



## Chapter 32

# Reading and Understanding Employee Benefit Plan Financial Statements

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If an employee benefit plan has over 100 participants, Department of Labor (DOL) regulations require the inclusion of audited financial statements with a plan's annual Form 5500 filing. A primary objective of these statements is to provide trustees, plan participants and others the information needed to assess accurately a plan's ability to pay benefits. Understanding a plan's financial statements is an important fiduciary responsibility. A step-by-step reading of the documents will provide a much better understanding of a plan's financial health. Trustees will also be better able to make prudent decisions for their plan as well as the participants and beneficiaries served.

To strengthen a trustee's grasp of financial statements, this chapter provides an overview of the required financial statements and aims to make them more useful. While this chapter focuses on multiemployer plans, it is also applicable to single employer and other plan types.

### Who Is Responsible for Preparing the Financial Statements?

Financial statements submitted with Form 5500 require an audit opinion by a certified public accountant (CPA). The audit must be performed according to generally accepted auditing standards (GAAS). When DOL regulations call for supplemental schedules, the Employee Retirement Income Security Act (ERISA) also requires the CPA to cover these schedules in the audit.

Ultimately, financial statements are the responsibility of plan management, even if an auditor assists in their preparation. The auditor is responsible for the audit report that provides an opinion whether the financial statements are free of material misstatements. The auditor does not guar-

antee the accuracy of the financial statements, but merely provides reasonable assurance that they are fairly stated.

### What Must Be Included in Plan Financial Statements?

To give information about its resources and obligations, a plan is required to provide some or all of these five documents:

1. A statement of net assets available for benefits
2. A statement of changes in net assets available for benefits
3. A statement of benefit obligations
4. A statement of changes in benefit obligations
5. Notes to the financial statements.

It is important to keep in mind that "one size does *not* fit all" for benefit plans. There are different reporting requirements for defined benefit (DB) plans and defined contribution (DC) plans. Benefit obligations will not be listed in the statements of a DC plan such as a 401(k) plan or an annuity plan—the net assets available for benefits of a DC plan are equivalent to its benefit obligations. On the other hand, DB plans must present benefit obligations and the changes in those benefit obligations in financial statements in one of three ways. As a result, a DC plan will not have items 3 and 4 listed above.

DB plans must file all five documents but there is some flexibility in how they are filed. Documents 3 and 4 may be filed in one of three ways:

1. As separate statements
2. Combined with the other statements—the statement of benefit obligations (Item 3) and the statement of changes in benefit obligations (Item 4) are superimposed on the statement of net assets available

- for benefits (Item 1) and the statement of changes in net assets available for benefits (Item 2), respectively.
3. Reported as a disclosure in the notes to the financial statements (Item 5).

### What Is the Statement of Net Assets Available for Benefits?

A balance sheet is the corporate equivalent of the statement of net assets available for benefits. This statement shows the assets and liabilities of the plan. Some key items shown on this statement are:

- **Fair value of investments.** For a security that is traded, *fair value* means the quoted market price of the security. If a quoted market price is not readily available, an alternative method is used to establish the investment's worth; for example, real estate is valued through professional appraisal.
- **Contributions receivable.** Contributions due a plan are from employers and, if it is a contributory plan, from employees. For a DB plan, the statement may include a line for *withdrawal liability*, which is monies due from withdrawing employers for their share of unfunded benefit obligations.
- **Property assets.** This category includes property owned by a fund such as land, buildings, office furniture and equipment. It is important to understand how real estate is stated. It can be presented under property assets at a depreciated historical cost or under investments at appraised value. How it is reported depends on how it is used. If a plan has real estate used primarily to house plan operations and related entities such as other plans, it is presented as a property asset. If the purpose of the real estate is to generate rental income from unrelated third parties, it should be shown in the investment section described above.
- **Amounts due to and from related entities.** This item appears if there is an administrative expense-sharing arrangement among related plans or other entities. Trustees need to ensure that balances owed by or to the other entity are collected or paid in a timely fashion. It is a very good idea to have a written expense-sharing agreement in place and to update it periodically. Updates should be at least every three years, or more frequently if a major event occurs (e.g., an office relocation) that will change the expense allocation.
- **Amounts due to and from brokers for investment trades.** These are for trades a plan executes at year-end but are settled afterward.

- **Operating liabilities.** Accounts payable and accrued expenses are operating liabilities. Specific examples include rent, salaries and professional fees owed by the plan.
- **Net assets available for benefits.** This category is very important and deserves special attention. It presents a plan's total assets less total liabilities. This number, when compared with the benefit obligations, provides information on the funding status of a DB plan. In the case of a DC plan, the net assets balance equals the sum of the participants' account balances.

### What Is a Statement of Changes in Net Assets Available for Benefits?

The statement of changes in net assets available for benefits includes a summary of a plan's financial activity—essentially, the plan's income and expenses for the fiscal year. This statement shows additions (income) to and deductions (expenses) from the net assets available for benefits. The corporate equivalent is the income statement. This statement also includes, among other things:

- **Net appreciation or depreciation.** This is the change in the fair value of investments reflecting both realized and unrealized gains and losses. A gain or loss in value is realized only when a security is sold. If the investment's market value changes and it is still owned by the plan, the gain or loss is unrealized.
- **Interest and dividends earned on investments**
- **Investment expenses.** These are investment costs such as fees paid to investment advisors, managers and custodians.
- **Employer (employee) contributions**
- **Benefits paid.** This item is always stated on a cash basis even though the statements may be on a modified cash or accrual basis of accounting.
- **Administrative expenses.** Salaries paid to plan personnel and office expenses are examples of administrative expenses.
- **Net increase or decrease in net assets, or total additions (income) less total deductions (expenses).** This is, in effect, the plan's bottom line, showing how well or poorly the plan has done financially.

### What Is a Statement of a Plan's Obligations?

#### *Health and Welfare Plans*

A health and welfare plan statement would show some or all of the following benefit obligations:

## Tip for Trustees

Review the footnotes before looking at the financial statements themselves. The footnotes provide background information that will help you review the financial statements.

- **Claims payable.** These are benefit claims that have been processed for payment but not paid at the end of the reporting period.
- **Claims incurred but not reported (IBNR).** These are injuries or illness that occurred before the end of the plan year but for which a claim has not yet been filed. In other words, these are the claims that do not exist at the end of the plan year. How can unknown claims be shown? Generally accepted accounting principles (GAAP) require these claims be estimated and reported. This amount can be combined with claims payable or reported as a separate total.
- **Accumulated eligibility credits (AEC).** This is an estimate of a plan's obligation to provide benefits to participants and dependents following the termination of the participant's employment. Where such coverage is provided, it is usually extended for a period of time—typically 30 to 90 days following termination, or a period where sufficient hours have not been worked to achieve full benefits. The length of time varies with the industry involved. Note that this is different from Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage.
- **Postretirement obligations.** These promised benefits must be estimated and reported if a plan provides health and welfare benefits to retirees or their dependents. This can be a large amount—well in excess of a plan's net assets available for benefits. Unlike pension benefits, however, these benefits are not vested. They may be modified or even terminated, depending on the financial condition of a plan. Realize, however, that these are obligations of the plan and eventually must be resolved.

Since the last three items involve some degree of estimation, an actuary or benefit consultant usually provides the information needed for the statement.

### Pension Plans

As mentioned above, DB plans do not include obligations for benefits in the statement of net assets available for benefits (*balance sheet*). Often, these obligations will be presented in a separate statement. Sometimes they appear combined with information in another statement or in the footnotes to the statements. Multiemployer DB plans commonly present accumulated plan benefits in the footnotes. Regardless of how they are presented, a plan must show the various components of benefit obligations.

Measurement of accumulated DB plan benefits (*pension liabilities*) is also prepared by an actuary and presented

as an annual actuarial valuation. Accumulated plan benefits should be reported in three categories: vested benefits of participants currently receiving benefits, other vested benefits and nonvested benefits.

### What Is Disclosed in the Footnotes?

Readers of financial statements often make the mistake of skimming through footnote disclosures. Although the information is not as clear as the statements themselves, the footnotes provide supporting details that are important to getting the complete financial picture. Below are some of the significant disclosures often found in footnotes.

- **Description of the plan.** This footnote provides a brief description of plan features.
- **Summary of accounting policies.** This is a statement of significant accounting policies followed by the plan.
- **Related party transactions.** Both GAAP and ERISA require transactions involving related parties (referred to as *parties in interest* under ERISA) be reflected in footnotes to the financial statements. Parties in interest include fiduciaries or employees of a plan and the union(s) whose members are plan participants. Examples of related party transactions include expense-sharing arrangements among related plans and transactions with a contributing employer. Related party transactions in multiemployer plans are commonly scrutinized during DOL audits and need to be well-documented and supported.
- **Nonexempt (prohibited) transactions.** ERISA generally prohibits transactions between a plan and a party in interest. However, there are exemptions such as the provision of accounting and legal services. These *prohibited transactions* should be disclosed in the footnotes. Additionally, prohibited transactions must be disclosed in Part III (nonexempt transactions) of Schedule G of Form 5500. The attached auditor's report must state in the opinion whether the information reported on Schedule G is fairly stated.

- **Benefit obligations.** For DB pension and welfare plans, the footnotes must disclose additional information from the actuary's valuation. Remember, disclosure in the footnotes is one method for presenting the information related to benefit liabilities. The additional information that must be disclosed by one of the three methods includes:
  - The method and significant assumptions used in calculating the accumulated plan benefits of a pension plan, and the postretirement benefit obligations of a health and welfare plan
  - For a pension plan, whether minimum funding requirements were met.
- **Subsequent events.** This footnote states the plan has evaluated events occurring through the report date and, if applicable, discusses significant matters. Events occurring after the end of the fiscal year that may be disclosed are a decision to terminate or merge a plan, a large employer going out of business and a significant decrease in investment values.
- **Plan amendments.** GAAP requires the disclosure of significant plan amendments such as those pertaining to participants covered, vesting and benefit provisions.
- **Investments.** Individual investments that are equal to or greater than 5% of net assets available for benefits at the end of the plan year must be disclosed in the notes. This should not be confused with the ERISA requirement to list investments held at the end of the plan year on a supplemental schedule discussed later in this chapter. Additionally, the appreciation or depreciation in the fair value of investments must be disclosed by category of investment—common stock, corporate debt instruments, governmental securities and so forth.
- **Fair value.** GAAP fair value rules apply to the plan's investment portfolio. In recent years, accounting rules have significantly increased the amount of plan investment disclosure. Investments are now categorized as Levels I-III depending upon the method used to measure fair value. *Level I* is restricted to securities traded in an active market with quoted market (e.g., NYSE) prices. *Levels II-III* contain investments not traded in active markets that require other valuation measures (e.g., real estate appraisals and yield curves for bonds). Plans are now also required to report totals within each major asset category, market sector or other distinction (e.g., international equity, distressed debt hedge funds, high-yield corporate bonds). Generally speaking, the extent of plan disclosure varies with the sophistication of the portfolio. Fair value disclosures can be complex

and require a collaborative effort among plan trustees and professional service providers.

- **Reconciliation between the financial statements and Form 5500.** Financial statements and Schedule H of Form 5500 report some information differently. For example, real estate held as an operating asset is reported at its depreciated historical cost in the financials, as required by GAAP. However, for Schedule H, fair market value is required. As a result, a building purchased for \$50,000 might appear in the financials at a depreciated value of \$40,000 and in Schedule H at today's market value of \$200,000. Reconciliation is required to be included as a footnote disclosure in the financial statements.

Another example comes from health and welfare plans. The net assets balance shown in Schedule H is reduced by benefits payable and benefits incurred but not reported. These liabilities are not included in the statement of net assets available for benefits; this means the statement and the schedule will show different results. ERISA requires these differences be explained in the notes.

Additional items commonly presented in the footnotes include but are not limited to the following:

- **Plan funding policy**
- **Investment contracts with insurance companies**
- **Securities lending provisions**
- **Pension Protection Act of 2006 certifications and funding improvement or rehabilitation plans.**

## What Schedules Are Required by ERISA?

In addition to what GAAP requires, ERISA requires the following supplemental schedules be included in the annual report whenever they apply:

- **Schedule of assets held for investment purposes and a listing of securities and other investments.** These are items such as real estate and participant loans held at the end of the year.
- **Schedule of reportable transactions.** Certain transactions over a 5% or greater threshold involving securities and individuals are reported here.
- **Schedule G of Form 5500**
  - **Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible**
  - **Part II—Schedule of Leases in Default or Classified as Uncollectible**
  - **Part III—Nonexempt Transactions.** All non-exempt (prohibited) transactions are reported, regardless of materiality.