity securities). In addition, we noted that in three of the cases where a source document other than the TDR was used, only the benefit payments or purchases and sales were recorded from the latest statements available prior to year-end; market adjustments were not made. The lack of audit trail documentation hampers effective management review.

- Third-party source documentation used in determining the asset values or obtained from PBGC during the year-end audit were not included in several of the case files for the trusteed plans (FOD), the plans pending trusteeship (FOD) and the plans probable for termination (IOD).

Based on our findings, it appears that the asset valuation review process within FOD is not consistent or thorough. FOD management cannot effectively review (a) asset statements if they are not included in case files, (b) reasonableness of journal entries if audit trail documentation is not provided, or (c) the reasonableness of the source documentation dates at year-end if this information is not included in the system or the case files. Management does not consistently review the date of the last activity reflected in the system, although it has the capability.

Our results also highlight the need for PBGC to develop a hierarchy of source information to use in valuing non-commingled assets. For example, current asset statements are most accurate and should be used if available. If not available, consider estimating changes in market values using industry market statistics for returns on fixed maturities and equity securities. The order of preference of methods should be documented and provided as guidance to each department involved. Given the nature of the estimation process and the range of possible situations, the methodology must permit a degree of judgment, and accordingly management approval of decisions affecting a threshold level of materiality or risk should be required.

Recommendations:

In order to properly value and record non-commingled assets, we recommend that PBGC:

Methodology

- Develop a systematic, reliable methodology for determining asset values of non-commingled assets of plans trusteed, pending trusteeship and probable for termination. Apply the methodology consistently in CFND, IOD, and FOD. **(OIG Control Number FOD-297)**

- Develop a hierarchy of source information to be used by CFND, IOD and FOD in valuing non-commingled assets. **(OIG Control Number FOD-298)**

Control Procedures

- Document the procedures for valuing non-commingled assets at each stage of the process prior to commingling at PBGC’s custodian, to include each department’s (CFND, IOD, and FOD) role and responsibilities in this process. In particular, ensure that CFND and IOD are accountable to FOD for their role in the process. **(OIG Control Number FOD-299)**

- Determine the most effective method and department to obtain asset statements for non-commingled assets in a timely manner, with out regard to whether the responsibility for valuing the assets has shifted to FOD. **(OIG Control Number FOD-300)**

- Develop, document, and implement a process to track asset statements of non-commingled assets throughout PBGC as they are received. **(OIG Control Number FOD-301)**

- Implement a procedure for CFND and IOD to include the breakdown of assets on the Trusteeship Decision Record, which is usually used by FOD to record asset values at date of plan termination. **(OIG Control Number FOD-302)**

- Document and implement a procedure to compare the asset information that is received after year-end cut-off to recorded amounts of non-commingled assets for reasonableness. **(OIG Control Number FOD-303)**

- Develop a process to document the audit trail of the asset valuations of non-commingled assets by CFND, IOD and FOD. **(OIG Control Number FOD-304)**

- Develop a process to periodically review the asset valuations of non-commingled assets throughout the year. **(OIG Control Number FOD-305)**

Section III

Report on Compliance with Applicable Laws and Regulations

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Independent Accountants' Report on Compliance with Laws and Regulations

To the Inspector General
Pension Benefit Guaranty Corporation

We have audited the financial statements of the Single-Employer and Multiemployer Program Funds administered by the Pension Benefit Guaranty Corporation (PBGC or the Corporation) as of and for the year ended September 30, 2002, and have issued our report thereon dated January 14, 2003. 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.

As part of obtaining reasonable assurance about whether PBGC's financial statements are free of material misstatement, we performed tests of PBGC's compliance with certain provisions of the Employee Retirement Income Security Act of 1974 (ERISA), the Federal Managers' Financial Integrity Act of 1982, the Retirement Protection Act of 1994, the Chief Financial Officers Act of 1990, and the Anti-Deficiency Act (limited to comparing the Corporation's recorded payments to related authorized limitations on certain payments and apportionments), 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 herein under *Government Auditing Standards*.

This report is intended solely for the information and use of PBGC's Office of Inspector General, its Board of Directors, the management of PBGC, and the United States Congress, and is not intended to be and should not be used by anyone other than those specified parties.

PricewaterhouseCoopers LLP

January 14, 2003

Section IV

Pension Benefit Guaranty Corporation's Fiscal Years 2002 and 2001 Financial Statements and Notes to the Financial Statements

PENSION BENEFIT GUARANTY CORPORATION
STATEMENTS OF FINANCIAL CONDITION

	Single-Employer Program		Multiemployer Program		Memorandum Total	
	September 30,		September 30,		September 30,	
(Dollars in millions)	**2002**	2001	**2002**	2001	**2002**	2001
ASSETS						
Cash and cash equivalents	**$ 716**	$ 776	**$ 3**	$ 17	**$ 719**	$ 793
Investments, at market (Note 3):						
Fixed maturity securities	**16,742**	13,829	**929**	777	**17,671**	14,606
Equity securities	**7,349**	6,245	**1**	2	**7,350**	6,247
Real estate and real estate investment trusts	**38**	40	**0**	0	**38**	40
Other	**6**	120	**0**	0	**6**	120
Total investments	**24,135**	20,234	**930**	779	**25,065**	21,013
Receivables, net:						
Sponsors of terminated plans	**209**	367	**0**	0	**209**	367
Premiums (Note 9)	**121**	153	**0**	1	**121**	154
Sale of securities	**45**	50	**0**	0	**45**	50
Investment income	**197**	182	**11**	10	**208**	192
Other	**3**	3	**0**	0	**3**	3
Total receivables	**575**	755	**11**	11	**586**	766
Furniture and fixtures, net	**4**	3	**0**	0	**4**	3
Total assets	**$25,430**	$21,768	**$944**	$807	**$26,374**	$22,575

The accompanying notes are an integral part of these financial statements.

PENSION BENEFIT GUARANTY CORPORATION

STATEMENTS OF FINANCIAL CONDITION

	Single-Employer Program		Multiemployer Program		Memorandum Total	
	September 30,		September 30,		September 30,	
(Dollars in millions)	**2002**	2001	**2002**	2001	**2002**	2001
LIABILITIES						
Present value of future benefits, net (Note 4):						
Trusteed plans	**$21,660**	$12,694	**$ 3**	$ 4	**$21,663**	$12,698
Terminated plans pending trusteeship	**476**	215	**0**	0	**476**	215
Settlements and judgments	**161**	177	**0**	0	**161**	177
Claims for probable terminations	**6,322**	411	**0**	0	**6,322**	411
Total present value of future benefits, net	**28,619**	13,497	**3**	4	**28,622**	13,501
Present value of nonrecoverable future financial assistance (Note 5)			**775**	679	**775**	679
Unearned premiums (Note 9)	**193**	191	**8**	8	**201**	199
Due for purchases of securities	**83**	195	**0**	0	**83**	195
Accounts payable and accrued expenses (Note 6)	**173**	153	**0**	0	**173**	153
Commitments and contingencies (Notes 7, 8, 14 and 15)						
Total liabilities	**29,068**	14,036	**786**	691	**29,854**	14,727
Net position	**(3,638)**	7,732	**158**	116	**(3,480)**	7,848
Total liabilities and net position	**$25,430**	$21,768	**$944**	$807	**$26,374**	$22,575

The accompanying notes are an integral part of these financial statements.

PENSION BENEFIT GUARANTY CORPORATION

STATEMENTS OF OPERATIONS AND CHANGES IN NET POSITION

(Dollars in millions)	Single-Employer Program For the Years Ended September 30, **2002**	2001	Multiemployer Program For the Years Ended September 30, **2002**	2001	Memorandum Total For the Years Ended September 30, **2002**	2001
UNDERWRITING:						
Income:						
Premium (Note 9)	**$ 787**	$ 821	**$ 25**	$ 24	**$ 812**	$ 845
Other	**28**	23	**0**	0	**28**	23
Total	**815**	844	**25**	24	**840**	868
Expenses:						
Administrative	**207**	171	**0**	0	**207**	171
Other	**15**	2	**0**	0	**15**	2
Total	**222**	173	**0**	0	**222**	173
Other underwriting activity:						
Losses from completed and probable terminations (Note 10)	**9,313**	705	**0**	0	**9,313**	705
Losses from financial assistance (Note 5)			**101**	269	**101**	269
Actuarial adjustments (Note 4)	**70**	(93)	**0**	1	**70**	(92)
Total	**9,383**	612	**101**	270	**9,484**	882
Underwriting income (loss)	**(8,790)**	59	**(76)**	(246)	**(8,866)**	(187)
FINANCIAL:						
Investment income (loss) (Note 11):						
Fixed	**2,043**	1,669	**118**	96	**2,161**	1,765
Equity	**(1,887)**	(2,509)	**0**	(1)	**(1,887)**	(2,510)
Other	**14**	(3)	**0**	0	**14**	(3)
Total	**170**	(843)	**118**	95	**288**	(748)
Expenses:						
Investment	**18**	13	**0**	0	**18**	13
Actuarial charges (Note 4):						
Due to passage of time	**1,077**	780	**0**	0	**1,077**	780
Due to change in interest rates	**1,655**	395	**0**	0	**1,655**	395
Total	**2,750**	1,188	**0**	0	**2,750**	1,188
Financial income (loss)	**(2,580)**	(2,031)	**118**	95	**(2,462)**	(1,936)
Net income (loss)	**(11,370)**	(1,972)	**42**	(151)	**(11,328)**	(2,123)
Net position, beginning of year	**7,732**	9,704	**116**	267	**7,848**	9,971
Net position, end of year	**$ (3,638)**	$ 7,732	**$158**	$ 116	**$ (3,480)**	$ 7,848

The accompanying notes are an integral part of these financial statements.

PENSION BENEFIT GUARANTY CORPORATION
STATEMENTS OF CASH FLOWS

	Single-Employer Program		Multiemployer Program		Memorandum Total	
	For the Years Ended September 30,		For the Years Ended September 30,		For the Years Ended September 30,	
(Dollars in millions)	**2002**	2001	**2002**	2001	**2002**	2001
OPERATING ACTIVITIES:						
Premium receipts	**$ 819**	$ 794	**$ 26**	$ 25	**$ 845**	$ 819
Interest and dividends received, net	**964**	861	**50**	46	**1,014**	907
Cash received from plans upon trusteeship	**662**	592	**0**	0	**662**	592
Receipts from sponsors/non-sponsors	**367**	22	**0**	0	**367**	22
Receipts from the missing participant program	**9**	14	**0**	0	**9**	14
Other receipts	**4**	2	**0**	0	**4**	2
Benefit payments - trusteed plans	**(1,482)**	(1,027)	**(1)**	(1)	**(1,483)**	(1,028)
Financial assistance payments			**(5)**	(4)	**(5)**	(4)
Settlements and judgments	**(393)**	(156)	**0**	0	**(393)**	(156)
Pretermination payments	**0**	(11)	**0**	0	**0**	(11)
Payments for administrative and other expenses	**(216)**	(180)	**0**	0	**(216)**	(180)
Net cash provided by operating activities (Note 13)	**734**	911	**70**	66	**804**	977
INVESTING ACTIVITIES:						
Proceeds from sales of investments	**23,207**	13,623	**643**	384	**23,850**	14,007
Payments for purchases of investments	**(24,001)**	(14,214)	**(727)**	(441)	**(24,728)**	(14,655)
Net cash used in investing activities	**(794)**	(591)	**(84)**	(57)	**(878)**	(648)
Net increase (decrease) in cash and cash equivalents	**(60)**	320	**(14)**	9	**(74)**	329
Cash and cash equivalents, beginning of year	**776**	456	**17**	8	**793**	464
Cash and cash equivalents, end of year	**$ 716**	$ 776	**$ 3**	$ 17	**$ 719**	$ 793

The accompanying notes are an integral part of these financial statements.

NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2002 AND 2001

Note 1 -- Organization and Purpose

The Pension Benefit Guaranty Corporation (PBGC or the Corporation) is a federal corporation created by Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) and is subject to the provisions of the Government Corporation Control Act. Its activities are defined in ERISA as amended by the Multiemployer Pension Plan Amendments Act of 1980, the Single-Employer Pension Plan Amendments Act of 1986, the Pension Protection Act of 1987, and the Retirement Protection Act of 1994. The Corporation insures pensions, within statutory limits, of participants in covered single-employer and multiemployer defined benefit pension plans that meet the criteria specified in Section 4021 of ERISA.

ERISA requires that PBGC programs be self-financing. The Corporation finances its operations through premiums collected from covered plans, assets assumed from terminated plans, collection of employer liability payments due under ERISA as amended and investment income. In addition, PBGC may borrow up to $100 million from the U.S. Treasury to finance its operations. The Corporation did not use this borrowing authority during the years ended September 30, 2002, or September 30, 2001, nor is use of this authority currently planned. ERISA provides that the U.S. Government is not liable for any obligation or liability incurred by PBGC.

Under the single-employer program, PBGC is liable for the payment of guaranteed benefits with respect only to underfunded terminated plans. An underfunded plan may terminate only if PBGC or a bankruptcy court finds that one of the four conditions for a distress termination, as defined in ERISA, is met or if PBGC involuntarily terminates a plan under one of five specified statutory tests. The net liability assumed by PBGC is generally equal to the present value of the future benefits (including amounts owed under Section 4022(c) of ERISA) less (1) the amounts that are provided by the plan's assets and (2) the amounts that are recoverable by PBGC from the plan sponsor and members of the plan sponsor's controlled group, as defined by ERISA.

Under the multiemployer program, if a plan becomes insolvent, it receives financial assistance from PBGC to allow the plan to continue to pay participants their guaranteed benefits. PBGC recognizes assistance as a loss to the extent that the plan is not expected to be able to repay these amounts from future plan contributions, employer withdrawal liability or investment earnings.

Note 2 -- Significant Accounting Policies

Basis of Presentation: The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates and assumptions may change over time as new information is obtained or subsequent developments occur. Actual results could differ from those estimates.

Valuation Method: Consistent with accounting principles generally accepted in the United States of America outlined in Statements of Financial Accounting Standards Nos. 35 ("Accounting and Reporting by Defined Benefit Pension Plans"), 60 ("Accounting and Reporting by Insurance Enterprises"), 87 ("Employers' Accounting for Pensions") and 133 ("Accounting for Derivative Instruments and Hedging Activities"), as amended, PBGC reports its assets and liabilities at fair value. A primary objective of PBGC's financial statements is to provide financial information that is useful in assessing PBGC's present and future ability to ensure that defined benefit pension plan beneficiaries receive benefits when due. PBGC believes that measuring its assets and liabilities at fair value provides the most relevant information to the reader.

Revolving and Trust Funds: PBGC accounts for its single-employer and multiemployer programs' revolving and trust funds on an accrual basis. Each fund is charged its portion of the benefits paid each year. PBGC has combined the revolving and trust funds for presentation purposes in the financial statements. The single-employer and multiemployer programs are separate programs by law and, therefore, PBGC reports them separately.

ERISA provides for the establishment of revolving funds that are to be used by PBGC in carrying out its duties. The revolving funds support the operational and administrative functions of PBGC and fund any deficits incurred by PBGC in trusteeing plans or providing financial assistance. Premiums collected from ongoing plans are accounted for through the revolving funds. The Pension Protection Act of 1987 created a single-employer revolving fund that is credited with all premiums in excess of $8.50 per participant, including all penalties and interest charged on these amounts, and its share of earnings from investments. This fund may not be used to pay PBGC's administrative costs or the benefits of any plan terminated prior to October 1, 1988, unless no other amounts are available.

The trust funds reflect accounting activity associated with: (1) trusteed plans -- plans for which PBGC has legal responsibility, (2) plans pending trusteeship -- terminated plans for which PBGC has not become legal trustee by fiscal year-end, and (3) probable terminations -- plans that PBGC determines are likely to terminate and be trusteed by PBGC. PBGC cannot exercise legal control over a plan's assets until PBGC becomes trustee, which may be several years after the date of plan termination.

Allocation of Revolving and Trust Funds: PBGC allocates revolving and trust fund assets, liabilities, income and expenses to each program's revolving and trust funds to the extent that such amounts are not directly attributable to a specific fund. Revolving fund income is allocated on the basis of each program's average cash available for investment during the year while the expenses are allocated on the basis of each program's present value of future benefits. Revolving fund assets and liabilities are allocated on the basis of the year-end equity of each program's revolving funds. The plan assets acquired by PBGC and commingled at PBGC's custodian bank are credited directly to the appropriate fund while the earnings and expenses on the commingled assets are allocated to each program's trust funds on the basis of each trust fund's value, relative to the total value of the commingled fund.

Cash and Cash Equivalents: Cash includes cash on hand and demand deposits. Cash equivalents are securities with a maturity of one business day.

Investment Valuation and Income: PBGC bases market values on the last sale of a listed security, on the mean of the "bid-and-asked" for nonlisted securities or on a valuation model in the case of fixed-income securities that are not actively traded. These valuations are determined as of the end of each fiscal year. Purchases and sales of securities are recorded on the trade date. Investment income is accrued as earned. Dividend income is recorded on the ex-dividend date. Realized gains and losses on sales of investments are calculated using an average cost basis. PBGC marks the plan's assets to market and any increase or decrease in the market value of a plan's assets occurring after the date on which the plan is terminated must, by law, be credited to or suffered by PBGC (see Notes 3, 4, and 11).

Sponsors of Terminated Plans, Receivables: The amounts due from sponsors of terminated plans or members of their controlled group represent the settled claims for employer liability (underfunding as of date of plan termination) and for contributions due their plan less an allowance for uncollectible amounts. PBGC discounts any amounts expected to be received beyond one year for time and risk factors. Some agreements between PBGC and plan sponsors provide for contingent payments based on future profits of the sponsors. The Corporation will report any such future amounts realized in the period in which they accrue or are received.

Premiums: Premiums receivable represent the estimated earned but unpaid portion of the premiums for plans that have a plan year commencing before the end of PBGC's fiscal year and past due premiums deemed collectible, including collectible penalties and interest. Unearned premiums represent an estimate of payments received during the fiscal year that cover the portion of a plan's year after PBGC's fiscal year-end. Premium income represents actual and estimated revenue generated from self-assessments from defined benefit pension plans as required by Title IV of ERISA (see Note 9).

Present Value of Future Benefits (PVFB): The PVFB is the estimated liability for future pension benefits that PBGC is or will be obligated to pay the participants of trusteed plans and terminated plans pending trusteeship. This liability is stated as the actuarial present value of estimated future benefits less the present value of estimated recoveries from sponsors and members of their controlled group and the assets of terminated plans pending trusteeship. PBGC also includes the estimated liabilities attributable to probable future plan terminations as a separate line item in the PVFB (net of estimated recoveries and assets). To measure the actuarial present value, PBGC uses assumptions to adjust the value of those future payments to reflect the time value of money (by discounting) and the probability of payment (by means of decrements, such as for death or retirement). PBGC also includes anticipated expenses to settle the benefit obligation in the determination of the PVFB. PBGC's benefit payments to participants represent a reduction to the PVFB liability.

The values of the PVFB are particularly sensitive to changes in underlying estimates and assumptions. It is likely that these estimates and assumptions will change in the near term and the impact of these changes may be material to PBGC's financial statements (see Note 4).

(1) Trusteed Plans -- represents the present value of future benefit payments less the present value of expected recoveries (for which a settlement agreement has not been reached with sponsors and members of their controlled group) for plans that have terminated and been trusteed by PBGC prior to fiscal year-end.

(2) Terminated Plans Pending Trusteeship -- represents the present value of future benefit payments less the plans' net assets (at fair value) anticipated to be received and the present value of expected recoveries (for which a settlement agreement has not been reached with sponsors and members of their controlled group) for plans that have terminated but have not been trusteed by PBGC prior to fiscal year-end.

(3) Settlements and Judgments -- represents estimated liabilities related to settled litigation.

(4) Net Claims for Probable Terminations -- includes reasonable estimates of the losses, net of plan assets and the present value of expected recoveries (from sponsors and members of their controlled group) for plans that are likely to terminate in a future year. These estimated losses are based on conditions that existed as of PBGC's fiscal year-end. Management believes it is likely that one or more events subsequent to PBGC's fiscal year-end will occur, confirming the loss. Criteria used for classifying a plan as probable include: the plan sponsor is in chapter 11 liquidation or comparable state insolvency proceeding with no known solvent controlled group member; sponsor files for distress plan termination; or PBGC seeks involuntary plan termination.

    In addition, PBGC provides a reserve for probable losses from plans not specifically identified and for plans with estimated underfunding less than $5 million. The reserve for unidentified losses is based on PBGC's historical experience.

(5) In accordance with Statement of Financial Accounting Standards No. 5, PBGC's exposure to losses from plans of companies that are classified as reasonably possible is disclosed in the footnotes. Criteria used for classifying a company as reasonably possible include: the plan sponsor in Chapter 11 reorganization; funding waiver pending or outstanding with the Internal Revenue Service (IRS); minimum funding contribution missed; below-investment-grade bond rating for Standard & Poor's (BB+) or Moody's (Ba1); no bond rating but unsecured debt below investment grade; or no bond

rating but the ratio of long-term debt plus unfunded benefit liability to market value of shares is 1.5 or greater (see Note 7).

(6) In addition, PBGC identifies certain plans as high risk if the plan sponsor meets the following criteria: the company is currently in Chapter 11 proceedings; has received a minimum funding waiver within the past five years; has granted security to an unsecured creditor as part of a renegotiation of debt within the past two years; is known to have been in default on existing debt within the past two years (regardless of whether it received a waiver of default); the company's unsecured debt is now rated CCC+/Caa1 or lower by S&P or Moody's, respectively; or any other set of circumstances that in the analyst's judgment constitutes a high risk situation.

PBGC specifically reviews each plan identified as high risk and classifies those plans as probable if, based on available evidence, PBGC concludes that plan termination is likely. Otherwise, high risk plans are classified as reasonably possible.

Present Value of Nonrecoverable Future Financial Assistance: In accordance with Title IV of ERISA, PBGC provides financial assistance to multiemployer plans, in the form of loans, to enable the plans to pay guaranteed benefits to participants and reasonable administrative expenses. These loans, issued in exchange for interest-bearing promissory notes, constitute an obligation of each plan.

The present value of nonrecoverable future financial assistance represents the estimated nonrecoverable payments to be provided by PBGC in the future to multiemployer plans that will not be able to meet their benefit obligations. The present value of nonrecoverable future financial assistance is based on the difference between the present value of future guaranteed benefits and expenses and the market value of plan assets, including the present value of future amounts expected to be paid by employers, for those plans that are expected to require future assistance. The amount reflects the rates at which, in the opinion of management, these liabilities (net of expenses) could be settled in the market for single-premium nonparticipating group annuities issued by private insurers (see Note 5).

A liability for a particular plan is included in the Present Value of Nonrecoverable Future Financial Assistance when it is determined that the plan is insolvent and will require assistance to pay the participants their guaranteed benefit. Determining insolvency requires considering several complex factors, such as an estimate of future cash flows, future mortality rates, and age of participants not in pay status.

Other Expenses: These expenses represent a current period estimate of the net amount of receivables deemed to be uncollectible. The estimate is based on the most recent status of the debtor (e.g., sponsor), the age of the receivables and other factors that indicate the element of uncollectibility in the receivables outstanding.

Losses from Completed and Probable Terminations: Amounts reported as losses from completed and probable terminations represent the difference as of the date of plan termination between the present value of future benefits (including amounts owed under Section 4022(c) of ERISA) assumed, or expected to be assumed, by PBGC, less related plan assets and the present value of expected recoveries from sponsors and members of their controlled group (see Note 10). In addition, the plan's net income from date of plan termination to the beginning of the fiscal year is included as a component of losses from completed and probable terminations for plans with termination dates prior to the year in which they were added to PBGC's inventory of terminated plans.

Actuarial Adjustments and Charges (Credits): PBGC classifies actuarial adjustments related to changes in method and the effect of experience as underwriting activity. Actuarial charges (credits) related to changes in interest rates and passage of time are classified as financial activity. These adjustments and charges (credits) represent the change in the PVFB that results from applying actuarial assumptions in the calculation of future benefit liabilities (see Note 4).

Depreciation: PBGC calculates depreciation of its furniture and equipment on a straight-line basis over the estimated useful lives of the assets. The useful lives range from five to 10 years. Routine maintenance and leasehold improvements (the amounts of which are not material) are charged to operations as incurred.

Reclassifications: Certain amounts in the 2001 financial statements have been reclassified to be consistent with the 2002 presentation.

Note 3 -- Investments

Premium receipts are invested in securities issued by the U.S. Government.

The trust funds include assets PBGC acquires or expects to acquire with respect to terminated plans and investment income thereon. These assets generally are held by custodian banks.

The basis and market value of the investments by type are detailed below. The basis indicated is cost of the asset if acquired after the date of plan termination or the market value at date of plan termination if the asset was acquired as a result of a plan's termination. PBGC marks the plan's assets to market and any increase or decrease in the market value of a plan's assets occurring after the date on which the plan is terminated must, by law, be credited to or suffered by PBGC. Note 11 provides the components of investment income.

INVESTMENTS OF SINGLE-EMPLOYER REVOLVING FUNDS AND SINGLE-EMPLOYER TRUSTEED PLANS

(Dollars in millions)	September 30, 2002 Basis	September 30, 2002 Market Value	September 30, 2001 Basis	September 30, 2001 Market Value
Fixed maturity securities:				
U.S. Government securities	**$14,165**	**$15,796**	$12,399	$13,206
Commercial paper	**28**	**28**	0	0
Asset backed securities	**440**	**447**	333	338
Corporate and other bonds	**478**	**471**	286	285
Subtotal	**15,111**	**16,742**	13,018	13,829
Equity securities	**6,847**	**7,349**	4,283	6,245
Real estate and real estate investment trusts	**42**	**38**	39	40
Insurance contracts	**15**	**6**	119	120
Total *	**$22,015**	**$24,135**	$17,459	$20,234

* This includes securities on loan at September 30, 2002, and September 30, 2001, with a market value of $122 million and $119 million, respectively.

INVESTMENTS OF MULTIEMPLOYER REVOLVING FUNDS AND MULTIEMPLOYER TRUSTEED PLANS

(Dollars in millions)	September 30, 2002 Basis	September 30, 2002 Market Value	September 30, 2001 Basis	September 30, 2001 Market Value
Fixed maturity securities:				
U.S. Government securities	**$832**	**$929**	$729	$777
Equity securities	**1**	**1**	1	2
Total	**$833**	**$930**	$730	$779

Derivative Investments: Derivatives are accounted for at market value in accordance with Statement of Financial Accounting Standards No. 133, as amended. Derivatives are marked to market with changes in value reported within financial income. During fiscal years 2001 and 2002, PBGC invested in an investment product that contained Standard & Poor's (S&P) 500 financial futures contracts. The objective of this investment strategy is to exceed, net of fees, the total rate of return of the S&P 500 Index while maintaining a very similar risk level to that of the index. S&P 500 Index futures are used to obtain cost-effective equity exposure for the strategy. In 2002 PBGC also invested in an investment product that contained U.S. and non-U.S. stock index futures contracts, U.S. and non-U.S. government bond futures and forward contracts, U.S. stock warrants, non-U.S. government debt option contracts, and foreign currency forward and option contracts. The objective of this investment strategy is to exceed, net of fees, the total rate of return of a customized benchmark for a global balanced mandate while maintaining a very similar risk level to that benchmark. Stock index futures contracts are held in a portfolio to affect asset allocation and country equity exposure. Government bond futures and forward contracts are held in a portfolio to affect sector asset allocation and to adjust interest rate (duration) and country exposure. U.S. stock warrants are held in a portfolio as a result of a corporate action. Non-U.S. government debt option contracts are held in a portfolio to reflect the investment views of the portfolio managers regarding government debt issues. Foreign currency forward and option contracts are held in a portfolio to hedge currency exposure (i.e., minimize currency risk) of certain assets and to adjust overall currency exposure to reflect the investment views of the portfolio managers regarding relationships between currencies. PBGC is accomplishing these objectives typically, but not exclusively, by holding long and short positions in stock index futures, government bond futures, foreign currency forward contracts and other derivative instruments. The counterparties to PBGC's foreign currency exchange contracts are major financial institutions. PBGC has never experienced non-performance by any of its counterparties.

In addition to the initial margin of generally 1 to 6 percent maintained with the broker in Treasury bills or similar instruments, financial futures contracts require daily settlement of variation margin. For the fiscal years ended September 30, 2002, and September 30, 2001, gains and losses from settled margin calls are reported in Investment Income on the Statements of Operations and Changes in Net Position. PBGC limits its investment in these derivative instruments to the investments in two portfolios. At September 30, 2002, and September 30, 2001, the notional cost amount of the financial futures contracts was approximately $264 million and $253 million, respectively. Open currency forward contracts as of September 30, 2002, in U.S. dollar terms were approximately $136 million long U.S. dollar/short foreign currencies and approximately $106 million long foreign currencies/short U.S. dollar. The fair value of the derivative instruments (the amount needed to settle at September 30) reported on the Statements of Financial Condition as part of "Sale of securities" was less than $1 million at September 30, 2002, as compared to approximately $5 million at September 30, 2001, and $6 million as part of "Due for purchases of securities" at September 30, 2002.

Financial futures contracts are traded on organized exchanges and thus bear minimal credit risk. The exchange clears, settles and guarantees transactions occurring through its facilities. Institutional investors hold these futures contracts on behalf of PBGC and mark to market daily. In periods of extreme volatility, margin calls may create a high liquidity demand on the underlying portfolio. To mitigate this, PBGC maintains adequate liquidity in its portfolio to meet these margin calls.

Security Lending: PBGC participates in a security lending program administered by its custodian bank. The custodian bank requires collateral that equals 102 percent to 105 percent of the securities lent. The collateral is held by the custodian bank. In addition to the lending program managed by the custodian bank, some of PBGC's investment managers are authorized to invest in repurchase agreements and reverse repurchase agreements. The manager either receives cash as collateral or pays cash out to be used as collateral. Any cash collateral received is invested. The total value of securities on loan at September 30, 2002, and September 30, 2001, was $122 million and $119 million, respectively.

Note 4 -- Present Value of Future Benefits

The following table summarizes the actuarial adjustments, charges and credits that explain how the Corporation's single-employer program liability for the present value of future benefits changed for the years ended September 30, 2002 and 2001.

For FY 2002, PBGC used a 25-year select interest rate of 5.70% followed by an ultimate rate of 4.75% for the remaining years and for FY 2001, a 20-year select interest rate of 6.70% followed by an ultimate rate of 5.25% for the remaining years. These rates were determined to be those needed to continue to match the survey of annuity prices provided by the American Council of Life Insurers. PBGC's regulations state that both the interest rate and the length of the select period may vary to produce the best fit with these prices. The prices reflect rates at which, in the opinion of management, the liabilities (net of expenses) could be settled in the market at September 30, for single-premium nonparticipating group annuities issued by private insurers. Many factors, including Federal Reserve policy, may impact these rates.

For September 30, 2002, PBGC used the 1994 Group Annuity Mortality (GAM) Static Table (with margins), set forward two years and projected 16 years to 2010 using Scale AA. For September 30, 2001, PBGC used the same table, set forward two years but projected 15 years to 2009 using Scale AA.

The reserve for administrative expenses in the 2002 and 2001 valuation was assumed to be 1.18 percent of benefit liabilities plus additional reserves for cases whose plan asset determinations, participant database audits and actuarial valuations were not yet complete. The factors to determine the additional reserves were based on case size, number of participants and time since trusteeship.

The present values of future benefits for trusteed multiemployer plans for 2002 and 2001 reflect the payment of benefits and the changes in interest assumptions, passage of time and the effect of experience.

The resulting liability represents PBGC's best estimate of the measure of anticipated experience under these programs.

RECONCILIATION OF THE PRESENT VALUE OF FUTURE BENEFITS FOR THE YEARS ENDED SEPTEMBER 30, 2002 AND 2001

	September 30,			
(Dollars in millions)	**2002**		2001	
Present value of future benefits, at beginning of year -- Single-Employer, net		**$13,497**		$10,631
Estimated recoveries, prior year		**19**		205
Assets of terminated plans pending trusteeship, net, prior year		**577**		84
Present value of future benefits at beginning of year, gross		**14,093**		10,920
Settlements and judgments, prior year		**(177)**		(242)
Net claims for probable terminations, prior year		**(411)**		(901)
Actuarial adjustments -- underwriting:				
Changes in method and assumptions	**$ (67)**		$ (63)	
Effect of experience	**137**		(30)	
Total actuarial adjustments -- underwriting	**70**		(93)	
Actuarial charges -- financial:				
Passage of time	**1,077**		780	
Change in interest rates	**1,655**		395	
Total actuarial charges -- financial	**2,732**		1,175	
Total actuarial charges, current year		**2,802**		1,082
Terminations:				
Current year	**7,704**		3,726	
Changes in prior year	**23**		(37)	
Total terminations		**7,727**		3,689
Benefit payments, current year*		**(1,537)**		(1,043)
Estimated recoveries, current year		**(38)**		(19)
Assets of terminated plans pending trusteeship, net, current year		**(323)**		(577)
Settlements and judgments, current year		**161**		177
Net claims for probable terminations:				
Future benefits**	**12,392**		1,350	
Estimated plan assets and recoveries from sponsors	**(6,070)**		939)	
Total net claims, current year		**6,322**		411
Present value of future benefits, at end of year -- Single-Employer, net		**28,619**		13,497
Present value of future benefits, at end of year -- Multiemployer		**3**		4
Total present value of future benefits, at end of year, net		**$28,622**		$13,501

* The benefit payments of $1,537 million and $1,043 million include $55 million in 2002 and $16 million in 2001 for benefits paid from plan assets by plans prior to trusteeship.

** The future benefits for probable terminations of $12,392 million and $1,350 million for fiscal years 2002 and 2001, respectively, include $70 million and $55 million, respectively, in net claims (future benefits less estimated plan assets and recoveries) for probable terminations not specifically identified and $12,322 million and $1,295 million, respectively, in net claims for specifically identified probables.

The following table details the assets that make up single-employer terminated plans pending trusteeship:

ASSETS OF SINGLE-EMPLOYER TERMINATED PLANS PENDING TRUSTEESHIP, NET

	September 30, 2002		September 30, 2001	
(Dollars in millions)	**Basis**	**Market Value**	Basis	Market Value
U.S. Government securities	**$ 0**	**$ 0**	$ 26	$ 26
Corporate and other bonds	**225**	**225**	197	195
Equity securities	**165**	**86**	338	338
Insurance contracts	**4**	**4**	1	1
Other	**8**	**8**	17	17
Total, net	**$402**	**$323**	$579	$577

Net Claims for Probable Terminations: Factors that are presently not fully determinable may be responsible for these claim estimates differing from actual experience. Included in net claims for probable terminations is a provision for future benefit liabilities for plans not specifically identified.

The values recorded in the following reconciliation table have been adjusted to the expected dates of termination.

RECONCILIATION OF NET CLAIMS FOR PROBABLE TERMINATIONS

	September 30,			
(Dollars in millions)	**2002**		2001	
Net claims for probable terminations, at beginning of year		**$ 411**		$ 901
New claims	**$6,232**		$ 318	
Actual terminations	**(338)**		(734)	
Eliminated probables	**(1)**		0	
Change in benefit liabilities	**23**		(15)	
Change in plan assets	**(5)**		(59)	
Change in expected recoveries	**0**		0	
Loss (credit) on probables		**5,911***		(490)*
Net claims for probable terminations, at end of year		**$6,322**		$ 411

* See Note 10

The following table itemizes the probable exposure by industry:

PROBABLES EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in millions)	**FY 2002**	FY 2001
Primary Metals and Fabricated Metal Products	**$5,831**	$184
Insurance Carriers	*****	107
Others	**491**	120
Total	**$6,322**	$411

* not included in principal category for the year but included in Others

The following table shows what has happened to plans classified as probables. This table does not capture or include those plans that were not initially classified as probable.

PROBABLES EXPERIENCE
As Initially Recorded Beginning in 1987

(Dollars in millions)	Status of Probables from 1987-2001 at September 30, 2002			
Beginning in 1987, number of plans reported as Probable:	Number of Plans	Percent of Plans	Net Claim	Percent of Net Claim
Probables that have terminated	164	78%	$3,038	83%
Probables still on list	5	2	76	2
Probables dropped from list	43	20	554	15
Total	212	100%	$3,668	100%

Note 5 -- Multiemployer Financial Assistance

PBGC provides financial assistance to multiemployer defined benefit pension plans in the form of loans. An allowance is set up to the extent that repayment of these loans is not expected.

NOTES RECEIVABLE
MULTIEMPLOYER FINANCIAL ASSISTANCE

	September 30,	
(Dollars in millions)	**2002**	2001
Gross balance at beginning of year	**$ 51**	$ 47
Financial assistance payments-- current year	**5**	4
Subtotal	**56**	51
Allowance for uncollectible amounts	**(56)**	(51)
Net balance at end of year	**$ 0**	$ 0

The losses from financial assistance reflected in the Statements of Operations and Changes in Net Position include annual changes in the estimated present value of nonrecoverable future financial assistance and assistance granted that was not previously accrued.

PRESENT VALUE OF NONRECOVERABLE FUTURE FINANCIAL ASSISTANCE AND LOSSES FROM FINANCIAL ASSISTANCE

	September 30,	
(Dollars in millions)	**2002**	2001
Balance at beginning of year	**$679**	$414
Changes in allowance:		
Losses from financial assistance	**101**	269
Financial assistance granted (previously accrued)	**(5)**	(4)
Balance at end of year	**$775**	$679

Note 6 -- Accounts Payable and Accrued Expenses

The following table itemizes accounts payable and accrued expenses reported in the Statements of Financial Condition:

ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	September 30,	
(Dollars in millions)	**2002**	2001
Annual leave	**$ 4**	$ 4
Collateral held for loaned securities	**128**	121
Other payables and accrued expenses	**41**	28
Accounts payable and accrued expenses	**$173**	$153

Note 7 -- Contingencies

There are a number of large single-employer plans that are sponsored by companies whose credit quality is below investment grade and may terminate. In addition, there are some multiemployer plans that may require future financial assistance. The amounts disclosed below represent the Corporation's best estimates given the inherent uncertainties about these plans.

In accordance with Statement of Financial Accounting Standards No. 5, PBGC classified a number of these companies as reasonably possible terminations as the sponsors' financial condition and other factors did not indicate that termination of their plans was likely as of year-end. The estimated aggregate unfunded vested benefits exposure to PBGC for the companies' single-employer plans classified as reasonably possible as of September 30, 2002, was approximately $35 billion.

The estimated unfunded vested benefits exposure has been calculated as of December 31, 2001. PBGC calculated this estimate as in previous years by using data obtained from filings and submissions with the government and from corporate annual reports for fiscal years ending in calendar 2001. The Corporation adjusted the value reported for liabilities to the December 31, 2001, PBGC select interest rate of 5.70% (the liabilities are not valued at September 30 as the information is not available). When available, data were adjusted to a consistent set of mortality assumptions. The underfunding associated with these sponsors' plans would generally tend to be greater at September 30, 2002, because of the economic conditions (e.g., lower interest rates and/or low investment returns on plan assets) that existed between December 31, 2001, and September 30, 2002. The Corporation did not adjust the estimate for events that occurred between December 31, 2001, and September 30, 2002.

The following table itemizes the reasonably possible exposure by industry:

REASONABLY POSSIBLE EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in billions)	**FY 2002**	FY 2001
Air Transportation	**$11.4**	$ 2.8
Primary Metals and Fabricated Metal Products	**5.7**	3.5
Industrial and Commercial Machinery and Computer Equipment	**1.8**	*
Chemicals and Allied Products	**1.4**	*
Rubber and Miscellaneous Plastics Products	**1.4**	*
Electronic and Other Electrical Equipment, except Computer Equipment	**1.3**	0.3
General Merchandise Stores	**1.3**	0.4
Paper and Allied Products	**1.2**	0.3
Stone, Clay, Glass and Concrete Products	*****	0.3
Transportation Equipment	*****	0.2
Others	**9.9**	3.1
Total	**$35.4**	$10.9

* not included in principal category for the year but included in Others

PBGC included amounts in the liability for the present value of nonrecoverable future financial assistance (see Note 5) for multiemployer plans that PBGC estimated may require future financial assistance. In addition, PBGC currently estimates that it is reasonably possible that other multiemployer plans may require future financial assistance in the amount of $127 million.

The Corporation calculated the future financial assistance liability for each multiemployer plan identified as probable or reasonably possible as the present value of guaranteed future benefit and expense payments net of any future contributions or withdrawal liability payments as of the later of September 30, 2002, or the projected (or actual, if known) date of plan insolvency, discounted back to September 30, 2002, using interest only. The Corporation's identification of plans that are likely to require such assistance and estimation of related amounts required consideration of many complex factors, such as an estimate of future cash flows, future mortality rates, and age of participants not in pay status. These factors are affected by future events, including actions by plans and their sponsors, most of which are beyond the Corporation's control.

PBGC used select and ultimate interest rate assumptions of 5.70% for the first 25 years after the valuation date and 4.75% thereafter. The Corporation also used the 1994 Group Annuity Mortality Static Table (with margins), set forward two years, projected 16 years to 2010 using Scale AA.

Note 8 -- Commitments

PBGC leases its office facility under a commitment that began on December 11, 1993, and expires December 10, 2008. The lease provides for periodic rate increases based on increases in operating costs and real estate taxes over a base amount. In addition, PBGC is leasing space for field benefit administrators. These leases began in 1996 and expire in 2010. The minimum future lease payments for office facilities having noncancellable terms in excess of one year as of September 30, 2002, are as follows:

COMMITMENTS: FUTURE LEASE PAYMENTS

(Dollars in millions)

Years Ending September 30,	Operating Leases
2003	$13.3
2004	13.5
2005	13.7
2006	14.1
2007	14.3
Thereafter	17.9
Minimum lease payments	$86.8

Lease expenditures were $12.2 million in 2002 and $12.1 million in 2001.

Note 9 -- Premiums

For both the single-employer and multiemployer programs, ERISA provides that PBGC shall continue to guarantee basic benefits despite the failure of a plan administrator to pay premiums when due. PBGC assesses interest and penalties on the unpaid or underpayment of premiums. Interest continues to accrue until the premium and the interest due are paid. The amount of penalty that can be levied is capped at 100 percent of the premium late payment or underpayment. Annual premiums for the single-employer program are $19 per participant for a fully funded plan. Underfunded single-employer plans pay an additional variable-rate charge, based on funding levels. The multiemployer premium is $2.60 per participant.

Note 10 -- Losses from Completed and Probable Terminations

Amounts reported as losses are the present value of future benefits (including amounts owed under Section 4022(c)) less related plan assets and the present value of expected recoveries from sponsors. The following table details the components that make up the losses:

LOSSES FROM COMPLETED AND PROBABLE TERMINATIONS -- SINGLE-EMPLOYER PROGRAM

	For the Years Ended September 30,					
	2002			2001		
(Dollars in millions)	**New Terminations**	**Changes in Prior Year Terminations**	**Total**	New Terminations	Changes in Prior Year Terminations	Total
Present value of future benefits	**$7,704**	**$23**	**$7,727**	$3,726	$ (37)	$3,689
Less plan assets	**4,664**	**8**	**4,672**	2,624	143	2,767
Plan asset insufficiency	**3,040**	**15**	**3,055**	1,102	(180)	922
Less estimated recoveries	**27**	**3**	**30**	0	(182)	(182)
Subtotal	**$3,013**	**$12**	**3,025**	$1,102	$ 2	1,104
Settlements and judgments			**377**			91
Loss (credit) on probables			**5,911***			(490)*
Total			**$9,313**			$ 705

* See Note 4

Note 11 -- Financial Income

The following table details the combined financial income by type of investment for both the single-employer and multiemployer programs:

FINANCIAL INCOME

	For the Years Ended September 30,	
(Dollars in millions)	**2002**	2001
Fixed-income securities:		
Interest earned	**$ 985**	$ 885
Realized gain	**315**	225
Unrealized gain	**861**	655
Total fixed-income securities	**2,161**	1,765
Equity securities:		
Dividends earned	**34**	26
Realized loss	**(382)**	(458)
Unrealized loss	**(1,539)**	(2,078)
Total equity securities	**(1,887)**	(2,510)
Other income (loss)	**14**	(3)
Total financial income (loss)	**$ 288**	$ (748)

Note 12 -- Employee Benefit Plans

All permanent full-time and part-time PBGC employees are covered by the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). Full-time and part-time employees with less than five years service under CSRS and hired after December 31, 1983, are automatically covered by both Social Security and FERS. Employees hired before January 1, 1984, participate in CSRS unless they elected and qualified to transfer to FERS.

The Corporation's contribution to the CSRS plan, for both 2002 and 2001, was 8.51 percent of base pay for those employees covered by that system. For those employees covered by FERS, the Corporation's contribution was 10.7 percent of base pay for both 2002 and 2001. In addition, for FERS-covered employees, PBGC automatically contributes 1 percent of base pay to the employee's Thrift Savings account, matches the first 3 percent contributed by the employee and matches one-half of the next 2 percent contributed by the employee. Total retirement plan expenses amounted to $8 million in 2002 and 2001.

These financial statements do not reflect CSRS or FERS assets or accumulated plan benefits applicable to PBGC employees. These amounts are reported by the U.S. Office of Personnel Management (OPM) and are not allocated to the individual employers. OPM accounts for federal health and life insurance programs for those eligible retired PBGC employees who had selected federal government-sponsored plans. PBGC does not offer other supplemental health and life insurance benefits to its employees.

Note 13 -- Cash Flows

The following is a reconciliation between the net income as reported in the Statements of Operations and

Changes in Net Position and net cash provided by operating activities as reported in the Statements of Cash Flows.

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

	Single-Employer Program		Multiemployer Program		Memorandum Total	
	September 30,		September 30,		September 30,	
(Dollars in millions)	**2002**	2001	**2002**	2001	**2002**	2001
Net income (loss)	**$(11,370)**	$(1,972)	**$ 42**	$(151)	**$(11,328)**	$(2,123)
Adjustments to reconcile net income to net cash provided by operating activities:						
Net (appreciation) decline in fair value of investments	**701**	1,709	**(67)**	(48)	**634**	1,661
Net loss of terminated plans pending trusteeship	**79**	5	**0**	0	**79**	5
Losses on completed and probable terminations	**9,313**	705	**0**	0	**9,313**	705
Actuarial charges	**2,802**	1,082	**0**	1	**2,802**	1,083
Benefit payments - trusteed plans	**(1,482)**	(1,027)	**(1)**	(1)	**(1,483)**	(1,028)
Settlements and judgments	**(393)**	(156)	**0**	0	**(393)**	(156)
Cash received from plans upon trusteeship	**662**	592	**0**	0	**662**	592
Pretermination payments	**0**	(11)	**0**	0	**0**	(11)
Receipts from sponsors/non-sponsors	**383**	24	**0**	0	**383**	24
Amortization of discounts	**(15)**	(2)	**0**	0	**(15)**	(2)
Changes in assets and liabilities, net of effects of trusteed and pending plans:						
(Increase) decrease in receivables	**39**	(26)	**0**	1	**39**	(25)
Increase in present value of nonrecoverable future financial assistance			**96**	265	**96**	265
Increase (decrease) in unearned premiums	**2**	(15)	**0**	(1)	**2**	(16)
Increase in accounts payable	**13**	3	**0**	0	**13**	3
Net cash provided by operating activities	**$ 734**	$ 911	**$ 70**	$ 66	**$ 804**	$ 977

Note 14 -- Litigation

PBGC records as a liability on its financial statements an estimated cost for unresolved litigation to the extent that losses in such cases are probable and estimable. Management believes that PBGC will prevail in these litigation proceedings but, in the unlikely event any such losses are incurred, they could have a material impact on the financial statements. No such costs have been recorded, but PBGC estimates that possible losses of up to $126 million could be incurred in the unlikely event that PBGC does not prevail in these matters.

Note 15 -- Subsequent Events

Subsequent to September 30, 2002, business and financial conditions significantly deteriorated for some sponsors of large single-employer plans that may terminate. Had these plan sponsor events occurred prior to FY 2002 year-end, PBGC's financial statements would have reflected an increase of $2.0 billion in the Net loss and a decrease in the Net position in the same amount.

There were no subsequent events to report on the multiemployer program.

Section V

Agency Comments

Pension Benefit Guaranty Corporation
1200 K Street, NW, Washington, DC 20005-4026

Office of the Executive Director

JAN 30 2003

TO: Deborah Stover-Springer
Deputy Inspector General

FROM: Steven A. Kandarian Steven A. Kandarian
Executive Director

SUBJECT: Comments on *Audit of Fiscal Year 2002 and 2001 Financial Statements 2003-3/23168-2*

We appreciate the Office of Inspector General's work on the subject report and the opportunity to comment. It is particularly heartening to note that our system of financial reporting continues to provide a sound basis for analyzing the long-term challenges that currently confront our system of pension insurance—and providing effective solutions. The Fiscal Year 2002 report now marks the 10th consecutive year of reliable data and unqualified audit opinions. By working together with your office we can continue this record of accomplishment.

The Corporation remains committed to achieving substantive progress in following up on the Office of Inspector General's open audit recommendations. We have made reducing the number of audit recommendations a corporate objective for this year. We anticipate working cooperatively with your office to make further progress in audit follow-up.

Again, we appreciate your good work and look forward to continuing a productive and cooperative relationship.

cc: Hazel Broadnax
Joseph Grant
John Seal
Rick Hartt
Ted Winter