Reading and Understanding Employee Benefit Plan Financial Statements

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If your employee benefit plan has more than 100 participants, chances are you've had to work your way through the audited financial statements you're required to include with your Form 5500 filing. These statements contain a wealth of information about the financial health of your plan, and understanding them is an important fiduciary responsibility. To strengthen your grasp of financial statements, this article gives an overview that will make a plan's financial statements more informative, explains their basic structure and provides information on some of the more arcane aspects (such as actuarial tables). While this article focuses on Taft-Hartley (multiemployer) plans, much of it applies to other types of employee benefit plans.

Generally speaking, financial statements must be submitted with Form 5500 for employee benefit plans with more than 100 participants. What's more, an independent qualified public accountant—that is, a certified public accountant (CPA)—must audit the statements. The audit is required to be performed according to generally accepted auditing standards (GAAS). And, when Department of Labor (DOL) regulations call for supplemental schedules, the Employee Retirement Income Security Act (ERISA) also requires an audit report on those schedules. Sometimes the two audit reports are combined.

The purpose of financial statements is to tell fiduciaries, managers and other interested parties about the plan's ability to pay benefits. Ultimately, the financial statements are management's responsibility, even though the auditor helps to prepare them or even performs all of their preparation. The auditor is responsible for the audit report, which provides an opinion as to whether the financial statements are free of material misstatements. The auditor does not, however, guarantee the *accuracy* of the financial statements, but merely provides reasonable assurance that they are fairly stated.

It is important to keep in mind that "one size does *not* fit all." That is, there are different reporting requirements for defined benefit (DB) plans and defined contribution (DC) plans. For instance, you won't find benefit obligations listed in the statements of a DC plan such as a 401(k) plan or an annuity plan, since the net assets available for benefits of a DC plan are equivalent to its obligations for benefits. These plans maintain an account for each participant. Such an account is credited with contributions, investment income and gains; and it is debited (charged) with distributions, investment losses and expenses. At any one time, the sum of the balances in these individual participant accounts represents the total benefit obligation to participants.

On the other hand, DB plans must show benefit obligations in their statements, and they are given some latitude in how the information is presented. Account balances pertaining to benefit obligations and the changes in those obligations of a DB plan—whether pension or health and welfare—may be presented as separate statements. They may also be combined with the statement of net assets available for benefits or the statement of changes in net assets available for benefits, or they may be reported as a disclosure in the notes to the financial statements.

What do financial statements consist of? To give information about its resources and obligations, a plan's financial statements will include:

- A statement of net assets available for benefits
- A statement of changes in net assets available for benefits
- A statement of a plan's obligations
- A statement of changes in a plan's obligations
- Notes to the financial statements.

Statement of Net Assets Available for Benefits

The corporate equivalent of the statement of net assets available for benefits is the balance sheet. This statement shows the assets and liabilities of the plan. The liabilities in this statement, however, are not obligations to members, such as benefits, but items such as amounts owed to vendors for operational and administrative expenses. Some key items shown on this statement are:

1. Investments—shown at fair value. In the case of securities that are traded, fair value means the quoted market prices of those securities. Investments for which quoted market prices are not readily available are valued using alternate methods: For example, real estate is valued through professional appraisal.
2. Contributions receivable from employers and, if it's a contributory plan, from employees
3. Property assets such as land and building, office furniture and equipment, etc. It is important to note how real estate is shown. It may be presented under property assets at historical cost after depreciation is factored in or under investments at appraised value. How it is reported depends on how it is used. If it serves primarily to house the operations of the plan and related entities such as other plans, then real estate is presented as a property asset. If it is held as an investment property, then it should be shown in the investment section described above.
4. Amounts due to and from related entities. This item almost always appears if there is an administrative expense-sharing arrangement among related entities. Trustees need to ensure that balances owed by or to a related entity are collected or paid in a timely fashion. It's a very good idea—one that can save you much grief later on—to have an actual written expense-sharing agreement in place and to update it periodically.
5. Amounts due to and from brokers for investment trades executed at year-end but settled afterward
6. Operating liabilities—accounts payable and accrued expenses. Examples include rent, salaries and professional fees.
7. Net assets available for benefits. This important category deserves special attention. It presents total assets less total liabilities. This number, when compared with the benefit obligations, provides information on the financial status of the plan.

Statement of Changes in Net Assets Available for Benefits

Here is where you find a summary of the plan's financial activity—essentially, its income and expenses—for the fiscal year. The corporate equivalent is the income statement. This statement shows additions (income) to and deductions (expenses) from the net assets available for benefits. In this statement you'll see, among other things:

1. Net appreciation or depreciation in the fair value of investments. This is just fancy language for realized and unrealized investment gains and losses. A gain or loss is realized only when a security is sold. If the investment's market value changes and it is still owned by the plan, i.e., if it has not been sold, the gain or loss is unrealized.
2. Interest and dividends earned on investments
3. Investment expenses such as fees paid to investment advisors, managers and custodians
4. Employers' (and employees') contributions
5. Benefit expenses. Note that this item is always shown on a cash basis even though the statements may be on a modified cash or accrual basis.
6. Administrative expenses such as salaries paid to plan personnel, office expenses, etc.
7. Net increase or decrease in net assets, or total additions (income) less total deductions (expenses). This is, in effect, the bottom line of the plan, telling you how well or poorly the plan has done financially.

Statement of a Plan's Obligations

DB plans do not include liabilities and obligations for benefits in the statement of net assets available for benefits. Often, you'll find those obligations presented in a separate statement. Sometimes they appear combined with information in another statement or in the footnotes to the statements. But in all cases, the presentation must show the various components of benefit obligations.

For example, a health and welfare plan statement would show some or all of the following:

1. Claims payable—claims that have been processed for payment but not paid as of the end of the plan's accounting period
2. Claims incurred but not reported (IBNR)—claims that have been incurred by participants and their dependents but have not been reported to the plan, that is, claims of which the plan is as yet unaware (sometimes referred to as pending and unrevealed claims). How can unknown claims be shown? Generally accepted accounting principles (GAAP) require that such claims be estimated and reported.
3. Accumulated eligibility credits (AEC)—This is an estimate of a plan's obligation to provide benefits to participants following their termination of employment. Where such coverage is provided, it is usually extended for a period of time—typically 30 to 90 days following termination—that varies with the industry involved. Note that this is different from the Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage.
4. Postretirement obligations—These must be estimated and reported if the plan provides health and welfare benefits to retirees or their dependents. For a plan this is a large amount, often well in excess of the plan's net assets available for benefits. Unlike pension benefits, however, these benefits are not vested, and they may be modified or even terminated, depending on the financial condition of the plan.

Since the last three items involve some degree of estimation, an actuary or benefit consultant usually provides the information for them. GAAP and GAAS dictate how this information is used and reported.

Benefit Obligations of a Pension Plan

Measurement of accumulated plan benefits (pension liabilities) is also prepared by an actuary and presented in an annual actuarial valuation. Some of this information appears in the financial statements. Accumulated plan benefits, i.e., the pension liabilities, should be reported in three categories: vested benefits of participants currently receiving benefits, other vested benefits and nonvested benefits.

Footnote Disclosures

Too often, readers of financial statements hurry past the footnote disclosures. That's a mistake. Even though footnotes may seem dry and dense, they are a treasure trove of information and an integral part of the financial statements. They play an important role in presenting and explaining the whole picture.

Related party transactions. Both accounting standards and ERISA require that 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 the plan and a union whose members are participants of the plan. Examples of these transactions include expense-sharing arrangements among related plans and transactions with a contributing employer.

Nonexempt (prohibited) transactions. ERISA generally prohibits transactions between a plan and a party in interest. But there are exemptions which permit certain transactions with parties in interest such as the provision of accounting and legal services. If a prohibited transaction has occurred, it should be disclosed in the footnotes to the financial statements. Additionally, prohibited transactions must be disclosed in Part III (nonexempt transactions) of Schedule G of Form 5500, and the auditor's report must state an 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. As mentioned previously, disclosure in the footnotes is one method of presenting the information related to the liabilities for benefits. Regardless of the method of reporting the amounts, additional information must be disclosed for benefit obligations, including:

- 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 will tell you about significant events that occurred after the end of the fiscal year such as a decision to terminate or merge the plan or a large employer going out of business.

Plan amendments. GAAP requires the disclosure of significant plan amendments such as those pertaining to participants covered, vesting and benefit provisions.

Investments (GAAP). 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, which is one of the supplemental schedules—See below. Additionally, the appreciation or depreciation in the fair value of investments must also be disclosed by category of investment—common stock, corporate debt instruments, governmental securities, and so forth.

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 depreciated historical cost in the financials but at fair market value in Schedule H. For example, a building purchased in 1980 for $50,000 might appear in the financials at a depreciated value of $40,000 and in Schedule H at $200,000, today's market value. This difference makes net assets available for benefits per the financials different from net assets as reported in Schedule H.

Another example is, in the case of a health and welfare plan, the net assets balance shown in Schedule H has been reduced by benefits payable and benefits incurred but not reported, as mentioned above. Since such liabilities are not included in the statement of net assets available for benefits, the statement and the schedule will show different results. ERISA requires these differences to be explained in the notes to the financials.

ERISA Schedules

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 held at the end of the year. Real estate and participants' loans should be included.
- 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 nonexempt (prohibited) transactions are required to be reported, regardless of materiality.)

Auditors' Reports

Supplemental Schedules

In addition to issuing a report on the basic financial statements, the auditor must also report on the above ERISA supplemental schedules. These reports may be combined or issued separately.

Basic Financial Statements

An auditor may issue several types of report, depending on how well the financial statements meet GAAP and ERISA requirements. But DOL will accept only two types—a report with an unqualified or "clean" opinion, or a report with a disclaimer of opinion due to limited scope. An auditor issues a report with a disclaimer due to limited scope when a plan opts not to have audit procedures performed on its investment-related balances in the financial statements. ERISA allows this choice, if certain conditions are met. In this case, an auditor would not be able to provide any opinion on the financial statements as a whole since the auditor had not performed any audit procedures on a highly material part of the statement, the investment-related balances.

DOL will reject a Form 5500 if it contains an adverse opinion, i.e., an opinion that the financial statements are not fairly stated as a whole, or an opinion that was qualified because of departures from GAAP or a restriction on the scope of the audit. A qualified opinion indicates that except for a specific reason, the financial statements are fairly stated.

Conclusion

As you can see, a step-by-step reading of the financial statements will give you a solid grasp of the financial health of your plan. That's what financial statements are designed to do—to provide an understanding of the financial condition of a benefit plan or other entity. They seek to capture important financial information in a way that is clear and useful. A careful reading will provide information you need to make prudent decisions for the plan and for the participants and beneficiaries it serves. ◆