Pension Benefit Guaranty Corporation

Office of Inspector General

Audit Report

Audit of the Pension Benefit Guaranty Corporation's Fiscal Years 2003 and 2002 Financial Statements

Report of Independent Auditors

Report on Internal Control

Report of Independent Auditors on Compliance With Laws and Regulations

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Pension Benefit Guaranty Corporation's
Fiscal Years 2003 and 2002 Financial Statements
and Notes to the Financial Statements

January 15, 2004

2004-2/23176-2

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

To the Board of Directors
Pension Benefit Guaranty Corporation

We contracted with the independent certified public accounting firm of PricewaterhouseCoopers LLP to audit the financial statements of Single-Employer and Multiemployer Program Funds administered by the Pension Benefit Guaranty Corporation (PBGC) as of the Fiscal Year (FYs) 2003 and 2002. This audit 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 *and the GAO/PCIE Financial Audit Manual.*

In its audit of the financial statements of Single-Employer and Multiemployer Program Funds administered by PBGC, PricewaterhouseCoopers found:

- The financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles,
- PBGC maintained effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations, except for a material weakness related to the methodology used in estimating multiemployer plan liabilities.
- No reportable noncompliance with laws and regulations it tested.

In addition, PricewaterhouseCoopers described significant matters in the following areas where PBGC needs to:

- integrate its financial management systems;
- complete its efforts to fully implement and enforce an effective information security program;
- improve controls related to single-employer premiums;
- continue to improve its controls over the identification and measurement of Single-Employer Program Fund contingent liabilities;
- improve controls over the estimation of reserves for Single-Employer Program Fund losses incurred but not reported or not specifically identified; and
- strengthen controls over the identification and classification of Multiemployer plans probable of receiving financial assistance.

PricewaterhouseCoopers is responsible for the accompanying auditor's report dated December 22, 2003 and the conclusions expressed in the report. We do not express opinions on PBGC's financial statements or internal control or conclusions on compliance with laws and regulations.

A set of PricewaterhouseCoopers' reports (2004-2/23176-2) is available upon request from the PBGC's Office of Inspector General.

Sincerely,

Robert L. Emmons
Inspector General

December 22, 2003

Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2003 and 2002 Financial Statements

Audit Report 2004-2/23176-2

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CFND	Corporate Finance and
CTO	Chief Technology Officer
EISSP	Enterprise Information System Security Plan
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
IT	Information Technology
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
TPL	Trust Plan Ledger

Section I

Report of Independent Auditors

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Suite 800W
1301 K Street NW
Washington DC 20005-3333

Report of Independent Auditors

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, 2003 and 2002, and the related statements of operations and changes in net position and 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 PBGC at September 30, 2003 and 2002, 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 and Multiemployer Program Funds (the Funds) must be self-sustaining, and therefore their premiums must be sufficient to cover both their short and long-term obligations. The Funds have been able to meet their short-term benefit obligations, and PBGC internal analyses project that they will be able to do so for a number of years. However, as discussed in Note 1, management believes that neither program at present has the resources to fully satisfy PBGC's long-term obligations to plan participants. The Funds' statements of financial condition report a net deficit position (liabilities in excess of assets) of the Single-Employer and Multiemployer Program Funds of $11.2 billion and $261 million, respectively, at September 30, 2003. Losses that are "reasonably possible" as a result of unfunded vested benefits are estimated to be $85.5 billion and $63 million for Single-Employer and Multiemployer Program Funds, respectively, at September 30, 2003, as discussed in Note 7. The Funds' net position, and long-term viability, could be further 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 accordance with Government Auditing Standards, we have also issued our reports dated December 22, 2003 on the effectiveness of PBGC's internal control and on our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

PricewaterhouseCoopers LLP

December 22, 2003

Section II

Report on Internal Control

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Suite 800W
1301 K Street NW
Washington DC 20005-3333

Independent Auditors' Report on Internal Control

To the Inspector General
Pension Benefit Guaranty Corporation

We have examined the effectiveness of Pension Benefit Guaranty Corporation's (PBGC) internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations as of September 30, 2003, based on the criteria contained in the Federal Managers' Financial Integrity Act of 1982 (FMFIA). We did not examine all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. PBGC's management is responsible for maintaining effective internal control. Our responsibility is to express an opinion on the effectiveness of internal control 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*, issued by the Comptroller General of the United States, and, accordingly, included obtaining an understanding of internal control, 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 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.

We noted a matter, described in the attached Schedule of Findings, "PBGC should reassess its methodologies for estimating multiemployer plan liabilities," which we believe to be a material weakness. A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. This condition was considered in determining the nature, timing, and extent of audit tests applied in our audit of the fiscal year 2003 financial statements, and this report does not affect our report dated December 22, 2003 on these financial statements.

In our opinion, except for the effects of the material weakness referred to in the preceding paragraph, PBGC has maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations as of September 30, 2003, based on criteria in FMFIA.

However, we noted certain matters involving the internal control and its operation, set forth below and in the attached Schedule of Findings, that we consider to be reportable conditions under standards established by the AICPA. A reportable condition is a matter coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

PRICEWATERHOUSECOOPERS

A material weakness, as defined by the AICPA, 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 misstatements caused by error 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. We believe that none of the six reportable conditions listed below is a material weakness as defined by the AICPA.

The reportable conditions we noted were:

(1) PBGC needs to integrate its financial management systems;
(2) PBGC needs to complete its efforts to fully implement and enforce an effective information security program;
(3) PBGC needs to improve controls related to single-employer premiums;
(4) PBGC needs to continue to improve its controls over the identification and measurement of Single-Employer Program Fund contingent liabilities;
(5) PBGC needs to improve controls over the estimation of reserves for Single-Employer Program Fund losses incurred but not reported or not specifically identified; and
(6) PBGC needs to strengthen controls over the identification and classification of Multiemployer plans probable of receiving financial assistance.

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

We noted other less significant matters involving the 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, the 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

December 22, 2003

PENSION BENEFIT GUARANTY CORPORATION
SCHEDULE OF FINDINGS
Audit of the Fiscal Year 2003 Financial Statements

MATERIAL WEAKNESS

1. PBGC should reassess its methodologies for estimating multiemployer plan liabilities

In many cases, the asset information of multiemployer plans available to PBGC is as of a date prior to PBGC's financial statement date, and may be several years old. In calculating the present value of nonrecoverable future financial assistance liability of the Multiemployer program, PBGC makes certain assumptions about the return on plan assets from the information date to the financial statement date. These assumptions may include using the PBGC select closing interest rate and the plan actuary's interest rate. These methods do not reflect market changes prior to PBGC's fiscal year-end.

We also note that these methods differ from those applied to single-employer terminated plans or single-employer plans probable of termination. The method for projecting assets of single-employer plans uses an assumed asset mix and looks to actual market performance over the period from the information date to the fiscal year end to estimate plan assets.

When this observation was noted to management during the audit, management recalculated the liability for six plans (with total assets in excess of $226 million), arriving at a difference of approximately $9.5 million, which increased the liability from $1,241 million to $1,250 million.

Recommendation:

When determining PBGC's best estimate of the Multiemployer program's liability for the present value of nonrecoverable future financial assistance, PBGC should use a model that considers market changes from the asset information date to PBGC's financial statement date.
(OIG Control Number IOD-214)

REPORTABLE CONDITIONS

1. PBGC needs to integrate its financial management systems

We continued to identify 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.

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 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).

Although PBGC made progress towards the development of the corrective action plan, it did not make key decisions to implement a course of action to address the lack of systems integration for the core financial systems. During the course of this past financial audit, we have noted the following examples of the lack of integration:

- Although participant information is entered and maintained in PRISM's Genesis database, management imports a copy of this data to the IPVFB database in order to value the seriatim liability.

- Both the PRISM Genesis and IPVFB Oracle databases have tables created without indices, which may lead to poor integrity of participant and liability data.

- PBGC utilizes three separate general ledger systems (TPL, PA, and FRS) to process trust, revolving, and consolidated transactions rather than integrating these transactions in a single integrated system.
- There are instances where data is manually re-keyed between systems. During the FY 2003 IPVFB application controls testing, we noted that the interface between IPVFB and the Financial Reporting System (FRS) requires manual processing and data entry.
- Financial management system developers were not required to adhere to system integration standards.

FY 2003 fieldwork revealed that management has formulated a Working Group to plan, design, and implement a system integration solution, as well as a Steering Group to oversee activities of the Working Group. These groups have taken the following steps that will help PBGC address, in the long term, a potential solution to address this problem:

- Established fiscal year 2005 as the time frame to formally implement a system integration solution;
- Began defining the baseline requirements for system integration; and
- Developed a timeline to establish milestones and monitor implementation progress.

During interviews with management, we noted the following actions underway:

- Defining the role/authority of the Steering Group to monitor Working Group's progress and ensuring adherence to project milestones;
- Adhering to the Systems Life Cycle Management methodology to address project management, system design and internal control issues;
- Planning for the complexity associated with migration from multiple and diverse stand-alone systems to a unified system;
- Developing a process for monitoring the external contractors in the implementation, maintenance, and modification of the integrated financial system environment; and
- Ensuring prior weaknesses are corrected in the new system.

Even with these actions, in the short term, the Corporation's ability to accurately and efficiently accumulate and summarize information required for internal and external financial reporting continues to be significantly impacted. This issue, therefore, remains a reportable condition for fiscal year 2003.

Recommendation:

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)**

2. PBGC needs to complete its efforts to fully implement and enforce an effective information security program

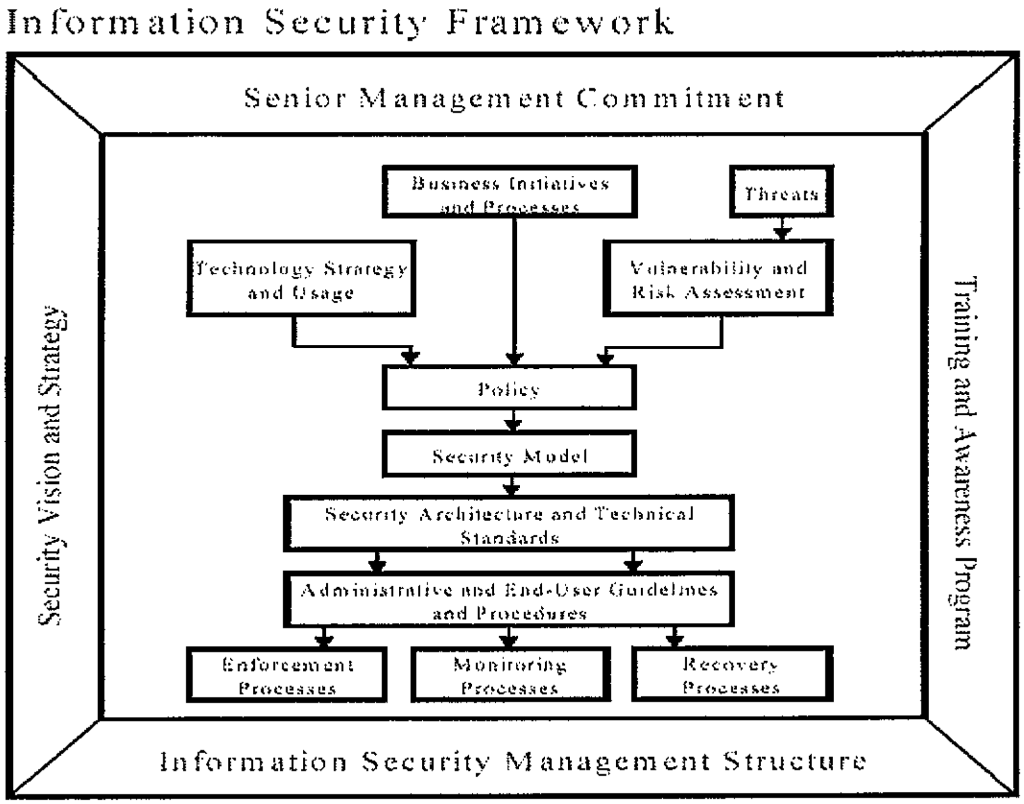
PBGC has responded positively to past issues concerning information security and has made progress implementing security-related corrective actions such as:

- Developing a directive requiring risk assessments to be completed for business systems as required by OMB;
- Implementing a process that defines the extent of background checks required to grant access to major business and general support systems until a complete investigation can be completed; and
- Implementing procedures requiring periodic background re-investigations in compliance with Office of Personnel Management (OPM) guidance.

In addition, PBGC's Chief Technology Officer (CTO) has developed and presented a business case for the Enterprise Information System Security Plan (EISSP). PBGC Management is planning to complete the EISSP by FY 2004. However, as of FY 2003, PBGC management has not yet implemented effective security controls that address the following:

- 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 related to system access, security violations and periodic reviews of user access; and
- Implementing effective security plans for all PBGC systems as well as proper certification and accreditation of systems for processing.

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, *Management of Federal Information Resources*, and associated NIST publications.



Exposures related to specific areas of this diagram exist at PBGC primarily because PBGC has not implemented an effective, fully integrated and functional enterprise-wide information security program. In our review of Information Technology (IT) controls, as part of our 2003 audit, we noted the following weaknesses:

- *Vulnerability and Risk Assessment* – PBGC contracted to have security risk assessments and certifications for the general support and major business systems completed. However, PBGC has not developed or documented criteria/guidance to conduct these risk assessments, certifications and accreditations. The contractors did not receive adequate criteria and did not fully assess the risks inherent to PBGC's systems, such as known weaknesses in Oracle and SUN Solaris.

- *Enforcement and Monitoring processes* – During an internal network security penetration study, several vulnerabilities within the PBGC network were identified in the areas of systems controls, security procedures, and user security awareness. 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. 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.

- Application developers have direct access to the production environments that process PBGC's financially significant applications.

- *Security Management Structure* – As of September 20, 2003, the Information Systems Security Officer (ISSO) reports directly to the IRMD Director, rather than the 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. However, it should be noted that, effective FY 2004, the ISSO will report directly to the CTO and have staff assigned to assist in developing and enforcing IT security policies and procedures across the agency.

Until 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. The need for a strong information security program will be further magnified as the corporation continues to transition to Internet and Web-based applications to better serve its customers.

Recommendations:

We continue to recommend that PBGC:

- 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)**

- 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)**

- 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)**

3. PBGC needs to improve controls related to single-employer premiums

As a result of our audit work, including review of work performed by PBGC's Office of Inspector General (OIG), we noted certain internal control weaknesses related to premiums of PBGC's Single-Employer Program Fund. Many of these matters are not new; they have been the subject of management letter comments in years past and a recent OIG premium report. Management has acknowledged premiums as an area with control weaknesses and has begun to take steps to improve controls, including plans for a new premium accounting system.

Our observations relate to two categories of control:

1. **Safeguarding of Assets** - *Ensuring PBGC collects all premiums due under statute.*

   OMB Circular A-123, *Management Accountability and Controls*, requires that:

   > Management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation. Management controls developed for agency programs should be logical, applicable, reasonably complete, and effective and efficient in accomplishing management objectives.

2. **Financial Reporting** - *Ensuring PBGC completely and reliably reports premium revenue and receivables in the financial statements.*

   OMB Circular A-123 states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports."

Enhancements are needed to PBGC's control procedures for safeguarding of premium related assets and financial reporting in the following areas:

A. *Ensure completeness of universe of benefit plans required to make premium payments.*

While PBGC's Premium Accounting System has a module to compare premium filings to plan filings with the Department of Labor to determine the completeness of the plan universe, we understand that there are barriers to its effective use.

B. *Ensure plan sponsors are accurately reporting participant and plan data used to determine fixed and variable-rate premiums, respectively.*

PBGC has identified premium compliance evaluations as a key control to verify the accuracy of plans' premiums filings, however this control has not been used extensively (a limited number of evaluations were completed in fiscal year 2003).

C. *Follow up with plans that submit premium filings and have under or over paid premiums by sending the plan a Statement of Account.*

PBGC placed greater emphasis on this control procedure during fiscal year 2003, however, only select Statements of Account were mailed during the year. We understand that a number of Statements of Account were not sent due to the need for identified corrections.

D. *Follow up with plans from which PBGC has not received a premium filing but expects to by sending a Past Due Filing Notice.*

PBGC placed greater emphasis on this control procedure during fiscal year 2003 after a period during which notices were not sent; however, only select Past Due Filing Notices were mailed during the year. We understand that a number of Past Due Filing Notices were not sent due to the need for identified corrections.

E. *Improve controls over the premiums system data quality.*

Management considers the data in the Premium Accounting System to be unreliable for purposes of reporting the premiums receivable in PBGC's financial statements, and performs a review of a sample of individual plan balances in the system in order to determine the premiums receivable for financial reporting purposes.

Data errors in the Premium Accounting System have resulted from the initial conversion of the legacy Premium Processing System. In addition, errors have increased due to incorrect data entry, adjustments, and system-generated balances. We noted the following control weaknesses that contribute to continuing data quality issues:

- Those designated to approve entries to the system are able to approve groups of transactions, rather than being required to review and approve individual transactions.
- There are items in suspense dating back to 1993. Although written procedures for clearing items from suspense exist, there are not written policies or procedures defining monitoring controls to ensure that old items are cleared timely.
- PBGC generates an exception report that lists inconsistencies between (a) the Premium Accounting System and (b) the premiums imaging system that contains underlying supporting documentation including premiums filings. However, this exception report is not consistently investigated or reviewed.

F. *Improve PBGC's premiums estimation techniques and assumptions to reflect changes in market conditions and plan funding levels compared to prior years.*

Premiums for calendar year plans are not due to PBGC until after fiscal year-end, requiring management to estimate current year premium income. In the current estimation process, PBGC considers actual premiums received after September 30, 2003. Given the timeframes associated with receipt of premium collections information, PBGC should reconsider its estimation processes to address shortened reporting deadlines beginning in fiscal year 2004.

G. *Document and distribute a comprehensive manual for processing and estimating premiums.*

PBGC's procedures consist of some formalized procedures, as well as various emails and handwritten procedures. Deficiencies in procedures documents included lack of policies and procedures to address clearing suspense items or investigating differences between the Premium Accounting System and the imaging system (as noted above).

As a result of the noted weaknesses in controls surrounding premiums, PBGC may be unable to produce reliable financial statements under OMB's accelerated fiscal year 2004 reporting schedule.

Recommendations

Address the matters noted above, and those raised by the OIG, to improve controls surrounding:

- Completeness of universe of benefit plans required to make premium payments;
- Accuracy of reporting by plan sponsors of participant and plan data;
- Follow-up with plans with under or over payments, or that failed to file;
- Premiums system data quality; and
- Premium estimation techniques.

(OIG Control Number FOD-325)

In addition, develop a comprehensive procedures manual for processing and estimating premiums.
(OIG Control Number FOD-326)

4. PBGC needs to continue to improve controls over the identification and measurement of the Single-Employer Program Fund contingent liabilities

During the fiscal year 2002 audit, PwC noted a reportable condition in the single-employer contingent liabilities area related to plan classification and errors in PBGC's calculations of its contingent liabilities for plans reasonably possible of termination. During the fiscal year 2003 audit, PwC noted that most of the recommendations regarding plan classification had been implemented. Specifically, PBGC:

- Documented the definition of a plan considered probable of termination, including the definition of a "very high risk plan" that should be classified as probable.
- Prepared guidance on factors to be considered in assessing whether a "high risk" plan should be classified as probable or reasonably possible for termination.
- Developed guidance to enhance the supporting documentation of the rationale and conclusions for classifying "high risk" plans as probable or reasonably possible for termination.
- Developed 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 continuation.
- Developed a procedures manual for Corporate Finance and Negotiations Department (CFND) to follow when generating information to be included in the financial statements.

However, PwC again noted errors and exceptions in our testing of contingencies:

- In the actuarial calculations of the unfunded vested benefits of plans classified as reasonably possible of termination, we noted errors that went undetected by management. Our testing indicated that nine plans (related to seven plan sponsors) contained errors totaling $522 million out of a sample of 98 sponsors with unfunded vested benefits totaling $69,702 million.
- We also noted instances in which required classification authorization forms were not completed, a plan was improperly excluded from the contingency list based on the credit rating, and a plan that had previously completed a standard termination was improperly included on the contingency list.

Further, CFND's new procedures did not address the changes in procedures that it should make to address the fiscal year 2004 compressed financial reporting time frames. During the fiscal year 2003 audit, we noted that PBGC made adjustments for five plans totaling $448 million to the draft financial statements well after year-end to include additional probable liabilities resulting from Type I subsequent events (conditions existed as of year-end and were confirmed after year-end). We also noted management's process of obtaining concurrence for high-risk memos extended into December 2003. Both of these indicate that the current procedures would not be sufficient to meet the fiscal year 2004 reporting requirements of audited financial statements by November 15, 2004.

These findings indicate evidence of failure of identified controls in preventing or detecting misstatements of accounting information. Therefore, we repeat this reportable condition in fiscal year 2003.

Recommendations:

We continue to recommend that PBGC:

- Implement independent review procedures of unfunded benefit liability calculations for contingent liabilities (i.e. plans classified as reasonably possible). [CFND-5]
- Reexamine the process for classifying and determining appropriate values of contingent liabilities to meet compressed financial reporting time frames. [CFND-6]

We also recommend that PBGC:

- Continue to review and promote compliance with procedures surrounding the classification of plans to ensure accuracy of plan classification.

(OIG Control Number CFND-8)

5. PBGC needs to improve controls over the estimation of reserves for Single-Employer Program Fund losses incurred but not reported or not specifically identified

PBGC records losses (both for plan terminations and existing conditions that make plan termination probable) that have been incurred but not reported or not specifically identified. PBGC determines reserves for this risk in three separate analyses:

(1) Incurred But Not Reported (IBNR) - This is a reserve for plans with under $5 million underfunding that terminated prior to year-end where PBGC had not been informed or had not captured appropriate information for the liability calculation. (Plans with over $5 million underfunding are already captured in the liability).

(2) Reserve for small probables - This is a reserve for plans with unfunded vested benefits (UVBs) of less than $5 million and conditions exist in the current fiscal year which indicate that a plan is likely to terminate. PBGC policy is to not perform a review of plans with less than $5 million UVB due to cost-benefit considerations. Although management has not identified or reviewed the plans, a loss has been incurred.

(3) Reserve for large unidentified probables - This is a reserve for plans with unfunded vested benefits (UVBs) of or more than $5 million and conditions exist in the current fiscal year which indicate that a plan is likely to terminate. The purpose of this reserve is to provide an allowance for plans that should be classified as probable, but have not been specifically identified by management.

We noted several weaknesses in these estimation processes as follows:

1. Management does not analyze loss data to determine whether losses from plans that terminated during the year should have been accrued in a previous period. Such a retrospective analysis could be used to determine the effectiveness of the specific reviews of plans for classification as probable, as well as the accuracy of the reserve estimation process. It would also allow management to quantify, on a historical basis, PBGC's loss experience relative to the various components of its contingent liability risk pools (see #3 below).

2. PBGC's reserve estimate is not based on actuarial methods but rather on simple averages of historical claims data with no input from PBGC's analysts or actuaries. There are inconsistencies in the methods used to calculate the three reserves. For example, one uses a five-year weighted average, another uses a five-year non-weighted average and the third uses a 10-year non-weighted average. Management has not adequately justified the rationale for the differences in the methodologies.
3. Management does not consider in its analysis the different characteristics of each of its pools of risk. For example, PBGC performs different levels of review at the plan sponsor level of the risk of plan termination. The basis for management's classification includes (a) performing an analysis of the likelihood of termination based on individual facts and circumstances of the plan sponsors; (b) making classification decisions based on the credit rating or debt to equity ratio; and (c) classifying plans as remote when management does not have any information on the credit rating or debt to equity ratio. However, loss experience is not separately analyzed for each of these pools.
4. No specific analysis was performed of plans classified as remote based on lack of available information, despite the increase in the underfunding of the plans in this category from $10 billion to $56 billion from fiscal year 2002 to 2003, respectively.
5. The reserve analyses are performed by members of the Financial Operations Department (FOD). FOD has not involved other departments in determining or reviewing the reserves. Members of these other departments are involved in the termination and contingency process year-round. As such, their involvement would be meaningful in performing the analysis of exposures and in determining the levels of reserves. Further, management has not used professional actuarial staff in the calculations of the reserves.

Recommendations:

Reevaluate the methods by which PBGC calculates its reserves. Management should consider:

- Types of risk and changes in exposure
- Clearly defining the purpose of the reserves
- Gathering meaningful data
- Using sound actuarial methods

(OIG Control Number FOD-327)

Retrospectively review the effectiveness of the reserve process each year, and utilize the knowledge and resources of other departments, including the actuarial staff.
(OIG Control Number FOD-328)

6. PBGC needs to strengthen controls over the identification and classification of multiemployer plans probable of receiving financial assistance

We noted several control weaknesses in the identification and classification of multiemployer liabilities that in the aggregate represent significant deficiencies in the design or operation of internal controls. It is useful to consider the process in three stages to understand the issues noted and the recommendations.

Stage One – Identification of the universe of multiemployer plans guaranteed by PBGC.

The Multiemployer Program Manager reconciles the universe from prior year to current year. PBGC's procedures require the preparer of the reconciliation to document the reasons for deleting plans from the universe. However, formal documentation of this process, including the reasons for plan additions or deletions, does not exist. Further, the reconciliation is not independently reviewed.

Recommendations:

Enforce procedures requiring documentation of the reasons for plan additions or deletions.
(OIG Control Number IOD-215)

Amend procedures to require the multiemployer universe reconciliation be independently reviewed. Such review should be documented.
(OIG Control Number IOD-216)

Stage Two – Initial screening for plan classification through financial ratios.

Using financial data obtained from pension plan information filed with the Department of Labor, PBGC calculates five screening ratios. Plans that fail two or more ratios are reviewed by the Multiemployer Program Manager for plan classification as probable, reasonably possible, or remote. This review includes a review of data integrity. Plans that fail zero or one ratio are not reviewed and are classified as remote.

Through discussion with management, we noted cases of imperfect data in the plans reviewed. Since PBGC's policy is to only review plans triggered by the screening ratios test, a risk exists that an error in plan information that could cause a plan to inappropriately pass screening ratios would go undetected.

Recommendation:

Reconsider PBGC's policy of not reviewing the data integrity of plans that fail zero or one screening ratios.
(OIG Control Number IOD-217)

Stage Three – Classifying plans that fail initial ratio screening as probable, reasonably possible, or remote.

The Multiemployer Working Group is required to document all plans that failed three or more ratios and were classified as remote-Watch List or remote. Both lists provide general facts about the plan, but not the reasons for the classification. When classifying these plans, the Multiemployer Working Group considers external information including the employers in the plan and the industry in which the plan operates. A reasonable person should be able to read the supporting documentation and draw the same conclusions.

Recommendation:

Amend the Multiemployer Working Group manual to provide greater clarity over what should be documented to support PBGC's classification decisions. If any external data is used to form the basis of conclusions, those sources should be cited in the memo.
(OIG Control Number IOD-218)

FOLLOW-UP ON PREVIOUS REPORT

In our report on internal control dated January 14, 2003, we reported the following five reportable conditions: (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 of termination. We believe items (2) and (5) have been corrected. Items (1), (3) and (4) remain as reportable conditions in fiscal year 2003.

Section III

Report of Independent Auditors on Compliance with Laws and Regulations

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
1301 K Street NW, Suite 800W
Washington DC 20005-3333

Report of Independent Auditors 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, 2003, and have issued our report thereon dated December 22, 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 laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, as follows:

- Employee Retirement Income Security Act of 1974 (ERISA);
- Federal Managers' Financial Integrity Act of 1982;
- Retirement Protection Act of 1994;
- Chief Financial Officers Act of 1990; and
- Anti-Deficiency Act (limited to comparing the Corporation's recorded payments to related authorized limitations on certain payments and apportionments).

However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of PBGC's Office of Inspector General, the 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

December 22, 2003

Section IV

Pension Benefit Guaranty Corporation's Fiscal Years 2003 and 2002 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)	2003	2002	2003	2002	2003	2002
ASSETS						
Cash and cash equivalents	$ 3,172	$ 716	$ 8	$ 3	$ 3,180	$ 719
Investments, at market (Note 3):						
Fixed maturity securities	17,250	16,742	975	929	18,225	17,671
Equity securities	12,641	7,349	1	1	12,642	7,350
Real estate and real estate investment trusts	93	38	0	0	93	38
Other	59	6	0	0	59	6
Total investments	30,043	24,135	976	930	31,019	25,065
Receivables, net:						
Sponsors of terminated plans	132	209	0	0	132	209
Premiums (Note 9)	254	121	0	0	254	121
Sale of securities	134	45	0	0	134	45
Investment income	274	197	16	11	290	208
Other	3	3	0	0	3	3
Total receivables	797	575	16	11	813	586
Furniture and fixtures, net	4	4	0	0	4	4
Total assets	$34,016	$25,430	$1,000	$944	$35,016	$26,374

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)	2003	2002	2003	2002	2003	2002
LIABILITIES						
Present value of future benefits, net (Note 4):						
Trusteed plans	$ 38,945	$21,660	$ 3	$ 3	$ 38,948	$21,663
Terminated plans pending trusteeship	463	476	0	0	463	476
Settlements and judgments	67	161	0	0	67	161
Claims for probable terminations	5,166	6,322	0	0	5,166	6,322
Total present value of future benefits, net	44,641	28,619	3	3	44,644	28,622
Present value of nonrecoverable future financial assistance (Note 5)			1,250	775	1,250	775
Unearned premiums (Note 9)	207	193	8	8	215	201
Due for purchases of securities	127	83	0	0	127	83
Accounts payable and accrued expenses (Note 6)	279	173	0	0	279	173
Total liabilities	45,254	29,068	1,261	786	46,515	29,854
Net position	(11,238)	(3,638)	(261)	158	(11,499)	(3,480)
Total liabilities and net position	$ 34,016	$25,430	$1,000	$944	$ 35,016	$26,374

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

Commitments and contingencies
(Notes 7, 8, 14 and 15)

PENSION BENEFIT GUARANTY CORPORATION
STATEMENTS OF OPERATIONS AND CHANGES IN NET POSITION

(Dollars in millions)	Single-Employer Program For the Years Ended September 30, 2003	Single-Employer Program 2002	Multiemployer Program For the Years Ended September 30, 2003	Multiemployer Program 2002	Memorandum Total For the Years Ended September 30, 2003	Memorandum Total 2002
UNDERWRITING:						
Income:						
Premium (Note 9)	$ 948	$ 787	$ 25	$ 25	$ 973	$ 812
Other	28	28	0	0	28	28
Total	976	815	25	25	1,001	840
Expenses:						
Administrative	271	207	0	0	271	207
Other	97	15	0	0	97	15
Total	368	222	0	0	368	222
Other underwriting activity:						
Losses from completed and probable terminations (Note 10)	5,377	9,313	0	0	5,377	9,313
Losses from financial assistance (Note 5)			480	101	480	101
Actuarial adjustments (Note 4)	108	70	1	0	109	70
Total	5,485	9,383	481	101	5,966	9,484
Underwriting loss	(4,877)	(8,790)	(456)	(76)	(5,333)	(8,866)
FINANCIAL:						
Investment income (loss) (Note 11):						
Fixed	1,276	2,043	37	118	1,313	2,161
Equity	2,059	(1,887)	0	0	2,059	(1,887)
Other	14	14	0	0	14	14
Total	3,349	170	37	118	3,386	288
Expenses:						
Investment	19	18	0	0	19	18
Actuarial charges (Note 4):						
Due to passage of time	1,770	1,077	0	0	1,770	1,077
Due to change in interest rates	4,283	1,655	0	0	4,283	1,655
Total	6,072	2,750	0	0	6,072	2,750
Financial income (loss)	(2,723)	(2,580)	37	118	(2,686)	(2,462)
Net income (loss)	(7,600)	(11,370)	(419)	42	(8,019)	(11,328)
Net position, beginning of year	(3,638)	7,732	158	116	(3,480)	7,848
Net position, end of year	$(11,238)	$ (3,638)	$(261)	$158	$(11,499)	$ (3,480)

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)	2003	2002	2003	2002	2003	2002
OPERATING ACTIVITIES:						
Premium receipts	$ 828	$ 819	$ 25	$ 26	$ 853	$ 845
Interest and dividends received, net	962	964	50	50	1,012	1,014
Cash received from plans upon trusteeship	360	662	0	0	360	662
Receipts from sponsors/non-sponsors	128	367	0	0	128	367
Receipts from the missing participant program	3	9	0	0	3	9
Other receipts	1	4	0	0	1	4
Benefit payments - trusteed plans	(2,154)	(1,482)	(1)	(1)	(2,155)	(1,483)
Financial assistance payments			(5)	(5)	(5)	(5)
Settlements and judgments	(90)	(393)	0	0	(90)	(393)
Payments for administrative and other expenses	(250)	(216)	0	0	(250)	(216)
Net cash provided (used) by operating activities (Note 13)	(212)	734	69	70	(143)	804
INVESTING ACTIVITIES:						
Proceeds from sales of investments	36,556	23,207	1,704	643	38,260	23,850
Payments for purchases of investments	(33,888)	(24,001)	(1,768)	(727)	(35,656)	(24,728)
Net cash provided (used) by investing activities	2,668	(794)	(64)	(84)	2,604	(878)
Net increase (decrease) in cash and cash equivalents	2,456	(60)	5	(14)	2,461	(74)
Cash and cash equivalents, beginning of year	716	776	3	17	719	793
Cash and cash equivalents, end of year	$ 3,172	$ 716	$ 8	$ 3	$ 3,180	$ 719

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

NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2003 AND 2002

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, the Retirement Protection Act of 1994 and the Consolidated Appropriations Act, 2001. 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, 2003, or September 30, 2002, 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. As of September 30, 2003, the single-employer and multiemployer funds reported deficits of $11.238 billion and $261 million, respectively. PBGC's operating results are subject to significant fluctuation from year to year depending on the severity of losses from plan terminations, changes in the select interest rate, general economic conditions and other factors such as changes in law. PBGC estimates that the total underfunding in single-employer plans exceeded $350 billion (unaudited), and in multiemployer plans approximated $100 billion (unaudited), as of September 30, 2003. PBGC's exposure to loss is less than these amounts because of the statutory limits of insured pensions. As disclosed in Note 7, the total underfunding in single-employer plans classified by PBGC as reasonably possible of termination as of September 30, 2003, was $85 billion. PBGC also estimates that, as of September 30, 2003, it is reasonably possible that multi-employer plans may require future financial assistance in the amount of $63 million.

Neither program at present has the resources to fully satisfy PBGC's long-term obligations to plan participants. However, the single-employer program's $34 billion in assets, and the multiemployer program's $1 billion in assets, provide PBGC with sufficient liquidity to pay benefits for a number of years.

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: A primary objective of PBGC's financial statements is to provide information that is useful in assessing PBGC's present and future ability to ensure that defined benefit pension plan beneficiaries receive benefits when due. Accordingly, PBGC values its financial assets at estimated fair value, consistent with the standards for pension plans contained in Statement of Financial Accounting Standards (FAS) No. 35 ("Accounting and Reporting by Defined Benefit Pension Plans"). PBGC values its liabilities for the present value of future benefits and present value of nonrecoverable future financial assistance at their estimated cost of settlement using the measurement principles of FAS No. 87 ("Employers' Accounting for Pensions").

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 it becomes trustee.

Allocation of Revolving and Trust Funds: PBGC allocates 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 investment income is allocated on the basis of each program's average cash and investments available 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. In addition, PBGC invests in and discloses its derivative investments in accordance with the guidance contained in FAS No. 133 ("Accounting for Derivative Instruments and Hedging Activities"). 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 first in first out for the revolving fund and average cost for the trust fund. 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 in the period they are realizable. Income and expenses related to amounts due from sponsors are reported in the underwriting section of the Statements of Operations and Changes in Net Position. Interest earned on settled claims for employer liability and due and unpaid employer contributions (DUEC) is reported as "Income: Other." The change in the allowances for uncollectible employer liability and DUEC is reported as "Expenses: Other."

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. The liability for unearned premiums represents 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 -- represents PBGC's best estimate 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; spon-sor files for distress plan termination; or PBGC seeks involuntary plan termination.

In addition, PBGC provides a reserve for probable losses for 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 (see Note 4).

(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.

<u>Present Value of Nonrecoverable Future Financial Assistance:</u> 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.

<u>Other Expenses:</u> 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.

<u>Losses from Completed and Probable Terminations:</u> Amounts reported as losses from completed and probable terminations represent the difference as of the actual or expected 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.

<u>Actuarial Adjustments and Charges (Credits):</u> PBGC classifies actuarial adjustments related to changes in method and the effect of experience as underwriting activity; actuarial adjustments are the result of the movement of plans from one valuation methodology to another (e.g., nonseriatim to seriatim) and of new data (e.g., deaths, revised participant data). 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.

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

	September 30, 2003		September 30, 2002	
(Dollars in millions)	Basis	Market Value	Basis	Market Value
Fixed maturity securities:				
U.S. Government securities	$14,997	$15,450	$14,165	$15,796
Commercial paper	87	87	28	28
Asset backed securities	937	942	440	447
Corporate and other bonds	740	771	478	471
Subtotal	16,761	17,250	15,111	16,742
Equity securities	10,040	12,641	6,847	7,349
Real estate and real estate investment trusts	97	93	42	38
Insurance contracts and other investments	74	59	15	6
Total *	$26,972	$30,043	$22,015	$24,135

* This includes securities on loan at September 30, 2003, and September 30, 2002, with a market value of $213 million and $122 million, respectively.

INVESTMENTS OF MULTIEMPLOYER REVOLVING FUNDS AND MULTIEMPLOYER TRUSTEED PLANS

	September 30, 2003		September 30, 2002	
(Dollars in millions)	Basis	Market Value	Basis	Market Value
Fixed maturity securities:				
U.S. Government securities	$946	$975	$832	$929
Equity securities	1	1	1	1
Total	$947	$976	$833	$930

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 2002 and 2003, 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 implementing the strategy. Beginning September 24, 2003, PBGC invested in an investment product that contained U.S. government bond futures and a swaption contract. The objective of this investment strategy is to exceed, net of fees, the total rate of return of a customized benchmark for a long duration fixed income mandate. This benchmark proxies the expected behavior of PBGC's liabilities and reflects the objective of mitigating interest rate sensitivity. Government bond futures are held to adjust interest rate exposure (duration). Swaptions are held (or sold) to adjust interest rate exposure (duration) and to generate income to reflect the investment views of the portfolio managers regarding relationships between interest rates. At September 30, 2003, PBGC had one written swaption with a notional amount of $59,000,000. In 2002 and 2003, 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 to affect asset allocation and country equity exposure. Government bond futures and forward contracts are held to affect sector asset allocation and to adjust interest rate (duration) and country exposure. U.S. stock warrants are held as a result of a corporate action. Non-U.S. government debt option contracts are held to reflect the investment views of the portfolio managers regarding government debt issues. Foreign currency forward and option contracts are held 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, 2003, and September 30, 2002, gains and losses from settled margin calls are reported in Investment income on the Statements of Operations and Changes in Net Position. 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 $2 million at September 30, 2003, as compared to less than $1 million at September 30, 2002, and $7 million as part of "Due for purchases of securities" at September 30, 2003, as compared to $6 million at September 30, 2002.

FAIR VALUE OF FINANCIAL INSTRUMENTS

	Notional Value at September 30,		Fair Value at September 30,	
(Dollars in millions)	2003	2002	2003	2002
Financial futures contracts	$662	$264	$(393)	$(335)
Open currency forward contracts				
U.S. Dollar long/short foreign currencies	132	136	135	136
U.S. Dollar short/long foreign currencies	135	106	139	106

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, 2003, and September 30, 2002, was $213 million and $122 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, 2003 and 2002.

For FY 2003, PBGC used a 20-year select interest rate of 4.40% followed by an ultimate rate of 4.50% for the remaining years and for FY 2002, a 25-year select interest rate of 5.70% followed by an ultimate rate of 4.75% 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 the respective year, for single-premium nonparticipating group annuities issued by private insurers. Many factors, including Federal Reserve policy, may impact these rates.

For September 30, 2003, PBGC used the 1994 Group Annuity Mortality (GAM) Static Table (with margins), set forward two years and projected 18 years to 2012 using Scale AA. For

September 30, 2002, PBGC used the same table, set forward two years but projected 16 years to 2010 using Scale AA. The number of years that PBGC projects the mortality table reflects the number of years from the 1994 base year of the table to the end of the fiscal year (9 years in 2003 versus 8 years in 2002) plus PBGC's calculated duration of its liabilities (9 years in 2003 versus 8 years in 2002). PBGC's procedure is based on the procedures recommended by the Society of Actuaries UP-94 Task Force (which developed the GAM94 table) for taking into account future mortality improvements.

The reserve for administrative expenses in the 2003 and 2002 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 expense assumption was based on a study performed for PBGC in 2000 by a major accounting firm. 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 2003 and 2002 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, 2003 AND 2002

(Dollars in millions)	September 30, 2003		2002	
Present value of future benefits, at beginning of year -- Single-Employer, net		$28,619		$13,497
Estimated recoveries, prior year		38		19
Assets of terminated plans pending trusteeship, net, prior year		323		577
Present value of future benefits at beginning of year, gross		28,980		14,093
Settlements and judgments, prior year		(161)		(177)
Net claims for probable terminations, prior year		(6,322)		(411)
Actuarial adjustments – underwriting:				
Changes in method and assumptions	$ 21		$ (67)	
Effect of experience	87		137	
Total actuarial adjustments -- underwriting	108		70	
Actuarial charges – financial:				
Passage of time	1,770		1,077	
Change in interest rates	4,283		1,655	
Total actuarial charges -- financial	6,053		2,732	
Total actuarial charges, current year		6,161		2,802
Terminations:				
Current year	13,431		7,704	
Changes in prior year	47		23	
Total terminations		13,478		7,727
Benefit payments, current year*		(2,488)		(1,537)
Estimated recoveries, current year		(68)		(38)
Assets of terminated plans pending trusteeship, net, current year		(172)		(323)
Settlements and judgments, current year		67		161
Net claims for probable terminations:				
Future benefits**	9,694		12,392	
Estimated plan assets and recoveries from sponsors	(4,528)		(6,070)	
Total net claims, current year		5,166		6,322
Present value of future benefits, at end of year -- Single-Employer, net		44,641		28,619
Present value of future benefits, at end of year – Multiemployer		3		3
Total present value of future benefits, at end of year, net		$44,644		$28,622

* The benefit payments of $2,488 million and $1,537 million include $334 million in 2003 and $55 million in 2002 for benefits paid from plan assets by plans prior to trusteeship.

** The future benefits for probable terminations of $9,694 million and $12,392 million for fiscal years 2003 and 2002, respectively, include $173 million and $70 million, respectively, in net claims (future benefits less estimated plan assets and recoveries) for probable terminations not specifically identified and $9,521 million and $12,322 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

(Dollars in millions)	September 30, 2003 Basis	September 30, 2003 Market Value	September 30, 2002 Basis	September 30, 2002 Market Value
Corporate and other bonds	$ 84	$ 89	$225	$225
Equity securities	66	75	165	86
Insurance contracts	4	4	4	4
Other	4	4	8	8
Total, net	$158	$172	$402	$323

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

(Dollars in millions)	September 30, 2003		2002	
Net claims for probable terminations, at beginning of year		$ 6,322		$ 411
New claims	$ 4,211		$6,232	
Actual terminations	(5,448)		(338)	
Deleted probables	(228)		(1)	
Change in benefit liabilities	229		23	
Change in plan assets	80		(5)	
Loss (credit) on probables		(1,156)*		5,911*
Net claims for probable terminations, at end of year		$ 5,166		$6,322

* See Note 10

The following table itemizes the probable exposure by industry:

PROBABLES EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in millions)	FY 2003	FY 2002
Primary Metals and Fabricated Metal Products	$2,062	$5,831
Air Transportation	1,290	*
Wholesale Trade - Non-Durable Goods	372	*
Apparel and Other Finished Products Made from Fabrics	231	0
Food Stores	201	0
Chemicals and Allied Products	125	*
Heavy Construction Other Than Building Construction - Contractors	112	*
Others	773	491
Total	$5,166	$6,322

* 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 1987-2002 at September 30, 2003			
Beginning in 1987, number of plans reported as Probable:	Number of Plans	Percent of Plans	Net Claim	Percent of Net Claim
Probables terminated	185	75%	$8,707	86%
Probables current	16	6	573	6
Probables deleted	47	19	783	8
Total	248	100%	$10,063	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)	2003	2002
Gross balance at beginning of year	$ 56	$ 51
Financial assistance payments--current year	5	5
Subtotal	61	56
Allowance for uncollectible amounts	(61)	(56)
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)	2003	2002
Balance at beginning of year	$ 775	$679
Changes in allowance:		
Losses from financial assistance	480	101
Financial assistance granted (previously accrued)	(5)	(5)
Balance at end of year	$1,250	$775

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

(Dollars in millions)	September 30, 2003	2002
Annual leave	$ 5	$ 4
Collateral held for loaned securities	220	128
Other payables and accrued expenses	54	41
Accounts payable and accrued expenses	$279	$173

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, 2003, ranged from $83 to $85 billion.

The estimated unfunded vested benefits exposure has been calculated as of December 31, 2002. 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 2002. The Corporation adjusted the value reported for liabilities to the December 31, 2002, PBGC select interest rate of 5.00% (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, 2003, because of the economic conditions (e.g., lower interest rates and/or low investment returns on plan assets) that existed between December 31, 2002, and September 30, 2003. The Corporation did not adjust the estimate for events that occurred between December 31, 2002, and September 30, 2003.

The following table itemizes the reasonably possible exposure by industry:

REASONABLY POSSIBLE EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in billions)	FY 2003	FY 2002
Air Transportation	$23.4	$11.4
Primary Metals and Fabricated Metal Products	10.2	5.7
Electronic and Other Electrical Equipment, except Computer Equipment	7.0	1.3
Industrial and Commercial Machinery and Computer Equipment	5.3	1.8
Transportation Equipment	4.0	*
Chemicals and Allied Products	3.9	1.4
Paper and Allied Products	3.7	1.2
Electric, Gas and Sanitary Services	2.8	*
Rubber and Miscellaneous Plastics Products	2.7	1.4
General Merchandise Stores	2.5	1.3
Others	20.0	9.9
Total	$85.5	$35.4

* 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 $63 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, 2003, or the projected (or actual, if known) date of plan insolvency, discounted back to September 30, 2003, 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 4.40% for the first 20 years after the valuation date and 4.50% thereafter. The Corporation also used the 1994 Group Annuity Mortality Static Table (with margins), set forward two years, projected 18 years to 2012 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, 2003, are as follows:

COMMITMENTS: FUTURE LEASE PAYMENTS

(Dollars in millions)

Years Ending September 30,	Operating Leases
2004	$15.6
2005	15.8
2006	16.2
2007	16.4
2008	16.2
Thereafter	8.3
Minimum lease payments	$88.5

Lease expenditures were $14.6 million in 2003 and $12.2 million in 2002.

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,					
	2003			2002		
(Dollars in millions)	New Terminations	Changes in Prior Year Terminations	Total	New Terminations	Changes in Prior Year Terminations	Total
Present value of future benefits	$13,431	$ 47	$13,478	$7,704	$23	$7,727
Less plan assets	6,963	(79)	6,884	4,664	8	4,672
Plan asset insufficiency	6,468	126	6,594	3,040	15	3,055
Less estimated recoveries	61	(3)	58	27	3	30
Subtotal	$ 6,407	$129	6,536	$3,013	$12	3,025
Settlements and judgments			(3)			377
Loss (credit) on probables			(1,156)*			5,911*
Total			$ 5,377			$9,313

* See Note 4

Note 11 -- Financial Income

The following tables detail the combined financial income by type of investment as well as the investment profile for both the single-employer and multiemployer programs:

FINANCIAL INCOME

	For the Years Ended September 30,	
(Dollars in millions)	2003	2002
Fixed-income securities:		
Interest earned	$ 941	$ 985
Realized gain	1,599	315
Unrealized gain (loss)	(1,227)	861
Total fixed-income securities	1,313	2,161
Equity securities:		
Dividends earned	75	34
Realized loss	(134)	(382)
Unrealized gain (loss)	2,118	(1,539)
Total equity securities	2,059	(1,887)
Other income	14	14
Total financial income	$ 3,386	$ 288

INVESTMENT PROFILE

	September 30,	
	2003	2002
Fixed-Income Assets		
Average Quality	AAA	AAA
Average Maturity (years)	17.2	18.1
Duration (years)	10.1	10.3
Yield to Maturity (%)	4.6	4.5
Equity Assets		
Average Price/Earnings Ratio	24.2	24.6
Dividend Yield (%)	1.7	1.9
Beta	0.96	0.96

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 the first three months of 2003 was 7.5 percent and 7.0 percent for the remainder of the year and 8.51 percent for 2002 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 2003 and 2002. 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 $10 million in 2003 and $8 million in 2002.

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

(Dollars in millions)	Single-Employer Program September 30, 2003	2002	Multiemployer Program September 30, 2003	2002	Memorandum Total September 30, 2003	2002
Net income (loss)	$(7,600)	$(11,370)	$(419)	$ 42	$(8,019)	$(11,328)
Adjustments to reconcile net income to net cash provided by operating activities:						
Net (appreciation) decline in fair value of investments	(2,308)	701	11	(67)	(2,297)	634
Net (gain) loss of terminated plans pending trusteeship	(108)	79	0	0	(108)	79
Losses on completed and probable terminations	5,377	9,313	0	0	5,377	9,313
Actuarial charges	6,161	2,802	1	0	6,162	2,802
Benefit payments - trusteed plans	(2,154)	(1,482)	(1)	(1)	(2,155)	(1,483)
Settlements and judgments	(90)	(393)	0	0	(90)	(393)
Cash received from plans upon trusteeship	360	662	0	0	360	662
Receipts from sponsors/non-sponsors	225	383	0	0	225	383
Amortization of discounts/premiums	108	(15)	7	0	115	(15)
Changes in assets and liabilities, net of effects of trusteed and pending plans:						
(Increase) decrease in receivables	(210)	39	(5)	0	(215)	39
Increase in present value of nonrecoverable future financial assistance			475	96	475	96
Increase in unearned premiums	14	2	0	0	14	2
Increase in accounts payable	13	13	0	0	13	13
Net cash provided (used) by operating activities	$ (212)	$ 734	$ 69	$ 70	$ (143)	$ 804

Note 14 -- Litigation

Legal challenges to PBGC policies and positions continued in 2003. At the end of the fiscal year, PBGC had 119 active cases in state and federal courts and 633 bankruptcy cases. 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 in amount. PBGC estimates that possible losses of up to $47 million could be incurred in the event that PBGC does not prevail in these matters.

Note 15 -- Subsequent Events

Subsequent to September 30, 2003, business and financial conditions significantly deteriorated for some sponsors of large single-employer plans that may terminate. These plans will be added as probables or to the terminated inventory in FY 2004. Had these plan sponsor events occurred prior to FY 2003 year-end, PBGC's financial statements would have reflected an increase of $48 million in the Net loss and a decrease in the Net position in the same amount.

Subsequent to September 30, 2003, a buyer for a company whose plan is classified as probable entered into an agreement to purchase the company and assume the pension plan. This plan has been removed from probables in FY 2004. Had this occurred prior to FY 2003 year-end, PBGC's single-employer financial statements would have reflected a decrease of $125 million in the Net loss and an increase in the Net position of the same amount.

The total effect of all of the afore-mentioned subsequent events would have resulted in a decrease of $77 million in the Net loss and an increase in the Net position of 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, N.W., Washington, D.C. 20005-4026
(202) 326-4010

Office of the Executive Director

Memorandum

January 8, 2004

To: Robert L. Emmons
Inspector General

From: Vince Snowbarger
Acting Executive Director

Subject: Response to PBGC's FY 2003 and 2002 Financial Statement Audit Reports (23176-2)

PBGC management appreciates the opportunity to comment on the subject financial statement audit reports. We appreciate the work of the OIG and PwC in completing a difficult, complex audit in record time. This accomplishment underscores the importance of continuing our strong working relationship, which serves to improve PBGC's internal controls.

We are pleased that PBGC has earned an unqualified audit opinion on our financial statements for the 11th consecutive year.

It is noteworthy that the Report of Independent Auditors, in an explanatory paragraph, calls attention to the record net deficit positions of both the Single-Employer and Multiemployer Funds. The auditors also cite a historically unprecedented contingent liability in the Single-Employer Fund. The report, which highlights the legal necessity of the Funds being self-sustaining, underscores the need for pension reform legislation, and we look forward to working with your Office in helping policy makers better understand the issues confronting PBGC.

PBGC management is in agreement with all of the reported findings and recommendations. Listed below are some comments on the Report on Internal Control.

Material Weakness: "PBGC should reassess its methodologies for estimating multiemployer plan liabilities."

We appreciate the work of the Office of Inspector General in reviewing the Corporation's internal controls for multiemployer plans. We agree with the report findings and had already planned to make these changes in FY 2004. Specifically, we look forward to working with the OIG and independent auditors to ensure that appropriate methodologies for estimating Multiemployer plan net liabilities are instituted and that they are consistently applied.

Reportable Conditions:

1. "PBGC needs to integrate its financial management systems."

PBGC has formulated a Working Group to plan, design, and implement a system integration solution, as well as Steering Group to oversee the activities of the Working Group. The Steering Group is currently in the process of developing a timeline to establish milestones and monitor implementation progress.

2. "PBGC needs to complete its efforts to fully implement and enforce an effective information security program."

PBGC made progress on information systems security and the security clearance of contractors during FY 2003. Most business critical systems will have a certification and accreditation completed and all financial and mixed systems will undergo annual risk assessments. Risk assessment criteria will be developed to reflect the threats and risks facing the corporation. During FY 2004, PBGC will begin implementation of a role-based access control service for use by all financial and mixed systems. Individual system implementations of the service will be phased in consistent with the risk and systems life cycle stage. Also, system security practices, policies, and procedures will be updated to reflect current National Institute of Standards and Technology (NIST) standards. On the security clearance of contractors issue, PBGC now performs an interim suitability check on new Federal and contractor staff through use of the Live Scan fingerprint system and a credit check. These two checks are completed within 72 hours and give information regarding criminal history and credit worthiness.

3. "PBGC needs to improve controls related to single-employer premiums."

We are actively involved in a full scale business re-engineering initiative for premium operations, including a close examination of the internal controls needed as part of a "to be" design for premium operations and detailed functional requirements. This will serve as the basis for the implementation of a new premium accounting system by the end of calendar year 2004.

4. "PBGC needs to continue to improve controls over the identification and measurement of the Single-Employer Program Fund contingent liabilities."

The auditors recognized improved documentation for those plans considered probable of termination; the new guidance prepared to help differentiate between plans classifiable as probable and reasonably possible for termination; and the development of a standard format when plans are categorized as "high risk." A procedures manual for staff was also developed. We are working to address the remaining few issues and fully implement our controls, especially as they relate to the compressed financial reporting time frames for the FY 2004 audit.

5. "PBGC needs to improve controls over the estimation of reserves for Single-Employer Program Fund losses incurred but not reported or not specifically identified."

PBGC has prepared a statement of work and will procure an outside contractor, with accounting and actuarial expertise, to provide assistance in developing and implementing improved controls over the estimation of reserves for the Single-Employer Program Fund losses incurred but not reported or not specifically identified.

6. "PBGC needs to strengthen controls over the identification and classification of Multiemployer plans probable of receiving financial assistance."

We have already initiated actions to begin to address this issue and look forward to working with the OIG and independent auditors to ensure controls over the identification and classification of multiemployer probable plans are strengthened.

Management appreciates the good work of the OIG in bringing important internal control issues to our attention. Considering the increasingly quicker turnaround times for our annual report process in FY 2004, management looks forward to working together closely with the OIG in achieving a record close for FY 2004 and solid, substantive improvements in our internal controls.