

Defined Benefit Pension Fraud: A Ticking Time Bomb

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In the midst of the recent economic meltdown and the corporate financial scandals related to accounting irregularities, insider trading and Congress' reaction to the same through the adoption of the Sarbanes-Oxley Act of 2002, there may be a new financial time bomb waiting to explode – pension fraud (Byron, 2005). There are many different kinds of pension fraud, but the type most likely to have significant adverse systemic consequences on an already strained national economy involves under-funding by employers of defined benefit pension obligations through two distinct types of fraud: nondisclosure and misrepresentation. This paper seeks to present a primer on the laws that regulate defined benefit plans, the problems presented by the understaffing of the Employee Benefits Security Administration and the under-funding of and lack of oversight by the Pension Benefit Guaranty Corporation, and the potential for escalating pension fraud in today's troubled corporate environment and depressed financial markets.

Seventy-eight million Americans were born between 1946 and 1964, and the first of these baby boomers turned 62 and became eligible to receive not only Social Security but also other private retirement benefits last year (2008). Because of the size of this population and the recent free fall of the stock market, the possibility of pension fraud and pension failure on the corporate level could directly impact not only employees but also market investors, and these negative

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consequences could join the myriad of recent financial crises, impacting the market sooner than later.

I. Regulation of Defined Benefit Pension Plans

Defined benefit pension plans are governed pursuant to federal laws and regulation, which are administered by particular federal agencies with varying responsibilities. In particular, defined pension benefit plans must meet the requirements of the Internal Revenue Code (IRC), the Employee Retirement Income Security Act of 1974 (ERISA), and the Pension Protection Act of 2006 (PPA). This most recent legislation, the PPA, has been called the most significant pension legislation since the passage of ERISA in 1974. In particular, the PPA requires companies which have under-funded their pension plans to pay higher premiums to the Pension Benefit Guaranty Corporation (PBGC), a government agency that provides insurance to underfunded or failed defined benefit plans, and extends the requirement of providing extra funding to the pension systems of companies that terminate their pension plans (Mingione, 2007). In addition, by adding a requirement to the qualified plan rules under the Internal Revenue Code, plans must be fully funded each year and any shortfall as of the end of 2007 must be funded over a period of not more than seven years (IRC §430). In a White House press release, George W. Bush indicated that by signing this bill he was sending a clear message to corporate America that it must keep its promises to its workers. He also indicated that this bill is necessary to secure retirement benefits for American workers given the fact that entitlement programs are projected to grow faster than the economy, faster than the population, and faster than the rate of inflation (Fact Sheet, 2006).

Importantly, the additional requirements set forth in the PPA penalize companies for under-funding their pension plans prior to the failure of the plans. Previously, the under-funding

problems continued to snowball until the employers had to terminate the plans. Since 2001, no less than eight major U.S. corporations have defaulted on their pension obligations by turning them over to the PBGC.¹ Requiring employers with under-funded plans to pay additional premiums increases the funding for the PBGC, which many people fear will face bankruptcy years down the road due to the increased dumping of pension plans by employers.

The PPA also requires companies to more accurately analyze their pension plans' obligations. It closes loopholes that previously allowed some companies to under-fund their plans by skipping payments, and it raises the cap on the amount employers are allowed to invest in their own plans (Mingione, 2007). Drafters of the PPA intended to increase disclosure requirements and close loopholes found by employers funding private pension benefit plans, and perhaps unwittingly fueled compliance pressures that could increase the risk of "earnings management" practices by already troubled corporations.

Department of Labor/Employee Benefits Security Administration (EBSA)

The Department of Labor became involved in the regulation of employee benefits plans upon passage of the Welfare and Pension Plans Disclosure Act in 1959 (WPPDA) (Department of Labor, 2008). Upon the enactment of ERISA in 1974, the Department of Labor became responsible for administering and enforcing fiduciary, reporting and disclosure requirements. Additionally, the Department of Labor created the Pension and Welfare Benefits Administration (PWBA), which changed its name in 2003 to the Employee Benefits Security Administration (EBSA), and assigned it the responsibility of ensuring compliance with Title I of ERISA. Accordingly, it is primarily the function of the EBSA to promote voluntary compliance, facilitate

self-regulation, and work diligently to provide quality assistance to plan participants and beneficiaries (Department of Labor, 2008).

Unfortunately, there are numerous criticisms about the effectiveness of EBSA oversight. These criticisms include allegations that the EBSA is largely reactive in its enforcement of plans, that it focuses primarily on fiduciary breaches rather than compliance violations, and that the agency itself is grossly understaffed (Bridgeford, 2008). In fact, the EBSA employs only 385 compliance officers to oversee more than 3.2 million benefit plans, whereas agencies like the SEC have close to 2,000 investigators to monitor some 17,000 investment professionals and companies (Bridgeford, 2008).

Pension Benefit Guaranty Corporation (PBGC)

The Pension Benefit Guaranty Corporation is an independent agency of the United States government that provides insurance to under-funded, terminated defined benefit pension plans. Title IV of ERISA created the PBGC in response to the growing number of failed private pension plans. The role of the PBGC is to encourage the continuation and maintenance of voluntary, private defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at the lowest level necessary to carry out its operations (*see generally* www.pbgc.gov).

Many sources of revenues fund the PBGC, which include insurance premiums paid by employer sponsors of defined benefit pension plans, assets from pension plans it takes over, recoveries of unfunded pension liabilities through bankruptcy, and investment income. The PBGC currently operates without funding from federal tax dollars, and there is a real risk in an unstable economy that the PBGC may face bankruptcy in the future if there is a wave of failed

pension plans resulting from underfunding. When the PBGC takes over a plan it becomes frozen, which means that no additional benefits accrue and no additional employees are covered (Kilgour, 2007). Assuming the PGBC has the resources to cover the failed funds, there are still costs to numerous beneficiaries, including highly compensated employees (the annual cap on payout by the PBGC is \$49,500), employees who have chosen to retire early, and midcareer participants whose frozen pension plans will be eroded by inflation (Kilgour, 2007).

In recent years, the gap between the PBGC assets and its obligations has grown significantly, with some experts predicting an \$87 billion deficit by 2015 (Boerner, 2006). The PBGC has recently been under attack for its lack of skepticism regarding the 4,000 failed pensions it accepted, in particular its non-action in response to the failure of any of the pensions it took over. Experts have called for federal forensic investigations of failed plans to learn more about rooting out fraud and abuse and to create a plan for correction (Butler, 2006, p. 2).

The FASB and Statement No. 158

The accounting for pension plans and other post-retirement benefits has changed dramatically. Initially companies did not report any liabilities for these amounts and simply recorded the costs of post-retirement benefits, including pensions, as they were paid. This may include payments to the pension trust or the payment of health insurance benefits for retirees as examples of these types of payments. In 1985, the Financial Accounting Standards Board (FASB) issued Statement No. 87 which required companies to use a standardized method for measuring net periodic pension cost, to recognize the liability (the minimum liability) associated with the accumulated benefit obligation if that exceeds the fair value of the plan assets, and to provide additional disclosures to provide more complete and current information for users of the

financial statements (FASB Stmt No. 87, Summary). In 1990, FASB Statement No. 106 required very similar treatment for post-retirement benefits other than pensions. The disclosure requirements for both pensions and other post-retirement benefits were updated and standardized by FASB Statement No. 132 in 1998.

The above reporting requirements have significantly increased the information available to market investors. Further, in 2006, Statement No. 158 was issued. According to the summary of the statement, the reason for the statement is that the Board believed information about the funded status of pension plans was not being communicated adequately (FASB Statement No. 158, Summary, p. 2). Companies were required to report the annual cost of the pension plan but were not required to report information about other changes to the funded status of the plan except in the footnotes. Specifically the new Statement requires that gains or losses and prior service costs or credits arising during the period must be recognized as a part of comprehensive income in the year in which they occur. The Statement also requires that the assets and obligations of the plan be measured at the date of the financial statements (FASB Statement No. 158, Summary, p. 1). The changes required by Statement No. 158 took effect by December 15, 2006 for publicly traded companies and June 15, 2007 for non-publicly traded companies (FASB Statement No. 158, Summary, p. 4).

One important point to note is that the financial reporting rules do not require any given level of funding or a “funded” status for a pension plan as does the requirements in the Internal Revenue Code. The financial reporting requirements only address how the status of the plan will be reported to investors in the financial statements. If the plan is severely underfunded and the employer does not make the required minimum contributions, the plan may lose its qualified status under the Internal Revenue Code (which, in turn, would cause the loss of significant tax

benefits) but as long as the financial statements clearly reflect the underfunding and the extent of the liability, no misrepresentation has occurred.

II. The Potential for Manipulation of Reports of Defined Benefit Pension Funding

Despite the extensive laws and the concurrent oversight regulation of no less than three federal administrative agencies, defined benefit pension fraud exists in the public sector² and in corporate America today. Unfortunately, many market investors think defined benefit pension fraud only affects the beneficiaries of employee benefit plans; however, the wake of the problem reaches far more people than just the beneficiaries. Market investors rely on financial data prepared by management of publicly traded companies. Therefore, if management intentionally understates its defined benefit pension obligations, it fraudulently misstates the financial position of the company. The reason behind this analysis lies in the fact that an intentional understatement of its defined benefit pension obligation also understates liabilities and expenses, subsequently overstating both net assets and net income.

The potential for fraud in the defined benefit pension area is largely based on the estimates and assumptions required for reporting pension obligations and cost in the financial statements. Companies are required to report the difference between the projected benefit obligation (PBO) and the value of the plan assets as a liability on the balance sheet.³ The PBO is defined as:

The actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered prior to that date. The projected benefit obligation is measured using assumptions as to future compensation levels if the pension benefit formula is based on those future compensation levels... (FASB Statement No. 87, as amended).

The measurement of this PBO requires estimates and assumptions. Actuaries must use estimates of how long employees will work for the company and what their future compensation will be. This means taking into account expected departures, early retirements, death, disability, etc. In estimating the payments that will be made after retirement, actuaries must use estimates of the life expectancy of the employees and/or their survivors, and any future changes in Social Security if the benefits formula relies in part on Social Security benefits available to the retiree.

The pension expense each year includes the amount of the pension liability attributable to the work performed by the employees during the current year. To calculate this amount, actuaries must use the above to determine what the PBO is after the employee's retirement. This amount is then adjusted to reflect its present value. The present value calculation requires the use of a discount (or interest) rate. According to the accounting standards, this rate must be reasonable and should be estimated with consideration for rates used for pricing annuity contracts that could settle the obligation and/or rates of return on high quality fixed-income investments currently available (FASB Statement No. 87, 12).

After the present value of the PBO is calculated, this amount is reduced by the expected return on the pension fund assets. As companies fund their pension trusts, those assets are invested so that the earnings on those assets can be used to help pay the pension obligation. Each year, management will estimate the rate of return that assets will earn between the current date and the date the obligation becomes payable. The expected earnings for the current year are then used to reduce current year pension expense.

As shown above, the reported pension amounts in the financial statements are subject to a significant number of estimates and assumptions. Actuaries calculate the pension liability, but most of these estimates and assumptions are provided to actuaries by management. In addition,

the estimates require specific information from management about the workforce demographics, e.g., number of employees, age of employees, gender makeup, etc., which provide additional opportunities for manipulation.

The subjectivity of the pension obligation calculation is what presents the potential for manipulation. Even though these assumptions (i.e. discount rate and rate of return) for public companies are evaluated by an actuary and then “reviewed” by the SEC as well as external auditors, the data provided for these assumptions are decided upon by management, thus allowing the opportunity for manipulation. Even small changes in these assumptions may cause significant changes in the reported numbers. Kieso et al. (2008) indicate that “a 1 percent decrease in the discount rate can increase pension liabilities 15 percent”. In 2005, reports indicated that GM’s pension plan was underfunded by as much as \$13 billion, or as little as \$12.3 billion (Adams, 2005). The difference is in different accounting methods used for the estimate (Adams, 2005). And in years 2000 and 2001, nearly 5 percent of IBM’s income before tax was the result of a 0.75% increase in the assumed rate of return on its pension assets. Without this change, the income growth would have been 5.6% rather than the reported 6.7% (Bergstresser, Desai and Rauh, 2006).

While many companies use a “best” estimate of the items required for these calculations, companies interested in manipulating the reported obligation and expense have the ability to do so. Potential fraudulent activity could range from choosing a discount rate or estimated growth rate for assets that, while “acceptable”, at least to former SEC scrutiny, is not reasonable for a variety of obvious reasons, to intentionally misrepresenting the information about the covered workforce. Another questionable tactic seems to be the use by some companies of Chapter 11 of the Bankruptcy Code to get rid of the obligation for underfunded pension plans at the expense of

their employees (Adams, 2005). Companies cited include US Airways, Huffy, Big Bear, United Airlines and Delta Airlines.

Recently, the Wall Street Journal (Schultz & Francis, 2008) highlighted a new initiative by some companies to move hundreds of millions of dollars of executive benefit obligations into the pension plans for their rank and file employees (2008, p A1). Companies which reportedly used this practice include Intel Corp, Centurytel Inc. and Consolidated Freightways. Companies are not required to contribute cash to the plan to fund these additional benefits when they are transferred into the plan, as long as the assets already in the plan are significant enough to result in adequate funding of the combined obligation. The potential weakening of the pension plan's funding position and the potential loss to rank and file employees could be significant.

III. Application of the Fraud Triangle

Given today's recent and dramatic economic downturn, the significant disclosure requirements of the PPA and their corresponding effects on reported corporate earnings, and the failure of governmental agencies to match policing efforts with disclosure requirements, the potential for defined benefit pension fraud is significant.

One of the leading predictors of fraudulent behavior is Donald Cressey's fraud triangle (Wells, 2005). An application of the fraud triangle to the current circumstances affecting financial reporting of pension fraud obligations supports that conclusion that all of the ingredients for a massive fraud on the market are present.

The model of the fraud triangle was developed by Cressey, a criminologist, as a way to explain why "good" people commit fraud. According to Cressey, there are three factors that must be present in order for an individual to commit fraud: opportunity, perceived need and rationalization (Wells, 2005). Opportunity can be related to both access and risk of detection. A

fraudster must not only have the means to commit the fraud, but also the perception that detection is unlikely for the opportunity element to be satisfied. Perceived need relates to some financial problem that the fraudster is unable to solve through legitimate means, such as the need to meet earnings to sustain investor confidence. Often the fraudster feels pressure to resolve the problem so as to avoid some sort of shame, embarrassment or disgrace. Finally, the last element of the fraud triangle is rationalization, which is the way in which the fraudster is able to justify the fraud so as to make it an acceptable or justifiable act. This three-pronged framework is used by CPAs and other fraud professionals as a tool to understand and manage fraud risks and has been formally adopted by the profession as part of Statement on Auditing Standard 99 (Wolfe, 2004).

Potential Defined Benefit Pension Fraud: Opportunity

Despite the comprehensive nature of ERISA and the enforcement tools of numerous governmental agencies, defined benefit pension fraud fails to be adequately identified, monitored and corrected. In response to the problems associated with pension regulation enforcement, “two federal lawmakers are calling for an investigation of the agencies that oversee the plans, claiming the government could do more to ensure pension plans operate lawfully” (Butler, 2006, p. 1). Yet despite calls for oversight and reform, the PBGC has yet to conduct a single audit to try to determine the cause of the more than 4,000 failed pension plans it has been required to bail out. Further, the EBSA, which is the primary enforcer of pension law compliance, is also grossly under-staffed and most likely under-funded. Thus, the lag in enforcement activity should not be surprising. At best, the EBSA may be reactive in its enforcement approach, but even then the risk of detection, given the ratio between the EBSA’s resources to obligations, is slim. This lack

of oversight by both the EBSA and the PBGC could lead a would-be fraudster to believe that pension fraud stands a good chance of success in today's enforcement environment.

According to the Government Accountability Office, the EBSA should conduct random compliance inspections, publicize the results of its investigations, and litigate violations in order to have any sort of deterrent effect on pension fraud (Bridgeford, 2008). One example of the EBSA's recent success was a \$5 million judgment against a Tennessee mining company whose CEO was taking pension assets and investing them in other business endeavors, but unfortunately successes like this are too few and too unknown to the general public to have any real deterrent effect (*see* Bridgeford, 2008).

Potential Pension Fraud: Perceived Financial Need

An important point about perceived financial need is that the need is in the eye of the potential fraudster. Often, the fraudster perceives a need which others do not see as important. For example, a manager may view material wealth as a personal need and based on that need will misrepresent the financial statements of the company to increase the stock price. In this way, the value of the manager's own stock rises and gives him/her the material wealth that he/she "needed." It is not necessary that the financial need be perceived as a need by anyone other than the potential fraudster.

Managers responsible for reporting pension plan obligations may feel pressure to misrepresent the outstanding unfunded liabilities to avoid the significant negative consequences associated with such a disclosure, especially given the likely consequences of PPA compliance on an already troubled corporate balance sheet. This could be achieved in a variety of ways, including a misrepresentation of asset growth or participant demand. The disclosure of a large

unfunded pension liability, especially in the current chaotic economic times, could dramatically decrease annual earnings and negatively impact the company's stock price, which may then affect the manager's performance evaluation and job, as well as his/her own personal wealth if the manager is heavily invested in the company. This disclosure could also further compromise a company's growing difficulties in the ability to borrow funds for operations and may even cause the company to violate loan agreements, which require that liabilities be kept at certain levels.

Another potential motivation for managers is the desire to remove the volatility from reported earnings or hit earnings expectations. Defined benefit pension plan reporting has been called a fertile area for earnings management (Bergstresser, Desai, and Rauh, 2006). In a speech given in 1989, Arthur Levitt, then Chairman of the Securities and Exchange Commission (SEC), called earnings management widespread and too little-challenged (Levitt, 1998). Chairman Levitt expressed concern that managers were so motivated to meet Wall Street earnings expectations that common sense business practices would suffer. He also feared that “[m]anaging may be giving way to manipulation; [i]ntegrity may be losing out to illusion” (Levitt, 1998, ¶ 6). One of his major concerns was the misuse of the concept of materiality. He cited situations where known errors were intentionally recorded but were not corrected because the errors were “immaterial” (Levitt, 1998, Materiality ¶2).

Significant evidence exists to support the use of pension plan reporting to manage earnings. Mulford and Comiskey (2002) specifically list pension actuarial assumptions as one of the targets of earnings management techniques or activities (p. 65). In a 2006 study, Bergstresser, et al., describe pension assumptions as a simple mechanism for managing earnings (p. 157) and provide evidence to support management's opportunistic use of pension plan assumptions to manage earnings. For example, in 2003 SBC Communications, Inc. reported a \$693 million

decrease in earnings by making three changes in its pension calculation assumptions. It lowered expected return by one percentage point, raised the assumption of health-care cost inflation by one point and lowered their estimate of future interest rates by just 0.75 percentage points. (Borras et. al., 2004).

Based on a historical study of returns in the equity and bond markets, the SEC indicated in December 2002 that rates of return above 9% (suggesting perhaps that only rates of return exceeding this estimate) would be scrutinized and the company would be required to show why this rate is appropriate (Borras, et al., 2004). In today's economic environment, an annual 9% return on investment would, in most instances, be pure fiction, but there is no word yet as to whether the SEC has modified its oversight standards to reflect today's hemorrhaging financial markets. Given the extent to which a slight change in this rate, which is only one of the many assumptions used, can affect reported earnings, managers clearly have significant discretion to manage earnings.

Another potential "need" could be created by the PPA. The PPA does not affect the reporting of the pension liability but does affect its funding liability. This funding requirement could have a significant effect on cash flow for a company whose defined benefit pension plan is underfunded. Indirect effects of this funding requirement could include adverse effects on liquidity and other financial ratios, etc., which could cause the company to violate debt covenants. Managers, then, may be motivated to reduce the reported liability to reduce the amount of cash that must be deposited into the pension fund each year and to avoid other adverse consequences. While companies are not required to use the same assumptions and estimates for the calculations under PPA and FASB 158, the use of different assumptions and estimates would raise significant questions that would need answers and may indicate earnings management.

If the defined benefit plan is unfunded due to conflicts of interest or other wrongdoing which the manager is aware of or involved in, the manager may also fear the consequences of disclosure and act to cover-up the wrongdoing. The disclosure of the liability could quickly lead to questions which may uncover potentially unethical or illegal behavior, and could subject the manager and/or others to personal embarrassment as well as civil and/or criminal liability.

Potential Pension Fraud: Rationalization

Cressey's research indicates that fraudsters will rationalize their own behavior. A manager may rationalize understating the pension liability by convincing him/herself that the actions are for the good of the shareholders. The manager may rationalize that the understatement is a temporary solution to a short-term financial difficulty which will be corrected in the future. The manager may rationalize covering up illegal or unethical behavior by considering the costs to family, employees, and shareholders and concluding that disclosure would only hurt everyone else. The manager may also feel that the employees are being promised too much in post-retirement benefits so it does not matter if they get short-changed. The potential rationalizations are endless and only limited by the imagination and desperation of a manager who finds himself in a difficult situation.

IV. Conclusion

Given today's recent economic collapse, the significant new funding requirements of the PPA, the significant disclosure requirements of FASB 158 and the corresponding effects on reported corporate earnings and cash flows, and the failure of governmental agencies to match policing efforts with disclosure requirements, the elements of the fraud triangle, a predictor of

fraudulent behavior, are in place and the potential for defined benefit pension abuse is significant. Too often, as we have just seen with the sub-prime mortgage crisis and the collateralized debt fiasco as it was exploited too long by Wall Street barons, warnings indicating the potential for massive fraud and abuse have fallen on deaf ears. Both regulators and the accounting profession have failed to heed warnings in the past; therefore, all market watchdogs must be proactive in efforts to diffuse this new time bomb before it explodes. Failure to do so could further devastate the lives of millions of men and women whose retirement security depends heavily on defined benefit pension plans.

Although the proper underlying framework for preventing and detecting pension fraud exists, regulators need to increase efforts immediately. Proactive steps should include additional staff in the EBSA to monitor the 30,000 or more existing defined benefit pension plans. To avoid bankruptcy, the PBGC should investigate all failed pension plans, prosecute fraudulent misconduct, and recover assets where appropriate and possible. Government regulators and private sector auditors should exercise caution and diligently monitor defined benefit plans with professional skepticism. This is the best hope to stop yet another financial disaster from further wreaking havoc on investor confidence in an already devastated financial market.

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Footnotes

¹ Some of the PBGC's significant obligations include the pension failures of United Airlines, Bethlehem Steel, National Steel, U. S. Airways, Kaiser Aluminum, and Weirton Steel. (Kilgour, 2007)

² Because publicly administered pension plans are not covered by ERISA and the PPA and because pension fraud in the public sector does not directly affect the equity market, public pension plans fraud will not be directly addressed in this article. However, the widespread pension fund abuse in the public sector has caught the attention of the SEC, which recently warned that although public pension funds are not subject to the requirements of ERISA, they are subject to antifraud laws. (Plourd, 2008).

³ For most companies, the PBO exceeds the value of the assets, resulting in a liability. In cases where the value of the assets exceeds the PBO, the company will report an asset on the balance sheet.

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