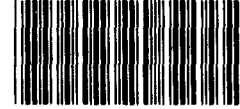


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FEDERAL GOVERNMENT'S OVERSIGHT OF
PENSION AND WELFARE FUNDS

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



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SUMMARY

The Internal Revenue Service (IRS) and Department of Labor are responsible for ensuring that pension plans, with about \$2 trillion in assets, and welfare benefit plans comply with the Employee Retirement Income Security Act of 1974 (ERISA). Their efforts have a significant impact on ensuring that employee benefit plans are free of mismanagement, fraud and abuse that place plan assets at risk and threaten plan participants' benefits. The effectiveness of their oversight also influences the potential for losses by the Pension Benefit Guaranty Corporation (PBGC).

Of particular concern to GAO is the effectiveness of federal oversight of employee benefit plans that are essential to the well-being of millions of Americans, and the government's potential exposure to underfunding in pension plans insured by PBGC, estimated to be between \$20 and \$30 billion in specific large plans.

GAO's preliminary observations on the government's oversight of ERISA indicate that although progress has been made, more needs to be done.

IRS has increased its examinations of plan operations, but devotes significant resources to examining plans that pose no risk to the federal government's insurance program, and places little emphasis on examining plans that are or may be underfunded and pose a risk to participants and the PBGC. Further, IRS is finding violations in far fewer examinations than expected because it is using outdated criteria to identify plans with characteristics that indicate a high potential for ERISA violations.

Labor and IRS have made substantial progress in improving the quality and timeliness of plan annual report data that are essential to effectively identifying violations. Labor also adopted a new enforcement strategy in December 1986 that allocated 50 percent of its enforcement resources toward investigations of financial institutions and welfare plan service providers that Labor characterized as having high potential for fiduciary abuse. However, the results of the new enforcement strategy have been disappointing. These investigations find fewer violations and take twice as long to complete as individual plan investigations.

GAO believes that recent proposals by Labor to strengthen ERISA's independent audit requirements would improve ERISA oversight and enhance the security of participants' benefits. GAO also believes that auditors should be required to review and report on plan management's assertions regarding the effectiveness of its internal control structure and compliance with laws and regulations, in addition to reporting on the plans' financial statements.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the federal government's oversight of pension and welfare benefit funds.

The Internal Revenue Service (IRS) and the Department of Labor are responsible for ensuring that pension plans, with about \$2 trillion in assets, and welfare benefit plans comply with the Employee Retirement Income Security Act of 1974 (ERISA). Their efforts have a significant impact on ensuring that employee benefit plans are free of mismanagement, fraud and abuse that place plan assets at risk and threaten plan participants' benefits. The effectiveness of their oversight also influences the potential for losses by the government's pension insurance program, administered by the Pension Benefit Guaranty Corporation (PBGC).

Of particular concern to GAO is the effectiveness of federal oversight of employee benefit plans that are essential to the well-being of millions of Americans, and the government's potential exposure to underfunding in pension plans insured by PBGC, estimated at between \$20 and \$30 billion in specific large plans.

GAO has a number of efforts underway in this area. These include a financial audit of PBGC and a review of recent criticisms made by Labor's Inspector General of the quality of

independent public accountant (IPA) audits of large employee benefit plans.

Today, however, I would like to provide our preliminary observations on two areas you specifically requested us to assess--the effectiveness of IRS' and Labor's ERISA enforcement programs. I will also provide GAO's views on Labor's proposals to enhance ERISA enforcement by strengthening IPA audits.

IRS'S ERISA ENFORCEMENT PROGRAM

One of IRS's primary missions is to enforce ERISA's vesting, participation, and funding provisions. It accomplishes this by (1) reviewing plan designs and (2) examining pension plan returns and operations for compliance with tax laws and regulations. Although IRS has increased its examinations of plan operations, we have questions about the effectiveness of its ERISA enforcement program.

Enforcement Resources Not Focused on Underfunded Plans

IRS's ERISA enforcement program is conducted by about 1,000 revenue agents in 7 key district offices nationwide. This represents about 83 percent of the combined staff resources available at IRS and Labor for the oversight of ERISA.

Historically, most of IRS's ERISA enforcement resources had been spent on reviewing plan designs, rather than examining plan

operations. This was because of the newness of ERISA and frequent changes in the law that required plan amendments. In a March 1979 report,¹ we concluded that IRS had made little effort to determine that plans were operating in compliance with ERISA, because most of its resources were spent reviewing plan designs.

IRS subsequently increased the number of pension plan examinations it conducted annually. However, between 1980 and 1986, examinations fluctuated from about 18,000 to about 28,000 because changes to ERISA required resources to be allocated to reviewing changes in plan designs. When examinations fell to about 5,000 in 1987, IRS decided that the number of plans examined was too low to ensure a high degree of voluntary compliance with ERISA. As a result, IRS redirected its resources so that 55 percent would be spent on examinations and 45 percent on reviewing plan designs.

Although IRS has directed more resources to examinations, it devotes significant resources to examining plans that pose no risk to the government's pension insurance program. For example, in the last 2 years, IRS devoted 65 and 68 percent of its examination resources to defined contribution plans that pose no risk to the government because, unlike defined benefit plans, they are not insured by PBGC. Defined contribution plans have

¹Internal Revenue Service Efforts and Plans to Enforce the Employee Retirement Income Security Act (HRD-79-55, Mar. 28, 1979).

represented 62 percent or more of IRS's total examinations during the last 5 years. IRS field staff told us that these examinations have been emphasized because they are easier for inexperienced agents to perform.

IRS intends to increase the number of defined benefit plans it examines during the next few years as part of a special revenue initiative focused on plans with fewer than 5 participants. This initiative is expected to generate up to \$800 million in additional tax revenue through 1993 by disallowing plan sponsors' tax deductions for plan contributions that IRS believes exceed ERISA's funding limitations. In contrast, IRS's work plans place little emphasis on examining plans that are or may be underfunded and pose a risk to participants and PBGC.

Although IRS's special emphasis on small overfunded defined benefit plans is expected to produce significant revenues, using resources for this effort limits those available to examine plans that may become liabilities of the PBGC. This raises a question regarding the inherent conflict between IRS's major missions. While revenue-raising initiatives should not be discouraged, IRS should determine how to better allocate its limited ERISA enforcement resources to also ensure that participants' benefits are protected and thus reduce the risk of plans becoming liabilities to PBGC.

IRS Needs to Improve Its
Examination Selection Procedures

IRS selects plans for examination using a computer program that seeks to identify plans with characteristics that indicate a high potential for ERISA violations. IRS developed this profile from almost 18,000 detailed examinations conducted during a taxpayer compliance measurement program (TCMP) survey of plans' 1978 returns.

The criteria IRS uses to select plans for examination may now be too old to provide an effective means of targeting. IRS expected to find violations in about 66 percent of all examinations selected using this profile. However, in each year since 1985, IRS has found ERISA violations in less than 32 percent of its examinations, and in 1989 only 21 percent of the plans examined had ERISA violations. IRS field staff attribute the low violation rate to the selection system's use of old criteria to identify plans for examination. The selection criteria appear outdated because of the numerous changes in ERISA's provisions and plan characteristics since the TCMP survey.

IRS plans to implement an alternative selection system this year that it hopes will enable it to more quickly and accurately target plans with a high potential for ERISA violations. Although we have not reviewed this plan in detail, it may be preferable to conducting another TCMP survey, because it would

likely cost less and produce results sooner. Nevertheless, we believe IRS's selection system should include criteria that target plans that pose a potential risk to the government's pension insurance program because of underfunding.

Ensuring Examination Quality

Historically, IRS's national and regional offices reviewed district office operations, in part to ensure that enforcement programs were effective and examinations met IRS's quality standards. However, IRS suspended this program in 1985. At two of the three district offices we visited, we found that from 1987 through 1989, neither the national nor the regional office had reviewed the quality of any examinations to ensure that they were sufficiently thorough to identify ERISA violations. At the other office, only 29 examinations had been reviewed.

IRS recently initiated a quality assurance program that will review each district office's employee plan operations every 2 years. The program includes a review of the quality of between 50 and 75 examinations. If properly implemented, this program could help ensure that examinations are sufficiently thorough to identify ERISA violations.

IRS Needs to Assess the Impact of Changes in How It Approves Plan Designs

IRS expects to receive many requests from plans to approve plan design changes made to comply with the Tax Reform Act of

1986. To meet this demand and continue to devote most of its ERISA enforcement resources to examinations, IRS made several changes to reduce the time spent reviewing plan designs. First, plans were encouraged to participate in several "volume submitter" programs that enable IRS to approve requests of a large number of plans with standardized provisions without a detailed review of each. Second, for plans that meet certain criteria, IRS intends to approve plan designs without reviewing the plan language to ensure that it complies with ERISA. IRS expects that it will approve up to 75 percent of all such requests without submitting them to an agent for a detailed review and that the great majority of these will be plans with standardized provisions.

IRS's expectations for high participation in the volume submitter program may not be realized. As of April 1990, only 61 out of about 7,000 practitioners who submit large numbers of requests had signed up for the program at the three district offices we visited. If high participation is not achieved, many design changes for non standard plans will have to be approved without a detailed review to meet examination goals and process the requests within the 270-day period specified by ERISA. IRS officials acknowledge that, in some cases, this could result in plans receiving approval for changes in plan design that do not comply with ERISA.

IRS views the approval of plan designs as an important element of its enforcement program. Because of the significant changes IRS has made in the way it approves plan designs, we believe IRS should develop a plan for evaluating the impact of these changes.

LABOR'S ERISA ENFORCEMENT PROGRAM

Within the Department of Labor, the Pension and Welfare Benefits Administration (PWBA) is responsible for enforcing ERISA. Labor focuses its enforcement efforts on conducting investigations to ensure that plans comply with ERISA's fiduciary provisions and are operated in the best interest of their participants. Labor is also responsible for enforcing ERISA's reporting and disclosure provisions.

Early this year, we initiated an assessment of Labor's ERISA enforcement program, focusing on its efforts to correct weaknesses we had previously identified. Our preliminary observation is that Labor has taken actions in recent years to address many of these weaknesses. However, some problems remain that diminish the program's effectiveness.

Enforcement Strategy

In an October 1985 report, we concluded that Labor did not have a comprehensive, consistent, long-term strategy for

enforcing ERISA.² In response to our report, Labor adopted a new enforcement strategy in December 1986. The strategy allocated 50 percent of PWBA's investigative resources to investigations of significant issue cases. These cases involve organizations that Labor characterized as having high potential for fiduciary abuse. These include (1) financial institutions, such as banks and trust companies, that serve as pension plan trustees, and (2) firms that provide services to welfare plans. The remaining investigative time was to be spent on individual plans.

The results of Labor's ERISA enforcement strategy have been disappointing. Labor's assessment of the strategy indicates that significant issue investigations find fewer violations and take twice as long to complete as investigations of individual plans.

Several factors appear to have contributed to these results. First, Labor has lacked adequate data to effectively target financial institutions and service providers with a high potential for ERISA violations. Second, investigators have not been provided standardized audit guides for investigating financial institutions and service providers. Labor is working to improve its targeting procedures and complete the audit guides.

²Strong Leadership Needed to Improve Management at the Department of Labor (GAO/HRD-86-12, Oct. 21, 1985).

ERISA Data Base and Targeting of
Plans for Investigation

We and others have reported that Labor's ERISA enforcement has been hindered by incomplete, inaccurate, and untimely plan data. Labor and IRS have made substantial progress on these problems, including increasing the amount of information captured from plan annual returns, using extensive edit checks and follow-up contact with plans to improve data completeness and accuracy, and processing return information within 60 days after the return is filed.

PWBA has developed a computerized system to use the improved data base to target plans, financial institutions, and service providers for investigation. Despite this progress, we are concerned that the system may miss plans with significant weaknesses. Certain data in the annual reports reflecting the funded status of defined benefit plans are not included in the system data base for 1988 plan returns, the first year to be included in the improved data base. As a result, Labor can not identify underfunded defined benefit plans for investigation. This information is critical to ensuring that these plans have not committed ERISA violations that may place plan assets and participants' benefits at risk, and that they do not end up becoming liabilities to PBGC and the taxpayers.

Small Staff Size
Relative to Plan Universe

Labor has an ERISA enforcement staff of about 200, or about 1 for every 4,500 pension plans. At this staffing level, Labor investigates less than 1 percent of the plan universe each year. Despite the growth in the number of pension and welfare plans since 1984, and the assets they hold, PWBA's field investigative staff remains under 200. Labor's fiscal year 1991 budget requests 133 additional staff members for ERISA enforcement. Although this increase, if approved, is a step in the right direction, it is unclear whether the additional staff and improvements in targeting will be enough to ensure that Labor can provide an effective deterrent to ERISA violations. The small amount of federal resources available to enforce ERISA heightens the importance of annual IPA plan audits.

VIEWS ON LABOR'S PROPOSALS ON PLAN AUDITS

ERISA requires administrators of employee benefit plans with 100 or more participants to engage, on behalf of plan participants, an IPA to conduct an annual audit of the plan's financial statements and certain required schedules contained in the annual report.

Labor's Inspector General has expressed concern that IPA audits are not as effective as they could be in ensuring the financial soundness of employee benefit plans because (1) substantial plan assets can be excluded from audit coverage, (2)

auditors are not required to test for compliance with ERISA, and (3) violations, if found, are not reported to Labor for enforcement action.

In response to the Inspector General's recommendations, Labor recently proposed two legislative changes in ERISA's audit requirements--to eliminate limited scope audits and to require auditors to obtain peer reviews. Labor is also working with the American Institute of Certified Public Accountants (AICPA) to develop procedures on compliance testing and direct reporting of violations to regulators.

Labor's proposals for strengthening audit requirements, as well as requiring plan management to report on internal controls and compliance with laws and regulations, should improve ERISA oversight and enhance the security of participants' benefits. Additional recommendations for improving ERISA oversight may result from our current review of IPA audits of employee benefit plans.

The Need for Full-Scope Audits

ERISA allows plan administrators to exclude assets that are held by regulated financial institutions, such as banks and insurance companies, from the scope of IPA audits. Instead of examining the financial institution's records, the auditor can, by regulation, accept the institution's certification that the

statement of assets received by the plan is accurate. As a result, significant amounts of plan assets are not audited. The Inspector General recently found that nearly half the IPA audits it reviewed had such a scope limitation.

Labor has proposed amending ERISA to repeal the limited scope exemption. Although we have not evaluated the specific details of the proposal, we agree that full-scope audits should be required for employee benefit plans.

Internal Control and Compliance

Labor is working with the AICPA in its revision of the industry audit guide applicable to ERISA audits to clarify and strengthen audit requirements concerning internal controls and compliance with ERISA. We believe strengthening plan management's reporting requirements should also be considered.

Plan administrators should be responsible for establishing sound internal controls and complying with ERISA and regulations. We have long advocated management reporting requirements that assess the effectiveness of internal controls and compliance with laws and regulations. Accordingly, we believe that as a part of the annual independent audit of financial statements, the auditor should be required to report on plan management's assertions regarding the effectiveness of its internal control structure and

compliance with laws and regulations, in addition to issuing an opinion on the financial statements.

We believe that requiring the auditor to review and publicly report on plan management's report on internal controls, including controls for compliance with laws and regulations, significantly enhances the reliability and credibility of the report and results in improved internal controls.

Our opinion on the need for management reporting and auditor review is driven by three fundamental beliefs.

First, the federal government, as insurer of defined benefit pension plans, faces a significant potential liability should plans with large unfunded liabilities terminate. Requiring auditors to review plan management reports would help protect the federal government's interests and ensure that plans maintain strong internal controls, adhere to laws and regulations, and properly report their financial condition.

Second, plan administrators have a fiduciary responsibility to operate plans in the best interests of plan participants. Requiring plan administrators to report to the regulators on their responsibilities for establishing and maintaining an effective internal control structure, including controls for compliance with laws and regulations, and on the effectiveness of

their internal controls would help ensure that controls are being maintained.

Third, the accounting profession has a responsibility to protect plan participants, and the government's and the taxpayers' interests, when auditing an employee benefit plan. Therefore, the profession should take a proactive role in assisting plans and the regulators in identifying, preventing, and correcting problems in financial reporting and internal controls. Because regulators have come to increasingly rely on "off-site" monitoring using reported financial information, it is imperative that this information be accurate, comprehensive, and reliable. The accounting profession is in a unique position to provide this assurance.

Direct Reporting

Given the potential liability to the government as an insurer of defined benefit plans, we believe that Labor should be informed, particularly of major fraud or serious fiduciary violations, directly and promptly. The plan administrator should be responsible for reporting violations identified by the auditor to Labor. However, the auditor should report the violations if the plan administrator does not fulfill this responsibility.

Peer Review

Labor has proposed that IPAs obtain a peer review every 3 years to be qualified to conduct ERISA audits. Currently, not all IPAs performing ERISA audits must undergo peer reviews. Peer review is essentially the verification by other accountants that an accountant or firm has a system of quality controls that provides reasonable assurance that audits are conducted within established standards.

The peer review program is the cornerstone of the accounting profession's quality assurance mechanism. Because the federal government is exposed to potentially tremendous losses from its pension insurance program, serious consideration should be given to requiring mandatory peer reviews for all auditors of insured plans.

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Mr. Chairman, this completes my statement. I would be happy to answer any questions at this time.