Pension Benefit Guaranty Corporation

Office of Inspector General

Audit Report

Audit of the Pension Benefit Guaranty Corporation's Fiscal Years 2004 and 2003 Financial Statements

Report of Independent Auditors

Report on Internal Control

Report of Independent Auditors on Compliance and Other Matters

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Pension Benefit Guaranty Corporation's
Fiscal Years 2004 and 2003 Financial Statements
and Notes to the Financial Statements

November 15, 2004

2005-2/23182-2

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 Years 2004 and 2003. This audit is performed in accordance with auditing standards generally accepted in the United States of America, *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 accounting principles generally accepted in the United States of America;
- PBGC's assertion about internal controls over financial reporting and compliance with laws and regulations is fairly stated, however;
- Five reportable conditions relating to financial management systems integration, information security, single-employer premiums, contingent liabilities for the Single-Employer Program Fund, and identifying and classifying probable Multiemployer plans; and
- No reportable noncompliance with laws and regulations it tested.

PricewaterhouseCoopers is responsible for the accompanying auditor's report dated November 12, 2004 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.

PricewaterhouseCoopers' reports (2005-2/23182-2) are available on our website at http://oig.pbgc.gov.

Sincerely,

Robert L. Emmons
Inspector General

November 12, 2004

Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2004 and 2003 Financial Statements

Audit Report 2005-2/23182-2

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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

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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, 2004 and 2003, 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, 2004 and 2003, 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. 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 $23.3 billion and $236 million, respectively, at September 30, 2004. The Single-Employer Program reported net losses of $12 billion and $7.6 billion and the Multiemployer Program reported net income of $25 million and a net loss of $419 million for 2004 and 2003, respectively. Losses for the Single-Employer Program that are reasonably possible as a result of unfunded vested benefits are estimated to be $96 billion as of September 30, 2004. Losses for the Multiemployer Program that are reasonably possible are estimated to be $108 million as of September 30, 2004. The Funds' net deficits, 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

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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 November 12, 2004 on our consideration of PBGC's internal control and a report dated November 12, 2004, on compliance and other matters. 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

November 12, 2004

Section II

Report on Internal Control

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Independent Auditors' Report on Internal Control

To the Inspector General
Pension Benefit Guaranty Corporation

We have examined management's assertion that the Pension Benefit Guaranty Corporation (PBGC) maintained effective internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations as of September 30, 2004, 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.

In our opinion, management's assertion that PBGC maintained effective internal control over financial reporting (including safeguarding of assets) and compliance with laws and regulations as of September 30, 2004 is fairly stated, in all material respects, based on criteria contained in FMFIA.

However, we noted certain matters involving the internal control and its operation, set forth below and in the attached *Schedule of Internal Control 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 PBGC's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

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 five reportable conditions listed below is a material weakness as defined by the AICPA.

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The reportable conditions we noted were:

(1) PBGC needs to complete the integration of 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 the single-employer contingent liabilities; and,
(5) PBGC needs to strengthen controls over the identification and classification of multiemployer plans probable of receiving financial assistance.

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, Office of Management and Budget, 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

November 12, 2004

PBGC Needs to Integrate its Financial Management Systems

In prior year audits, we identified a lack of integration of the PBGC's financially significant systems. These systems include: Financial Reporting System (FRS), Performance Accounting (PA) system, Trust Accounting System (TAS), Participant Records Information System Management (PRISM), Premium Accounting System (PAS), Integrated Present Value of Future Benefits (IPVFB), and Pension and Lump Sum System (PLUS).

Office of Management and Budget (OMB) Circular A-127 *Financial Management System* requires that financial management systems should be designed to provide for effective and efficient interrelationships between systems. This Circular states the following:

> 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, 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.

PBGC has effective controls to foster data integrity among its financially significant systems and is currently instituting methodologies that will promote further integration as systems are developed or changed, which was evidenced by the following:

- PBGC formulated a Steering Committee and Working Group to plan, design, and implement a system integration solution.
- The system interface controls, used to reconcile data transmitted to and from the three general ledger applications, appear to be operating effectively.
- The manual interface controls, used to reconcile data between IPVFB and FRS, appear to be operating effectively.
- Although not complete, progress has been made on the development of a logical database model for IOD databases. Once database models are completed for IOD and FOD, all new development will be required to conform to these models. (physical re-design will be implemented as applications are developed or significantly enhanced).
- A System Lifecycle Methodology (SLCM) Methodologist, who ensures that projects fully comply with the SLCM, has been assigned to the following financially significant development efforts: SPECTRUM/PRISM, PPS/PAS, and Database Redesign.

More needs to be done, however, to integrate PBGC's existing financially significant systems. We identified the following factors relevant to the integration of systems:

Lack of standard data classifications and common data elements:

- The logical database models have not been finalized for the IOD databases and have not been initiated for the FOD databases. Therefore, no centralized data catalog defining data elements or data access methods is available for current databases.
- The current decentralized database structure may lead to erroneous financial and participant data. For example, the same data elements are required to be reformatted or are used for different purposes across PBGC's various applications.
- The current decentralized database structure may lead to untimely financial or participant data. Participant data must be reformatted and distributed to multiple PBGC systems; therefore, users may be relying on outdated information to make business decisions.

Duplication of transaction entry:

- PBGC uses three general ledger systems (TAS, PA, and FRS) to track trust, revolving, and consolidated transactions rather than one system to track all three. Therefore, manual adjusting journal entries (AJE) are required to synchronize the data between TAS, PA, and FRS.
- Probable and Multi-employer plan data, which were initially entered into IPVFB, must be manually reentered into a spreadsheet and then manually entered into FRS as adjusting journal entries.
- Plan data, which were initially entered into the CAS Application, must be reentered into the TAS application's portfolio header.
- Plan contingency listings are determined using data extracted from PAS. However, plans with multiple filings must be manually aggregated before the plans can be classified. In FY 2004, we noted one plan that was not included in the supplemental list.
- Plan sponsor data, which were initially entered into PAS to process receivables, must also be entered into PA to process refunds.

Poor data integrity:

- The data in the Premium Accounting System requires significant manual review and adjustment before it can be used for the purposes of reporting the premiums income and receivables in PBGC's financial statements.

Systems not planned or managed together:

- PBGC has not finalized the SLCM Manual that would foster integration for newly developed applications. Our testing identified the following issues:
    - The SLCM Policy is still in the process of becoming a directive.
    - Several SLCM components are still in draft.
    - The Enterprise Architecture component of the SLCM does not require compliance with the FOD and IOD database models.

In the short term, the Corporation's ability to accurately and efficiently accumulate and summarize information required for internal and external financial reporting may be impacted. For this reason, this issue remains a reportable condition for FY 2004.

Recommendations:

We are encouraged by the improvement made and direction taken by PBGC, in the areas noted above. However, we recommend that PBGC continue its efforts in this area by doing the following:

- Integrate its financial management systems, in accordance with OMB Circular A-127. **(OIG Control Number FOD-268)**

PBGC Needs to Complete its Efforts to Fully Implement and Enforce an Effective Information Security Program

During the fiscal year 2002 and 2003 financial audits, we noted that PBGC's enterprise-wide security management program needed improvement. During our fiscal year 2004 review of PBGC's existing security program, we noted that PBGC made the following progress:

- Effective FY 2004, the ISSO now reports directly to the CTO. This reporting relationship provides the ISSO with the necessary independence from the Office of Information Technology (OIT). Furthermore, the ISSO has been assigned staff to assist in developing and enforcing IT security policies and procedures across the agency.
- Background or suitability checks appear to be performed consistently for all federal employees and contractors across PBGC.

However, our review of PBGC's existing security program revealed weaknesses in controls that expose PBGC's financially significant systems and data to unauthorized access and/or modification. Weaknesses included the following:

- PBGC OIT security management, application owners, and application administrators have not completed effective security plans, risk assessments, certifications, and accreditations for PBGC's financially significant applications and general support systems. Furthermore, OIT has not developed or documented criteria/guidance to conduct risk assessments, certifications, and accreditations.
- PBGC has not consistently deployed security configurations across its financial significant applications and general support systems.
- PBGC has not formalized effective processes for granting, removing, and recertifying user access to financially significant applications and general support systems.
- Application owners or administrators do not perform periodic auditing and monitoring of user access and sensitive transactions for financially significant systems.
- OIT management, application owners, and application administrators are not aware of their responsibilities regarding user and security administration for financially significant systems.
- PBGC has granted developers inappropriate access to the production environment.
- OIT has not developed a process that would allow the ISSO to manage and monitor the effectiveness of the entity-wide security program.

Until PBGC implements a complete enterprise-wide information security program, its ability to mitigate effectively the risk of unauthorized access to, and/or modification or disclosure of, sensitive PBGC financial and production data will be impaired.

We recommend that PBGC management do the following:

- Assign specific resources to 1) update the general security plan and associated security policies to reflect the current operating environment, and 2) 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)**

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

Work performed during the 2003 financial statement audit and separately by the PBGC Inspector General, indicated several internal control weaknesses related to the single-employer premiums. Management has acknowledged the weaknesses associated with the single-employer premiums and has taken steps, including plans for a new premiums accounting system, to improve the internal controls for premiums. However, we continue to note internal control weaknesses in our 2004 audit.

The control weaknesses we identified relate to the following internal control objectives:

- Safeguarding of Assets – Ensuring PBGC collects all premiums due under statute. OMB Circular A-123, *Management Accountability and Controls*, requires: 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.

- Financial Reporting – Ensuring PBGC complete 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."

Data Quality Weaknesses
Underlying several of the control weakness noted during our testing is the fact that PBGC's Premium Accounting System suffers from numerous data quality issues which are attributable to data errors introduced into Premium Accounting System (PAS) 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 continue to contribute to the data quality issues:

- PAS allows individuals who are responsible for approving transactions to approve groups of transactions, rather than being required to review and approve individual transactions for accuracy and completeness.
- PAS continues to carry suspense transactions dating back to 1994. Although PBGC has written procedures for clearing items from suspense, there are no written policies or procedures defining monitoring controls to ensure that old items are cleared timely.

We also noted during our current and past audits, that PBGC does not have or maintain a complete list of plans that are required to file a Form 1 (premium filing form) with PBGC. As such PBGC's ability to effectively ensure that all required plans that have filed and paid premiums is limited. PBGC's ability to collect premiums owed is further limited because the Corporation does not use the Audit and Enforcement module within PAS to compare Form 1 filings to pension plan filings with the Department of Labor. Completing this analysis would enable PBGC to potentially identify plans which had not filed or paid their associated premiums. PBGC notes that resource constraints prevent them from effectively using the Audit and Enforcement module of PAS.

Impact of Data Quality Weaknesses
Because of the data quality issues noted, PBGC is unable to efficiently utilize two of its primary tools, Past Due Filing Notices (PDFN) and Statements of Account (SOA), to ensure the accuracy and completeness of premium data. The PDFN is a PAS generated notice mailed to plans who have not submitted premiums. The SOA is also a PAS generated notice used to ensure that under or over paid

premiums from a plan sponsor are effectively rectified. We noted during the audit that PDFNs and SOAs are not mailed timely in accordance with PBGC policy due to the fact that significant resources must be expended prior to mailing each notice in order to validate the information. Because these notices are not mailed in a timely manner, the potential exists that premiums will not be collected or that errors in amounts reflected in PAS will not be detected.

Other Control Matters
Finally, we noted that all of the pertinent policies and procedures related to the premium accounting cycle have not been documented, communicated or implemented throughout the Corporation.

Recommendations

While we acknowledge that PBGC is currently working toward the implementation of a new premiums system with an implementation date currently scheduled for spring 2005, we continue to recommend that PBGC:

- Develop and implement a systematic methodology for validating and correcting data stored within PAS prior to the implementation of a new premium system. **(OIG Control Number FOD-331)**
- Eliminate the ability to approve groups or multiple premium transactions. **(OIG Control Number FOD-332)**
- Develop and implement policies and procedures requiring all suspended transactions to be researched and resolved in a timely manner and ensuring that adjustments are appropriately reviewed and approved. **(OIG Control Number FOD-333)**
- Implement controls to reconcile Form 1 information received by PBGC to Form 5500 information received by the Department of Labor as a means of identifying plans that have not filed or paid their associated premiums. **(OIG Control Number FOD-334)**
- Compile a comprehensive polices and procedures manual for processing and accounting for premium revenue. **(OIG Control Number FOD-335)**

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

In previous audits, PwC has noted several internal control weaknesses in the single-employer contingent liabilities area, including errors in PBGC's calculations of its contingent liabilities and weaknesses related to the classification of plans as probable, reasonably possible, or remote.

In the current fiscal year, PBGC continued its efforts to improve the internal controls utilized to identify and value contingent liabilities. Some of the efforts, which extended through the end of our audit, included:

- Refining the definitions of contingency classifications.
- Enhancing guidance on factors to be considered in assessing probable and reasonably possible plans.
- Enhancing guidance to support the rationale and conclusions for classifying contingent liabilities.
- Standardizing the format of memos used to document the conclusions for classifying contingent liabilities.

These are important steps toward improving the internal controls; however PwC noted the following calculation errors and other internal control weaknesses when testing the contingent liabilities.

Benefit Liability Calculations

- We noted errors that went undetected by management in the actuarial calculations of the unfunded vested benefits of plans classified as reasonably possible of termination. Our testing indicated that eight plans (related to six plan sponsors), from a sample of 94 plan sponsors, contained calculation errors totaling $254.66 million, which had a net liability decrease of $149.54 million to the unfunded vested benefits liability of $95.67 million. Subsequent to our initial testing, PBGC corrected the errors noted.
- Documentation utilized by PBGC to support liability calculations was not consistently maintained in accordance with Office of Management and Budget (OMB) Circular A-123, Management Accountability and Control. OMB A-123 requires agencies to maintain documentation which is clear and readily available for review. Furthermore, the documentation to support the liability calculations contained no evidence of independent or supervisory review.

Completeness of Contingency List

- We noted four plans (related to four plan sponsors) which were inappropriately excluded from the contingency list and two plans (related to one plan sponsor) which were inappropriately included on the contingency list. We also noted one instance when a plan was classified both as a reasonably possible and a remote contingent liability. The absolute dollars associated with these findings totaled $74.6 million, while the net increase in the liability totaled $7.2 million. Subsequent to our initial testing, PBGC corrected the errors noted.

Definitions of Criteria

- The contingency policy guidance initially provided to PwC, and utilized by PBGC during a portion of the audit period, contained erroneous classification criteria, that were inconsistent with PBGC's accounting policies. Specifically, the probable criteria initially provided indicated that, "It is more likely than not that the plan will have to be terminated within one year of the scheduled financial statement issuance date." However, the policy states, "It is likely that the plan will have to be terminated within one year of the scheduled financial statement issuance date." While these definitions appear subtle, the use of an incorrect definition could result in the improper classification of a contingent liability.

- A classification memo made reference to PBGC experience, as support for classification of a plan as probable. PBGC did not provide requested support for this experience; rather, a revised memo was prepared which cited additional facts and did not include the previously articulated rationale for classification.

Documentation of Decisions

- Memos that document PBGC's classification of a plan as probable or "high risk" reasonably possible, did not include all relevant considerations used by PBGC to make classification decisions and were inconsistently prepared. For example, documentation for some plans articulated why the plans should be considered probable and conversely indicated the rationale for not classifying the plans as reasonably possible. However, the documentation for other plans only included the rationale for classifying the plans as a probable, but did not identify reasons why the plans should not be classified reasonably possible.
- We noted that PBGC will often prepare multiple memos regarding the classification of specific plans and the underlying facts and circumstances which support the recommended classifications. We noted during our testing that these time series memos are not chronologically dated. Furthermore, we noted that the subsequently prepared memos do not consistently articulate the rationale for moving plans between liability classifications.

Approval of Decisions

- During our audit, we tested thirty "high risk" memos prepared during fiscal year 2004. We noted two instances when the "high risk" memos were not approved by the CFND Deputy Director, as required by PBGC policy guidance.

Subsequent Events

- Subsequent to September 30, 2004, but prior to the issuance of the financial statements, PBGC obtained information related to a plan which led to its classification as probable of termination. PBGC concluded that this event should be classified as a Type II subsequent event and not recorded as probable as of September 30, 2004. However, the facts associated with this plan, and used by PBGC to reach its conclusion existed prior to September 30, 2004. As such, this plan should have been categorized as probable of termination and recorded as a liability of the Corporation as of September 30, 2004.

Small Reasonably Possible Methodology

- The process used to estimate the disclosure of small probables (less than $5 million of UVB) reasonably possible of termination relied on the extrapolation of characteristics from the large plans to the smaller plan population. However, this approach was invalidated by significant changes in the large plan population over the last two years. PBGC continued to apply this method in developing the 2004 disclosures.

In the aggregate, we believe that these weaknesses constitute a significant deficiency in internal controls to prevent or detect misstatements of the contingent liability information.

Recommendations:

We recommend that PBGC:

- Develop and implement internal controls to ensure the accuracy of the unfunded benefit liability calculations. The procedures implemented should ensure that documentation supporting the liability calculations is clear and readily available, and contain evidence of an independent or supervisory review. **(OIG Control Number CFND-9)**
- Consistently implement and enforce internal controls to ensure the completeness of the contingency listing. **(OIG Control Number CFND-10)**
- Consistently implement and apply policy guidance regarding the definitions and criteria utilized to classify plans as probable, reasonably possible, or remote. **(OIG Control Number CFND-11)**
- Consistently implement procedures and guidance for documenting the decisions and judgments made to support plan classifications. Documentation should be completed in a timely manner, appropriately dated, include relevant facts and the consideration of all relevant criteria, and clearly indicate when a plan has satisfied or failed to satisfy specific classification criteria. **(OIG Control Number CFND-12)**
- Consistently implement procedures to ensure that classification memos are appropriately reviewed and approved. **(OIG Control Number CFND-13)**
- Enhance and consistently implement guidance to fully support subsequent event determinations. Judgments and decisions regarding subsequent events should be based on events completed by the plan sponsors rather than events controlled by PBGC. Furthermore, PBGC should implement policies and procedures to fully document each subsequent event, which includes the relevant facts and the final judgments made by PBGC. **(OIG Control Number CFND-14)**
- Implement procedures to periodically review and assess the methodologies used to calculate or estimate the liability amounts reported within the financial statements and to ensure that calculations and estimates are reflective of PBGC's underlying risks. **(OIG Control Number CFND-15)**

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

In our prior audits of PBGC, 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. Our current audit revealed that PBGC had made some progress regarding policies and procedures, but the weaknesses previously documented and described below had not been corrected. We believe that the condition highlighted in the following three stages, highlights the noted weaknesses.

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

The Multiemployer Program Manager reviews system generated information to assist in the preparation of the reconciliation of the multiemployer 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, was not documented. Furthermore, this reconciliation was not independently reviewed or validated for accuracy or completeness.

Recommendations:

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

- Amend existing documentation procedures to require the preparer to date and sign the reconciliation. Further, update the procedures to specify the completion of an independent review of this reconciliation. **(OIG Control Number IOD-240)**

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.

Through discussion with management, we noted cases of imperfect or missing data uploaded to MES and subsequently used in the liquidity ratio analysis. In an attempt to identify plans with imperfect or missing data, PBGC implemented procedures during 2003 to review plans which failed one or fewer ratios if during the previous two years the plans had failed two or more ratios. However, even with this new procedure in place we noted two instances in which plan level financial information was not accurately transferred from the Department of Labor, and therefore not utilized by PBGC to determine if the associated plans should have been added to the contingency list. Furthermore, we noted that the information and analysis had not been subject to supervisory review. Subsequent discussions with PBGC representatives indicted that if the MES had been appropriately updated with the data available to PBGC for review, neither plan would have been included on the contingency list.

Recommendation:

- Develop and implement procedures to ensure that the MES and other data used by PBGC to classify plans includes all information available to PBGC. **(OIG Control Number IOD-241)**

- Develop and implement procedures to complete supervisor reviews of information and analysis performed during the initial screening of plan classifications. **(OIG Control Number IOD-242)**

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. This information, along with other data regarding the employers sponsoring the plan and the industry in which the plan operates is also considered when determining the classification. However, the totality of criteria used to make the classification decisions has not been fully documented. A reasonable person should be able to read the supporting documentation, compare it against the criteria and draw the same conclusions. During our review PBGC was unable to provide the documentation necessary to support the classification. Steps were taken during the year to improve the documentation of the classification criteria and the documentation to support the classification decisions; however, we believe that additional improvements are still needed.

Recommendation:

- Document and implement a clear and consistent policy regarding the definitions and classification criteria utilized to classify plans as probable, reasonably possible, or remote. To the extent possible, classifications should be based on objective and verifiable criteria. **(OIG Control Number IOD-243)**

- Develop, and implement guidance to enhance the documentation regarding decisions and judgments made to support plan classifications. The documentation of this information should be completed in a consistent fashion, clearly indicating when a plan had satisfied or failed to satisfy classification criteria. The documentation should be written in a manner which would allow a third party to objectively assess the classification. Financial ratios or other financial data used to support the classification decisions should be clearly and consistently documented. **(OIG Control Number IOD-244)**

Section III

Report of Independent Auditors on Compliance
and
Other Matters

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Report of Independent Auditors on Compliance and Other Matters

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) as of and for the year ended September 30, 2004, and have issued our report thereon dated November 12, 2004. 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.

The management of PBGC is responsible for compliance with laws and regulations. As part of obtaining reasonable assurance about whether PBGC's financial statements are free of material misstatement, we performed tests of 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).

We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to PBGC. 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 of compliance disclosed no instances of noncompliance with laws and regulations discussed in the preceding paragraph or other matters 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, Office of Management and Budget, 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

November 12, 2004

Section IV

Pension Benefit Guaranty Corporation's Fiscal Years 2004 and 2003 Financial Statements and Notes to the Financial Statements

PENSION BENEFIT GUARANTY CORPORATION
STATEMENTS OF FINANCIAL CONDITION

(Dollars in millions)	Single-Employer Program September 30, 2004	2003	Multiemployer Program September 30, 2004	2003	Memorandum Total September 30, 2004	2003
ASSETS						
Cash and cash equivalents	$ 7,692	$ 3,172	$ 14	$ 8	$ 7,706	$ 3,180
Investments, at market (Note 3):						
Fixed maturity securities	17,333	17,250	1,042	975	18,375	18,225
Equity securities	11,115	12,641	1	1	11,116	12,642
Real estate and real estate investment trusts	91	93	0	0	91	93
Other	23	59	0	0	23	59
Total investments	28,562	30,043	1,043	976	29,605	31,019
Receivables, net:						
Sponsors of terminated plans	129	132	0	0	129	132
Premiums (Note 9)	619	254	1	0	620	254
Sale of securities	1,756	134	0	0	1,756	134
Investment income	213	274	12	16	225	290
Other	2	3	0	0	2	3
Total receivables	2,719	797	13	16	2,732	813
Capitalized assets, net	20	4	0	0	20	4
Total assets	$38,993	$34,016	$1,070	$1,000	$40,063	$35,016

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)	2004	2003	2004	2003	2004	2003
LIABILITIES						
Present value of future benefits, net (Note 4):						
Trusteed plans	$ 43,344	$ 38,904	$ 3	$ 3	$ 43,347	$ 38,907
Terminated plans pending trusteeship	501	463	0	0	501	463
Settlements and judgments	65	67	0	0	65	67
Claims for probable terminations	16,926	5,207	0	0	16,926	5,207
Total present value of future benefits, net	60,836	44,641	3	3	60,839	44,644
Present value of nonrecoverable future financial assistance (Note 5)			1,295	1,250	1,295	1,250
Unearned premiums (Note 9)	223	207	8	8	231	215
Due for purchases of securities	531	127	0	0	531	127
Accounts payable and accrued expenses (Note 6)	708	279	0	0	708	279
Total liabilities	62,298	45,254	1,306	1,261	63,604	46,515
Net position	(23,305)	(11,238)	(236)	(261)	(23,541)	(11,499)
Total liabilities and net position	$ 38,993	$ 34,016	$1,070	$1,000	$ 40,063	$ 35,016

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

	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)	**2004**	2003	**2004**	2003	**2004**	2003
UNDERWRITING:						
Income:						
Premium (Note 9)	**$ 1,458**	$ 948	**$ 27**	$ 25	**$ 1,485**	$ 973
Other	**24**	28	**0**	0	**24**	28
Total	**1,482**	976	**27**	25	**1,509**	1,001
Expenses:						
Administrative	**263**	271	**0**	0	**263**	271
Other	**(36)**	97	**0**	0	**(36)**	97
Total	**227**	368	**0**	0	**227**	368
Other underwriting activity:						
Losses from completed and probable terminations (Note 10)	**14,707**	5,377	**0**	0	**14,707**	5,377
Losses from financial assistance (Note 5)			**55**	480	**55**	480
Actuarial adjustments (Note 4)	**1,525**	108	**1**	1	**1,526**	109
Total	**16,232**	5,485	**56**	481	**16,288**	5,966
Underwriting loss	**(14,977)**	(4,877)	**(29)**	(456)	**(15,006)**	(5,333)
FINANCIAL:						
Investment income (Note 11):						
Fixed	**983**	1,276	**54**	37	**1,037**	1,313
Equity	**2,196**	2,059	**0**	0	**2,196**	2,059
Other	**18**	14	**0**	0	**18**	14
Total	**3,197**	3,349	**54**	37	**3,251**	3,386
Expenses:						
Investment	**25**	19	**0**	0	**25**	19
Actuarial charges (Note 4):						
Due to passage of time	**1,881**	1,770	**0**	0	**1,881**	1,770
Due to change in interest rates	**(1,619)**	4,283	**0**	0	**(1,619)**	4,283
Total	**287**	6,072	**0**	0	**287**	6,072
Financial income (loss)	**2,910**	(2,723)	**54**	37	**2,964**	(2,686)
Net income (loss)	**(12,067)**	(7,600)	**25**	(419)	**(12,042)**	(8,019)
Net position, beginning of year	**(11,238)**	(3,638)	**(261)**	158	**(11,499)**	(3,480)
Net position, end of year	**$(23,305)**	$(11,238)	**$(236)**	$(261)	**$(23,541)**	$(11,499)

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

PENSION BENEFIT GUARANTY CORPORATION
STATEMENTS OF CASH FLOWS

	Single-Employer Program For the Years Ended September 30,		Multiemployer Program For the Years Ended September 30,		Memorandum Total For the Years Ended September 30,	
(Dollars in millions)	**2004**	2003	**2004**	2003	**2004**	2003
OPERATING ACTIVITIES:						
Premium receipts	**$ 1,108**	$ 828	**$ 28**	$ 25	**$ 1,136**	$ 853
Interest and dividends received, net	**1,155**	962	**64**	50	**1,219**	1,012
Cash received from plans upon trusteeship	**51**	360	**0**	0	**51**	360
Receipts from sponsors/non-sponsors	**120**	128	**0**	0	**120**	128
Receipts from the missing participant program	**3**	3	**0**	0	**3**	3
Other receipts	**4**	1	**0**	0	**4**	1
Benefit payments - trusteed plans	**(2,888)**	(2,154)	**(1)**	(1)	**(2,889)**	(2,155)
Financial assistance payments			**(10)**	(5)	**(10)**	(5)
Settlements and judgments	**(7)**	(90)	**0**	0	**(7)**	(90)
Payments for administrative and other expenses	**(278)**	(250)	**0**	0	**(278)**	(250)
Net cash provided (used) by operating activities (Note 13)	**(732)**	(212)	**81**	69	**(651)**	(143)
INVESTING ACTIVITIES:						
Proceeds from sales of investments	**71,260**	36,556	**1,269**	1,704	**72,529**	38,260
Payments for purchases of investments	**(66,008)**	(33,888)	**(1,344)**	(1,768)	**(67,352)**	(35,656)
Net cash provided (used) by investing activities	**5,252**	2,668	**(75)**	(64)	**5,177**	2,604
Net increase in cash and cash equivalents	**4,520**	2,456	**6**	5	**4,526**	2,461
Cash and cash equivalents, beginning of year	**3,172**	716	**8**	3	**3,180**	719
Cash and cash equivalents, end of year	**$ 7,692**	$ 3,172	**$ 14**	$ 8	**$ 7,706**	$ 3,180

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

NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 2004 AND 2003

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 the pension benefits, within statutory limits, of participants in covered single-employer and multiemployer defined benefit pension plans.

ERISA requires that PBGC programs be self-financing. The Corporation's principal sources of revenues are premiums collected from covered plans, assets assumed from terminated plans, collection of employer liability payments due under ERISA, and investment income. ERISA provides that the U.S. Government is not liable for any obligation or liability incurred by PBGC.

As of September 30, 2004, the single-employer and multiemployer programs reported deficits of $23.305 billion and $236 million, respectively. To date, neither program's deficit has affected the Corporation's ability to maintain liquidity and meet its obligations. However, neither program at present has the resources to fully satisfy PBGC's long-term obligations to plan participants. The single-employer program has assets of nearly $39 billion and the multiemployer program has assets in excess of $1 billion. Sufficient liquidity exists to meet the programs' obligations for a number of years.

<u>Single-Employer and Multiemployer Program Exposure</u>

Measures of risk in PBGC's insured base of plan sponsors suggest that the single-employer deficit may continue to worsen. PBGC's best estimate of the total underfunding in plans sponsored by companies with credit ratings below investment grade and classified by PBGC as reasonably possible of termination as of September 30, 2004 was $96 billion. The comparable estimates of reasonably possible exposure for 2003 and 2002 were $82 billion and $35 billion, respectively. These estimates are measured as of December 31 of the previous year (see Note 7). For 2004, this exposure is concentrated in the following sectors: manufacturing; transportation, communication and utilities; and wholesale and retail trade.

PBGC estimates that the total underfunding in single-employer plans exceeded $450 billion (unaudited), as of September 30, 2004 and exceeded $350 billion (unaudited) as of September 30, 2003. A comparable estimate was not made in 2002. PBGC's estimate of underfunding as of September 30, 2004 is largely (about 80%) based upon employers' reports to PBGC under section 4010 of ERISA of their December 31, 2003 market value of assets and termination liability. These values were then rolled forward to September 30, 2004 on a plan-by-plan basis using an average pension asset return from published reports, an average benefit accrual increment, and a liability adjustment factor to reflect the change in interest factors. The roll forward did not adjust for contributions, benefit payments, changes in liabilities due to the passage of time, or plan amendments since this information was not readily or reliably available. PBGC's exposure to loss is less than these amounts because of the statutory limits on insured pensions. For single-employer plans sponsored by employers that do not file with PBGC under section 4010 of ERISA, PBGC's estimates are based on data obtained from other filings and submissions with the government and from corporate annual reports for fiscal years ended in calendar 2003.

Total underfunding of multiemployer plans is estimated to exceed $150 billion (unaudited) at September 30, 2004. In 2003, PBGC estimated multiemployer underfunding at $100 billion (unaudited). Multiemployer plan data is much less current and complete than single-employer data - it is generally two years older and in some cases three years older than single-employer data and comes only from Form 5500 filings.

PBGC estimates that, as of September 30, 2004, it is reasonably possible that multiemployer plans may require future financial assistance in the amount of $108 million. As of September 30, 2003 and 2002, these exposures were estimated at $63 million and $127 million, respectively.

There is significant volatility in plan underfunding and sponsor credit quality over time, which makes long term estimates of PBGC's expected claims difficult. This volatility, and the concentration of claims in a relatively small number of terminated plans, have characterized PBGC's experience to date and will likely continue. Among the factors that will influence PBGC's claims going forward are economic conditions affecting interest rates, financial markets, and the rate of business failures.

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 payable by PBGC 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 using assumptions derived from annuity prices from insurance companies, as described in the Statement of Actuarial Opinion. As described in Paragraph 21 of FAS No. 35, the assumptions are "those assumptions that are inherent in the estimated cost at the (valuation) date to obtain a contract with an insurance company to provide participants with their accumulated plan benefits." Also, in accordance with Paragraph 21 of FAS No. 35, PBGC selects assumptions for expected retirement ages and the cost of administrative expenses in accordance with its best estimate of anticipated experience.

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 the revolving fund where premiums are collected and held. The assets in the revolving fund are used to cover deficits incurred by plans trusteed and provides funds for financial assistance. The trust fund supports the operational functions of PBGC. The Pension Protection Act of 1987 created a single-employer revolving (7th) 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"), as amended. 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.

Sponsors of Terminated Plans, Receivables: The amounts due from sponsors of terminated plans or members of their controlled group represent the settled, but uncollected, claims for employer liability (underfunding as of date of plan termination) and for contributions due their plan less an allowance for estimated 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).

Capitalized Assets: Capitalized assets include furniture and fixtures, EDP equipment and internal-use software. Beginning in Fiscal Year 2004, PBGC, in compliance with AICPA Statement Of Position 98-1 and FASB EITF 97-13 began to account for the cost of computer software developed for internal use. This includes costs for internally developed software incurred during the application development stage (system design including software configuration and software interface, coding, testing including parallel processing phase). These costs are shown net of depreciation and amortization.

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 as of the date of the financial statements. 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). 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. These estimates and assumptions could change 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 – In accordance with Statement of Financial Accounting Standards No. 5 (Accounting for Contingencies) PBGC recognizes net claims for probable terminations which represent 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 specific plan as a probable termination include, but are not limited to, one or more of the following conditions: the plan sponsor is in liquidation or comparable state insolvency proceeding with no known solvent controlled group member; sponsor filed or intends to file for distress plan termination; or PBGC seeks involuntary plan termination. In addition, Management takes into account other economic events and factors in making judgements regarding the classification of a plan as a probable termination. These events and factors may include, but are not limited to: the plan sponsor is in bankruptcy or has indicated that a bankruptcy filing is imminent; the plan sponsor has stated that plan termination is likely; the plan sponsor has received a going concern opinion from its independent auditors; or the plan sponsor is in default under existing credit agreement(s).

In addition, a reserve for large unidentified probable losses is recorded based on actual PBGC experience, as well as the historical industry bond default rates. This reserve has been developed by segregating plan sponsors with aggregate underfunding equal to or greater than $5 million into risk bands which reflect their level of credit risk. A reserve for small unidentified probable losses and incurred but not reported claims is also recorded based on an actuarial loss development methodology (triangulation) (see Note 4).

(5) PBGC identifies certain plans as high risk if the plan sponsor meets one or more criteria that include, but are not limited to, the following conditions: sponsor is in Chapter 11 proceedings; sponsor received a minimum funding waiver within the past five years;

sponsor granted security to an unsecured creditor as part of a renegotiation of debt within the past two years; sponsor is known to have been in default on existing debt within the past two years (regardless of whether it received a waiver of default); or sponsor's unsecured debt is rated CCC+/Caa1 or lower by S&P or Moody's respectively. 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.

(6) In accordance with Statement of Financial Accounting Standards No. 5 (Accounting for Contingencies), PBGC's exposure to losses from plans of companies that are classified as reasonably possible is disclosed in footnotes. Criteria used for classifying a company as a reasonably possible include, but are not limited to, one or more of the following conditions: the plan sponsor is in Chapter 11 reorganization; funding waiver pending or outstanding with the Internal Revenue Service (IRS); sponsor missed minimum funding contribution; sponsor's bond rating is below-investment-grade for Standard & Poor's (BB+) or Moody's's (Ba1); sponsor has no bond rating but unsecured debt is below investment grade; or sponsor has 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).

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

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

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

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

Losses from Completed and Probable Terminations: Amounts reported as losses from completed and probable terminations represent the difference as of the 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 PBGC's fiscal year is included as a component of losses from completed and probable terminations for plans with termination dates prior to the year in which they were added to PBGC's inventory of terminated plans.

Actuarial Adjustments and Charges (Credits): PBGC classifies actuarial adjustments related to changes in method and the effect of experience as underwriting activity; actuarial 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 and Amortization: PBGC calculates depreciation on the straight-line basis over estimated useful lives of 5 years for equipment and 10 years for furniture and fixtures. PBGC calculates amortization for capitalized software, which includes certain costs incurred for purchasing and developing software for internal use, on the straight-line basis over estimated useful lives not to exceed 5 years, commencing on the date that the Corporation determines that the internal-use software is implemented. Routine maintenance and leasehold improvements (the amounts of which are not material) are charged to operations as incurred.

Reclassification: Certain amounts in the 2003 financial statements have been reclassified to be consistent with the 2004 presentation.

Note 3 -- Investments

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

The trust funds include assets PBGC acquires or expects to acquire with respect to terminated plans (e.g., recoveries from sponsors) 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 as well as related investment profile data. 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, 2004		September 30, 2003	
(Dollars in millions)	Basis	Market Value	Basis	Market Value
Fixed maturity securities:				
U.S. Government securities	$15,095	$15,667	$14,997	$15,450
Commercial paper	188	188	87	87
Asset backed securities	399	396	937	942
Corporate and other bonds	1,050	1,082	740	771
Subtotal	16,732	17,333	16,761	17,250
Equity securities	7,536	11,115	10,040	12,641
Real estate and real estate investment trusts	83	91	97	93
Insurance contracts and other investments	38	23	74	59
Total *	$24,389	$28,562	$26,972	$30,043

* This includes securities on loan at September 30, 2004, and September 30, 2003, with a market value of $622 million and $213 million, respectively.

INVESTMENTS OF MULTIEMPLOYER REVOLVING FUNDS AND MULTIEMPLOYER TRUSTEED PLANS

	September 30, 2004		September 30, 2003	
(Dollars in millions)	Basis	Market Value	Basis	Market Value
Fixed maturity securities:				
U.S. Government securities	$1,006	$1,042	$946	$975
Equity securities	0	1	1	1
Total	$1,006	$1,043	$947	$976

INVESTMENT PROFILE

	September 30, 2004	September 30, 2003
Fixed-Income Assets		
Average Quality	AAA	AAA
Average Maturity (years)	15.2	17.2
Duration (years)	9.1	10.1
Yield to Maturity (%)	4.4	4.6
Equity Assets		
Average Price/Earnings Ratio	20.4	24.2
Dividend Yield (%)	1.7	1.7
Beta	0.98	0.96

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. The standard requires disclosure of fair value of these instruments. During fiscal years 2003 and 2004, PBGC invested in investment products, which used various U.S. and non-U.S. derivative instruments including but not limited to: equity index futures contracts, money market and government bond futures contracts, swap contracts, swaption contracts, stock warrants and rights, debt option contracts and foreign currency forward and option contracts. Some of these derivatives are traded on organized exchanges and thus bear minimal credit risk. The counterparties to PBGC's non-exchange-traded derivative contracts are major financial institutions. PBGC has never experienced non-performance by any of its counterparties.

Futures are exchange-traded contracts specifying a future date of delivery or receipt of a certain amount of a specific tangible or intangible product. The futures exchange's clearinghouses clear, settle, and guarantee transactions occurring through its facilities. Institutional investors hold these future contracts on behalf of PBGC as efficient and liquid substitutes for purchases and sales of financial market indices and securities. Open futures positions are marked to market daily. An initial margin of generally 1 to 6 percent is maintained with the broker in Treasury bills or similar instruments. In addition, futures contracts require daily settlement of variation margin resulting from the marks to market. 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.

The table below summarizes the Corporation's financial futures positions at September 30, 2004 and 2003. The table includes the notional and fair value of the instrument. The notional is the theoretical cost of a futures contract defined as the number of contracts held times trade price times a multiplier. The fair value is the market value (amount needed to settle) of a financial instrument contract.

FAIR VALUE OF FINANCIAL FUTURES

	Notional at September 30,		Fair Value at September 30,	
(Dollars in millions)	**2004**	2003	**2004**	2003
Financial futures contracts	**$2,025**	$1,023	**$16**	$(4)

Foreign currency forward and option contracts are used 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. Other investments held by the Corporation include swap contracts and swaption (i.e., option on swap) contracts. A swap is an agreement between two parties to exchange different financial returns on a notional investment amount. For example, an interest rate swap involves exchanges of fixed rate and floating rate interest. There is no exchange of the underlying principal. PBGC uses swap and swaption contracts to adjust exposure to interest rates, fixed income securities exposure, and to generate income based on the investment views of the portfolio managers regarding interest rates, indices and debt issues. Stock warrants and rights allow PBGC to purchase securities at a stipulated price within a specified time limit. For the fiscal years ended September 30, 2004 and September 30, 2003 gains and losses from settled margin calls are reported in Investment income on the Statement of Operations and Changes in Net Position.

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, 2004, and September 30, 2003, was $622 million and $213 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, 2004 and 2003.

For FY 2004, PBGC used a 25-year select interest factor of 4.8% followed by an ultimate factor of 5.0% for the remaining years and for FY 2003, a 20-year select interest factor of 4.4% followed by an ultimate factor of 4.5% for the remaining years. These factors were determined to be those needed, given the mortality assumptions, to continue to match the survey of annuity prices provided by the American Council of Life Insurers (ACLI). PBGC's regulations state that both the interest factor 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 administrative 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, 2004, PBGC used the 1994 Group Annuity Mortality (GAM) Static Table (with margins), set forward 1 year and projected 20 years to 2014 using Scale AA. For September 30, 2003, PBGC used the same table, set forward two years but projected 18 years to 2012 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 (10 years in 2004 versus 9 years in 2003) plus PBGC's calculated duration of its liabilities (10 years in 2004 versus 9 years in 2003). 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.

During FY 2004, PBGC conducted a mortality study. The study showed that the mortality assumptions used in FY 2003 reflected higher mortality than was realized in PBGC's seriatim population. Therefore, PBGC adopted a base mortality table (i.e., GAM94 set forward one year instead of GAM94 set forward two years) that better reflects past mortality experience. The ACLI survey of annuity prices, when combined with the mortality table, provides the basis for determining the interest factors used in calculating the PVFB. The insurance annuity prices, when combined with the stronger mortality table, result in a higher interest factor. The increase in the liability due to the change in the mortality table is included in the actuarial adjustments. There is a compensating decrease in the actuarial charge due to the change in interest rates.

The reserve for administrative expenses in the 2004 and 2003 valuations 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 2004 and 2003 reflect the payment of assistance and the changes in interest and mortality 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, 2004 AND 2003

(Dollars in millions)	2004		2003	
	September 30,			
Present value of future benefits, at beginning of year -- Single-Employer, net		$44,641		$28,619
Estimated recoveries, prior year		68		38
Assets of terminated plans pending trusteeship, net, prior year		172		323
Present value of future benefits at beginning of year, gross		44,881		28,980
Settlements and judgments, prior year		(67)		(161)
Net claims for probable terminations, prior year		(5,207)		(6,322)
Actuarial adjustments -- underwriting:				
Changes in method and assumptions	$1,340		$ 21	
Effect of experience	185		87	
Total actuarial adjustments -- underwriting	1,525		108	
Actuarial charges -- financial:				
Passage of time	1,881		1,770	
Change in interest rates	(1,619)		4,283	
Total actuarial charges -- financial	262		6,053	
Total actuarial charges, current year		1,787		6,161
Terminations:				
Current year	6,926		13,428	
Changes in prior year	(427)		9	
Total terminations		6,499		13,437
Benefit payments, current year*		(3,006)		(2,488)
Estimated recoveries, current year		(364)		(68)
Assets of terminated plans pending trusteeship, net, current year		(678)		(172)
Settlements and judgments, current year		65		67
Net claims for probable terminations:				
Future benefits**	30,953		9,735	
Estimated plan assets and recoveries from sponsors	(14,027)		(4,528)	
Total net claims, current year		16,926		5,207
Present value of future benefits, at end of year -- Single-Employer, net		60,836		44,641
Present value of future benefits, at end of year -- Multiemployer		3		3
Total present value of future benefits, at end of year, net		$60,839		$44,644

* The benefit payments of $3,006 million and $2,488 million include $119 million in 2004 and $334 million in 2003 for benefits paid from plan assets by plans prior to trusteeship.

** The future benefits for probable terminations of $30,953 million and $9,735 million for fiscal years 2004 and 2003, respectively, include $431 million and $214 million, respectively, in net claims (future benefits less estimated plan assets and recoveries) for probable terminations not specifically identified and $30,522 million and $9,521 million, respectively, in net claims for specifically identified probables.

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

ASSETS OF SINGLE-EMPLOYER TERMINATED PLANS PENDING TRUSTEESHIP, NET

	September 30, 2004		September 30, 2003	
(Dollars in millions)	Basis	Market Value	Basis	Market Value
U.S. Government securities	$ 3	$ 3	$ 0	$ 0
Corporate and other bonds	265	281	83	88
Equity securities	364	382	66	75
Insurance contracts	2	2	4	4
Other	10	10	5	5
Total, net	$644	$678	$158	$172

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, 2004		2003	
Net claims for probable terminations, at beginning of year		$ 5,207		$ 6,322
Change in IBNR		(41)		0
New claims	$14,407		$4,211	
Actual terminations	(3,258)		(5,448)	
Deleted probables	(243)		(228)	
Change in benefit liabilities	929		270	
Change in plan assets	(75)		80	
Loss (credit) on probables		11,760		(1,115)
Net claims for probable terminations, at end of year		$16,926		$ 5,207

The following table itemizes the probable exposure by industry:

PROBABLES EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in millions)	FY 2004	FY 2003
Transportation, Communication and Utilities	**$15,057**	$1,290
Manufacturing	**630**	2,725
Finance, Insurance, and Real Estate	**569**	31
Wholesale and Retail Trade	**219**	573
Agriculture, Mining, and Construction	**0**	237
Services/Other	**451**	351
Total	**$16,926**	$5,207

For further detail, see Note 2 subpoint (4).

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 1987-2003 at September 30, 2004			
Beginning in 1987, number of plans reported as Probable:	Number of Plans	Percent of Plans	Net Claim	Percent of Net Claim
Probables terminated	237	76%	$11,746	82%
Probables not yet terminated or deleted	11	4	1,486	11
Probables deleted	62	20	1,021	7
Total	310	100%	$14,253	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)	2004	2003
Gross balance at beginning of year	$ 61	$ 56
Financial assistance payments--current year	10	5
Subtotal	71	61
Allowance for uncollectible amounts	(71)	(61)
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 period changes in the estimated present value of nonrecoverable future financial assistance.

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

	September 30,	
(Dollars in millions)	2004	2003
Balance at beginning of year	$1,250	$ 775
Changes in allowance:		
Losses from financial assistance	55	480
Financial assistance granted (previously accrued)	(10)	(5)
Balance at end of year	$1,295	$1,250

Note 6 -- Accounts Payable and Accrued Expenses

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

ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	September 30,	
(Dollars in millions)	2004	2003
Annual leave	$ 5	$ 5
Collateral held for loaned securities	637	220
Other payables and accrued expenses	66	54
Accounts payable and accrued expenses	$708	$279

Note 7 -- Contingencies

There are a number of single-employer plans that are sponsored by companies whose credit quality is below investment grade which poses a greater risk of being terminated. In addition, there are some multiemployer plans that may require future financial assistance. The amounts disclosed below represent the Corporation's best estimates of the possible losses in these plans 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 best estimate of aggregate unfunded vested benefits exposure to PBGC for the companies' single-employer plans classified as reasonably possible with an underfunding of $5 million or greater as of September 30, 2004, was $96 billion.

The estimated unfunded vested benefits exposure has been calculated as of December 31, 2003. 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 2003. The Corporation adjusted the value reported for liabilities to the December 31, 2003, PBGC select interest rate of 4.0% (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, 2004, because of the economic conditions (e.g., lower interest rate factors and/or low investment returns on plan assets) that existed between December 31, 2003, and September 30, 2004. The Corporation did not adjust the estimate for events that occurred between December 31, 2003, and September 30, 2004.

The following table itemizes the reasonably possible exposure by industry:

REASONABLY POSSIBLE EXPOSURE BY INDUSTRY (PRINCIPAL CATEGORIES)

(Dollars in millions)	FY 2004	FY 2003
Manufacturing	$48,444	$39,470
Transportation, Communication and Utilities	30,480	32,937
Services/Other	7,926	2,501
Wholesale and Retail Trade	5,806	4,346
Agriculture, Mining and Construction	1,866	1,762
Finance, Insurance, and Real Estate	1,151	1,079
Total	$95,673	$82,095

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 $108 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, 2004, or the projected (or actual, if known) date of plan insolvency, discounted back to September 30, 2004. 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 4.8% for the first 25 years after the valuation date and 5.0% thereafter. The Corporation also used the 1994 Group Annuity Mortality Static Table (with margins), set forward 1 year, projected 20 years to 2014 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. However, a new lease will take effect on January 1, 2005. The new lease agreement was entered into because of the need for additional office space. 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 2013. The minimum future lease payments for office facilities having noncancellable terms in excess of one year as of September 30, 2004, are as follows:

COMMITMENTS: FUTURE LEASE PAYMENTS
(Dollars in millions)

Years Ending September 30,	Operating Leases
2005	$ 16.7
2006	17.3
2007	17.3
2008	17.0
2009	14.2
Thereafter	125.0
Minimum lease payments	$207.5

Lease expenses were $15.6 million in 2004 and $14.6 million in 2003.

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 portion of 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 flat- rate premiums for the single-employer program are $19 per participant. Underfunded single-employer plans also pay variable-rate premiums of $9 per $1,000 of underfunding if not exempt from the variable-rate premiums. Annual flat-rate premiums for the multiemployer program are $2.60 per participant and there are no variable-rate premiums. PBGC recorded premium income, excluding interest and penalty, of approximately $677 million in flat-rate premiums and $804 million in variable-rate premiums for fiscal year 2004, and approximately $676 million in flat-rate premiums and $301 million in variable-rate premiums for fiscal year 2003.

Note 10 -- Losses from Completed and Probable Terminations

Amounts reported as losses are the present value of future benefits 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,					
	2004			2003		
(Dollars in millions)	New Terminations	Changes in Prior Year Terminations	Total	New Terminations	Changes in Prior Year Terminations	Total
Present value of future benefits	$6,926	$(427)	$ 6,499	$13,428	$ 9	$13,437
Less plan assets	3,137	125	3,262	6,963	(79)	6,884
Plan asset insufficiency	3,789	(552)	3,237	6,465	88	6,553
Less estimated recoveries	280	11	291	61	(3)	58
Subtotal	$3,509	$(563)	2,946	$ 6,404	$ 91	6,495
Settlements and judgments			1			(3)
Loss (credit) on probables			11,760*			(1,115)*
Total			$14,707			$ 5,377

* See Note 4

Note 11 -- Financial Income

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

FINANCIAL INCOME

	For the Years Ended September 30,	
(Dollars in millions)	2004	2003
Fixed-income securities:		
Interest earned	$ 908	$ 941
Realized gain (loss)	(20)	1,599
Unrealized gain (loss)	149	(1,227)
Total fixed-income securities	1,037	1,313
Equity securities:		
Dividends earned	104	75
Realized gain (loss)	1,044	(134)
Unrealized gain	1,048	2,118
Total equity securities	2,196	2,059
Other income	18	14
Total financial income	$3,251	$ 3,386

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 2004 was 7.0 percent of base pay for those employees covered by that system. For FY 2003, the rate for the first three months was 7.5 percent and 7.0 percent for the remainder of that year. For those employees covered by FERS, the Corporation's contribution was 10.7 percent of base pay for both 2004 and 2003. 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 both 2004 and 2003.

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

Note 13 -- Cash Flows

The following is a reconciliation between the net income as reported in the Statements of Operations and Changes in Net Position and net cash provided by operating activities as reported in the Statements of Cash Flows.

RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES

	Single-Employer Program		Multiemployer Program		Memorandum Total	
	September 30,		September 30,		September 30,	
(Dollars in millions)	2004	2003	2004	2003	2004	2003
Net income (loss)	$(12,067)	$(7,600)	$25	$(419)	$(12,042)	$(8,019)
Adjustments to reconcile net income to net cash provided by operating activities:						
Net (appreciation) decline in fair value of investments	(2,160)	(2,308)	(3)	11	(2,163)	(2,297)
Net gain of terminated plans pending trusteeship	(84)	(108)	0	0	(84)	(108)
Losses on completed and probable terminations	14,707	5,377	0	0	14,707	5,377
Actuarial charges	1,787	6,161	1	1	1,788	6,162
Benefit payments - trusteed plans	(2,888)	(2,154)	(1)	(1)	(2,889)	(2,155)
Settlements and judgments	(7)	(90)	0	0	(7)	(90)
Cash received from plans upon trusteeship	51	360	0	0	51	360
Receipts from sponsors/non-sponsors	84	225	0	0	84	225
Amortization of discounts/premiums	128	108	11	7	139	115
Changes in assets and liabilities, net of effects of trusteed and pending plans:						
(Increase) decrease in receivables	(311)	(210)	3	(5)	(308)	(215)
Increase in present value of nonrecoverable future financial assistance			45	475	45	475
Increase in unearned premiums	16	14	0	0	16	14
Increase in accounts payable	12	13	0	0	12	13
Net cash provided (used) by operating activities	$ (732)	$ (212)	$81	$ 69	$ (651)	$ (143)

Section V

Agency Comments

Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026
PBGC U.S. GOVERNMENT AGENCY

Office of the Executive Director

NOV 1 2 2004

TO: Robert L. Emmons
Inspector General

FROM: Bradley D. Belt

SUBJECT: PBGC's Response to the FY 2004 and FY 2003 Financial Statements Audit Reports

PBGC management welcomes the opportunity to respond to the fiscal year 2004 financial statements audit reports. We also appreciate the work of the Office of Inspector General (OIG) and PricewaterhouseCoopers to complete a complex audit within the 45-day period specified in the President's Management Agenda.

The fiscal year 2004 report marks the 12th consecutive year we have received an unqualified audit opinion. Working together, we intend to continue this record of achievement.

The Report of the Independent Auditors calls attention to the growing financial challenges facing PBGC, and the statutory requirement that PBGC's insurance programs be self-sustaining. The Report's recognition of the threats to the long-term viability of the pension insurance program helps to underscore the need for comprehensive pension reforms to strengthen the retirement security of the 44 million Americans protected by PBGC.

PBGC management is in agreement with all of the reported findings and recommendations.

The Report on Internal Control acknowledges that corrective actions have been completed on the material weakness and one reportable condition from FY 2003, and that the recommendations associated with these issues have been closed. In addition, the report highlights progress on the remaining five reportable conditions. As you will note in the specific responses below, we are actively pursuing corrective actions on these issues.

Reportable Conditions:

1. Regarding the need to integrate financial management systems, PBGC has established an interdepartmental working group that includes audit representatives from the OIG to implant appropriate corrective actions. Management has obtained contractor assistance to conduct a review of the financial systems to identify the areas that do not meet integration requirements. PBGC's implementation efforts include the formal adoption of the updated Joint Financial Management Improvement Program's (JFMIP) Framework for Federal Management Systems (JFMIP-SR-01-04), to be applied to all PBGC financial systems development initiatives.

2. On information systems security and enforcement, PBGC completed work to finalize accreditation and certification of its business critical systems and implemented established procedures for conducting risk assessments. All financial and mixed systems will undergo annual risk assessments. Also, PBGC implemented a security plan for key production environments, as prescribed by the National Institute of Standards and Technology (NIST) standards and OMB. Work continues to fully address two remaining recommendations associated with this reportable condition.

3. To improve controls related to single-employer premiums, PBGC implemented My Plan Administration Account, enabling plan sponsors or plan administrators to electronically complete and submit its premium filing and payment. PBGC is working on a full-scale business re-engineering initiative for premium operations, including an evaluation of the related internal controls. The Corporation is also working on implementation of a new premium accounting system to further strengthen controls, which will be operational with implementation of the new system, and comprehensive procedures for processing and estimating premiums. The new system is designed to improve timeliness and accuracy in premium operations in order to strengthen financial management and customer service.

4. PBGC continues to make progress in improving controls over the identification and measurement of the Single-Employer Program Fund Contingent Liabilities. The OIG recognized improvements already made for plans considered probable of termination; new guidance developed to help differentiate between plans classifiable as probable and reasonable possible for termination; the development of a staff procedures manual; etc. Management has completed work to implement controls as they relate to the compressed financial reporting time frames for the FY 2004 audit, including new procedures

to cover all aspects of plan classification. Management has also implemented independent review procedures of unfunded benefit liability calculations for contingent liabilities.

5. PBGC continues to strengthen controls over the identification and classification of multiemployer plans probable of receiving financial assistance. The Corporation has initiated actions to address this issue, and we are working with the OIG and independent auditors to ensure that the program has effective controls in this area. Program procedures and controls have been strengthened to require documentation and concurrence on additions and deletions to the universe of plans probable of receiving financial assistance, including reasons for plan additions and deletions. Management completed revisions to program procedures to clarify documentation needed to support classification decisions, and to require the multiemployer universe reconciliation be independently reviewed, and that the review be documented.

The Corporation remains committed to achieving substantive progress in following up on the OIG's open audit recommendations, and we anticipate working cooperatively with your office to make further gains in the audit follow-up process.