In order to make prudent decisions about an employee benefits plan, it’s worth taking the time to read—and understand—the plan’s financial statements.

Financial Statements—Gaining a Deeper Understanding

by Joseph A. Reinhardt
The ability to read and genuinely understand financial statements is pivotal in gauging the financial health of an employee benefit plan. This article will help put you on firm ground in knowing what goes into a financial statement and why.

Generally, if your plan has more than 100 participants, you must submit financial statements, audited by a certified public accountant, along with Form 5500. The audit must be performed according to generally accepted auditing standards (GAAS). In cases where Department of Labor (DOL) regulations require supplemental schedules, the Employee Retirement Income Security Act (ERISA) calls for an audit report on those schedules. In certain situations the two audit reports are combined.

Purpose and Responsibilities

Fiduciaries, managers and other interested parties use financial statements to get a reading on an employee benefit plan’s ability to pay benefit obligations. While the auditor may help to prepare the financial statements, they ultimately are management’s responsibility.

The auditor is responsible for the audit report, which provides an opinion as to whether the financial statements are free from material misstatements. The auditor does not guarantee the accuracy of the financial statements but does provide reasonable assurance that they are fairly stated.
Know the Difference

It is important to recognize there are different reporting requirements for defined benefit (DB) plans and defined contribution (DC) plans. For example, there are no benefit obligations listed in the statements of a DC plan, such as a 401(k) or annuity plan, since the net assets available are equivalent to its obligations for benefits. For each participant DC plans maintain an account that is credited with contributions, investment income and gains and debited with distributions, investment losses and expenses. The sum of the balances in these individual participant accounts represents the total benefit obligation.

DB plans are required to show benefit obligations in their statements—with some latitude in how the information may be presented. Account balances pertaining to benefit obligations and changes in those obligations, 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 reported as a disclosure in the notes to the financial statements.

The Anatomy of a Financial Statement

To deliver the appropriate information about its resources and obligations, a plan’s financial statements will include:

The Statement of Net Assets Available for Benefits

This statement presents the assets and liabilities of the plan. These liabilities are not obligations to members, such as benefits, but items such as amounts owed to vendors for operational and administrative expenses. Among the key items on this statement are:

- Investments shown at fair value. For securities that are traded, fair value means the quoted market prices. For investments where quoted market prices are not readily available, alternate methods are used. For example, real estate would be valued through professional appraisal.
- Contributions receivable from employers and, for contributory plans, from employees
- Property assets such as land and buildings, 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 the property primarily serves to house the operations of the plan and related entities such as other plans, the real estate is presented as a property asset. If it is held as an investment property, it must be shown in the investment section described previously.
- 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. To circumvent problems down the road, it is wise to have a written expense-sharing agreement in place that is updated periodically.
- Operating liabilities, accounts payable and accrued expenses. These include rent, salaries and professional fees.
- Net assets available for benefits. This is a particularly important category since it presents total assets less total liabilities. This

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number, when compared with the benefit obligations, provides vital information on the financial status of the plan.

**The Statement of Changes in Net Assets Available for Benefits**

This is where you summarize the plan’s financial activity—its income and expenses for the fiscal year—essentially like a corporation’s income statement. This statement shows additions (income) to and deductions (expenses) from the net assets available for benefits. In these statements, you’ll find, among other things:

- Net appreciation or depreciation in the fair value of investments—effectively, 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, the gain or loss is unrealized.
- Interest and dividends earned on investments
- Investment expenses. These include fees paid to investment advisors, managers and custodians.
- Employers’ and employees’ contributions
- Benefit expenses. This is always shown on a cash basis even though the statements may be on a modified cash or accrual basis.
- Administrative expenses such as salaries paid to plan personnel, office expenses, etc.
- Net increase or decrease in net assets, or total additions less total deductions. Essentially the bottom line of the plan, it reveals how well or poorly the plan has done.

**The Statement of Plan Benefit Obligations**

DB plans do not include liabilities and obligations for benefits in the statement of net assets available for benefits. Typically, you’ll find those obligations in a separate statement. Sometimes they are combined with information in another statement or in the footnotes. 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:

- **Claims payable** are claims that have been processed for payment but were not paid as of the end of the plan’s accounting period.
- **Claims incurred but not reported (IBNR claims)** are those that have been incurred by participants and their dependents but have not been reported to the plan. They are sometimes referred to as pending and unrevealed claims. How can something unrevealed be shown? Under generally accepted accounting principles (GAAP), you are required to make and report an estimate.
- **Accumulated eligibility credits (AECs)** are estimates of a plan’s obligation to provide benefits to participants after they have been terminated. This type of coverage typically is provided 30 to 90 days following termination and varies depending upon industry. AECs are different from Consolidated Omnibus Budget Reconciliation Act (COBRA) coverage.
- **Postretirement obligations**—If the plan provides health and welfare benefits to retirees or their dependents, these must be estimated and reported. This can be a considerable amount—frequently more than the plan’s net assets available for benefits. However, unlike pension benefits, these benefits are not vested. They may be modified or even terminated, depending on the financial condition of the plan.

For the previous three items, an actuary or benefit consultant usually provides the information, and GAAP and GAAS dictate how this information is used and reported.

**Benefit Obligations of a Pension Plan**

An actuary prepares a measurement of accumulated plan benefits (the pension’s liabilities) and presents it in an annual actuarial valuation. Some of this information is found in the financial statements. Accumulated plan benefits should be reported in three categories:

1. Vested benefits of participants currently receiving benefits
2. Other vested benefits

**Disclosures in Footnotes**

The footnotes in financial statements can be a fountain of valuable information and should never be overlooked. They play an important role in presenting and explaining the whole picture. Here is what can be found in the footnotes:

- **Related party transactions.** Accounting standards and ERISA require that related party transactions (known
as *parties in interest* under ERISA) be reflected in footnotes. Parties in interest include fiduciaries or employees of the plan and a union whose members participate in the plan. Examples include expense-sharing arrangements among related plans and transactions with a contributing employer.

- **Nonexempt (prohibited) transactions.** Generally, ERISA prohibits transactions between a plan and a party in interest. There are exemptions that 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. Additionally, prohibited transactions must be disclosed in Part III (nonexempt transactions) of Schedule G of Form 5500, and the auditor’s report must provide an opinion as to whether the Schedule G information is fairly stated.

- **Benefit obligations.** For DB pension and welfare plans, the footnotes must disclose additional information from the actuary’s valuation, including:
  - The method and significant assumptions used in calculating the accumulated plan benefits of a pension plan and the post-retirement benefit obligations of a health and welfare plan
  - For a pension plan, whether minimum funding requirements were met.

- **Subsequent events.** This reveals important events that occurred after the end of the fiscal year. Examples include a decision to terminate or merge the plan or a large employer going out of business.

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

- **Investments (GAAP).** If an individual investment is equal to or greater than 5% of net assets available for benefits at the end of the plan year, it must appear in the footnotes. 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 discussed later. Additionally, the appreciation or depreciation in the fair value of investments must also be disclosed by category of investment—common stock, corporate debt instruments and governmental securities, among others.

- **Fair value measurements.** This footnote enables the reader to determine how the investment’s fair market value was determined and provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets (referred to as **Level 1 assets**) and the lowest priority to unobservable inputs (known as **Level 3 assets**).

- **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 financial, but at fair market value in Schedule H. Consider this: 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 $300,000, today’s market value. This difference in changing value makes net assets available for benefits per the financials different from net assets as reported in Schedule H and would require a reconciliation.

Another example is a health and welfare plan where the net assets balance shown in Schedule H has
been reduced by benefits payable and claims 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 footnotes.

**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 along with a listing of securities and other investments held at the end of the year. Further, 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 (i.e., prohibited) transactions are required to be reported, regardless of materiality.

**Auditors’ Reports**

- **Supplemental schedules.** In addition to 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 reports, depending on how well the financial statements meet GAAP and ERISA requirements. However, DOL will accept only two types—a report with an unmodified opinion (formerly known as an unqualified or clean opinion) or a modified report with a disclaimer of opinion due to limited scope. A report with a disclaimer is issued by an auditor 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 a modified report with an adverse opinion—where 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 modified report with a qualified opinion indicates that, except for a specific reason, the financial statements are fairly stated.

**A Top-to-Toe Checkup**

Only through an in-depth reading of the financial statements can you gain a solid grasp of the financial health of a benefit plan. That’s what financial statements are designed to give you. They seek to capture important financial information in a way that is clear and useful. A careful examination will provide the information you need to make prudent decisions for the plan and for the participants and beneficiaries it serves.