

# **Are Your Pensions Safe? Who are the Watchdogs?**

**A Forum Hosted by**

**Vincent C. Ross Institute of Accounting Research  
NYU Stern School of Business**

**December 7, 2006**

*Research/Reporter: Claire Eckstein, PhD, CPA*

Dean Thomas Cooley provided the welcoming remarks applauding Professor Seymour Jones and Mark Lilling for their ongoing efforts in convening esteemed panelists to discuss the timely and important issues that are of deep concern to our community. In the 90's Dean Cooley wrote a research paper entitled, "*Will Social Security Survive the Baby Boom?*" His unvarnished response at that time? "No". Dean Thomas Cooley's response to the question of the day, "*Are your pensions safe?*"—was-- again, "No". The Dean believes that pension reform is one of the major issues that need to be addressed, and was looking forward to hearing what the incredibly distinguished panel was going to tell us.

Seymour Jones, Associate Director of the Ross Institute and Clinical Professor of Accounting, cited inadequate funding and corporate deficiencies for what appears to be an epidemic of broken promises and subsequent loss of retirement security. He suggested that before we can find solutions, we must first understand the evolution of the current crisis. Professor Jones' sequencing of speakers provided the audience with a "where are we?....how did we get here?....what is being done?....what else can be done to get us out of this mess?" informative and lively discussion.

\*\*\*\*

Mark S. Lilling (BS '72), Chief Executive and Managing Partner of CPA firm Lilling & Company LLP, and founder of the Audit Committee Consulting Team LLC, argued that we have a social responsibility to provide retirement income, and as people live longer, the need will rise. Mr. Lilling expressed concern over the increased flow of pension-plan dollars into hedge and private-equity funds, currently permitted under the newly enacted Pension Protection Act of 2006. These funds are, in general, riskier and subjected to less regulation than publicly traded securities. The fact that these funds have no ready market, creates an additional concern related to *liquidity* constraints.

In 2004, Department of Labor (DOL) audit records report 75,000 pension plans totaling \$4.5 trillion. "Who are the Watchdogs?" Primary in the *watchdog hierarchy* are the trustees whose reports are the foundation upon which the *chain of reliance* is built. This chain links auditors, regulators, sponsors, beneficiaries, etc. "Who is watching the Trust Companies?" Has the title "Trust" lulled us into complacency, and thus created a situation where trillions of dollars are not audited. How secure is a chain built on a faulty foundation? With the decline of defined-benefit plans, and the increase of 401-K plans that place the investment risks and benefits on the individual, Mr. Lilling stressed that it is more important than ever to secure the foundation upon we have relied, and revisit the issue of "limited scope" audits.

\*\*\*\*

Michael E. Auerbach, CPA, Chief of Division of Accounting Services, US Department of Labor (DOL), provided participants with an overview of the fiduciary role of the DOL in the enforcement of ERISA. ERISA requires audits of plans with 100 or more participants. The DOL Office of Inspector

General has reported a steady decline in audit quality deficiency rates. Actions taken to reduce deficiencies have included the creation of the Office of the Chief Accountant by the Employee Benefits Security Administration (EBSA), and an outreach program with the accounting profession to improve guidance and technical materials. DOL attempts to get Congress to pass legislation to eliminate the limited scope audit have thus far met with failure.

A two-pronged approach has been adopted to improve quality: A CPA Firm Inspection Program and an Augmented Workpaper Review Program. The CPA firm inspection is similar to PCAOB inspections. The workpaper reviews focus on firms performing a small number of EBP audits. Although the Office of the Chief Accountant was created for the sole purpose of improving audit quality, it has a staff of 13 auditors, responsible for the review of 75,000 plans.

Another problem is that the distribution of the 10,000 independent CPA firms that audit pension plans is highly skewed.<sup>1</sup> This questions the expertise of auditors with limited experience. The percentage of DOL “limited scope” audits (63%) are within the range (56%) of the dollar value of all plan assets. Audit deficiencies were approximately the same for single or multi-employer plans. However, the workpaper reviews of the AICPA EBP Audit Quality Center members had significantly fewer audit failures.<sup>2</sup> Actions taken by the DOL on audit deficiencies include notification to the AICPA’s Professional Ethics Division, and State Boards of Public Accountancy.

\*\*\*\*

John Biggs, Former Chairman TIAA-CREF, currently an Executive-in-Residence at NYU, told participants that of the \$14.5 trillion of assets invested in pension plans at the end 2005, only \$4.5 trillion were subject to audit by the DOL. The bulk of pension assets are invested in IRA’s that are neither audited, controlled nor regulated by the employer or government. Where once the three-legged stool of financial security was equally balanced by government, employer and family—there has been a dramatic shift to the weight of family responsibility.

Federal regulation in the form of ERISA introduced IRA’s, was favorably biased towards defined contribution plans, while providing punitive measures for defined-benefit plans (DBP). The new Pension Protection Act has furthered this bias and the demise of DBP. None the less, legacy DBP will be around for a long time and Mr. Biggs believes that the problems of how to account for DBP on the financial reports is of far greater concern than funding provisions.

In order to provide some measure of security for the future, it would be of utmost importance to educate the public of the need to start contributing to their pensions at a young age. He warned that the current trend of taking lump-sum payouts upon retirement opens a Pandora’s Box. The trusting retiree may provide an easy target for a friend, relative, or opportunist. It would be both wise and prudent for the government to undertake an educational campaign urging both savings and the importance of retirement annuities. The prospect of individual responsibility for managing assets and securing their retirement income caused Mr. Biggs to quote, “*We have met the enemy, and they are us*”.

\*\*\*\*

Joshua Livnat, NYU Professor of Accounting addressed the audience “*wearing the hat of entrepreneur/concerned citizen*” rather than as an academic scholar. Professor Livnat is a co-inventor of a financial product for pension planning. In his research of “How do employees manage their own funds?” he found that one-third of individuals offered defined contribution plans [DCP] do not enroll.

---

<sup>1</sup> 1,000 audits (74% of plan assets) are performed by six auditors; 8,200 perform 5 or fewer audits.

<sup>2</sup> A complete report with detailed statistics and informative brochures are available at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

Individuals who manage their own pension funds (17%), prefer the safety of money market funds. These funds have not kept up with inflation. Additionally, opting out of employer-sponsored plans, results in a loss of both tax benefits and employer matching. Professor Livnat suggests investing in life-cycle type funds. These funds are designed for reaping the benefits of the risk/reward tradeoff early in the life cycle, with more secure investments after the age of 50. The average balance in DCP is the equivalent of one-year's salary per single employee. Not a comforting thought.

\*\*\*\*

Kenneth Dakdduk, Partner PriceWaterhouseCoopers, presented an overview of how the financial reports prepared under the current requirements can be used to assess the safety of pension benefits. The overview included the funding and measurement of the obligation, the assessment and performance of plan assets, and the need to observe behavioral patterns.

Is the Obligation Funded? As of 12/31/2006 balance sheets will report the funded status as either an asset (overfunded) or a liability (underfunded). Footnote disclosures identifying asset categories are useful in assessing the plan assets, as are the narrative discussions of investment policies and strategies, risk management practices, percentage of employer securities in the plan, dividend patterns, the expected versus actual returns history and plan restrictions.

In order to measure the obligation, it is necessary to understand the key assumptions used to measure the benefit obligation: The expected return, discount rate, salary progression rate, and industry rates for comparison. The pattern of behavior can be analyzed by reviewing past or planned benefit modifications, explanations thereof, and disclosure of contingencies. The recently promulgated GAAP, in conjunction with the new requirements of the Pension Protection Act, will enhance the ability of analysts to assess the safety of employee pension benefits. The new Act, which among other things limits benefits, lump-sum payments and freezes accruals when funding falls below a prescribed percentage, will be a major factor in the future of employer-sponsored retirement plans.

\*\*\*\*

Michele M. Weldon, Audit Business Advisory Service Partner. PWC, provided participants with a *Plan Auditor's Viewpoint* of "Are Your Pensions Safe?" Ms. Weldon was in full agreement with the concerns presented by others relative to limited scope audits. However, she pointed out that these audits were authorized under ERISA when the majority of plans were DBP, with "plain vanilla" assets invested in regulated industries, e.g. banks, that had sophisticated and accurate pricing systems.

The increased popularity of DCP plans and the continued growth of derivatives, hedge funds, and private equity – has resulted in an inability to report plan assets at *fair market values*. She also finds that custodians are not doing due diligence to make sure their assets are being properly valued, and that there is an over reliance on service providers. Problems include the following:

- Plan sponsors are failing in their fiduciary responsibility to monitor the service providers.
- Trust companies are basing their certification on record-keeping reports of participant's accounts and trial balances prepared by service providers.
- Plan sponsors don't always take ownership of financial/Form 5500 reporting.
- Assets held by more than one custodian are listed as one fund on the financial reports.

Ms. Weldon expressed concern that the spiraling cost of audits is leading to selection of auditors based on *fee* instead of *expertise*.

\*\*\*\*

Christopher J. Sues, Employee Benefits Partner, Pryor, Cashman, Sherman & Flynn, addressed the issue of pension safety from the legal point of view. The enactment of ERISA established the watchdogs and gatekeepers with respect to protection of pension rights: the DOL, IRS, and the PBGC. Historically, it is the IRS that has granted funding waivers to floundering companies, but it is the PBGC, the guarantor of benefits, that has born the cost when these companies have declared bankruptcy.

Annual filing requirements include notification to participants of underfunding, material modifications, reduction in rate of future benefit accruals and intent to terminate. Mr. Sues also highlighted some of the effects that corporate transactions, e.g. dispositions and acquisitions, had on defined benefit plans. These included, but were not limited to, freezing future accruals and terminations. The fact that it is the employer who is held to fiduciary expert standards with respect to investments, questions the role of investment managers. Although the spotlight has been on “underfunding of pensions”, Mr. Sues provided insight into the many other factors involved in the ability of companies to provide meaningful pension benefits for their employees.

\*\*\*\*

Diane Oakley, Legislative Assistant, Office of Congressman Earl Pomeroy had the opportunity to be “last but not least”. She filled in the gaps, wrapped up loose ends, and then proceeded to provide participants with a congressional *insider view*. Ms. Oakley asked the question that is on everyone’s mind, “Will my money be there for me?” Are the investments sound? Can people afford to save? Is Congress passing a law? Does Congress know what they are doing?

Congress cannot predict the outcome of the pension legislation. They do not have past data to use for making predictions. How many plans will be frozen? How many plans will be terminated? At this point in time no one has the answers. No one in Congress is making predictions. It came as a shock to be told that the amount of time we had spent in today’s Forum, exceeded the amount of time Congress spent debating the issue of pension safety on the *floor*.

Billions of dollars of work-place benefits related tax breaks are being lost as we move towards a “*you are on your own (yoyo) society*”. The American economic sense of instability, job loss, etc. is 2.5 times what it was in 1983. It is a fact that the new funding rules will create earnings volatility. What remains unknown at this time is the effect the volatility will have on the future of pension benefits.

“How safe is my pension?” According to GAO audits, there is only a 10% chance that the PBGC will have the money to get through to 2020. Premiums are being raised and latest figures coming out showed a \$5 billion improvement in the deficit. The answer to the question of “How safe is my pension?” .....only time will tell.