What ERISA Practitioners Need to Know About Accounting for Plans

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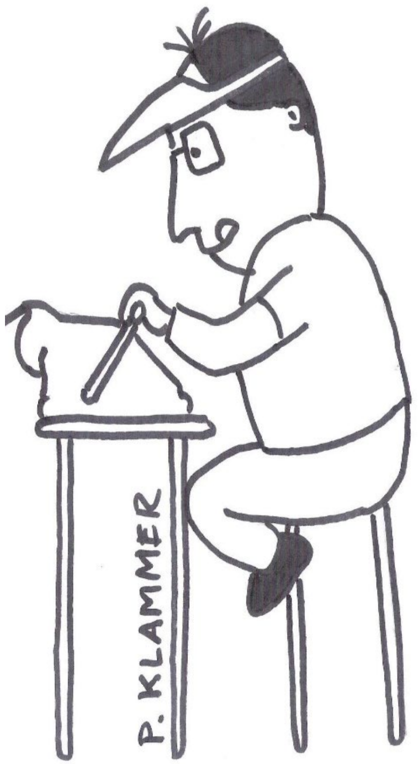
What is Accounting?

- The system of recording and summarizing business and financial transactions and analyzing, verifying, and reporting the results.
- The process of identifying, measuring and communicating quantitative information (primarily financial in nature) to permit informed judgment and decision by users of the information.
- Provides information about the financial health of an entity or Plan
- Provides information about solvency and liquidity of an entity or Plan
- Enron principle: Don’t cook your books.



What are Financial Statements?

- Financial statements are written records that convey the financial activities and conditions of a business or entity, such as an employee benefit plan.
- The two major financial statement reports are the income statement and balance sheet. Companies often also have a cash flow statement but plans often do not.
- Financial statements are often audited by government agencies, accountants, firms, etc. to ensure their accuracy.

Balance Sheets

- The balance sheet provides an overview of assets, liabilities and equity at a snapshot in time.
- For plans, “Statement of Net Assets Available to Pay Benefits”.
- Date at the top tells you when the snapshot was taken, which is generally the end of the fiscal year.
- Company balance sheet equation: Assets = Liabilities + Equity
  - This equation is foundation of double-entry accounting system, which ensures balance sheet remains “balanced,”
  - Each entry made on debit side should have corresponding entry on credit side.

What Does a Balance Sheet/ Statement of Net Assets Look Like?

SAMPLE MULTIEMPLOYER PENSION PLAN
STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS
DECEMBER 31, DECEMBER 31, 20X1 AND 20X0

Sample

	20X1	20X0
ASSETS		
Investments - at fair value		
U.S. government and government agency obligations	$ 7,382,785	$ 8,028,176
Corporate bonds	7,653,043	6,227,712
Foreign securities	505,511	512,000
Common stocks	21,315,679	21,605,221
Common/collective trusts	24,517,601	23,421,880
Mutual funds	9,080,679	9,035,172
Hedge funds	8,897,762	7,201,727
Pooled separate account	4,438,920	-
Short-term investment funds	1,083,158	1,244,911
	84,875,138	77,276,799
Receivables		
Employer contributions	545,698	563,312
Interest and dividends	122,390	125,333
Due from broker for investments sold	1,107,728	987,214
Other	71,725	-
	1,847,541	1,675,859
Cash	361,593	229,198
TOTAL ASSETS	87,084,272	79,181,856
LIABILITIES		
Accounts payable	134,231	120,020
Due to broker for investments purchased	894,313	311,364
TOTAL LIABILITIES	1,028,544	431,384
NET ASSETS AVAILABLE FOR BENEFITS	$ 86,055,728	$ 78,750,472

Income Statements

- Also called P&L ("profit and loss") or "Statement of Operations"
- For plans: "Statement of Changes in Net Assets Available for Benefits"
- Income statement provides an overview of revenues and expenses.
- Unlike the balance sheet, the income statement covers a range of time, which is a year for annual financial statements and a quarter for quarterly financial statements, stated at the top.

What Does the Income Statement/ Statement of Changes in Net Assets Available for Benefits Look Like?

SAMPLE MULTIEMPLOYER PENSION PLAN
STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS
FOR THE YEARS ENDED DECEMBER 31, 20X1 AND 20X0

Sample

	20X1	20X0
ADDITIONS TO PLAN ASSETS ATTRIBUTED TO		
Investment income		
Net appreciation in fair value of investments	$ 6,704,957	$ 7,397,649
Interest	939,464	857,968
Dividends	964,096	690,634
	8,608,517	8,946,251
Investment expenses	(516,181)	(401,166)
	8,092,336	8,545,085
Employer contributions	5,399,422	5,130,740
TOTAL ADDITIONS	13,491,758	13,675,825
DEDUCTIONS FROM PLAN ASSETS ATTRIBUTED TO		
Benefits	5,314,164	4,252,120
Administrative expenses		
Contract administrator's fees	557,492	496,157
Actuarial fees	37,599	60,609
Legal fees	42,000	42,000
Audit fees	46,620	35,200
Payroll audit fees	24,452	19,885
Pension Benefit Guaranty Corporation premiums	111,704	100,573
Insurance and bonding	33,638	17,539
Printing, postage and miscellaneous	15,640	13,882
Meetings and conferences	3,193	7,845
	872,338	793,690
TOTAL DEDUCTIONS	6,186,502	5,045,810
NET INCREASE	7,305,256	8,630,015
NET ASSETS AVAILABLE FOR BENEFITS AT BEGINNING OF YEAR	78,750,472	70,120,457
NET ASSETS AVAILABLE FOR BENEFITS AT END OF YEAR	$ 86,055,728	$ 78,750,472

What Does a DB Plan's Actuarial Information Look Like?

NOTE 6: ACTUARIAL INFORMATION

The Plan's actuary has reported the following information as of January 1, 20X1 and 20X0.

	20X1	20X0
Actuarial present value of accumulated plan benefits		
Vested benefits		
Active participants	$ 46,993,084	$ 43,045,523
Retirees and beneficiaries	32,329,797	29,698,625
Terminated vested	16,345,351	10,138,671
	95,668,232	82,882,819
Non-vested benefits	5,653,186	6,483,475
Total actuarial present value of accumulated plan benefits	$ 101,321,418	$ 89,366,294

As reported by the actuary, the changes in the present value of accumulated plan benefits during the year ended December 31, 20X0 were as follows:

Actuarial present value of accumulated plan benefits at beginning of year	$ 89,366,294
Increase (decrease) during year attributable to	
Benefits accumulated	3,198,263
Benefits paid	(4,252,120)
Increase for interest	7,238,352
Experience losses	1,609,375
Changes in assumptions	4,161,254
Net increase	11,955,124
Actuarial present value of accumulated plan benefits at end of year	$ 101,321,418

What Does a Health Plan's Benefit Obligations Look Like?

NOTE 8: BENEFIT OBLIGATIONS

The Plan reports its benefit obligations in conformity with the American Institute of Certified Public Accountants' Statement of Position 92-6, as amended by Statement of Position 01-2. Information regarding amounts currently payable to or for participants, beneficiaries, and dependents for service providers and insurance premiums as of December 31, 20X1 and 20X0 are determined by the Plan's management. Information regarding amounts currently payable to or for participants, beneficiaries, and dependents for claims currently payable and amounts incurred but not paid and the present value of the Plan's postretirement benefit obligations as of December 31, 20X1 and 20X0, is determined by the Plan's actuaries. Information regarding the present value of the Plan's benefit obligations as of December 31, 20X1 and 20X0, is shown below:

	20X1	20X0
Amounts currently payable to or for participants, beneficiaries, and dependents		
Claims currently payable and amounts incurred but not paid	$ 6,200,000	$ 4,900,000
Group insurance and service providers payable	49,356	53,589
	6,249,356	4,953,589
Postretirement benefit obligations		
Current retirees	33,400,000	33,300,000
Other participants fully eligible for benefits	43,000,000	35,400,000
Participants not fully eligible for benefits	67,100,000	62,400,000
	143,500,000	131,100,000
Total benefit obligations	$ 149,749,356	$ 136,053,589

What Does a Health Plan's Benefit Obligations Look Like?

NOTE 8: BENEFIT OBLIGATIONS - continued

Information regarding the changes in benefit obligations for the years ended December 31, 20X1 and 20X0 is shown below:

	20X1	20X0
Amounts currently payable to or for participants, beneficiaries, and dependents		
Balance at beginning of year	$ 4,953,589	$ 5,162,244
Increase (decrease) during year attributable to		
Changes in medical claims and claims incurred but not reported	1,300,000	(200,000)
Changes in group insurance and service providers payable	(4,233)	(8,655)
Balance at end of year	6,249,356	4,953,589
Postretirement benefit obligations		
Balance at beginning of year	131,100,000	216,900,000
Increase (decrease) during year attributable to		
Benefits earned and other changes	4,900,000	(2,000,000)
Changes due to passage of time	9,700,000	16,100,000
Benefits paid	(2,200,000)	2,100,000
Changes in actuarial assumptions	-	(70,000,000)
Plan amendments	-	(32,000,000)
Balance at end of year	143,500,000	131,100,000
Total plan benefit obligations	$ 149,749,356	$ 136,053,589

Practice Tips

- Look at “Notes to the financial statements” – these are not like normal footnotes. Often the notes are where the action is, especially hidden clues which are code for “we lost a lot of money.”
- Notes often start with a “Description of the Plan,” which will tell you a lot about how the plan is organized and about the plan’s terms.

Practice Tips, Cont.

- Companies that have a defined benefit will report information in a “Note” usually titled “Pension and Other Postretirement Benefits”
  - Discloses Over/Underfunded status of the Plan
  - Discloses the investment allocation for the Plan’s assets
  - Discloses assumptions regarding rate of return the company assumes on its investments
  - Present Value of the Liabilities
    - Discount rate
    - Actuarial Assumptions regarding the life expectancy of the workforce etc.

Practice Tips, Cont.

- "Pesky Zeros Problem"
  - Are statements numbers what they appear? (meaning $2,345 = $2,345)
  - Do you see "**($ in thousands)**"? If so, then $2,345 = $2,345,000. This is very common.
  - If "**($ in millions)"** then $2,345 = or $2.3 billion (this does happen).
  - Example: company discloses notional/payout value of derivatives contracts in a table showing $2,345,000 but states "($ in millions)." This means contracts could require payment of **$2.34 trillion.**

Uses of Financial Statements in ERISA Practice & Litigation

- Audits
- Investigate financial health of a Plan
- Investigate financial health of a defendant, important for collectability of a judgment
  - Disclosures about your lawsuit if liability is potentially significant are required
- Purpose of Form 5500s: provide participants information about their plan and provide the government information for compliance and enforcement.

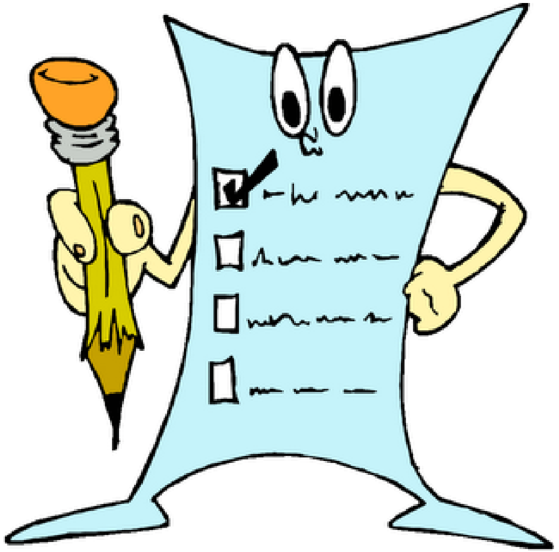
Statutory Basis for Audit Requirement

- According to ERISA § 103(a)(3)(A):
  - The plan administrator shall engage an IQPA who will examine books and records deemed necessary to determine if required financial statements and schedules are presented in conformity to and consistently with GAAP.
  - This examination shall be conducted in accordance with GAAS and shall involve testing as determined by the IQPA.
  - The IQPA shall offer an opinion as to whether the separate schedules specified in subsection (b)(3) of this section and the summary material required under section 104(b)(3) present fairly and in all material respects the information contained therein when considered in conjunction with the financial statements taken as a whole.
  - The opinion by the IQPA shall be included in the annual report.

Audit Requirement, cont.

- IQPA requirement:
  - Qualified public accountant is defined in ERISA § 103(a)(3)(D) as a certified public accountant or a licensed public accountant or a person certified by the Secretary of Labor as a QPA per regulations for person who practices in state where there is no certification or licensing for accountants
  - What makes such a person independent?
    - DOL said in brochure for fiduciaries that this means that "Auditors of employee benefit plans should not have any financial or other conflicts of interests with respect to the plan or the plan sponsor that would affect their ability to render an objective, unbiased opinion about the plan's financial condition."
    - That means, among other things, that the auditor has to be an outside party and cannot be an employee of the fund. Further, <u>the auditor cannot maintain books for the plan for any reason</u>.
  - Sponsors of plans subject to a Form 5500 audit requirement have a fiduciary responsibility to prudently select the IQPAs they use.

Audit Requirement, cont.



- What is GAAP and GAAS?
  - GAAP (Generally Accepted Accounting Principles) and GAAS (Generally Accepted Auditing Standards) are set by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA).
  - GAAP contains general rules, standards and conventions of preparing financial statements.
  - GAAS consists of standards that govern how to audit financial statements.

Audit Requirement, cont.

- Financial Statements must be prepared on a consistent basis with that of the preceding year – *see* ERISA § 103(b)(3)(A).
- Statement of Net Assets Available for Benefits must be comparative with the prior period. The Statement of Changes in Net Assets Available for Benefits may be a single year presentation.
- Limited Scope Audits are permissible under ERISA. They cost less because these do not require the auditor to extend any audit procedures over investments certified by a custodian, including valuation.

Audit Requirement, cont.

- What tests of the books and records does the auditor perform?
  - Testing the accuracy of benefit payments
  - Testing the fair value of assets held for investment purposes and the income received and gain/loss from the sale of investments
  - Testing contributions received and receivable by the plan to ensure completeness
  - Testing administrative expenses to ensure consistent with plan documents and that they represent actual and necessary plan costs
  - Testing participant loans on DC plan and that the allocation of income to participant balances is calculated and posted properly
  - Testing the completeness of plan benefit obligation by confirming participant data provided to and used by the actuary

Questions DOL Identified That a Fiduciary Should Ask the Plan Auditor :

- Whether plan assets covered by the audit have been fairly reported;
- Whether plan obligations are properly stated and described;
- Whether contributions to the plan were properly calculated and timely received;
- Whether benefit payments were made in accordance with plan terms;
- Whether employees were properly included or excluded from participation in the plan;
- If applicable, whether participant accounts are fairly stated;
- Whether issues were identified that may impact the plan’s tax status; and
- Whether any transactions prohibited under ERISA were properly reported

Investment Valuation – What's Required

GAAP requires an entity to:

- Establish accounting and reporting process for determining fair value measurements and disclosures
- Select appropriate valuation method
- Identify and support any significant assumptions used
- Prepare the valuation
- Ensure presentation and disclosure of the fair value measurements are in accordance with GAAP

Investment Valuation – What is the Basis for Valuation?

- Level 1 – unadjusted quoted prices in active markets for identical assets (stocks, mutual funds)
- Level 2 – quoted market prices for similar assets in active markets or for identical or similar assets in markets that aren't active (bonds, government securities)
- Level 3 – valuation is based on significant unobservable inputs (real estate)
- Net Asset Value (NAV) – valuation is based on the fair value of underlying assets (Fund of funds, private funds, real estate funds)

Investment Valuation – Issues for Fiduciaries

Fiduciaries may look to an advisor to assist in the mechanics of the valuation. However, fiduciaries are responsible for obtaining sufficient information to evaluate and independently challenge the valuation and ensure footnotes are complete.

- EBSA's Boston Regional office issued July 1, 2008 letter (the "Boston Letter")
  - Trustees failed to value accounts
  - Trustees failed to establish a process and evaluate fair value
- DOL position: both failures violated ERISA

Summary: Administrator should establish a process to evaluate the fair value of any hard to value assets to include a complete understanding of underlying investments, funds, investment strategy and thorough knowledge of investments valuation methodology.

Investment Valuation – Issues for Fiduciaries

The Boston Letter stated, in part,

It is incumbent upon the Plan Administrator to establish a process to evaluate the fair market value of any “hard-to-value assets” held by the plan. Such a process will include a complete understanding of the underlying investments and the fund’s investment strategy. In addition, the Plan Administrator must have a thorough knowledge of the general partner’s valuation methodology to assure it comports with the fund’s written valuation provisions and reflects fair market value. A process which merely uses the general partner’s established value for all funds without additional analysis may not insure that the alternative investments are valued at fair market value.

Investment Valuation – Is DOL Doing Enough?

OIG Report on DOL Oversight of ERISA Filings – September, 2013

- DOL needs to issue more guidance directed to Plan Administrators to identify and adequately support the fair value of hard to value investments
- OIG found no independent valuation methods or analytical processes by Administrators to determine fair value of all hard-to-value assets reported on Form 5500s.
- OIG recommended increased enforcement efforts.

Investment Valuation - What Should Trustees/Investment Committees Do Periodically?

- Understand how these investments are valued
- Understand who is responsible for valuing the investment
- Inquire about the consistency of the valuation process
- Understand how prior valuations and actual sales compare to one another
- Determine how the manager oversees the investment
- Assess whether there are environmental, legislative or other non-financial influences that may or should impact valuation

Required Plan Reporting – Form 5500

- Annual report for all employee benefit plans (except certain apprenticeship plans)
  - Statutory basis:
    - ERISA § 103 – sets forth required contents of annual report, including audit requirement
    - § 104 -- process issues re: report, and
    - § 4065 -- adds requirements for content of annual report of DB plan relating to withdrawal liability: statement of plan's enrolled actuary relating to the value of vested benefits and plan assets, statement of each claim for withdrawal liability, the number of employers having an obligation to contribute, and the number of employers required to make WL payments.
- Filed electronically with DOL
- Must be filed within seven months after end of PY unless extension received – one extension is automatic if request is filed on Form 5558 on or before due date of Form 5500

Other Financial Reports in ERISA Practice

- Form 990 – annual return for tax-exempt organizations – must be filed by group health plans and welfare plans to maintain tax-exempt status
- PBGC Premium filing – DB Plans only – note the intersection with numbers reported on Form 5500
- SEC reporting for public companies
  - Annual Reports, 10-Ks, 10-Qs
- 11-Ks - form filed with SEC, which deals with employee stock purchases and savings plans with interests in SEC registered securities

DOL and Audit Quality

- Auditor capability/experience has been a hot topic for the DOL on audits and has led to litigation between the plan and the plan auditor.
- DOL's Audited Landscape
  - 82,320 plans are subject to audit
  - 129 million participants
  - $7.4 trillion in assets subject to audit

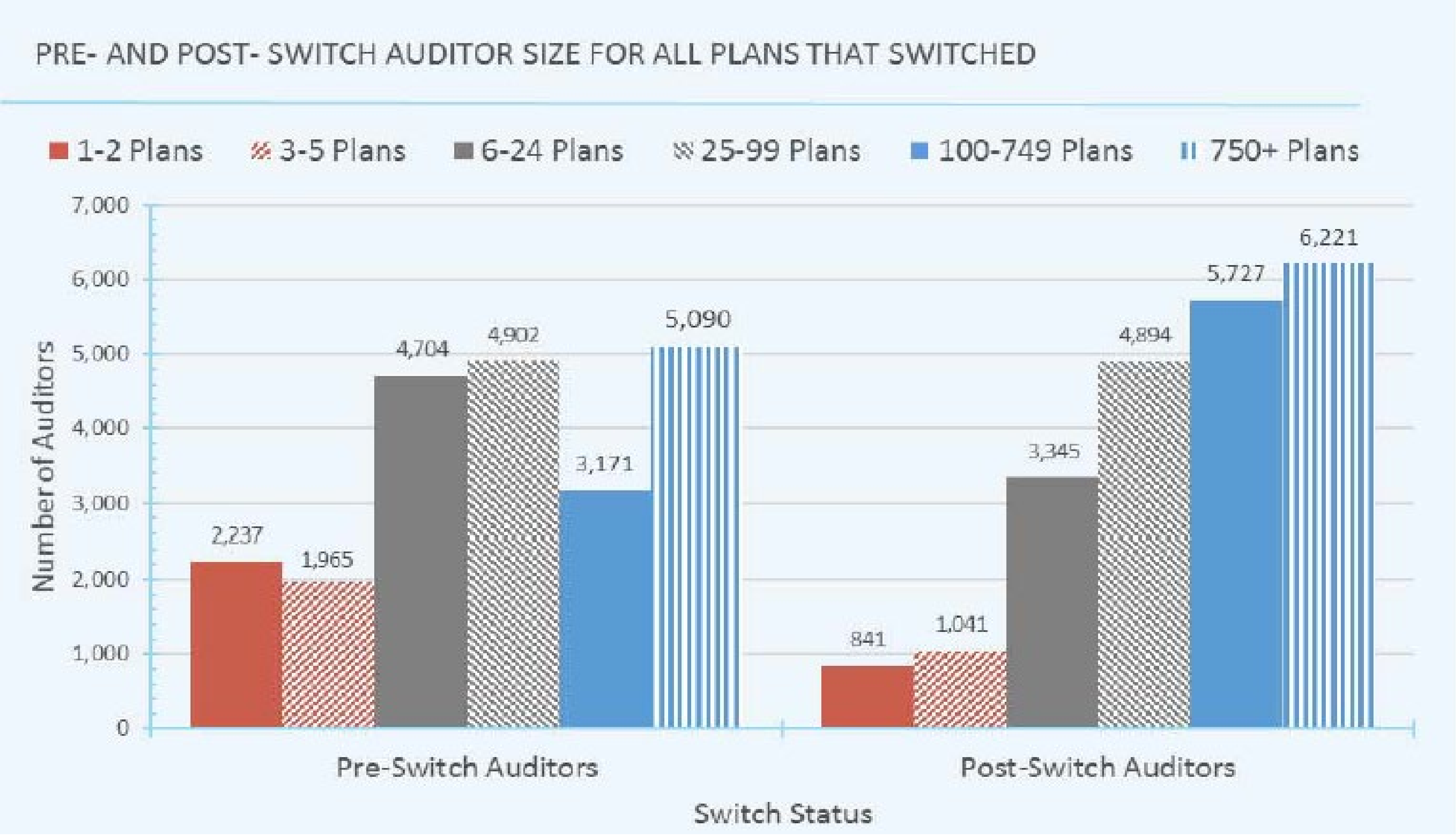
<u>THE ISSUE:</u>

  - 67% of the firms (5,825) audit 5 or fewer plans

Audit Quality – By the Numbers

- Overall deficiencies in plan audits of nearly 40% - but this doesn't tell the whole story
  - Firms with largest EBP practices – 12% error rate
  - Firms with smallest EBP practices – 76% error rate
- Large firms have their own risks and challenges
  - Consistency throughout firm
  - Firm growth through acquisition
  - Dabbling
  - Relationship partners without EBP experience

Audit Quality – What Is Trending Now?



Audit Quality

- Peer review is not a good indicator of a quality benefit plan auditor
- Pay attention to DOL correspondence in this area:
  - 20% resulted in further enforcement action, and,
  - 30% of those cases resulted in financial civil penalties

Other Issues of Concern re: Audits

- Audit legal representation letters –
  - tension with attorney’s duty of client confidentiality
  - ABA Statement of Policy regarding Lawyers' Responses to Auditors' Request for Information ("ABA Statement of Policy")

- In plan mergers, plan auditor should vet financial documents from the other side as part of due diligence.

Audit Issues: Employer Withdrawal Liability

- Paragraph 6.66 of EBP Audit Guide

  " A multiemployer plan may also have a receivable for a withdrawing employer's share of the plan's unfunded liability. The plan should record the receivable, net of any allowance deemed uncollectible, when entitlement has been determined."

Withdrawal Liability - When Is Entitlement Determined?

- When the employer notifies the plan they are leaving?
- When the plan notifies the employer that an obligation exists?
- When the plan actuary calculates the obligation?
- When the plan assesses the liability against the employer?
- If contested, when the arbitration is settled?

Withdrawal Liability - What Amount Should Be Booked as a Receivable?

- None—book it on the cash basis?
- Should a plan record the assessed obligation or the present value of amount assessed?
- What discount rate should be used to determine the present value and why?
- Allowance for Uncollectible Amounts
  - Who determines?
  - What should be considered?
  - Should it be determined for each employer separately?
- When is a 100% allowance acceptable?
- When should the asset be written off?

Payroll Audits

- Multiemployer plan trustees have a fiduciary duty under ERISA to make sure the fund is receiving all employer contributions that are due based on participants' hours worked.
- Payroll audit is an examination of the records of a contributing employer to determine whether all of the hours or wages that a collective bargaining agreement (CBA) requires were reported.
- *See* IRS Multiemployer Plan Examination guidelines, 4.72.14.2.4 (09-26-2017):

  Because obtaining correct information is essential for maintaining qualified status, plans may also use field auditors to check the accuracy of the employer's information. Independent field auditors visit the Contributing Employers to compare their remittance reports with their payroll and other personnel records with union dues and other records the union or affiliated health and welfare plans maintain.

Questions?