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United States General Accounting Office
Washington, DC 20548

July 22, 2003

The Honorable Thomas M. Davis
Chairman
Committee on Government Reform
House of Representatives

The Honorable Danny K. Davis
Ranking Minority Member
Subcommittee on Civil Service and
Agency Organization
Committee on Government Reform
House of Representatives

The Honorable Dave Weldon
House of Representatives

Subject: *Thrift Savings Plan: Delayed Allocation of Failed System Development Costs to Participant Accounts*

The Thrift Savings Plan (TSP) is a retirement savings and investment plan for federal employees, governed by the Federal Retirement Thrift Investment Board (Board). The TSP is a defined contribution retirement plan[1] available to eligible federal employees. The TSP had about 2.6 million participants and held about $100.6 billion in Net Assets Available for Benefits as of December 31, 2001, and about 3 million participants and $102.3 billion in Net Assets Available for Benefits as of December 31, 2002.

In 1997, the Board awarded a contract to American Management Systems, Inc. (AMS) to develop and implement a new record-keeping system for the TSP. In 2001, after several implementation delays, the Board terminated the contract, and the Board's former Executive Director filed a lawsuit against the contractor on behalf of the TSP.[2] On June 20, 2003, 2 days after we provided a draft of this report to the Board for its

[1]Under a defined contribution plan, employees have individual accounts to which employers, the employees, or both can make periodic contributions. Defined contribution plan benefits are based on the contributions to and the investment returns (gains and losses) on individual accounts.

[2]The Executive Director who filed the related litigation resigned from his post on November 18, 2002.

review, a settlement between the parties was reached.[3] Then, on June 23, 2003, the net unrecovered cost from the system development failure was allocated to participant account balances as recommended in our draft report. While the loss has now been allocated to participant accounts, albeit on a belated basis, we believe there is value associated with issuing this product in response to the request to illustrate the operative principles and concepts that should govern allocation of costs in the future.

Since the TSP is an important component of retirement income for many federal employees, participants must be assured of proper accounting of their funds. Therefore, you asked us to examine federal oversight of the TSP and the TSP's accounting for its failed system development costs. Our report on federal oversight of the TSP was issued in April 2003.[4] This report addresses whether (1) the TSP's management followed U.S. generally accepted accounting principles (GAAP) in accounting for the costs associated with the failed development of the new record-keeping system and (2) the TSP should have allocated the costs to participants' accounts when the loss occurred.

Results in Brief

The TSP's write-down of $41 million in failed system development costs, as an expense on its 2001 income statement and balance sheet was consistent with GAAP. However, the decision not to allocate those costs to participant accounts at the same time was not consistent with the TSP's practice of allocating expenses on a monthly basis or with its accounting treatment of the expenses on the financial statements. In prior accounting periods, the TSP had recorded administrative expenses on its financial statements and reduced participant accounts for the expenses when incurred. The effect of not concurrently allocating the expenses attributable to the system write-down to individual accounts was that each then-existing participant account was overstated by a pro rata amount.

This differing treatment for financial statements and account balances resulted in aggregate reported TSP assets being $41 million less than the sum of individual accounts from the end of July 2001 through the most recent June 23, 2003, posting of the expense to accounts and allowed those who have withdrawn from the TSP since 2001 to not share in those costs. If the $41 million had been allocated to participants' accounts in 2001, the TSP expense ratios would, on average, have been approximately one-twentieth of 1 percent more—or about 41 cents per $1,000 account balance. Thus, the amounts chargeable to individual accounts would have been minimal—ranging from virtually nothing for new employees to roughly $400 for an account of $1 million.

The reason given by the Executive Director for not allocating the $41 million to account balances at the time of the asset write down was confidence that the TSP would prevail in the court action and that, in the final analysis, the TSP would not

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[3]The lawsuit brought by the Board is still pending before the U.S. Court of Appeals for the District of Columbia Circuit. While the parties have notified the Court that they have agreed to a settlement, as of July 16, 2003, the Court has not dismissed the case.

[4]U.S. General Accounting Office, *Federal Pensions: DOL Oversight and Thrift Savings Plan Accountability*, GAO-03-400 (Washington, D.C.: Apr. 23, 2003).

suffer any losses due to the system development failure. The TSP's former and current independent auditors reviewed and concurred with this treatment. Given uncertainties inherent in any court action and the fact that significant numbers of account holders enroll and depart annually, in our view, allocating the $41 million to account balances when the loss occurred would have been more prudent, as well as being acceptable treatment under GAAP. In particular, allocation at the time the loss occurred would have met two underlying concepts of accounting—consistency and conservatism.

Background

The TSP was authorized by Congress under the Federal Employees' Retirement System Act of 1986 (FERSA).[5] As of December 31, 2002, the Board reported that the TSP fund had approximately 3 million federal employee participants and $102.3 billion in Net Assets Available for Benefits, making it one of the largest retirement savings plans in the United States. The TSP is available to federal and postal employees, members of Congress and congressional employees, members of the uniformed services, and members of the judicial branch. The TSP provides federal (and, in certain cases, state) income tax deferral on employee contributions and related earnings. The TSP's assets and earnings on these assets generally cannot be used for any purpose other than providing benefits to participants and their beneficiaries, and paying TSP administrative expenses. From December 2001 through February 2003, approximately 720,000 new participants joined the TSP, while approximately 510,000 participants withdrew.[6]

In 1997, the Board awarded a contract to AMS to develop a new TSP record-keeping system to provide participants with the ability to make investment changes and to view updates of their account balances daily. Prior to the recent system upgrade announced in mid-June 2003, participants' interfund transfers could take up to 45 days to implement, and participants could only view monthly updates of their account balances. In July 2001, after numerous implementation delays and disappointing interim results, the Board terminated the 1997 AMS contract for development of the new system and awarded a new contract to a different contractor. At the time the contract with AMS was terminated, the TSP wrote off $41 million of its capital assets as a result of the failed system development. At the same time, a suit was filed on behalf of the TSP against AMS, seeking $50 million[7] in actual damages and $300 million in punitive damages. Then, AMS filed a contract termination settlement claim against the Board for improper contract termination

[5]Pub. L. No. 99-335, 100 Stat. 514 (1986) (codified as amended largely at 5 U.S.C. §8351 and §§8401 – 8479).

[6]Withdrawals from the TSP include withdrawal of funds upon retirements from the federal government, withdrawal of funds upon resignation from the federal government, and any other removal of previously contributed funds from the TSP.

[7]The $50 million in actual damages being sought includes $30 million in invoices paid to the contractor, $12 million in salaries and benefits paid for TSP staff and other contractors related to the system implementation, $9 million in other start-up costs of the system implementation, and less $1 million paid for off-the-shelf software that had future use to the TSP.

seeking $58 million in damages.[8] On June 20, 2003, 2 days after we provided a draft of this report to the Board for its review, a settlement was reached between the parties. The net result of the settlement required AMS to pay $5 million to the TSP, thus reducing the amount of the loss from $41 million to $36 million. On June 23, 2003, the $36 million was allocated to the participant accounts on a pro rata basis, based on respective investment fund balances.

The TSP prepares and reports its financial statements using GAAP. The TSP's annual financial statements are audited and have received unqualified or "clean" audit opinions since its inception in 1987. Statement on Auditing Standards No. 69 (SAS 69), *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* provides a definition of GAAP and discusses a hierarchy of guidance that is to be followed. The statement describes four categories of authoritative guidance, referred to as the GAAP hierarchy, which are listed in table 1.

Table 1: GAAP Hierarchy of Guidance

Category	Guidance
A (most authoritative)	• Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards and Interpretations • Accounting Principles Board (APB) Opinions • American Institute of Certified Public Accountants (AICPA) Accounting Research Bulletins
B	• FASB Technical Bulletins • Certain AICPA Industry Audit and Accounting Guides • AICPA Statements of Position
C	• Certain AICPA Accounting Standards Executive Committee Practice Bulletins • Positions of the FASB Emerging Issues Task Force
D (least authoritative)	• AICPA accounting interpretations and implementation guides • Other practices that are widely recognized and prevalent

Source: SAS 69.

In the absence of guidance in the four categories on a particular transaction, SAS 69 allows for consideration of other relevant accounting literature, such as FASB Statements of Financial Accounting Concepts; AICPA Issue Papers; and Federal Accounting Standards Advisory Board Statements, Interpretations, and Technical Bulletins.

Scope and Methodology

In order to determine if the TSP followed GAAP in accounting for the costs of the failed systems development and whether the costs should have been allocated to

[8]The $58 million in actual damages included $26 million of unpaid invoices and $32 million of other costs to close the contract.

participant accounts when the contract was terminated, we reviewed relevant laws and regulations, including FERSA and applicable federal regulations. We reviewed accounting guidance associated with accounting for defined contribution plans, systems development capitalization, and asset impairment, including Financial Accounting Standard 121 (FAS 121), *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*; AICPA's Audit and Accounting Guide, *Audits of Employee Pension Benefit Plans;* and Statement of Financial Accounting Concepts No. 2 (SFAC 2), *Qualitative Characteristics of Accounting Information*. We also reviewed the TSP's audited financial statements for calendar years 2000, 2001, and 2002; literature published by the TSP; and minutes of Board meetings. In addition, we interviewed officials from the TSP, the Department of Labor (DOL), and another defined contribution plan provider. We requested and received written comments from the Executive Director of the Board. These comments are discussed in the Agency Comment and Our Evaluation section and are reprinted in the enclosure. We conducted our work from January 2003 through May 2003 in accordance with generally accepted government auditing standards.

Accounting Treatment for System Write-Down Was Acceptable

The TSP's financial statement treatment of writing down the capitalized costs of its failed system development costs was consistent with GAAP. FAS 121 provides authoritative guidance (category A) for properly accounting for an impaired asset. FAS 121 requires that when the carrying amount of an impaired asset exceeds its fair value, the impaired asset must be written down to its fair value.[9] The difference between the asset's carrying amount and its fair value is to be recognized as an impairment loss and a reduction of income from continuing operations. Therefore, the TSP's write-down of the failed system development costs, by recording an expense of that amount and likewise reducing the asset value, was consistent with FAS 121.

At the time the systems development contract with AMS was terminated, the TSP had recorded a capitalized asset on its books for $65 million in systems development costs. This amount represented contractor invoices totaling $53 million and $12 million of internal development costs. Of the $53 million in contractor invoices, $23 million had not yet been paid and was reflected as an account payable. Upon contract termination, the Board rejected the $23 million in unpaid invoices and decreased the capitalized asset by the same amount, resulting in a residual recorded cost of approximately $42 million. This capitalized asset was considered impaired and written down from approximately $42 million to an estimated fair value of $1 million.[10] The $41 million write-down of the asset to its net realizable value was reported on the Statement of Changes in Net Assets Available for Benefits as a component of administrative expenses. Table 2 summarizes the systems development write-down that resulted in a $41 million impairment loss on the capitalized asset. While the write-down was not separately classified as an impairment loss, its

[9]FAS 121 defines fair value as "the amount at which the asset could be bought or sold in a current transaction between willing parties."

[10]The remaining $1 million represents a recoverable asset that the TSP determined, in conjunction with the new contractor, to be of future use. The asset is off-the-shelf software that was used by the new contractor in the system improvements.

inclusion in administrative expenses resulted in a reduction of income from continuing operations.[11]

Table 2: TSP System Development Write-down Resulting in $41 Million Impairment Loss on Capitalized Asset

Contractor invoices (paid at time of contract termination)	$30 million
Contractor invoices (not paid at time of contract termination)	$23 million
Internal cost of system development	$12 million
Original capitalized asset	$65 million
Less: invoices rejected	$23 million
Capitalized asset	$42 million
Less: estimated fair market value of capitalized asset	$1 million
Impairment loss on capitalized asset	$41 million

Sources: TSP and the 2001 Financial Statements of the Thrift Savings Fund.

At that time, these record-keeping system development costs constituted most of the TSP's recorded fixed assets. The write-down of the $41 million resulted in the TSP's total fixed assets being reduced from $50 million to $9 million. It also was a major cause of the increase in administrative expenses from $62 million in fiscal year 2000 to $106 million for fiscal year 2001.

Nonallocation to Individual Accounts Was Inconsistent with Prior Practices

The decision not to allocate the expenses related to the failed system development to participant accounts when the loss occurred was not consistent with the TSP's practice of allocating expenses on a monthly basis or with the accounting treatment of the expenses on the financial statements.[12] Under FERSA, the Executive Director is charged with prescribing regulations governing the TSP's allocation of net earnings, net losses, and administrative expenses to participants' accounts. In prior accounting periods, the TSP had recorded administrative expenses on its financial statements and reduced participant accounts for the expenses when incurred.

The effect of not concurrently allocating the expenses attributable to the system write-down to individual accounts was that each then-existing participant account was overstated by a pro rata amount, and was thus not the most conservative

[11]The TSP classified the $41 million impairment loss as administrative expenses on its financial statements since the amount was considered immaterial in relation to the TSP's total assets of about $100.6 billion.

[12]See 5 U.S.C. § 8439(a)(3) and 5 C.F.R. § 1645.4.

treatment available. Accounting guidance[13] we reviewed related to private pension plans and another defined contribution plan service provider[14] we contacted stated that the sum of participant accounts should be equal to total net assets. Under this approach, the TSP loss should have been allocated to accounts when the loss occurred. However, neither the guidance nor the other service provider offered any insights related to allocation of expenses when such expenses might be recovered as a result of pending litigation.

The decision not to allocate the expenses when the loss occurred, as was discussed with the Board and documented in the February, April, and May 2002 minutes of the Board meetings, was based on the belief that it was preferable to defer allocation until after the outcome of the pending litigation against the original contractor was resolved. The former Executive Director expected to prevail in the litigation and stated that expenses from the failed systems development would be netted against the anticipated recovery from the contractor. Nonallocation of these expenses was disclosed in the TSP Fund's 2001 financial statements, which received an unqualified audit opinion. In a June 2002 letter, DOL suggested that the TSP obtain competent advice concerning the propriety of the nonallocation procedure disclosed in the financial statements. The TSP requested that another external auditing firm review the accounting treatment; that firm reported in August 2002 that the treatment was reasonable.

We were unable to locate any specific guidance on the proper accounting treatment in cases for which expenses incurred by a defined contribution plan may be recovered through a pending lawsuit. The AICPA's Audit and Accounting Guide, *Audits of Employee Benefit Plans* (category B guidance in the GAAP hierarchy), which provides accounting and auditing guidance for private sector defined benefit and defined contribution plans, states that individual participants' account information "should necessarily be in agreement with the aggregate participant account information contained in the basic books and records." Applying this criterion, the $41 million should have been allocated to participants' accounts when the loss occurred. However, this guidance applies to private sector plans and not federal plans such as the TSP. Instead, under FERSA, the Executive Director is charged with prescribing regulations governing the TSP's allocation of administrative expenses to participants' accounts. We did not find anything in the guidance or the TSP regulations to suggest that the accounting treatment should be different depending on any unusual circumstances, such as situations involving pending litigation with a potential recovery.

Since this accounting event was unusual, we contacted another large defined contribution plan service provider to determine what it might have done in a similar situation. The large defined contribution plan we contacted has net plan assets of approximately $140 billion. The representative we spoke with explained that that plan had never been in a similar situation but that the plan allocates all expenses and investment gains and losses to plan participants daily. Most of this plan's expenses

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[13]The accounting guidance we reviewed included the AICPA's Audit and Accounting Guide, *Audits of Employee Benefit Plans*.

[14]The other service plan provider we contacted is also a large defined contribution plan with approximately $140 billion in net plan assets available for benefits.

are for services provided by third parties, and the plan remits payment for these services each day.

Notwithstanding the lack of specific guidance on the proper accounting treatment of allocating a loss to participant accounts in a defined contribution plan when there is a pending lawsuit with a potential recovery, financial accounting concepts suggest that the TSP accounting treatment was not applied in accordance with the accounting concepts of consistency and conservatism. According to SFAC 2, accounting treatment across accounting periods should be consistent in order to increase the informational value of accounting data. The decision not to allocate the administrative expenses related to failed systems development as the TSP had allocated all other administrative expenses when the loss occurred and in prior accounting periods was inconsistent. In addition, not allocating the loss to plan participants in 2001 was inconsistent with the financial statement accounting treatment.

SFAC 2 also addresses the concept of conservatism. The statement indicates that in determining the appropriate accounting treatment when there are uncertainties, the preferable method is one that does not overstate assets or understate expenses and therefore does not overstate operating results. By recording the loss on the financial statements, but not allocating administrative expenses related to the failed systems development, individual plan participants' assets were overstated and thus did not reflect the most conservative method of accounting. Given uncertainties inherent in any court action and the fact that significant numbers of account holders enroll and depart annually, in our view, allocating the loss to account balances when the loss occurred would have been more prudent, as well as being acceptable treatment under GAAP. In particular, allocation would have met two underlying concepts of accounting—consistency and conservatism.

Because these expenses were not allocated, the sum of all participants' plan accounts was more than the Net Assets Available for Benefits reported on the financial statements from when the loss occurred to June 2003 when the lawsuit was settled. Although the loss in relation to the $100.6 billion fund balance as of December 2001 (approximately .04 percent) is insignificant, the timing of the allocation to individual accounts may be sensitive to some plan holders. If the $41 million loss had been allocated in 2001, plan holders would have been charged approximately one-twentieth of 1 percent–-or about 41 cents more per $1,000 in their account balances. Thus, the amounts chargeable to individual accounts would have been minimal—ranging from virtually nothing for new employees to about $400 for an account of $1 million. Given that the average account balance in 2001 was approximately $39,000 (i.e., $100.6 billion in Net Assets Available for Benefits divided by 2.6 million participants), the average additional charge for administrative expenses for the year would have been about $16.

As a result of the settlement between the parties related to the system development, the TSP recovered approximately $5 million, which partially offsets the $41 million in previously recorded but unallocated administrative expenses. We confirmed that the resulting $36 million net loss was allocated to participants' accounts on June 23, 2003.

Conclusion

The financial statement treatment of writing down the failed system development costs was consistent with GAAP; however, we believe it would have been prudent to also write down the participants' accounts when the loss occurred. Not allocating the loss to individual participant accounts when it occurred was based on a premise of recovery for which there was no certainty. It also marked a departure from routine cost allocation practices, and in this situation, a significant number of account holders have departed from the TSP and were not allocated a share of these costs. Although we would hope that the Board does not have to face unusual circumstances similar to this again, it is important that consistency and conservatism principles and concepts govern future accounting and allocation decisions.

Recommendation for Executive Action

To be consistent with the financial statement treatment and its routine allocation practices, in light of uncertainties involving the litigation, and to prevent a growing percentage of account holders from departing the TSP and not sharing in the system failure costs, we recommend that the Federal Retirement Thrift Investment Board require the Executive Director to allocate the loss as soon as possible to participant accounts in the most equitable and efficient manner.

Agency Comments and Our Evaluation

In commenting on a draft of our report, the Executive Director discussed the June 20, 2003, settlement and the resulting $36 million allocation to participant accounts on June 23, 2003. We verified that the allocation was made, thus implementing the recommendation in this report.

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As agreed with your offices, unless you release its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies to interested congressional committees as well as the Executive Director of the Federal Thrift Retirement Investment Board and the Secretary of Labor. We will also make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact me at (202) 512-6906 or Casey Keplinger at (202) 512-9323. Heather Dunahoo also made major contributions to this report.

McCoy Williams

McCoy Williams
Director
Financial Management and Assurance

Enclosure

Comments from the Federal Retirement Thrift Investment Board

THRIFT SAVINGS PLAN

FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

July 9, 2003

Mr. McCoy Williams
Director
Financial Management and Assurance
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Williams:

This is in regard to your June 18, 2003 draft report, entitled "Thrift Savings Plan: Failed System Development Costs Should Be Allocated to Participant Accounts" (GAO-03-827R). Your report contained a recommendation that the Federal Retirement Thrift Investment Board require the TSP Executive Director to allocate the ". . .$41 million as soon as possible to participant accounts in the most equitable and efficient manner."

On June 20, 2003, Mehle v. American Management Systems (AMS) was resolved by a settlement between the parties. The net result of the settlement required AMS to pay $5 million to the Thrift Savings Plan. By offsetting the $5 million settlement proceeds against the $41 million outstanding, the amount to be allocated to the participants is reduced from $41 million to $36 million. On June 23, 2003, the $36 million was allocated to the participant accounts pursuant to 5 CFR Part 1645.4(c), which requires that accrued administrative expenses not covered by forfeitures will be charged on a pro rata basis, based on the respective investment fund balances on the last day of the prior valuation period.

I believe this satisfies your recommendation. Should you have any further questions or concerns, please do not hesitate to contact me.

Very truly yours,

Gary A. Amelio
Executive Director

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