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Audits of employee benefit plans with conforming changes as of May 1, 1995; Audit and accounting guide:

American Institute of Certified Public Accountants. Employee Benefit Plans Committee

AICPA
Audit
and
Accounting
Guide

AUDITS of EMPLOYEE BENEFIT PLANS

With Conforming Changes as of May 1, 1995

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This edition of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which was originally issued in 1991, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. The changes made are identified in a schedule in appendix K of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

American Institute of Certified Public Accountants

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Employee Benefit Plans Committee on the application of generally accepted auditing standards to audits of financial statements of employee benefit plans. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for employee benefit plans. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

The Employee Benefit Plans Committee gratefully acknowledges the contributions of Melissa A.R. Krause and Andrew E. Nolan, Jr., former committee members; Daniel J. Cronin; The Office of Chief Accountant, Pension and Welfare Benefits Administration; and the Office of the Inspector General, U.S. Department of Labor.

Preface

This guide has been prepared to assist the practitioner in preparing, auditing, and reporting on financial statements of employee benefit plans, including defined benefit pension plans, defined contribution plans, and employee health and welfare benefit plans. This guide applies to audits of financial statements of employee benefit plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as those that are not. Appendix A identifies and summarizes relevant Employee Retirement Income Security Act of 1974 (ERISA) requirements and regulations.

Generally accepted auditing standards and accounting principles are applicable in general to employee benefit plans. The broad application of those standards and principles is not discussed here. Rather, the guide focuses on the special problems in auditing and reporting on financial statements that are unique to employee benefit plans.

The guide contains certain suggested auditing procedures, but detailed internal control questionnaires and audit programs are not included. The nature, timing, and extent of auditing procedures are a matter of professional judgment and will vary depending on the size, organizational structure, internal control structure, and other factors in a specific engagement.

The guide also includes information regarding statutory rules and regulations applicable to employee benefit plans and illustrations of plan financial statements and auditors' reports. The Department of Labor, Pension and Welfare Benefits Administration strongly encourages the use of this guide in meeting the requirements contained in ERISA section 103 that a plan have an audit conducted in accordance with generally accepted auditing standards.

The guidance in this audit guide is in certain respects more detailed than that generally included in other AICPA audit guides. To facilitate reference, paragraphs have been numbered.

Generally Accepted Accounting Principles

In March 1980 the Financial Accounting Standards Board (FASB) issued Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. In August 1992 the FASB issued Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, which amends FASB Statement No. 35. FASB Statements No. 35 and 110 do not, however, apply to defined contribution plans and employee health and welfare benefit plans.

Chapters 3 and 4 of this guide describe the specialized accounting principles and practices for defined contribution plans and employee health and welfare benefit plans, respectively. The accounting guidance in those chapters is consistent with the accounting and reporting standards in FASB Statement No. 35 to the extent that this is appropriate.

In August 1992, Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, was issued which clarifies several accounting and reporting requirements set forth in chapter 4 and updates the guide to incorporate new statements issued by the FASB. The SOP is effective for audits of single-employer plans with more than 500 participants for plan years beginning after December 15, 1992; for audits of single employer plans with no more than 500 participants for plan years beginning after December 15, 1994; and for audits of multiemployer plans for plan years beginning after December 15, 1995. Earlier adoption is encouraged. When a plan adopts the SOP, it must be adopted in its entirety.

Effective Date

The provisions of this guide are effective for audits of financial statements for plan years beginning after December 15, 1990. The provisions of this guide should also be applied in audits of financial statements for earlier plan years when such audits are performed concurrently with audits for plan years beginning after December 15, 1990.

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Chapter 1

Introduction and Background

1.01 The purpose of this guide is to provide guidance on accounting, auditing, and reporting on the financial statements of employee benefit plans (plans). This guide applies to defined benefit pension plans, defined contribution pension plans, and defined benefit and defined contribution health and welfare benefit plans. In the United States, there are approximately 731,000 private pension plans and 9 million health and welfare benefits. The private pension plans alone cover approximately 76.4 million participants and include assets of more than $1.67 trillion.

1.02 This guide applies to audits of financial statements and supplemental schedules, as applicable, of plans that are subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 (ERISA), as well as to those that are not. The recommendations contained in this guide apply to the financial statements of plans sponsored by commercial or not-for-profit private sector entities. The accounting provisions of this guide are not intended to apply to governmental employee benefit plans; however, portions of the guide may be useful to auditors of those plans. The guide discusses accounting, auditing, and reporting for ongoing and terminated plans. A plan is the reporting entity as defined under ERISA and Financial Accounting Standards Board (FASB) Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*. Although this guide does not specifically discuss accounting, auditing, and reporting for employee benefit trusts as separate entities, it may be useful to auditors reporting on employee benefit trusts.

1.03 The guidance presented is not all-inclusive, but rather is limited generally to matters that warrant special emphasis or that experience has indicated may be useful. This guide bases on the assumption that the readers are generally expert in accounting and auditing and focuses on specific problems of auditing, accounting, and reporting with respect to the financial statements of employee benefit plans. Accordingly, the guide does not discuss the application of all generally accepted accounting principles and auditing standards as they pertain to the auditing of such financial statements. The nature, timing, and extent of auditing procedures are matters of professional judgment and will vary according to the size of the plan, the plan operations and administrative structure, the auditor's assessment of the level of risk, and other factors. The independent auditor is also expected to be familiar with applicable governmental laws and regulations.

1.04 *Defined benefit pension plans* provide a promise to pay to participants specified benefits that are determinable and are based on such factors as age, years of service, and compensation.

1.05 *Defined contribution pension plans* provide an individual account for each participant and provide benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan. These plans, which are discussed in more detail in chapter 3, include (*a*) profit-sharing plans, (*b*) money purchase pension plans, (*c*) stock bonus and employee stock ownership plans (ESOPs), (*d*) thrift or savings plans including 401(k) arrangements, and (*e*) certain target benefit plans.

1.06 *Health and welfare benefit plans*, which are discussed in more detail in chapter 4, include plans that provide (*a*) medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits; (*b*) unemployment, disability, vacations or holiday benefits; and (*c*) apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits. Health and welfare benefit plans may be either defined-benefit or defined-contribution plans, as explained in the following paragraphs and in more detail in chapter 4:

a. Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of reimbursement to the covered plan participant or a direct payment to providers or third party insurers for the cost of specified services.

b. Defined-contribution health and welfare plans maintain an individual account for each plan participant. Such plans have provisions that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive.

Financial Accounting and Reporting Standards

1.07 FASB Statement No. 35, issued in March 1980, established standards of financial accounting and reporting for financial statements of defined benefit pension plans but did not establish standards for defined contribution or health and welfare benefit plans. This Audit and Accounting Guide provides guidance on certain accounting, auditing, and reporting matters considered unique to employee benefit plans, including defined contribution and health and welfare benefit plans. SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, was issued August 3, 1992. It will supersede chapter 4 of this guide.

1.08 Employee benefit plans that are subject to ERISA are required to report certain information annually to federal government agencies—that is, U.S. Department of Labor (DOL), Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC)—and to provide summarized information to plan participants. For many plans, the information is reported to the IRS on Form 5500, *Annual Return/Report of Employee Benefit Plan*, which includes financial statements prepared in conformity with generally accepted accounting principles and certain financial schedules (for example, plan investments and reportable transactions).

Governmental Regulations

1.09 Various provisions of the Internal Revenue Code (IRC) affect employee benefit plans and trusts established pursuant to employee benefit plans. If an employee benefit plan and its underlying trust qualify under section 401(a) of the IRC, certain tax benefits are available, including (*a*) current tax deductions by plan sponsors for contributions, subject to certain limitations; (*b*) deferment of income to participants until the benefits are distributed; (*c*) exemption of the trust from income taxes, other than tax on unrelated business income; and (*d*) favorable tax treatment of certain benefit distributions to participants or their estates. Special rules apply to nonqualified plans and trusts depending on whether the plan is funded or unfunded. Generally, qualified plans provide benefits to relatively broad groups of employees, whereas unqualified plans provide benefits to only a few key employees and may not be currently funded. Generally, ERISA preempts state laws and regulations (see discussion of ERISA in appendix A).

Reporting and Disclosure Requirements

1.10 ERISA provides for substantial federal government oversight of the operating and reporting practices of employee benefit plans. In addition to establishing extensive reporting requirements for covered plans, ERISA establishes minimum standards for participation, vesting, and funding for defined benefit and defined contribution plans sponsored by private entities. It also establishes standards of fiduciary conduct and imposes specific restrictions and responsibilities on fiduciaries.

1.11 Under ERISA, the DOL and the IRS have the authority to issue regulations covering reporting and disclosure requirements and certain administrative responsibilities. The PBGC guarantees participants in most defined benefit pension plans against the loss of certain pension benefits if the plan terminates, and it administers terminated plans in certain circumstances.

1.12 Appendix A describes which plans are covered by ERISA and pertinent provisions of ERISA and related reporting and disclosure regulations issued by the DOL. Additional guidance concerning the effects of the IRC, ERISA, and related regulations on the operating and reporting practices of employee benefit plans is discussed throughout this guide.

1.13 Section 104(a)(4) of ERISA describes the power of the DOL to reject reports, including the authority to change auditors. Section 107 of ERISA requires that working papers supporting audits of employee benefit plans be kept for a period of six years. Section 502(c)(2) of ERISA describes the substantial penalties that may be assessed by the DOL (see appendix A).

Audit Requirements

1.14 ERISA contains a requirement for annual audits of plan financial statements by an independent qualified public accountant. Generally, plans with 100 or more participants (see appendix A) are subject to the audit requirement. The independent auditor's objective and responsibility, under generally accepted auditing standards (GAAS), are to express an opinion on whether the financial statements are fairly presented in conformity with generally accepted accounting principles, and that the related supplemental information is presented fairly, in all material respects, when considered in conjunction with the financial statements taken as a whole. It should be recognized that although the audit requirement in ERISA is an important part of the total process designed to protect plan participants, a GAAS audit is not designed to ensure compliance with ERISA's provisions. Under the law, plan administrators, the IRS and the DOL have responsibility to ensure such compliance. The annual report and the financial statements prepared by the plan administrator and the independent auditor's report all contribute to the monitoring activities of these parties and agencies. An audit is an important discipline on the financial information reported by the plan administrator, but it does not ensure compliance with all legislative and regulatory requirements.

Operation and Administration

1.15 Employee benefit plans vary by basic type (defined benefit pension plans, defined contribution plans, and defined benefit and defined contribution health and welfare benefit plans) and by basic operating and administrative characteristics. Employee benefit plans may be single employer plans or multiemployer plans.[1] The most distinguishing characteristic between single employer plans and multiemployer plans is administration. Single employer plans are generally established by the management of one employer (or a controlled group of corporations) either unilaterally or through collective bargaining. In a single employer plan, the employer is the plan sponsor. By contrast, multiemployer plans are normally negotiated and established pursuant to a collective bargaining agreement between an associated group of employers, such as in the construction trades, and the union representing the employees. The plan sponsor of a multiemployer plan, with whom ultimate administrative responsibility rests, is a joint employer/union board of trustees.

1.16 Contributions may be required from both employers and participants (contributory plans) or from employers only (noncontributory plans). Noncontributory plans may contain provisions for payment of contributions or premiums by participants to maintain their eligibility during periods of unemployment; they may also provide for voluntary contributions by participants.

1.17 Plans may be funded through accumulated contributions and investment income (self-funded plans), funded through insurance contracts (insured plans), or funded through a combination of both (split-funded plans).

1.18 Employee benefit plans are normally established and maintained by plan sponsors pursuant to plan instruments. The provisions of plan instruments normally deal with such matters as eligibility to participate, entitlement to benefits, funding, plan amendments, operation and administration of plan provisions, identification of the plan's named fiduciary and allocation of responsibilities among those who also serve in the capacity as fiduciaries for control and management of the plan, and delegation by fiduciaries of duties in connection with administration of the plan. A plan subject to ERISA is required to be in writing. The IRS has prepared and updated standard (master or prototype) plans that are available to plan sponsors and may be qualified by simplified procedures. In addition, standardized (or pattern) plans that have IRS approval are available from various sources.

1.19 The named fiduciary is responsible for the operation and administration of a plan including the identification of a plan administrator. This individual is usually an officer or other employee of the plan sponsor and typically reports to the plan sponsor's board of directors or management. Sometimes the named fiduciary is a trustee and a union representative. The named fiduciary has continuing responsibility for operation of the plan in accordance with the terms of the plan instrument, any trust instrument or insurance contracts, and government laws and regulations. Generally, the named fiduciary makes policy decisions concerning such matters as interpretation of the plan provisions, determination of the rights of participants under the plan, management of investments, and delegation of operational and administrative duties.

1.20 Although the named fiduciary retains responsibility for oversight of the plan, the plan's day-to-day administration (for example, collection of contri-

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[1] ERISA defines the term "multiemployer plan" as a plan to which more than one employer is required to contribute, that is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer, and that satisfies other requirements that may be prescribed by DOL regulations. As used in this guide, the term "single employer plan" may include plans with more than one employer under common control.

butions, payment of benefits, management of cash and investments, maintenance of records, and preparation of reports) generally is allocated to one or more of the following: (*a*) the plan sponsor; (*b*) a trustee, such as a bank trust department; (*c*) an insurance company; (*d*) an investment advisor; or (*e*) the person or persons designated as the plan administrator or administrative agent.

1.21 In self-funded plans, the plan assets typically are managed in accordance with a trust instrument that sets forth, among other matters, the authority and responsibilities of the trustees and any investment advisors and managers. In insured plans, the plan assets typically are managed in accordance with an agreement that sets forth the duties and responsibilities of the insurance company.

Accounting Records

1.22 As with other entities, the accounting records of employee benefit plans should produce information necessary for effective management and reliable financial reporting. The complexity of a plan's accounting records will vary with such factors as the type of plan, number of employer contributors, complexity of the benefit formula, variety of benefit payment options, and delegation of administrative duties.

1.23 The accounting and other plan records of employee benefit plans often are maintained at several locations. Depending on the type of plan, the allocation of fiduciary responsibilities, and the delegation of administrative duties, records may be maintained by trustees, insurance companies, consulting actuaries, service bureaus, the plan administrator, contract administrators, and plan sponsors. The records of plans including, among others, the basic accounting records, generally should include—

a. *Investment asset records.* ERISA requires detailed reporting of investment assets including reportable transactions, party in interest transactions, and leases and loans in default.

b. *Participants' records.* Records should be maintained to determine each employee's eligibility to participate in the plan and receive benefits. Eligibility for participation and benefits may be based on such factors as length of service, earnings, production, and contributions, and can be affected by age or breaks in service. These records are generally part of or derived from the personnel and payroll records maintained by the employer or the plan. These records are often made available to the plan's actuary to be used in computing various amounts including amounts to be funded.

c. *Contribution records.* Separate contribution records should be maintained for each plan contributor to record payments and accumulated contributions and to determine delinquencies and errors. These records should provide sufficient detail to record contributions and payments received from a number of employers according to pertinent agreements or from individual participants.

d. *Claim records.* Claim records for health and welfare plans are generally extensive. They are used for such purposes as determining when benefit limits, if any, are reached by individual claimants and accumulating various historical data regarding types and amounts of claims, amounts paid, and timing of claims.

e. *Distribution records.* Records should be maintained to support all distributions. These records should identify entitlements, amounts, payment commencement data, terminations, forfeitures, transfers, and information to determine the tax consequences of distributions.

f. *Individual participants' account information.* ERISA requires information that reflects each plan participant's share of the total net assets of the plan be maintained. Changes in the value of net assets are allocated to the participants' accounts in accordance with the terms of the plan instrument. This information, which is not part of the basic books and records of a defined contribution plan, should necessarily be in agreement with the aggregate participant account information contained in the basic books and records.

g. *Administrative expenses.* These expenses should be supported by invoices, contracts, agreements, or other written evidence.

h. *General accounting records.* Plans are required to maintain records of their receipts and disbursements; however, in many cases they are prepared by the trustee. General ledgers are also generally maintained by the trustee.

Chapter 2

Accounting and Reporting by Defined Benefit Pension Plans

2.01 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, establishes generally accepted accounting principles for defined benefit pension plans and prescribes the general form and content of financial statements of those plans.

2.02 This chapter is intended to familiarize the auditor with some of the principal provisions of FASB Statement No. 35, as amended, to provide further discussion of certain principles set forth in the statement and, in the section dealing with terminating plans (paragraphs 2.33 through 2.36), to address an important matter not addressed in the statement. This chapter is not intended to modify or to serve as a substitute for the statement, which should be referred to for the specific accounting requirements for defined benefit pension plans. Appendix C of this guide reproduces the accounting standards of FASB Statement No. 35, as amended, and appendix D contains the illustrative financial statements from the statement.

2.03 Generally accepted accounting principles other than those discussed in this chapter may also apply to defined benefit pension plans.

Regulatory Reporting Requirements

2.04 In addition to the reporting requirements of FASB Statement No. 35, as amended, defined benefit pension plans have reporting requirements under ERISA. The financial statements required by ERISA are a statement of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed-income obligations due in default or uncollectible, leases in default or uncollectible, and reportable transactions. The ERISA reporting requirements are described in appendix A.

2.05 In accordance with the requirements of ERISA sections 105 and 209, the plan administrator must furnish to any participant who so requests in writing—but not more than once a year—a statement of the participant's total accrued benefit and the earliest date on which he or she will become vested.

Financial Statements

2.06 The FASB has determined that the primary objective of a plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. That objective requires the presentation of information about the plan's economic resources and a measure of participants' accumulated benefits.

2.07 Unless the financial statements are not intended to be presented in accordance with generally accepted accounting principles, the financial statements of a defined benefit pension plan should be prepared on the accrual basis and should include the following:[2]

a. A statement of the net assets available for benefits as of the end of the plan year[3]

b. A statement of changes in net assets available for benefits for the year then ended

c. Information regarding the actuarial present value of accumulated plan benefits

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in accumulated plan benefits

2.08 FASB Statement No. 35, as amended, gives guidance on the form and content of the required financial statements and specifies that they be presented in sufficient detail to assist readers of plan financial statements in assessing the plan's present and future ability to pay benefits when due. Information regarding the actuarial present value of accumulated plan benefits and changes therein, however, may be presented in the financial statements or in the notes.

Net Assets Available for Benefits

Investments

2.09 Plan investments are generally to be presented at their fair value at the reporting date (see paragraph 2.12 for special provisions concerning the valuation of insurance contracts). Fair value of plan investments is the amount that the plan could reasonably expect to receive in a current sale of assets and should be measured by quoted market prices when available. Original cost of investments is not required to be disclosed. Assets used in the administration of the plan are to be stated at cost less accumulated depreciation or amortization.

2.10 Some plan investments may not have market quotations and, therefore, will need to be valued "in good faith." Examples include real estate, mortgages or other loans, restricted securities, unregistered securities, and securities for which the market is thin. It is the obligation of the plan's trustees, the administrator, and the corporate trustee (*a*) to satisfy themselves that all appropriate factors relevant to the value of the investments have been considered and (*b*) to select a method to estimate the fair value of the investments. To the extent considered necessary, the plan may use the services of a specialist to estimate the fair value of investments valued in good faith.

2.11 Some of the general factors that may be considered in estimating the fair value of plan investments are the type of investment, cost at date of purchase, size and period of holdings, information about transactions or offers

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[2] FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale* (an amendment of FASB Statement No. 95, *Statement of Cash Flows*), excluded defined benefit pension plans that present information in accordance with the provisions of FASB Statement No. 35, as amended, from the requirement of FASB Statement No. 95 to present a statement of cash flows. Plans should consider providing a statement of cash flows when that statement would provide relevant information about the ability of the plan to pay benefits (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

[3] ERISA requires that this statement be presented in comparative form.

regarding the investment, reported prices and extent of trading in similar investments, a forecast of expected cash flows from the investment, changes in economic conditions relating to the investment, financial condition of the investee or issuer, current interest rates, and the nature and duration of restrictions on disposition. The foregoing is not a complete list of all factors that may be considered.

2.12 A defined benefit plan should report investment contracts at fair value. See FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*. Whether or not the plan is subject to ERISA, insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by a plan with certain governmental agencies pursuant to ERISA, consistent with the requirements of DOL Form 5500 or 5500-C/R. The current Form 5500 (1992) permits unallocated insurance contracts to be reported at either current value or as determined on the Schedule A, *Insurance Information*, that is, contract value. This is an exception to the general requirement of FASB Statement No. 35, as amended, that plan investments be presented at fair value. A plan not subject to ERISA should present its insurance contracts as if the plan were subject to the reporting requirements of ERISA.

2.13 Presentation of plan investments in the statement of net assets available for benefits should be detailed by general type such as government securities, short-term securities, corporate bonds, common stocks, mortgages, and real estate. Also reflected as individual line items in the financial statements are investments in bank common and commingled trust funds and master trusts and investments in contracts with insurance companies, including separate accounts, deposit administration (DA), and immediate participation guarantee (IPG) contracts. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were otherwise determined.

Contributions

2.14 Contributions receivable are amounts due as of the date of the financial statements, including legal or contractual obligations and, for a single employer plan, obligations resulting from a formal commitment. Evidence of a formal commitment may include (*a*) a formal resolution by the sponsor, (*b*) amounts relating to an established funding policy, (*c*) a deduction on the federal tax return, or (*d*) the employer's recognition, as of the reporting date, of a contribution payable to the plan.[4] Contributions receivable should include an allowance for estimated uncollectible amounts.

2.15 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 for an amount deemed uncollectible, when entitlement has been determined.

Accrued Liabilities

2.16 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, in-

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[4] The existence of accrued costs in the employer's financial statements or a deficit in net assets of the plan do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

come taxes payable by the plan or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. Benefit amounts should not be accrued as liabilities.

Changes in Net Assets Available for Benefits

2.17 Information regarding changes in net assets available for benefits is intended to present the effects of significant changes in net assets during the year and should present, at a minimum—

a. The net change in the fair value (or estimated fair value) of each significant type of investment (see paragraph 2.13). Gains and losses from investments sold need not be segregated from unrealized gains and losses relating to investments held at year-end.

b. Investment income, exclusive of changes in fair value described in (*a*) preceding.

c. Contributions from employers.

d. Contributions from participants.

e. Contributions from other sources.

f. Benefits paid.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

Other changes (for example, transfers of assets to or from other plans) should also be presented if they are significant.

Accumulated Plan Benefits

2.18 Accumulated plan benefits are to be presented as the present value of future benefits attributable, under the plan's provisions, to service rendered to the date of the actuarial valuation. The accumulated benefit information may be presented as of the beginning or the end of the plan year; under FASB Statement No. 35, as amended, however, an end-of-year benefit information date is considered preferable. If the information is as of the beginning of the year, prior-year statements of net assets and changes therein are also required; otherwise, comparative statements are not required.

2.19 Accumulated plan benefits include benefits for (*a*) retired or terminated employees or their beneficiaries, (*b*) beneficiaries of deceased employees, and (*c*) present employees or their beneficiaries. To the extent possible, plan provisions should govern the measurement of accumulated plan benefits. When the plan does not specify the benefits earned in each year, a general method for measurement is provided in FASB Statement No. 35, paragraph 17. Future service should be considered only in determining an employee's eligibility for certain benefits. Future increases in salaries and benefits are assumed only to the extent that they have been specified (for example, automatic cost-of-living increases). Plans providing death and disability benefits should consider these factors in the calculation. Retroactive plan amendments adopted before the date of the calculation should be given effect in the calculation, even if some provisions take effect only in future periods. Plan amendments occurring after the date of the calculation should be excluded. As in the presentation of plan assets, benefits that are guaranteed by a contract with an insurance company, that is, *allocated contracts*, should be excluded.

2.20 The assumptions used in calculating accumulated plan benefits are to be based on the premise of an ongoing plan. Accordingly, the interest rates used for discounting expected future payments should reflect the rates of return expected on plan investments during the periods for which the benefits are deferred (see paragraph 20 of FASB Statement No. 35). An appropriate allowance for future employee mortality and turnover should be provided. The significant assumptions used in the calculation must be developed using an *explicit* approach, whereby each assumption, standing alone, represents the best estimate of the plan's future experience. These assumptions may differ from those used in the determination of the plan's funding and the plan sponsor's pension costs.

2.21 As noted previously, the benefit information may be presented in a separate statement, combined with other information in a financial statement, or presented in a note to the financial statements. The information, however, must all be located in one place and should be classified as follows:

a. Vested benefits of participants currently receiving benefits

b. Other vested benefits

c. Nonvested benefits

If the plan is contributory, accumulated contributions of active employees including, if applicable, interest credited on those contributions, should be disclosed. If interest is credited on the contributions, the interest rate should also be disclosed.

Changes in Accumulated Plan Benefits

2.22 Information regarding the change in accumulated benefits from the beginning to the end of the year should be presented to identify significant factors affecting the comparability of the year-to-year accumulated benefits. As with the accumulated benefit information, the changes may be presented in the body of the financial statements or in the notes; they may be presented in either a reconciliation or a narrative format. Minimum disclosures should include the significant effects of such factors as plan amendments, changes in the nature of the plan, and changes in actuarial assumptions. Changes in actuarial assumptions are to be viewed as changes in accounting estimates, and, therefore, previously reported amounts should not be restated. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified *other* category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

2.23 APB Opinion No. 22, *Disclosure of Accounting Policies*, requires the disclosure of significant accounting policies, and FASB Statement No. 35, as amended, requires disclosure of (*a*) the method and significant assumptions used to value investments and contracts with insurance companies and (*b*) the method and significant assumptions used in determining the actuarial present value of accumulated plan benefits, including any significant changes in the method or assumptions during the year.

2.24 FASB Statement No. 35, as amended, also requires disclosure of—

a. A brief general description of the plan agreement, including its vesting and benefit provisions.

b. A description of significant plan amendments adopted during the year. If the amendments were adopted after the date of the accumulated benefit information, and accordingly their effect was not included in the calculation, this fact should be stated.

c. A brief description of the benefit priority and PBGC coverage in the event of plan termination.

d. The funding policy and any changes in the policy during the year. When applicable, the method of determining employee contributions should be disclosed. ERISA plans should disclose their status with respect to any applicable minimum funding requirements.

e. The policy regarding the purchase of insurance contracts that have been excluded from plan assets and the income from those contracts for the year.

f. The federal income tax status of the plan if a favorable determination letter from the IRS has not been obtained or maintained. Note that reports filed in accordance with the requirements of ERISA must include disclosure of "information concerning whether or not a tax ruling or determination letter has been obtained," which is more than is required by FASB Statement No. 35, as amended.

g. Investments that represent 5 percent or more of total net assets. (Listing all investments in the schedule of Assets Held for Investment Purposes required by ERISA does not eliminate the requirement to include this disclosure in the financial statements.)

h. Significant related-party transactions (see appendix A and chapter 11 for a discussion of related-party transactions).

i. Significant subsequent events that may affect the usefulness of the financial statements (see chapter 12 for a discussion of subsequent events).

This list is not intended to modify the disclosure requirements of FASB Statement No. 35, as amended, but, rather, to serve as a reference to the major requirements. Nor does this list include information required by ERISA to be disclosed in the schedules filed as part of a plan's annual report. In this connection, it is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information on the face of the financial statements or in the notes to the financial statements but not in the schedules is not acceptable.

2.25 FASB Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires all entities to disclose information principally about financial instruments with off-balance-sheet risk. Financial instruments of a pension plan, other than obligations for pension benefits, when subject to the accounting and reporting requirements of FASB Statement No. 35, as amended, are included in the scope of FASB Statement No. 105, as amended. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87, *Employers' Accounting for Pensions*; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statement Nos. 60, *Accounting and Reporting by Insurance Enterprises* and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*.

2.26 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of this statement are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest rate and foreign currency swaps.

2.27 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with off-balance-sheet credit risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22
- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

2.28 As indicated in paragraph 2.13 investments in master trusts are presented in a single line item in the statement of net assets available for benefits. In the notes to the financial statements the investments of the master trust should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages and real estate, as of the date of each statement of net assets available for benefits presented. The net change in the fair value of each significant type of investment of the master trust and total investment income of the master trust by type, e.g., interest, dividends, etc., should also be disclosed in the notes for each period for which a statement of changes in net assets available for benefits is presented. The notes to the financial statements should also include a description of the basis used to allocate net assets, net investment income, gains and losses to participating plans, and the plan's percentage interest in the master trust as of the date of each statement of net assets available for benefits presented.

2.29 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 119, requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a pension plan other than (i) obligations for pension benefits as defined in FASB Statement No. 35, as amended, and (ii) insurance contracts as defined in FASB Statement No. 110 are included in the scope of FASB Statement No. 107 and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

2.30 FASB Statement No. 107, as amended, requires entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

2.31 FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

2.32 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Terminating Plans

2.33 FASB Statement No. 35, as amended, explicitly excludes terminating plans. For purposes of this guide, terminating plans include all plans as to which a decision to terminate has been made, regardless of whether the terminated plan will be replaced.

2.34 When the decision to terminate a plan has been made,[5] or a wasting trust or frozen plan (that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits) exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, described subsequently. If the decision is made after the year-end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, section 560, *Subsequent Events*, paragraph 5.

2.35 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis. An Auditing Standards Division staff interpretation, *Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting* (AICPA *Professional Standards*, vol. 1, AU section 9508.33—.38), contains applicable guidance as to the auditor's reporting responsibilities with respect to terminating plans (see paragraph 13.37). For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance contracts carried at *contract values*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

2.36 Accumulated plan benefits should be determined on a liquidation basis, which may differ significantly from the actuarial present value of accumulated plan benefits reported for an ongoing plan. In general, upon termination all benefits should be reported as vested (see paragraph 13.37).

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[5] Refer to paragraph 12.11, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation as to whether there is a present intention to terminate the plan. Refer also to paragraph 10.33h, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

Chapter 3

Accounting and Reporting by Defined Contribution Plans

3.01 This chapter describes generally accepted accounting principles for accounting and financial reporting that are particularly important to defined contribution plans. Other generally accepted accounting principles may also apply. Except for differences in determining plan benefits, as noted in paragraph 3.03, defined contribution plans are similar to defined benefit plans. Accordingly, the guidance in this chapter is consistent with the accounting and reporting standards in FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended, and chapter 2 of this guide to the extent that this is appropriate.

3.02 Defined contribution plans require an individual account for each participant and provide benefits based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience on such amounts, (*c*) expenses, and (*d*) any forfeitures allocated to the account.

3.03 Under a defined contribution plan the employer contribution rate is generally determined periodically at the discretion of the employer or by contractual agreement, or both. When a participant retires or withdraws from the plan, the amount allocated to the participant's account (if fully vested) represents the participant's accumulated benefits. That amount may be paid to the participant or used to purchase a retirement annuity. The amount of benefits a participant will ultimately receive is generally not determined until the time of payment. By contrast, in a defined benefit plan, benefits are determinable and the contribution necessary to provide those benefits is actuarially determined. In other respects, defined contribution plans are similar to defined benefit plans.

3.04 There are three general types of defined contribution plans: profit-sharing plans, money purchase pension plans, and stock bonus plans.

a. A *profit-sharing plan* is a defined contribution plan that is not a pension plan (as defined in the IRC) or a stock bonus plan. Employer contributions may be discretionary or may be based on a fixed formula related to profits, compensation, or other factors. Before 1987, contributions had to be made from the plan sponsor's current or accumulated profits. This requirement is no longer in effect. A profit-sharing plan must be designated as such in the plan document.

b. A *money purchase pension plan* is a defined contribution plan under which employer contributions are based on a fixed formula that is not related to profits and that is designated as a pension plan by the plan sponsor.

c. A *stock bonus plan* is a defined contribution plan under which distributions are normally made in stock of the employer, unless the distributee elects otherwise.

3.05 A number of more specialized plans exist that are included in the three general types of plans. These include the following:

- A *cash-or-deferred arrangement* (also called a *section 401(k) plan*) may be incorporated into a profit-sharing or stock bonus plan (a few pre-

ERISA money purchase pension plans also incorporate cash-or-deferred arrangements). Under such an arrangement, a participant is permitted to elect to receive amounts in cash or have them contributed to the plan as employer contributions on the participant's behalf.

- A *thrift plan* (also called a *savings plan*) is a profit-sharing or stock bonus plan under which participants make after-tax employee contributions that are usually matched, in whole or in part, by employer contributions.
- An *employee stock ownership plan* (an *ESOP*) is a stock bonus plan that may borrow money from, or on the guarantee of, a related party (a *party in interest* as defined in section 3(14) of ERISA) for the purpose of acquiring securities issued by the plan sponsor and that invests primarily in such securities (a *leveraged ESOP*). The term *employee stock ownership plan* is also generally applied to (*a*) nonleveraged stock bonus plans that satisfy various requirements set forth in section 4975(e)(7) of the IRC and (*b*) profit-sharing plans (and certain pre-ERISA money purchase pension plans) that invest primarily in securities issued by the plan sponsor (see illustrated ESOP financial statements in appendix E).
- A *tax credit employee stock ownership plan* is a profit-sharing or stock bonus plan established before 1987 that satisfies the requirements of section 409 of the IRC. The sponsor of such a plan is allowed a tax credit, rather than a deduction, for its contributions. Before 1982 these plans were commonly known as TRASOPs (for Tax Reduction Act Stock Ownership Plan), and the maximum allowable credit was based on the plan sponsor's investments that qualified for the investment tax credit. In 1982 TRASOPs were succeeded by PAYSOPs, under which the credit was based on the plan sponsor's payroll.
- A *target benefit plan* is a form of money purchase pension plan under which the employer's annual contribution on behalf of each participant is the actuarially determined amount required to fund a *target benefit* established by a plan formula. The target benefit is usually based on compensation and length of service. For some target benefit plans, the substance of the plan may be to provide a defined benefit. For such plans, accounting and reporting as defined benefit plans, as discussed in chapter 2 of this guide, may be more appropriate.
- A *Keogh plan* (also called an *HR 10 plan*) is any defined benefit or defined contribution plan that covers one or more self-employed individuals.

Regulatory Reporting Requirements

3.06 ERISA established annual reporting requirements for employee benefit plans, including defined contribution plans. Those requirements, including financial statement and schedule requirements, are described in appendix A. The financial statements required by ERISA are a statement of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed income obligations due in default or uncollectible, leases in default or uncollectible, and reportable transactions.

3.07 Some defined contribution plans are required to register and report to the Securities and Exchange Commission (SEC). Regulation S-X prescribes the form of the statements of financial position and statements of income and changes in plan equity that those plans must file with the SEC. The SEC has amended its rules for Form 11-K to permit plans subject to ERISA to file financial statements in accordance with ERISA rather than in accordance with Regulation S-X.

3.08 In accordance with the requirements of ERISA sections 105 and 209, the plan administrator must furnish to any participant who so requests in writing—but not more than once a year—a statement of the participant's total vested and nonvested accrued benefits.

Financial Statements

3.09 The primary objective of a defined contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and how the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[6]

3.10 Unless the financial statements are not intended to be presented in accordance with generally accepted accounting principles, the financial statements of a defined contribution plan should be prepared on the accrual basis of accounting[7] and should include (*a*) a statement of net assets available for benefits as of the end of the plan year[8] and (*b*) a statement of changes in net assets available for benefits for the year then ended.

3.11 Appendix E provides illustrative financial statements for a defined contribution plan. The information should be presented in sufficient detail to assist readers of plan financial statements in assessing the plan's present and future ability to pay benefits when due.

Net Assets Available for Benefits

Investments

3.12 Plan investments are generally to be presented at their fair value at the reporting date (see paragraph 3.15 for special provisions concerning the

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[6] In a defined contribution plan, the plan's net assets available to pay benefits equals the sum of participants' individual account balances. Accordingly, the plan's ability to pay benefits when they are due relates to the plan's ability to pay individual participants the then current value of their account balances when due. It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (*b*) financial statements for several plan years can provide more useful information for assessing the plan's future ability to pay benefits than can financial statements for a single plan year.

FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Acquired for Resale,* exempts certain benefit plans from the requirement to provide a statement of cash flows. Plans should consider providing a statement of cash flows when that statement would provide relevant information about the ability of the plan to pay benefits (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

[7] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and *(a)* the fair value of the securities purchased or sold immediately before the financial statement date does not change significantly from the trade date to the financial statement date and *(b)* the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[8] ERISA requires that this statement be presented in comparative form.

valuation of contracts with insurance companies). Fair value of plan investments is the amount that the plan could reasonably expect to receive in a current sale of assets and should be measured by quoted market prices when available. Original cost of investments is not required to be disclosed.

3.13 Some plan investments may not have market quotations and, therefore, will need to be valued "in good faith." Examples include real estate, mortgages or other loans, including loans to participants of a 401(k) plan, restricted securities, unregistered securities, and securities for which the market is thin. It is the obligation of the plan's trustees, the administrator, and the corporate trustee (*a*) to satisfy themselves that all appropriate factors relevant to the value of the investments have been considered and (*b*) to select a method to estimate the fair value of the investments. To the extent considered necessary, the plan may use the services of a specialist to estimate the fair value of investments valued in good faith.

3.14 Some of the general factors that may be considered in estimating the fair value of plan investments are the type of investment, cost at date of purchase, size and period of holdings, information about transactions or offers regarding the investment, reported prices and extent of trading in similar investments, a forecast of expected cash flows from the investment, changes in economic conditions relating to the investment, financial condition of the investee or issuer, current interest rates, and the nature and duration of restrictions on disposition. The foregoing is not a complete list of all factors that may be considered.

3.15 Whether the plan is subject to ERISA or not, contracts with insurance companies are to be included as plan assets in the manner required by ERISA annual reporting requirements and are to be reported in a manner consistent with the requirements of DOL Form 5500 or 5500-C/R. The current Form 5500 (1992) permits unallocated insurance contracts to be reported at either current value or as determined on the Schedule A, *Insurance Information*, that is, contract value. This is an exception to the general requirement that plan investments be presented at fair value. The exception applies only to investments in contracts issued by insurance companies; investments in similar contracts issued by banks, savings and loan associations, or other financial institutions are presented at fair value. Further discussion of insurance contracts is provided in chapter 7.

3.16 Presentation of plan investments in the statement of net assets available for benefits should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages, loans to participants, and real estate. Also reflected as individual line items in the financial statements are the values of investments in bank common and commingled trust funds and master trusts and investments in contracts with insurance companies, including separate accounts, deposit administration (DA), and immediate participation guarantee (IPG) contracts. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were otherwise determined.

Contributions Receivable

3.17 Contributions receivable are the amounts due, as of the financial statement date, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants, which should be separately identified). Contributions receivable include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution, (*b*) a consistent pattern of making payments after the plan's year-end pursuant to an established contribution policy that attributes such subsequent payments to the preceding plan year, (*c*) a deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date, or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[9] Contributions receivable should include an allowance for estimated uncollectible amounts.

Operating Assets

3.18 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be presented at cost less accumulated depreciation or amortization.

Accrued Liabilities

3.19 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits. The plan should not reflect as liabilities amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid (see paragraph 3.23*m*).

Changes in Net Assets Available for Benefits

3.20 Information regarding changes in net assets available for benefits is intended to present the effects of significant changes in net assets during the year and should present at a minimum—

a. The change in fair value (or estimated fair value) of each significant type of investment (see paragraph 3.16). Gains and losses from investments sold need not be segregated from unrealized gains and losses relating to investments held at year-end.[10]

b. Investment income, exclusive of changes in fair value described in (*a*) preceding.

c. Contributions from employers, segregated between cash and noncash contributions (a noncash contribution should be recorded at fair value; the nature of noncash contributions should be described either parenthetically or in a note).

d. Contributions from participants, including those transmitted by the sponsor.

e. Contributions from other identified sources (for example, state subsidies or federal grants).

f. Benefits paid to participants.

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[9] The existence of an accrued contribution payable in the employer's financial statements does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

[10] Realized gains and losses on investments that were both bought and sold during the period should be included.

g. Payments to insurance companies to purchase contracts that are excluded from plan assets.

h. Administrative expenses.

3.21 The minimum disclosures should be made to the extent that they apply to the plan. The list of minimum disclosures is not intended to limit the amount of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful. Other changes (for example, transfers of assets to or from other plans) should also be presented if they are significant.

Additional Financial Statement Disclosures

3.22 Disclosure of the plan's accounting policies should include a description of the methods and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies (if any).[11]

3.23 The financial statements should also disclose, if applicable—

a. A brief, general description of the plan agreement including, but not limited to, vesting and allocation provisions and the disposition of forfeitures. If a plan agreement or a description providing this information is otherwise published and made available, this description may be omitted from the financial statement provided that reference to the other source is made.

b. A description of significant plan amendments adopted during the period, and the effects of such amendments on net assets if significant either individually or in the aggregate.

c. The amount of unallocated assets, as well as the basis used to allocate asset values to participants' accounts when that basis differs from the one used to record assets in the financial statements.

d. The basis for determining contributions by employers and, for a contributory plan, the method of determining participants' contributions.[12] Plans subject to the minimum funding requirements of ERISA, such as money purchase pension plans, should disclose whether those requirements have been met. If a minimum funding waiver has been granted by the IRS, or if a request for waiver is pending before the IRS, that fact should be disclosed.

e. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets.

f. The federal income tax status of the plan if a favorable determination letter has not been obtained or maintained. Note that reports filed in accordance with the requirements of ERISA must include disclosure of "information concerning whether a tax ruling or determination letter has been obtained," which is more than is required by FASB Statement No. 35, as amended.

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[11] See APB Opinion No. 22, *Disclosure of Accounting Policies.*

[12] If significant costs of plan administration are being absorbed by the employers, that fact should be disclosed.

g. Identification of investments that represent 5 percent or more of the net assets available for benefits. (Listing all investments in the schedule of Assets Held for Investment Purposes required by ERISA does not eliminate the requirement to include this disclosure in the financial statements.)

h. Significant related-party transactions (see appendix A and chapter 11 for a discussion of related-party transactions).

i. Investments pledged to secure debt of the plan as well as a description of the provisions regarding the release of such investments from the pledge and the amounts of investments released from the pledge in the last period.

j. Guarantees by others of debt of the plan.

k. If the plan provides for participant-directed investment programs (for example, equity, debt, or employer securities), amounts relating to those individual programs should be disclosed as a separate fund and shown either in the financial statements in columnar form (by participant-directed and non-participant-directed), or in the related disclosures, or by separate financial statements for each program. Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans* (appendix J), clarifies the reporting requirements set forth in this paragraph, as follows:

— A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying types of investments—for example, equity funds or fixed income funds. The participant can select among the various available alternatives and periodically change that selection. Each investment alternative provided is considered a separate investment fund option. For example, if the plan provides two bond funds, an equity fund, a fixed income fund, and an employer securities fund, the plan would offer five separate investment fund options.

— The plan should disclose information about the net assets and significant components of the changes in net assets for each investment fund option. If an investment fund option contains both participant-directed and nonparticipant-directed investments, the participant-directed and nonparticipant-directed portions should be disclosed separately.

— Aggregation of investment fund options with similar investment objectives is not appropriate except that, for materiality considerations, any individual investment fund option with net assets of less than 5 percent of the plan's total net assets may be combined with funds having similar investment objectives. If investment fund options are aggregated, that fact should be disclosed. If the plan provides for self-directed investing whereby each participant selects his or her own specific investments such as individual stocks or bonds, changes in these investments may be aggregated and presented in one column as one fund option.

— The information about the net assets and significant components of the changes in net assets for each investment fund option is a required part of the basic financial statements. Such information may be presented in a multicolumnar format on the face of the financial statements, in the notes to the financial statements, or in separate financial statements for each investment fund option. Single line item presentation of the net assets available for benefits may be appropriate unless an individual investment fund option has a material asset or liability other than investments that require disclosure.

An illustration of a single line item presentation in the statement of net assets available for benefits, along with a multicolumnar presentation of the changes in net assets available for benefits for each investment fund option is presented in illustration 1 of appendix E.

l. For plans that assign units to participants, the total number of units and the net asset value per unit during the period (for example, monthly or quarterly, depending on the plan's provisions for calculating the unit values) and at the end of the period.

m. Amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid. These amounts should not be reported as a liability on the statement of net assets available for benefits, in financial statements prepared in conformity with generally accepted accounting principles. A footnote to reconcile the audited financial statements to the Form 5500 may be necessary to comply with ERISA (see paragraphs A.50a and A.51c).

n. Significant subsequent events that may affect the usefulness of the financial statements (see chapter 12 for a discussion of subsequent events).

o. The amount and disposition of forfeited nonvested accounts. Specifically, identification of those amounts that will be used to reduce future employer contributions.

This list does not include information required by ERISA to be disclosed in the schedules filed as part of a plan's annual report. In this connection, it is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information on the face of the financial statements or in the notes to the financial statements but not in the schedules is not acceptable.

3.24 FASB Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires all entities to disclose information principally about financial instruments with off-balance-sheet risk. Financial instruments of a pension plan, other than obligations for pension benefits, are included in the scope of FASB Statement No. 105, as amended. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87, *Employers' Accounting for Pensions*; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statement Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*.

3.25 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of this statement are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, future contracts, and interest rate and foreign currency swaps.

3.26 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with off-balance-sheet credit risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22
- The amount of accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

3.27 As indicated in paragraph 3.16 investments in master trusts are presented in a single line item in the statement of net assets available for benefits. In the notes to the financial statements the investments of the master trust should be detailed by general type, such as government securities, short-term securities, corporate bonds, common stocks, mortgages and real estate, as of the date of each statement of net assets available for benefits is presented. The net change in the fair value of each significant type of investment of the master trust and total investment income of the master trust by type, e.g., interest, dividends, etc., should also be disclosed in the notes for each period for which a statement of changes in net assets available for benefits is presented. The notes to the financial statements should also include a description of the basis used to allocate net assets, net investment income, gains and losses to participating plans, and the plan's percentage interest in the master trust as of the date of each statement of net assets available for benefits presented.

3.28 FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, as amended by FASB Statement No. 119, requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a defined-contribution pension plan are included in the scope of FASB Statement No. 107 and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

3.29 FASB Statement No. 107, as amended, requires entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

3.30 FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

3.31 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Terminating Plans

3.32 The Auditing Standards Division staff interpretation, *Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting* (AICPA *Professional Standards*, vol. 1, AU section 9508.33—.38), contains applicable guidance regarding the auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced.

3.33 When the decision has been made to terminate a plan,[13] or a wasting trust or frozen plan—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, described below. If the decision is made after the year-end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, section 560, *Subsequent Events*, paragraph 5.

3.34 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance contracts carried at *contract values*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

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[13] See paragraph 12.11, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent, written representation as to whether there is a present intention to terminate the plan. Refer also to paragraph 10.33, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

Chapter 4

Accounting and Reporting by Health and Welfare Benefit Plans

Note: In August 1992, the AICPA issued SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, which amends chapter 4 of this guide. SOP 92-6 is effective for financial statements of single-employer plans prepared for plan years beginning after December 15, 1992, except that the application of SOP 92-6 to plans of single employers with no more than 500 participants in the aggregate is effective for plan years beginning after December 15, 1994. SOP 92-6 is effective for financial statements of multiemployer plans prepared for plan years beginning after December 15, 1995. Earlier application is encouraged. When a plan adopts the SOP it must be adopted in its entirety.

Because of the multiple effective dates of SOP 92-6, certain plans are not yet required to adopt the provisions of the SOP, and therefore will be reporting in accordance with the guidance in effect before the SOP was issued. Chapter 4 now contains guidance for plans that have adopted SOP 92-6 and those that have not. It has been divided into two subchapters: Chapter 4A and Chapter 4B.

Chapter 4A reflects the provisions of SOP 92-6. The guidance in chapter 4A should be followed for audits of plans that have adopted SOP 92-6.

Health and welfare benefit plans that have not adopted SOP 92-6 should follow the accounting and reporting guidance in chapter 4B.

For SOPs whose effective date is subsequent to March 15, 1992, auditors should follow the applicable hierarchy established in paragraph 10 of Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report,* in determining whether an entity's financial statements are fairly presented in conformity with generally accepted accounting principles.

Chapter 4A

Accounting and Reporting by Health and Welfare Benefit Plans

> **Note:** The following guidance should *only* be followed by health and welfare benefit plans that have adopted the provisions of SOP 92-6. Refer to the Note at the beginning of this chapter for details of the effective dates of SOP 92-6.

Scope

4.01 Health and welfare benefit plans include plans that provide—

a. Medical, dental, visual, psychiatric, or long-term health care; life insurance (offered separately from a pension plan); certain severance benefits; or accidental death or dismemberment benefits.

b. Benefits for unemployment, disability, vacations, or holidays.

c. Other benefits such as apprenticeships, tuition assistance, day care, dependent care, housing subsidies, or legal services.

This chapter applies to both defined-benefit and defined-contribution health and welfare benefit plans (referred to hereafter as *health and welfare benefit plans*).

4.02 Defined-benefit health and welfare plans specify a determinable benefit, which may be in the form of a reimbursement to the covered plan participant or a direct payment to providers or third-party insurers for the cost of specified services. Such plans may also include benefits that are payable as a lump sum, such as death benefits. The level of benefits may be defined or limited based on factors such as age, years of service, and salary. Contributions may be determined by the plan's actuary or be based on actual claims paid or other factors determined by the plan sponsor. Even when a plan is funded pursuant to agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined-benefit health and welfare plan if its substance is to provide a defined benefit.

4.03 Defined-contribution health and welfare plans maintain an individual account for each plan participant. They have terms that specify the means of determining the contributions to participants' accounts, rather than the amount of benefits the participants are to receive. The benefits a plan participant will receive are limited to the amount contributed to the participant's account, investment experience, expenses, and any forfeitures allocated to the participant's account. These plans also include flexible spending arrangements.

4.04 Health and welfare benefit plans generally are subject to certain fiduciary, reporting, and other requirements of the Employee Retirement Income Security Act of 1974 (ERISA). Plans that are unfunded (that is, those whose benefits are paid solely and directly out of the general assets of the employer), are fully insured (through the direct payment of premiums to the insurance company by the employer; see paragraphs 4.12 and 4.13), or are certain combinations thereof (for example, self-funded plans with stop-loss coverage; see paragraph 4.15) may not be required to include financial statements in their ERISA filings (see appendix A). An understanding of the health and welfare benefit plan is needed to determine its accounting and reporting requirements. It is also important to consider the new forms of funding vehicles that are emerging, particularly with respect to postretirement health benefits.

4.05 This chapter describes generally accepted accounting principles (GAAP) that are particularly important to defined-benefit and defined-contribution health and welfare plans. Generally accepted accounting principles other than those discussed in this chapter may also apply. This chapter does not address the preparation of financial statements on a comprehensive basis of accounting other than GAAP; however, the presentation of a plan's benefit obligation information in GAAP-basis financial statements, as required by paragraph 4.18, is consistent with the disclosures required in financial statements prepared on such bases as the cash basis or modified cash basis, as defined by the requirements of financial reporting to the Department of Labor (DOL).

4.06 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans; however, as set forth in the guide, the methods of valuing plan investments and requirements for financial statement disclosures are the same as those specified in FASB Statement No. 35.

4.07 FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, establishes standards of financial accounting and reporting by employers for health and welfare benefits expected to be provided to a participant during retirement. While FASB Statement No. 106 does not apply to health and welfare benefit plans, this chapter adopts certain of its measurement concepts (see paragraphs 4.42 through 4.47). Terminology used in discussing postretirement benefits in this chapter is intended to follow usage and definitions provided in FASB Statement No. 106.

Background

4.08 Plan participants may be active or terminated employees (including retirees), as well as covered dependents and beneficiaries, of a single employer or group of employers. Employer contributions may be voluntary or required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Plans may require contributions from employers and participants (contributory plans) or from employers only (noncontributory plans). During periods of unemployment, a noncontributory plan may require contributions by participants to maintain their eligibility for benefits. Benefits may be provided through insurance contracts paid for by the plan (an insured plan), from net assets accumulated in a trust established by the plan (a self-funded plan), or both.

4.09 As noted above, a plan may establish a trust to hold assets to pay all or part of the covered benefits. The assets may be segregated and legally restricted under a trust arrangement (such as a voluntary employees' beneficiary association or a 501(c)(9) trust, a 401(h) account, or other funding vehicles). Generally, if a separate trust exists, financial statements are required under ERISA. A trust always exists for a multiemployer plan. Such trusteed plans with more than 100 participants generally will require an audit. For ERISA filings, the DOL will not accept an accountant's report that covers the assets of more than one plan. For example, where the assets of more than one plan are held in a 501(c)(9) Voluntary Employees' Beneficiary Association (VEBA) trust, separate reports must be prepared for each plan. If the trustee of the VEBA is a bank or trust company, and the trust holds the assets of more than one plan sponsored by a single employer or by a group of companies under common control, it is a master trust subject to the DOL's master trust filing requirements.

4.10 A health and welfare plan may process benefit payments directly or it may retain a third-party administrator (see paragraph 4.16). In either case, a plan that is fully or partially self-funded is obligated for the related benefits (see paragraphs 4.34 through 4.47).

Arrangements With Insurance Companies

4.11 The nature of, and method of accounting for, the assets and benefit obligations of a health and welfare benefit plan may be determined by the arrangement with the insurance company. The insurance company may assume all or a portion of the financial risk (see paragraphs 4.12 through 4.15), or it may provide only administrative services (see paragraph 4.16) or investment management services (see chapter 7). It is important to have an understanding of the insurance arrangement to determine whether any or all of the risks associated with benefit payments or claims have been transferred to the insurance company. Also, other arrangements are being developed that may involve new types of contracts that involve other parties, including those involving payments to providers, risk sharing of administrative expense with carriers, and so on. Details of these arrangements must also be reviewed carefully.

4.12 In a fully insured, pooled arrangement, specified benefits are covered by the insurance company. The insurance company pools the experience of the plan with that of other similar businesses and assumes the financial risk of adverse experience. In such an arrangement, a plan generally has no obligation for benefits covered by the arrangement other than the payment of premiums due to the insurance company (see paragraph 4.38).

4.13 In a fully insured experience-rated arrangement, specified benefits are paid by the insurance company that assumes all the financial risk. Contract experience is monitored by the insurance company. Contract experience may or may not include the experience of other similar contract holders. To the extent that benefits incurred plus risk charges and administration costs are less than premiums paid, the plan is entitled to an experience-rating refund or dividend (see paragraphs 4.27 and 4.28). If the total of benefits incurred, risk charges, and administrative costs exceeds premiums, the accumulated loss is generally borne by the insurance company but may be carried over to future periods until it has been recovered (see paragraphs 4.39 and 4.40). The plan often has no obligation to continue coverage or to reimburse the carrier for any accumulated loss, although there are certain types of contracts that require additional payments by the plan.

4.14 In a minimum premium plan arrangement, specified benefits are also paid by the insurance company. The insurance contract establishes a dollar limit, or *trigger point*. All claims paid by the insurance company below the trigger point are reimbursed by the plan to the insurance company. The insurance company is not reimbursed for benefits incurred that exceed the trigger point. This type of funding arrangement requires the plan to fund the full claims experience up to the trigger point. Minimum premium plan arrangements may have characteristics of both self-funded and fully insured experience-rated arrangements. Details of each arrangement must be reviewed carefully to determined the specific benefit obligations assumed by the insurance company.

4.15 In a stop-loss insurance arrangement, a plan's obligation for any plan participant's claims may be limited to a fixed dollar amount, or the plan's total obligation may be limited to a maximum percentage (for example, 125 percent) of a preset expected claims level. These arrangements are commonly used with administrative service arrangements. The insurance company assumes the benefit obligation in excess of the limit. Stop-loss insurance arrangements may have characteristics of both self-funded and fully insured arrangements. Stop-loss arrangements of this type may be described by a variety of terms; therefore, details of all insurance or administrative arrangements should be reviewed carefully to determine if stop-loss provisions are included and to determine the specific benefit obligations assumed by the insurance company.

4.16 In an administrative service arrangement, the plan retains the full obligation for plan benefits. The plan may engage an insurance company or other third party to act as the plan administrator. The administrator makes all benefit payments, charges the plan for those payments, and collects a fee for the services provided.

Financial Statements of Defined-Benefit Health and Welfare Plans

4.17 The objective of financial reporting by defined-benefit health and welfare plans is the same as that of defined-benefit pension plans; both types of plans provide a determinable benefit. Accordingly, the primary objective of the financial statements of a defined-benefit health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefit obligations when due. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) benefit obligations, (*c*) the results of transactions and events that affect the information about those resources and obligations, and (*d*) other factors necessary for users to understand the information provided.[14]

4.18 The financial statements of a defined-benefit health and welfare plan prepared in accordance with GAAP[15] should be prepared on the accrual basis of accounting and include—

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[14] It should be recognized that (*a*) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay its benefit obligations when due and (*b*) financial statements for several plan years may provide more useful information in assessing the plan's future ability to pay benefit obligations than can financial statements for a single year.

[15] Financial statements prepared on a comprehensive basis of accounting other than GAAP should disclose information regarding benefit obligations (see paragraphs 13.19 through 13.22, which discuss auditor's report considerations).

- A statement of net assets available for benefits as of the end of the plan year (see paragraphs 4.23 through 4.31).
- A statement of changes in net assets available for benefits for the year then ended (see paragraphs 4.32 and 4.33).
- Information regarding the plan's benefit obligations as of the end of the plan year (see paragraphs 4.34 through 4.47).
- Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the plan's benefit obligations (see paragraphs 4.48 and 4.49).

Information regarding the benefit obligations should be presented on the face of one or more financial statements. The information should be presented in such reasonable detail as is necessary to identify the nature and classification of the obligations.[16]

4.19 FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, provides that employee benefit plans other than pension plans (such as health and welfare plans, both defined benefit and defined contribution) that provide information similar to that required by FASB Statement No. 35 are not required to provide a statement of cash flows. However, FASB Statement No. 102 encourages that a statement of cash flows be included in the financial statements of an employee benefit plan when such a statement would provide relevant information about the ability of the plan to meet future obligations (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).

Financial Statements of Defined-Contribution Health and Welfare Plans

4.20 The objective of financial reporting by a defined-contribution health and welfare plan is to provide financial information that is useful in assessing the plan's present and future ability to pay its benefits when due. To accomplish that objective, a plan's financial statements should provide information about (*a*) plan resources and the manner in which the stewardship responsibility for those resources has been discharged, (*b*) the results of transactions and events that affect the information about those resources, and (*c*) other factors necessary for users to understand the information provided.[17]

4.21 The financial statements of a defined-contribution health and welfare plan prepared in accordance with GAAP[18] should be prepared on the accrual basis of accounting and include—

- A statement of net assets available for benefits of the plan as of the end of the plan year (see paragraphs 4.23 through 4.31).
- A statement of changes in net assets available for benefits of the plan for the year then ended (see paragraphs 4.32 and 4.33).

Because a plan's obligation to provide benefits is limited to the amounts accumulated in an individual's account, information regarding benefit obligations is not applicable.

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[16] Appendix F provides illustrative financial statements of two health and welfare benefit plans.

[17] See footnote 14.

[18] See footnote 15.

ERISA Reporting Requirements

4.22 ERISA established annual reporting requirements for employee benefit plans, including health and welfare benefit plans.[19] The financial statements required by ERISA are comparative statements of assets and liabilities and a statement of changes in net assets available for benefits. The schedules required by ERISA include assets held for investment purposes, transactions with parties in interest, loans or fixed-income obligations due that are in default or uncollectible, leases that are in default or uncollectible, and reportable transactions.

Statement of Net Assets Available for Benefits

Investments

4.23 Plan investments, whether they are in the form of equity or debt securities, real estate, or other investments (excluding contracts with insurance companies), should be reported at their fair value at the financial statement date.[20] The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for the investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may be used to estimate fair value.[21]

4.24 Whether or not a plan is subject to ERISA, contracts with insurance companies are to be included as plan assets in the manner required by ERISA's annual reporting requirements and are to be reported in a manner consistent with the requirements of DOL Form 5500 or 5500-C.[22] The current Form 5500 (1990) permits the reporting of unallocated insurance contracts either at current value or as determined on Schedule A, "Insurance Information," that is, contract value. This is an exception to the general requirement that plan investments be presented at fair value. The exception applies only to investments in contracts issued by insurance companies; investments in similar con-

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[19] ERISA annual reporting requirements, as well as the common exemptions, are described in appendix A.

[20] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is later than the financial statement date and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[21] For an indication of the factors to be considered in determining the discount rate, see paragraph 27 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. The fair value of an investment should be reported net of the brokerage commissions and other costs normally incurred in a sale, if significant (see also paragraphs 2.09 and 2.10).

[22] In September 1994, the AICPA issued SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, which may substantially change the way certain health and welfare benefit plans report the investment contracts held by those plans. SOP 94-4 is generally effective for plan years beginning after December 15, 1994. (See appendix I.)

tracts issued by banks, savings and loan associations, or other financial institutions are presented at fair value. Further discussion of insurance contracts is provided in chapter 7.

4.25 Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or have been determined otherwise (paragraph 4.51 specifies additional disclosures related to investments).

Contributions Receivable

4.26 Contributions receivable are the amounts due, as of the date of the financial statements, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants), each of which should be separately identified. They include amounts due pursuant to firm commitments, as well as legal or contractual requirements. With respect to employers' contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution; (*b*) a consistent pattern of making payments after the end of the plan year, pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year; (*c*) a deduction of a contribution for federal income tax purposes for periods ending on or before the financial statement date; or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[23] Contributions receivable should include an allowance for estimated uncollectible amounts.

Deposits With and Receivables From Insurance Companies and Other Service Providers

4.27 Whether a premium paid to an insurance company represents payment for the transfer of risk or merely represents a deposit will depend on the circumstances of the arrangement. As noted earlier, the nature of payments made to an insurance company should be analyzed to determine the extent to which financial risk has been transferred from the plan to the insurance company. Insurance companies may require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. These deposits should be reported as plan assets until such amounts are used to pay premiums. Similarly, premium stabilization reserves, which exist when premiums paid to an insurance company exceed the total of claims paid and other charges, are held by an insurance company and used to reduce future premium payments. Premium stabilization reserves generally should be reported as assets of the plan until such amounts are used to pay premiums. Disclosure of the nature of this type of deposit or reserve should be made. If such reserves are forfeitable if the insurance contract terminates, this possibility should be considered in recognizing this asset.

4.28 Certain group insurance contracts covering health and welfare benefit plans include a provision for a refund, at the end of the policy year, of the excess of premiums paid over the total of paid claims, required reserves, and the fee charged by the insurance company. Often such experience-rating refunds (or dividends) are not determined by the insurance company for several

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[23] The existence of an accrued liability in the employer's statement of financial position or a plan's benefit obligations exceeding its net assets available for benefit obligations does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

months after the end of the policy year. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be reported as a plan asset if it is probable that a refund is due and the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed.

4.29 Service providers may require that deposits by the plan be applied against claims paid on behalf of plan participants. Such deposits should be reported as plan assets until the deposit is applied against paid claims.

Operating Assets

4.30 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be reported at cost less accumulated depreciation or amortization.

Accrued Liabilities

4.31 A plan may have liabilities (other than for benefits) that should be accrued. Such liabilities may be for amounts owed for securities purchased, income taxes payable by the plan, or other expenses (for example, third-party administrator fees). These liabilities should be deducted to arrive at net assets available for benefits.

Statement of Changes in Net Assets Available for Benefits

4.32 The statement of changes in net assets available for benefits should be presented in enough detail to identify the significant changes during the year including, as applicable—

- Contributions from employers, segregated between cash and noncash contributions. A noncash contribution should be reported at fair value at the date of the contribution. The nature of noncash contributions should be described either parenthetically or in a note.
- Contributions from participants, including those collected and remitted by the sponsor.
- Contributions from other identified sources (for example, state subsidies or federal grants).
- The net appreciation or depreciation[24] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.
- Investment income, excluding the net appreciation or depreciation.
- Income taxes paid or payable, if applicable.
- Payments of claims, excluding payments made by an insurance company pursuant to contracts that are excluded from plan assets.
- Payments of premiums to insurance companies to purchase contracts that are excluded from plan assets.[25]

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[24] Net appreciation or depreciation includes realized gains and losses on investments that were both purchased and sold during the period. Ordinarily, information regarding the net appreciation or depreciation in the fair value of investments is found in the notes to the financial statements.

[25] Refer to paragraphs 7.25 and 7.26 for further discussion of allocated insurance contracts.

- Operating and administrative expenses.
- Other changes (such as transfers of assets to or from other plans), if significant.

4.33 The list of minimum disclosures is not intended to define the degree of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful.

Benefit Obligations

4.34 Benefit obligations[26] for single-employer, multiemployer, and multiple-employer defined-benefit health and welfare benefit plans should include the actuarial present value, as applicable, of the following:

- Claims payable and currently due for active and retired participants
- Premiums due under insurance arrangements
- Claims incurred but not reported to the plan for active participants[27]
- Accumulated eligibility credits for active participants
- Postretirement benefits for—
  - Retired participants, including their beneficiaries and covered dependents
  - Active or terminated participants who are fully eligible to receive benefits
  - Active participants not yet fully eligible to receive benefits

Benefits expected to be earned for future service by active participants (for example, vacation benefits) during the term of their employment should not be included. Benefit obligations should be reported as of the end of the plan year.[28] The effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods. For example, if a plan amendment grants a different benefit level for employees retiring after a future date, that increased or reduced benefit level should be included in current-period measurements for employees expected to retire after that date.

4.35 As noted previously (see paragraph 4.18), information regarding benefit obligations may be presented either in a separate statement or with other information on another financial statement. However, all the information must be located in one place.

Claims

4.36 In an insured health and welfare benefit plan, claims payable and currently due and claims incurred but not yet reported to the plan will be paid by the insurance company. Consequently, they should be excluded from the benefit obligations of the plan. Benefit obligations of a self-funded plan should

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[26] Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing benefit obligations shall be reflected by appropriately adjusting the assumed rates of return. The adjustment of the assumed rates of return shall be separately disclosed.

[27] IBNR may be computed in the aggregate for active participants and retirees. When the IBNR for retirees is not included in the postretirement benefit obligation, it may be included in claims incurred but not reported.

[28] Postretirement benefit obligations should be determined as of the end of the plan year or, if used consistently from year to year, as of a date not more than three months prior to that date, in accordance with paragraph 72 of FASB Statement No. 106.

present the amount of claims payable and currently due for active and retired participants, dependents, and beneficiaries and IBNR for active participants. IBNR for retired participants is included in the postretirement benefit obligation.[29]

4.37 For a self-funded plan, the cost of IBNR should be measured at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims. Estimated ultimate cost should reflect the plan's obligation to pay claims to or for participants, regardless of status of employment, beyond the financial statement date pursuant to the provisions of the plan or regulatory requirements. For example, an individual contracts a terminal disease or has a catastrophic accident in December. The claim is reported to the plan subsequent to year-end. Treatment is ongoing and is expected to continue throughout the next year. The plan does not require any return to work and will fully cover all services. The actuarial present value of the obligation for all future payments to be made as of the plan year end should be included as a benefit obligation in IBNR.

Premiums Due Under Insurance Arrangements

4.38 Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company (see paragraphs 4.12 through 4.16). Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may provide for annual renewal. The contract generally specifies, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are due. The benefit obligations should include any obligation for premiums due but not paid.

4.39 If the insurance contract requires payment of additional premiums (for example, retrospective premiums) when the loss ratio exceeds a specified percentage, an obligation for the estimated additional premiums should be included in the benefit obligations.

4.40 Experience ratings determined by the insurance company or by estimates (see paragraph 4.13) may result in a premium deficit. Premium deficits should be included in the benefit obligations if (*a*) it is probable that the deficit will be applied against the amounts of future premiums or future experience-rating refunds[30] and (*b*) the amount can be reasonably estimated. If no obligation is included for a premium deficit because either or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made if it is reasonably possible that a loss or an additional loss has been incurred.

Accumulated Eligibility Credits

4.41 Plans may provide for the payment of insurance premiums or benefits for a period of time for those participants who have accumulated a sufficient number of eligibility credits or hours. Eligible participants are provided with insurance coverage during periods of unemployment, when employer contributions to the plan would not otherwise provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent an ob-

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[29] See footnote 27.

[30] This determination should consider (*a*) the extent to which the insurance contract requires payment of such deficits and (*b*) the plan's intention, if any, to transfer coverage to another insurance company.

ligation of the plan arising from prior employee service for which employer contributions have been received. This benefit obligation is generally determined by applying current insurance premium rates to accumulated eligibility credits or, for a self-funded plan, by applying the average cost of benefits per eligible participant to accumulated eligibility credits. In either case, the obligation for accumulated eligibility credits should consider assumptions for mortality and expected employee turnover or other appropriate adjustments, to reflect the obligation at the amount expected to be paid.

Postretirement Benefit Obligations

4.42 Health and welfare benefit plans may continue to provide benefits to participants after retirement (postretirement benefits). Those benefits may commence immediately upon termination of service or payment may be deferred until the participant attains a specified age. If a plan provides postretirement benefits to participants, an estimated amount for those benefits, as described below should be included in the benefit obligations.

4.43 The postretirement benefit obligation as of the measurement date is the actuarial present value of all future benefits attributed to plan participants' services rendered to that date, assuming the plan continues in effect and all assumptions about future events are fulfilled. Postretirement benefits comprise benefits expected to be paid to or on behalf of any retired or active participant, terminated participant, beneficiary, or covered dependent who is expected to receive benefits under the health and welfare benefit plan. Postretirement benefits expected to be paid to or for an active participant, beneficiary, or covered dependent who is still earning his or her postretirement benefits (that is, one who is not yet fully eligible) should be measured over the participant's credited period of service up to the date when full eligibility for benefits is attained.[31]

4.44 If a multiemployer health and welfare benefit plan provides postretirement benefits, the benefit obligations must include the postretirement benefit obligation. Consideration should be given to the promises currently made to employees and the history of making such payments to retirees. The fact that benefits may be reduced or even potentially eliminated would not ordinarily affect the promise made as of the end of the plan year unless the change meets the substantive plan criteria of FASB Statement No. 106 (for example, an amendment is in place or has been communicated to employees). The fact that the contributing employers of a multiemployer plan do not record a similar obligation under FASB Statement No. 106 does not affect the accounting for the obligations by the plan.

4.45 The postretirement benefit obligation should be measured using the plan's written provisions to the extent possible, as well as the substantive plan if it differs from the written plan. In many health and welfare benefit plans, postretirement benefits are not defined as a specified amount for each year of service. FASB Statement No. 106, paragraphs 23 through 44, describes the measurement of the postretirement benefit obligation. For multiemployer plans that do not have date-of-hire information as required by paragraph 44 of FASB Statement No. 106, reasonable estimates thereof should be used to mea-

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[31] For example, if a participant has worked eight years and must work another sixteen to be fully eligible for benefits after retirement, one-third of the postretirement benefits have been earned and should be included in the postretirement benefit obligation if it is probable that the employee will work the remaining sixteen years.

sure the obligation. Death or disability benefits provided outside of a pension plan (when the employee is considered to be retired) should also be included in the calculation of the postretirement benefit obligation. Benefits that are provided through an insurance contract should be excluded.[32]

4.46 In measuring the postretirement benefit obligation explicit assumptions must be used, each of which represents the best estimate of a particular future event. All assumptions should presume that the plan will continue in its present form, unless there is evidence to the contrary. Principal actuarial assumptions used should include—

- Discount rates, used to reflect the time value of money in determining the present value of future cash outflows currently expected to be required to satisfy the liability in the due course of business.
- The timing and amount of future postretirement benefit payments (taking into consideration per capita claims cost by age, health care cost-trend rates, current Medicare reimbursement rates, retirement age, dependency status, and mortality).
- Salary progression (for pay-related plans).
- The probability of payment (considering turnover, retirement age, dependency status, and mortality).
- Participation rates (for contributory plans).

4.47 The postretirement benefit obligation information should include the following classifications:

- Obligations related to retired plan participants, including their beneficiaries and covered dependents
- Obligations related to active or terminated participants who are fully eligible to receive benefits
- Obligations related to other plan participants not yet fully eligible for benefits

Separate disclosure for each classification for each significant benefit (for example, medical and death) may be appropriate.

Changes in Benefit Obligations

4.48 Information regarding changes in the benefit obligations within a plan period should be presented to identity significant factors affecting year-to-year changes in benefit obligations. Like the benefit obligation information (see paragraph 4.35), the changes should be presented within the body of the financial statements. Providing such information in the following three categories will generally be sufficient: (*a*) claims payable and premiums due to insurance companies, (*b*) IBNR and eligibility credits, and (*c*) postretirement benefit obligations.

4.49. Minimum disclosure regarding changes in benefit obligations should include the significant effects of (*a*) plan amendments, (*b*) changes in the nature of the plan (mergers or spinoffs), and (*c*) changes in actuarial assumptions (health care cost-trend rate or interest rate). Changes in actuarial assumptions are to be considered as changes in accounting estimates and, therefore, previously reported amounts should not be restated. The significant effects of other

[32] Insured plans should be reviewed carefully to determine the extent to which postretirement benefits are insured. Currently, except for single-premium life insurance contracts, few, if any, insurance contracts unconditionally obligate an insurance company to provide most forms of postretirement benefits.

factors may also be identified. These include, for example, benefits accumulated,[33] the effects of the time value of money (for interest), and benefits paid. If presented, benefits paid should not include benefit payments made by an insurance company pursuant to a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchases of annuities with amounts allocated from existing investments with the insurance company) should be included in benefits paid.[34] If only the minimum disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the initial and ultimate amounts.

Additional Financial Statement Disclosures

4.50 Disclosure of a health and welfare benefit plan's accounting policies should include—[35]

- A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of insurance contracts.
- A description of the methods and significant actuarial assumptions used to determine the plan's benefit obligations. Any significant changes in assumptions made between financial statement dates and their effects should be described.

4.51 The plan's financial statements should also disclose other information.[36] Separate disclosures may be made to the extent that the plan provides both health and other welfare benefits. The disclosures should include, when applicable—

- A brief, general description of the plan agreement, including, but not limited to, participants covered, vesting, and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted, provided that a reference to the other source is made.
- A description of significant plan amendments adopted during the period, as well as significant changes in the nature of the plan (for example, a plan spin-off or merger with another plan) and changes in actuarial assumptions.
- The funding policy and any changes in the policy made during the plan year. If the benefit obligations exceed the net assets of the plan, the method of funding this deficit, as provided for in the plan agreement or collective bargaining agreement, also should be disclosed.[37] For a contributory plan, the disclosure should state the method of determining participants' contributions.

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[33] Actuarial experience gains or losses may be included with the effects of additional benefits accumulated rather than separately disclosed. If the effects of changes in actuarial assumptions cannot be separately determined, those effects should be included in benefits accumulated and described accordingly.

[34] Because of the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumulated plan benefits. If that information is available, it should be presented as an actuarial experience gain or loss.

[35] See Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies*.

[36] Certain of the disclosures relate to plans with accumulated assets rather than those with trusts that act more as conduits for benefit payments or insurance premiums.

[37] If significant plan administration or related costs are being borne by the employer, that fact should be disclosed.

- The federal income tax status of the plan. There is no determination letter program for health and welfare plans; however a 501(c)(9) VEBA trust must obtain a determination letter to be exempt from taxation.
- The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. Consideration should be given to disclosing the type and extent of insurance coverage, as well as the extent to which risk is transferred (for example, coverage period and claims reported or claims incurred).
- Identification of investments that represent 5 percent or more of total plan assets. Consideration should be given to disclosing provisions of insurance contracts included as plan assets that could cause an impairment of the asset value upon liquidation or other occurrence (for example, surrender charges and market value adjustments).
- The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties.
- Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.
- Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits attributable to an employee's service rendered before that date, a significant change in the market value of a significant portion of the plan's assets, or the emergence of a catastrophic claim should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not reasonably determinable, the reasons why they are not quantifiable should be disclosed.
- Material lease commitments, other commitments, or contingent liabilities.
- The assumed health care cost-trend rate(s) used to measure the expected cost of benefits covered by the plan for the next year, a general description of the direction and pattern of change in the assumed trend rates thereafter, the ultimate trend rate(s), and when that rate is expected to be achieved.
- For health and welfare benefit plans providing postretirement health care benefits, the effect of a one-percentage-point increase in the assumed health care cost-trend rates for each future year on the postretirement benefit obligation.
- Any modification of the existing cost-sharing provisions that are encompassed by the substantive plan(s) and the existence and nature of any commitment to increase monetary benefits provided by the plan and their effect on the plan's financial statements.
- Termination provisions of the plan and priorities for distribution of assets, if applicable.
- Restrictions, if any, on plan assets (for example, legal restrictions on multiple trusts).

- In a defined contribution health and welfare plan—the accounting policy for, and the amount and disposition of, forfeited nonvested accounts. Specifically, identification of whether those amounts will be used to reduce future employer contributions or will be allocated to participants accounts.

This list does not include information that, in accordance with ERISA requirements, must be disclosed in the schedules filed as part of a plan's annual report. It is important to note that any information required by ERISA to be disclosed in the schedules must be disclosed in the schedules; disclosure of the information in the footnotes to the financial statements but not in the schedules is not acceptable to the DOL.

4.52 FASB Statement No. 105, as amended by FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, requires all entities, including health and welfare benefit plans, to disclose information principally about financial instruments with off-balance-sheet risk. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87, *Employers' Accounting for Pensions*; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statement Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*.

4.53 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of FASB Statement No. 105 are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest-rate and foreign-currency swaps.

4.54 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with off-balance-sheet credit risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion 22
- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

4.55 FASB Statement No. 107, as amended by FASB Statement No. 119, requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a health and welfare plan are included in the scope of FASB Statement No. 107 and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

4.56 FASB Statement No. 107, as amended, requires entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

4.57 FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and No. 107.

4.58 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Terminating Plans

4.59 The auditing interpretation "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU section 9508.33-.38) contains applicable guidance regardingthe auditor's reporting responsibilities for terminating plans. For purposes of this discussion, a terminating plan includes all plans about which a termination decision has been made regardless of whether the terminating plan will be replaced.

4.60 When the decision has been made to terminate a plan,[38] or a wasting trust—that is, a plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already accrued benefits—exists, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the decision to terminate a plan is made before the end of the plan year, it is also necessary for the plan's year-end financial statements to be prepared on the *liquidation* basis of accounting, as described below. If the decision is made after the year end but before the year-end financial statements have been issued, the decision is generally a *type two* subsequent event requiring the disclosure described in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 560.05).

4.61 Plan financial statements for periods ending after the termination decision are prepared on the liquidation basis of accounting. For plan assets, changing to the liquidation basis will usually cause little or no change in values, most of which are current market values. Assets that may not be carried at market values include operating assets, insurance and certain investment contracts carried at *contract value*, or large blocks of stock or other assets that cannot be readily disposed of at their quoted market prices.

4.62 Benefit obligations should be determined on a liquidation basis, and their value may differ from the actuarial present value of benefit obligations reported for an ongoing plan. Consideration should be given upon termination to whether any or all benefits become vested.

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[38] See paragraph 12.11, which states that the auditor should obtain from the plan trustee, administrator, or administrative agent written representation about whether there is a present intention to terminate the plan. Refer also to paragraph 10.33, which states that the auditor should consider confirming with the plan's actuary knowledge of an intent on the part of the employer to terminate the plan.

Chapter 4B

Accounting and Reporting by Employee Health and Welfare Benefit Plans

> **Note:** The following guidance should *only* be followed by health and welfare benefit plans that have not yet adopted the provisions of SOP 92-6. Refer to the Note at the beginning of this chapter for details of the effective dates of SOP 92-6.

4.63 Employee health and welfare benefit plans include plans that provide—

a. Medical, dental, visual, or psychiatric care; life insurance; or accidental death or dismemberment benefits.

b. Benefits during periods of unemployment or disability.

c. Benefits during vacations or holidays.

d. Benefits such as apprenticeships, scholarships, day-care centers, or legal services.

4.64 The participants in health and welfare benefit plans may be employees of a single employer or of a group of employers. Contributions by an employer may be voluntary or may be required under the terms of a collective bargaining agreement negotiated with one or more labor organizations. Contributions may be required from employers and participants (contributory plans) or from employers only (noncontributory plans). A noncontributory plan may provide for self-payment of contributions by participants to maintain their eligibility for benefits during periods of unemployment. Benefits either are paid from a fund's accumulated contributions and income (a self-insured plan) or are provided through insurance with an insurance company (an insured plan). Health and welfare benefit plans generally are subject to the requirements of ERISA.

Background and Scope

4.65 The 1972 AICPA Industry Audit Guide *Audits of Employee Health and Welfare Benefit Funds*, prepared by the AICPA Committee on Health, Welfare, and Pension Funds, described generally accepted accounting principles for health and welfare benefit funds.

4.66 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, does not apply to health and welfare benefit plans, but it establishes certain standards that differ from those in the 1972 audit guide, primarily relating to the valuation of plan investments and additional financial statement disclosures.

4.67 This chapter describes generally accepted accounting principles for financial statements of health and welfare benefit plans. This chapter replaces the accounting and reporting principles and practices specified in *Audits of Employee Health and Welfare Benefit Funds*.

4.68 Existing generally accepted accounting principles other than those discussed in this chapter may also apply. The principles described in this chapter are particularly important to health and welfare benefit plans or are different from existing generally accepted accounting principles for other types of entities.

Financial Statements

4.69 The primary objective of a health and welfare benefit plan's financial statements is to provide information about (*a*) plan resources and obligations and how the stewardship responsibility for those resources and obligations has been discharged, (*b*) the results of transactions and events that affect the information about those resources and obligations, and (*c*) other factors necessary for users to understand the information provided.[39]

4.70 The financial statements of a health and welfare benefit plan should include comparative statements of net assets of the plan, presenting assets and liabilities as of the end of the period,[40] and a statement of changes in net assets during the period. The accrual basis of accounting should be used in preparing a plan's financial statements.[41] Appendix G provides illustrative financial statements of a health and welfare benefit plan and a vacation benefit plan.

Statement of Net Assets

Investments

4.71 Plan investments, whether equity or debt securities, real estate, or other investments (excluding contracts with insurance companies), should be presented at their fair value at the financial statement date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value should be measured by the market price if there is an active market for the investment. If there is no active market for an investment but there is a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[42]

4.72 Contracts with insurance companies should be presented in the same manner as that contained in the annual report filed by the plan with certain

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[39] It should be recognized that (*a*) information in addition to that contained in the plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (*b*) financial statements for several plan years can provide more useful information in assessing the plan's future ability to pay benefits than can financial statements for a single plan year.

[40] ERISA requires that this statement be presented in comparative form.

[41] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[42] For an indication of the factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment should reflect the brokerage commissions and other costs normally incurred in a sale. (See also paragraphs 2.10 and 2.11 of this guide.)

governmental agencies pursuant to ERISA.[43] A plan not subject to ERISA should present its contracts with insurance companies as if the plan were subject to the reporting requirements of ERISA.

4.73 Information regarding a plan's investments should be presented in enough detail to identify the types of investments and should indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. Paragraphs 4.88f and 4.88g specify additional disclosures related to investments.

Contributions Receivable

4.74 Contributions receivable are the amounts due, as of the financial statement date, to the plan from employers, participants, and other sources of funding (for example, state subsidies or federal grants, which should be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (*a*) a resolution by the employer's governing body approving a specified contribution, (*b*) a consistent pattern of making payments after the plan's year-end pursuant to an established funding policy that attributes such subsequent payments to the preceding plan year, (*c*) a deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date, or (*d*) the employer's recognition as of the financial statement date of a contribution payable to the plan.[44]

Operating Assets

4.75 Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) should be presented at cost less accumulated depreciation or amortization.

Insurance Premiums Payable

4.76 Benefits to participants may be provided through insurance arrangements that transfer the risks of loss or liability to an insurance company. Group insurance contracts for health and welfare plans are usually written for a one-year period, although the contract may provide for annual renewal. The contract may specify, among other things, the schedule of benefits, eligibility rules, premium rate per eligible participant, and the date that premiums are due. The plan's financial statements should include a liability for premiums due but not paid.

4.77 If the insurance policy requires payment of additional contingent premiums when the loss ratio exceeds a specified percentage, a liability for the estimated additional premiums should be recorded.

Deposits With Insurance Companies

4.78 Whether a premium paid to an insurance company represents payment for the transfer of risk or whether it represents merely a deposit will depend on the circumstances of each insurance arrangement. An analysis of the contract is needed to determine whether risk has been transferred from the

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[43] For 1990 plan years, the pertinent governmental reporting requirements relate to item 34 of either Form 5500 or item 30 of 5500-C.

[44] The existence of accrued costs in the employer's financial statements or a deficit in net assets of the plan do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

plan and to what extent. Many insurance companies require that a deposit be maintained that can be applied against possible future losses in excess of current premiums. Premium deposits should be reported as assets of the plan until they are refunded to the plan or it becomes probable that the insurance company will apply the deposit as payment of premiums. Disclosure of the nature of this type of deposit should be made in the financial statements.

Accrued Experience-Rating Adjustments

4.79 Certain group insurance contracts covering health and welfare benefit plans include a provision for the refund, at the end of the policy year, of the excess of premiums paid over paid claims, reserves required by the insurance company, and the insurance company's retention (fee). Often such experience-rating refunds (or dividends) are not determined by the insurance company for several months after the year-end. In this event, and in cases when the policy year does not coincide with the plan's fiscal year, the refund due as of the financial statement date should be recorded if the amount can be reasonably estimated. If the amount of the refund cannot be reasonably estimated, that fact should be disclosed.

4.80 Experience ratings, determined by the insurance company or by estimates, may also result in a premium deficit. Premium deficits should be recorded as a liability of the plan (or a reduction of a deposit, if applicable) if (*a*) it is probable that the deficit will be applied against the amounts of future premiums or experience-rating refunds[45] and (*b*) the amount can be reasonably estimated. If no accrual is made for a premium deficit because one or both of the conditions are not met, or if an exposure to loss exists in excess of the amount accrued, disclosure of the premium deficit should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.

Claims

4.81 In an insured health and welfare benefit plan, claims reported to the plan but not paid and claims incurred but not yet reported to the plan will be paid by the insurance company and, therefore, will not appear in the financial statements as liabilities of the plan. The financial statements of a self-insured plan should present the amount of each of those liabilities.

4.82 Claims reported but not paid may be determined from the records of the plan. The estimated liability for claims incurred but not reported is generally determined by a specialist, such as the plan's actuary.

4.83 If a self-insured plan provides death benefits, the financial statements should include the estimated liability for those benefits based on determinations by the plan's actuary.

Accumulated Eligibility Credits

4.84 The eligibility rules of some plans provide for the payment of insurance premiums or benefits for a period of time subsequent to the financial statement date for those participants who have accumulated a sufficient number of eligibility credits or hours. Such rules permit eligible participants

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[45] Considerations in making this determination include (*a*) the extent to which the contract with the insurance company requires payment of such deficits and (*b*) whether the plan intends to transfer coverage to another insurance company.

insurance coverage or benefits during periods of unemployment, when employer contributions to the plan would otherwise not provide coverage or benefits. At the financial statement date, such accumulated eligibility credits represent a liability of the plan arising from prior employee service for which employer contributions have been received. The liability is generally determined by applying current insurance premium rates to accumulated eligibility credits or, for a self-insured plan, by applying the average cost of benefits per eligible participant.

Statement of Changes in Net Assets

4.85 The statement of changes in net assets during the period should be presented in enough detail to identify the significant changes during the period. The minimum disclosures should include—

a. The net appreciation or depreciation in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined.[46]

b. Investment income, excluding (*a*) preceding.

c. Contributions from employers, segregated between cash and noncash contributions. (A noncash contribution should be recorded at fair value. The nature of noncash contributions should be described either parenthetically or in a note.)

d. Contributions from participants, including those transmitted by the sponsor.

e. Contributions from other identified sources (for example, state subsidies or federal grants).

f. Benefits paid to participants. This should not include benefit payments made by an insurance company in accordance with a contract that is excluded from plan assets.

g. Payments of premiums to insurance companies.

h. Changes during the period in liabilities for benefits by major types.

i. Administrative expenses.

j. Change during the period in net assets.

4.86 The minimum disclosures should be made to the extent they apply to the plan. The list of minimum disclosures is not intended to limit the amount of detail or the manner of presenting the information, and subclassifications or additional classifications may be useful.

Additional Financial Statement Disclosures

4.87 Disclosure of a health and welfare benefit plan's accounting policies[47] should include—

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[46] Realized gains and losses on investments that were both bought and sold during the period should be included.

[47] See APB Opinion No. 22, *Disclosure of Accounting Policies*.

a. A description of the methods and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies (if any).

b. A description of significant actuarial assumptions used to determine the plan's liabilities. Any significant changes of assumptions between financial statement dates should be described.

4.88 The plan's financial statements should also disclose, if applicable—

a. A brief, general description of the plan agreement, including, but not limited to, vesting and benefit provisions. If a plan agreement or a description thereof providing this information is otherwise published or made available, the description in the financial statement disclosures may be omitted provided that the reference to the other source is made.

b. A description of significant plan amendments adopted during the period as well as the significant effects on plan liabilities of such factors as plan amendments, changes in the nature of the plan (for example, a plan spin-off or merger with another plan), and changes in actuarial assumptions.

c. The funding policy, and any changes in the policy during the plan year, and, if there is a deficit in net assets of the plan, the method of funding the deficit as provided for in the plan agreement or collective bargaining agreement.[48] For a contributory plan, the disclosure should state the method of determining participants' contributions.

d. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets.

e. The federal income tax status of the plan, if a favorable letter of determination has not been obtained or maintained.

f. Identification of investments that represent 5 percent or more of total plan assets.

g. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: the sponsor, the plan administrator, employers, or employee organizations.

h. Unusual or infrequent events or transactions occurring after the financial statement date, but before issuance of the financial statements, that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest financial statement date that significantly increases future benefits that are attributable to employees' service rendered before that date should be disclosed. If reasonably determinable, the effects of such events or transactions should be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable should be disclosed.

4.89 FASB Statement No. 105, as amended by FASB Statement No. 119, requires all entities, including health and welfare benefit plans, to disclose information principally about financial instruments with off-balance-sheet

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[48] If significant costs of plan administration are being absorbed by the employer, that fact should be disclosed.

risk. Financial instruments of a pension plan, other than obligations for pension benefits, when subject to the accounting and reporting requirements of FASB Statement No. 35, are included in the scope of FASB Statement No. 105. However, the disclosure requirements in paragraphs 17, 18, and 20 of FASB Statement No. 105 do not apply to (*a*) financial instruments of a pension plan, including plan assets, when subject to the accounting and reporting requirements of FASB Statement No. 87; (*b*) employers' and plans' obligations for pension benefits, postretirement health care and life insurance benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements; (*c*) insurance contracts, other than financial guarantees and investment contracts as discussed in FASB Statements No. 60 and No. 97; and (*d*) unconditional purchase obligations subject to the disclosure requirements of FASB Statement No. 47.

4.90 Some examples of financial instruments of employee benefit plans with off-balance-sheet risk that are included within the scope of this guide are obligations to repurchase securities sold, outstanding commitments to purchase or sell financial instruments at predetermined prices, futures contracts, and interest-rate and foreign-currency swaps.

4.91 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with off-balance-sheet credit risk:

- The face or contract amount (or notional principal amount if there is no face or contract amount)
- The nature and terms, including, at a minimum, a discussion of (*a*) the credit and market risk of those instruments, (*b*) the cash requirements of those instruments, and (*c*) the related accounting policy pursuant to the requirements of APB Opinion No. 22
- The amount of the accounting loss the entity would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the entity
- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

Those disclosures should distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading.

4.92 FASB Statement No. 105, as amended, requires entities to disclose the following information about financial instruments with concentrations of credit risk:

- Information about the (shared) activity, region, or economic characteristic that identifies the concentration
- The amount of the accounting loss due to credit risk the entity would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the entity

- The entity's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the entity's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments

4.93 FASB Statement No. 107, as amended by FASB Statement No. 119, requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. Generally, financial instruments of a health and welfare plan are included in the scope of FASB Statement No. 107 and are subject to the disclosure requirements of paragraphs 10 through 14 of that Statement.

4.94 FASB Statement No. 107, as amended, requires entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments.

4.95 FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics. It also amends existing requirements of FASB Statements No. 105 and 107.

4.96 FASB Statement No. 119 requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105 because they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. FASB Statement No. 119 requires additional disclosures about those derivative financial instruments held for trading purposes, those held for purposes other than trading, and those accounted for as hedges of anticipated transactions.

Chapter 5

Planning

Audit Scope

5.01 The nature, timing, and extent of auditing procedures to be performed are based on the scope of services requested by the plan administrator. For each audit engagement, the auditor should establish a clear understanding concerning the scope of audit services to be performed and the auditor's responsibilities regarding any supplemental schedules accompanying the basic financial statements.

5.02 The auditor may be engaged to audit the financial statements of an employee benefit plan in accordance with generally accepted auditing standards (*full-scope* audit). Alternatively, ERISA section 103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. The election is available, however, only if the trustee or custodian certifies both the *accuracy and completeness* of the information submitted. Certifications that address only accuracy *or* completeness, but not both, do not comply with the DOL's regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit. This *limited-scope* audit provision does not apply to information about investments held by a broker/dealer or an investment company. The provision applies only to *investment* information, and does not extend to benefit payment or other information whether or not it is certified by the trustee or custodian. The provision is implemented by 29 CFR 2520.103-8 of the Department of Labor's (DOL) Rules and Regulations for Reporting and Disclosure under ERISA. The limited scope exemption does not exempt the plan from the requirement to have an audit. Guidance on the auditor's report and responsibilities for this type of limited-scope audit is provided in paragraphs 7.47 and 13.25 through 13.28. Exhibit 5-1 summarizes the conditions that generally allow for limited scope audits in decision tree format.

5.03 Generally, the plan's financial statements accompany the Form 5500 that is filed by the plan administrator. Form 5500 requires footnote disclosure of any differences between the audited financial statements and the statements included as part of the Form 5500. The DOL may reject a filing that does not properly reconcile information contained in the financial statements with information contained in the Form 5500.

Exhibit 5-1

Type of Audit Decision Tree

Conditions Generally Allowing a Limited-Scope Audit Versus a Full-Scope Audit for Employee Benefit Plans Subject to ERISA

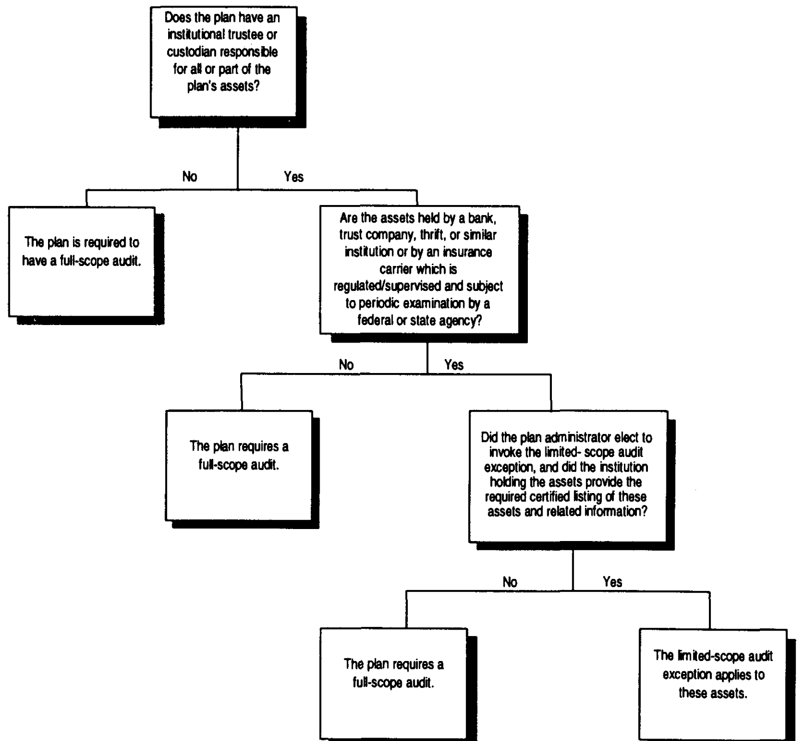
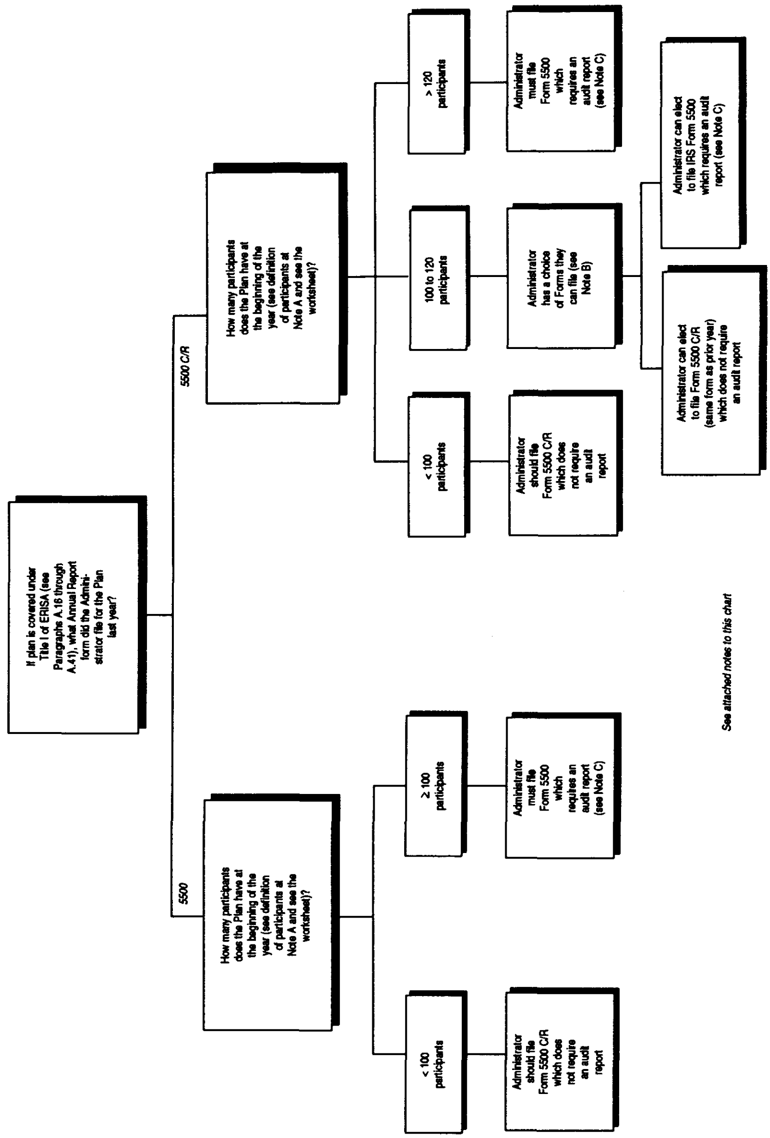


Exhibit 5-2

PENSION PLAN AUDIT DECISION TREE

Conditions generally requiring an audit of a pension plan finanical statement and the required supplementary schedules



See attached notes to this chart

Note A—***Participants*** are defined by the DOL as follows:

Active participants

- Any individuals who are currently in employment covered by a plan and who are earning or retaining credited service under a plan;
- Any individuals who are currently below the integration level in a plan that is integrated with social security, and/or eligible to have the employer make payments to a 401(k) or Section 125 arrangements (participants only have to be eligible for the plan, not necessarily participating in a 401(k) or Section 125 arrangement);
- Any nonvested individuals who are earning or retaining credited service under a plan.

Active participants does not include nonvested former employees who have incurred the break in service period specified in the plan.

Inactive participants

- Any individuals who are retired or separated from employment covered by a plan and who are receiving or entitled to receive benefits.

The term inactive participants does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the individual is entitled under the plan.

Deceased participants include:

- Any deceased individuals who have beneficiaries who are receiving or are entitled to receive benefits under the plan.

The term deceased participants does not include any individual to whom an insurance company has made an irrevocable commitment to pay all the benefits to which the beneficiaries of the individual are entitled under the plan.

Note B—***80—120 Rule***

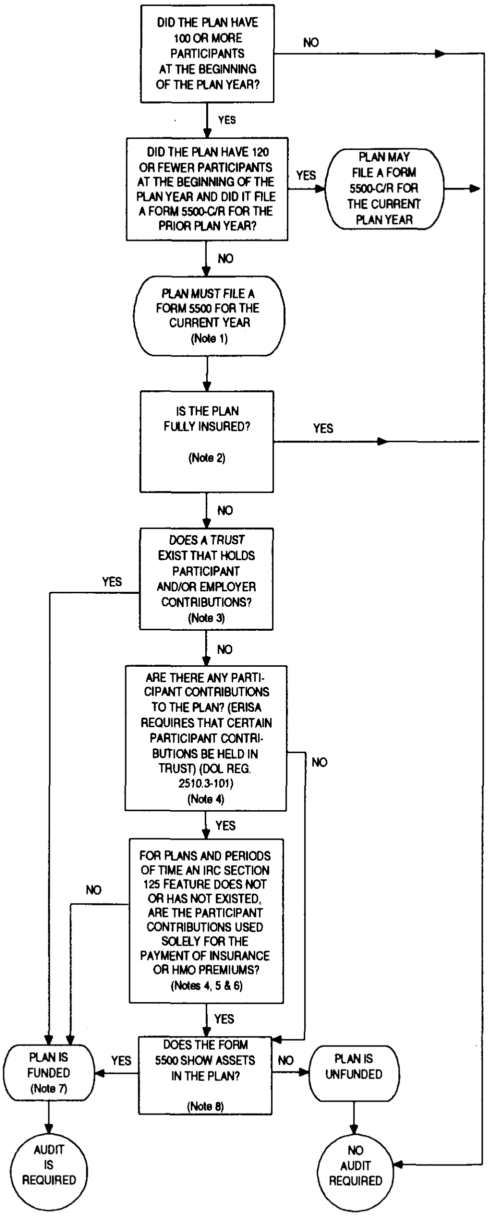
Under DOL reg. 2520.103-1(d), if a plan has between 80 and 120 participants (inclusive) as of the beginning of a plan year, it may elect to file the same return as it did in the prior year (e.g., Form 5500-C/R) and avoid the audit requirement. There is no limit to the number of years this election can be made. DOL officials have indicated that Health and Welfare Plans with 100 or more participants which involve employee contributions generally must have an audit unless employee contributions are used to purchase insurance from a third-party insurer or forwarded to an HMO within prescribed timeframes, even if the sponsor does not maintain a trust and considers the assets to be subject to the rights of general creditors (DOL Reg. 2520.104-44). Careful consideration should be given in these circumstances as to whether an audit is required.

Note C—***Audit Requirement***

If a Form 5500 is filed, an audit of the financial statements generally is required except that (1) pension plans that have a short plan year of seven months or less may elect to defer (but not eliminate) the audit requirement, and (2) pension plans whose sole assets are insurance contracts that fully guarantee benefit payments are not required to be audited (see appendix A).

Exhibit 5-3

WELFARE BENEFIT PLANS AUDIT:
DECISION FLOWCHART



Note 1 - Welfare benefit plans filing Form 5500 are generally required to have an audit unless the plan is unfunded, fully insured, or a combination of unfunded and insured. The remainder of the flowchart will assist in the determination of whether this exception applies.

Note 2 - A fully insured welfare benefit plan has its benefits provided **exclusively** through insurance contracts or policies, the **premiums** of which must be paid **directly** by the employer or employee organization from its general assets or partly from its general assets and partly from contributions by its employees or members (which the employer or organization forwards within three months of receipt). Any such insurance contract must involve the transfer of risk for providing the promised benefits to an insurance company or HMO. Administrative services only (ASO) arrangements with insurance companies with or without stop-loss insurance do not qualify as a fully insured plan.

Note 3 - According to the Department of Labor ("DOL"), under Reg. 2520.104-44, the existence of a separate fund or account for the plan by the employee or a TPA can cause the requirement that funds be paid directly from the general assets of the employer not to be met. For example, if a separate account is maintained which would be deemed to be a trust under state law, then the related plan would be deemed to be funded under ERISA.

Note 4 - According to DOL technical releases 88-1 and 92-1, participant contributions to a welfare benefit plan which has an IRC Section 125 cafeteria plan feature do not have to be held in trust pending further guidance from the DOL. If a Section 125 arrangement exists, all contributions are deemed to be employer contributions.

Note 5 - According to the DOL, under DOL Reg. 2520.104-44, all participant contributions for plans or periods of time where an IRC Section 125 feature is or was not present must be used solely to pay premiums to an insurer or HMO in order for the financial reporting and audit relief accorded under this regulation to apply. As a result, the insurer or HMO must assume the risk for benefit payments for this relief to apply (e.g., ASO arrangements do not qualify).

Note 6 - Salary reduction amounts (e.g., under Section 125 arrangements) and COBRA premiums are considered participant contributions under ERISA.

Note 7 - If a plan is deemed to be funded for a part of a plan year, then the entire plan year is subject to ERISA's financial reporting and under requirements and all plan-related activity must be reported.

Note 8 - DOL will assume the plan is funded if assets are shown on line 34 or line 35 of Form 5500. Only plans which are deemed to be funded based on this decision flowchart should show assets on Form 5500.

5.04 ERISA requires that certain supplemental schedules accompany the basic financial statements. Usually the auditor is engaged to report on such supplemental schedules only in relation to the basic financial statements taken as a whole. In such circumstances, the auditor's measure of materiality with regard to the information in the supplemental schedules is the same as that for the financial statements taken as a whole. The auditor's responsibility for reporting on a document that contains information in addition to the client's basic financial statements is described in Statement on Auditing Standards (SAS) No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and is described in paragraphs 13.14 through 13.16. If the auditor is separately engaged to express an opinion on the supplementary information, as described in SAS No. 62, *Special Reports*, the measurement of materiality must be related to each individual element, account, or item reported on rather than to the aggregate thereof on the basic financial statements taken as a whole.

5.05 In addition, plans with fewer than 100 participants that elect to file the Form 5500 under the 80-120 participant rule, rather than a Form 5500-C/R, are also required to engage an independent auditor. Under this rule, if a plan has between 80 and 120 participants (inclusive) at the beginning of the plan year, the plan may elect to file the same annual return/report form that was filed for the previous year. Exhibit 5-2 summarizes the conditions that generally require audits of pension plan financial statements and schedules under ERISA in decision tree format. Exhibit 5-3 summarizes the conditions that generally require audits of welfare benefit plans under ERISA in decision tree format.

5.06 The understanding with the client concerning the scope of services is frequently documented in a letter, sometimes referred to as an engagement letter or a letter of arrangement. Among the matters the auditor might include are:

- Whether the engagement represents a full-scope or a limited scope audit (see paragraph 5.02).
- The auditor's responsibility with respect to supplemental schedules accompanying the basic financial statements (see paragraphs 3.23k and 5.04).
- The auditor's responsibility with respect to consideration of the plan's qualification for tax-exempt status, with sufficient specificity to make clear that the audit does not contemplate an opinion on plan tax qualification (see paragraphs 12.01 through 12.03).
- The auditor's responsibility with respect to information in the Form 5500 (see paragraphs 12.12 through 12.14). The letter might address the fact that, where the auditor's report is to be included in the Form 5500 filing, the Form 5500 should be made available to the auditor before the audit report is issued.
- The auditor's responsibility with respect to reporting matters that come to the auditor's attention regarding lack of compliance with ERISA requirements, making it clear that the audit does not encompass procedures specifically directed at determining such compliance (see paragraph 1.14).

Exhibit 5-4

Following is an illustrative engagement letter for a full-scope employee benefit plan audit engagement. If the engagement is for other than a full scope audit, the letter should be modified accordingly.

Sample Company Employee Benefit Plan and
Sample Company
[*Address*]

Attention: _____________, Plan Administrator, Sample Company Employee Benefit Plan
_____________, President, Sample Company

Dear _____________ and _____________:

This letter will confirm our understanding of our engagement to report on our audit of the financial statements and supplemental schedules of Sample Company Employee Benefit Plan (the Plan) as of December 31, 19X1 and 19X0, and for the year[s] ended December 31, 19X1 [and 19X0], all of which are to be included in the Plan's Form 5500 filing with the Internal Revenue Service.

We will conduct the audit in accordance with generally accepted auditing standards with the objective of expressing an opinion as to whether the presentation of the financial statements, taken as a whole, conforms with generally accepted accounting principles and whether the supplemental schedules are fairly stated in all material respects in relation to the basic financial statements taken as a whole. In conducting the audit, we will perform tests of the accounting records and such other procedures as we consider necessary in the circumstances to provide a reasonable basis for our opinion on the financial statements and supplemental schedules. We also will assess the accounting principles used and significant estimates made by management, and evaluate the overall financial statement presentation. Our report will be addressed to the Plan Administrator.*

The Plan and Sample Company (the Plan Sponsor) agree that all records, documentation, and information we request in connection with our audit will be made available to us, that all material information will be disclosed to us, and that we will have the full cooperation of Plan's and Plan Sponsor's personnel. As required by generally accepted auditing standards, we will make

* If a limited scope audit engagement is to be performed, this paragraph should be replaced with the following:

We will conduct the audit in accordance with generally accepted auditing standards except that, as permitted by Regulation 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA and as instructed by you, we will not perform any auditing procedures with respect to information prepared and certified to by [*name of trustee or custodian*], the trustee or custodian, other than comparing that information with the related information included in the financial statements and supplemental schedules. Because of the significance of the information that we will not audit, we will not express an opinion on the financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified to by the trustee, will be audited by us in accordance with generally accepted auditing standards, and will be subjected to tests of your accounting records and other procedures as we consider necessary to enable us to express an opinion as to whether they are presented in compliance with the DOL Rules and Regulations for Reporting and Disclosure under ERISA. Our report will be addressed to the Plan Administrator.

specific inquiries of management about the representations embodied in the financial statements and the effectiveness of the internal control structure over financial reporting, and obtain a representation letter from management about these matters. The responses to our inquiries, the written representations and the results of audit tests comprise the evidential matter we will rely upon in forming an opinion on the financial statements.**

Generally accepted auditing standards require that we assess the risk that errors, irregularities, and illegal acts may cause the financial statements to contain a material misstatement. Our audit is designed to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, because of the concept of reasonable assurance and because we will not perform a detailed examination of all transactions, there is a risk that material errors, irregularities, or illegal acts, including prohibited transactions with parties in interest, other violations of ERISA rules and regulations, fraud, or defalcations, may exist and not be detected by us. We will advise you, however, of any matters of that nature that come to our attention and will assess whether all identified prohibited party in interest transactions are included in the supplemental schedule of nonexempt transactions.

The Plan Administrator has responsibility for the financial statements and all representations contained therein. The Plan Administrator also has the responsibility for the adoption of sound accounting policies and the implementation of recordkeeping and an internal control structure to maintain the reliability of the financial statements and to provide reasonable assurance against the possibility of errors and irregularities that are material to the financial statements.

While we are not being engaged to report on the Plan's internal control structure, we will furnish to you any recommendations about the internal control structure that we note during the audit which appear to be of significance under the circumstances. Additionally, if we become aware of any material weaknesses in the Plan's internal control structure, we will communicate them to you in a separate letter.

You have not engaged us to prepare or review the Plan's 5500 filing with the Internal Revenue Service and Department of Labor, however, the audited financial statements of the Plan are required to be filed with the Form 5500. Professional standards require that we read the Plan's Form 5500 prior to its filing. The purpose of this procedure is to consider whether such information, or the manner of its presentation, is materially inconsistent with the information, or the manner of its presentation, appearing in the financial statements. These procedures are not sufficient nor are they intended to ensure that the form is completely and accurately prepared. In the event that our auditor's report is issued prior to our having read the Plan's Form 5500, you agree not to attach such auditor's report to the financial statements included with the Form 5500 filing until we have read the completed Form 5500.***

As a part of our audit, we will perform certain procedures, as required by generally accepted auditing standards, directed at considering the Plan's compliance with applicable Internal Revenue Code requirements for tax exempt status, including inspecting the Plan's latest tax determination letter

** If a limited scope audit engagement is to be performed, the words "forming an opinion" should be replaced with "issuing our report."

*** This paragraph should be deleted if the auditor has in fact been engaged to prepare or review the plan's 5500 filing.

from the IRS. As we conduct our audit, we will be aware of the possibility that events affecting the Plan's tax status may have occurred. Similarly, we will be aware of the possibility that events affecting the Plan's compliance with the requirements of ERISA may have occurred. We will inform you of any instances of tax or ERISA noncompliance that come to our attention during the course of our audit. You should recognize, however, that our audit is not designed to nor is it intended to determine the Plan's overall compliance with applicable provisions of the Internal Revenue Code or ERISA.

We may be requested to make certain working papers available to [*name(s) of regulator(s)*] pursuant to authority given to it by law or regulation. If requested, access to such working papers will be provided under the supervision of [*name of audit firm*] personnel. Furthermore, upon request, we may provide photocopies of selected working papers to [*name(s) of regulator(s)*]. The [*name(s) of regulator(s)*] may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies.

[*Discussion of fees and billing arrangements.*]

We shall be pleased to discuss this letter with you at any time. For your convenience in confirming these arrangements, we enclose a copy of this letter. Please sign and return it to us.

Very truly yours,

____

[*Signature*]

Planning the Audit

5.07 SAS No. 22, *Planning and Supervision*, contains guidance on planning an audit in accordance with generally accepted auditing standards. The planning process involves the development of an overall strategy for the expected conduct of the audit. The nature, timing, and extent of planning will vary according to the type of employee benefit plan, size and complexity of the plan's operations, and any restrictions placed on the audit (see paragraph 5.02).

5.08 If the auditor of the plan's financial statements is also the auditor of the financial statements of the sponsoring employer, it may be more efficient for the auditor to coordinate the audits, particularly with regard to the testing of payroll and participant data provided to the plan's actuary.

5.09 Also, as required by SAS No. 22, the auditor should possess sufficient knowledge of matters affecting employee benefit plans, including ERISA, applicable sections of the IRC, and related DOL and IRS regulations. For further discussion of applicable laws and regulations, see appendix A.

5.10 The auditor's considerations in forming an opinion on the financial statements of an employee benefit plan consist of obtaining and evaluating evidential matter regarding management's assertions in the financial statements. Assertions are representations by management that are embodied in the financial statements. They can be either explicit or implicit and can be classified according to the following broad categories: existence and occurrence, completeness, rights and obligations, evaluation and allocation, and presentation and disclosure.

5.11 In selecting particular substantive tests to achieve the audit objectives that the auditor has developed, the auditor considers (*a*) the assessment of the level of control risk, (*b*) the relative risk of errors and irregularities that would be material to the financial statements, and (*c*) the expected effectiveness and efficiency of tests. These considerations include the materiality of the items being tested, the kind and competence of available evidential matter, and the nature of the audit objective to be achieved. The results of the auditor's substantive tests and his or her assessment of the level of inherent risk and control risk should provide a reasonable basis for the auditor's opinion.

Initial Audits of the Plan

5.12 If the auditor did not audit the plan's financial statements for the prior year, he or she should apply procedures that are practicable and reasonable in the circumstances to obtain reasonable assurance that the accounting principles used by the plan in the current and the preceding year are consistent. If the plan has maintained adequate records, the auditor ordinarily should be able to apply auditing procedures to determine that generally accepted accounting principles have been consistently applied.

5.13 Certain areas require special consideration in an initial audit of a plan's financial statements. The auditor should consider the completeness of participant data and records of the prior year, especially as they relate to participant eligibility, amounts and types of benefits, eligibility for benefits, and account balances. The nature, timing, and extent of auditing procedures applied by the auditor are a matter of judgment and will vary with such factors as the adequacy of past records, the significance of beginning balances, and the complexity of the plan's operations. Since ERISA requires that audited plan financial statements present comparative statements of net assets available for benefits, the current year statements should be audited and the prior year presented for comparative purposes should be either compiled, reviewed, or audited. Appropriate reference in the audit report should be made to describe the level of responsibility assumed (see paragraph 13.39).

Communication and Coordination

5.14 Communication and coordination considerations are a particularly important aspect in performing an audit of a plan because of the many parties who normally maintain accounting records of the plan or are involved in the administration of the plan, such as the plan sponsor, trustees, administrator, investment trustee, insurance company, other independent auditors, actuary, and attorney.

5.15 SAS No. 61, *Communication With Audit Committees*, establishes a requirement that the auditor determine that certain matters related to the conduct of an audit are communicated to those who have a responsibility for the oversight of the financial reporting process. Communications required by SAS No. 61 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. Communication with the audit committee (or similar entity as discussed previously) by the auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
- SAS No. 54, *Illegal Acts by Clients*
- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*
- SAS No. 71, *Interim Financial Information*

Information Gathering

5.16 The early stage of planning ordinarily includes obtaining sufficient information to identify the significant aspects of the audit. The auditor should consider applying the following procedures to gather information for planning the audit.

a. Discuss with trustees, plan administrator, or other appropriate representative of the plan the scope of the audit. Determine whether the scope of the audit will be restricted (limited-scope audit), for example, to exclude financial information certified by a bank or insurance carrier (paragraph 5.02). The types of reports and other services to be rendered should also be discussed, including the supplementary information, if any, required by ERISA and DOL regulations; the auditor should determine what supplementary information will be reported on, as required by ERISA and DOL regulations, and on what information he or she will disclaim an opinion.

b. Make inquiries of plan management whether—
   - The plan's financial statements will be prepared in conformity with generally accepted accounting principles or with another basis of accounting permitted by ERISA or DOL regulations (see paragraphs 13.19 through 13.22).
   - Investment assets are held by outside custodians. If investment assets are held by outside custodians, the auditor should determine the location of investments and the nature of safekeeping arrangements, including whether the investments are held in the name of the plan.

- — The plan's accounting records and participant data are maintained by the plan sponsor, by a bank, by an insurance carrier, or by other outside parties; and how they are maintained.
- — A data processing service center is used.
- — Periodic financial statements are prepared.
- — The plan maintains a list of *parties in interest*, as defined by ERISA section 3(14).
- — The plan has procedures for identifying reportable transactions as defined by ERISA and applicable DOL regulations.
- — The plan maintains a list of entities whose employees are participants in the plan.
- — The plan has either an audit committee or a group equivalent to an audit committee that has been formally designated oversight of the financial reporting process.
- — There is a present intention to terminate the plan.

c. Read the plan instrument, including amendments, to determine, among other things, whether the plan is (1) a single employer or multiemployer plan, (2) a contributory or noncontributory plan, and (3) required to be funded or not, and (4) the nature of the benefits promised.

d. Read agreements with trustees, investment advisors, and insurance companies to determine whether the plan is a self-funded, insured, or split-funded plan. If the plan is an insured or split-funded plan, determine the type of insurance contract (for example, deposit administration, immediate participation guarantee, or individual policy).

e. Review the prior-year financial statements and Form 5500, filings with the IRS and DOL and related correspondence, and the status of IRS determination letters and DOL advisory or exemption opinions, if any. Consider the tax-exempt status of the plan, including whether the plan has procedures for assuring compliance with applicable IRC plan qualification requirements.

f. Determine the extent of involvement, if any, of specialists, internal auditors, and other independent auditors.

g. Read reports from the plan's actuary, bank or trustee, insurance company, service auditors, other independent auditors, and internal auditors. After reading these reports, communications may be necessary with the preparers of these reports to determine the extent of audit procedures or the ability to rely on the content of any of these reports.

h. Consider discussing with actuaries their use of participant and other data that is significant to the actuarial computations. Determine the extent of testing of participant data that is necessary by the auditor.

Audit Risk

5.17 In determining the scope of audit procedures to be performed, the auditor should be aware that certain aspects of employee benefit plans are usually subject to a greater level of audit risk. The risk of error is greater for some balances or classes of transactions than others. Also, financial statement assertions derived from accounting estimates pose greater risk than do those derived from relatively routine, factual data.

5.18 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of audit risk and materiality when planning or performing an audit of financial statements in accordance with generally accepted auditing standards. A few areas presenting particular audit risk when auditing employee benefit plans are (*a*) the fair market value of investments with no readily ascertainable market, (*b*) new types of investments, and (*c*) benefit amounts.

5.19 The auditor's judgment about the level of risk on the audit may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of the audit, and degree of professional skepticism. For example, if an aspect of the audit is judged to involve high risk, the auditor should consider staffing the engagement with auditors having appropriate relevant experience in auditing the aspect assessed to have high risk, increase the extent of audit work, and use a higher degree of professional skepticism.

5.20 In assessing audit risk, the following factors should be considered:

Management characteristics
- Plan operating and administrative policies are dominated by a single person.
- Plan sponsor places undue emphasis on investment earnings.
- Management lacks experience in dealing with employee benefit matters.

Operating and industry characteristics
- Plan investment decision making is decentralized without adequate monitoring.
- A significant number of contributing employers within an industry have filed for protection under the bankruptcy laws.

Engagement characteristics
- Plan transactions involving parties in interest.
- Investment strategies have been changed.
- The marketability of investments held has decreased.
- In the prior period(s), a significant number of differences arose in calculation of benefit payments.
- The sponsor has cash flow difficulties.

Internal Control Structure

5.21 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit. The internal control structure of employee benefit plans is discussed in chapter 6.

Data Processing Provided by Independent Organizations

5.22 Many employee benefit plans use the services of independent organizations. Examples include bank trust departments, data processing service bureaus, third-party administrators and benefit paying agents. Guidance on auditing records where third party services are significantly involved in the operation of an employee benefit plan is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*.

Analytical Procedures

5.23 SAS No. 56, *Analytical Procedures*, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. For planning purposes, these procedures should focus on (*a*) enhancing the auditor's understanding of the plan and the transactions and events that have occurred since the last audit date and (*b*) identifying areas that may represent specific risk relevant to the audit. These procedures can help to identify such things as the existence of unusual transactions and events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

5.24 The following are examples of analytical procedures that the auditor may find useful in planning an audit of an employee benefit plan:

- Comparison of investment balances and rates of return with prior-period amounts
- Analysis of changes in contributions and benefit payments during the current period based on statistical data (for example, number of participants eligible to receive benefits in the current period, number of terminations)

Party in Interest Transactions

5.25 Section 3(14) of ERISA defines a party in interest to include, among others, fiduciaries or employees of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee organization whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee organization, or relatives of such persons just mentioned.

5.26 Certain plan transactions with parties in interest are prohibited under ERISA sections 406 and 407 and are required, without regard to their materiality, to be disclosed in the plan's annual report to the DOL (see paragraph 11.15 for a discussion of the effect of management's failure to properly disclose prohibited party in interest transactions on the auditor's report and appendix A for a discussion of DOL reporting requirements). Prohibited transactions are also of interest from the perspective of the plan's financial statements because they can give rise to significant receivables; a plan fiduciary is liable to make good on losses to the plan resulting from a breach of fiduciary duty and restore to the plan any profits that the fiduciary made through the use of the plan's assets. The potential effects of any contingencies on the plan as a result of engaging in prohibited transactions may need to be disclosed in the plan's financial statements in accordance with the requirements of FASB Statement No. 5, *Accounting for Contingencies*.

5.27 Prohibited transactions have an impact on the other party to the transactions as well as on the plan. ERISA provides for the levy of an excise tax on the other party up to the full amount of the prohibited transaction. Also, the fiduciary generally must reverse the transaction, compensate the plan for any losses, and return any profits made using plan assets.

5.28 Transactions between a plan and a party in interest that are generally prohibited under section 406(a) of ERISA include—

- A sale, exchange, or lease of property.
- A loan or other extension of credit.

- The furnishing of goods, services, or facilities.
- A transfer of plan assets to a party in interest for the use or benefit of a party in interest.
- An acquisition of employer securities or real property in violation of the 10 percent limitation.

5.29 There are certain exceptions dealing with party in interest transactions that do not prevent a plan fiduciary from receiving reasonable compensation for services to a plan, or receiving benefits from a plan as a participant or beneficiary, as long as such benefits are in accordance with the terms of a plan as applied to all other participants and beneficiaries. In addition, payments to parties in interest for reasonable compensation for office space and legal, accounting, and other services necessary for the operation of a plan are permitted.

5.30 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all party in interest transactions will be discovered. Nevertheless, during the course of his or her audit, the auditor should be aware of the possible existence of party in interest transactions that are required to be disclosed. Procedures directed toward identifying party in interest transactions that are ordinarily performed during the planning phase of the audit are listed in paragraph 11.05.

5.31 Chapter 11 and appendix A discuss additional procedures and considerations related to party in interest transactions.

Errors, Irregularities, and Illegal Acts

5.32 In addition to the audit risks noted previously, SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, sets forth the auditor's responsibility for the detection of errors and irregularities in audits of financial statements conducted in accordance with generally accepted auditing standards. It also describes factors that influence the auditor's ability to detect such errors and irregularities and explains how the exercise of due care should give appropriate consideration to the possibility of errors and irregularities.

5.33 SAS No. 53 requires the auditor to assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements. Chapters 12 and 13 discuss considerations related to the disclosure and reporting implications of errors and irregularities.

5.34 SAS No. 54, *Illegal Acts by Clients*, sets forth the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client. The term *illegal acts*, for purposes of that statement, relates to violations of laws or government regulations.

Accounting Estimates

5.35 In determining the scope of audit procedures to be performed, the auditor should recognize that certain areas of employee benefit plans operations require accounting estimates that may be material in the preparation and presentation of financial statements. SAS No. 57, *Auditing Accounting Estimates*, provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. Although the responsibility for making estimates is that of management, the auditor is responsible for evaluating reasonableness of estimates and should consider appropriate procedures and planning to perform the audit. These should consider both subjective and objective factors.

5.36 Although significant accounting estimates may affect many elements of an employee benefit plan's financial statements, they often affect the asset values for nonreadily marketable investments. In health and welfare plans, estimates may also affect the obligation for incurred but not reported benefit obligations, the obligation for accumulated eligibility credits, and accrued experience-rating adjustments.

Going Concern Considerations

5.37 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. For financial reporting purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the plan's ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of business, externally forced revision of its operations, or similar actions. During the course of the audit, the auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminently potential impact on the plan entity and should consider the sponsor's plans for dealing with its conditions.

5.38 SAS No. 59 states that the auditor has a responsibility to evaluate whether there is substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor considers the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit to identify conditions and events that, when considered in the aggregate, create substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time. An explanatory paragraph is required regardless of the auditor's assessment of asset recoverability and amount and classification of liabilities. For example, if the sponsoring employer intends to terminate the plan within twelve months of the date of the financial statements, the auditor should include an explanatory paragraph in his or her report that discloses that fact (see paragraph 13.37).

Chapter 6

Internal Control Structure

6.01 The second standard of fieldwork states that a sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed. The following paragraphs summarize the auditor's consideration of the internal control structure under SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

> An entity's internal control structure consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.
>
> After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he or she believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.
>
> After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.
>
> The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

Considering the Internal Control Structure

6.02 In obtaining an understanding of the control environment, the auditor gains knowledge about the overall attitude, awareness, and actions of the plan administrator, board of trustees, and others concerning the importance of control and its emphasis in the entity. In this connection, the auditor considers management's philosophy and operating style, the plan's organizational structure, methods of assigning authority and responsibility, and other factors related to the control environment. In gaining an understanding of the control environment, the auditor should normally consider the plan administrator's and others' attitudes, awareness, and actions related to ERISA or other compliance matters (for example, ERISA's prohibited transaction rules) that might affect the plan's financial statements and schedules.

6.03 The auditor's understanding of the accounting system and control procedures is ordinarily obtained through discussion with plan personnel and review of documents in the office of the plan administrator (appendix B contains examples of certain internal control policies and procedures a plan might establish). The understanding of the accounting system and relevant control procedures, along with information about the control environment, is used to assess the risk of a material misstatement in financial statement assertions.

6.04 In some cases, a third-party administrator or service organization, such as a bank trustee, insurance company, or contract administrator (hereafter referred to collectively as service organization), executes certain transactions and maintains the related accountability on behalf of the plan administrator. The auditor's consideration of elements of the internal control structure maintained by the service organization will depend on the nature of the relationship between the plan and service organization.

6.05 If a service organization executes transactions only on the specific authorization of the plan, the plan will be able to maintain independent records of transactions authorized to be executed by the service organization. In those circumstances, the auditor may be able to obtain a sufficient understanding of the internal control structure relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those elements of the internal control structure maintained by the service organization. An example of such a service organization is a bank trust department that invests and holds assets for a plan under a nondiscretionary or directed trust arrangement. However, even in such circumstances, the auditor may still find it more efficient to seek a reduction in the assessed level of control risk for assertions related to transactions executed by the service organization by considering the internal control structure maintained by the service organization.

6.06 If the service organization is authorized by the plan to execute transactions without specific authorization of individual transactions, the plan may not have independent records of the transactions executed by the service organization. In those circumstances, the auditor may not be able to obtain a sufficient understanding of the internal control structure relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those elements of the internal control structure maintained by the service organization.

6.07 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity, such as an employee benefit plan, that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for independent auditors who issue reports on the processing of transactions by service organizations, such as bank trust departments, third-party administrators, or data processing service organizations, for use by other auditors. A report prepared in accordance with SAS No. 70 should be designed to provide user auditors with a sufficient understanding of the control structure policies and procedures at the service organization to plan the audit in accordance with SAS No. 55.

6.08 Under SAS No. 70, two types of reports may be issued by a service auditor:

a. A *Report on Policies and Procedures Placed in Operation* (Type I report) is a report on a service organization's description of its control structure policies and procedures that may be relevant to a user organization's internal control structure. It addresses whether the description presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to user organizations; whether such policies and procedures were suitably designed to achieve specified control objectives; and whether they had been placed in operation as of a specific date. Such reports may be useful in providing user auditors with an understanding of the service organization's control structure policies and procedures sufficient to plan the audit and to design effective tests of controls and substantive tests at the user organization. However, they are not intended to provide user auditors with a basis for reducing their assessment of control risk below the maximum for financial statement assertions affected by the policies and procedures.

b. A *Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness* (Type II report) is a report on a service organization's description of its control structure policies and procedures that may be relevant to a user organization's internal control structure. It addresses whether the description presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to user organizations; whether such policies and procedures were suitably designed to achieve specified control objectives; whether they had been placed in operation as of a specific date; and whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Such reports may be useful in providing user auditors with an understanding of the service organization's control structure policies and procedures that is sufficient to plan the audit and may also provide user auditors with a basis for reducing their assessment of control risk below the maximum for financial statement assertions affected by the policies and procedures.

6.09 The type of report (Type I or Type II) provided by the service organization may affect the nature, timing, and extent of the audit procedures performed by the auditor of an employee benefit plan. For example, a bank trust department may specify the control objective that security prices are received timely from an authorized source and properly used to price securities. If the bank provides a Type I report, the report should provide the auditor with sufficient information to plan the audit, in other words, to assess whether there are any deficiencies in the design of the control policies and procedures that could affect financial statement assertions in the user organization's financial statements. However, the auditor would have no basis to conclude that the controls were operating with sufficient effectiveness to achieve the control objective because they have not been tested. Therefore, the auditor may have to expand the testing of prices used at year-end. If, however, the bank issued a Type II report, the auditor could have a basis to rely on the effective operation of control policies and procedures and therefore reduce the extent of the price testing.

6.10 When the administrator elects a full scope audit, even though a limited scope audit could be performed (see paragraphs 5.02 and 13.25 for a discussion of limited scope audits), or where the trustee or custodian does not qualify for the limited scope audit exemption, the auditor may need to obtain an understanding of the control structure policies and procedures at the trustee or custodian. A similar understanding may be required for information processed by the trustee or custodian related to financial statement components not subject to the limited scope audit exemption, for example, benefit claims or payments. As previously noted, this understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70 for the service organization. In determining whether a SAS No. 70 report would be useful, the auditor should consider (1) the nature and materiality of the transactions or accounts affected by the service organization, and (2) the degree of interaction between the internal control structure policies and procedures at the user organization and the control structure policies and procedures at the service organization. Many SAS No. 70 reports include a list of controls that should be in place at the user organization that may need to be tested by the user auditor.

6.11 If a SAS No. 70 report is not available, the user auditor should consider information available at the user organization about the control structure policies and procedures at the service organization, including user manuals, system overviews, technical manuals, and reports from service or user organization internal auditors. If the user auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's control structure policies and procedures to plan the audit, consideration should be given to contacting the service organization through the user organization, to obtain information or request that a service auditor be engaged to perform procedures at the service organization. If the user auditor is unable to obtain sufficient evidence to achieve the audit objectives, the user auditor should qualify the audit opinion or disclaim an opinion on the financial statements because of a scope limitation. (Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions or disclaimers of opinion on plan financial statements other than those issued in connection with a limited scope audit pursuant to 29 CFR 2520.103-8 or 12.)

6.12 A service organization that prepares a report in accordance with SAS No. 70 for use by auditors of financial statements of employee benefit plans will typically address in that report the control objectives that are relevant to the specific objectives of employee benefit plans as set forth in Exhibit B-2.

Documentation

6.13 The auditor should document the understanding of the plan's internal control structure elements obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions in which control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions in which the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

Reportable Conditions

6.14 SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, requires that reportable conditions be communicated to the entity's audit committee or individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one. Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. For a single employer plan that does not have an audit committee, the individual with the level of authority and responsibility equivalent to an audit committee would normally be the named fiduciary, which is often the plan sponsor, an officer thereof, or the sponsor's board of directors. For a multiemployer plan, authority and responsibility equivalent to that of an audit committee would ordinarily rest with the board of trustees.

Chapter 7

Auditing Investments

Background

7.01 The investments of an employee benefit plan often consist of marketable securities, such as common or preferred stocks, bonds, notes, or shares of registered investment companies. Other investments may include real estate, mortgages or other loans, leases, nonreadily marketable securities, or units of participation in common or commingled trust funds maintained by a bank or similar institution. Investments may also be in the form of deposit administration or immediate participation guarantee contracts and individual or pooled separate accounts maintained by an insurance company.

7.02 Within the last decade, many plans have adopted aggressive investment strategies that incorporate a variety of techniques or specialized products to increase investment returns. Use of investment advisors has increased, and their roles are increasingly specialized. It is common for larger plans to use more than one advisor with the intention of increasing diversity in their portfolios through asset allocation. Many of these advisors are specialists selected to invest a portion of the plan's portfolio in a particular product or industry, or to use specialized strategies or techniques.

7.03 During this same period, corporate restructurings have increased the frequency of divestitures and management buyouts. Leveraged buyouts have become a common means of financing these transactions. Corporate financing strategy has given rise to an increase in the use of debt, and a market for high-risk *junk bonds* has been created. More recently, defaults by issuers of junk bonds, as well as the financial difficulties encountered in the savings and loan industry and the need for financial institutions to maintain adequate capital levels, are posing questions of national interest. These and other issues are reflective of the increased inherent risk in many employee benefit plan investment portfolios. This increase is, in part, reflective of the complexity in valuing unique, specialized, or nonreadily marketable securities. It is moreover a reflection of the changing nature of pension and benefit plan portfolios that once were considered to follow conservative investment policies and approaches.

7.04 Advisors also are using existing investments for new or different purposes. Many newer forms of investments, such as repurchase or reverse repurchase agreements, futures and options, and securities lending arrangements, are now available. Collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and myriad securitized portfolio investments are part of the growing list of specialized real estate related investment securities found in plan portfolios.

7.05 Chapter 5 discusses planning procedures, including those relevant to auditing investments. In planning the audit, the auditor should possess or obtain an understanding of these investments and their audit implications. Similarly, the auditor in planning his or her work should have or obtain an understanding of the role of the investment manager or advisor (for self-directed plans, the participants themselves) and how that role interrelates to the plan, trustee, administrator, or custodian with respect to investment decisions or plan administration.

7.06 Paragraphs 7.07 through 7.22 discuss the auditing objectives and related procedures for auditing trusteed assets, and paragraphs 7.38 through 7.42 discuss the auditing objectives and related procedures for auditing plan assets held with an insurance company. Paragraphs 7.45 and 7.46 discuss the auditing objectives and related procedures for auditing certain other types of plan investments. Paragraph 7.47 discusses the auditing procedures to be performed when the audit is limited with respect to assets held by a bank or similar institution or insurance company.[49] Appendix H provides a summary of objectives, procedures, and other considerations for auditing investments.

Trusteed Assets

7.07 Although investments are an integral part of the assets and operations of an employee benefit plan, the investment activities ordinarily are administratively distinct from other aspects of the plan because the plan administrator or named fiduciary usually engages a trustee or an investment manager, or both.

7.08 In a *directed trust*, including a participant-directed trust, the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, the participant, or the plan's investment advisor. A *discretionary trust* differs in that the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions. A discretionary trust gives the trustee authority to purchase and sell investment assets within the framework of the trust instrument. There are many variations of investment authority that may be given to the trustee, such as a combination of discretionary and directed arrangements within a trust. Furthermore, a plan may have one or more trusts as well as one or more custodial or safekeeping accounts. Many multiemployer plans make use of the services of a third-party administrator (TPA) who contracts to be responsible for plan administration. While TPAs are not normally considered trustees under ERISA, there may be circumstances where they perform investment income collection or other related functions.

7.09 Trustees generally are responsible for the safekeeping of the investments under their control. Sometimes, however, a plan will not appoint a trustee to maintain custody of the plan's investments but, rather, will self-administer the investments and investment transactions and provide for their safekeeping with a custodian.

7.10 The auditor should be aware that the auditing procedures will vary according to the nature of the trustee arrangement (discretionary or directed) and the physical location and control of the plan's records and investments.

Auditing Objectives

7.11 The objectives of auditing procedures applied to investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

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[49] See paragraphs 13.25 through 13.28 for a discussion of the scope of the audit when it is limited with respect to assets held by banks, similar institutions, or insurance carriers.

b. Whether investments are owned by the plan and are free of liens, pledges, and other security interests or, if not, whether the security interests are identified.

c. Whether investment principal and income transactions are recorded and investments are properly valued in conformity with generally accepted accounting principles.

d. Whether information about investments is properly presented and disclosed.

General Auditing Procedures

7.12 The auditing procedures to be applied to the investments of a plan ordinarily should include[50]—

a. Obtaining an understanding of the plan's investment strategy and its impact on the plan's investment portfolio. Generally the audit risk associated with valuation of nonreadily marketable, specialized, or unique securities would also be assessed annually as would the determination of whether the inherent risk of investments held by the plan had changed.

b. Obtaining an analysis of changes in investments during the period. The analysis ordinarily will include such information as (*1*) the name of the issuer, (*2*) a description of the investment, including the number of shares of stock, par value of bonds, principal amount of mortgages, maturity date, interest rate, and collateral, (*3*) cost and fair value at the beginning and end of the period and the basis of determining the fair value, and (*4*) cost of investments acquired and proceeds from investments sold during the period.

c. Obtaining evidence regarding the existence and ownership of investments and information about any liens, pledges, or other security interests, either by direct confirmation from the trustee or custodian or by physical count (in the increasingly less common circumstance in which securities are held in the plan or employer's vault or safe deposit box and registered in the name of the plan or its nominee). With respect to the confirmation procedure, the trustee, such as a bank, is legally responsible for assets held in its trust department. Thus, if a plan's investments are held by a bank's trust department, the auditor ordinarily accepts a confirmation from the bank as evidence of the existence and ownership of the investments. When a confirmation is used, the auditor should obtain information regarding the trustee's responsibility and financial capability. Procedures that the auditor may consider include—

  - Reviewing the trust instrument provision to determine the trustee's responsibilities.
  - Determining whether the trustee has insurance covering the plan assets under his or her control.
  - Reading recent financial statements of the trustee.

  The auditing procedures in paragraph 7.15 ordinarily will provide additional evidence regarding the existence and ownership of plan assets.

d. Reviewing minutes, agreements, and confirmations for evidence of liens, pledges, or other security interest in investments.

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[50] When deemed appropriate, these procedures can be used for audits of a directed trust.

e. Testing investment transactions by—
- Determining that they were properly authorized.
- Examining brokers' advices, cash records, and other supporting documentation for the historical cost or selling price, quantity, identification, and dates of acquisition and disposal of the investments.[51]
- Comparing prices at which purchases and sales were recorded with published market price ranges on the trade dates.
- Checking the computation of realized and unrealized gains and losses when such items are presented in the statement of changes in net assets or in the notes to the financial statements. (See appendix A for specific DOL rules regarding the computation of realized gains and losses.)

f. Confirming with the plan's custodian or cotrustee broker the status of any securities that are in transit.

g. Determining whether income accruing from investments during the period has been properly recorded. If the investment manager's compensation is material and is based on the plan's investment performance or other similar criteria, a determination should be made that the investment performance criteria affecting such compensation have been adequately tested to serve both purposes. It may be necessary for the plan administrator to engage a specialist as part of this procedure.

h. Testing the fair value of investments by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, *Auditing Accounting Estimates*. If fair value has been determined in good faith by the plan's board of trustees, administrative committee, or other designated party, the plan auditor does not substitute his or her judgment for that of the plan trustees, the plan administrator, or other advisor, because the plan auditor is not an appraiser or investment banker. In establishing the scope of his or her work and when selecting transactions for testing, the auditor should take into consideration the increased complexity inherent in valuing many of the new forms of investments. Procedures that the auditor should consider applying include—
- Reviewing and evaluating the plan's methods and procedures for estimating the fair value of investments.
- Determining whether the plan's methods and procedures for estimating fair value were followed.
- Testing the underlying documentation supporting the estimates.
- If the investment manager's compensation is material and based on the fair value of plan investments, determining whether the fair value of investments has been adequately tested for this purpose.
- Applying the procedures in SAS No. 73, *Using the Work of a Specialist*. With plans making significantly more investments in

[51] The accrual basis of accounting requires that purchases and sales of securities be recorded on a trade-date basis. If the settlement date is after the financial statement date, however, and (*a*) the fair value of the securities purchased or sold just before the financial statement date does not change significantly from the trade date to the financial statement date and (*b*) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

nonreadily marketable, specialized, or unique investments, the need to engage a valuation specialist is increasing. The auditor should follow the requirements of SAS No. 73.

— Inquiring if the plan's board of trustees, administrative committee, or other designated party has reviewed and approved estimates of the fair value of plan investments, and reading supporting minutes or other documentation (see paragraph 13.29).

i. Testing the computation of net change in appreciation or depreciation of fair value of investments.

j. Inquiring of the plan administrator or other appropriate parties if they are aware of any situation where the plan's investments or other transactions violate applicable laws or regulations (see chapters 5, 11, and appendix A for a discussion of prohibited party in interest transactions under ERISA).

k. Once the auditor has obtained the requisite investment information from the plan trustee, the auditor should consider obtaining the same type of information from the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor (the directing party) and reviewing and reconciling the directing party's reports (investment position and activity) with those of the trustee.

Discretionary Trusts

7.13 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires that in all audits the auditor should obtain sufficient understanding of each of three elements of the internal control structure (the control environment, the accounting system, and control procedures) to plan the audit. This understanding is obtained by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The knowledge provided by the understanding of the internal control structure and the assessed level of control risk is used in determining the nature, timing, and extent of substantive tests for financial statement assertions.

7.14 If investments are maintained in a discretionary trust arrangement (see paragraph 7.08), the plan auditor should apply the auditing procedures discussed in paragraph 7.12 as appropriate to records maintained by the plan. Under a discretionary trust arrangement, the plan will not have an independent record of investment transactions executed by the trust, and thus the plan auditor is unable to examine brokers' advices, cash records, and other supporting documentation to verify investment transactions.

7.15 For the plan auditor to gain sufficient support for transactions executed by the discretionary trust, he or she should do one of the following:

a. If the trustee has engaged an independent auditor to prepare a report on the processing of transactions by a service organization for use by other auditors, the plan auditor should obtain and read a copy of the latest available report and obtain a sufficient understanding of each of the three elements of the entity's internal control structure to conduct the plan audit (see SAS No. 70 for service auditors' reports dated after March 31, 1993). Ordinarily it should not be necessary for the plan auditor to review the trust department auditor's single-audit working papers, provided that the plan auditor is satisfied with the professional reputation and independence of the trust department auditor (see SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, paragraph 10a).

b. If a special-purpose report on the internal control procedures of the trust department cannot be obtained, the plan auditor should apply appropriate procedures at the trust department. In applying those auditing procedures, the plan auditor may consider using the work of the trust department's independent auditor or internal auditor (see SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*).

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limitation on the scope of the audit (see SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 40 through 44). The significant number of new and different types of investments generally has increased the inherent risk and the audit risk related to plan investments. It is the responsibility of the plan auditor to read the report of the service auditor to determine that the tests performed encompass the types of investments held by the plan. If the report is unclear or it does not address such circumstances, it will be necessary for the auditor, as discussed in SAS No. 70, to supplement his or her understanding of the trust auditor's procedures and conclusions by discussing with the service auditor the scope and results of his or her work.

Investments in Common or Commingled Trust Funds

7.16 A bank common or commingled trust fund may be used to invest some or all of a plan's assets. A plan generally acquires investment units, sometimes referred to as *units of participation*, representing an undivided interest in the underlying assets of the trust. The purchase or redemption price of the units is determined periodically by the trustee, based on the current market values of the underlying assets of the fund. The financial statements of many common and commingled trust funds are examined and reported on by auditors engaged by the bank.

7.17 The objectives of auditing procedures applied to investments in common and commingled trust funds are to provide the auditor with a reasonable basis for concluding—

a. Whether the units of participation held by the plan exist.

b. Whether the units of participation are owned by the plan and are unencumbered.

c. Whether valuation of units of participation at the plan's year-end has been determined in conformity with generally accepted accounting principles.

d. Whether purchase, redemption, and income transactions of the units held by the plan are properly recorded.

7.18 The auditing procedures to be applied to investments in common and commingled trust funds should include—

a. Confirming directly with the trustee the units of participation held by the plan.

b. Examining documents approving and supporting selected investment transactions in units of participation, such as investment committee minutes, trust agreements, or investment guidelines.

c. Obtaining a copy of the current financial statements of the fund and relating the reasonableness of the unit information reported in the fund's financial statements to unit information recorded by the participating plan, including market values, purchase and sales values, and income earned and accrued. In examining documents that provide support for the unit value information, the plan auditor should do the following:

- If the fund's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the fund's financial statements and the auditor's report. The fund's financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor's objectives. The auditor should consider the effect that any reported matters, such as restrictions on redemption or subjectively determined values, may have on the carrying amount of the units of participation held by the plan. If the auditor believes that the carrying amount may be impaired, he or she should consider applying analytical procedures to the interim financial information of the fund from the date of the fund's audited financial statements to determine whether such a loss in value has occurred.
- If the common or commingled trust fund's financial statements are not audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the common or commingled trust fund's internal control procedures, if such a report is available (see SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*). Although a report on internal control procedures will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the trustee's internal control structure if the scope of the report includes the appropriate aspects of common and commingled trust funds (for example, determination of unit values and control over share transactions). If the report is not available, appropriate procedures should be performed, including obtaining an understanding of the internal control structure and assessing control risk relating to the common or commingled trust fund. In applying those auditing procedures, the plan auditor may consider using the work of the bank's independent auditor or internal auditor.

If the plan auditor is unable to apply the auditing procedures discussed in this paragraph, ordinarily he or she should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the audit (see SAS No. 58, paragraphs 40 through 44).

Master Trusts and Similar Vehicles

7.19 A company that sponsors more than one employee benefit plan or a group of corporations under common control may place assets relating to some or all of the plans into one combined trust account, sometimes referred to as a *master trust*. Each plan has an undivided interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation. A bank ordinarily serves as the trustee for a master trust, acts as custodian, and may or may not have discretionary control over the assets.

7.20 Plan administrators normally engage an auditor to report only on the financial statements of individual plans. The auditing objectives and procedures described in paragraphs 7.11 and 7.12 also apply to the activities of a master trust in which a plan participates. When the same auditor examines the master trust and the individual plans that have some or all of their assets in the master trust, it will normally be efficient for the auditor first to apply appropriate procedures to the master trust and then to examine how ownership is attributed to individual plans.

7.21 If the master trust is audited by another independent auditor, the plan auditor should obtain the other auditor's report on the master trust's financial statements. The plan auditor should use this report in a manner that is consistent with his or her use of the report of another auditor on the financial statements of a common or commingled trust fund (see paragraph 7.18c). If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to plan investments or qualify or disclaim his or her report.

7.22 The plan auditor should review the trust instrument to obtain reasonable assurance that the accounting for the undivided interest is consistent with the instrument. If the instrument does not specify the accounting method, the auditor should be satisfied that all administrators of plans participating in the master trust agree with the method of allocation.

Insurance Contracts

7.23 A plan may invest assets with an insurance company pursuant to any of a number of different types of contracts. The nature of the contract will determine the related accounting and regulatory reporting requirements.[52]

7.24 The amounts remitted to an insurance company become the assets of the insurance company, for which it, in turn, assumes an obligation to fulfill the contract terms. This differs from a bank trust arrangement in which a bank holds the assets for the plan as a fiduciary and the assets are not included in the bank's financial statements.[53] The extent to which the assets and transactions related to insurance arrangements are recorded in the plan's financial statements, and the extent of auditing procedures to be applied, depend on the terms of the contract with the insurance company.

7.25 For employee benefit plans, the fundamental basis of distinction in classifying contracts for accounting purposes is (*a*) whether the contributions are currently used to purchase insurance or annuities for the individual participants or (*b*) whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right.[54] Contractual arrangements under which funds

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[52] As noted in appendix A, plans funded solely with certain types of insurance contracts are not required under ERISA to prepare financial statements or engage an independent auditor.

[53] See paragraphs 7.33 through 7.37 and 7.41 for a discussion of insurance company separate accounts.

[54] Although the term "allocated account" is used by insurance companies in connection with defined contribution plans when amounts are recorded in separate participant accounts, the term "allocated," as it is used here, refers to situations in which the obligation to pay defined benefits under the plan is assumed by the insurance company.

are currently allocated to purchase insurance or annuities for individual participants are referred to as *allocated* funding arrangements, whereas other arrangements are called *unallocated* funding arrangements. Funds in an unallocated contract may be withdrawn or otherwise invested. Some contractual arrangements may involve both allocated and unallocated funding. Essentially, allocated contracts are excluded from, and unallocated contracts are included in, plan assets.[55]

7.26 Allocated funding arrangements include insurance or annuity contracts in which the insurer has a legal obligation to make all benefit payments for which it has received the premiums or requested consideration. Allocated funding instruments can be individual insurance or annuity contracts, group permanent insurance contracts, or conventional deferred group annuity contracts. Some of these contracts may also include unallocated side or auxiliary funds, which ordinarily would be considered plan assets.

7.27 Unallocated funding instruments apply to any arrangement under which employer or employee contributions to an employee benefit plan are held in an undivided fund until they are used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of employment with vested benefits. Unallocated funding ordinarily is associated with a group deposit administration contract (DA) and an immediate participation guarantee contract (IPG).[56] For investment purposes, unallocated funds may be commingled in a general or pooled separate account or held in an individual separate account.

7.28 Determining whether contract assets and related obligations should be reported in the plan's financial statements requires a careful review of the contract. Typical DA and IPG contracts are unallocated funding arrangements, and the value of these contracts generally should be included in a plan's financial statements. Assets held in separate accounts are similarly reflected in the plan's financial statements, because they are unallocated amounts held by the insurance company.

Deposit Administration Contracts

7.29 The term *deposit administration* is applied to a type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Under a DA contract, payments to the insurance company that are intended to provide future benefits to present employees are credited to an account. For investment purposes, the monies in the account are commingled with other assets of the insurance company. The account is credited with interest at the rate specified in the contract; it is charged with the purchase price of annuities when participants retire and with any incidental benefits (death, disability, and withdrawal) disbursed directly from the account.

7.30 Although the insurance company will guarantee a minimum stipulated interest rate on funds in the *active life fund* and rates at which annuities may be purchased, it does not guarantee that sufficient funds will be available to meet the cost of annuities to be purchased.

7.31 Experience-rated interest credits on funds in the undivided account are determined by the insurance company, but they are not guaranteed. The

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[55] See paragraph 2.12 in this guide as well as FASB Statement No. 35, paragraphs 12 and 112 through 126.

[56] The term *group annuity* is frequently applied to a broad category of insurance contracts that provide the vehicle for funding pension benefits. Those include *deferred group annuity* contracts, *deposit administration* contracts, and *immediate participation guarantee* contracts.

calculation of these credits is based on internal records kept by the insurance company for each contract and are determined by the actual investment experience of the insurance company. These interest credits may be paid out, added to the balance of funds in the undivided account, or considered in an overall dividend calculation that also takes into account mortality, other actuarial experience, and reserves required by the insurance company. Under DA contracts, amounts of dividend or rate credits are determined solely at the discretion of the insurance company, which has no contractual obligation to pay a dividend. The contract holder has no contractual right to demand an accounting.

Immediate Participation Guarantee Contracts

7.32 The IPG contract is a variation of the DA contract. In an IPG contract, the account is credited with the contributions received during the contract period plus its share of the insurance company's actual investment income. The IPG contract is written in two forms. Under either form the insurance company is obligated to make lifetime benefit payments to retired employees. One form provides for the actual purchase of annuities as employees retire. There is an annual adjustment to the account to reflect the insurance company's experience under the annuities. In the other form, the IPG contract may accomplish the same objective through a different technique. When an employee retires, pension payments are made directly from the account without the purchase of an annuity. However, the balance of the account must be maintained at the amount required, according to a premium schedule in the contract, to provide for the remaining pension benefits for all current retirees. That portion of the account is referred to as the *retired life fund.* Thus, if necessary, the account could always be used to buy all annuities in force.

Investment Arrangements With Insurance Companies

7.33 A separate account may be used independently of, or as an adjunct to, a DA or IPG contract.

7.34 Separate accounts were developed to allow insured plans to compete with trust funds in making investments and in funding variable annuity plans. The assets of a separate account plan are assets of the insurance company but are not commingled with the insurance company's general assets. The purpose of a separate account is to provide flexibility in the investment of the plan's funds. A separate account may be established solely for one plan or, more commonly, may be pooled with the funds of several plans.

7.35 A separate account in which only one plan participates is generally referred to as an *individual separate account* or as a *separate-separate account.* The investments in the account must be separately identified, and the account is operated similarly to a bank trust fund, although it is included in the insurance company's financial statements.

7.36 A separate account in which several plans participate generally is referred to as a *pooled separate account.* Each plan's share of a pooled separate account is determined on a participation-unit or variable-unit basis.[57] The plan's equity account provides a cumulative record of the number of participation units credited to the account and the number of units allocated or with-

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[57] In some separate accounts, a plan receives a guaranteed rate of return on funds held in the separate account. Accordingly, a plan's share would be determined by applying the contractual guarantee to the plan's account balance, and the funds held in the separate account should be viewed as an unallocated funding instrument as described in paragraph 7.27.

drawn from the account. The balance of participation units credited to the account multiplied by the current participation-unit value equals the amount of equity account assets held on behalf of the policyholder at any given time. The participation-unit value is adjusted periodically, usually each business day, to reflect investment results under the separate account.

7.37 Many plans hold guaranteed investment contracts (GICs) in their investment portfolios. Normally issued through the general account, in its simplest form a GIC is a contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period. Variations include contracts in which the plan is permitted to make deposits or withdrawals during certain windows during the contract life, contracts with multiple maturities (and rates), contracts in which the insurance company guarantees a minimum rate and may credit the contract holder with additional interest, and contracts with floating rates. These contracts are unallocated and are to be included as plan assets in the manner required by ERISA, and they are to be reported in a manner consistent with Form 5500 or 5500-C.*

Auditing Objectives

7.38 The objectives of auditing procedures applied to plan assets held with an insurance company are to provide the auditor with a reasonable basis for concluding—

a. Whether plan assets, represented by insurance contracts, exist.

b. Whether changes in plan assets during the period are properly recorded and valued in conformity with generally accepted accounting principles.

c. Whether the plan has any intention of seeking to dispose of or terminate the contract.

d. Whether the terms of the contract are being complied with and are appropriately disclosed in the plan's financial statements.

Auditing Procedures

7.39 The auditing procedures to be applied to contracts with insurance companies (to the extent they are applicable to a particular contract) ordinarily should include—

a. Reading the contracts between the contract holder and the insurance company and evaluating whether they are investment or insurance contracts, in accordance with FASB Statement No. 110, if applicable.

b. Confirming the following directly with the insurance company, as applicable:
   - Contributions or premium payments made to the fund or account during the year
   - Interest, dividends, refunds, credits, and changes in value, and whether such amounts have been charged or credited during the year on an estimated or actual basis

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* In September 1994, the AICPA issued SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, which may substantially change the way certain health and welfare benefit plans report the investment contracts held by those plans. SOP 94-4 is generally effective for plan years beginning after December 15, 1994. SOP 94-4 is included in appendix I of this guide.

- The value of the contracts at the plan's year-end and the basis for determining such value. The propriety of such valuations should also be considered
- The amount of insurance company fee and other expenses chargeable during the year
- For insurance contracts with unallocated funds, annuity purchases or benefits paid from unallocated plan assets during the year
- Transfers between various funds and accounts

c. Evaluating whether the characteristics of the contract that restrict the use of assets require disclosure in the financial statements of the plan. For example, if the plan has indicated an intention to dispose of or terminate the contract or the contract contains a termination clause (for example, a market value determination adjustment), the auditor is responsible for performing sufficient procedures either with plan representatives or the insurance company to satisfy the audit objectives identified in the foregoing with respect to proper valuation and appropriate disclosure. Alternatively, if plan management is aware that an event has affected the contract issuer that may require disclosure or, in rare circumstances, may cause plan management to conclude that reporting the investment at a value less than contract value is appropriate, the auditor is responsible for performing sufficient procedures to satisfy the audit objectives identified.

7.40 For contracts in which assets are held in the insurance company's general account (DAs and IPGs), the following additional auditing procedures should be applied:

a. For DA contracts, evaluating the reasonableness of the interest credited to the contracts in relation to any minimum guaranteed interest rate stated in the contract.[58]

b. For IPG contracts, considering the plan administrator's conclusion regarding the basis for recording changes in contract values to recognize investment returns in accordance with the terms of the contract. This conclusion is usually made by referring to investment yield data furnished to the plan by the insurance company. Generally, this evaluation would sufficiently satisfy the auditor regarding the aggregate investment income credited to the contract. If the amount of investment yield credited to the contract, based on current investment returns, does not appear reasonable, the auditor should apply additional procedures, such as making inquiries of the insurance company regarding its compliance with the method required under the terms of the contract for computing investment return. In the event that the plan auditor is unable to obtain assurance as to the reasonableness of the rate of investment return credited, he or she should consider asking the plan administrator to contact the insurance company to arrange for the insurer's independent auditor to perform agreed-upon procedures and issue a report thereon (see SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to*

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[58] The plan auditor need not apply auditing procedures to the experience fund of a typical DA account or to any similar fund that is used by the insurance company to determine a "discretionary" dividend or rate credit under the contract (see paragraph 7.31).

Specified Elements, Accounts, or Items of a Financial Statement). Those procedures would be applied to the insurance company's determination of investment returns in accordance with the contract.

c. Determining that annuity purchases were made on the basis of rates stipulated in the contract. If annuities are not purchased and benefits are paid directly from the fund, benefit payments should be tested in accordance with the auditing procedures discussed in paragraph 9.03.

d. Reading the financial statements of the insurance company.

e. Evaluating whether expenses charged to the contract by the insurance company are in accordance with the insurance contract or are otherwise authorized by the plan.

7.41 For insurance contracts in which investments are made in separate accounts, the auditor should apply the following additional procedures:

a. For investments in which assets are held in individual separate accounts, the plan audit should include the individual investment transactions and documents that provide support for those transactions. The plan auditor should do the following:
   - If the separate account's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the separate account's financial statements and the auditor's report. The financial statements need not cover the exact period covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor.
   - If the separate account's financial statements have not been audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the insurance company's separate account activities, if such a report is available (see SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*). Although a report on internal control policies and procedures will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the insurance company's internal control structure if the scope of the report includes the appropriate aspects of separate accounts (for example, determination of unit values and control over share transactions). If the report is not available, he or she should apply appropriate procedures at the insurance company, including obtaining an understanding of the internal control structure and assessing control risk relating to the separate account. In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

b. For investments in pooled separate accounts, the plan audit is concerned with the plan's units of participation in the pooled account, and the plan auditor should examine documents that provide support for those transactions. To perform those procedures, the plan auditor should do the following:
   - If the pooled account's financial statements have been audited by an independent auditor, the plan auditor should obtain and read the pooled account's financial statements and the auditor's report. The financial statements need not cover the exact period

covered by the plan's financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. The auditor should consider the effect that any reported matters may have on the carrying amounts of the units of participation held by the plan, such as restrictions on redemption or subjectively determined values. If the auditor believes the carrying amount may be impaired, he or she should consider applying analytical procedures to the interim financial information of the pooled account from the date of the account's audited financial statements to determine whether such a loss in value has occurred.

- If the pooled separate account's financial statements have not been audited by an independent auditor, the plan auditor should obtain a copy of a service auditor's report relating to the pooled account's activities, if such a report is available (see SAS No. 70). Although a report on internal control policies and procedures will not provide the auditor with the same level of assurance as audited financial statements, it will normally provide sufficient evidence as to the effectiveness of the insurance company's internal control structure if the scope of the report includes the appropriate aspects of pooled separate accounts (for example, determination of unit values and control over share transactions). In applying those auditing procedures, the plan auditor may consider using the work of the insurance company's independent auditor or internal auditor.

7.42 If the plan auditor is unable to apply the auditing procedures discussed in paragraphs 7.39 through 7.41, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limited scope of the audit (see SAS No. 58, paragraphs 40 through 44).

Other Investments

7.43 The objectives of auditing procedures applied to participant loans are to provide the auditor with a reasonable basis for concluding—

a. Whether all participant loans exist.

b. Whether the participant loans are recorded and are properly valued in conformity with generally accepted accounting principles.

7.44 The auditing procedures to be applied to participant loans may include—

a. Examining participant loan documentation supporting loans.

b. Confirming loans with participants.

c. Testing that interest is properly recorded.

d. Testing whether the loans were made in conformance with the plan document.

e. Reviewing financial statement classification to ascertain that participant loans are properly reported as plan investments and included in the supplemental schedule of Assets Held for Investment Purposes.

f. Determining whether delinquent loans should be reclassified as distributions. This determination should be made based on the terms of the plan document and related plan policies and procedures.

g. Ascertaining that participant loans considered to be delinquent based on the terms of the plan document and related plan policies and procedures are included in the supplemental schedule of Loans in Default or Uncollectible. Delinquent loans are considered to be assets held for investment purposes.

7.45 The objectives of auditing procedures applied to other types of investments and related transactions are to provide the auditor with a reasonable basis for concluding—

a. Whether all investments are recorded and exist.

b. Whether the investments are owned by the plan and are free of liens, pledges, and other security interests, or if not, whether the security interests are identified.

c. Whether investment transactions are recorded and the investments are properly valued in conformity with generally accepted accounting principles.

7.46 The auditing procedures to be applied to other types of investments ordinarily should include—

For real estate

a. Examining closing and other documents supporting the cost of ownership.

b. Examining deeds, title policies, encumbrances, and other evidence related to ownership.

c. Testing the fair value (see paragraph 7.12h).

d. Examining current-year tax bills and relating them to property descriptions under (*b*) just listed.

e. Testing investment income from real estate, such as rents, and payments of related expenses, such as taxes and maintenance.

f. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See appendix A for a discussion of *party in interest* and *reportable transactions* under ERISA.)

For loans and mortgages

a. Examining documents, including notes, mortgages, deeds, and insurance policies, supporting selected loans and mortgages.

b. Confirming selected loans and mortgages with borrowers.

c. Testing the fair value, including the extent of collateral, if any (see paragraph 7.12h).

d. Testing to see that interest is properly recorded.

e. Inquiring whether the plan's investments or other transactions violate applicable laws or regulations. (See appendix A for a discussion of *party in interest* and *reportable transactions* under ERISA.)

f. Reviewing financial statement classification to ascertain that participant loans are properly reported as plan investments.

Limited-Scope Auditing Procedures

7.47 As discussed in paragraphs 5.02 and 13.25, the audit may be restricted with respect to assets held and transactions executed by certain institutions. In an ERISA limited scope audit, the auditor can limit the scope of testing on any investment information prepared and certified by a qualified trustee or custodian. The auditor has no responsibility to obtain an understanding of the internal control structure maintained by the certifying institution over assets held and transactions executed for the Plan or to assess control risk associated with assets held and transactions executed by the institution. The auditor's responsibilities for any assets covered by the limited-scope exception are (1) to compare the information certified by the plan's trustee or custodian to the financial information contained in the plan's financial statements and (2) to perform the necessary procedures to become satisfied that any received or disbursed amounts (for example, contributions and benefit payments) reported by the trustee or custodian were determined in accordance with the plan provisions.

7.48 Although the auditor is not required to audit certain investment information when the limited scope audit exception is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of preparing financial statements. In addition, if it comes to the auditor's attention that the required supplementary schedules are omitted, do not contain all required information, or contain information that is inaccurate or is inconsistent with the financial statements, the auditor should consider modifying his or her report on the supplementary schedules (see paragraph 13.15). Furthermore, the scope limitation and the corresponding limitation of the auditor's work extends only to investments and related investment activity certified by the qualified trustee/custodian. Plan investments not held by a qualified trustee/custodian, such as real estate, leases, mortgages, and participant loans, and any other investments or assets not covered by such an entity's certification should be subjected to appropriate audit procedures. Moreover, the appropriate audit procedures for all noninvestment related information (for example, benefit payments, employer/employee contributions, and receivables) are the same for a limited scope audit as for a full scope audit.

Chapter 8

Auditing Contributions Received and Related Receivables

8.01 For all types of employee benefit plans, the basis for determining employer and, if applicable, employee contributions is specified in the plan instrument or related documents. For defined benefit plans covered by ERISA, employer annual contributions must also satisfy the minimum funding standards of ERISA. (See paragraphs A.10 through A.13 for a discussion of the funding standard account and minimum funding standards of ERISA.) The existence of an accrued liability in the employer's statement of financial position or of a plan's accumulated benefit obligations in excess of its net assets available for benefits do not, by themselves, provide sufficient support for recognition of a contribution receivable by the plan.

Auditing Objectives

8.02 The objectives of auditing procedures applied to contributions received and related receivables of employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the amounts received or due the plan have been determined and recorded and disclosed in the financial statements in conformity with plan documents and generally accepted accounting principles.

b. Whether an appropriate allowance has been made for uncollectible plan contributions receivable in conformity with generally accepted accounting principles.

Auditing Procedures

8.03 The auditing procedures to be applied to employer and employee contributions ordinarily should include—

a. Obtaining a list of participating employers (in a multiemployer plan) and testing its completeness by examining appropriate plan documents (for example, a collective bargaining agreement).

b. Obtaining a schedule of contributions received or receivable and relating the contributions to the listing of participating employers obtained in procedure (*a*) of this list and of other plans under reciprocal arrangements.

c. Testing contribution reports to see that the reports are arithmetically correct and that the contribution rate specified in the plan instrument, including collective bargaining agreements, if applicable, was used.

d. Reconciling contributions received from the schedule obtained in procedure (*b*) to the plan's cash receipts records and bank statements or trustee reports. Sometimes a central bank account is used for the deposit of employer contributions to several related employee benefit plans. In those circumstances it may be necessary to test the amounts transferred to the bank account of the individual employee benefit plan.

e. Testing postings from the employer contribution reports to the participant employee or employer records and from participant records to contribution reports.

f. Confirming directly with contributors amounts received and receivable.

g. Reviewing criteria used by the plan in accruing employer and employee contributions receivable and determining that the accruals have been recorded in accordance with generally accepted accounting principles.

h. Evaluating the reasonableness of the plan's allowance for estimated uncollectible amounts based on testing of collections subsequent to the date of the financial statements and reviewing the status of unpaid amounts.

8.04 The auditor may accomplish the foregoing procedures more efficiently by coordinating the auditing procedures for plan contributions with those for participants' data (see chapter 10). In auditing the financial statements of a multiemployer plan, the auditor may need to make special arrangements to examine employer records. The auditing procedures and related guidance described in paragraph 10.06 may be applicable to those circumstances (see also paragraph 13.26).

Defined Benefit Plans

8.05 In addition to the auditing procedures discussed in paragraph 8.03, procedures that the auditor should consider applying in auditing the financial statements of a defined benefit pension plan or a defined benefit health and welfare plan include—

a. Determining that employer contributions are consistent with the report of the plan's actuary, if applicable.

b. Reviewing the amount contributed and, if applicable, determining that it meets the requirements of the funding standard account (see appendix A for a discussion of the funding standard account).

c. Considering the results of the auditing procedures described in chapter 10 for participants' data and using the work of an actuary when examining the amount recorded as contributions in the plan's financial statements. For example, significant errors in participants' data provided to the actuary may have a material effect on the actuarially determined amount of contributions.

Defined Contribution Plans

8.06 Besides the auditing procedures discussed in paragraph 8.03, additional procedures that the auditor should consider applying in auditing contributions to defined contribution plans include—

a. Reviewing the contribution provisions of the plan instrument and testing compliance with the plan instrument. (The plan instrument of a defined contribution plan often specifies the criteria that must be met for the employer and employee to make a contribution, the formula to determine upper and lower contribution limits, or the rates for determining the contribution.)

b. Comparing the amount of employer contributions recorded in the plan's records to the amount approved by the board of directors of the plan sponsor, if the plan instrument requires that the board of directors determine or approve the employer contribution.

c. Considering, if applicable, the results of the auditing procedures described in chapter 10 for participants' data (including any contributions for salary reduction plans).

Chapter 9

Auditing Benefit Payments

9.01 The amount, timing, and form of benefits paid or payable to participants and beneficiaries are determined in accordance with the plan instrument or related documents. The plan administrator or his or her agent is responsible for assuring that any disbursements of plan assets satisfy the requirements set forth in the plan instrument and related documents and are otherwise consistent with ERISA.

Auditing Objectives

9.02 The objectives of auditing procedures applied to benefit payments for employee benefit plans are to provide the auditor with a reasonable basis for concluding—

a. Whether the payments are in accordance with plan provisions and related documents.

b. Whether the payments are made to or on behalf of persons entitled to them and only to such persons (that is, that benefit payments are not being made to deceased beneficiaries or to persons other than eligible participants and beneficiaries).

c. Whether transactions are recorded in the proper account, amount, and period.

Auditing Procedures

9.03 The auditing procedures to be applied to benefit payments ordinarily should include—

a. For selected participants receiving benefit payments—
- Examining the participant's file for type and amount of claim and propriety of required approvals including tracing approval of benefit payments to board of trustees or administrative committee minutes, if applicable. For health and welfare benefit plans, examining service provider statements or other evidence of service rendered.
- Evaluating the participant's or beneficiary's eligibility (that is, whether the payee meets the plan's eligibility requirements) by: examining evidence of age and employment history data; comparing employment dates, credited service, earnings, and any employee contributions to payroll or other appropriate records; and examining the benefit election form and dependent designation to determine appropriateness of payment, including the form of distribution (for example, lump sum, installments, or annuity contract).
- For plan benefits, such as death and disability benefits, examining a copy of the death certificate and beneficiary form, physician's statement, and other appropriate documents.
- Recomputing benefits based on the plan instrument and related documents, option elected, and pertinent service or salary history.

- Comparing the benefit payment amount to cash disbursement records or trustee reports.
- For health and welfare plans, comparing the payment of premiums to an insurance company, prepaid health plan or similar organization on behalf of a participant to the participant's eligibility records.

b. Evaluating whether procedures exist for determining the continued eligibility of participants or beneficiaries to receive benefits to assure that individuals are removed from the benefit rolls upon death and that payments made to individuals over an unusually long number of years are still appropriate.

c. Evaluating whether procedures exist for investigating long-outstanding benefit checks.

d. For defined contribution plans, comparing disbursements to participants with individual participant's account records that have been examined in accordance with the auditing procedures in paragraphs 10.09 through 10.11.

e. For defined contribution pension plans, review the criteria used by the plan to record benefit payments and determine that the benefit payments have been recorded in accordance with generally accepted accounting principles. The auditor should refer to paragraph 3.23*m* for guidance in reporting benefit payments on the statement of net assets available for benefits.

f. For health and welfare plans that are reporting under SOP 92-6, review the criteria used by the plan to record benefit payments, and determine that the benefit payments have been recorded in accordance with generally accepted accounting principles. The auditor should refer to paragraphs 4.34 through 4.47 for more complete guidance.

g. For health and welfare plans that are not reporting under SOP 92-6 (transition period plans that have not elected earlier adoption), the auditor should review the criteria used by the plan to record benefit payments and accrue benefits payable, including premiums payable to an insurance company, and determine that the benefit payments have been made and the accruals recorded in accordance with generally accepted accounting principles.

Depending on the results of the procedures described in (*b*) and (*c*) in the preceding list, the auditor may also wish to compare canceled checks with the plan's cash disbursement records or to confirm payment of benefits by corresponding directly with selected participants, service providers, and beneficiaries and comparing signatures with the application for plan benefits, service provider statements, or other appropriate documents.

9.04 In some circumstances, benefit disbursements are determined or made by a third party such as a bank, an insurance company, or other service provider (that is, third-party administrator). In these circumstances, the auditor may need to obtain an understanding of the internal control procedures of the third party. This can be satisfied either through obtaining a service auditor's report in accordance with SAS No. 70, *Reports on Processing of Transactions by Service Organizations*, or through applying appropriate auditing procedures to the third-party administrator. These procedures are performed irrespective of whether the plan avails itself of the limited-scope audit exemption relating to certain assets held by a bank or similar institution or insurance carrier regulated and supervised and subject to periodic examination by a state or federal agency. The use of such a third party's independent auditor or internal auditors to perform certain of the foregoing procedures may be appropriate in those circumstances.

Chapter 10

Auditing Participant Data and Plan Obligations

Participant Data

10.01 The nature of plan benefit obligations and the accounting methods and auditing procedures for them differ with the various types of plans; however, each type requires the testing of certain participant data. The type of participant data to be tested differs according to the type of plan, and from plan to plan within each type. The data used to determine accumulated plan benefits will be identified in the plan instrument or collective bargaining agreement, if applicable. If the plan requires the services of an actuary, an actuarial report may describe or summarize the participant data used by the actuary. The data should be tested by the auditor in accordance with SAS No. 73, *Using the Work of a Specialist* (see paragraphs 10.18 through 10.23 and 10.32 and 10.33 of this guide).

10.02 The objectives of auditing procedures applied to participant data are to provide the auditor with a reasonable basis for concluding (*a*) whether all covered employees have been properly included in employee eligibility records and, if applicable, in contribution reports and (*b*) whether accurate participant data for eligible employees were supplied to the plan administrator and, if appropriate, to the plan actuary.

10.03 The period for which the data are tested will depend on the date as of which the related financial information is presented in the financial statements. For example, if the accumulated plan benefits are actuarially valued as of the beginning of the plan year, the data to be tested will be as of or for the period ending as of that date. Similarly, if contributions are determined on the basis of an actuarial valuation as of the beginning of the plan year, data submitted to the actuary and to be tested by the auditor would be as of that date. If the auditor also audits the employer's financial statements, the auditing procedures applied in the prior year's audit of the employer's financial statements generally need not be duplicated in the audit of the plan's financial statements. The auditor may find that he or she can accomplish the work more efficiently by coordinating the auditing procedures for participant data with procedures for plan contributions and plan benefits described in chapters 8 and 9.

10.04 The types of participant data that ordinarily should be tested in an audit of a plan's financial statements will vary from plan to plan, depending on the factors on which contributions and benefits are determined. In general, the data tested may include—

a. Demographic data, such as sex, marital status, birth date, period of service with the employer, and other service history.

b. Payroll data, such as wage rate, hours worked, earnings, and contributions to the plan, if any.

c. Benefit data for participants receiving benefits, such as benefit levels and benefit options selected.

10.05 In testing the employer's participant records, procedures that should be considered include—

a. Reviewing pertinent sections of the plan instrument and collective bargaining agreement, if applicable, as a basis for considering what participant data should be tested in the audit of the plan's financial statements.

b. Testing the summarization of the payroll journal and schedules of participant data, if applicable, and tracing postings of gross pay to general or subsidiary ledger accounts.

c. Testing payroll data for one or more pay periods and for a number of participants by—
- Tracing the individual payrolls from the payroll journal to the participants' earnings records.
- For participants paid on an hourly or piecework basis, testing payroll hours, production tickets, or other supporting evidence and testing the computation of hours.
- Testing rates of pay to authorizations or union contracts.
- Testing calculations of earnings.
- Reviewing personnel files for hiring notice and employment data, pay rates and rate changes, termination notice, sex, birth date, and so forth.

d. If participant files are maintained in the custody of the plan administrator, testing whether the data maintained in those files correspond to the data maintained in employer payroll and personnel files.

For multiemployer plans, in addition to the procedures described in (*a*) through (*d*) preceding, the auditor should consider comparing the employer's contribution reports with the information shown in participants' earnings records and comparing hours worked and earnings records with the employer's contribution reports to evaluate whether the participants have been properly included in or excluded from the reports. If significant participant data are missing or incomplete, the auditor should satisfy himself or herself as to the adequacy of the methods used by the plan administrator or plan actuary to give effect to such missing data.

10.06 If the auditor is unable to examine the participant records, which may occur in a multiemployer plan, there may be circumstances, depending on the existing internal control structure, in which the auditor can obtain the necessary assurance by applying one or more procedures, such as—

a. If the plan administrator maintains records of participant data and maintains an internal control structure to help ensure that data on all participants are included in the records, testing the data on which contributions and actuarially determined amounts are based by direct communication with participants and by comparison with union or other records, if applicable. The auditor may also confirm hours, pay rates, and other appropriate information.

b. If the plan administrator's normal procedures include periodic visits to employers to test data submitted to him or her, reviewing and testing the plan administrator's procedures.

c. Obtaining a report from the auditor of the employer company stating that agreed-upon procedures (as described in paragraph 10.05) have been performed, and obtaining the auditor's findings regarding the procedures applied. In addition, the plan auditor should apply such other auditing procedures as he or she considers necessary in the circumstances. In this regard, it may be necessary for the plan auditor to request the other auditor to apply additional tests (see SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*).

If the auditor is unable to obtain the necessary assurance regarding participant data, he or she ordinarily should conclude that it will be necessary to express a qualified opinion or disclaim an opinion because of the limitation on the scope of the audit (see SAS No. 58, paragraphs 40 through 44 and paragraphs 13.25 through 13.28 of this guide).

Defined Benefit Plans

10.07 Contributions to a defined benefit plan ordinarily are determined on the basis of an actuarial valuation of the plan carried out by the plan actuary, using participant data received from the plan administrator or the employer company and using actuarial techniques. For multiemployer plans and certain other negotiated plans, contribution levels are normally specified in the plan instrument or collective bargaining agreement, and an actuarial valuation is used to compare accumulated contributions to date with accumulated plan benefits. SAS No. 73, paragraph 12, states, "The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements." Accordingly, the auditor should satisfy himself or herself that the participant data provided to and used by the actuary were accurate and complete in all material respects.

10.08 In addition to the auditing procedures described in paragraphs 10.04 through 10.06 of this chapter, when auditing the financial statements of defined benefit plans that involve actuarial valuations, the auditor should consider applying auditing procedures that include—

a. Tracing information obtained during tests of participant data to the participant data given by the plan administrator to the actuary.

b. Testing the basic data used by the actuary in his or her calculations (for example, name, sex, birth date, hours worked, employment dates, dates of participation in plan, and salary) by tracing data from the actuary's report (if the data are shown in the report) or from a confirmation letter obtained from the actuary to the data furnished by the plan. This test would normally include a selection of individuals as well as summary totals (see paragraph 10.20*f*).

Defined Contribution Plans

10.09 For defined contribution plans, the types of participant data that should be tested will vary from plan to plan. The data tested generally should include—

a. Covered compensation of individual participants. IRS regulations generally require that the company contribution be allocated to participants on the basis of the ratio of their covered compensation to total covered compensation for all participants.

b. Individual participants' contributions to the plan.

c. Birth date, date of hire, and other demographic data that determine eligibility and vesting.

10.10 In addition to other uses, these data are used by the auditor to test the validity of terminations and the eligibility of individuals to participate in the plan. Examples of the auditor's procedures in which the data are used are—

a. Tracing individuals who have terminated to benefit payments or to benefits payable and, if forfeitures are involved, to the record of forfeited amounts.

b. For individuals who qualify for participation during the year and who elect to participate, evaluating whether the individuals have been properly included in the individual participant accounts.

10.11 The auditing procedures discussed in paragraphs 10.04 through 10.06 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data.

Health and Welfare Benefit Plans

10.12 The types of participant data that should be tested in the audit of the financial statements of a health and welfare benefit plan differ widely from plan to plan. In general, the data tested may include—

a. Payroll data, including salary or wage rate and hours worked.

b. Demographic data, including sex, birth date, date of hire, and number of dependents.

c. Claims history records maintained by the plan administrator.

10.13 The auditing procedures discussed in paragraphs 10.04 through 10.06 (including procedures relating to the use of the work of an actuary, if applicable) should also be applied to the data. The use of the data in evaluating eligibility and benefits is discussed in paragraph 9.03.

Plan Obligations

10.14 As discussed earlier in this chapter and in chapters 2, 3, and 4, the nature of plan benefit obligations and the methods of valuing and recording those obligations differ significantly among the three types of plans.

Defined Benefit Plans

10.15 The objective of auditing procedures applied to accumulated plan benefits is to provide the auditor with a reasonable basis for concluding whether the actuarial present value of accumulated plan benefits, components of those benefits, and amounts of changes in the actuarial present value of accumulated plan benefits are presented in conformity with FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*. That objective is ordinarily accomplished by applying the auditing procedures described in paragraph 9.03 for benefit payments, paragraphs 10.04 through 10.08 for participant data, and paragraphs 10.18 through 10.23 for using the work of an actuary.

10.16 The actuarial valuation used to determine accumulated plan benefits in accordance with FASB Statement No. 35 is based on the benefit provisions of the plan and on participant data. For many defined benefit plans the participant data submitted to the actuary are current only as of the beginning of the plan year. The practice of preparing valuations as of the beginning of a plan year developed as a practical expedient to facilitate completion of the valuation on a timely basis. For financial reporting purposes, the information may be presented either as of the beginning or the end of the plan year; FASB Statement No. 35 states, however, that an end-of-year benefit information date is considered preferable.

10.17 In the event that an actuarial valuation has not been prepared as of the beginning or the end of the plan year, the plan administrator may nevertheless prepare financial statements using estimated accumulated benefit information as contemplated by FASB Statement No. 35. If the benefit information is so estimated, the auditor should assure himself or herself that the methods and assumptions used to estimate the accumulated benefit information are reasonable in the circumstances, and he or she should apply the procedures set forth in SAS No. 73.

Using the Work of an Actuary

10.18 The auditor's qualifications do not encompass actuarial science or the complexities of probability and longevity associated with life contingencies. The auditor may have a general awareness and understanding of actuarial concepts and practices; he or she does not, however, purport to act in the capacity of an actuary. The auditor, therefore, needs to follow the guidance of SAS No. 73 to obtain assurance regarding the work of an actuary on such matters as plan contributions (see chapter 8) and accumulated benefit valuations.[59]

10.19 An audit of plan financial statements requires cooperation and coordination between the auditor and the plan actuary. The auditor uses the work of an actuary as an audit procedure to obtain competent evidential matter; the auditor does not merely rely on the report of an actuary. Although the appropriateness and reasonableness of the methods and assumptions used, as well as their application, are within the expertise of the actuary, the auditor does not divide responsibility with the actuary for his or her opinion on the financial statements taken as a whole. Thus, the auditor should satisfy himself or herself as to the professional qualifications and reputation of the actuary, obtain an understanding of the actuary's methods and assumptions, test accounting data provided to the actuary, and consider whether the actuary's findings support the related representations in the financial statements. Ordinarily, the auditor would use the work of the actuary unless the auditing procedures lead him or her to believe that the findings were unreasonable in the circumstances. Sometimes it may be necessary for the auditor to obtain the services of an actuary other than the one who prepared the plan's actuarial valuation. This might occur when the plan actuary is related to the plan (see paragraph 10.20d) or when the auditor believes that the determinations made by the plan actuary are unreasonable.

10.20 With respect to the actuarial present value of accumulated plan benefits and changes therein (as well as contributions), the auditor, in following the guidance in SAS No. 73, should—

a. Obtain satisfaction regarding the professional qualifications of the actuary. If the actuary is not known to the auditor, the auditor should consider other factors that might provide information regarding the actuary's qualifications. Examples of factors to consider are whether

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[59] With regard to actuarial services provided a client by the auditor's firm, a related ethics ruling under the AICPA Rules of Conduct states: "Performance by a member of appraisal, valuation, or actuarial services, the results of which may be incorporated in the client's financial statements, would not impair a member's independence if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results of those services." (AICPA *Professional Standards*, vol. 2, ET section 191.108, Ethics Ruling on Independence, Integrity and Objectivity No. 54, "Member Providing Appraisal, Valuation, or Actuarial Services.")

the actuary is an "enrolled actuary" under ERISA sections 3041 and 3042; the actuary's membership in a recognized professional organization; and the opinion of other actuaries, whom the auditor knows to be qualified, regarding the actuary's professional qualifications.[60]

b. Obtain an understanding of the actuary's objectives, scope of work, methods, and assumptions, and their consistency of application. For defined benefit plans the auditor should ascertain whether the method and assumptions used in the accumulated plan benefit information are in conformity with FASB Statement No. 35 and whether the funding method and assumptions are in accordance with ERISA.

c. Inquire whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations. For example, amounts contributed by employees and earnings thereon are properly included as vested benefits.

d. Inquire about the nature of any relationship the actuary may have with the plan or the employer company that may impair objectivity. This can usually be accomplished by asking the client to have the actuary describe in writing the relationship, if any, that may exist and that may appear to impair the objectivity of the actuary's work. The engagement of a consulting actuary to perform valuations on behalf of plan participants or a sponsor company ordinarily is not a relationship that would impair the objectivity of the actuary. If the actuary is related to the client, or if the auditor is unable to determine that the actuary has no relationship with the client that might impair objectivity, the auditor should consider performing additional auditing procedures regarding some or all of the actuary's methods and assumptions to determine that the findings are not unreasonable.

e. Test the reliability and completeness of the census data provided by the plan and used by the actuary in the actuarial valuation. These tests may be coordinated with the auditing procedures described in paragraphs 8.03 through 8.05 for plan contributions and 10.01 through 10.08 for participant data. In the event that data provided to the actuary are significantly incomplete, the auditor should inquire of the actuary in regard to the treatment of the incomplete data and should determine if the method used by the actuary to give effect to the missing data in his or her valuation is reasonable in the circumstances. This situation is most likely to occur in multiemployer plans.

f. Confirm aggregate participant data used in the actuarial valuation. (The auditor may wish to include this request as part of the audit inquiry letter to the plan's actuary.) In addition, the auditor may also wish to confirm information related to selected individual participants that is part of the aggregate amounts.

10.21 The auditor should ask the plan administrator to send a letter to the plan's actuary requesting that the actuary (*a*) provide the auditor with a

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[60] There are no universal standards for establishing the professional qualifications of an actuary. Some actuaries specialize in or concentrate on pension matters; others confine their practice to life or property and liability insurance matters. Qualification, by education and experience, to practice in one of these areas does not necessarily prepare the actuary to practice in other areas.

copy of the actuarial report, Schedule B of Form 5500, or comparable information or (*b*) confirm to the auditor the actuarial information that has already been obtained from the plan in connection with the audit.

10.22 An illustration of a letter to the plan's actuary requesting a copy of the actuary's report or other information on the plan appears as Exhibit 10.34. In situations in which the auditor also audits the financial statements of the sponsor company, he or she should consider combining the request for this information with a request for information necessary for compliance with FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*.

10.23 An illustration of a letter to the plan's actuary requesting confirmation of information taken from the actuary's report or the plan's or the sponsor company's records appears as Exhibit 10.35.

Defined Contribution Plans

10.24 The net assets available for benefits for defined contribution plans are normally allocated to individual participant accounts according to procedures set forth in the plan instrument or in a collective bargaining agreement. In some cases the plan instrument may even specify the allocation of individual plan assets.

10.25 The objective of auditing procedures applied to individual participant accounts of defined contribution plans is to provide the auditor with a reasonable basis for concluding—

a. Whether net assets have been allocated to the individual participant accounts in accordance with the plan instrument.[61]

b. Whether the sum of the participant accounts reconciles with the total net assets available for plan benefits.

10.26 Procedures that the auditor ordinarily should apply to individual participant accounts include—

a. Reviewing pertinent sections of the plan instrument or collective bargaining agreement to obtain an understanding of how allocations are to be made.

b. Testing the allocation of income or loss, appreciation or depreciation in value of investments, administrative expenses, and amounts forfeited for selected accounts.

c. Testing the allocation of the employer's contribution.

d. For plans with participant contributions, determining whether individual contributions are being credited to the proper participant accounts and to the investment medium selected by the participant, if applicable.

e. Determining whether the sum of individual accounts reconciles with the total net assets available for benefits.

Depending on the existing internal control structure and the results of other auditing procedures, the auditor may also wish to confirm contributions and other pertinent information directly with participants.

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[61] The effects of misallocation of assets should be considered in relation to the financial statements as a whole rather than in relation to individual accounts.

Health and Welfare Benefit Plans

10.27 Plan obligations for health and welfare benefit plans are paid out of a fund of accumulated contributions and income (a self-funded plan), are provided through insurance purchased by the plan from an insurance company (an insured plan), or are provided through some combination of the two. Insured plans may involve several funding arrangements including (*a*) fully insured, pooled; (*b*) fully insured, experience-rated; (*c*) minimum premium plans; and (*d*) stop-loss arrangements. Insured plans may also encompass a continuum of products including (*a*) basic indemnity plans; (*b*) preferred provider plans; (*c*) point-of-service plans (also known as multi-option); and (*d*) health maintenance organization (HMO) plans. Self-funded plans may take several forms including (*a*) Administrative Service Only (ASO) arrangements; (*b*) Claims Service Only (CSO) arrangements; and (*c*) unlimited retro-premium arrangements. This significant variety of funding, product, and service arrangements increases the inherent risk in identifying and valuing the benefit obligations of the plan. For example, in an insured plan, obligations for claims reported but not paid and obligations for claims incurred but not reported will be paid, *in whole or in part* (depending on the funding and/or product arrangements) by the insurance company and, therefore, to such extent would not appear as obligations in the financial statements of the plan. Alternatively, a self-funded plan should include in its financial statements information regarding the plan's obligations for each of these types of claims. With regard to plan obligations, the auditor should read all relevant provisions of the plan instrument and underlying contracts and determine that they are properly accounted for.

10.28 For insured plans, the auditor should determine whether the proper dollar amount of premiums has been remitted to the insurance company and whether any obligation for unpaid insurance premiums has been properly recorded. Insurance premium payments are generally determined from the participants' eligibility records and the premium rates in the insurance contract. In testing the premium payments and related obligation, procedures that should be considered include—

a. Comparing the number of eligible participants, as shown by the eligibility records, to the premium computation and tracing the applicable premium rates to the insurance contract.

b. Tracing participants listed in the premium computation list to the eligibility records.

c. Comparing premiums paid, including subsequent payments, and investigating the reasons for significant changes.

d. Requesting direct confirmation from the insurance company of the total amount of premiums paid during the year, premiums payable to the insurance company, and other obligations and assets of the plan at year-end.

Any premium payable to the insurance company should be recorded as a benefit obligation. Insurance contracts should be reviewed to determine that the obligation is in accordance with the contract provisions.

10.29 In self-funded plans, claims reported to the plan administrator but not paid are obligations of the plan. In testing the obligation for claims reported but not paid, procedures that should be considered include—

a. Comparing individual claims with the trial balance, and reviewing the nature of the claim and the documentary support.

b. Reviewing payments made after the date of the financial statements to determine whether all claims reported have been properly included in the trial balance.

c. Performing a search of open claim files, an option the auditor may choose, depending on the timing of the audit.

10.30 As of the date of the financial statements, there will be certain claims incurred but not yet reported to the plan, and some of these may not be reported for an extended period of time. Claims of this nature cannot be determined on an individual basis, but the aggregate amount of such claims should be subject to reasonable estimation on the basis of past loss experience and actuarial determination (see paragraph 10.32). If information necessary to make this estimate is not available, the auditor should consider the possible effect on his or her report.

10.31 The eligibility rules for many plans provide for the accumulation of eligibility credits for participants. The obligation arising from eligibility credits is generally determined by applying current insurance premium rates to accumulated eligibility credits or, in the case of a self-funded plan, by applying the average cost of benefits per eligible participant. The accrued obligation should be reviewed and tested for adequacy and reasonableness. Such tests should include a comparison of the employer's contributions with the participants' eligibility records, a test of the arithmetical accuracy of the accumulated credits, and a review of the overall computation of the estimated obligation.

10.32 Many health and welfare benefit plans provide benefits that require an actuarial determination of the plan's benefit obligation. An actuary may also be used to determine contribution rates. If the plan requires the services of an actuary in determining amounts in the financial statements, the auditor should apply the procedures discussed in paragraphs 10.18 through 10.23 for using the work of an actuary.

10.33 The types of information the auditor should consider confirming with the actuary include—

a. A description of participant groups covered.

b. A brief, general description of the characteristics of the plan used in the actuary's calculations, including, but not limited to, benefit provisions.

c. The number of employees in the actuary's valuation and the number of participants and beneficiaries who are active, terminated with vested benefits, or retired under the plan.

d. The present value of the plan's benefit obligations. (Be careful that the actuarially calculated benefit obligations do not include claims included elsewhere in the statement of net assets. Consider also whether all claims are properly included.)

e. The dates of the valuation of the benefit obligations and of the census data used. (If the date of the census data used is other than the plan year-end, the actuary should be asked to indicate the basis for projecting the data to the year-end.)

f. Descriptions of the principal assumptions and methods used in determining the present value of plan obligations and of any changes in assumptions or methods (for example, interest rates), and the effect of any changes.

g. The significant effects (either individually or in the aggregate) on the current year of the changes resulting from plan amendments.

h. Knowledge of an intent on the part of the employer (sponsor company) to fully or partially terminate the plan.

i. The amount of unbilled or unpaid actuary's fees applicable to the plan's year-end and payable by the plan.

Exhibit

10.34

Illustrative Letter to Plan Actuary

In connection with an audit of the financial statements of XYZ Pension Plan [*date of statements*], please furnish our auditors [*name and address*], the information described below as of [*the more recent benefit information date, either the date of the plan year-end or the date of beginning of plan year*]. For your convenience, you may supply in response to these requests pertinent sections, properly signed and dated, of your actuarial report or Schedule B of Form 5500, if available and if the requested information is contained therein.

a. Please indicate the actuarial present value of accumulated plan benefits as defined in FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, classified as follows:

1. Vested benefits of participants and beneficiaries currently receiving payments	$________
2. Other vested benefits	$________
3. Nonvested benefits	$________
4. Total	$________

b. The date of the above valuation of accumulated plan benefits is ____.

c. Describe the principal assumptions used in determining the actuarial present value of accumulated plan benefits.

d. Please indicate the minimum annual contribution, including the use of any credit balances in the funding standard account available to offset present or future contributions under ERISA and the actuarial cost method being used; a description of the actuarial assumptions used in computing the funding standard account; and the aggregate effect of any change in the method or assumption(s). Also, indicate whether the alternative funding standard account was elected and whether the full-funding limitation is applicable.

e. Briefly describe the employee group covered.

f. Please provide the following:

1. A brief general description of the benefit provisions of the plan used in the actuarial calculation

2. A description of any benefits, as prescribed by FASB Statement No. 35, not included in the accumulated plan benefits valuation and the reason therefore

3. The effective date of the last plan amendment included in this valuation

g. Please provide the following information relating to the employee census data used in performing the actuarial valuation:

1. The date as of which the census data were collected is ______.

Compensation Participant	Number of persons	Compensation (if applicable)
Currently receiving payments	________	________
Active with vested benefits	________	________
Terminated with deferred vested benefits	________	________
Active without vested benefits	________	________
Other (describe)	________	________
Total	________	________

Note: If information is not available for each of the above categories, indicate which categories have been grouped. Please describe any group or groups of participants not included in the above information.

2. Information for specific individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

[*Note to auditor: The auditor should select information from employer records to compare with the census data used by the actuary. In addition, the auditor may wish to have selected certain census data from the actuary's files to compare with the employer's records.*]

h. Describe, if significant (either individually or in the aggregate), the effects of the following factors on the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date. (Effects that are individually significant should be separately identified.)

1. Plan amendments
2. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)
3. Changes in actuarial assumptions

i. Describe, for the current year, the effects of the following on changes in the present value of accumulated plan benefits:

1. Increase in benefits accumulated
2. Increase due to the passage of time
3. Benefits paid

[*Note to auditor: Item (i) generally applies only if the change in actuarial information is being presented in statement format.*]

j. If an accumulated funding deficiency exists, the amount necessary to reduce the deficiency to zero under ERISA is $_____.

k. Have you been notified of a decision by the sponsor company to fully or partially terminate the plan? If so, please describe the effect on the plan.

l. Please describe the nature of the relationship, if any, that you may have with the plan or the sponsor company and that may appear to impair the objectivity of your work.

m. What is the amount of the unbilled and/or unpaid actuarial or other fees due your firm applicable to the plan year-end and payable by the plan?

n. Please supply any additional information that you believe is necessary.

Your prompt attention to this request will be appreciated.

Very truly yours,

____

Plan Administrator

Exhibit
10.35

Illustrative Letter to Plan Actuary

In connection with their audit of our financial statements as of [*date of plan year-end*], our auditors [*name and address*], have requested that you confirm to them the following information as of [*benefit information date*] with respect to our defined benefit pension plan described in your report dated ______.

[List of information to be confirmed]

Please confirm the above information by signing the enclosed copy of this letter in the space provided, and return it directly to our auditors. If the above information is not correct, please inform our auditors directly and, if possible, send them full details of the differences.

Your prompt attention to this request will be appreciated.

Very truly yours,

____
Plan Administrator

The above information is correct except as noted below.

____
(Signature of Actuary)

Chapter 11

Party in Interest Transactions

11.01 Section 3(14) of ERISA defines a "party in interest" to include fiduciaries or employees of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee organization whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or relatives of such persons just listed. Although not identical, ERISA defines "parties in interest" in much the same way as FASB Statement No. 57, *Related Party Disclosures*, defines the term *related parties*.

11.02 Certain transactions between a plan and a party in interest are generally prohibited under section 406(a) of ERISA:

- A sale, exchange, or lease of property
- A loan or other extension of credit
- The furnishing of goods, services, or facilities
- A transfer of plan assets to a party in interest for the use or benefit of a party in interest
- An acquisition of employer securities or real property in violation of the 10-percent limitation.

Additional information regarding prohibited transactions under ERISA is found in paragraphs A.82 through A.87.

11.03 There are certain exceptions dealing with party in interest transactions that do not prevent a plan fiduciary from receiving reasonable compensation for services to a plan, or receiving benefits from a plan as a participant or beneficiary, as long as such benefits are in accordance with the terms of a plan as applied to all other participants and beneficiaries. In addition, payments to parties in interest for reasonable compensation for office space and legal, accounting, and other services necessary for the operation of a plan are permitted if certain conditions are met. For example, while transactions with a trustee affiliate also serving as a fund advisor/manager would generally be prohibited transactions, the DOL has issued Prohibited Transaction Exemptions (PTE) (Nos. 84-24, 80-51, 78-19, 84-14, and 77-4) relating to these types of transactions. Therefore, they are considered to be *exempt* party in interest transactions and would not have to be reported on the Form 5500 or in the related supplemental schedules. However, in accordance with FASB Statement No. 57, related party transactions should be disclosed if they are material to the financial statements.

11.04 An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all related-party or party in interest transactions will be discovered. Nevertheless, during the course of his or her audit, the auditor should be aware of the possible existence of party in interest and material related-party transactions that could affect the financial statements or for which DOL Reporting Regulations (see appendix A) and FASB Statement No. 57 require disclosure. Many of the procedures outlined in the following paragraphs are normally performed in an audit in accordance with generally accepted auditing standards, even if the auditor has no reason to suspect that party in interest transactions exist. Other audit procedures set forth in this section are specifically directed to party in interest transactions.

11.05 The existence of certain party in interest relationships, such as plan-sponsor, may be clearly evident. Determining the existence of other parties in interest requires the application of specific audit procedures, which may include the following:

a. Evaluate the plan administrator's procedures for identifying and properly accounting and reporting for party in interest transactions.

b. Request from appropriate personnel the names of all parties in interest and inquire whether there were any transactions with these parties during the period.

c. Review filings (for example, Forms 5500 and LM-2) by the reporting entity with the DOL and other regulatory agencies for the names of parties in interest.

d. Review prior years' working papers for the names of known parties in interest.

e. Inquire of the predecessor plan auditor, if applicable, concerning his or her knowledge of existing relationships and the extent of management involvement with parties in interest.

f. Inquire of the plan administrator whether any prohibited transactions have been identified as a result of past IRS or other governmental examinations.

11.06 The following procedures are intended to provide guidance for identifying transactions with known parties in interest and for identifying transactions that may be indicative of the existence of previously undetermined party in interest relationships:

a. Provide audit personnel performing segments of the audit with the names of known parties in interest so that they may become aware of transactions with such parties during the audit.

b. Review the minutes of the meetings of the board of trustees of the plan and executive or operating committees for information about transactions authorized or discussed at their meetings.

c. Review correspondence from and material filed with the DOL and other regulatory agencies for information about transactions with parties in interest.

d. Review conflict-of-interests statements obtained by the plan from its officials.[62]

e. Review the extent and nature of business transacted with the plan's major investees, suppliers, borrowers, lessees, and lenders for indications of previously undisclosed relationships.

f. Consider whether transactions are occurring but are not being given accounting recognition, such as receiving or providing accounting management or other services at no charge or a major stockholder of the plan-sponsor absorbing plan expenses.

g. Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.

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[62] Conflict-of-interests statements are intended to provide plan officials with information about the existence or nonexistence of relationships between the reporting persons and parties with whom the plan transacts business.

h. Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by parties in interest.

i. Review invoices from law firms that have performed regular or special services for the plan for indications of the existence of parties in interest or party in interest transactions.

j. Review confirmations of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

11.07 The auditor should place emphasis on testing material transactions with known parties in interest. After identifying party in interest transactions, the auditor should apply the procedures he or she considers necessary to obtain satisfaction concerning the purpose, nature, and extent of these transactions and their effect on the financial statements. The procedures should be directed toward obtaining and evaluating sufficient competent evidential matter and should extend beyond inquiry of management. Procedures that should be considered include the following:

a. Obtain an understanding of the business purpose of the transaction.[63]

b. Examine invoices, executed copies of agreements, contracts, and other pertinent documents.

c. Determine whether the transaction has been approved by the board of trustees or other appropriate officials.

d. Test for reasonableness the compilation of amounts to be disclosed or considered for disclosure.

e. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

11.08 When necessary to fully understand a particular party in interest transaction, the following procedures, which might not otherwise be deemed necessary to comply with generally accepted auditing standards, should be considered:[64]

a. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.

b. Inspect evidence in possession of the other party or parties to the transaction.

c. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.

d. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.

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[63] Until he or she understands the business sense of material transactions, the auditor cannot complete his or her audit. If the auditor lacks sufficient specialized knowledge to understand a particular transaction, he or she should consult with persons who do have the requisite knowledge.

[64] Arrangements for certain procedures should be made or approved in advance by appropriate plan officials.

e. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Prohibited Transactions

11.09 In accordance with the provisions of SAS No. 54, *Illegal Acts by Clients*, the auditor also should be alert to party in interest transactions that may be prohibited by ERISA. When the auditor becomes aware of information concerning a possible prohibited party in interest transaction, the auditor should obtain an understanding of the nature of the transaction, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. In doing so, the auditor should inquire of plan management at a level above those involved, if possible. If management does not provide satisfactory information that the transaction is not prohibited, the auditor should—

a. Consult with the client's legal counsel or other specialists about the application of ERISA to the circumstances and the possible effects on the financial statements. Arrangements for such consultation with the client's legal counsel should be made by the client.

b. If necessary, apply procedures such as those described in paragraphs 11.07 and 11.08 to obtain further understanding of the nature of the transaction.

11.10 If the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that a party in interest transaction has resulted in the occurrence of an illegal act, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

11.11 The auditor should consider the effect of the prohibited transaction on the amounts presented in financial statements including contingent monetary effects, such as fines, penalties, and damages. Because a plan fiduciary is liable to make good on losses to the plan resulting from a breach of fiduciary duty and to restore to the plan any profits that the fiduciary made through the use of the plan's assets, prohibited transactions can give rise to significant receivables. Any receivable to be recorded should include an allowance for estimated uncollectible amounts. Contingencies arising from prohibited transactions may also need to be disclosed in accordance with the requirements of FASB Statement No. 5, *Accounting for Contingencies*.

11.12 The auditor should evaluate the adequacy of disclosure in the financial statements and required supplementary schedules of the potential effects of prohibited transactions on the plan's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, that information should be considered for disclosure.

Implications for Audit

11.13 The auditor should consider the implications of prohibited transactions in relation to other aspects of the audit, particularly the reliability of representations of management. The implications of particular prohibited transactions will depend on the relationship of the perpetration and concealment, if any, of the transactions to specific control procedures and the level of management or employees involved.

Effect on the Auditor's Report

11.14 Both ERISA and generally accepted auditing standards require that the auditor's report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules—including the schedule of party in interest transactions—presented along with the basic financial statements. Chapter 13 includes a discussion of auditor's reports on financial statements and information in supplementary schedules as well as examples of such reports.

11.15 ERISA requires that all transactions with parties in interest (excluding any transactions exempted from prohibited transaction rules) be disclosed in the supplementary schedule without regard to their materiality. If the auditor concludes that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplementary schedule, the auditor should (*a*) express a qualified opinion or an adverse opinion on the supplementary schedule if the transaction is material to the financial statements or (*b*) modify his or her report on the supplementary schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements (see paragraph 13.17 for examples of reports). If the client refuses to accept the auditor's report as modified, the auditor should withdraw from the engagement and indicate the reasons for withdrawal in writing to the plan administrator or board of trustees.

Communication With Responsible Parties

11.16 The auditor should assure himself or herself that the plan administrator, or others with equivalent authority and responsibility, is adequately informed with respect to prohibited transactions and other illegal acts that come to the auditor's attention (see paragraph 6.14 for a discussion of individuals with the level of authority and responsibility equivalent to an audit committee). The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the plan administrator on the nature of such matters to be communicated.

Chapter 12

Other Auditing Considerations

Plan Tax Status

12.01 A trust established under an employee benefit pension plan ordinarily is qualified under the Internal Revenue Code (IRC) as exempt from federal income taxes. The objective of auditing procedures applied with respect to the tax status of a plan is to permit the auditor to consider—

a. Whether the trust is qualified under the IRC as being exempt from federal income taxes and whether transactions or events have occurred that might affect the plan's qualified status.[65]

b. Whether asserted and unasserted claims and assessments affecting plan assets resulting from the loss of tax exemption have been properly recorded or disclosed in conformity with generally accepted accounting principles.

12.02 The financial statements of an employee benefit plan generally have no accrued income tax liability or provision for income tax expense. Plans must be designed and operated in accordance with IRC requirements in order to maintain their qualified status. The existence of a determination letter does not in and of itself serve as evidence that the plan is qualified. Determination letters provide evidence that the plan is designed in accordance with applicable IRC requirements. However, qualified plans must comply with certain operating tests in order to be tax qualified (for example, coverage, discrimination, and maximum benefit limitation tests). Nevertheless, the auditor of an employee benefit plan should be aware of the possibility that violations of tax laws and regulations may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred (see SAS No. 54, *Illegal Acts by Clients*, paragraph 7). The auditor is also expected to inquire of, and obtain representations from, management concerning compliance with the laws and regulations and the prevention of violations that may cause disqualification. As noted in paragraph 5.09, the auditor should possess sufficient knowledge of matters affecting employee benefit plans, including applicable sections of the IRC.

12.03 The auditing procedures applied in an audit of a plan's tax status ordinarily are—

a. Reviewing the IRS tax determination letter or an opinion letter from the plan's qualified tax counsel. If the plan has been amended, review any new rulings issued by the IRS regarding the modified plan instrument. If the plan is amended subsequent to the receipt of the latest determination letter, appropriate disclosure should be made, for example:

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[65] Note that ERISA requires disclosure of "information concerning whether or not a tax ruling or determination letter has been obtained." Generally accepted accounting principles (for example, FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended) require disclosure of the federal income tax status of a plan only if a favorable tax determination has not been obtained or maintained.

> The plan obtained its latest determination letter on [*date*], in which the Internal Revenue Service stated that the plan, as then designed, was in compliance with the applicable requirements of the Internal Revenue Code. The plan has been amended since receiving the determination letter. However, the plan administrator and the plan's tax counsel believe that the plan is currently designed and being operated in compliance with the applicable requirements of the Internal Revenue Code. Therefore, no provision for income taxes has been included in the plan's financial statements.

If a determination letter has not been requested and an opinion letter from the plan's tax counsel is not available, the auditor may wish to review those aspects of the plan document relevant to the determination of its tax-exempt status.

b. Inquiring of the plan administrator or other appropriate plan representative about the plan's operations or changes in plan design that may cause the plan to lose its tax exempt status. Examples of IRC requirements with which a plan must comply in order to maintain its tax exempt status include the following:
- Minimum coverage test
- Minimum participation tests
- Nondiscrimination test
- Average deferral and contribution percentage limits
- Annual additions limitation
- Top heavy test
- Exclusive benefit rule

c. Reviewing the results of auditing procedures applied in other areas of the audit and considering the findings in relation to tax qualification requirements such as those noted in *b* above.

As a result of the procedures performed in *b* and *c* above, the auditor may become aware of possible violations of tax laws and regulations that could adversely affect the plan's tax status. In those situations, the auditor should consider the effect on the financial statements as well as implications for other aspects of the audit as described in SAS No. 54.

Commitments and Contingencies

12.04 Procedures that the auditor ordinarily should apply in connection with the commitments and contingencies of an employee benefit plan include—

a. Discussing possible areas of commitments and contingencies with the sponsoring employer, plan administrator, or other parties performing the plan's management functions.

b. Reviewing minutes of various committees of the plan during and subsequent to the period being audited for discussion of possible contingent liabilities or commitments.

c. Analyzing legal expenses for the period and reviewing invoices and statements from legal counsel for indications of possible contingencies. The legal expenses of a single employer plan may be paid directly by the employer, in which case the auditor should consider reviewing those expenses.

d. Obtaining a representation letter from the appropriate persons, normally the plan's administrator or other parties performing the plan's management function (see SAS No. 19, *Client Representations*, and paragraph 12.11 of this guide).

e. Inquiring as to any audit or investigation that the DOL, the IRS, or other regulatory agency has made of the plan's activities or filings since the last audit (such reviews might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption). Obtain and review for financial statement implications any report of an audit or investigation not reviewed as part of the audit planning process, (see paragraph 5.16(*e*)) including the effect of transactions noted therein that give rise to potential receivables arising from breaches of fiduciary duties or prohibited transactions. Consider whether this information obtained from the inquiry should be included in the representation letter.

12.05 An audit inquiry letter to the plan's lawyer is the auditor's primary means of corroborating the information provided by plan management concerning litigation, claims, and assessments (see SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*). The American Bar Association (ABA) has approved a "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information," which is set forth in Exhibit II to SAS No. 12. Audit inquiries to plan lawyers should be made in the context of the ABA/AICPA understanding, as discussed in SAS No. 12.

12.06 The auditor should request plan management to send an audit inquiry letter to those lawyers who have been consulted regarding litigation, claims, assessments, and qualification matters relating to the plan. The matters that ordinarily should be covered by the audit inquiry letter are described in SAS No. 12, paragraph 9, and include a list prepared by management (or a request by management that the lawyer prepare a list) that describes and evaluates pending or threatened litigation, claims, and assessments or unasserted claims with respect to which the lawyer has been engaged and to which he or she has devoted substantial attention on behalf of the plan in the form of legal consultation or representation. The matters described in *a* through *g* below should be included in the "pending or threatened litigation" or "unasserted claims and assessments" sections of the attorney's letter. They should not be listed as "other matters" and the letter should refer to specific matters disclosed by management, or should expressly state that management has advised the auditor that there are no such matters.

a. Breach of fiduciary responsibilities.

b. Prohibited party in interest transactions and other transactions prohibited by ERISA. (Parties in interest are defined in ERISA section 3(14) and regulations under that section. See also chapter 11.)

c. Loans or leases in default and reportable to the DOL.

d. Events reportable to the PBGC.

e. Events that may jeopardize the plan's tax qualification status.

f. Legal actions brought by the plan on behalf of plan participants and beneficiaries.

g. Review or inquiry by the DOL, the IRS, or other regulatory agency of the plan's activities or filings since the last audit. (A review or inquiry might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption.)

Cash Balances

12.07 Cash balances of employee benefit plans tend to be very small, representing residual amounts not otherwise invested. When cash balances are held in trust under a trust agreement or under an insurance contract, confirmation of the balance normally is adequate. For a plan that maintains and controls cash accounts that are independent from the trust accounts or insurance contracts, auditing procedures such as those customarily used in audits of other entities are normally appropriate.

Administrative Expenses

12.08 The objective of auditing procedures applied to administrative expenses is to provide the auditor with a reasonable basis for concluding whether those expenses are in accordance with agreements, are properly classified, and are recorded in appropriate amounts and periods.

12.09 The audit of administrative expenses ordinarily should include—

a. Analyzing the account and examining supporting invoices, documents, and computations.

b. Reviewing the terms of the plan instrument and the minutes of the board of trustees or administrative committee to determine that administrative expenses were properly authorized.

c. If the plan employs a contract administrator, reviewing the contract and testing to ascertain that the services contracted for were performed and that payments were in accordance with the terms of the contract.

d. If one office functions as a service organization for several plans and administrative expenses are allocated because they are not directly associated with a specific plan, reviewing the allocation to determine that it is appropriate and determining that the method of allocation selected was approved by the board of trustees or administrative committee.

e. Determining that fees charged by trustees, investment advisors, and others are in accordance with the respective agreements.

Subsequent Events

12.10 Guidance on the auditor's procedures relating to subsequent events is provided in SAS No. 1, section 560, *Subsequent Events*. The following auditing procedures ordinarily should be applied for all employee benefit plans. The list is not all-inclusive and should be modified to suit the circumstances of a specific engagement.

a. Reviewing minutes of committee meetings held through the completion of the fieldwork.

b. Obtaining supplemental legal representations if there is a significant period between the date of the plan's legal counsel's response and the date of completion of fieldwork.

c. Obtaining the plan's interim financial statements for a period subsequent to the audit date, if they are available, comparing them with the financial statements being audited, and investigating any unusual fluctuations.

d. Inquiring of and discussing with the plan administrator or other parties performing the plan's management function—
   - Abnormal disposal or purchase of investments since year-end.
   - Amendments to plan and trust instruments and insurance contracts.
   - Matters involving unusual terminations of participants, such as termination arising from a sale of a division or layoffs.
   - Changes in plan commitments or contingent liabilities.
   - Any review or inquiry by the DOL, the IRS, or other regulatory agency of the plan's activities or filings since the last audit (a review or inquiry might arise, for example, from enforcement activities, from a request for an advisory opinion, or from a request for a prohibited transaction exemption).

Plan Representations

12.11 The auditor should obtain certain written representations from appropriate persons, normally the plan's administrator or other parties performing the plan's management function (see SAS No. 19, *Client Representations*). In addition to the representations obtained under SAS No. 19, the representation letter ordinarily should include, as applicable, representations regarding—

a. Whether the plan instrument has been amended, including amendments to comply with applicable laws.

b. Whether current versions of the plan and/or trust documents have been filed with the appropriate agency.

c. Whether there were omissions from the participant data (for example, for defined benefit plans: "There were no omissions from the participants' data provided the plan's actuary for the purpose of determining the actuarial present value of accumulated plan benefits and other actuarially determined amounts in the financial statements") (for example, for health and welfare benefit plans that require the services of an actuary: "There were no omissions from the participants' data provided the plan's actuary for the purpose of determining the liability for claims incurred but not reported and other actuarially determined amounts in the financial statements").

d. Whether an appropriate person, normally the plan's administrator, accepts the actuarial methods and assumptions used by the actuary for funding purposes and for determining accumulated plan benefits and has no knowledge or belief that would make such methods or assumptions inappropriate in the circumstances.

e. Whether there have been changes in (1) the actuarial methods or assumptions used in calculating amounts recorded or disclosed in the financial statements and (2) plan provisions between the actuarial valuation date and the date of this letter. (Item *(e)* applies only to defined benefit plans and to those health and welfare benefit plans that require the services of an actuary.)

f. Whether the plan and the trust established under the plan are qualified under the appropriate section of the Internal Revenue Code and intend to continue as a qualified plan and trust.

g. Whether the plan has complied with the fidelity bonding requirements of ERISA.

h. Whether there were transactions with parties in interest (as defined in ERISA section 3(l) and regulations under that section) that were not disclosed in the supplemental schedules or financial statements.

i. Whether there were investments in default or considered to be uncollectible that were not disclosed in the supplemental schedules.

j. Whether there were reportable transactions (as defined in ERISA section 103(b)(3)(H) and regulations under that section) that were not disclosed in the supplemental schedules.

k. Whether there is a present intention to terminate the plan.

Form 5500

12.12 Information in the Form 5500 may be relevant to an independent audit or to the continuing propriety of the auditor's report. The auditor's responsibility for information in the Form 5500 does not extend beyond the financial information identified in his or her report, and the auditor has no obligation to perform any procedures to corroborate other information contained in the Form 5500. However, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. If the auditor concludes that there is a material inconsistency, he or she should determine whether the financial statements, the auditor's report, or both require revision. If the auditor concludes that they do not require revision, he or she should ask the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, the auditor should consider other actions such as revising his or her report to include an explanatory paragraph describing the material inconsistency, withholding the use of the auditor's report in the document, and withdrawing from the engagement. The action he or she takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

12.13 If, while reading the other information contained in the Form 5500, the auditor becomes aware of information that he or she believes is a material misstatement of fact that is not a material inconsistency, the auditor should discuss the matter with the client. In connection with this discussion, the auditor should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion. If the auditor concludes that he or she has a valid basis for concern, the auditor should propose that the client consult with some other party whose advice might be useful, such as the client's legal counsel.

12.14 If, after discussing the matter, the auditor concludes that a material misstatement of fact remains, the action the auditor takes will depend on his or her judgment in the particular circumstances. The auditor should consider such steps as notifying the plan administrator in writing of his or her views concerning the information and consulting his or her legal counsel as to further appropriate action in the circumstances.

Reports Issued Prior to Form 5500 Filing

12.15 The auditor may encounter situations in which the financial statements and auditor's report are issued prior to the auditor's review of Form 5500. If such a situation occurs, the auditor should inform the plan administrator that the financial statements and auditor's report are not to be attached to the filing without the auditor's review of the filing on Form 5500. If an engagement letter is prepared, it should clearly state that if the financial statements and auditor's report are issued prior to the filing of Form 5500, those statements and report should not be attached to the filing without it being reviewed by the auditor. The auditor may also wish to consider including a statement in the transmittal letter to the client indicating that the financial statements and auditor's report, as presented, are not to be attached to the Form 5500 filing without the auditor's review of that filing.

12.16 ERISA requires a plan's financial statements to include a note explaining differences, if any, between amounts reported in the financial statements and the amounts reported in the Form 5500. If, upon review of the Form 5500 subsequent to the issuance of the plan's financial statements, the auditor identifies any such differences, he or she should reissue the auditor's report, dual-dated with respect to the note explaining the differences. If the differences represent a material inconsistency or misstatement of fact in the preparation of the Form 5500, guidance in paragraphs 12.12 through 12.14 should be followed.

Chapter 13

The Auditor's Report

13.01 This chapter provides guidance on the auditor's report on the financial statements of an employee benefit plan when—

a. The auditor expresses an unqualified opinion on financial statements presented in accordance with generally accepted accounting principles (paragraphs 13.03 through 13.08).

b. Supplemental schedules relating to ERISA and DOL regulations accompany the financial statements (paragraphs 13.09 through 13.18).

c. The financial statements have been prepared on a basis of accounting other than generally accepted accounting principles (paragraphs 13.19 through 13.22).

d. Information regarding accumulated plan benefits is omitted or is not measured in conformity with generally accepted accounting principles (paragraphs 13.23 and 13.24).

e. The scope of the audit was limited (paragraphs 13.25 through 13.28).

f. The auditor is reporting on the financial statements of a trust established under a plan (paragraph 13.29).

g. The plan's investments include nonreadily marketable securities, and either the valuation is appropriate but the range of possible values is significant or the investments are not valued in accordance with generally accepted accounting principles (paragraphs 13.30 through 13.32).

h. The plan auditor uses the work of other auditors regarding plan investments (paragraph 13.33).

i. A defined contribution plan provides investment options to participants, and the financial statements are presented in columnar format showing assets and changes in assets by the separate funds (paragraph 13.34).

j. The employee benefit plan is not expected to continue in existence (paragraphs 13.37 and 13.38).

The Auditor's Standard Report

13.02 The illustrative auditor's reports presented in this chapter have been prepared to present the standard auditor's reports on financial statements of employee benefit plans in accordance with SAS No. 58, *Reports on Audited Financial Statements*. These reports may be addressed to the plan or the trust whose financial statements are being audited, or to the plan administrator or board of trustees, or to participants and beneficiaries. Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions, or disclaimers of opinion other than those issued in connection with a limited scope audit pursuant to 29 CFR 2520.103-8 or 12.

Defined Benefit Plans

13.03 The following are illustrations of an auditor's report with an unqualified opinion on the financial statements of a defined benefit plan. In addition to the statement of net assets available for benefits and the statement of changes during the year in net assets available for benefits required by FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, the illustrations assume (unless otherwise noted) that information regarding the actuarial present value of accumulated plan benefits and changes therein is presented in separate financial statements. [66] Under an ERISA filing, as discussed in paragraph 13.09, an auditor's report should cover the required supplemental schedules. See paragraph 13.11 for guidance on the reporting on such supplemental schedules.

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming End-of-Year Benefit Information Date

13.04

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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[66] FASB Statement No. 35 permits variation in the presentation of information regarding the actuarial present value of accumulated plan benefits and changes therein. If such information is not presented in separate financial statements but is presented on the face of one or more financial statements or the notes thereto, the scope paragraph of the auditor's report should refer only to the financial statements that are presented. For example, if information regarding accumulated plan benefits and changes therein is presented in the notes to the financial statements regarding net assets available for benefits and changes therein, the first sentence of the auditor's report might read as follows: "We have audited the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2, and the related statement of changes in net assets available for benefits for the year then ended." The wording of the opinion paragraph would be the same as in the illustration and would refer to the financial status of the plan.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 19X2 and 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.[67]

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[Signature of Firm]

[City and State]
[Date]

Illustration of Auditor's Report on Financial Statements of Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

13.05

Independent Auditors' Report

[Addressee]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 19X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan's net assets available for benefits as of December 31, 19X2, and changes therein for the year then ended

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[67] APB Statement No. 4,* paragraph 133, states, "The financial position of an enterprise at a particular time comprises its assets, liabilities, and owners' equity and the relationship among them." FASB Statement No. 35 left unresolved the question of whether accumulated plan benefit information represents a liability of a defined benefit pension plan. Accordingly, since the financial statements of a defined benefit pension plan do not present information on accumulated plan benefits as a liability of the plan, and since they do not present an account comparable to the owners' equity of other types of entities, the auditor's opinion in the illustrative reports does not refer to the presentation of the financial position of the plan. The terms "financial status" and "changes in financial status," as used here, refer to the presentation of information regarding net assets available for plan benefits and changes therein and information regarding accumulated plan benefits and changes therein as specified in FASB Statement No. 35 (see FASB Statement No. 35, paragraph 235).

*Statement of Position 93-3, *Rescission of Accounting Principles Board Statements*, rescinds APB Statement No. 4.

and its financial status as of December 31, 19X1, and changes therein for the year then ended in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Defined Contribution Plans

13.06 The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of a profit-sharing plan.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Health and Welfare Benefit Plans

13.07 The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare benefit plan prepared in accordance with the provisions contained in chapter 4.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets of Bizco Corporation Employee Health and Welfare Benefit Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets for the year ended December 31, 19X1. These financial statements are the responsibility of the

Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

13.08 The following is an illustration of an auditor's report with an unqualified opinion on the financial statements of an employee health and welfare benefit plan, assuming that the provisions of SOP 92-6 have been adopted.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 19X2 and 19X1, and the related statements of changes in net assets available for benefits and of changes in plan benefits obligations for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 19X2 and 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

Supplemental Schedules Relating to ERISA and DOL Regulations

13.09 Besides the financial statements and related disclosures, which may conform to the requirements of FASB Statement No. 35, ERISA and DOL regulations require additional information to be disclosed. Some of this information is required to be covered by the auditor's report (for example, supplemental schedules; see paragraph A.51(b)), but other required additional information need not be covered by the auditor's report. (The information required by ERISA and by the regulations is described in appendix A.)

13.10 SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, provides guidance on the form and content of reporting when the auditor submits to the client or others a document containing information accompanying the basic financial statements. Paragraph 6 of SAS No. 29 provides the following guidelines for the auditor's report in those circumstances:

a. The report should state that the audit has been performed for the purpose of forming an opinion on the basic financial statements taken as a whole.

b. The report should identify the accompanying information. (Identification may be by descriptive title or page number of the document.)

c. The report should state that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements. The report may refer to regulatory agency requirements applicable to the information.

d. The report should include either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.

e. The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or appear separately in the auditor-submitted document.

13.11 An example of an auditor's report on supplemental schedules required by ERISA and DOL regulations follows.

Independent Auditors' Report

[*Addressee*]

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

13.12 When additional information is presented on which the auditor does not express an opinion, the information should be marked as unaudited or should refer to the auditor's disclaimer of opinion, and the last sentence of the preceding example paragraph should state the following: "The supplemental schedules have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on them."

13.13 In situations in which a disclaimer arises from the exemption permitted under 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA, see paragraph 13.25 in this guide for guidance on the reporting on the supplemental schedules.

13.14 In an audit in accordance with generally accepted auditing standards, the report need not state that the financial statements and schedules comply with the DOL filing requirements. During the audit, however, the auditor may become aware of a departure from such requirements that is not also a departure from generally accepted accounting principles.If the departure is not related to a prohibited transaction with a party in interest, the auditor should consider emphasizing the matter in an explanatory paragraph of the report. If the auditor becomes aware that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplementary schedule, he or she should follow the guidance in paragraph 11.15.

13.15 When the auditor concludes that the supplemental schedules do not contain all required information or contain information that is inaccurate or is inconsistent with the financial statements, the auditor should consider, depending on the nature of the problem and the type of examination, either (*a*) modifying his or her report on the supplemental schedules by adding a paragraph to disclose the omission of the information or (*b*) expressing a qualified or an adverse opinion on the supplemental schedules, as appropriate. The following table illustrates the report modifications that an auditor might consider to be necessary when a required schedule, or information thereon, is omitted or is materially inconsistent with the financial statements.

Error, Omission, or Inconsistency	Report Modification: Full Scope Audit	Limited-Scope Audit (defined in paragraph 7.48): Exception in Information Certified by Trustee or Custodian	Limited-Scope Audit (defined in paragraph 7.48): Exception in Information Not Certified by Trustee or Custodian But Tested by Auditor (see paragraph 7.48)
Required information omitted from schedule, for example, historical cost information	Explanatory paragraph	Explanatory paragraph	Qualified or adverse as to schedules
Required schedule omitted,* for example, schedule of reportable transactions	Explanatory paragraph	Explanatory paragraph	Qualified or adverse as to schedules
Required schedule materially inconsistent with financial statements	Qualified or adverse as to schedules	Explanatory paragraph	Qualified or adverse as to schedules

13.16

Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that should be added to the auditor's report when the auditor should modify his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations.

Independent Auditors' Report

[*Addressee*]
[*Same first, second, and third paragraphs as the standard report.*]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations of Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose the historical cost of certain plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

* See paragraph 11.15 when Schedule of Prohibited Transactions is omitted.

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[Signature of Firm]

[City and State]

[Date]

Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following paragraphs should be added to the auditor's report when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the standard report.]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan had loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

In the following illustration, the schedule of assets held for investment purposes which accompanies the Plan's financial statements does not disclose that the Plan has loans to participants. Because the omitted participant loan information is information that is not certified by the trustee or custodian, an omission of participant loan information would require that a qualified or adverse opinion be issued on the applicable supplemental schedules (see table in paragraph 13.15).

Independent Auditors' Report

[Addressee]

[Same first and second paragraphs as the limited-scope report.]

The schedule of assets held for investment purposes that accompanies the Plan's financial statements does not disclose that the Plan has loans to participants which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with generally accepted auditing standards and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

or

In the following illustration, the Plan has not presented the schedule of reportable transactions. Because the schedule of reportable transactions is information that is certified by the trustee or custodian, an omission of the schedule would require that an explanatory paragraph be added to the auditor's report (see table in paragraph 13.15).

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the limited-scope report.]

The Plan has not presented the schedule of reportable transactions (transactions in excess of 5 percent of the current value of plan assets at the beginning of the year). Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

13.17 When the auditor concludes that the plan has entered into a prohibited transaction with a party in interest, and the transaction has not been properly disclosed in the required supplementary schedule, the auditor should (*a*) express a qualified opinion or an adverse opinion on the supplementary schedule[68] if the effect of the transaction is material to the financial statementsor (*b*) modify his or her report on the supplementary schedule by adding a paragraph to disclose the omitted transaction if the effect of the transaction is not material to the financial statements. Illustrations of reports modified in those circumstances follow. All of the illustrations are presented assuming that the report on the supplemental schedules is added to the auditor's standard report on the basic financial statements (see paragraph 13.10*c*.)

Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor concludes that his or her opinion on the supplemental schedules should be qualified because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditors' Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.*][69]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]

[*Date*]

Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

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[68] If a material party in interest transaction that is not disclosed in the supplementary schedule is also considered a related-party transaction and if that transaction is not properly disclosed in the notes to the financial statements, the auditor should express a qualified or adverse opinion on the financial statements as well as on the supplemental schedule. See paragraph 13.18.

[69] See footnote 68.

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the standard report.][70]

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan *[describe prohibited transaction]*. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following paragraphs should be added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditors' Report

[Addressee]

[Same first, second, and third paragraphs as the standard report.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of *[identify]* are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the Plan *[describe prohibited transaction]*. Disclosure of this information, which is not considered material to the financial

[70] See footnote 68.

statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

13.18 When the auditor concludes that the plan has entered into a prohibited transaction with a party in interest that is also considered a related-party transaction and is material to the financial statements, and the transaction has not been properly disclosed in the notes to the financial statements and the required supplementary schedule, the auditor should express a qualified or adverse opinion on the financial statements and the supplementary schedule. The following is an example of a qualified opinion issued on the financial statements of a profit-sharing plan, and the related supplementary schedules, under those circumstances.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Plan's financial statements do not disclose that the Plan [*describe related-party transaction*]. Disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

The schedule of prohibited transactions that accompanies the plan's financial statements does not disclose that the plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[*Signature of Firm*]

[*City and State*]
[*Date*]

Non-GAAP-Basis Financial Statements

13.19 Present DOL regulations permit, but do not require, financial statements included in the annual report (Form 5500) to be prepared on a basis of accounting other than generally accepted accounting principles. Also, they do not prohibit variances from generally accepted accounting principles if the variances are described in a note to the financial statements.

13.20 A common example of the use of a basis other than generally accepted accounting principles is financial statements prepared on the modified cash basis of accounting for filing with the DOL. SAS No. 62, *Special Reports,* paragraphs 2 through 10, provides guidance on "Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles." Included in the definition of a "comprehensive basis of accounting" are the cash basis and modifications thereof having substantial support. Cash basis financial statements that adjust securities investments to fair value are considered to be prepared on a modified cash basis of accounting.

13.21 The following is an illustration of an auditor's report on the financial statements of a defined benefit pension plan prepared on the modified cash basis. The illustration assumes that information on accumulated plan benefits is included in the notes to the financial statements.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements and supplemental schedules were prepared on a modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits and the accumulated. Plan benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits and changes in accumulated Plan benefits for the year ended December 19X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]
[*Date*]

13.22 Paragraph 9 of SAS No. 62 states that when reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. If the plan administrator prepares financial statements on a modified cash basis or other basis not in conformity with generally accepted accounting principles, he or she might consider not disclosing information regarding accumulated plan benefits (such as the amount of the plan's estimated accumulated plan benefits or accumulated benefit obligations, as applicable, and the amount of accumulated benefit obligations by type, for example, claims payable, IBNR, accumulated eligibility credits, and postretirement benefit obligations). If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or an adverse opinion on the financial statements.

Accumulated Plan Benefits—GAAP Departures and Changes in Accounting Estimates

13.23 As noted in paragraph 2.07, the financial statements of a defined benefit pension plan, prepared in conformity with generally accepted accounting principles, should include information regarding the actuarial present value of accumulated plan benefits and the effects, if significant, of certain factors affecting the year-to-year change in accumulated plan benefits. If the benefit information either is omitted or is not appropriately measured in conformity with FASB Statement No. 35, the auditor should express a qualified or adverse opinion (see paragraph 13.22 regarding omitted disclosures in non-GAAP-basis financial statements).

13.24 The auditor's report need not be modified as to consistency for changes in actuarial assumptions, changes that merely result in presenting new or additional accumulated plan benefits information, a change in the format of presentation of accumulated plan benefit information (for example, from a separate statement to disclosure in the notes to the financial statements) or a change from presenting the accumulated plan benefit information (of a defined benefit pension plan) as of the beginning of the year to presenting it as of the end of the year (see AICPA *Professional Standards*, AU section 9420.64-.65).

Limited-Scope Audits Under DOL Regulations

13.25 As discussed in paragraph 7.47, under DOL regulations the plan auditor need not examine and report on certain information prepared by banks, similar institutions, or insurance carriers that are regulated, supervised, and subject to periodic examination by a state or federal agency if that information is certified as complete and accurate by the bank or similar institution, or an insurance carrier (see paragraphs A.57 and A.58). Thus the plan administrator may restrict the auditor's examination of the assets held and transactions executed by such institutions. The following is an example of the auditor's report in these special circumstances when he or she believes this to be a significant limitation on the scope of the audit.[71]

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the financial statements and supplemental schedules of XYZ Pension Plan as of December 31, 19X1 and 19X0, and for the year ended December 31, 19X1, as listed in the accompanying index. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the years ended December 31, 19X1 (and 19X2), that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with generally accepted auditing standards and,

[71] If the plan's financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor's report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP. Paragraph 13.21 provides an illustration of the wording of such paragraph.

in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

____

[Signature of Firm]

[City and State]
[Date]

Limited-Scope Audit in Prior Year

13.26 An employee benefit plan administrator may elect not to limit the scope of the audit in the current year even though the scope of the audit in the prior year was limited in accordance with DOL regulations.[72] The following illustrates a report on comparative financial statements of a defined benefit pension plan under those circumstances.

Independent Auditors' Report

[Addressee]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2, and the statements of accumulated plan benefits as of December 31, 19X2 and 19X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 19X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 19X1. The form and content of the information included in the 19X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and

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[72] Present DOL regulations prescribe that the annual report include a statement of net assets available for benefits on a comparative basis; the statement of changes in net assets available for benefits is required for the current year only.

Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 19X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles.

Our audit of the Plan's financial statements as of and for the year ended December 31, 19X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

Limited-Scope Audit in Current Year

13.27 A plan may exclude from the auditor's examination its assets held by banks or insurance companies in the current year, whereas the scope of the audit in the prior year was unrestricted. When comparative financial statements will be issued in those circumstances, the auditor should report on the prior year's financial statements of the plan. Although the auditor's report should ordinarily be dated as of the completion of the most recent audit, the procedures performed in an audit that has been restricted, as permitted by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure, generally are not sufficient to enable the auditor to update the report on the prior year's financial statements. Accordingly, the auditor should consider referring to the date of the previously issued report on the prior year's financial statements in expressing an opinion on that information. The following illustrates a report on comparative financial statements in those circumstances.[73]

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2 and the supplemental schedules of (1) assets held for investment purposes, (2) transactions in excess of 5 percent of the current value of plan assets, and (3) investments in loans and fixed income obligations in default or classified as uncollectible as of or for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management.

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[73] This illustration assumes that information regarding accumulated plan benefits and changes therein is included in the notes to the financial statements.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 19X2 financial statements and the supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 19X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 19X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 19X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with generally accepted auditing standards and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 19X1, and in our report dated May 20, 19X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X1, in conformity with generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Limited-Scope Audit for Multiemployer Pension Plan

13.28 The following is an example of the auditor's report disclaiming an opinion on the financial statements of a multiemployer pension plan when the auditor has been unable to apply all the procedures he or she considers necessary with regard to participants' data maintained by, and contributions from, the sponsor companies.

Independent Auditors' Report

[*Addressee*]

We were engaged to audit the statements of [*identify*] of XYZ Multiemployer Pension Plan as of December 31, 19X2 and 19X1, and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

Reporting on the Financial Statements of a Trust Established Under a Plan

13.29 Under both FASB Statement No. 35 and ERISA, the reporting entity is the employee benefit plan. However, the plan administrator may engage an independent auditor to report on the financial statements of a trust established under the plan. In such audits, the auditor should observe the applicable provisions of this guide. Users of the financial statements of the trust may not be aware of the distinction between the trust and the plan. Therefore, when reporting on such a trust, the auditor's report should explain that the financial statements of the trust do not purport to present the financial status or changes in financial status of the plan in accordance with generally accepted accounting principles and that the financial statements do not purport to satisfy the DOL reporting and disclosure requirements. The following is an example of the auditor's report on the financial statements of a trust established under an employee benefit plan.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 19X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 19X2, and the changes in its net assets and trust balance for the year then ended in conformity with generally accepted accounting principles.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with generally accepted accounting principles. Furthermore, these statements do not purport to satisfy the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

Nonreadily Marketable Investments

13.30 ERISA defines current value as "fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary." Investments for which fair market value may not be readily determinable include such items as securities that are not readily marketable, private debt placements, and real estate investments (see paragraphs 2.10 through 2.12).

13.31 The auditor's report should include an explanatory paragraph when the financial statements include securities whose values were estimated by the plan (for example, board of trustees, plan administrator, investment committee, or other named fiduciary) in the absence of readily ascertainable market values, when the range of possible values of those securities is significant, and when the auditor concludes that, after examining the underlying documentation supporting the plan's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, and are reasonably supported by the documentation. The following is an illustration of a report with the appropriate opinion and explanatory paragraphs (in the audit report on the financial statements of a defined contribution plan) in those circumstances:

Independent Auditors' Report

[*Addressee*]

[*Same first and second paragraphs as the standard report.*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

As explained in note 2, the financial statements include securities valued at $_____ (__ percent of net assets), whose values have been estimated by the Board of Trustees in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Trustees in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

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[*Signature of Firm*]

[*City and State*]
[*Date*]

13.32 If the auditor's review discloses that the valuation procedures followed by the plan are inadequate or unreasonable, or if the underlying documentation does not appear to support the valuation, the auditor should qualify his or her opinion because of the departure from generally accepted accounting principles. Accordingly, an "except for" or adverse opinion would be appropriate. The following illustration provides an example of the explanatory paragraph and opinion paragraph of an auditor's report qualified because of inadequate procedures to value investments. The illustration assumes that the auditor cannot reasonably determine the effects of the departure.

Independent Auditors' Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1 and of accumulated Plan benefits as of December 31, 19X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to $______ (__ percent of net assets available for benefits) as of December 31, 19X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with generally accepted accounting principles. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2 and information regarding the Plan's net assets available for benefits as of December 31, 19X1, and the changes in its financial status for the year ended December 31, 19X2 in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature of Firm*]

[*City and State*]
[*Date*]

Reference to the Work of Other Auditors

13.33 Throughout this guide, circumstances are discussed in which the plan auditor may use the work of another auditor regarding plan investments. For example, the plan auditor may use the report of the independent auditor of the financial statements of a common or commingled trust fund or a separate account to obtain assurance regarding significant amounts of the plan's assets, and the auditor may use a service auditor's report on the processing of transactions by a service organization (see SAS No. 70) in considering the plan's internal control structure. Although the amount of the plan's assets covered by the other auditor's report or relating to the internal control structure covered by the service auditor's report may be material in relation to the net assets of the plan, the plan auditor ordinarily would be the principal auditor. The work of the other auditor is used by the plan auditor in obtaining an understanding of the internal control structure relating to plan investments. Because the plan auditor performs procedures with respect to investments, contributions, benefit payments, plan obligations, participants' data, and other elements of the financial statements, the plan auditor is ordinarily the only auditor in a position to express an opinion on the plan's financial statements taken as a whole. The plan auditor may use reports by other auditors in the audit of the plan's financial statements, but the other auditors are not responsible for examining a portion of the plan's financial statements as of any specific date or for any specific period. Thus, there cannot be a meaningful indication of a division of responsibility for the plan's financial statements. Therefore, the plan auditor should not refer to the other auditors in his or her report in such circumstances.

Reporting Separate Investment Fund Information

13.34 Requirements for presenting information related to separate investment fund options of defined contribution plans are described in paragraph 3.23(*k*). Article 6A of Regulation S-X addresses reporting requirements for profit sharing, stock bonus, thrift or savings, and similar plans, that are required to file reports with the SEC. Those rules, which are similar to those in paragraph 3.23(*k*), allow a plan providing for investment programs with separate funds to present the required information either in columnar form in the financial statements, or by separate financial statements for each fund, or in schedules. The SEC amended its rules for Form 11K to permit plans subject to ERISA to file financial statements in accordance with ERISA rather than in accordance with Regulation S-X. Accordingly, adherence to the requirements of paragraph 3.23(*k*) and other pertinent GAAP and ERISA requirements described in this guide should satisfy the SEC rules.

13.35 Where the required information on separate investment options is presented on the face of the financial statements, the auditor's measure of materiality remains that with respect to the financial statements taken as a whole, rather than each investment fund option. Accordingly, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the information taken by itself. Only in the unusual circumstance in which the separate fund option information is presented in the form of separate financial statements for each fund—which is not required by either SEC or DOL regulations—would materially be measured with respect to each individual fund. In that circumstance, the audit scope should be increased sufficiently to enable the auditor to report on each of the separate investment fund financial statements.

13.36 The following is an illustration of an auditor's report on the financial statements of a savings plan, containing separate investment fund option information, filed with Form 5500.

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits[74] of XYZ Employee Savings Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts of disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X2 and 19X1, and the changes in net assets available for benefits for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*insert titles of DOL required schedules*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department for Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The Fund Information in the [statement of net assets available for benefits and the] statement of changes in net assets available for benefits is presented for purposes of additional analysis rather than to present the [net assets available for plan benefits and] changes in net assets available for plan benefits of each fund. The supplemental schedules and Fund Information have been subjected to the auditing procedures applied in

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[74] If the financial statements are included in an SEC filing not subject to ERISA, the words "including the schedules of investments" would be added here. Additionally, the report would cover the required statements of changes in net assets available for plan benefits for each of the three years in the period ended December 31, 19X2.

the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

The auditor should be satisfied that the separate investment fund information is suitably identified. For example, when the separate fund information is included in columnar form on the face of the statement of changes in net assets available for benefits, the statement might be titled "Statement of Changes in Net Assets Available for Benefits, With Fund Information," and the columns including the separate fund information might be marked "Fund Information." In reporting on a limited scope audit, no special mention of the investment fund option information is necessary because the auditor is disclaiming on the financial statements taken as a whole, including the fund information and the supplemental schedules as they relate to such financial statements.

Terminating Plans

13.37 The accounting and reporting by a defined benefit pension plan for which a decision to terminate has been made are described in paragraphs 2.33 through 2.36. The auditor may express an unqualified opinion on financial statements prepared on the liquidation basis of accounting, provided the basis has been properly applied and that adequate disclosures are made in the financial statements. The auditor's report normally should be modified by the addition of an explanatory paragraph that states that the plan is being terminated and that the financial statements (including the benefit information disclosures presented) have been prepared on a liquidation basis. If the financial statements are presented along with financial statements of a period prior to adoption of a liquidation basis that were prepared on the basis of generally accepted accounting principles for ongoing plans, the explanatory paragraph should state that the plan has changed the basis of accounting used to determine the amounts at which assets, liabilities, and benefit information are presented from the ongoing plan basis to a liquidation basis. The following is an illustration of the explanatory paragraph when the auditor wishes to emphasize that a defined benefit plan is being terminated:

> As further discussed in Notes A and B to the financial statements, the Board of Directors of the XYZ Company, the Plan's sponsor, voted on November 9, 19X2 to terminate the Plan. In accordance with generally accepted accounting principles, the Plan has changed its basis of accounting used to determine the amounts at which investments in insurance contracts and the accumulated benefit information are stated, from the ongoing plan basis used in presenting the 19X1 financial statements to the liquidation basis used in presenting the 19X2 financial statements.

13.38 During the audit of a nonterminated employee benefit plan, the auditor may become aware that the plan sponsor may not be able to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminently potential impact on the plan entity. The auditor should consider the sponsor's plans for dealing with its conditions, and in that regard the auditor should refer to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

Initial Audits of Plans

13.39 For initial audits of plans where the plan had assets in the prior year, ERISA requires presenting a comparative statement of net assets available for plan benefits. Comparative statements are not required under generally accepted accounting principles. Generally sufficient auditing procedures can be performed on the prior year's balances if the records are complete (paragraph 5.13) so that the auditor can express an unqualified opinion or a limited-scope opinion on the prior year's statement of net assets available for plan benefits. If the prior-year's financial statements have not been audited, the prior year statement(s) should be marked to indicate their status (either reviewed or compiled). Additional guidance on the reporting on audited and unaudited financial statements in comparative form is contained in SAS No. 26, *Association With Financial Statements,* and Statement on Standards for Accounting and Review Services (SSARS) 2, *Reporting on Comparative Financial Statements.*

13.40 When the financial statements of the prior period have not been audited (but a statement of net assets is included for comparative purposes in compliance with the regulations), the report on the current period should contain an additional paragraph. This paragraph should include (*a*) a statement of the level of service performed in the prior period, (*b*) the date of the report on that service, (*c*) a description of any material modifications noted in that report, and (*d*) a statement that the service was less in scope than an audit and does not provide the basis for the expression of an opinion on the financial statements taken as a whole (SAS No. 26, paragraph 17). However, when the accountant performs more than one service for a prior period (for example, a compilation and an audit), he or she should issue the report that is appropriate for the highest level of service rendered (SSARS 1, *Compilation and Review of Financial Statements,* paragraph 5).

Appendix A

ERISA and Related Regulations

Introduction

A.01 The following description, prepared with the assistance of the Pension and Welfare Benefits Administration, U.S. Department of Labor, is intended to enable the auditor to familiarize himself or herself with the important provisions of the Employee Retirement Income Security Act of 1974 (ERISA). This is a summary and is not intended to serve as a substitute for the entire Act, the related regulations, or for the advice of legal counsel. Changes in the statute and related regulations subsequent to publication of this guide also should be considered.

A.02 The primary purpose of ERISA is to protect the interests of workers who participate in employee benefit plans and their beneficiaries. ERISA seeks to attain that objective by requiring financial reporting to government agencies and disclosure to participants and beneficiaries, by establishing standards of conduct for plan fiduciaries, and by providing appropriate remedies, sanctions, and access to the federal courts. Another objective of ERISA is to improve the soundness of employee pension benefit plans[75] by requiring plans (*a*) to vest the accrued benefits of employees with significant periods of service, (*b*) to meet minimum standards of funding, and (*c*) with respect to defined benefit pension plans, to subscribe to plan termination insurance through the Pension Benefit Guaranty Corporation (PBGC).

A.03 ERISA replaced the Welfare and Pension Plans Disclosure Act of 1958, amended certain sections of the Internal Revenue Code (IRC), and generally preempted state laws that related to employee benefit plans.

Coverage Under Title I

A.04 Title I of ERISA generally applies to employee benefit plans established or maintained by employers engaged in interstate commerce or in any industry or activity affecting interstate commerce or by employee organizations representing employees engaged in such activities, or by both employer and employee organizations.[76] Most aspects of ERISA do not apply to—

a. Governmental plans, including those of state and local governments.

b. Church plans unless the plan has made a voluntary election under IRC section 410(d).

c. Plans established and maintained solely for the purpose of complying with applicable workers' compensation, unemployment compensation, or disability insurance laws.

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[75] Pension plans are broadly defined in ERISA to include all defined benefit and defined contribution plans, including profit-sharing, stock bonus, and employee stock ownership plans.

[76] There is no correlation between coverage under Title I of ERISA and qualification under the IRC.

d. Plans maintained outside the United States primarily for nonresident aliens.[77]

e. Unfunded excess benefit plans (ERISA section 3(36)).[78]

Participant Standards for Pension Plans (ERISA Section 202)[79]

A.05 ERISA generally provides that a pension plan cannot exclude an employee from participation because of age or service if he or she has completed one year of service and is at least twenty-one years old. However, a pension plan may defer participation until attainment of age twenty-one and two years of service, provided that benefits vest 100 percent thereafter. In addition, ERISA provides that an individual may not be denied the right to participate in a plan on the basis of having attained a specific age.

Vesting Standards for Pension Plans (ERISA Section 203)

A.06 Pension plan participants' rights to accrued benefits from their own contributions are nonforfeitable. In addition, generally, plans must provide that the employees' rights to accrued benefits from employer contributions vest in a manner that equals or exceeds either of two alternative schedules: (*a*) graded vesting of accrued benefits, with at least 20 percent vesting after three years of service, at least 20 percent each year thereafter for four years, so that the employee's accrued benefit would be 100 percent vested after seven years; and (*b*) 100 percent vesting of accrued benefits after five years of service, with no vesting required before the end of the five-year period.

A.07 Tax-qualified plans require more stringent vesting if there is a termination, partial termination, or discontinuance of contribution to the plan, or the plan is top-heavy (IRC sections 411(d) and 416).

A.08 For computation of years of service as they relate to an employee's vesting rights, a year of service is defined in ERISA as a twelve-month period during which the participant has completed at least 1,000 hours of service (ERISA section 203(b)(2)). Regulations that refine that definition are complex. In addition, complex rules apply that define breaks in service.

A.09 Sufficient records must be maintained to determine an employee's benefits. ERISA section 105 generally requires that the plan administrator, on request, furnish to participants and beneficiaries under the plan the latest information available about their total benefits accrued and the nonforfeitable benefits, if any, that have accrued or the earliest date on which benefits will become nonforfeitable. ERISA section 209 requires a similar statement to be furnished upon request, as well as upon a termination or break in service. ERISA section 209 also requires the maintenance of records relating to individual benefit reporting. ERISA section 107 provides general record retention requirements for employee benefit plans.

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[77] The phrase "Plans maintained outside the United States" does not include a plan that covers residents of Puerto Rico, the U.S Virgin Islands, Guam, Wake Island, or America Samoa.

[78] Certain plans excluded from Title I and "fringe benefit plans," as defined in Exhibit A-4, are nonetheless required under the IRC to file annual reports with the IRS (see A.18 through A.28).

[79] Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) generally transferred from the Secretary of Labor to the Secretary of the Treasury regulatory and interpretative authority for Parts 2 and 3 of Title I of ERISA.

Minimum Funding Standards for Pension Plans (ERISA Sections 301 Through 306)

A.10 ERISA requires that pension plans subject to the minimum funding standards maintain an account called the *funding standard account* (FSA). This account is a memorandum account, and it is not included in the plan's financial statements. Defined benefit pension plans are required to maintain an FSA. Certain defined contribution plans (that is, money-purchase and target-benefit plans) must maintain FSAs, but on a more limited basis. The FSA is used to determine compliance with minimum funding standards set forth in ERISA.

A.11 For most defined benefit pension plans, the sponsor's annual contribution to the plan must be sufficient to cover the normal cost for the period, and the amount to amortize initial unfunded past service liability, and increases or decreases in unfunded past service liability resulting from plan amendments, experience gains or losses, and actuarial gains or losses from changes in actuarial assumptions.

A.12 An accumulated funding deficiency is the excess of total charges (required contributions) to the FSA for all plan years (beginning with the first plan year when the funding standards are applicable) over total credits (actual contributions) to the account for those years. Accumulated funding deficiencies, in the absence of a funding waiver issued by the IRS, may result in an excise tax payable by the plan sponsor for failure to meet the minimum funding standards and in possible action by the IRS to enforce the standards. If there is a deficiency in the FSA at the end of the plan year, the auditor should consider whether a receivable from the employer company (and, possibly, a related reserve for uncollectible amounts) should be reflected in the plan's financial statements (see chapter 8 for a discussion of contributions receivable).

A.13 The IRS may waive all or part of the minimum funding requirements for a plan year in which the minimum funding standard cannot be met without imposing substantial business hardship on the employer. That waiver is issued, however, only if failure to do so would be adverse to the participants' interests. The IRS determines whether a substantial hardship would occur on the basis of various factors, certain of which are stated in ERISA section 303. This does not change the plan's possible need to record a contribution receivable.

Trust Requirements

A.14 Tax laws require that qualified pension, profit-sharing, and stock bonus plans be funded through a trust. The Internal Revenue Code (IRC) does not contain any such requirement for welfare benefit plans or fringe benefit plans. ERISA generally requires, however, that the assets of all employee benefit plans, including welfare plans, be held in trust. Participant contributions, including salary reduction amounts, are considered to be employee contributions under ERISA and generally do constitute "plan assets." An employer is required to segregate employee contributions from its general assets as soon as practicable, but in no event more than ninety days after the contributions are paid by employees or withheld from their wages [ref. DOL Reg. 2510.3-102]. The DOL has announced that it will not presently enforce the trust requirement for cafeteria plans under IRC section 125 to which employees make contributions. This policy also temporarily relieves contributory welfare plans from compliance with the trust requirements of ERISA with respect to participant contributions used to pay insurance premiums in accordance with the Department's reporting regulations.*

Voluntary Employee Benefit Associations (VEBAs)

A.15 A VEBA is a welfare trust under IRC section 501(c)(9). Generally, plans funded by a section 501(c)(9) trust must be audited unless it is exempt under the fewer-than-100-participants rule.

Reporting and Disclosure for Pension and Welfare Plans (ERISA Sections 101 Through 111 and 1031 Through 1034)

A.16 ERISA generally requires that the administrator of an employee benefit plan prepare and file various documents with the DOL, the IRS, and the PBGC. Under Title I of ERISA, the plan administrator is required to file with the DOL a copy of the summary plan description, changes to the information required to be contained in the summary plan description, and updates to the summary plan description (section 104(a)(1)(B)-(D)) (see paragraph A.18 of this appendix). In addition, most plans are required to file an annual report that also satisfies the annual reporting requirements of Titles I and IV of ERISA (sections 104(a)(1)(A), 1031 and 4065) and the Internal Revenue Code. Title I of ERISA also requires that the plan administrator furnish certain information relative to the employee benefit plan to each participant and beneficiary receiving benefits under the plan. These disclosures include summary plan descriptions, including summaries of changes and updates to the summary plan description (section 104(b)(1)), summary annual reports (section 104(b)(3)), and, in the case of most pension plans, individual benefit reports describing the participant's accrued and vested benefits under the plan (sections 105 and 209).

Annual Report

A.17 The report of most significance to the auditor is the annual report. The annual report required to be filed for employee benefit plans generally is the Form 5500 Series. The Form 5500 Series is a joint-Agency Form developed by the IRS, DOL, and PBGC, which may be used to satisfy the annual reporting requirements of the IRC and Titles I and IV of ERISA. For purposes of Title I of ERISA only, a plan administrator may, in lieu of filing the Form 5500 Series, elect to file the information required by ERISA section 103. However, almost all plan administrators use the Form 5500 Series. Use of the Form 5500 Series is required for filings under the IRC and Title IV of ERISA.

Who Must File

A.18 An administrator of an employee benefit plan subject to ERISA, and not otherwise exempt, must file an annual report for each such plan every year (see ERISA sections 104, 1031, and 4065).[80] The IRS, DOL, and PBGC have

* See 29 CFR 2520.104-20(b)(2)(ii) or (iii) and 29 CFR 2520.104-44(b)(1)(ii) or (iii), as applicable.

[80] IRC section 6039D also requires certain other entities to file with the IRS. When these entities are required to file Form 5500 or 5500-C/R, the instructions to the forms refer to these entities as "fringe benefit plans."

consolidated their requirements into the Form 5500 Series to minimize the filing burden for plan administrators and employers. In general, administrators of plans with 100 or more participants are required to file the Annual Return/Report Form 5500, with the required attachments and schedules (Form 5500); and administrators of plans with fewer than 100 participants are required to file the Annual Return/Report Form 5500-C/R with the required attachments and schedules (Form 5500-C/R). In addition, plans with fewer than 100 participants that elect to file the Form 5500 under the 80-120 participant rule, rather than a Form 5500-C/R, are also required to engage an independent qualified public accountant. Under this rule, if a plan has between 80 and 120 participants (inclusive) at the beginning of the plan year, the plan may elect to file the same annual return/report form that was filed for the previous year. The Form 5500 Series is filed with the IRS in accordance with the instructions to the forms.

Participants

A.19 ERISA section 3(7) defines a participant as any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan that covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.

A.20 In determining whether a 401(k) plan has 100 "participants," all employees who are eligible to make a contribution are counted as participants regardless of whether an employee elects to contribute or has an account under the plan [ref: DOL Reg. 29 CFR 2510.3-3(d) and the Form 5500 Instructions]. However, a "participant" in a fringe benefit plan means any individual who has had at least one dollar excluded from income by reason of Code section 120, 125, or 127.* It also should be noted, however, that the determination of the number of participants in a welfare benefit plan, whether or not implemented in conjunction with a cafeteria plan, is determined by reference to 29 CFR 2510.3-3(d).

Stop-Loss Coverage

A.21 Many self-funded plans carry stop-loss coverage to limit either the plan's or employer's loss exposure. Stop-loss coverage is a contract with an insurer that provides that the insurer will pay claims in excess of a specified amount. The coverage may be aggregate (that is, the insurer will pay if total claims exceed the specified amount) or specific (that is, the insurer will pay if an individual claim exceeds the specified amount). Plans that have stop-loss insurance may qualify for an exception from the annual report and/or audit requirement depending on the number of participants covered under the plan and the type of annual report filed (for example, Form 5500 or Form 5500-C/R).

Plans Required to File the Annual Report and Audited Financial Statements

A.22 Generally, plans subject to Part 1 of Title I of ERISA require an audit. Certain plans are not covered by ERISA and accordingly are not subject to the federal audit requirement (for example, governmental plans, church plans, un-

* See line 5 of Schedule F (1992 Form 5500).

funded excess benefit plans, plans maintained solely for the purpose of complying with applicable workmen's compensation, unemployment, or disability insurance laws, and plans maintained outside the United States primarily for the benefit of persons substantially all of whom are nonresident aliens). In addition, it should be noted that the plan administrator's obligation to retain an accountant to audit the plan continues to remain in effect even when the plan loses its tax-qualified status.

Who Must Engage an Independent Qualified Public Accountant

A.23 Employee benefit plans filing Form 5500 (usually plans with 100 or more participants) are generally required to engage an IQPA pursuant to ERISA section 103(a)(3)(A). In counting participants for these purposes, an individual usually becomes a participant under a welfare plan when he or she becomes eligible for a benefit, and under a pension plan when he or she has satisfied the plan's age and service requirements for participation (see paragraph 5.09 and instructions to the Form 5500 series). An IQPA's opinion must also be attached to Form 5500 unless (*a*) the plan is an employee welfare benefit plan that is unfunded, fully insured, or a combination of unfunded and insured as described in 29 CFR 2520.104-44(b)(1);[81] (*b*) the plan is an employee pension benefit plan whose sole asset(s) consist of insurance contracts that provide that, upon receipt of the premium payment, the insurance carrier fully guarantees the amount of benefit payments attributable to plan participants for that plan year as specified in 29 CFR 2520.104-44(b)(2);[82] or (*c*) the plan has elected to defer attaching the accountant's opinion for the first of two plan years, one of which is a short plan year of seven months or less as allowed by 29 CFR 2520.104-50[83] (see paragraphs A.59 and A.67, and 29 CFR 2520.104-44, 2520.104-50, and the instructions to the Form 5500).

Pension Benefit Plans

A.24 An annual report is generally required to be filed even if (*a*) the plan is not qualified, (*b*) participants no longer accrue benefits, and (*c*) contributions were not made for the plan year. The following are among the pension benefit plans for which a Form 5500 or 5500-C/R must be filed:

- Annuity arrangements under IRC section 403(b)(1)
- Custodial account established under IRC section 403(b)(7) for regulated investment company stock
- Individual retirement account established by an employer under IRC section 408(c)
- Pension benefit plan maintained outside the United States primarily for nonresident aliens if the employer who maintains the plan is a

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[81] Single employer welfare plans using an IRC section 501(c)(9) trust are generally not exempt from the requirement of engaging an independent qualified public accountant. See paragraph A.35 for an explanation of the welfare plans considered to be unfunded, fully insured, or a combination of unfunded and insured.

[82] See paragraph A.68*n*.

[83] 29 CFR 2520.104-50 permits the administrator of an employee benefit plan to defer the audit requirement for the first of two consecutive plan years, one of which is a short plan year of seven or fewer months' duration, and to file an audited statement for that plan year when the annual report is filed for the immediately following plan year, subject to certain conditions.

domestic employer, or a foreign employer with income derived from sources within the United States (including foreign subsidiaries of domestic employers) and deducts contributions to the plan on its U.S. income tax return
- Church plans electing coverage under IRC section 410(d)

Pension benefit plans generally provide retirement income and include—
- defined benefit plans; and
- defined contribution plans, including profit-sharing plans, money-purchase pension plans, stock-bonus and employee stock-ownership plans (ESOPs), and 401(k) and other thrift or savings plans.

General Filing Requirements:
- plans with 100 or more participants at the beginning of the plan year must file Form 5500.
- plans with fewer than 100 participants at the beginning of the plan year may file Form 5500-C/R.

Exception:

Pursuant to DOL Regulation 20 CFR 2520.103-1(d), a plan that covers between 80 and 120 participants at the beginning of the plan year may elect to file the same report that was filed the previous year. Plans that file the Form 5500-C/R pursuant to the 80/120 rule are not required to have an audit of their financial statements [ref: DOL Reg. 29 CFR 2520.104.46].

General Audit Requirements:
- plans with 100 or more participants at the beginning of the plan year that file the Form 5500 are required to have an annual audit of their financial statements.
- plans with fewer than 100 participants at the beginning of the plan year that file the Form 5500-C/R are exempt from the audit requirement. Plans with fewer than 100 participants that do not meet the exemption requirements listed below, that elect to file Form 5500 are required to have an annual audit of their financial statements.

General Exemptions From Filing and Audit Requirements:
- plans that are unfunded or fully insured and provide benefits only to a select group of management or highly compensated employees. *Note:* There is a one-time DOL notification requirement for "top hat" plans [ref: DOL Reg. 29 CFR 2520.104-23].

General Exemptions From Audit Requirement Only:

Plans, irrespective of the number of participants at the beginning of the plan year, that—
- provide benefits exclusively through allocated insurance contracts. A contract is considered to be allocated only if the insurance company or organization that issued the contract unconditionally guarantees, upon receipt of the required premium or consideration, to provide a retirement benefit of a specified amount, without adjustment for fluctuations in the market value of the underlying assets of the company or organization, to each participant, and each participant has a legal right to such benefits that is legally enforceable directly against the insurance company or organization;
- are funded solely by premiums paid directly from the general assets of the employer or the employee organization maintaining the plan, or

partly from such general assets and partly from contributions from employees;
- forward any participant contributions within three months of receipt; and
- provide for the return of refunds to contributing participants within three months of receipt by the employer or employee organization [ref: DOL Reg. 29 CFR 2520.104-44(b)(2)].

Welfare Benefit Plans

A.25 These plans are described in section 3(1) of Title I of ERISA. An employee welfare benefit plan includes any plan, fund, or program that provides, through the purchase of insurance or otherwise, medical, surgical, hospital, sickness, accident, disability, severance, vacation, prepaid legal services, apprenticeship, and training benefits for employees.

General Filing Requirements:
- plans with 100 or more participants at the beginning of the plan year must file the Form 5500.
- plans with fewer than 100 participants at the beginning of the plan year may file the Form 5500-C/R.

Exception:

Pursuant to DOL Reg. 29 CFR 2520.103-1(d), a plan that covers between 80 and 120 participants at the beginning of the plan year may elect to file the same report that was filed the previous year. Plans that file the Form 5500-C/R pursuant to the 80/120 rule are not required to have an audit of their financial statements [ref: DOL Reg. 29 CFR 2520.104-46].

General Audit Requirements:
- plans with 100 or more participants at the beginning of the plan year are required to have an annual audit of their financial statements.
- plans with fewer than 100 participants at the beginning of the plan year that file the Form 5500-C/R are exempt from the audit requirement. Plans with fewer than 100 participants that do not meet the exemption requirements below, that elect to file Form 5500 will be required to have an annual audit of their financial statements.

General Exemptions From Filing and Audit Requirements:
- plans that are unfunded or fully insured and provide benefits only to a select group of management or highly compensated employees. Note: The Department of Labor can require that certain information be provided upon request [ref: DOL Reg. 29 CFR 2520.104-24].
- plans that have fewer than 100 participants at the beginning of the plan year, and—
  - (*1*) pay benefits solely from the general assets of the employer or employee organization maintaining the plan, or (*2*) provide benefits exclusively through insurance contracts or policies issued by a qualified insurance company or through a qualified HMO, the premiums of which are paid directly out of the general assets of the employer or employee organization, or partly from general assets and partly from employee or member contributions, or (*3*) partly as in (*1*) and partly as in (*2*); *AND*
  - forward any employee contributions to the insurance company within three months of receipt; *AND*

— pay any employee refunds to employees within three months of receipt [ref: DOL Reg. 29 CFR 2520.104-20].

General Exemption From Audit Requirement Only:

Plans, irrespective of the number of participants at the beginning of the plan year, that—

- (*1*) pay benefits solely from the general assets of the employer or employee organization maintaining the plan, or (*2*) provide benefits exclusively through insurance contracts or policies issued by a qualified insurance company or through a qualified HMO, the premiums of which are paid directly out of the general assets of the employer or employee organization, or partly from general assets and partly from employee or member contributions, or (*3*) provide benefits partly from the general assets of the employer or employee organization and partly through insurance (for example, a stop-loss insurance policy purchased or owned by the plan); *AND*
- forward any employee contributions to the insurance company within three months of receipt; *AND*
- pay any employee refunds to employees within three months of receipt [ref: DOL Reg. 29 CFR 2520.104-44(b)(1)].

Plans Covered by IRC Sections 6058 and 6039D (Fringe Benefit Plans)

A.26 Most retirement and savings plans (for example, pension, profit-sharing, or stock bonus plans) are required to file a Form 5500 series return under IRC section 6058 as well as ERISA. According to Announcement 82-146, however, church plans that have not made a section 410(d) election and governmental plans are not required to file a return. IRC section 6039D requires employers sponsoring fringe benefit plans described in IRC sections 120 (group legal services), 125 (cafeteria), or 127 (educational assistance) to file an annual report. Although the Tax Reform Act of 1986 (TRA '86) added plans under IRC sections 79 (life insurance), 105 and 106 (accident and health), and 129 (dependent care assistance) to IRC section 6039D, Notice 90-24 suspended this reporting obligation for these plans until further notice. Some fringe benefit plans may be required to file a Form 5500 (or Form 5500-C/R, as appropriate) *only* because of section 6039D, and not because of any ERISA requirement (see footnote 79). This may be the case, for example, for a cafeteria plan that covers fewer than 100 participants. Once the IRS suspension under Notice 90-24 is lifted, it would also be the case for plans under section 79, and some plans under sections 105 or 106 that have fewer than 100 participants. No plan required to file a Form 5500 *solely* because of section 6039D is required to be audited, because only ERISA requires audits. It should be noted that fringe benefit plans may also be welfare benefit plans required to file annual reports under Title I of ERISA.

Cafeteria Arrangements (IRC Section 125 Plans)

A.27 Cafeteria arrangements do not have to be audited unless they also provide welfare benefits (for example, medical benefits), in which case, they must be audited under the above criteria (for example, a plan that has 100 or more participants and is funded through a trust). Cafeteria arrangements that do not provide welfare benefits must, however, file a Form 5500 (or Form 5500-C/R, as appropriate) pursuant to IRC section 6039D.

PWBA Technical Release 92-1

A.28 In June 1992, PWBA issued Technical Release 92-1 announcing the DOL's enforcement policy with respect to welfare benefit plans with participant contributions. Cafeteria plans described in section 125 of the Internal Revenue Code, may not be required to have an audit, if the participant contributions used to pay benefits have not been held in trust. An audit may also not be required for other contributory welfare benefit plans where participant contributions are applied to the payment of premiums and such contributions have not been held in trust. The enforcement policy stated in ERISA Technical Release 92-01 will continue to apply until the adoption of final regulations addressing the application of the trust and reporting requirements of Title I of ERISA to welfare plans that receive participant contributions. See exhibit 5-3, "Welfare Benefit Plans Audit Decision Flowchart" for further guidance.

Plans Excluded From Filing (This Does Not Apply to Fringe Benefit Plans)

A.29 Plans maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws are excluded from filing.

A.30 An unfunded excess benefit plan (section 3(36)) is excluded from filing.

A.31 A welfare benefit plan maintained outside the United States primarily for persons substantially all of whom are nonresident aliens (see footnote 77) is excluded from filing.

A.32 A pension benefit plan maintained outside the United States is excluded from filing if it is a qualified foreign plan within the meaning of IRC section 404A(e) that does not qualify for the treatment provided in IRC section 402(c) (see paragraph A.04*d* in this appendix).

A.33 A church plan not electing coverage under IRC section 410(d) or a governmental plan is excluded from filing.

A.34 An annuity arrangement described in 29 CFR 2510.3-2(f) is excluded from filing.

A.35 A welfare benefit plan as described in 29 CFR 2520.104-20 is excluded from filing. Such a plan has fewer than 100 participants as of the beginning of the plan year and generally is one of the following:

a. *Unfunded.* Benefits are paid as needed directly from the general assets of the employer or the employee organization that sponsors the plan.[84]

b. *Fully insured.* Benefits are provided exclusively through insurance contracts or policies, the premiums being paid directly by the employer or employee organization from its general assets or partly from its general assets and partly from contributions by its employees or members.

c. *A combination of unfunded and insured.* Benefits are provided partially as needed directly from the general assets of the employer

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[84] "Directly" means that the plan does not use a trust or separately maintained fund (including a Code section 501(c)(9) trust) to hold plan assets or to act as a conduit for the transfer of plan assets.

or the employee organization that sponsors the plan and partially through insurance contracts or policies, the premiums being paid directly by the employer or employee organization from its general assets (see paragraph A.68*d* in this appendix).

A.36 An apprenticeship or training plan meeting all of the conditions specified in 29 CFR 2520.104-22 is excluded from filing (see paragraph A.68*f*).

A.37 An unfunded pension benefit plan or an unfunded or insured welfare benefit plan (*a*) whose benefits go only to a select group of management or highly compensated employees and (*b*) that meets the requirements of 29 CFR 2520.104-23 (including the requirement that a notification statement be filed with DOL) or 29 CFR 2520.104-24, respectively, is excluded from filing (see paragraphs A.68*g* and A.68*h*).

A.38 Day-care centers as specified in 29 CFR 2520.104-25 are excluded from filing (see paragraph A.68*i*).

A.39 Certain dues-financed welfare and pension plans that meet the requirements of 29 CFR 2520.104-26 and 2520.104-27 are excluded from filing (see paragraph A.68*j*).

A.40 A welfare plan that participates in a group insurance arrangement that files a Form 5500 on behalf of the welfare plan is excluded from filing (see paragraphs 29 CFR 2520.104-43 and A.68*l*).

A.41 A simplified employee pension (SEP) described in IRC section 408(k) that conforms to the alternative method of compliance described in 29 CFR 2520.104-48 or -49 is excluded from filing. A SEP is a pension plan that meets certain minimum qualifications regarding eligibility and employer contributions (see paragraphs A.68*p* and A.68*q*).

Kinds of Filers

A.42 A *single employer plan* is a plan sponsored by one employer.[85]

A.43 A *plan for a controlled group of corporations or group of trades or businesses under common control* is a plan sponsored by a group defined in IRC sections 414(b) and (c). To file as such a plan, benefits must be payable to participants from the plan's total assets without regard to contributions by each participant's employer.[86]

A.44 A *multiemployer plan* is a plan (*a*) in which more than one employer is required to contribute, (*b*) that is maintained pursuant to one or more collective bargaining agreements, and (*c*) that had not made the election under ERISA section 3(37)(E).

A.45 A *multiple employer collectively bargained plan* is a plan that involves more than one employer, is collectively bargained and collectively funded, and, if covered by PBGC termination insurance, had properly elected before September 27, 1981, not to be treated as a multiemployer plan under ERISA sections 3(37)(E) and 4001(a)(3).

[85] If several employers participate in a program of benefits wherein the funds attributable to each employer are available only to pay benefits to that employer's employees, each employer must file as a sponsor of a single employer plan.

[86] An employer who participates in such a pension plan who is not a member of the sponsoring group must file a return for IRS by completing only a limited number of items on Form 5500-C/R.

A.46 A *multiple-employer plan (other)* is a plan that involves more than one employer, is not one of the plans described in paragraphs A.43 through A.45, and includes only plans whose contributions from individual employers are available to pay benefits to all participants.[87]

A.47 A *group insurance arrangement* is an arrangement that provides welfare benefits to the employees of two or more unaffiliated employers (not in connection with a multiemployer plan nor a multiple employer collectively bargained plan), fully insures one or more welfare plans of each participating employer, and uses a trust (or other entity such as a trade association) as the holder of the insurance contracts and the conduit for payment of premiums to the insurance company. If such an arrangement files a Form 5500 in accordance with 29 CFR 2520.103-2, the welfare plans participating in the arrangement need not file a separate report.[88]

When to File

A.48 The plan administrator must file the annual report seven months after the end of a plan year, including a short plan year (any plan year less than twelve months). A plan year ends upon the date of the change in accounting period or upon the complete distribution of the assets of the plan.

A.49 A one-time extension of time up to two and one-half months may be granted for filing the annual report if Form 5558, *Application for Extension of Time to File Certain Employee Plan Returns*, is filed with the IRS before the normal due date of the report. In addition, single-employer plans and plans sponsored by a controlled group of corporations that file consolidated federal income tax returns are automatically granted an extension of time to file Forms 5500 and 5500-C/R to the due date of the federal income tax return of the single employer or controlled group of corporations if certain conditions described in the instructions to the forms are met. A copy of the extension must be filed with the annual report.

Filing Under the Statute Versus the Regulations

A.50 As stated in A.17, plan administrators may, for purposes of Title I of ERISA, file an annual report containing all of the information required by ERISA section 103 (that is, the statute) or the information required by the regulations. As also noted in A.17, however, a filing in accordance with ERISA section 103 will not satisfy an administrator's annual reporting obligations under the IRC or Title IV of ERISA; the Form 5500 Series must be filed to comply with those requirements.

a. *Regulations.* Filing the Form 5500 Series is considerably different from filing by the statute. The regulations require that the accountant's report—
   - Disclose any omitted auditing procedures deemed necessary by the accountant and the reasons for their omission.
   - State clearly the accountant's opinion of the financial statements and schedules covered by the report and the accounting principles and practices reflected therein.
   - State clearly the consistency of the application of the accounting principles between the current year and the preceding year or

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[87] Each participating employer that provides pension benefits must file a return for the IRS by completing only a limited number of items on Form 5500-C/R.

[88] Also see 29 CFR 2520.104-21 and 2520.104-43.

as to any changes in such principles which have a material effect on the financial statements.[89]

- State clearly any matters to which the accountant takes exception, the exception, and to the extent practical, the effect of such matters on the related financial statements. Exceptions are required to be further identified as (*a*) those that are the result of DOL regulations and (*b*) all others.[90]

The regulations also require (*1*) current value,[91] comparing the beginning and end of the plan year, (*2*) a description of accounting principles and practices reflected in the financial statements and, if applicable, variances from GAAP and an explanation of differences, if any, between the information contained in the separate financial statements and the net assets, liabilities, income, expense, and changes in net assets as required to be reported on the Form 5500.

b. *Statute*. In particular, a plan administrator electing to comply with the statute must satisfy all the requirements of ERISA section 103 and may not rely on regulatory exemptions and simplified methods of reporting or alternative methods of compliance prescribed with respect to the Form 5500 Series. In addition, the statute requires (*1*) the accountant to express an opinion on whether the financial statements and ERISA section 103(b) schedules conform with generally accepted accounting principles on a basis consistent with that of the preceding year and (*2*) current value, comparing the end of the previous plan year and the end of the plan year being reported.

A.51 The statute and the regulations require that the examination be conducted in accordance with generally accepted auditing standards.

a. Financial information required under both methods includes plan assets and liabilities (aggregated by categories and valued at their current value with the same data displayed in comparative form using the end of the current plan year and either (*1*) the end of the previous plan year (statute) or (*2*) beginning of the current plan year (regulations), and information concerning plan income, expenses, and changes in net assets during the plan year).

b. Required supplemental information includes (see paragraph A.72)—
- Assets held for investment purposes. If filing under the alternative method, a schedule of assets acquired and disposed of during the year is also required.
- Transactions with parties in interest.

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[89] An accountant's report prepared in accordance with SAS No. 58, *Reports on Audited Financial Statements*, which prescribes that no reference be made to the consistent application of GAAP in those cases where there has been no accounting change, will be viewed as consistent with the requirements of ERISA and regulations issued thereunder with regard to the required submission of an accountant's report.

[90] Other requirements are that the report be dated, manually signed, and that it indicate the city and state where it is issued, and that it identify (without necessarily enumerating) the statements and schedules covered.

[91] "Current value," as used in this document, means fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary (as defined in section 402(a)(2)) pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination (section 3(26) of ERISA).

- Loans or fixed income obligations due in default or uncollectible.
- Leases in default or uncollectible.
- Reportable transactions (that is, transactions that exceed 3 percent (statute) or 5 percent (regulations) of the current value of plan assets at the beginning of the year).[92] In addition, the annual report must include the statements of assets and liabilities for any bank common/collective trusts and/or insurance carrier pooled separate accounts that held plan assets.

c. Notes to the financial statements, when applicable, shall be provided concerning—
- A description of the plan, including significant changes in the plan and effect of the changes on benefits.
- The funding policy and changes in funding policy (including policy with respect to prior service cost), and any changes in such policies during the year (only applicable under the statutory method for pension plans).
- A description of material lease commitments and other commitments and contingent liabilities.
- A description of any agreements and transactions with persons known to be parties in interest.
- A general description of priorities in the event of plan termination.
- Whether a tax ruling or determination letter has been obtained.
- Any other information required for a fair presentation.
- An explanation if differences, if any, between the information contained in the separate financial statements and the net assets, liabilities, income, expense, and changes in net assets as required to be reported on the Form 5500, if filing under the alternative method (see paragraph A.41).

Investment Arrangements Filing Directly With DOL

A.52 Generally, when the assets of two or more plans are maintained in one trust or account or separately maintained fund, all annual report entries, including any attached schedules, shall be completed by including the plan's allocable portion of the trust, account, or fund. Certain exceptions have been made, however, for plans that invest in certain investment arrangements that are either required to, or may elect to, file information concerning themselves and their relationship with employee benefit plans directly with DOL as discussed subsequently. Plans participating in these investment arrangements are required to attach certain additional information to the Form 5500 or 5500-C/R filed with IRS as specified below. For a definition of plan assets and the look-through provisions, see 29 CFR 2510.3-101.

Common/Collective Trusts and Pooled Separate Accounts

A.53 For reporting purposes, a common/collective trust is a trust maintained by a bank, trust company, or similar institution that is regulated, super-

[92] Plans filing their annual reports under the statutory method are required to report transactions that exceed 3 percent of the fair value of plan assets at the beginning of the year, whereas plans that file pursuant to the alternative method of compliance prescribed in DOL regulations are required to report transactions that exceed 5 percent of the fair value of plan assets at the beginning of the year.

vised, and subject to periodic examination by a state or federal agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations, as the term is used in IRC section 1563.

For reporting purposes, a pooled separate account is an account maintained by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations, as that term is used in IRC section 1563.

A plan investing in one or more of these trusts and/or accounts is required to attach the additional information specified in either (*a*) or (*b*) following for each trust and account for which the plan held units of participation during the plan year to the Form 5500 or 5500-C/R.

a. The most recent statement of the assets and liabilities of any common/collective trust or pooled separate account.

b. A certification that (*1*) the statement of the assets and liabilities of the common/collective trust or pooled separate account has been submitted directly to DOL by the financial institution or insurance carrier, and (*2*) the plan has received a copy of the statement and (*3*) includes the employer identification number (EIN) and other numbers used by the financial institution or insurance carrier to identify the trusts or accounts in the direct filing made with DOL.

   The following information is required to be filed directly with DOL by the financial institution or insurance carrier for plans that attach the certification discussed in (*b*):

   1. The annual statement of the assets and liabilities of the common/collective trust or pooled separate account for the fiscal year of the trust or account ending within the plan year for which the annual report is made
   2. The EIN of the trust or account to identify the annual statement being submitted, or, if more than one trust or account is covered by the same EIN, both the EIN and any additional number assigned by the financial institution or insurance carrier (such as 99-1234567, Trust No. 1)
   3. A list of all plans participating in the trust or account, identified by the plan number, EIN, and name of the plan sponsor.

See paragraphs A.68b and A.68c and 29 CFR 2520.103-3, -4 and -5, and 2520.103-9.[93]

Master Trust

A.54 For reporting purposes, a master trust is a trust for which a regulated financial institution serves as trustee or custodian (regardless of whether such institution exercises discretionary authority or control with respect to the

[93] For reporting purposes, a separate account that is not considered to be holding plan assets pursuant to 29 CFR 2510.3-101(h)(1)(iii) shall not constitute a pooled separate account.

management of assets held in the trust), and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.[94] The following additional information for the master trust fiscal year ending with or within the plan year is required to be attached to the Form 5500 or 5500-C/R: a list of each master trust investment account in which the plan has an interest indicating the plan's name, EIN, and plan number (PN) and the name of the master trust used in the master trust information filed with DOL. In tabular format, show the net value of the plan's interest in each investment account at the beginning and end of the plan year and the net investment gain (or loss) allocated to the plan for the plan year from the investment account.[95]

The following information is required to be filed by the plan administrator or by a designee directly with DOL no later than the date on which the plan's report is due. The plan's report will not be deemed complete unless all the information is filed within the prescribed time. The statements and schedules must indicate the name of the master trust and the name of the master trust investment account.

a. The name and fiscal year of the master trust and the name and address of the master trustee

b. A list of all plans participating in the master trust, showing each plan's name, EIN, PN, and its percentage interest in each master trust investment account

c. A Schedule A (Form 5500) for each insurance or annuity contract held in the master trust (see paragraph A.69)

d. A statement, in the same format as Part I of Schedule C (Form 5500), for each master trust investment account (see paragraph A.71)

e. A statement for each master trust investment account showing the assets and liabilities of the investment account grouped in the same categories as those specified in item 34 of Form 5500

f. A statement for each master trust investment account showing the income and expenses, changes in net assets, and net increase (decrease) in net assets of each investment account

g. Schedules, in the format set forth in the instructions to item 30 of Form 5500, with respect to each master trust investment account[96]

See paragraph A.68*a* and 29 CFR 2520.103-1(e).

Plans Versus Trusts

A.55 Under ERISA, the audit requirement is applied to each separate plan and not each separate trust. As a result, each plan funded under a master trust arrangement is subject to a separate Form 5500 and audit requirement, unless otherwise exempt.

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[94] A "regulated financial institution" means a bank, a trust company, or a similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency. Common control is determined on the basis of all relevant facts and circumstances.

[95] If a master trust investment account consists solely of one plan's asset(s) during the reporting period, the plan may report the(se) asset(s) either as an investment account to be reported as part of the master trust report filed directly with DOL or as a plan asset(s) that is not part of the master trust (and therefore subject to all instructions pertaining to assets not held in a master trust).

[96] All statements and schedules will be completed in accordance with the instructions to the Form 5500 except that the words "investment account" shall replace the word "plan" when appropriate.

103-12 Investment Entities

A.56 For purposes of the annual report, entities described in the next paragraph that file the information directly with DOL as specified subsequently constitute "103-12 Investment Entities" (103-12 IEs).[97] Plans may invest in an entity, the underlying assets of which include "plan assets" (within the meaning of 29 CFR 2510.3-101) of two or more plans that are not members of a related group of employee benefit plans. For reporting purposes, a "related group" consists of each group of two or more employee benefit plans (*a*) each of which receives 10 percent or more of its aggregate contributions from the same employer or from a member of the same controlled group of corporations (as determined under IRC section 1563(a), without regard to IRC section 1563(a)(4) thereof); or (*b*) each of which is either maintained by, or maintained pursuant to, a collective bargaining agreement negotiated by the same employee organization or affiliated employee organizations. For purposes of this paragraph, an "affiliate" of an employee organization means any person controlling, controlled by, or under common control with such organization.

The following information for the fiscal year of the 103-12 IE ending with or within the plan year must be filed directly with DOL by the sponsor of the 103-12 IE no later than the date on which the plan's annual report is due before the plan administrator can elect the alternative method of reporting:

a. The name, fiscal year, and EIN of the 103-12 IE and the name and address of the sponsor of the 103-12 IE. If more than one 103-12 IE is covered by the same EIN, they shall be sequentially numbered as follows: 99-1234567, Entity No. 1.

b. A list of all plans participating in the 103-12 IE, showing each plan's name, EIN, PN, and its percentage interest in the 103-12.

c. A Schedule A (Form 5500) for each insurance or annuity contract held in the 103-12 IE (see paragraph A.69).

d. A statement, in the same format as Part 1 of Schedule C (Form 5500), for the 103-12 IE (see paragraph A.71).

e. A statement showing the assets and liabilities.

f. A statement showing the income and expenses, changes in net assets, and net increase (decrease) in net assets grouped in the same categories as those specified in item 35 of Form 5500.

g. Schedules, in the format set forth in the instructions for item 30 of Form 5500 (except item 30c) with respect to the 103-12 IE.

h. A report of an independent qualified public accountant (IQPA) regarding the above items and other books and records of the 103-12 IE that meets the requirements of 29 CFR 2520.103-1(b)(5).[98]

See 29 CFR 2520.103-12 and A.77.

Limited-Scope Audit Exemption

A.57 Under DOL regulations, certain assets held by a bank, trust company, or similar institution or by an insurance company that is regulated and

[97] The plan administrator cannot use this alternative method of reporting unless the report of the investment entity has been submitted to DOL in accordance with the requirements specified in the Form 5500 and 5500-C/R instructions.

[98] All statements and schedules will be completed in accordance with the instructions to the Form 5500 except that the words "103-12 IE" shall replace the word "plan" when appropriate.

subject to periodic examination by a state or federal agency, and related information does not have to be audited provided the plan administrator exercises this option and the institution holding the assets certifies the required information. The limited scope audit exemption does not exempt the plan from the requirement to have an audit.[99]

A.58 The limited-scope audit exemption does not apply to assets held by a broker/dealer or an investment company. It also does not extend to benefit payment information [ref: DOL Reg. 29 CFR 2520.103-8; 2520.103-3; and 2520.103-4]. See paragraphs 7.47 and 13.25 through 13.28 for a discussion of the auditor's responsibilities when the scope of the audit is so restricted.

What to File (See Exhibit 3)

A.59 File Form 5500 annually for each plan required to file with 100 or more participants at the beginning of the plan year (see 29 CFR 2520.104a-5 and -6 and paragraphs A.29 through A.41 and A.61 through A.77).[100]

A.60 File Form 5500-C/R annually for each plan required to file with fewer than 100 participants at the beginning of the plan year (see 29 CFR 2520.104a-5 and -6, and paragraphs A.29 through A.41 and A.61 through A.77).

A.61 Exception to A.59 and A.60: If a plan has between 80 and 120 participants (inclusive) as of the beginning of the plan year, the plan may elect, instead of following paragraphs A.59 and A.60, to file the same Form (that is, either Form 5500 or 5500-C/R) that it filed the previous year (see 29 CFR 2520.104a-5 and paragraph A.65).

A.62 File Form 5500EZ, *Annual Return of One-Participant Pension Benefit Plan*, annually for certain one-participant plans. For Form 5500EZ purposes, a *one-participant plan* is a pension benefit plan that covers only (*a*) an individual, or an individual and his or her spouse, who wholly owns a trade or business, whether incorporated or unincorporated; or (*b*) partners and/or the spouses of partners in a partnership. See the instructions to the Form 5500EZ to determine which one-participant plans must file.

A.63 Amended reports should be filed as appropriate; however, they must include an original signature of the plan administrator.

A.64 A final report is required when all assets under a pension plan (including insurance/annuity contracts) have been distributed to the participants and beneficiaries or distributed to another plan or when all liabilities for which benefits may be paid under a welfare benefit plan have been satisfied and all assets, if the plan is not unfunded, have been distributed. A final report is filed on the Form 5500 Series.

Exemptions—Audit

A.65 Plans that file the Form 5500-C/R need not engage an auditor for purposes of the annual report. Plans filing the Form 5500 generally must engage an auditor (see paragraphs A.23, A.59, A.60, A.61, A.77, and 29 CFR 2520.104-41 and 2520.104-46).

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[99] This limitation on the scope of an auditor's examination applies to plans sponsored by a "regulated" bank or insurance carrier for its own employees, as well as to other plans.

[100] For reporting purposes, see definition of "participant" in the instructions to the Form 5500 Series.

A.66 Plan years of seven months or less, due to: (*1*) initial year; (*2*) merger; or (*3*) change of plan year can generally postpone (but not eliminate) the audit requirement (but not the requirement to file a Form 5500) until the following year. This rule also applies when a full plan year is followed by a short plan year of seven months or less. The audit report would therefore cover both the short year and the full plan year [ref: DOL Reg. 29 CFR 2520.104-50].

Exemptions—Other Filing Requirements

A.67 Plans that are filing in a short plan year may defer the IQPA's report (see 29 CFR 2520.104-50).

A.68 The following is a list of variances, which modify the general annual reporting requirements:

a. 29 CFR 2520.103-1(e) provides the regulatory authority for the reporting of financial information by plans participating in a master trust (see paragraph A.54).

b. 29 CFR 2520.103-3 and -4 provide exemptions for plans some or all the assets of which are held in a common/collective trust of a bank or similar institution or a pooled separate account of an insurance carrier from reporting information concerning the individual transactions of the common/collective trusts and pooled separate accounts provided the conditions of the regulation are satisfied (see paragraph A.53).

c. 29 CFR 2520.103-9 permits the direct filing of financial information to the DOL by banks and insurance companies of information otherwise required to be submitted to IRS with the Form 5500 or 5500-C/R when plans hold units of participation in common/collective trusts or pooled separate accounts (see paragraph A.53).

d. 29 CFR 2520.104-20 provides a limited exemption for certain small welfare plans (see paragraphs A.35 and A.60).

e. 29 CFR 2520.104-21 provides a limited exemption for certain group insurance arrangements.

f. 29 CFR 2520.104-22 provides an exemption for apprenticeship and training plans (see paragraph A.36).

g. 29 CFR 2520.104-23 provides an alternative method of compliance for pension plans for certain selected employees (see paragraph A.37).

h. 29 CFR 2520.104-24 provides an exemption for welfare plans for certain selected employees (see paragraph A.37).

i. 29 CFR 2520.104-25 provides an exemption for day-care centers (see paragraph A.38).

j. 29 CFR 2520.104-26 provides a limited exemption for certain dues-financed welfare plans maintained by employee organizations (see paragraph A.39).

k. 29 CFR 2520.104-27 provides a limited exemption for certain dues-financed pension plans maintained by employee organizations.

l. 29 CFR 2520.104-41 prescribes simplified annual reporting requirements for plans with fewer than 100 participants (see paragraph A.60).

m. 29 CFR 2520.104-43 provides an exemption from annual reporting requirements for certain group insurance arrangements (see paragraph A.40).

n. 29 CFR 2520.104-44 provides a limited exemption and alternative method of compliance for the annual report of certain unfunded and insured plans (see paragraphs A.57 through A.59).[101]

o. 29 CFR 2520.104-46 provides a waiver of examination and report of an auditor for plans with fewer than 100 participants (see paragraph A.60).

p. 29 CFR 2520.104-47 provides a limited exemption and alternative method of compliance for filing of insurance company financial reports (see section 103(e)).

q. 29 CFR 2520.104-48 provides an alternative method of compliance for Model Simplified Employee Pensions (see paragraph A.41).

r. 29 CFR 2520.104-49 provides an alternative method of compliance for certain simplified employee pensions (see paragraph A.41).

Schedules

A.69 Schedule A (Form 5500), *Insurance Information*, must be attached to Forms 5500 and 5500-C/R if any benefits under the plan are provided by an insurance company, insurance service, or other similar organization (such as Blue Cross, Blue Shield, or a health maintenance organization) (see paragraphs A.54, A.56, A.59, and A.60).

A.70 Schedule B (Form 5500), *Actuarial Information*, must be attached to Forms 5500, 5500-C/R, or 5500EZ for most defined benefit pension plans (see paragraphs A.59 and A.60).

A.71 Schedule C (Form 5500), *Service Provider and Trustee Information*, must be attached to Form 5500 and, when applicable, to master trust and 103-12 IE reports (see paragraphs A.54, A.56, A.59, and A.76).

A.72 *Schedule G, Financial Schedules*, will be required for reporting certain supplemental financial information for all plan years beginning on or after January 1, 1993 (see Exhibit A-1).

A.73 Schedule SSA (Form 5500), *Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits*, must be attached to Form 5500 and 5500-C/R if the plan had any separated participants that must be reported in accordance with the schedule SSA instructions (see paragraphs A.54, A.56, and A.59).

A.74 Schedule P (Form 5500), *Annual Return of Fiduciary of Employee Benefit Trust*, must be attached to Forms 5500, 5500-C/R, and 5500EZ for the plan year in which the trust year ends for any fiduciary (trustee or custodian) of an organization that is qualified under IRC section 401(a) and exempt from tax under IRC section 401(a) who wants to protect the organization under the statute of limitations provided in IRC section 6501(a) (see paragraphs A.59 through A.62).

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[101] For purposes of 29 CFR 2520.104-44, a contract is considered to be "allocated" only if the insurance company or organization that issued the contract unconditionally guarantees, upon receipt of the required premium or consideration, to provide a retirement benefit of a specified amount, without adjustment for fluctuations in the market value of the underlying assets of the company or organization, to each participant, and each participant has a legal right to such benefits that is legally enforceable directly against the insurance company or organization.

A.75 Additional separate schedules must be attached to Form 5500 or Form 5500-C/R only in accordance with the instructions to the form and must always clearly reference the item number that requires this information (see Exhibit A-1).

Termination of Accountant or Actuary

A.76 Terminations of certain service providers must be reported in Part III of Schedule C, which is attached only to the Form 5500, and when applicable, to master trust and 103-12 IE reports. In addition, the plan administrator is required to provide terminated accountants and actuaries with a copy of the explanation for the termination as reported on Schedule C and a notice stating that the terminated party has the opportunity to comment directly to the DOL concerning the explanation (see paragraphs A.59 and A.71).

103-12 IEs

A.77 If a plan's assets include assets of a 103-12 investment entity, the examination and report of an independent qualified public accountant required by 29 CFR 2520.103-1 need not extend to such assets, if the entity reports directly to DOL pursuant to 29 CFR 2520.103-12 and the instructions to the Form 5500 Series. Under 29 CFR 2520.103-12, the entity is required to include the report of an IQPA.

Independence of Independent Qualified Public Accountants

A.78 ERISA section 103(a)(3)(A) requires that the accountant retained by an employee benefit plan be "independent" for purposes of examining plan financial information and rendering an opinion on the financial statements and schedules required to be contained in the annual report. Under this authority DOL will not recognize any person as an auditor who is in fact not independent with respect to the employee benefit plan upon which that accountant renders an opinion in the annual report.

DOL has issued guidelines (29 CFR 2509.75-9) for determining when an auditor is independent for purposes of auditing and rendering an opinion on the annual report. For example, an accountant will not be considered independent with respect to a plan if—

a. During the period of professional engagement to examine the financial statements being reported, at the date of the opinion, or during the period covered by the financial statements the accountant or his or her firm or a member thereof—
   - Had, or was committed to acquire, any direct financial interest or any material indirect financial interest in the plan or plan sponsor;
   - Was connected as a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee of the plan or plan sponsor except that a firm will not be deemed not independent if a former officer or employee of the plan or plan sponsor is em-

ployed by the firm and such individual has completely disassociated himself or herself from the plan or plan sponsor and does not participate in auditing financial statements of the plan covering any period of his or her employment by the plan or plan sponsor.

b. An accountant or a member of an accounting firm maintains financial records for the employee benefit plan.

However, an auditor may permissibly engage in or have members of his or her firm engage in certain activities that will not have the effect of removing recognition of independence. For example, an accountant will not fail to be recognized as independent if—

c. At or during the period of his or her professional engagement the accountant or his or her firm is retained or engaged on a professional basis by the plan sponsor. However, the accountant must not violate the prohibitions in (*a*) and (*b*) preceding.

d. The rendering of services by an actuary associated with the accountant or his or her firm shall not impair the accountant's or the firm's independence. The auditor should ensure that the provision of these services complies with the prohibited transaction rules of ERISA section 406(a)(1)(c).

Penalties

A.79 ERISA and the IRC provide for the assessment or imposition of penalties for failures to comply with the reporting and disclosure requirements.

Annual Reporting Penalties

A.80 One or more of the following penalties may be imposed or assessed in the event of a failure or refusal to file reports in accordance with the statutory and regulatory requirements:

a. Up to $1,000 a day for each day a plan administrator fails or refuses to file a complete annual report (see ERISA section 502(c)(2) and 29 CFR 2560.502c-2).

Perfection Penalties for Deficient Filings

Presently the Department assesses penalties of; *(1)* $150 a day (up to $50,000) per annual report filing where the required auditor's report is missing; *(2)* $100 a day (up to $36,500) per annual report filing that contains deficient financial information (for example, missing required supplemental schedules); and *(3)* $10 a day (up to $3,650) for information required on the Form 5500 Series reports (i.e. failure to answer a question).

Non-Filer and Late Filer Penalties

Presently the Department assesses non-filer penalties of $300 per day, up to $30,000 per annual report, per year. Late filer penalties are assessed at $50 per day.

Egregious Penalties may be assessed in addition to other penalty amounts.

b. $25 a day (up to $15,000) for not filing returns for certain plans of deferred compensation, certain trusts and annuities, and bond purchase plans by the due dates(s) (see IRC section 6652(e)). This penalty also applies to returns required to be filed under IRC section 6039D.

c. $1 a day (up to $5,000) for each participant for whom a registration statement (Schedule SSA (Form 5500)) is required but not filed (see IRC section 6652(d)(1)).

d. $1 a day (up to $1,000) for not filing a notification of change of status of a plan (see IRC section 6652(d)(2)).

e. $1,000 for not filing an actuarial statement (see IRC section 6692).

These penalties may be waived or reduced if it is determined that there was reasonable cause for the failure to comply.

A.81 The following are other penalties:

a. Any individual who willfully violates any provision of Part 1 of Title I of ERISA shall be fined not more than $5,000 or imprisoned not more than one year or both (see ERISA section 501).

b. A penalty up to $10,000, five years imprisonment, or both, for making any false statement or representation of fact, knowing it to be false, or for knowingly concealing or not disclosing any fact required by ERISA (see section 1027, Title 18, U.S.C., as amended by ERISA section 111).

c. Any employer maintaining a plan who fails to meet the notice requirement of section 101(d) with respect to any participant or beneficiary may in the court's discretion be liable to such participant or beneficiary in the amount of up to $100 a day from the date of such failure, and the court may in its discretion order such other relief as it deems proper (see ERISA section 502(c)(3)).

d. Civil penalties may be assessed against parties in interest or disqualified persons who engage in prohibited transactions (see ERISA section 502(i). There is also an excise tax for prohibited transactions under IRC section 4975).

e. ERISA section 502(l) requires a civil penalty to be assessed by the Secretary of Labor against a fiduciary who breaches his or her fiduciary duty or commits a violation of Part 4 of Title I or any other person who knowingly participates in such breach or violation. The civil penalty is 20 percent of the amount recovered pursuant to a settlement agreement with the Secretary or ordered to be paid by a court.[102]

Fiduciary Responsibilities (ERISA Sections 401 Through 414)

A.82 ERISA establishes standards for plan investments and transactions and imposes restrictions and responsibilities on plan fiduciaries.

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[102] An accountant who knows about a fiduciary breach or violation but chooses not to disclose it may knowingly participate in a breach or violation for purposes of section 502(l).

A.83 A fiduciary's responsibilities include managing plan assets solely in the interest of participants and beneficiaries (with the care a prudent person would exercise) and diversifying investments to minimize the risk of large losses unless it is clearly not prudent to do so (see ERISA section 404). Plans are prohibited from acquiring or holding employer securities that are not qualifying employer securities (QES) or employer real property that is not qualifying employer real property (QERP). Furthermore, plans (other than certain individual account plans) may not acquire any QES or QERP if immediately after such acquisition the aggregate fair market value of QES and QERP held by the plan exceeds 10 percent of the assets of the plan (see ERISA section 407).

A.84 A plan fiduciary is prohibited from causing the plan to engage in certain transactions with a party in interest (see ERISA section 406).[103] The following transactions between a plan and a party in interest are generally prohibited (see ERISA section 406):

a. A sale, exchange, or lease of property, except to the extent allowed

b. A loan or other extension of credit

c. The furnishing of goods, services, or facilities, except as allowed under ERISA

d. A transfer of plan assets to a party in interest for the use or benefit of a party in interest

e. An acquisition of employer securities or real property, except to the extent allowed (see ERISA section 408(e))

However, conditional exemptions from the application of these provisions are provided by ERISA.

A.85 A fiduciary is also generally prohibited from using the plan assets for his or her own interest or account, acting in any plan transactions on behalf of a party whose interests are adverse to those of the plan or its participants, and receiving consideration for his or her own account from a party dealing with the plan in connection with a transaction involving the plan assets (see ERISA section 406(b)).

A.86 ERISA section 408 provides for exceptions to the rules on prohibited transactions. Section 408(a) gives authority to the Secretary of Labor to grant administrative exemptions from the prohibited transaction restrictions of ERISA sections 406 and 407. Sections 408(b), (c), and (e) provide statutory exemptions from the prohibited transaction rules for various transactions, provided the conditions specified in the statutory exemptions are satisfied. For example, reasonable arrangements can be made with a party in interest to provide services if the one who selects and negotiates with the service provider on behalf of the plan is independent of the service provider. Advice of legal counsel should be obtained when investigating a possible prohibited transaction or a possible breach of fiduciary duty.

A.87 A fiduciary must make good any losses to the plan resulting from a breach of fiduciary duty and must return to the plan any profits he or she made through the use of plan assets (see ERISA section 409).

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[103] ERISA defines a party in interest generally as any fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 50 percent or more of such an employer or employee association, or a relative of a person described in the foregoing (see ERISA section 3(14)).

Plan Termination Insurance

A.88 The insurance provisions under Title IV of ERISA, as amended, apply to qualified, defined benefit pension plans, with certain statutory exceptions, and do not apply to defined contribution plans (see ERISA section 4021).

A.89 The PBGC's termination insurance program is funded in part through premiums paid to the PBGC. The designated payor must make annual premium payments to the PBGC (see ERISA section 4007). For this purpose, the designated payor for a single employer plan is the contributing sponsor or the plan administrator. The designated payor for a multiemployer plan is the plan administrator. For single employer plans, premiums are based on the number of participants in a plan and the amount by which the plan's benefits are underfunded (see ERISA section 4006). Premiums for multiemployer plans are based solely on the number of participants in the plan. In general, premiums may be paid by the contributing sponsor or by plan funds, whichever is permitted under the terms of the plan; however, premiums for a plan that is undergoing a distress termination or an involuntary termination must be paid by the contributing sponsor (see 29 CFR 2610.26). Each member of the contributing sponsor's controlled group, if any, is jointly and severally liable for the required premiums (see ERISA section 4007).

A.90 A plan administrator or contributing sponsor must notify the PBGC when a "reportable event" such as bankruptcy of the contributing sponsor or inability of the plan to pay benefits occurs (see ERISA sections 4041(c) and 4043; 29 CFR Part 2615). Each person who is a contributing sponsor of a single employer pension plan is responsible for quarterly contributions required to meet the minimum funding standards (see ERISA section 302(e)). If the contributing sponsor is a member of a controlled group, each person who is also a member of the controlled group is jointly and severally liable for the contributions (see ERISA section 302(c)(11)). Failure to make the required contributions may result in a lien upon all property and property rights belonging to such persons, which lien may be enforced by the PBGC. ERISA provides for two types of single employer plan terminations: a standard termination and a distress termination (ERISA section 4041). A plan may be terminated voluntarily in a standard termination only if it can pay all benefit liabilities under the plan. A plan may be terminated in a distress termination only if the contributing sponsor and each member of the contributing sponsor's controlled group meet the necessary distress criteria (for example, undergoing liquidation). In either type of termination, an enrolled actuary's certification of the value of the plan's assets and benefits must be filed with the PBGC. When an underfunded single employer plan terminates in a distress termination, the contributing sponsor and each member of the contributing sponsor's controlled group are liable to the PBGC for the total amount of unfunded benefit liabilities and the total amount of unpaid minimum funding contributions and applicable interest (see ERISA section 4062). If an employer that contributes to a multiemployer plan withdraws from the plan in a complete or partial withdrawal, the employer is generally liable to the plan for an allocable share of the unfunded vested benefits of the plan (see ERISA section 4201).

Administration and Enforcement (ERISA Sections 501 Through 514)

A.91 Responsibility for administration of ERISA and enforcement of its provisions rests primarily with the IRS and the DOL. The agencies are empowered to bring suit in federal court in civil actions, criminal actions, or both.

A.92 Failure to meet ERISA's requirements can result in the imposition of substantial fines, excise taxes, and other penalties, including possible loss of tax-exempt status. Although ERISA states that the plan is subject to certain of the penalties, the penalties are likely to fall not on the plan but on the sponsoring employer because Congress, in formulating ERISA, sought to protect plan assets for participants and their beneficiaries, not to protect employers from liability (see paragraphs A.80 and A.81).

A.93 ERISA was intended to generally supersede state laws relating to employee benefit plans. Thus, plans subject to Title I of ERISA or Title IV of ERISA are generally not subject to state regulation. Preemption of state laws does not extend, however, to generally applicable criminal statutes or laws regulating insurance, banking, or securities.

A.94 Plans that are multiple employer welfare arrangements (MEWAs) may also be subject to state or local regulation even if the MEWA is also an employee benefit plan covered under Title I of ERISA. A MEWA is any employee welfare benefit plan or other arrangement that provides benefits to the employees of two or more employers but does not include arrangements maintained under or pursuant to one or more collective bargaining agreements, by a rural electric cooperative, or by two or more trades or businesses within the same control group (see ERISA section 3(40)). If the MEWA is a fully insured plan covered by Title I of ERISA, the state government may only provide standards requiring specified levels of reserves and specified levels of contributions adequate to be able to pay benefits in full when due. If the MEWA is a plan covered by Title I that is not fully insured, any law of a state regulating insurance may apply to the extent that it is not inconsistent with the provisions of Title I of ERISA.

Exhibit A-1

Examples of Form 5500 Schedules

Required By the Regulations

[Not Permitted If Filing By the Statutory Method]

The following schedule is the "Schedule of Assets Held for Investment Purposes." In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. The schedule must be clearly labeled, "Item 27a—Schedule of Assets Held for Investment Purposes."

(a)	(b) Identity of issue, borrower, lessor or similar party	(c) Description of investment including maturity date, rate of interest, collateral, par, or maturity value	(d) Cost	(e) Current value

Note: Participant loans may be aggregated and presented with a general description of terms and interest rates.

The following schedule of investment assets which were both acquired and disposed of within the plan year (see 2520.103-11) is the "Schedule of Assets Held for Investment Purposes." The schedule must be clearly labeled, "Item 27a—Schedule of Assets Held for Investment Purposes Which Were Both Acquired and Disposed of Within the Plan Year."

(a) Identity of issue, borrower, lessor or similar party	(b) Description of investment including maturity date, rate of interest, collateral, par, or maturity value	(c) Costs of acquisitions	(d) Proceeds of dispositions

The following schedule is the "Schedule of Loans or Fixed Income Obligations." In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. Include all loans that were renegotiated during the plan year. Also, explain what steps have been taken or will be taken to collect overdue amounts for each loan listed. The schedule must be clearly labeled, "Item 27b—Schedule of Loans or Fixed Income Obligations."

(a)	(b) Identity and address of obligor	(c) Original amount of loan	Amount received during reporting year		(f) Unpaid balance at end of year	(g) Detailed description of loan including dates of making and maturity, interest rate, the type and value of collateral, any renegotiation of the loan and the terms of the renegotiation and other material items	Amount overdue	
			(d) Principal	(e) Interest			(h) Principal	(i) Interest

**Cost* or *Cost of Asset* for the item 27a, 27d, 27e and 27f schedules refers to the original or acquisition cost of the asset.

***Current Value* means fair market value where available. Otherwise, it means the fair value as determined in good faith under the terms of the plan by a trustee or a named fiduciary, assuming an orderly liquidation at the time of the determination.

The following schedule is the "Schedule of Leases in Default or Classified as Uncollectible." In column (a), place an asterisk (*) on the line of each identified person known to be a party in interest to the plan. The schedule must be clearly labeled, "Item 27c—Schedule of Leases in Default or Classified as Uncollectible."

(a)	(b) Identity of lessor/lessee	(c) Relationship to plan, employer, employee organization or other party-in-interest	(d) Terms and description (type of property, location and date it was purchased, terms regarding rent, taxes, insurance, repairs, expenses, renewal options, date property was leased)	(e) Original cost	(f) Current value at time of Lease	(g) Gross rental receipts during the plan year	(h) Expenses paid during the plan year	(i) Net Receipts	(j) Amount in arrears

The following schedule is the "Schedule of Reportable (5%) Transactions." The schedule must be clearly labeled, "Item 27d—Schedule of Reportable Transactions."

(a) Identity of party involved	(b) Description of asset (include interest rate and maturity in case of a loan)	(c) Purchase price	(d) Selling price	(e) Lease rental	(f) Expense incurred with transaction	(g) Cost of asset	(h) Current value of asset on transaction date	(i) Net gain or (loss)

This schedule is the "Schedule of Non-Exempt Transactions." The schedules must be clearly labeled as appropriate—"Item 27e—Schedule of Nonexempt Transactions" and/or "Item 27f—Schedule of Nonexempt Transactions."

(a) Identity of party involved	(b) Relationship to plan, employer or other party-in-interest	(c) Description of transactions including maturity date, rate of interest, collateral, par or maturity value	(d) Purchase price	(e) Selling price	(f) Lease rental	(g) Expenses incurred in connection with transaction	(h) Cost of asset	(i) Current value of asset	(j) Net gain or (loss) on each transaction

Exhibit A-2

Pension and Welfare Benefit Admin., Labor **Part 2520**

SUBCHAPTER C—REPORTING AND DISCLOSURE UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2520—RULES AND REGULATIONS FOR REPORTING AND DISCLOSURE

Subpart A—General Reporting and Disclosure Requirements

Subpart B—Contents of Plan Descriptions and Summary Plan Descriptions

Subpart C—Annual Report Requirements

Subpart D—Provisions Applicable to Both Reporting and Disclosure Requirements

§ 2520.101-1

Authority: Secs. 101, 102, 103, 104, 105, 109, 110, 111(b)(2), 111(c), and 505, Pub. L. 93-406, 88 Stat. 840-52 and 894 (29 U.S.C. 1021-25, 1029-31, and 1135); Secretary of Labor's Order No. 27-74, 13-76, 1-87, and Labor Management Services Administration Order No. 2-6.

Exhibit A-3

Reporting and Disclosure Requirements (See Notes 1,2,3)

U.S. Department of Labor
Pension and Welfare Benefits Administration

Forms	Pension Plans... ...with 100 or more participants	Pension Plans... ...with fewer than 100 participants	Welfare Plans... ...with 100 or more participants	Welfare Plans... ...with fewer than 100 participants which are not: (1) Fully insured, (2) Unfunded or (3) Combination of insured and unfunded.
Summary Plan Description (Or amended if SPD already furnished) *	DOL - **Initial** - SPD within 120 days after plan is subject to ERISA. **Amended** - A summary of material modification or updated SPD is due 210 days after end of plan year in which a change was made or the SPD was updated.	DOL - **Initial** - SPD within 120 days after plan is subject to ERISA. **Amended** - A summary of material modification or updated SPD is due 210 days after end of plan year in which a change was made or the SPD was updated.	**DOL** - **Initial** - SPD within 120 days after plan is subject to ERISA. **Amended** - A summary of material modification or updated SPD is due 210 days after end of plan year in which a change was made or the SPD was updated.	DOL - **Initial** - SPD within 120 days after plan is subject to ERISA. **Amended** - A summary of material modification or updated SPD is due 210 days after end of plan year in which a change was made or the SPD was updated.
Annual Return/Report Form 5500 (See Note 2)	**IRS** - By last day of the 7th month after end of plan year. Final Report - to IRS 7 months after final distribution of assets.		**IRS** - By last day of the 7th month after end of plan year. Final Report - to IRS 7 months after final distribution of assets.	
Annual Return/Report Form 5500-C ** (See Note 2)		**IRS** - By the last day of the month after end of plan year. Final Report - to IRS 7 months after final distribution of assets.		**IRS** - By the last day of the month after end of plan year. Final Report - to IRS 7 months after final distribution of assets.
Registration Statement Form 5500-R (See Note 2)		**IRS** - By the last day of the 7th month after end of plan year for which Form 5500-C is not required to be filed.		**IRS** - By the last day of the 7th month after end of plan year for which Form 5500-C is not required to be filed.
Schedule A Insurance Information	**IRS** - For insured plans, filed with Form 5500.	**IRS** - For insured plans, filed with Form 5500 - C/R.	**IRS** - For insured plans, filed with Form 5500.	**IRS** - For insured plans, filed with Form 5500 - C/R.
Schedule B Actuarial Information	**IRS** - If subject to minimum funding standards, filed with Form 5500.	**IRS** - If subject to minimum funding standards, filed with Forms 5500-C/R.		
Schedule C Trustee/Service Provider Information	**IRS** - For service provider, trustee and termination information, filed with Form 5500.		**IRS** - For service provider, trustee and termination information, filed with Form 5500.	
Schedule SSA Identification of Separated Participants with Deferred Vested Benefits	**IRS** - If plan has participants with deferred vested benefits separated during plan year filed with Form 5500.	**IRS** - If plan has participants with deferred vested benefits separated during plan year filed with Forms 5500-C/R.		
Summary Annual Report (Not required to be filed with the DOL)	**Participants** (or beneficiary) - 9 months after end of plan year.	**Participants** (or beneficiary) - 9 months after end of plan year. ***	**Participants** (or beneficiary) - 9 months after end of plan year.	**Participants** (or beneficiary) - 9 months after end of plan year.
PBGC-1 Annual Premium Filing	**PBGC** - For defined benefit plans, premiums are due no later than 7 months after close of prior plan year.	**PBGC** - For defined benefit plans, premiums are due no later than 7 months after close of prior plan year.		
Notice of Reportable Event or Intent to Terminate	**PBGC** - For defined benefit plans, file some reportable events within 30 days of the occurrence. File other events on Form 5500. For intent to terminate, file at least 10 days before the proposed termination date.	**PBGC** - For defined benefit plans, file some reportable events within 30 days of the occurrence. File other events on Form 5500. For intent to terminate, file at least 10 days before the proposed termination date.		

NOTE 1: Certain categories of plans have been exempted from most or all of the reporting and disclosure requirements, while other plans meeting certain conditions are exempted from some of the requirements. Administrators should refer to the applicable section published in Title 29, Part 2520 - Rules and regulations for Reporting and Disclosure. These plans include: apprenticeship plans - section 2520.104-22, pension and welfare plans for certain selected employees - sections 2520.104-23 and 2520.104-24, certain dues financed pension and welfare plans - sections 2520.104-27 and 2520.104-26; welfare plans participating in certain group insurance arrangements - sections 2520.104-21 and 2520.104-43; certain unfunded welfare plans - section 2520.104-20 and certain simplified employee pension plans - sections 2520.104-48 and 2520.104-49.

NOTE 2: If the plan has between 80 and 120 participants (inclusive) at the beginning of the plan year, the plan administrator may file the same type of form that was filed in the previous year. Such forms can be Form 5500 or Form 5500 - C/R, whichever applies.

NOTE 3: For Annual Return of One-Participant Pension Plan Return file Form 5500 EZ with the IRS by the last day of the 7th month after the end of the plan year.

KEY

DOL	Department of Labor
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation

* **Participants & Beneficiaries only - Initial** - SPD within 120 days after plan is subject to ERISA. New Participants within 90 days after becoming covered by the plan. **Amended** - A summary of material modification or updated SPD is due 210 days after end of plan year in which a change was made or the SPD was updated.

** The form 5500-C must be filed A) The initial plan year (the year the plan begins), B) The year a final report would be filed; C) At least once every 3 years with the Form 5500-R filed for each plan year in which the 5500-C is not filed. See the instructions to the appropriate forms under the heading "What to File".

*** These plans must either distribute Form 5500-R in place of the existing SAR for the years they file that form or post and/or distribute a notice of its availability. See DOL regulations 2520.104b-1 and 2520.104-10(b).

Exhibit A-4

Special Rules

"Plan Assets"—Plan Investments

DOL Regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than common or collective trusts, pooled separate accounts, and master trusts), the underlying assets of which include "plan assets" (within the meaning of DOL Reg. 29 CFR 2510.3-101) of two or more plans that are not members of a "related group" of employee benefit plans. For reporting purposes, these investment entities (commonly referred to as 103-12 Investment Entities) are required to provide certain information directly to DOL for the fiscal year of the entity ending with or within the plan year for which the plan's annual report is made. This information includes the report of an independent qualified public accountant regarding the *statements* and *schedules* described in DOL Reg. 29 CFR 2520.103-12(b)(2)-(5), which meets the requirements of DOL Reg. 29 CFR 2520.103-1(b)(5).

Fringe Benefit Plans

Fringe benefit plans are employer-sponsored arrangements required to file the information specified by IRC section 6039D in accordance with the instructions to the Form 5500 or 5500-C/R (see footnote 77). It should be noted that fringe benefit plans may also be welfare benefit plans required to file annual reports under Title I of ERISA.

Welfare Benefit Plans

Under ERISA, according to DOL Regulation 29 CFR 2510.3-1, a welfare plan provides medical, surgical, or hospital benefits, or benefits in event of sickness, accident, disability, death, or unemployment, or vacation benefits, apprenticeship or training programs, or day-care centers (distinct from dependent care assistance programs), scholarship funds, prepaid legal services and certain benefits under the Labor Management Relations Act of 1947. Plan sponsors have a great degree of discretion regarding the number of benefits provided through one welfare benefit plan.

Appendix B

Examples of Internal Control Structure Policies and Procedures

B.01 This appendix provides examples of selected internal control structure policies and procedures for employee benefit plans. The policies and procedures included are related to specific control objectives that may be relevant to an audit of a plan's financial statements, and, accordingly, control procedures concerning the effectiveness, economy, and efficiency of certain management decision-making processes are not included. The examples are not intended to be all-inclusive or to suggest the specific objectives, policies, and procedures that should necessarily be adopted by employee benefit plans. Some of the illustrated control objectives may not be relevant to particular plans because of the type of plan or the absence of certain types of transactions.

B.02 The examples relate to two control objectives: reliability of financial records and safeguarding of assets. Some of the examples may serve to achieve more than one objective, but each example is listed in only one place.

Exhibit B-1

Investments: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Investment transactions are recorded at the appropriate amounts and in the appropriate periods on a timely basis.	• Reports submitted by trustees or investment management are reviewed. • Detailed subsidiary records are reconciled to the general ledger on a regular basis. • Report of trustee's independent auditor is reviewed.
Investment income and expenses are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Commissions and management fees are reviewed for appropriateness and adherence to the contract. • Interest, dividends, and other sources of income, including securities lending fees, are reviewed for receipt and for accuracy by reference to reliable sources.
Investments (other than contracts with insurance companies) are measured at fair value.	• Quotation sources and appraisal reports are compared with recorded values. • Valuation methods are documented in the trust agreement or plan committee minutes. • Basis for "good faith" estimates including independent appraisals, if any, is documented. • "Good faith" estimates are approved by plan committee.
Premiums and interest relating to insurance contracts are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Premium statements are compared with insurance contracts. • Interest amount calculation is tested. • List of current participants is reviewed.

Exhibit B-2

Investments: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Investment criteria and objectives are authorized, and investment strategies are executed in accordance with formal authorizations.	• Investment criteria or objectives are documented in the plan instrument or plan committee minutes. • Authority to execute transactions is specified in the plan instrument or plan committee minutes. • Investment transactions are reviewed by a plan committee for adherence to investment guidelines.
Investment assets are protected from loss or misappropriation.	• Responsibility for investment decisions and transactions is segregated from custodian's functions. • Financial stability of financial institutions holding investments is reviewed. • Securities that are physically held (e.g., by a custodian or depository) are periodically counted or otherwise verified. • Written-off investments are reviewed for possible appreciation. • Documents are controlled in a limited-access, fireproof area. • Securities held by independent custodians are confirmed.
Obligations under insurance companies' insurance contracts can be met.	• Financial statements of insurance companies are reviewed. • Rating bureau reports are reviewed.
For deposits with insurance companies, terms of insurance contracts are authorized.	• Terms are specified in the plan instrument. • Modifications of contracts are approved by the plan committee.

Exhibit B-3

Contributions Received and Related Receivables: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Amounts of contributions by employers and participants meet authorized or required amounts.	• Contribution requirements or limitations are described in the plan instrument or collective bargaining agreement. • Contributions are determined using approved eligibility lists. • Actuary is used to make periodic valuations and reports.
Contributions are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Sponsor or employer payroll records are compared with contribution calculations. In the case of multiemployer plans, some form of periodic payroll audit is performed. • Initial controls are established over contribution records for both employer and participant contributions (e.g., salary reduction amounts). • Clerical accuracy of contribution forms is checked. • Subsidiary contribution records are reconciled to the general ledger. • Contribution forms are reconciled to cash receipts ledger and bank deposits. • Control totals for contributions withheld from participant records are maintained. • Contribution receipts are issued to participants containing notices requesting reviews of discrepancies.
Loans receivable from plan participants and related interest income are properly reported.	• Loans are made only with proper authorization based on guidelines reflecting, for example, adherence to rules regarding prohibited transactions. • Entries to detailed loan records are reconciled with cash disbursements and receipts records. • Interest income is calculated periodically and properly accrued. • Detailed records are reconciled with general ledger accounts. • Records are reviewed periodically for past-due amounts.

Exhibit B-4

Contributions Received and Related Receivables: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Access to cash receipts, cash receipts records, and contribution records is suitably controlled to prevent or detect within a timely period the interception of unrecorded cash receipts or the abstraction of recorded cash receipts.	• Cash is independently controlled upon receipt. • Cash receipts are deposited intact daily. • Checks are restrictively endorsed upon receipt. • Responsibility for receiving and processing contributions is adequately segregated. • Bank accounts are reconciled monthly. • Past-due contributions are investigated on a timely basis.

Exhibit B-5

Benefit Payments: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Benefit payments are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Benefit calculations supporting payments are checked for clerical accuracy. • Benefits payable outstanding for a long period are investigated. • Initial controls are established over benefit applications. • Benefit amounts are compared with plan or insurance company records. • Control totals for monthly pension benefits are maintained. • Participants or beneficiaries are notified of their right to have denied claims reviewed.

Exhibit B-6

Benefit Payments: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Benefit payments are determined and authorized in accordance with the plan instrument.	• Changes in participant eligibility are approved by the plan committee. • Eligibility lists are approved. • Signed benefit application forms are used. • Benefit applications that provide for review of eligibility, benefit amounts, or plan compliance require approval.
Participant's benefit and cash disbursement records are controlled to prevent or detect on a timely basis unauthorized or duplicate payments.	• Responsibilities for benefit approval, recording of benefits, and maintenance of participant files are adequately segregated. • Blank forms are prenumbered and effectively controlled. • Periodic correspondence with retired beneficiaries is maintained, and correspondence or benefit payments are returnable to plan committee if undeliverable. • Benefit check endoresements are compared with signature in applicable participant records. • Supporting documents are effectively canceled on payment.

Exhibit B-7

Participant Data and Plan Obligations: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Participant data are properly recorded on a timely basis.	• Enrollment applications are numerically controlled and are maintained for future reference. • The number of plan participants is reconciled using enrollment forms. • Subsidiary records are maintained for participants who are active, retired, or terminated with vested benefits. • Participants' subsidiary records are reconciled with general ledger. • Participant data are updated and reconciled to employer's personnel and payroll records before being sent to actuary.
Actuarial valuation of accumulated benefits reflects the understanding and agreement of the plan committee or responsible officials.	• Plan committee or responsible officials discuss with the actuary the actuarial methods and significant assumptions that are the basis for actuarial calculations.
Accumulated benefit amounts and other actuarially determined information are determined periodically and recorded in the plan's records at the appropriate amounts.	• Valuation report prepared by an enrolled actuary is reviewed. • Participant data in the actuary's valuation report are reconciled with the participants' subsidiary records.

Exhibit B-8

Participant Data and Plan Obligations: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Participant eligibility is determined in accordance with authorization.	• Eligibility is defined in the plan instrument. • Enrollment applications are reviewed by the plan committee or a responsible official.
Employees are notified of their eligibility.	• Procedures for identifying and contacting eligible employees are established. • Employee participation refusals are retained for future reference. • Benefit data are furnished to participants on written request.
Access to participants' data is controlled to prevent unauthorized changes or additions.	• Maintenance of participant data is segregated from responsibility for benefit approval or processing. • In the case of multiemployer plans, participant data on a sample basis are updated and reconciled to the contributing employer's personnel and payroll records during the course of a payroll audit.

Exhibit B-9

Administrative Expenses: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Administrative expenses are recorded at the appropriate amount and in the appropriate period on a timely basis.	• Expenses are compared to contracts and to disbursements. • If expenses are allocated to more than one plan, allocation methods and calculations are reviewed.

Exhibit B-10

Administrative Expenses: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Types of administrative services to be offered are authorized.	● Administrative services are described in the plan instrument. ● Expenses are approved by a responsible official.
Access to accounts payable and cash disbursements records is controlled to prevent or detect on a timely basis unauthorized or duplicate payments.	● Responsibilities for expense approval and processing are adequately segregated. ● Supporting documents are effectively canceled on payment.

Exhibit B-11

Reporting: Reliability of Financial Records

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Accounting records are maintained in sufficient detail to provide for proper accountability.	• Subsidiary ledgers are reconciled with the general ledger on a periodic and timely basis. • Procedures are established to identify required disclosure items, for example, party in interest transactions and transactions in excess of 5 percent of plan assets.
Financial statements' actuarial information and disclosures are prepared in conformity with management's authorization.	• Accumulating information for disclosure in accordance with the rules and regulations of appropriate authorities. • Review of all financial reports and filings. • Written representations on financial matters are obtained from actuaries, banks, insurance companies, and others. • Plan committee reviews presentation of, and disclosures in, financial reports.
Journal entries made are authorized.	• Journal entries are adequately approved by a responsible official.
Accounting policies, including selections from among alternative principles, are adopted as authorized.	• Responsibility is assigned for approval of accounting policies.

Exhibit B-12

Reporting: Safeguarding of Assets

Specific Objectives	*Examples of Selected Control Policies and Procedures*
Direct and indirect access to the plan's records is controlled to protect against physical hazards and to prevent or detect on a timely basis unauthorized entries.	● Critical forms are prenumbered and controlled before and after issuance. ● Record files are maintained in a controlled area with a suitable retention program. ● Information pertinent to plan activities is identified and prepared for analysis.

Appendix C

Excerpt From FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans

This appendix reproduces the standards of financial accounting and reporting by defined benefit pension plans from paragraphs 1 through 30 of FASB Statement No. 35. These standards are presented for the convenience of readers of this audit guide. A thorough understanding of these standards requires a reading of the entire statement, including its appendix B, "Basis for Conclusions," and its appendix D, "Illustration of Financial Statements." (The latter is reproduced, with revisions, in appendix D of this guide.) The complete statement is available from the Financial Accounting Standards Board.

Statement of Financial Accounting Standards No. 35 †

Accounting and Reporting by Defined Benefit Pension Plans

March 1980

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for the annual financial statements of a **defined benefit pension plan** (pension plan or plan).* Plans covered are those that principally provide **pension benefits** but may also provide **benefits** on death, disability, or termination of employment.

2. This Statement applies to an ongoing plan that provides pension benefits for the **employees** of one or more employers, including state and local governments, or for the members of a trade or other employee association. Such a plan may have no intermediary **funding agency** or it may be financed through one or more trust funds, one or more contracts with insurance companies, or a combination thereof. This Statement applies to plans that are subject to the provisions of the Employee Retirement Income Security Act of 1974 (**ERISA** or the **Act**) as well as to those that are not. It is not intended to apply to a plan that is expected to be terminated, nor to a government-sponsored social security plan. This Statement does not require the preparation, distribution, or attestation of any plan's financial statements (paragraph 51).

3. Standards of financial accounting and reporting for defined benefit pension plans are presented in paragraphs 4-30. Background information for this Statement is presented in appendix A. The basis for the Board's conclusions, as well as alternatives considered and reasons for their rejection, are discussed in appendix B. Illustrations of certain applications of the requirements of this Statement appear in Appendixes E and F.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Existing Generally Accepted Accounting Principles

4. Existing generally accepted accounting principles other than those discussed in this Statement may apply to the financial statements of defined benefit pension plans. The financial accounting standards discussed in this Statement are those of particular importance to pension plans or that differ from existing generally accepted accounting principles for other types of entities.

Primary Objective of Plan Financial Statements

5. The primary objective of a pension plan's financial statements is to provide financial information that is useful in assessing the plan's present and future

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* Terms defined in the Glossary (appendix D) are in boldface type the first time they appear in this Statement.

ability to pay benefits when due.[1] To accomplish that objective, a plan's financial statements should provide information about (a) plan resources and how the stewardship responsibility for those resources has been discharged, (b) the **accumulated plan benefits** of **participants,** (c) the results of transactions and events that affect the information regarding those resources and benefits, and (d) other factors necessary for users to understand the information provided.

Financial Statements

6. The annual financial statements of a plan shall include:

a. A statement that includes information regarding the **net assets available for benefits** as of the end of the plan year

b. A statement that includes information regarding the changes during the year in the net assets available for benefits

c. Information regarding the **actuarial present value of accumulated plan benefits** as of either the beginning[2] or end of the plan year

d. Information regarding the effects, if significant, of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits.

7. The primary objective set forth in paragraph 5 is satisfied only if (a) information regarding both the net assets available for benefits and the actuarial present value of accumulated plan benefits is presented as of the same date and (b) information regarding both the changes in net assets available for benefits and the changes in the actuarial present value of accumulated plan benefits is presented for the same period. Therefore, if the **benefit information date** pursuant to paragraph 6(c) is the beginning of the year, a statement that includes information regarding the net assets available for benefits as of that date and a statement that includes information regarding the changes during the preceding year in the net assets available for benefits shall also be presented. Use of an end-of-year benefit information date is considered preferable. Plans are encouraged to develop procedures to enable them to use that date (paragraph 29).

8. The Board believes it is desirable to allow certain flexibility in presenting the information regarding the actuarial present value of accumulated plan benefits and the year-to-year changes therein. Therefore, either or both of those categories of information may be presented on the face of one or more financial statements or in notes thereto. Regardless of the format selected, each category of information shall be presented in its entirety in the same location. If a statement format is selected for either category, a separate statement may be used to present that information or, provided the information is as of the same date or for the same period, that information may be presented together with information regarding the net assets available for benefits and the year-to-year changes therein.

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[1] The Board recognizes that (a) information in addition to that contained in a plan's financial statements is needed in assessing the plan's present and future ability to pay benefits when due and (b) financial statements for several plan years can provide information more useful in assessing the plan's future ability to pay benefits than can the financial statements for a single plan year (paragraphs 58-63).

[2] Financial information presented as of the beginning of the year shall be the amounts as of the end of the preceding year.

Net Assets Available for Benefits

9. The accrual basis of accounting[3] shall be used in preparing information regarding the net assets available for benefits. The information shall be presented in such reasonable detail as is necessary to identify the plan's resources that are available for benefits.

Contributions Receivable

10. Contributions receivable are the amounts due as of the **reporting date** to the plan from the employer(s), participants, and other sources of funding (for example, state subsidies or federal grants—which shall be separately identified). Amounts due include those pursuant to formal commitments as well as legal or contractual requirements. With respect to an employer's contributions, evidence of a formal commitment may include (a) a resolution by the employer's governing body approving a specified contribution, (b) a consistent pattern of making payments after the plan's year-end pursuant to an established **funding policy** that attributes such subsequent payments to the preceding plan year, (c) a deduction of a contribution for federal tax purposes for periods ending on or before the reporting date, or (d) the employer's recognition as of the reporting date of a contribution payable to the plan.[4]

Investments

11. Plan investments, whether equity or debt securities, real estate, or other (excluding contracts with insurance companies) shall be presented at their fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is not an active market for an investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved.[5]

12. Contracts with insurance companies shall be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA.[6] A plan not subject to ERISA shall similarly present its contracts with insurance companies, that is, as if the plan were subject to the reporting requirements of ERISA.

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[3] The accrual basis requires that purchases and sales of securities be recorded on a trade-date basis. However, if the settlement date is after the reporting date and (a) the fair value of securities purchased or sold just before the reporting date does not change significantly from the trade date to the reporting date, and (b) the purchases or sales do not significantly affect the composition of the plan's assets available for benefits, accounting on a settlement-date basis for such sales and purchases is acceptable.

[4] The existence of accrued pension costs does not, by itself, provide sufficient support for recognition of a contribution receivable (paragraph 92).

[5] For an indication of factors to be considered in determining the discount rate, see paragraphs 13 and 14 of APB Opinion No. 21, *Interest on Receivables and Payables*. If significant, the fair value of an investment shall reflect the brokerage commissions and other costs normally incurred in a sale.

[6] For 1979 plan years, the pertinent governmental reporting requirements relate to item 13 of either Form 5500 or Form 5500-C.

13. Information regarding a plan's investments shall be presented in enough detail to identify the types of investments and shall indicate whether reported fair values have been measured by quoted prices in an active market or are fair values otherwise determined. (Paragraphs 28(g) and 28(h) require certain additional disclosures related to investments.)

Operating Assets

14. Plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) shall be presented at cost less accumulated depreciation or amortization.

Changes in Net Assets Available for Benefits

15. Information regarding changes in net assets available for benefits shall be presented in enough detail to identify the significant changes during the year. Minimum disclosure shall include:

a. The net appreciation (depreciation)[7] in fair value for each significant class of investments, segregated between investments whose fair values have been measured by quoted prices in an active market and those whose fair values have been otherwise determined

b. Investment income (exclusive of (a) above)

c. Contributions from the employer(s), segregated between cash and noncash contributions[8]

d. Contributions from participants, including those transmitted by the **sponsor**

e. Contributions from other identified sources (for example, state subsidies or federal grants)

f. Benefits paid to participants

g. Payments to insurance companies to purchase contracts that are excluded from plan assets[9]

h. Administrative expenses.

Actuarial Present Value of Accumulated Plan Benefits

16. Accumulated plan benefits are those future benefit payments that are attributable under the plan's provisions to employees' **service** rendered to the benefit information date. Accumulated plan benefits comprise benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of deceased employees, and (c) present employees or their beneficiaries.

17. To the extent possible, plan provisions shall apply in measuring accumulated plan benefits. In some plans, benefits are a specified amount for each year of service. Even if a plan does not specify a benefit for each year of service, another of its provisions (for example, a provision applicable to terminated employees or to termination of the plan—if independent of funding patterns) may indicate how to measure accumulated plan benefits. If the benefit for each

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[7] Realized gains and losses on investments that were both bought and sold during the year shall be included.

[8] A noncash contribution shall be recorded at fair value. The nature of noncash contributions shall be described, either parenthetically or in a note.

[9] Paragraph 28(e) requires disclosure of the plan's dividend income related to excluded contracts and permits that income to be netted against item (g).

year of service is not stated by or clearly determinable from the provisions of the plan, the benefit shall be considered to accumulate in proportion to (a) the ratio of the number of years of service completed to the benefit information date to the number that will have been completed when the benefit will first be fully vested, if the type of benefit is includable in **vested benefits** (for example, a supplemental early retirement benefit that is a vested benefit after a stated number of years of service), or (b) the ratio of completed years of service to projected years of service upon anticipated separation from covered employment, if the type of benefit is not includable in vested benefits (for example, a death or disability benefit that is payable only if death or disability occurs during active service).

18. In measuring accumulated plan benefits, the following shall apply:

a. Except as indicated in (b) and (c) below, accumulated plan benefits shall be based on employees' history of pay and service and other appropriate factors as of the benefit information date.[10]

b. Projected years of service shall be a factor only in determining employees' expected eligibility for particular benefits, such as:

i. Increased benefits that are granted provided a specified number of years of service are rendered (for example, a pension benefit that is increased from $9 per month to $10 per month for each year of service if 20 or more years of service are rendered)

ii. Early retirement benefits

iii. Death benefits

iv. Disability benefits.

c. Automatic benefit increases specified by the plan (for example, automatic cost-of-living increases) that are expected to occur after the benefit information date shall be recognized.

d. Benefits to be provided by means of contracts excluded from plan assets for which payments to the insurance company have been made shall be excluded.

e. Plan amendments adopted after the benefit information date shall not be recognized.

f. If it is necessary to take future compensation into account in the determination of Social Security benefits, employees' compensation as of the benefit information date shall be assumed to remain unchanged during their assumed future service. Increases in the wage base or benefit level pursuant to either the existing Social Security law or possible future amendments of the law shall not be recognized.

19. The actuarial present value of accumulated plan benefits is that amount as of the benefit information date that results from applying actuarial assumptions to the benefit amounts determined pursuant to paragraphs 16-18, with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

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[10] An example of the application of paragraphs 18(a) and 18(b) appears in Appendix E.

20. An assumption of an ongoing plan shall underlie the other assumptions used in determining the actuarial present value of accumulated plan benefits. Every other significant assumption used in that determination and disclosed pursuant to paragraph 27(b) shall reflect the best estimate of the plan's future experience solely with respect to that individual assumption. As to certain assumptions, the following shall apply:

a. Assumed rates of return shall reflect the expected rates of return during the periods for which payment of benefits is deferred and shall be consistent with returns realistically achievable on the types of assets held by the plan and the plan's investment policy. To the extent that assumed rates of return are based on values of existing plan assets, the values used in determining assumed rates of return shall be the values presented in the plan's financial statements pursuant to the requirements of this Statement.

b. Expected rates of inflation assumed in estimating automatic cost-of-living adjustments shall be consistent with the assumed rates of return.

c. Administrative expenses expected to be paid by the plan (not those paid by the sponsor) that are associated with providing accumulated plan benefits shall be reflected either by appropriately adjusting the assumed rates of return or by assigning those expenses to future periods and discounting them to the benefit information date. If the former method is used, the adjustment of the assumed rates of return shall be separately disclosed (paragraph 27(b)).

21. In selecting certain assumptions to be used in determining the actuarial present value of accumulated plan benefits, an acceptable alternative to that discussed in paragraph 20 is to use those assumptions that are inherent in the estimated cost at the benefit information date to obtain a contract with an insurance company to provide participants with their accumulated plan benefits. Those other assumptions that are necessary but are not inherent in that estimated cost shall be selected pursuant to the requirements in paragraph 20.

Presentation of the Actuarial Present Value of Accumulated Plan Benefits

22. The total actuarial present value of accumulated plan benefits as of the benefit information date shall be segmented into at least the following categories:

a. Vested benefits of participants currently receiving payments

b. Other vested benefits

c. Nonvested benefits.

Category (a) shall include those benefits due and payable as of the benefit information date. Present employees' accumulated contributions as of the benefit information date (including interest, if any) shall be disclosed. If interest has been credited on employees' contributions, the rate(s) shall be disclosed.

Changes in the Actuarial Present Value of Accumulated Plan Benefits

23. Changes in actuarial assumptions made to reflect changes in the plan's expected experience shall be viewed as changes in estimates. That is, the effects of those changes shall be accounted for in the year of change (or in the year of change and future years if the change affects both) and shall not be accounted for by restating amounts reported in financial statements for prior years or by reporting pro forma amounts for prior years.

24. Assumed rates of return used to determine the actuarial present value of accumulated plan benefits may change periodically due to changes in expected rates of return or as changes occur in the factors affecting estimates. A change in assumed rates of return need not necessarily result when a decision is made to replace fixed-income securities currently held with lower-rated fixed-income securities because the higher yield associated with the lower-rated securities reflects increased risk. Accordingly, a higher ultimate return on the aggregate investment portfolio may not result.

Presentation of Changes in the Actuarial Present Value of Accumulated Plan Benefits

25. If significant, either individually or in the aggregate, the effects of certain factors affecting the change in the actuarial present value of accumulated plan benefits from the preceding to the current benefit information date shall be identified. Effects that are individually significant shall be separately identified. Minimum disclosure shall include the significant effects of factors such as the following:

a. Plan amendments

b. Changes in the nature of the plan (for example, a plan spin-off or a merger with another plan)

c. Changes in actuarial assumptions.[11]

The significant effects of other factors may also be identified, including, for example, benefits accumulated,[12] the increase (for interest) as a result of the decrease in the discount period, and benefits paid. If presented, *benefits paid* shall not include benefit payments made by an insurance company in accordance with a contract that is excluded from plan assets. However, amounts paid by the plan to an insurance company pursuant to such a contract (including purchasing annuities with amounts allocated from existing investments with the insurance company) shall be included in *benefits paid.*[13] If the minimum required disclosure is presented in other than a statement format, the actuarial present value of accumulated plan benefits as of the preceding benefit information date shall also be presented.

26. Information regarding changes in the actuarial present value of accumulated plan benefits may be presented either (a) in a statement that accounts for the change between two benefit information dates or (b) elsewhere in the fin-

[11] Plans that measure the actuarial present value of accumulated plan benefits by insurance company rates pursuant to the alternative approach described in paragraph 21 shall, if practicable, disclose the effects of changes in actuarial assumptions reflected in changes in those insurance rates.

[12] Actuarial experience gains or losses may be included with the effects if additional benefits accumulated rather than being separately disclosed. If the effects of changes in actuarial assumptions discussed in footnote 11 cannot be separately disclosed, those effects shall be included in benefits accumulated.

[13] Due to the use of different actuarial assumptions, the amount paid by the plan to an insurance company may be different from the previous measure of the actuarial present value of the related accumlated plan benefits. That difference is an actuarial experience gain or loss (footnote 12).

ancial statements. If only the minimum required disclosure is presented, presentation in a statement format will necessitate an additional unidentified "other" category to reconcile the beginning and ending amounts.

Additional Financial Statement Disclosures

27. Disclosure of the plan's accounting policies[14] shall include the following:

a. A description of the method(s) and significant assumptions used to determine the fair value of investments and the reported value of contracts with insurance companies.

b. A description of the method and significant assumptions (for example, assumed rates of return, inflation rates, and retirement ages) used to determine the actuarial present value of accumulated plan benefits. Any significant changes of method or assumptions between benefit information dates shall be described.

28. The financial statements shall include the following additional disclosures, if applicable:

a. A brief, general description of the plan agreement, including—but not limited to—vesting and benefit provisions.[15]

b. A description of significant plan amendments adopted during the year ending on the latest benefit information date. If significant amendments were adopted between the latest benefit information date and the plan's year-end, it shall be indicated that the actuarial present value of accumulated plan benefits does not reflect those amendments.

c. A brief, general description of (i) the priority order of participants' claims to the assets of the plan upon plan termination and (ii) benefits guaranteed by the Pension Benefit Guaranty Corporation (**PBGC**), including a discussion of the application of the PBGC guaranty to any recent plan amendment.[16]

d. The funding policy and any changes in such policy during the plan year.[17] For a **contributory plan,** the disclosure shall state the method of determining participants' contributions. Plans subject to ERISA shall disclose whether the minimum funding requirements of ERISA have been met. If a minimum funding waiver has been granted by the Internal Revenue Service (*IRS*) or if a request for a waiver is pending before the IRS, that fact shall be disclosed.

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[14] See APB Opinion No. 22, *Disclosure of Accounting Policies.*

[15] If a plan agreement or a description thereof providing this information is otherwise published and made available, the description required by paragraph 28(a) may be omitted provided that reference to such other source is made.

[16] If material providing this information is otherwise published and made available to participants, the descriptions required by paragraph 28(c) may be omitted provided that (a) reference to such other source is made and (b) disclosure similar to the following is made in the financial statements: "Should the plan terminate at some future time, its net assets generally will not be available on a pro rata basis to provide participants' benefits. Whether a particular participant's accumulated plan benefits will be paid depends on both the priority of those benefits and the level of benefits guaranteed by the PBGC at that time. Some benefits may be fully or partially provided for by the then existing assets and the PBGC guaranty while other benefits may not be provided for at all."

[17] If significant costs of plan administration are being absorbed by the employer(s), that fact shall be disclosed.

e. The policy regarding the purchase of contracts with insurance companies that are excluded from plan assets. The plan's dividend income for the year that is related to excluded contracts shall be disclosed, and for purposes of paragraph 15 may be netted against item (g).

f. The federal income tax status of the plan, if a favorable letter of determination has not been obtained or maintained.

g. Identification of investments that represent five percent or more of the net assets available for benefits.

h. Significant real estate or other transactions in which the plan and any of the following parties are jointly involved: (i) the sponsor, (ii) the employer(s), or (iii) the employee organization(s).

i. Unusual or infrequent events or transactions occurring after the latest benefit information date but before issuance of the financial statements that might significantly affect the usefulness of the financial statements in an assessment of the plan's present and future ability to pay benefits. For example, a plan amendment adopted after the latest benefit information date that significantly increases future benefits that are attributable to employees' service rendered before that date shall be disclosed. If reasonably determinable, the effects of such events or transactions shall be disclosed. If such effects are not quantified, the reasons why they are not reasonably determinable shall be disclosed.

Use of Averages or Reasonable Approximations

29. The Board recognizes that literal application of certain of the requirements of this Statement could require a degree of detail in recordkeeping and computation that might be unduly burdensome. Accordingly, the use of averages or other methods of approximation is appropriate, provided the results obtained are substantially the same as the results contemplated by this Statement. Thus, rolling back to the beginning of the year or projecting to the end of the year detailed employee service-related data as of a date within the year may be acceptable in approximating beginning-or end-of-year **benefit information.** The use of averages and other methods of approximation consistent with recommended actuarial practice may be useful in conjunction with other provisions of this Statement, particularly when applied to plans sponsored by small employers. If participants' individual historical salary data for plan years before the effective date of this Statement are not available, reasonable approximations thereof are acceptable.

Effective Date and Transition

30. This Statement shall be effective for plan years beginning after December 15, 1980, except that it shall be effective for plan years beginning after June 15, 1982 for plans that are sponsored by, and provide benefits for the employees of, one or more state or local governments.* Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be made retroactively. Financial statements of prior plan years are required to be restated to comply with the provisions of this Statement *only* if

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* [As amended by FASB Statement No. 59, *Deferral of the Effective Date of Certain Accounting Requirements for Pension Plans of State and Local Governmental Units* (April 1982).—Editor]

presented together with financial statements for plan years beginning after December 15, 1980. If accounting changes were necessary to conform to the provisions of this Statement, that fact shall be disclosed when financial statements for the year in which this Statement is first applied are presented either alone or only with financial statements of prior years.

The provisions of this Statement need not be applied to immaterial items.

Appendix D*

Illustration of Financial Statements: Defined Benefit Pension Plan

This appendix illustrates certain applications of the requirements of FASB Statement No. 35 (the "Statement"), as amended, that are applicable for the annual financial statements of a hypothetical plan, the C&H Company Pension Plan. It does not illustrate other requirements of the Statement, as amended, that might be applicable in circumstances other than those assumed for the C&H Company Pension Plan. The formats presented and the wording of accompanying notes are illustrative and are not necessarily the only possible presentation. Further, the circumstances assumed for the C&H Company Pension Plan are designed to facilitate illustration of many of the requirements of the Statement, as amended. Therefore, the notes to the illustrative financial statements probably are more extensive than would be expected for a typical plan.

Included are illustrations of the following alternatives permitted by paragraphs 6, 8, 25, and 26:

a. An end-of-year vs. beginning-of-year benefit information date.

b. Separate vs. combined statements for presenting information regarding (a) the net assets available for benefits and the actuarial present value of accumulated plan benefits and (b) changes in the net assets available for benefits and changes in the actuarial present value of accumulated plan benefits.

c. A separate statement that reconciles the year-to-year change in the actuarial present value of accumulated plan benefits vs. presenting the effects of a change in actuarial assumptions on the face of the statement of accumulated plan benefits.

Although not illustrated, paragraph 8 of the Statement permits the information regarding the actuarial present value of accumulated plan benefits and changes therein to be presented as notes to the financial statements.

The notes to the financial statements are for the illustrative financial statements that use end-of-year benefit information. Modifications to the notes necessary when beginning-of-year benefit information is presented are in brackets.

Generally accepted accounting principles do not require comparative financial statements. ERISA requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

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* Source: FASB Statement No. 35, appendix D, modified for changes required by FASB Statement No. 110 and ERISA requirements.

CONTENTS

The Statement of Net Assets Available for Benefits assuming a beginning-of-year information date would be the same as that illustrated in Exhibit D-1.

Exhibit D-1

C&H COMPANY PENSION PLAN

STATEMENT OF NET ASSETS AVAILABLE FOR BENEFITS

	December 31,	
	19X1	19X0
Assets		
Investments, at fair value (Notes B, E, F, and G):		
Plan interest in C&H Master Trust	$2,250,000	$1,860,000
C&H Company common stock	690,000	880,000
Investment contract with Insurance company	1,000,000	890,000
Corporate bonds and debentures	3,500,000	3,670,000
U.S. government securities	350,000	270,000
Mortgages	480,000	460,000
Real estate	270,000	240,000
Total investments	8,540,000	8,270,000
Receivables:		
Employer's contribution	40,000	35,000
Securities sold	310,000	175,000
Accrued interest and dividends	77,000	76,000
Total receivables	427,000	286,000
Cash	200,000	90,000
Total assets	9,167,000	8,646,000
Liabilities		
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	85,000	40,000
Total liabilities	155,000	500,000
Net assets available for benefits	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-2

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

	Year Ended December 31, 19X1
Investment income:	
Net appreciation in fair value of investments (Note E)	$ 278,000
Interest	325,000
Dividends	5,000
	608,000
Less investment expenses	39,000
	569,000
Plan interest in C&H Master Trust investment income (Note F)	129,000
	698,000
Contributions (Note C):	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Net assets available for benefits:	
Beginning of year	8,146,000
End of year	$9,012,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-3

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS

	December 31, 19X1	December 31, 19X0
Actuarial present value of accumulated plan benefits (Notes B and C)		
Vested benefits:		
Participants currently receiving payments	$ 3,040,000	$ 2,950,000
Other participants	8,120,000	6,530,000
	11,160,000	9,480,000
Nonvested benefits	2,720,000	2,400,000
Total actuarial present value of accumulated plan benefits	$13,880,000	$11,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-4

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS

	Year Ended December 31, 19X1
Actuarial present value of accumulated plan benefits at beginning of year	$11,880,000
Increase (decrease) during the year attributable to:	
Plan amendment (Note H)	2,410,000
Change in actuarial assumptions (Note B)	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B)	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Actuarial present value of accumulated plan benefits at end of year	$13,880,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-5

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS

[An alternative for Exhibits D-1 and D-3]

	December 31, 19X1	December 31, 19X0
Accumulated Plan Benefits (Notes B and C)		
Actuarial present value of vested benefits		
Participants currently receiving payments	$3,040,000	$2,950,000
Other participants	8,120,000	6,530,000
	11,160,000	9,480,000
Actuarial present value of nonvested benefits	2,720,000	2,400,000
Total actuarial present value of accumulated plan benefits	13,880,000	11,880,000
Net Assets Available for Benefits		
Investments, at fair value (Notes B, E, F, and G):		
Plan interest in C&H Master Trust	2,250,000	1,860,000
C&H Company common stock	690,000	880,000
Investment contract with Insurance company	1,000,000	890,000
Corporate bonds and debentures	3,500,000	3,670,000
U.S government securities	350,000	270,000
Mortgages	480,000	460,000
Real estate	270,000	240,000
Total investments	8,540,000	8,270,000
Receivables:		
Employer's contribution	40,000	35,000
Securities sold	310,000	175,000
Accrued interest and dividends	77,000	76,000
Total receivables	427,000	286,000
Cash	200,000	90,000
Total assets	9,167,000	8,646,000
Due to broker for securities purchased	—	400,000
Accounts payable	70,000	60,000
Accrued expenses	85,000	40,000
Total liabilities	155,000	500,000
Net assets available for benefits	9,012,000	8,146,000
Excess of actuarial present value of accumulated plan benefits over net assets available for benefits	$4,868,000	$3,734,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-6

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN ACCUMULATED PLAN BENEFITS AND NET ASSETS AVAILABLE FOR BENEFITS

[An alternative for Exhibits D-2 and D-4]

	Year Ended December 31, 19X1
Net Increase in Actuarial Present Value of Accumulated Plan Benefits	
Increase (decrease) during the year attributable to:	
Plan amendment (Note H)	$2,410,000
Change in actuarial assumptions (Note B)	(1,050,500)
Benefits accumulated	895,000
Increase for interest due to the decrease in the discount period (Note B)	742,500
Benefits paid	(997,000)
Net increase	2,000,000
Net Increase in Net Assets Available for Benefits	
Investment income:	
Net appreciation in fair value of investments (Note E)	278,000
Interest	325,000
Dividends	5,000
	608,000
Less investment expenses	39,000
	569,000
Plan interest in C&H Master Trust investment income (Note F)	129,000
	698,000
Contributions (Note C):	
Employer	780,000
Employees	450,000
	1,230,000
Total additions	1,928,000
Benefits paid directly to participants	740,000
Purchases of annuity contracts (Note G)	257,000
	997,000
Administrative expenses	65,000
Total deductions	1,062,000
Net increase	866,000
Increase in excess of actuarial present value of accumulated plan benefits over net assets available for benefits	1,134,000
Excess of actuarial present value of accumulated plan benfits over net assets available for benefits:	
Beginning of year	3,734,000
End of year	$4,868,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-7

C&H COMPANY PENSION PLAN

STATEMENT OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

(If a beginning-of-year benefit information date is selected)

	Year Ended December 31, 19X1	Year Ended December 31, 19X0
Investment income:		
Net appreciation in fair value of investments (Note E)	$ 278,000	$ 41,000
Interest	325,000	120,000
Dividends	5,000	90,000
	608,000	251,000
Less investment expenses	39,000	35,000
	569,000	216,000
Plan interest in C&H Master Trust investment income (Note F)	129,000	150,000
	698,000	366,000
Contributions (Note C):		
Employer	780,000	710,000
Employees	450,000	430,000
	1,230,000	1,140,000
Total additions	1,928,000	1,506,000
Benefits paid directly to participants	740,000	561,000
Purchases of annuity contracts (Note G)	257,000	185,000
	997,000	746,000
Administrative expenses	65,000	58,000
Total deductions	1,062,000	804,000
Net increase	866,000	702,000
Net assets available for benefits:		
Beginning of year	8,146,000	7,444,000
End of year	$9,012,000	$8,146,000

The accompanying notes are an integral part of the financial statements.

Exhibit D-8

C&H COMPANY PENSION PLAN

STATEMENT OF ACCUMULATED PLAN BENEFITS
(If a beginning-of-year benefit information date is selected)

	December 31 19X0
Actuarial present value of accumulated plan benefits (Notes B and C)	
Vested benefits:	
Participants currently receiving payments	$ 2,950,000
Other participants	6,530,000
	9,480,000
Nonvested benefits	2,400,000
Total actuarial present value of accumulated plan benefits	$11,880,000

During 19X0, the actuarial present value of accumulated plan benefits increased $700,000 as a result of a change in actuarial assumptions (Note B). Also see Note H. The actuarial present value of accumulated plan benefits was $9,890,000 at December 31, 19W9.

The accompanying notes are an integral part of the financial statements.

C&H COMPANY PENSION PLAN

NOTES TO FINANCIAL STATEMENTS[104]

A. Description of Plan

The following brief description of the C&H Company Pension Plan (Plan) is provided for general information purposes only. Participants should refer to the Plan agreement for more complete information.

1. *General.* The Plan is a defined benefit pension plan covering substantially all employees of C&H Company (Company). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. *Pension Benefits.* Employees with 10 or more years of service are entitled to annual pension benefits beginning at normal retirement age (65) equal to 1 ½% of their final 5-year average annual compensation for each year of service. The Plan permits early retirement at ages 55-64. Employees may elect to receive their pension benefits in the form of a joint and survivor annuity. If employees terminate before rendering 5 years of service, they forfeit the right to receive the portion of their accumulated plan benefits attributable to the Company's contributions. Employees may elect to receive the value of their accumulated plan benefits as a lump-sum distribution upon retirement or termination, or they may elect to receive their benefits as a life annuity payable monthly from retirement. For each employee electing a life annuity, payments will not be less than the greater of (a) the employee's accumulated contributions plus interest or (b) an annuity for five years.
3. *Death and Disability Benefits.* If an active employee dies at age 55 or older, a death benefit equal to the value of the employee's accumulated pension benefits is paid to the employee's beneficiary. Active employees who become totally disabled receive annual disability benefits that are equal to the normal retirement benefits they have accumulated as of the time they become disabled. Disability benefits are paid until normal retirement age at which time disabled participants begin receiving normal retirement benefits computed as though they had been employed to normal retirement age with their annual compensation remaining the same as at the time they became disabled.

B. Summary of Accounting Policies

The following are the significant accounting policies followed by the Plan:

1. *Basis of Accounting.* The accompanying financial statements are prepared on the accrual basis of accounting.
2. *Investment Valuation and Income Recognition.* If available, quoted market prices are used to value investments.

   The amounts shown in Note E for securities that have no quoted market price represent estimated fair value. Many factors are

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[104] The notes are for the accompanying illustrative financial statements that use an end-of-year benefit information date. Modifications necessary to accompany the illustrative financial statements that use a beginning-of-year benefit information date are presented in brackets.

considered in arriving at that fair market value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices. Mortgages have been valued on the basis of their future principal and interest payments discounted at prevailing interest rates for similar investments. The fair value of real estate investments, principally rental property subject to long-term leases has been estimated on the basis of future rental receipts and estimated residual values discounted at interest rates commensurate with the risks involved. The fair value of the Plan's interest in the C&H Master Trust (Master Trust) is based on the beginning of year value of the Plan's interest in the trust plus actual contributions and allocated investment income less actual distributions and allocated administrative expenses (Note F). Quoted market prices are used to value investments in the Master Trust. The Plan's investment contract with the National Insurance Company (National) (Note G) is valued at fair value by discounting the related cash flows based on current yields of similar instruments with comparable durations. Funds under the investment contract that have been allocated and applied to purchase annuities (that is, National is obligated to pay the related pension benefits) are excluded from the Plan's assets.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

3. *Actuarial Present Value of Accumulated Plan Benefits.* Accumulated plan benefits are those future periodic payments, including lump-sum distributions, that are attributable under the Plan's provisions to the service employees have rendered. Accumulated plan benefits include benefits expected to be paid to (a) retired or terminated employees or their beneficiaries, (b) beneficiaries of employees who have died, and (c) present employees or their beneficiaries. Benefits under the Plan are based on employees' compensation during their last five years of credited service. The accumulated plan benefits for active employees are based on their average compensation during the five years ending on the date as of which the benefit information is presented (the valuation date). Benefits payable under all circumstances—retirement, death, disability, and termination of employment—are included, to the extent they are deemed attributable to employee service rendered to the valuation date. Benefits to be provided via annuity contracts excluded from Plan assets are excluded from accumulated Plan benefits.

   The actuarial present value of accumulated plan benefits is determined by an actuary from the AAA Company and is that amount that results from applying actuarial assumptions to adjust the accumulated plan benefits to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment. The significant actuarial assumptions used in the valuations as of December 31, 19X1 [19X0] and 19X0 were (a) life expectancy of participants (the 1991 Group Annuity Mortality Table was used), (b) retirement age assumptions (the assumed average retirement age was 60), and (c) investment return. The 19X1 [19X0] and 19X0 valuations included assumed average rates of return of 7% [6.25%] and 6.25%, respectively, including a reduction of .2% to reflect anticipated administrative expenses associated with providing benefits. The foregoing actuarial assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of accumulated plan benefits.

4. *Payment of Benefits*. Benefit payments to participants are recorded upon distribution.

C. Funding Policy

As a condition of participation, employees are required to contribute 3% of their salary to the Plan. Present employees' accumulated contributions at December 31, 19X1 and 19X0 were $2,575,000 and $2,325,000, respectively, including interest credit on an interest rate of 5% compounded annually. The Company's funding policy is to make annual contributions to the Plan in amounts that are estimated to remain a constant percentage of employees' compensation each year (approximately 5% for 19X1 [and 19X0]), such that, when combined with employees' contributions, all employees' benefits will be fully provided for by the time they retire. Beginning in 19X2, the Company's contribution is expected to increase to approximately 6% to provide for the increase in benefits attributable to the Plan amendment effective July, 19X1 (Note H). The Company's contributions for 19X1 [and 19X0] exceeded the minimum funding requirements of ERISA.

Although it has not expressed any intention to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions set forth in ERISA.

D. Plan Termination

In the event the Plan terminates, the net assets of the Plan will be allocated, as prescribed by ERISA and its related regulations, generally to provide the following benefits in the order indicated:

a. Benefits attributable to employee contributions, taking into account those paid out before termination.

b. Annuity benefits that former employees or their beneficiaries have been receiving for at least three years, or that employees eligible to retire for that three-year period would have been receiving if they had retired with benefits in the normal form of annuity under the Plan. The priority amount is limited to the lowest benefit that was payable (or would have been payable) during those three years. The amount is further limited to the lowest benefit that would be payable under Plan provisions in effect at any time during the five years preceding Plan termination.

c. Other vested benefits insured by the Pension Benefit Guaranty Corporation (PBGC) (a U.S. government agency) up to the applicable limitations (discussed below).

d. All other vested benefits (that is, vested benefits not insured by the PBGC).

e. All nonvested benefits.

Benefits to be provided via contracts under which National (Note G) is obligated to pay the benefits would be excluded for allocation purposes.

Certain benefits under the Plan are insured by the PBGC if the Plan terminates. Generally, the PBGC guarantees most vested normal age retirement benefits, early retirement benefits, and certain disability and survivor's pensions. However, the PBGC does not guarantee all types of benefits under the Plan, and the amount of benefit protection is subject to certain limitations. Vested benefits under the Plan are guaranteed at the level in effect on the date of the Plan's termination. However, there is a statutory ceiling, which is adjusted periodically, on the amount of an individual's monthly benefit that the PBGC guarantees. For Plan terminations occurring during 19X2 that ceiling is $X,XXX per month. That ceiling applies to those pensioners who elect to receive their benefits in the form of a single-life annuity and are at least 65 years old at the time of retirement or plan termination (whichever comes later). For younger annuitants or for those who elect to receive their benefits in some form more valuable than a single-life annuity, the corresponding ceilings are actuarially adjusted downward. Benefit improvements attributable to the Plan amendment effective July 1, 19X1 (Note H) may not be fully guaranteed even though total benefit entitlements fall below the aforementioned ceilings. For example, none of the improvement would be guaranteed if the Plan were to terminate before July 1, 19X2. After that date, the PBGC would guarantee 20% of any benefit improvements that resulted in benefits below the ceiling, with an additional 20% guaranteed each year the Plan continued beyond July 1, 19X2. If the amount of the benefit increase below the ceiling is also less than $100, $20 of the increase (rather than 20%) becomes guaranteed by the PBGC each year following the effective date of the amendment. As a result, only the primary ceiling would be applicable after July 1, 19X6.

Whether all participants receive their benefits should the Plan terminate at some future time will depend on the sufficiency, at that time, of the Plan's net assets to provide for accumulated benefit obligations and may also depend on the financial condition of the Plan sponsor and the level of benefits guaranteed by the PBGC.

E. Investments

The following table presents the fair values of investments. Investments that represent 5 percent or more of the Plan's net assets are separately identified.

	December 31, 19X1	December 31, 19X0
Investments at Fair Value As Determined by Quoted Market Price		
C&H Company common stock, 25,000 shares	$ 690,000	$ 880,000
U.S. government securities	350,000	270,000
Corporate bonds and debentures	3,000,000	3,670,000
	4,040,000	4,820,000
Investments at Estimated Fair Value		
Plan interest in C&H Master Trust	2,250,000	1,860,000
Investment contract with National Insurance Company #8041A, 8.0% (Note G)	1,000,000	890,000
Corporate bonds and debentures	500,000	—
Mortgages	480,000	460,000
Real estate	270,000	240,000
	4,500,000	3,450,000
	$8,540,000	$8,270,000

During 19X1 [and 19X0], the Plan's investments (including gains and losses on investments bought and sold, as well as held during the year) appreciated in value by $278,000 [and $41,000, respectively,] as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31, 19X1	Year Ended December 31, 19X0
Investments at Fair Value as Determined by Quoted Market Price		
C&H Company common stock	$208,000	$(59,000)
U.S. government securities	20,000	40,000
Corporate bonds	10,000	—
	238,000	(19,000)
Investments at Estimated Fair Value		
Investment contract with insurance company	40,000	100,000
Corporate bonds and debentures	(50,000)	60,000
Mortgages	100,000	(90,000)
Real estate	(50,000)	(10,000)
	40,000	60,000
	$278,000	$ 41,000

F. Interest in C&H Master Trust

A portion of the Plan's investments are in the Master Trust which was established for the investment of assets of the Plan and several other C&H Company sponsored retirement plans. Each participating retirement plan has an undivided interest in the Master Trust. The assets of the Master Trust are held by GLC Trust Company (Trustee). At December 31, 19X1 and 19X0, the Plan's interest in the net assets of the Master Trust was approximately 9% and 11%, respectively. Investment income and administrative expenses relating to the Master Trust are allocated to the individual plans based upon average monthly balances invested by each plan.

The following table presents the fair values of investments for the Master Trust.

	December 31, 19X1	December 31, 19X0
Investments at fair value:		
Common stocks	$11,900,000	$ 8,800,000
Corporate bonds	11,800,000	6,700,000
U.S. government securities	867,000	750,000
	$24,567,000	$16,250,000

Investment income for the Master Trust is as follows:

	Year Ended December 31, 19X1	Year Ended December 31, 19X0
Investment income:		
Net appreciation in fair value of investments:		
Common stocks	$ 300,000	$ 200,000
Corporate bonds	200,000	200,000
U.S. government securities	300,000	200,000
	800,000	600,000
Interest	400,000	300,000
Dividends	230,000	300,000
	$1,430,000	$1,200,000

G. Contract With Insurance Company

In 19W8, the Company entered into an investment contract with the National Insurance Company under which the Plan deposits a minimum of $100,000 a year. National maintains the contributions in an unallocated fund to which it adds interest at a rate of 8%. The interest rate is guaranteed through 19X3 but is subject to change for each succeeding five-year period. When changed, the new rate applies only to funds deposited from the date of change. At the direction of the Plan's administrator, a single premium to buy an annuity for a retiring employee is withdrawn by National from the unallocated fund. Purchased annuities are contracts under which National is obligated to pay benefits to named employees or their beneficiaries. The premium rates for such annuities to be purchased in the future and maximum administration expense charges against the fund are also guaranteed by National on a five-year basis.

The annuity contracts provide for periodic dividends at National's discretion on the basis of its experience under the contracts. Such dividends received by the Plan for the year(s) ended December 31, 19X1 [and 19X0] were $25,000 [and $24,000, respectively]. In reporting changes in net assets, those dividends have been netted against amounts paid to National for the purchase of annuity contracts.

H. Plan Amendment

Effective July 1, 19X1, the Plan was amended to increase future annual pension benefits from 1 ¼% to 1 ½% of final 5-year average annual compensation for each year of service, including service rendered before the effective date. The retroactive effect of the Plan amendment, an increase in the actuarial present value of accumulated plan benefits of $2,410,000, was accounted for in the year ended December 31, 19X1. [The actuarial present value of accumulated plan benefits at December 31, 19X0 do not reflect the effect of that Plan amendment. The Plan's actuary estimates that the amendment's retroactive effect on the actuarial present value of accumulated plan benefits at December 31, 19X0 was an increase of approximately $1,750,000, of which approximately $1,300,000 represents an increase in vested benefits.]

I. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated June 30, 19XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel beleive that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Appendix E

Illustrations of Financial Statements: Defined Contribution Plans

E.01 This appendix illustrates certain applications of the provisions of chapter 3 that apply for the annual financial statements of hypothetical plans, the XYZ Company 401(k) Plan (illustration 1), the XYZ Company Profit-Sharing Plan (illustration 2) and the Sponsor Company Employee Stock Ownership Plan (illustration 3). It does not illustrate other provisions of chapter 3 that might apply in circumstances other than those assumed in this example. The formats presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

E.02 Although generally accepted accounting principles do not require comparative financial statements, ERISA requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

E.03 ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

Illustration 1: Illustration of Financial Statements: 401(k) Plan

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits

	December 31, 19X1	December 31, 19X0
Assets		
Investments:		
At fair value—(Note B)		
Shares of registered investment companies:		
Prosperity Investments Common Stock Fund	$1,973,000	$2,600,000
Prosperity Investments Balanced Fund	3,949,000	3,500,000
XYZ Company Stock	655,000	200,000
Participant notes receivable	100,000	45,000
	6,677,000	6,345,000
At contract value—(Note C)		
National Insurance Company Investment Contract #2012A, matures 12/31/X2	2,500,000	1,650,000
Total investments	9,177,000	7,995,000
Receivables:		
Employer's contribution	14,000	10,000
Participants' contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
Liabilities		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	$9,218,000	$8,035,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits With Fund Information
[Alternative presentation for statement of net assets available for benefits]

	December 31, 19X1							
	Participant Directed						Non-Participant Directed	
Assets	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Investments, at fair value (Note B):								
Shares of registered investment companies:								
Prosperity Investments Common Stock Fund	$ 1,973,000	$ —	$ —	$ —	$ —	$ —	$ —	$ 1,973,000
Prosperity Investments Balanced Fund	—	3,949,000	—	—	—	—	—	3,949,000
XYZ Company Stock	—	—	455,000	—	—	—	200,000	655,000
Participant notes receivable	—	—	—	100,000	—	—	—	100,000
	1,973,000	3,949,000	455,000	100,000	—	—	200,000	6,677,000
Investments, at contract value (Note C):								
National Insurance Company Investment Contract #2012A, matures 12/31/X2	—	—	—	—	2,500,000	—	—	2,500,000
Total investments	1,973,000	3,949,000	455,000	100,000	2,500,000	—	200,000	9,177,000
Receivables:								
Employer's contribution	—	—	—	—	—	14,000	—	14,000
Participants' contributions	—	—	—	—	—	52,000	—	52,000
Total receivables	—	—	—	—	—	66,000	—	66,000
Total assets	1,973,000	3,949,000	455,000	100,000	2,500,000	66,000	200,000	9,243,000
Liabilities								
Accounts payable	—	—	—	—	—	10,000	—	10,000
Accrued expenses	—	—	—	—	—	15,000	—	15,000
Total liabilities	—	—	—	—	—	25,000	—	25,000
Net assets available for benefits	$ 1,973,000	$ 3,949,000	$ 455,000	$ 100,000	$ 2,500,000	$ 41,000	$ 200,000	$ 9,218,000

The accompanying notes are an intergral part of these financial statements

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits With Fund Information
[Alternative presentation for statement of net assets available for benefits]

	December 31, 19X0							
	Participant Directed						Non-Participant Directed	
Assets	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Investments, at fair value (Note B):								
Shares of registered investment companies:								
Prosperity Investments Common Stock Fund	$ 2,600,000	$ —	$ —	$ —	$ —	$ —	$ —	$ 2,600,000
Prosperity Investments Balanced Fund	—	3,500,000	—	—	—	—	—	3,500,000
XYZ Company Stock	—	—	100,000	—	—	—	100,000	200,000
Participant notes receivable	—	—	—	45,000	—	—	—	45,000
	2,600,000	3,500,000	100,000	45,000	—	—	100,000	6,345,000
Investments, at contract value (Note C):								
National Insurance Company Investment Contract #2012A, matures 12/31/X2	—	—	—	—	1,650,000	—	—	1,650,000
Total investments	2,600,000	3,500,000	100,000	45,000	1,650,000	—	100,000	7,995,000
Receivables:								
Employer's contribution	—	—	—	—	—	10,000	—	10,000
Participants' contributions	—	—	—	—	—	50,000	—	50,000
Total receivables	—	—	—	—	—	60,000	—	60,000
Total assets	2,600,000	3,500,000	100,000	45,000	1,650,000	60,000	100,000	8,055,000
Liabilities								
Accounts payable	—	—	—	—	—	20,000	—	20,000
Net assets available for benefits	$ 2,600,000	$ 3,500,000	$ 100,000	$ 45,000	$ 1,650,000	$ 40,000	$ 100,000	$ 8,035,000

The accompanying notes are an intergral part of these financial statements

XYZ Company 401(k) Plan
Statement of Changes in Net Assets Available for Benefits With Fund Information

Year Ended December 31, 19X1

	Participant Directed						Non-Participant Directed	
Assets	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Additions to net assets attributed to:								
Investment income								
Net appreciation in fair value of investments	$ 107,000	$ 92,000	$ 40,000	$ —	$ —	$ —	$ 40,000	$ 279,000
Interest	—	205,000	—	10,000	224,000	—	—	439,000
Dividends	100,000	65,000	—	—	—	—	—	165,000
	207,000	362,000	40,000	10,000	224,000	—	40,000	883,000
Less investment expenses	(10,000)	(20,000)	—	—	(20,000)	—	—	(50,000)
	197,000	342,000	40,000	10,000	204,000	—	40,000	833,000
Contributions:								
Participants'	296,000	612,000	307,000	—	246,000	52,000	—	1,513,000
Employer's	—	—	—	—	—	14,000	72,000	86,000
	296,000	612,000	307,000	—	246,000	66,000	72,000	1,599,000
Total additions	493,000	954,000	347,000	10,000	450,000	66,000	112,000	2,432,000
Deductions								
Deductions from net assets attributed to:								
Benefits paid to participants	400,000	494,000	30,000	—	210,000	—	10,000	1,144,000
Administrative expenses	25,000	45,000	3,000	—	25,000	5,000	2,000	105,000
Total deductions	425,000	539,000	33,000	—	235,000	5,000	12,000	1,249,000
Net increase prior to interfund transfers	68,000	415,000	314,000	10,000	215,000	61,000	100,000	1,183,000
Interfund transfers	(695,000)	34,000	41,000	45,000	635,000	(60,000)	—	—
Net increase (decrease)	(627,000)	449,000	355,000	55,000	850,000	1,000	100,000	1,183,000
Net assets available for benefits:								
Beginning of year	2,600,000	3,500,000	100,000	45,000	1,650,000	40,000	100,000	8,035,000
End of year	$ 1,973,000	$ 3,949,000	$ 455,000	$ 100,000	$ 2,500,000	$ 41,000	$ 200,000	$ 9,218,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401 (k) Plan
Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") 401(k) Plan ("Plan") provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined benefit or contribution plans. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. Additional amounts may be contributed at the option of the Company's board of directors. All employer contributions are invested in XYZ Company common stock. Contributions are subject to certain limitations.

3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and allocations of (*a*) the Company's contribution and, (*b*) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

4. *Vesting.* Participants are immediately vested in their contributions plus actual earnings thereon. Vesting in the Company's matching and discretionary contribution portion of their accounts plus actual earnings thereon is based on years of continuous service. A participant is 100 percent vested after five years of credited service.

5. *Investment Options.* Upon enrollment in the Plan, a participant may direct employee contributions in 25 percent increments in any of four investment options.

    Prosperity Investments Common Stock Fund—Funds are invested in shares of a registered investment company that invests mainly in common stocks.

    Prosperity Investments Balanced Fund—Funds are invested in shares of a registered investment company that invests in corporate bonds, common stocks and U.S. Government securities.

    XYZ Company Stock—Funds are invested in common stock of XYZ Company.

    National Insurance Company Investment Contract—Funds are invested in a guaranteed investment contract with an insurance company.

    Participants may change their investment options quarterly.

6. *Participant Notes Receivable.* Participants may borrow from their fund accounts a minimum of $1,000 up to a maximum equal to the lesser of $50,000 or 50 percent of their account balance. Loan transactions are treated as a transfer to (from) the investment fund from (to) the Participant Notes fund. Loan terms range from 1-5 years or up to 25 years for the purchase of a primary residence. The loans are secured by the balance in the participant's account and bear interest at a rate commensurate with local prevailing rates as determined quarterly by the Plan administrator. Interest rates range from 6 percent to 10 percent. Principal and interest is paid ratably through monthly payroll deductions.
7. *Payment of Benefits.* On termination of service due to death, disability or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten year period. For termination of service due to other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.
8. *Forfeited Accounts.* At December 31, 19X1, forfeited nonvested accounts totalled $7,500. These accounts will be used to reduce future employer contributions. Also, in 19X1, employer contributions were reduced by $5,000 from forfeited nonvested accounts.

B. Summary of Accounting Policies

Basis of Accounting

The financial statements of the Plan are prepared under the accrual method of accounting.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value except for its investment contract which is valued at contract value (Note C). Shares of registered investment companies are valued at quoted market prices which represent the net asset value of shares held by the Plan at year-end. The Company stock is valued at its quoted market price. Participant notes receivable are valued at cost which approximates fair value.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

C. Investment Contract with Insurance Company

In 19X0, the Plan entered into an investment contract with National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with earnings on the underlying investments (principally bank certificates of deposit) and charged for Plan withdrawals and administrative expenses charged by National. The contract is included in the financial statements at contract value, which approximates fair value, as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less Plan withdrawals and administrative expenses.

D. Related Party Transactions

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest. Fees paid by the Plan for the investment management services amounted to $105,000 for the year ended December 31, 19X1.

E. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts.

F. Reconciliation of Financial Statements to Form 5500

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

	December 31, 19X1	December 31, 19X0
Net assets available for benefits per the financial statements	$9,218,000	$8,035,000
Amounts allocated to withdrawing participants	(50,000)	(35,000)
Net assets available for benefits per the Form 5500	$9,168,000	$8,000,000

The following is a reconciliation of benefits paid to participants per the financial statements to the Form 5500:

	Year ended December 31, 19X1
Benefits paid to participants per the financial statements	$1,144,000
Add: Amounts allocated to withdrawing participants at December 31, 19X1	50,000
Less: Amounts allocated to withdrawing participants at December 31, 19X0	(35,000)
Benefits paid to participants per the Form 5500	$1,159,000

Amounts allocated to withdrawing participants are recorded on the Form 5500 for benefit claims that have been processed and approved for payment prior to December 31 but not yet paid as of that date.

G. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 19XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Illustration 2: Illustration of Financial Statements: Profit-Sharing Plan

XYZ Company Profit-Sharing Plan
Statement of Net Assets Available for Benefits

	December 31, 19X1	December 31, 19X0
Assets		
Investments:		
At fair value—(Notes B, C, and E)		
U.S. government securities	$ 455,000	$ 425,000
Corporate bonds and debentures	3,900,000	3,730,000
Common stocks	2,822,000	1,931,000
Certificates of deposit	1,000,000	1,000,000
	8,177,000	7,086,000
At contract value—(Note D)		
Investment contract with insurance company	1,000,000	1,000,000
Total investments	9,177,000	8,086,000
Receivables:		
Employer's contribution	14,000	12,000
Participants' contributions	52,000	47,000
Due from broker for securities sold	403,000	357,000
Accrued interest and dividends	77,000	62,000
	546,000	478,000
Cash	280,000	198,000
Total assets	10,003,000	8,762,000
Liabilities		
Accounts payable	10,000	8,000
Accrued expenses	100,000	150,000
Due to broker for securities purchased	75,000	63,000
Total liabilities	185,000	221,000
Net assets available for benefits	$9,818,000	$8,541,000

The accompanying notes are an integral part of these financial statements.

XYZ Company Profit-Sharing Plan
Statement of Changes in Net Assets Available for Benefits

	Year Ended December 31, 19X1
Additions to net assets attributed to:	
Investment income:	
Net appreciation in fair value of investments (Note C)	$ 269,000
Interest	449,000
Dividends	165,000
	883,000
Less investment expenses	(50,000)
	833,000
Contributions:	
Employer's	1,014,000
Participants'	585,000
	1,599,000
Total additions	2,432,000
Deductions from net assets attributed to:	
Benefits paid to participants	1,050,000
Administrative expenses	105,000
Total deductions	1,155,000
Net increase	1,277,000
Net assets available for plan benefits:	
Beginning of year	8,541,000
End of year	$9,818,000

The accompanying notes are an integral part of these financial statements.

XYZ Company Profit-Sharing Plan
Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company ("Company") Profit- Sharing Plan ("Plan") provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. *General.* The Plan is a defined contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. *Contributions.* Each year, the Company contributes to the Plan 10 percent of its current profits before pension and profit-sharing costs and income taxes. Additional amounts may be contributed at the option of the Company's board of directors. Participants may contribute up to 10 percent of their annual wages before bonuses and overtime. Contributions are subject to certain limitations.
3. *Participant Accounts.* Each participant's account is credited with the participant's contribution and an allocation of (*a*) the Company's contribution, (*b*) Plan earnings, and (*c*) forfeitures of terminated participants' nonvested accounts and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.
4. *Vesting.* Participants are immediately vested in their voluntary contributions plus actual earnings thereon. Vesting in the Company contributions portion of their accounts plus earnings thereon is based on years of continuous service. A participant is 100 percent vested after five years of credited service.
5. *Payment of Benefits.* On termination of service due to death, disability or retirement, a participant may elect to receive an amount equal to the value of the participant's vested interest in his or her account in either a lump-sum amount, or in annual installments over a ten year period. For termination of service due to other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

B. Summary of Accounting Policies

Basis of Accounting
The financial statements of the Plan are prepared under the accrual method of accounting.

Investment Valuation and Income Recognition
The Plan's investments are stated at fair value except for its investment contract which is valued at contract value with an insurance company (Note D). If available, quoted market prices are used to value investments. The amounts shown in Note C for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common

stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices. Certificates of deposit are valued based on amortized cost or original cost plus accrued interest.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

C. Investments

Except for its investment contract with an insurance company (Note D), the Plan's investments are held in a bank-administered trust fund. The following table presents investments. Investments that represent 5 percent or more of the Plan's net assets are separately identified.

	December 31 19X1	December 31 19X0
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities	$ 455,000	$ 425,000
Corporate bonds and debentures:		
National Auto 7%, face value of $860,000 and $1,000,000, respectively, bonds due 12/31/X5	875,000	1,226,000
Other	2,775,000	2,328,000
Common stocks:		
Bizco Corporation, 100,000 and 90,000 shares, respectively	950,000	685,000
Other	1,497,000	981,000
	6,552,000	5,645,000
Investments at Estimated Fair Value		
Certificates of Deposit	1,000,000	1,000,000
Corporate bonds and debentures	250,000	176,000
Common stocks	375,000	265,000
	1,625,000	1,441,000
Investment at Contract Value		
Investment contract with National Insurance Company, #2012A, matures 12/31/X2 (Note D)	1,000,000	1,000,000
Total investments	$9,177,000	$8,086,000

During 19X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $269,000 as follows:

Net Change in Fair Value

	Year Ended December 31 19X1
Investments at Fair Value as Determined by Quoted Market Price	
U.S. government securities	$ (15,000)
Corporate bonds and debentures	(175,000)
Common stocks	439,000
Net change in fair value	249,000
Investments at Estimated Fair Value	
Corporate bonds and debentures	(5,000)
Common stocks	25,000
	20,000
Net change in fair value	$ 269,000

D. Investment Contract With Insurance Company

In 19X0, the Plan entered into an investment contract with National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with actual earnings on the underlying investments (principally bank certificates of deposit) and charged for Plan withdrawals and administration expenses charged by National. The contract is included in the financial statements at contract value, which approximates fair value, as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less Plan withdrawals and administrative expenses.

E. Certificates of Deposit

Certificates of deposit at December 31, 19X1 and 19X0 consist of amounts on deposit at banks or savings and loan associations, with interest rates ranging from 5.4 percent to 9.1 percent, with maturities of three months or less. These deposits include $400,000 and $500,000 which are in excess of federally insured limits at December 31, 19X1 and 19X0, respectively.

F. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts.

G. Tax Status

The Internal Revenue Service has determined and informed the Company by letter dated August 30, 19XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable provisions of the IRC.

Illustration 3: Illustration of Financial Statements: Employee Stock Ownership Plan

Sponsor Company Stock Ownership Plan
Statements of Net Assets Available for Benefits

	December 31,					
	19X2			19X1		
	Allocated	Unallocated	Total	Allocated	Unallocated	Total
Assets:						
Cash and cash equivalents	$ 156,000	$ 863,000	$ 1,019,000	$ 101,000	$ 448,000	$ 549,000
Receivables:						
Employer contributions	—	8,607,000	8,607,000	—	7,062,000	7,062,000
Dividends and interest	570,000	459,000	1,029,000	280,000	3,000	283,000
Investment in sponsor company common stock, at fair value	34,890,000	57,430,000	92,320,000	24,568,000	47,015,000	71,583,000
Total assets	$35,616,000	$67,359,000	$102,975,000	$24,949,000	$54,528,000	$79,477,000
Liabilities:						
Interest payable	—	1,396,000	1,396,000	—	1,033,000	1,033,000
Loan payable	—	73,970,000	73,970,000	—	80,000,000	80,000,000
Total liabilities	—	75,366,000	75,366,000	—	81,033,000	81,033,000
Net assets available (deficit) for plan benefits	$35,616,000	$(8,007,000)	$ 27,609,000	$24,949,000	$(26,505,000)	$ (1,556,000)

The accompanying notes are an integral part of these financial statements.

Sponsor Company Stock Ownership Plan
Statement of Changes in Net Assets
Available for Benefits

	December 31, 19X2		
	Allocated	Unallocated	Total
Investment income (loss):			
Net unrealized appreciation (depreciation) in market value of investments	$ 9,205,000	$15,052,000	$24,257,000
Interest	31,000	58,000	89,000
Dividends	1,380,000	2,184,000	3,564,000
Employer contributions	—	11,524,000	11,524,000
Allocation of 142,000 shares of common stock of Sponsor Company, at market	4,637,000	—	4,637,000
	15,253,000	28,818,000	44,071,000
Interest expense	—	5,683,000	5,683,000
Distributions to participants	4,586,000	—	4,586,000
Allocation of 142,000 shares of common stock of Sponsor Company, at market	—	4,637,000	4,637,000
Total deductions	4,586,000	10,320,000	14,906,000
Net increase (decrease)	10,667,000	18,498,000	29,165,000
Net assets (deficit) available for benefits:			
Beginning of year	24,949,000	(26,505,000)	(1,556,000)
End of year	$35,616,000	$ (8,007,000)	$27,609,000

The accompanying notes are an integral part of these financial statements.

Sponsor Company Stock Ownership Plan

Notes to Financial Statements

December 31, 19X2

1. Plan Description and Basis of Presentation

The Sponsor Company (Company) established the Sponsor Company Stock Ownership Plan (Plan) effective as of January 1, 19XX. As of January 1, 19XY, the Plan was amended and operates, in relevant part, as a leveraged employee stock ownership plan (ESOP), and is designed to comply with Section 4975(e)(7) and the regulations thereunder of the Internal Revenue Code of 1986, as amended (Code) and is subject to the applicable provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The Plan is administered by an Employee Benefits Administration Committee comprising up to three persons appointed by the Sponsor Company's Board of Directors. The trust department of an independent third-party bank is the Plan's Trustee.

The Plan purchased Company common shares using the proceeds of a bank borrowing (see Note 6) guaranteed by the Company, and holds the stock in a trust established under the Plan. The borrowing is to be repaid over a period of ten years by fully deductible Company contributions to the trust fund. As the Plan makes each payment of principal, an appropriate percentage of stock will be allocated to eligible employees' accounts in accordance with applicable regulations under the Code. Shares vest fully upon allocation.

The borrowing is collateralized by the unallocated shares of stock and is guaranteed by the Company. The lender has no rights against shares once they are allocated under the ESOP. Accordingly, the financial statements of the Plan for the years 19X2 and 19X1 present separately the assets and liabilities and changes therein pertaining to:

(*a*) the accounts of employees with vested rights in allocated stock (Allocated) and

(*b*) stock not yet allocated to employees (Unallocated).

Employees of the Company and its participating subsidiaries are generally eligible to participate in the Plan after one year of service providing they worked at least 1,000 hours during such plan year. Participants who do not have at least 1,000 hours of service during such plan year or are not employed on the last working day of a plan year are generally not eligible for an allocation of Company contributions for such year.

No distributions from the Plan will be made until a participant retires, dies (in which case, payment shall be made to his or her beneficiary or, if none, his or her legal representatives), or otherwise terminates employment with the Company and its participating subsidiaries. Distributions are made in cash or, if a participant elects, in the form of Company common shares plus cash for any fractional share.

Each participant is entitled to exercise voting rights attributable to the shares allocated to his or her account and is notified by the Trustee prior to the time that such rights are to be exercised. The Trustee is not permitted to vote any share for which instructions have not been given by a participant.

The Company reserves the right to terminate the Plan at any time, subject to Plan provisions. Upon such termination of the Plan, the interest of each participant in the trust fund will be distributed to such participant or his or her beneficiary at the time prescribed by the Plan terms and the Code. Upon termination of the Plan, the Employee Benefits Administration Committee shall direct the Trustee to pay all liabilities and expenses of the trust fund and to sell shares of financed stock held in the loan suspense account to the extent it determines such sale to be necessary in order to repay the loan.

2. **Summary of Significant Accounting Policies**

Investment Valuation and Income Recognition

The common shares of the Company are valued at fair value on December 31, 19X2 and 19X1. Fair value is determined by annual independent appraisals.

Dividend income is accrued on the ex-dividend date.

Purchases and sales of securities are recorded on a trade-date basis. Realized gains and losses from security transactions are reported on the average cost method.

3. **Tax Status**

The Internal Revenue Service has determined and informed the Company by a letter dated June 30, 19XX, that the Plan is qualified and the trust established under the Plan is tax-exempt, under the appropriate sections of the Code. The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is currently designed and being operated in compliance with the applicable requirements of the Code. Therefore, they believe that the Plan was qualified and the related trust was tax-exempt as of the financial statement date.

4. **Administration of Plan Assets**

The Plan's assets, which consist principally of Sponsor Company common shares, are held by the Trustee of the Plan.

Company contributions are held and managed by the Trustee, which invests cash received, interest, and dividend income and makes distributions to participants. The Trustee also administers the payment of interest and principal on the loan, which is reimbursed to the Trustee through contributions as determined by the Company.

Certain administrative functions are performed by officers or employees of the Company or its subsidiaries. No such officer or employee receives compensation from the Plan. Administrative expenses for the Trustee's fees are paid directly by the Company.

5. **Investments**

The Plan's investments, at December 31, are presented in the following table:

	19X2		19X1	
	Allocated	Unallocated	Allocated	Unallocated
Sponsor Company Common Shares:				
Number of Shares	1,069,000	1,759,000	1,074,000	2,055,000
Cost	$27,014,000	$74,456,000	$29,910,000	$80,000,000
Market	$34,890,000	$57,430,000	$24,568,000	$47,015,000

6. **Loan Payable**

In 19XX, the Plan entered into an $80,000,000 term loan agreement with a bank. The proceeds of the loan were used to purchase Company's common stock. Unallocated shares are collateral for the loan. The agreement provides for the loan to be repaid over ten years. The scheduled amortization of the loan for the next five years and thereafter is as follows: 19X3—$6,500,000; 19X4—$7,000,000; 19X5—$7,500,000; 19X6—$8,000,000; 19X7—$8,500,000; and thereafter—$31,470,900. The loan bears interest at the prime rate of the lender. For 19X2 and 19X1 the loan interest rate averaged 7.34 percent and 5.12 percent, respectively.

7. **Employer Contributions**

The Company is obligated to make contributions in cash to the Plan which, when aggregated with the Plan's dividends and interest earnings, equal the amount necessary to enable the Plan to make its regularly scheduled payments of principal and interest due on its term loan.

Appendix F

Illustrations of Financial Statements: Employee Health and Welfare Benefit Plans

F.01 This appendix illustrates certain applications of the provisions of chapter 4A to the annual financial statements of two hypothetical health and welfare benefit plans that have assets in underlying trusts and have adopted SOP 92-6. They are—

a. Allied Industries Benefit Plan, a multiemployer plan that displays the benefit obligation information in separate financial statements (exhibit A).

b. Classic Enterprises Benefit Plan, a single-employer plan that displays the benefit obligation information on the face of the financial statements along with the net asset information (exhibit B).

F.02 The plan in exhibit A pays all benefits directly from plan assets. The plan in exhibit B obtains insurance for current benefits from its assets. It is assumed that both plans provide health benefits and life insurance coverage to both active and retired participants. Exhibit A also assumes that the plan provides long-term disability benefits and limited coverage during periods of unemployment based on accumulated eligibility credits.

F.03 The examples do not illustrate other provisions of chapter 4A that might apply in circumstances other than those assumed. The format presented and the wording of the accompanying notes are illustrative only and are not necessarily the only possible presentations. Although generally accepted accounting principles encourage but do not require comparative financial statements ERISA requires comparative statements of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

F.04 ERISA and DOL regulations require that certain information be included in supplemental schedules, which are not required under generally accepted accounting principles, and reported on by the independent auditor. See appendix A for a further discussion of the ERISA and DOL requirements.

Exhibit A

ALLIED INDUSTRIES BENEFIT PLAN
Allied Industries Benefit Plan
Statements of Net Assets Available for Benefits
December 31, 19X1 and 19X0

	19X1	*19X0*
Assets		
Investments, at fair value (see note 3)		
U.S. government securities	$5,000,000	$4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total Investments	8,000,000	6,200,000
Receivables		
Participating employers' contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	140,000	115,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	$8,515,000	$6,600,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Benefit Plan
Statement of Changes in Net Assets Available for Benefits
Year Ended December 31, 19X1

	19X1
Additions	
Contributions	
Participating employers	$15,000,000
Participants	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
Total investment income	850,000
Less investment expenses	15,000
Net investment income	835,000
TOTAL ADDITIONS	18,835,000
Deductions	
Benefits paid to participants	
Health care	16,000,000
Disability and death	770,000
Total benefits paid	16,770,000
Administrative expenses	150,000
TOTAL DEDUCTIONS	16,920,000
NET INCREASE DURING YEAR	1,915,000
Net assets available for benefits	
Beginning of year	6,600,000
End of year	$ 8,515,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Benefit Plan
Statements of Plan's Benefit Obligations
December 31, 19X1 and 19X0

	19X1	*19X0*
Amounts currently payable to or for participants, beneficiaries, and dependents		
Health claims payable	$ 1,100,000	$ 975,000
Death and disability benefits payable	100,000	75,000
	1,200,000	1,050,000
Other obligations for current benefit coverage, at present value of estimated amounts		
Claims incurred but not reported	350,000	290,000
Accumulated eligibility credits	200,000	225,000
Long-term disability benefits	800,000	485,000
	1,350,000	1,000,000
Total obligations other than postretirement benefit obligations	2,550,000	2,050,000
Postretirement benefit obligations		
Current retirees	3,900,000	3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Other participants not yet fully eligible for benefits	5,000,000	4,165,000
	11,000,000	9,665,000
PLAN'S TOTAL BENEFIT OBLIGATIONS	$13,550,000	$11,715,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Benefit Plan
Statement of Changes in Plan's Benefit Obligations
Year Ended December 31, 19X1

	19X1
Amounts currently payable to or for participants, beneficiaries, and dependents	
Balance at beginning of year	$ 1,050,000
Claims reported and approved for payment	16,920,000
Claims paid (including disability)	(16,770,000)
Balance at end of year	1,200,000
Other obligations for current benefit coverage, at present value of estimated amounts	
Balance at beginning of year	1,000,000
Net change during year:	
Long-term disability benefits	315,000
Other	35,000
Balance at end of year	1,350,000
Total obligations other than postretirement benefit obligations	2,550,000
Postretirement benefit obligation	
Balance at beginning of year	9,665,000
Increase (decrease) during the year attributable to:	
Benefits earned and other changes	1,250,000
Plan amendment	(175,000)
Changes in actuarial assumptions	260,000
Balance at end of year	11,000,000
PLAN'S TOTAL BENEFIT OBLIGATIONS AT END OF YEAR	$13,550,000

The accompanying notes are an integral part of the financial statements.

Allied Industries Benefit Plan
Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Allied Industries Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and other benefits covering all participants in the widgets industry in the Greater Metropolis area. The Plan and related trust were established on May 8, 1966, pursuant to a collective bargaining agreement between the Allied Employers' Trade Association and the Allied Union, Local 802. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental), life insurance coverage, long-term disability benefits, and death benefits to full-time participants (with at least 450 hours of work in the industry during a consecutive three-month period) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health benefits (in excess of Medicare coverage) provided they have attained at least age sixty-two and have fifteen years of service with participating employers before retirement.

The Plan also provides health benefits to participants during periods of unemployment, provided they have accumulated in the current year or in prior years credit amounts (expressed in hours) in excess of the hours required for current coverage. Accumulated eligibility credits equal to one year's coverage may be carried forward.

Health, disability, and death claims of active and retired participants, dependents, and beneficiaries are processed by the Administrator Group, but the responsibility for payments to participants and providers is retained by the Plan.

In 19X1 the board of trustees amended the Plan to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 19X2. The amendment will not affect participating employers' contributions to the Plan in 19X2 under the current collective bargaining agreement.

Contributions. Participating employers contribute 5.5 percent of wages pursuant to the current collective bargaining agreement between employers and the union (expiring February 19, 19X5). Employees and retirees may contribute specified amounts, determined periodically by the Plan's actuary, to extend coverage to eligible dependents.

Other. The Plan's board of trustees, as Sponsor, has the right under the Plan to modify the benefits provided to active employees. The Plan may be terminated only by joint agreement between industry and union, subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. *Valuation of Investments.* The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Plan's board of trustees has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

B. Postretirement Benefits. The postretirement benefit obligation represents the total actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired or terminated employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the participating employers. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service in the industry rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 19X2; the rate was assumed to decrease gradually to 8.0 percent for 19X7 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 19X1.

The following were other significant assumptions used in the valuations as of December 31, 19X1 and 19X0.

Weighted-average discount rate	8.0%—19X1; 8.25%—19X0
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

C. Other Plan Benefits. Plan obligations at December 31 for health claims incurred by active participants but not reported at that date, for accumulated eligibility of participants, and for future disability payments to members considered permanently disabled at December 31 are estimated by the Plan's actuary in accordance with accepted actuarial principles. Such estimated amounts are reported in the accompanying statement of the Plan's benefit obligations at present value, based on an 8.0 percent discount rate. Health claims incurred by retired participants but not reported at year end are included in the postretirement benefit obligation.

NOTE 3: BENEFIT OBLIGATIONS

The Plans deficiency of net assets over benefit obligations at December 31, 19X1 and 19X0, relates primarily to the postretirement benefit obligation, the funding of which is not covered by the contribution rate provided by the current bargaining agreement. It is expected that the deficiency will be funded through future increases in the collectively bargained contribution rates.

The weighted-average health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported in the accompanying financial statements. If the assumed rates increased by one percentage point in each year, it would increase the obligation as of December 31, 19X1 and 19X0, by $2,600,000 and $2,500,000, respectively.

NOTE 4: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 19X1 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000, as follows:

	19X1	
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*
Fair Value as determined by quoted market price:		
U.S. government securities	$200,000	$5,000,000
Corporate bonds and debentures	(25,000)	1,750,000
Common stocks	100,000	1,000,000
	275,000	7,750,000
Fair value as estimated by Plan's board of trustees:		
Corporate bonds	25,000	250,000
	$300,000	$8,000,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	19X1	*19X0*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 19X6 ($360,000 face amount)		350,000

NOTE 5: OTHER MATTERS

The trust established under the Plan to hold the Plan's assets is intended to qualify pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Plan has obtained a favorable tax determination letter from the Internal Revenue Service, and the Plan sponsor believes that the Plan, as amended, continues to qualify and to operate in accordance with applicable provisions of the Internal Revenue Code.

NOTE 6: RECONCILIATION TO FINANCIAL STATEMENTS TO FORM 5500

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

	December 31,	
	19X1	*19X0*
Net assets available for benefits per the financial statements	$8,515,000	$6,600,000
Benefit obligations currently payable (health claims, death and disability benefits)	1,200,000	1,050,000
Net assets available for benefits per the Form 5500	$7,315,000	$5,550,000

The following is a reconciliation of benefits paid to participants per the financial statements to the Form 5500:

	Year ended December 31, 19X1
Benefits paid to participants per the financial statements	$16,770,000
Add: Amounts currently payable at December 31, 19X1	1,200,000
Less: Amounts currently payable at December 31, 19X0	(1,050,000)
Benefits paid to participants per the Form 5500	$16,920,000

Amounts currently payable to or for participants, dependents, and beneficiaries are recorded on the Form 5500 for benefit claims that have been processed and approved for payment prior to December 31, but not yet paid as of that date.

Exhibit B

CLASSIC ENTERPRISES BENEFIT PLAN

Classic Enterprises Benefit Plan
Statements of Benefit Obligations and Net Assets Available for Benefits
December 31, 19X1 and 19X0

	19X1	*19X0*
BENEFIT OBLIGATIONS (see note 4)		
Amounts due insurance companies	$ 1,200,000	$ 1,000,000
Postretirement benefit obligations	11,000,000	9,665,000
Total benefit obligations	12,200,000	10,665,000
NET ASSETS		
Assets		
Investments at fair value (see note 3)		
U.S. government securities	$ 5,000,000	$ 4,000,000
Corporate bonds and debentures	2,000,000	1,600,000
Common stock	1,000,000	600,000
Total investments	8,000,000	6,200,000
Receivables		
Sponsor's contributions	500,000	430,000
Participants' contributions	100,000	80,000
Accrued interest and dividends	50,000	40,000
Total receivables	650,000	550,000
Cash	75,000	60,000
Insurance premium deposits	65,000	55,000
TOTAL ASSETS	8,790,000	6,865,000
Liabilities		
Due to broker for securities purchased	250,000	240,000
Accounts payable for administrative expenses	25,000	25,000
TOTAL LIABILITIES	275,000	265,000
NET ASSETS AVAILABLE FOR BENEFITS	8,515,000	6,600,000
EXCESS OF BENEFIT OBLIGATIONS OVER NET ASSETS AVAILABLE FOR BENEFITS	$ 3,685,000	$ 4,065,000

The accompanying notes are an integral part of the financial statements.

Classic Enterprises Benefit Plan
Statement of Changes in Benefit Obligations and Net Assets Available for Benefits
Year Ended December 31, 19X1

	19X1
Net Increase in Benefit Obligations	
Increase (Decrease) during the year attributable to:	
Benefits earned and other changes	$1,510,000
Additional amounts payable to insurance company	200,000
Plan amendment	(175,000)
	1,535,000
Net Increase in Net Assets Available for Benefits	
Additions	
Contributions	
Sponsor	15,000,000
Participants	3,000,000
Total contributions	18,000,000
Investment income	
Net appreciation in fair value of investments	300,000
Interest	500,000
Dividends	50,000
	850,000
Less investment expenses	15,000
Net investment income	835,000
TOTAL ADDITIONS	18,835,000

(continued)

	19X1
Deductions	
Insurance premiums paid for health benefits, net of experience-rating adjustments of $250,000 for 19X0 received in 19X1	16,035,000
Insurance premiums paid for death benefits	780,000
	16,815,000
Administrative expenses	105,000
TOTAL DEDUCTIONS	16,920,000
NET INCREASE	1,915,000
Decrease in Excess of Benefit Obligations Over Net Assets Available for Benefits	(380,000)
Excess of Benefit Obligations Over Net Assets Available for Benefits	
Beginning of year	4,065,000
End of year	$3,685,000

The accompanying notes are an integral part of the financial statements.

Classic Enterprises Benefit Plan
Notes to Financial Statements

NOTE 1: DESCRIPTION OF PLAN

The following description of the Classic Enterprises Benefit Plan (the Plan) provides only general information. Participants should refer to the Plan agreement for a complete description of the Plan's provisions.

General. The Plan provides health and death benefits covering substantially all active and retired employees of Classic Enterprises (the Sponsor). It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended.

Benefits. The Plan provides health benefits (medical, hospital, surgical, major medical, and dental) and death benefits to full-time employees of the Sponsor (with at least 1,000 hours of service each year) and to their beneficiaries and covered dependents. Retired employees are entitled to similar health and death benefits provided they have attained at least age fifty-five and have at least ten years of service with the Sponsor.

Current health claims of active and retired participants and their dependents and beneficiaries are provided under group insurance contracts with ABC Carrier, which are experience rated after the anniversary dates of the policies (generally March 31). Death benefits are covered by a group-term policy with DEF Carrier.

Contributions. The Sponsor's policy is to contribute the maximum amounts allowed as a tax deduction by the Internal Revenue Code. Under present law, the Sponsor is not permitted to deduct amounts for future benefits to current employees and retirees.

Employees and retirees may contribute specified amounts, determined periodically by the Plan's insurance companies, to extend coverage to eligible dependents.

In 19X1 the Plan was amended to increase the deductible under major medical coverage from $100 to $300 and to extend dental coverage to employees retiring after December 31, 19X1. The amendment is not expected to significantly affect the Sponsor's contribution to the Plan in 19X2.

Other. Although it has not expressed any intention to do so, the Sponsor has the right under the Plan to modify the benefits provided to active employees, to discontinue its contributions at any time, and to terminate the Plan subject to the provisions set forth in ERISA.

NOTE 2: SUMMARY OF ACCOUNTING POLICIES

A. Valuation of Investments. The Plan's investments are stated at fair value. Securities traded on the national securities exchange are valued at the last reported sales price on the last business day of the plan year. Investments traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the average of the last reported bid and asked prices. For certain corporate bonds that do not have an established fair value, the Classic Enterprises Benefits Committee has established a fair value based on yields currently available on comparable securities of issuers with similar credit ratings.

B. Plan Benefits. The postretirement benefit obligation (see note 4) represents the actuarial present value of those estimated future benefits that are attributed to employee service rendered to December 31. Postretirement benefits include future benefits expected to be paid to or for (1) currently retired employees and their beneficiaries and dependents and (2) active employees and their beneficiaries and dependents after retirement from service with the Sponsor. Prior to an active employee's full eligibility date, the postretirement benefit obligation is the portion of the expected postretirement benefit obligation that is attributed to that employee's service rendered to the valuation date.

The actuarial present value of the expected postretirement benefit obligation is determined by an actuary and is the amount that results from applying actuarial assumptions to historical claims-cost data to estimate future annual incurred claims costs per participant and to adjust such estimates for the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as those for death, disability, withdrawal, or retirement) between the valuation date and the expected date of payment.

For measurement purposes at December 31, 19X1, a 9.5 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 19X2; the rate was assumed to decrease gradually to 8.0 percent for 19X7 and to remain at that level thereafter. These assumptions are consistent with those used to measure the benefit obligation at December 31, 19X0.

The following were other significant assumptions used in the valuations as of December 31, 19X1 and 19X0.

Weighted-average discount rate	8.0%
Average retirement age	60
Mortality	1971 Group Annuity Mortality Table

The foregoing assumptions are based on the presumption that the Plan will continue. Were the Plan to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of the postretirement benefit obligation.

NOTE 3: BENEFIT OBLIGATIONS

Health costs incurred by participants and their beneficiaries and dependents are covered by insurance contracts maintained by the Plan. It is the present intention of the Sponsor and the Plan to continue obtaining insurance coverage for benefits. As stated in note 1, the Sponsor is not permitted under present tax law to deduct amounts for future benefits (beyond one year). Insurance premiums for future years in respect of the Plan's postretirement benefit obligation will be funded by Sponsor contributions to the Plan in those later years.

The postretirement benefit obligation at December 31, 19X1 and 19X0, principally health benefits, related to the following categories of participants (including their beneficiaries and dependents):

	19X1	*19X0*
Current retirees	$ 3,900,000	$3,500,000
Other participants fully eligible for benefits	2,100,000	2,000,000
Participants not yet fully eligible for benefits	5,000,000	4,165,000
	$11,000,000	$9,665,000

The health care cost-trend rate assumption (see note 2B) has a significant effect on the amounts reported. If the assumed rates increased by one percentage point in each year, that would increase the obligation as of December 31, 19X1 and 19X0, by $2,600,000 and $2,500,000, respectively.

NOTE 4: INVESTMENTS

The Plan's investments are held by a bank-administered trust fund. During 19X1, the plan's investments (including investments bought, sold, and held during the year) appreciated in value by $300,000, as follows:

	19X1	
	Net Increase (Decrease) in Value During Year	*Fair Value at End of Year*
Fair value as determined by quoted market price:		
U.S. government securities	$200,000	$5,000,000
Corporate bonds and debentures	(25,000)	1,750,000
Common stocks	100,000	1,000,000
	275,000	7,750,000
Fair value as estimated by Classic Enterprise Benefits Plan Investment Committee:		
Corporate bonds	25,000	250,000
	$300,000	$8,000,000

The fair value of individual investments that represent 5.0 percent or more of the Plan's net assets are as follows:

	19X1	*19X0*
Commonwealth Power Co., 9.0% bonds due 2014 ($500,000 face amount)	$475,000	$450,000
ABC Company common stock (2,000 shares)	500,000	450,000
U.S. Treasury bond, 8.5% due 19X6 ($360,000 face amount)		350,000

NOTE 5: OTHER MATTERS

The trust established under the Plan to hold the Plan's net assets is qualified pursuant to Section 501(c)9 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Sponsor has obtained a favorable tax determination letter from the Internal Revenue Service and the Sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

NOTE 6: RECONCILIATION OF FINANCIAL STATEMENTS TO FORM 5500

The following is a reconciliation of net assets available for benefits per the financial statements to the Form 5500:

	December 31,	
	19X1	*19X0*
Net assets available for benefits per the financial statements	$8,515,000	$6,600,000
Amounts due to insurance companies	1,200,000	1,000,000
Net assets available for benefits per the Form 5500	$7,315,000	$5,600,000

The following is a reconciliation of insurance premiums paid for participants per the financial statements to the Form 5500:

	Year ended December 31, 19X1
Insurance premiums paid per the financial statements	$16,815,000
Add: Amounts due insurance companies at December 31, 19X1	1,200,000
Less: Amounts due insurance companies at December 31, 19X0	(1,000,000)
Insurance premiums paid to participants per the Form 5500	$17,015,000

Appendix G

Illustrations of Financial Statements: Employee Health and Welfare Benefit Plan and Vacation Benefit Plan

This appendix illustrates certain applications of the provisions of chapter 4 that apply for the annual financial statements of a hypothetical self-insured health and welfare benefit plan, the Bizco Corporation Employee Health and Welfare Benefit Plan, and a hypothetical vacation benefit plan, the UAGW Vacation Benefit Plan, which have not yet adopted SOP 92-6. It does not illustrate other provisions of chapter 4 that might apply in circumstances other than those assumed in these examples. The format presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations. For purposes of illustration, only single-year financial statements are shown.

Employee Health and Welfare Benefit Plan

Bizco Corporation Employee Health and Welfare Benefit Plan
Statement of Net Assets

	December 31, 19X1
Assets	
Investments, at fair value (Notes B and D)	
U.S. government securities	$1,171,000
Corporate bonds and debentures	360,000
Common stock	219,000
Total investments	1,750,000
Receivables	
Employer's contributions (Note A)	562,000
Employees' contributions (less allowance for doubtful accounts of $4,000)	138,000
Accrued interest and dividends	25,000
Due from broker for securities sold	31,000
	756,000
Cash	58,000
Total assets	2,564,000
Liabilities	
Health claims payable	402,000
Estimated health claims incurred but not reported	182,000
Estimated future benefits based on participant's accumulated eligibility (Note A)	592,000
Estimated future benefits to retired participants	385,000
Estimated future death benefits	315,000
Due to broker for securities purchased	35,000
Other liabilities	38,000
Total liabilities	1,949,000
Net assets	$ 615,000

The accompanying notes are an integral part of these financial statements.

Bizco Corporation Employee Health and Welfare Benefit Plan
Statement of Changes in Net Assets

	Year Ended December 31, 19X1
Additions to plan assets attributed to:	
Investment income	
Net appreciation in fair value of investments (Note D)	$ 12,000
Interest	165,000
Dividends	7,000
	184,000
Less investment expenses	(11,000)
	173,000
Employer's contributions (Notes A and C)	2,320,000
Employees' contributions	833,000
Total additions	3,326,000
Deductions from plan assets attributed to:	
Payments for—	
Health claims	2,683,000
Retired participants' benefits	173,000
Death benefits	112,000
	2,968,000
Additions to liabilities for—	
Health claims (Note C)	134,000
Participants' accumulated eligibility	75,000
Future benefits to retired participants	29,000
Death benefits	12,000
Administrative expenses	166,000
Total deductions	3,384,000
Net decrease	(58,000)
Net assets	
Beginning of year	673,000
End of year	$ 615,000

The accompanying notes are an integral part of these financial statements.

Bizco Corporation Employee Health and Welfare Benefit Plan
Notes to Financial Statements

A. Description of the Plan

The following description of the Bizco Corporation (Corporation) Employee Health and Welfare Benefit Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. General. The Plan provides health and death benefits covering substantially all employees of the Corporation. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).
2. Benefits. The Plan provides health benefits (hospital, surgical, major medical, and long-term disability) covering full-time employees of the Corporation with 1000 hours of service each year. The Plan also provides health benefits to certain active and retired employees if they have accumulated in the current year or prior years credit amounts (expressed in hours) in excess of hours required for current coverage. Accumulated eligibility credits equal to approximately one year's coverage may be carried forward, and any credits in excess of approximately one year's coverage are converted into specified amounts of paid-up death benefits.
3. Contributions. The Plan agreement provides that the Corporation make quarterly contributions to the Plan of a specified amount for each hour worked (approximately x cents per hour in 19X1) to provide benefits for employees. The employer's contribution rate is determined annually by the Plan's actuary. Beginning in 19X2, the Corporation's contribution is expected to increase approximately 7 percent (to y cents per hour) to provide for the increase in benefits attributable to the Plan amendment effective July 1, 19X1 (Note C). An employee may contribute specified amounts, determined annually by the Plan's actuary, to extend coverage to eligible dependents of the employee.

B. Summary of Accounting Policies

1. Valuation of Investments. If available, quoted market prices are used to value investments. The amounts shown in Note D for securities that have no quoted market price represent estimated fair value. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock less an appropriate discount. If a quoted market price for unrestricted common stock of the issuer is not available, restricted common stocks are valued at a multiple of current earnings less an appropriate discount. The multiple chosen is consistent with multiples of similar companies based on current market prices.
2. Plan Benefits. Plan liabilities for health claims incurred but not reported, future benefits to retired participants and accumula-

ted eligibility of participants as of December 31, 19X1, are estimated by the plan's actuary in accordance with accepted actuarial principles. The liability for death benefits has been determined by the application of the unit risk rates computed in accordance with actuarial principles and discounted to present value assuming an average investment return rate of 7.5 percent.

C. Plan Amendment

Effective July 1, 19X1, the Plan was amended to increase major medical coverage from 60 to 75 percent of costs after $100 deductible. The Plan's actuary estimates that the amendment has resulted in an increase in health benefits payable under the Plan of $115,000 in 19X1, and that the amendment will result in an increase of 7 percent in the Corporation's contribution in 19X2.

D. Investments

The Plan's investments are held by a bank-administered trust fund. The following table presents the fair values of investments. Investments that represent 5 percent or more of total plan assets are separately identified.

Fair Value of Investments

	December 31, 19X1	
	Numbers of Shares or Principal Amount	Fair Value
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities		$1,171,000
Corporate bonds and debentures		
Commonwealth Power 9% bonds due 19X4	$200,000	172,000
Other		74,000
Common stocks		
Bizco Corporation	2,000	30,500
Other		110,000
		1,557,500
Investments at Estimated Fair Value		
Corporate bonds	$150,000	114,000
Common stocks		78,500
		192,500
Total investments at fair value		$1,750,000

During 19X1, the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $12,000 as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31, 19X1
Investments at Fair Value as Determined by Quoted Market Price	
U.S. government securities	($15,000)
Corporate bonds and debentures	(7,000)
Common stocks	31,000
	9,000
Investments at Estimated Fair Value	
Corporate bonds	(2,000)
Common stocks	5,000
	3,000
Net appreciation in fair value	$12,000

E. Tax Status

The trust established under the Plan to hold the Plan's assets is qualified pursuant to section 501(c)3 of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Plan has obtained a favorable tax determination letter from the Internal Revenue Service and the Plan sponsor believes that the Plan, as amended, continues to qualify and to operate as designed.

Vacation Benefit Plan

UAGW Vacation Benefit Plan
Statement of Net Assets

	December 31, 19X2
Assets	
Investments, at fair value (Notes B and C)	
U.S. government securities	$ 850,000
Certificates of deposit	650,000
Total investments	1,500,000
Receivables	
Employers' contributions (Note A)	152,000
Accrued interest	9,000
	161,000
Cash	26,000
Total assets	1,687,000
Liabilities	
Accounts payable	17,000
Vacation benefits payable	
19X0 and prior plan years	25,000
19X1 plan year	31,000
19X2 plan year	1,600,000
Total vacation benefits payable	1,656,000
Total liabilities	1,673,000
Net assets	$ 14,000

The accompanying notes are an integral part of these financial statements.

UAGW Vacation Benefit Plan
Statement of Changes in Net Assets

	Year Ended December 31, 19X2
Additions to net assets attributed to:	
Investment income	
Net appreciation in fair value of investments (Note C)	$ 6,000
Interest	113,000
Less investment expenses	(8,000)
	111,000
Employers' contributions	2,145,000
Total additions	2,256,000
Deductions from net assets attributed to:	
Payments for vacation benefits for —	
19X0 and earlier plan years	37,000
19X1 plan year	1,427,000
19X2 plan year	624,000
	2,088,000
Net additions to total liability for vacation benefits	103,000
Administrative expenses	85,000
Total deductions	2,276,000
Net decrease	(20,000)
Net assets	
Beginning of year	34,000
End of year	$ 14,000

The accompanying notes are an integral part of these financial statements.

UAGW Vacation Benefit Plan
Notes to Financial Statements

A. Description of the Plan

The following description of the UAGW Vacation Benefit Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

1. General. The Plan was formed under an agreement between the Contractors' Association and the UAGW labor union (Union). The Plan covers all members of the Union employed under the terms of the collective bargaining agreement with the members of the Contractors' Association.
2. Contributions and Benefits. Employers contribute to the Plan x cents for each hour worked by Plan participants. The amount accumulated in each participant's vacation account as of September 30 of each year is paid on or after December 1 to the participant unless the participant elects to hold the amount in the vacation account. Benefits unclaimed after seven years revert to the Plan.

3. Investment Income. Investment income in the Plan is used primarily to pay the Plan's administrative expenses. Excess of investment income over administrative expenses may be carried forward to later years or distributed to participants on a pro rata basis at the discretion of the trustees.

B. Summary of Accounting Policies

1. Valuation of Investments. Investments are valued at fair value as of December 31, 19X2. If available, quoted market prices are used to value investments. Such investments are valued at the mean of bid and asked prices as obtained from one or more market makers in those securities. The amounts shown in Note C for investments that have no quoted market price represent estimated fair value, which is determined based on yields equivalent for such securities or for securities of comparable maturity, quality, and type as obtained from market makers. Gains and losses on investments that were both bought and sold during the year are included in net appreciation in fair value.
2. Contributions. Employers' contributions receivable represents amounts due as of December 31, 19X2, under terms of the collective bargaining agreement. The amount shown is net of $3,000 estimated to be uncollectible.

C. Investments

The Plan's investments consist of U.S. Treasury bills, other obligations issued or guaranteed by the U.S. government or its agencies, and bank certificates of deposit. The Plan's investments are held by a bank-administered trust. The following table presents the fair value of investments. Investments that represent 5 percent or more of total plan assets are separately identified.

D. Tax Status

The trust established under the Plan to hold the Plan's assets is qualified pursuant to the appropriate section of the Internal Revenue Code, and, accordingly, the trust's net investment income is exempt from income taxes. The Plan has obtained a favorable tax determination letter from the Internal Revenue Service and the Plan sponsor believes that the Plan continues to qualify and to operate as designed.

Fair Value of Investments

	December 31, 19X2	
	Principal Amount	Fair Value
Investments at Fair Value as Determined by Quoted Market Price		
U.S. government securities		
U.S. Treasury notes, 8.1%, Feb. 15, 19X3	$250,000	$ 248,000
Other various	617,000	602,000
		850,000
Investments at Estimated Fair Value		
Negotiable bank certificates of deposit		
Bakers Trust, 8.4%, Jan. 22, 19X3	200,000	200,000
Mechanical Bank, 9.8%, Feb. 14, 19X3	200,000	201,000
Zitibank, N.A., 10.2%, March 1, 19X3	200,000	201,000
Other various	48,000	48,000
		650,000
Total investments at fair value		$1,500,000

During 19X2 the Plan's investments (including investments bought, sold, and held during the year) appreciated in value by $6,000 as follows:

Net Appreciation (Depreciation) in Fair Value

	Year Ended December 31, 19X2
Investments at Fair Value as Determined by Quoted Market Prices	
U.S. government securities	$8,000
Investments at Estimated Fair Value	
Negotiable bank certificates of deposit	(2,000)
Net appreciation in fair value	$6,000

Appendix H

Summary of Objectives, Procedures, and Other Considerations for Auditing Investments

H.01 This appendix summarizes the objectives, procedures, and other considerations for auditing plan investments discussed in chapter 7. Exhibit H-1 summarizes the objectives and procedures for auditing trusteed assets and assets invested in common/commingled and master trust funds. Exhibit H-2 summarizes the objectives and procedures for auditing plan assets held with an insurance contract.

H.02 This appendix is not intended to be all-inclusive or to suggest the specific objectives and procedures that should necessarily be adopted by an auditor of an employee benefit plan. Some of the illustrated objectives and procedures may not be relevant to a particular plan because of the type of plan or the absence of certain types of transactions or investments.

Exhibit H-1

	Paragraph References			
	Trusteed Assets		Types of Investments	
	Directed	Discretionary	Common/ Commingled	Master Trusts*
General Audit Objectives:				
Investments or units are recorded and exist	7.11(a)	7.11(a)	7.17(a)	7.11(a)
Investments or units are owned by the plan and are unencumbered, or, if not, security interests are identified	7.11(b)	7.11(b)	7.17(b)	7.11(b)
Investment or unit valuation is in accordance with generally accepted accounting principles (GAAP)	7.11(c)	7.11(c)	7.17(c)	7.11(c)
Purchase, redemption, and income transactions of the investments or units are recorded in accordance with GAAP	7.11(c)	7.11(c)	7.17(d)	7.11(c)
Investment presentation and disclosure is adequate	7.11(d)	7.11(d)	7.11(d)**	7.11(d)
General Auditing Procedures:				
Obtain an understanding of the plan's investment strategy and the investments held by the plan	7.12(a)	7.14, 7.12(a)	7.16, 7.12(a)	7.12(a)
Obtain an understanding of the plan's internal control structure relating to investments, in accordance with SAS No. 55	6.01, 7.13	6.01, 7.13	6.01, 7.18(c)	6.01
Obtain single-audit reports (SAS No. 70 report) on trustee	6.07	6.07, 7.15	6.07, 7.18(c)	6.07
Obtain an analysis of changes in investment portfolio	7.12(b)	7.14, 7.12(b)	7.18(c)	7.12(b)
Obtain evidence of existence and ownership (i.e., confirmation or physical inspection)	7.12(c)	7.14, 7.12(c)	7.18(a)	7.12(c)
Obtain an understanding of the trustee's responsibility and financial capability	7.12(c)	7.14, 7.12(c)	n/a	n/a
Review minutes, agreements, and confirmations for security interests	7.12(d)	7.14, 7.12(d)	7.18(b)	7.12(d)
Tests investment transactions (i.e., authorization, brokers advices, and computation of realized gains)	7.12(e)	n/a	7.18(b)	7.12(e)
Confirm securities in transit	7.12(f)	n/a	n/a	n/a
Test income accrual	7.12(g)	n/a	7.18(c)	7.12(g)
Test the computation of fair value	7.12(h)	7.14, 7.12(h)	n/a	n/a
Test change in appreciation/depreciation	7.12(i)	n/a	7.18(c)	7.12(i)
Inquire regarding investments or transactions that violate laws or regulations	7.12(j)	7.14, 7.12(j)	7.18(b)	7.12(j)
Obtain trust fund financial statements and agree units information	n/a	n/a	7.18(c)	7.21

* The audit objectives and procedures described in paragraphs 7.11 and 7.12 also apply to the activities of a master trust pursuant to paragraph 7.20.

** Although this audit is not specifically listed in paragraphs 7.17, paragraph 7.11 lists audit objectives for all types of plan assets.

Exhibit H-2

	Paragraph References—Insurance Contracts					
	Deposit Administration	Immediate Participation Guarantee	Allocated Contracts	Guaranteed Investment Contract	Individual Separate Account	Pooled Separate Account
General Audit Objectives:						
Plan assets, represented by insurance contracts, exist	7.38(a)	7.28(a)	n/a	7.38(a)	7.38(a)	7.38(a)
Changes in plan assets are properly recorded and valued in accordance with generally accepted accounting principles	7.38(b)	7.38(b)	n/a	7.38(b)	7.38(b)	7.38(b)
No intention to dispose of or terminate contract	7.38(c)	7.38(c)	7.38(c)	7.38(c)	7.38(c)	7.38(c)
Compliance with contract terms and appropriate disclosure	7.38(d)	7.38(d)	7.38(d)	7.38(d)	7.38(d)	7.38(d)
General Auditing Procedures:						
Read the contract	7.39(a)	7.39(a)	7.39(a)	7.39(a)	7.39(a)	7.39(a)
Confirm the following:						
Contributions or premium payments made to the fund or account	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)
Interest, dividends, refunds, credits, and changes in value	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)
Contract value of the funds in the general account	7.39(b)*	7.39(b)*	n/a	7.39(b)	n/a	n/a
Fair value of the funds in the separate account	7.39(b)*	7.39(b)*	n/a	n/a	7.39(b)	7.39(b)
The amount of insurance company fee and other expenses	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)	7.39(b)
Annuity purchases or benefits paid from unallocated plan assets	7.39(b)	7.39(b)	n/a	n/a	7.39(b)	7.39(b)
Transfers between various funds and accounts	7.39(b)	7.39(b)	n/a	7.39(b)	7.39(b)	7.39(b)
Evaluate the reasonableness of interest credited to the contracts in relation to any minimum guaranteed interest rate stated in contract	7.40(a)	n/a	n/a	7.40(a)	n/a	n/a
Review the investment yield data furnished by the insurance company and compare the plan's investment return and changes in contract value	n/a	7.40(b)	n/a	n/a	n/a	n/a
Determine that annuity purchases were made pursuant to the rates stipulated in the contract	7.40(c)	n/a	n/a	n/a	n/a	n/a
Test benefits paid directly from the fund	7.40(c)	7.40(c)	n/a	n/a	7.40(c)**	7.40(c)**
Obtain an understanding of the insurance company's responsibility and financial capability	7.40(d)	7.40(d)	7.40(d)**	7.40(d)**	7.41	7.41
Test expenses charged to the contract	7.40(e)	7.40(e)	7.40(e)	n/a	7.40(e)**	7.40(e)**
Test investment or unit transactions	n/a	n/a	n/a	n/a	7.41(a)	7.41(b)
Obtain an understanding of the plan's internal control structure relating to investments, in accordance with SAS No. 55	6.01	6.01	6.01	6.01	6.01, 7.41	6.01,7.41
Obtain single-audit reports (SAS No. 70 report) on trustee	n/a	n/a	n/a	n/a	7.41(a)	7.41(b)
Obtain insurance company's financial statements and agree unit information	n/a	n/a	n/a	n/a	7.41(a)	7.41(b)

* For investment purposes, unallocated funds may be commingled in a general or pooled separate account or held in an individual separate account.
** The audit procedures discussed in the referenced paragraphs are also applicable to this type of insurance contract.

Appendix I

Statement of Position 94-4

Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans

September 23, 1994

Amendment to
AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans and SOP 92-6,
Accounting and Reporting by Health and Welfare Benefit Plans

Prepared by the
Employee Benefit Plans Committee
Federal Government Division

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This statement of position (SOP) amends chapters 3, 4, and 7 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) with conforming changes as of May 1, 1994, and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*.

This SOP specifies the accounting for health and welfare benefit plans and defined-contribution pension plans for investment contracts issued by either an insurance enterprise or other entity. Defined-contribution plans, including both health and welfare, and pension plans should report investment contracts with *fully benefit-responsive* features(as defined in the SOP) at contract value and other investment contracts at fair value. Defined-benefit health and welfare benefit plans should report investment contracts at fair value. This SOP also permits health and welfare benefit plans and defined-contribution pension plans to report contracts that incorporate mortality or morbidity risk at contract value.

This SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of this SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made as of the beginning of the year in which the change is adopted. The effect of initially applying this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes,* paragraph 20). Pro forma effects of retroactive application (APB Opinion 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans

Introduction

1. The American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) includes standards of financial accounting and reporting for the financial statements of health and welfare benefit plans and defined-contribution pension plans. The Guide states that plan investments are generally to be presented at their fair value at the reporting date. Paragraph 3.15 of the Guide states that "contracts with insurance companies are to be included as plan assets in the manner required by [the Employee Retirement Income Security Act of 1974] ERISA annual reporting requirements and are to be reported in a manner consistent with the requirements of [Department of Labor] DOL Form 5500 or 5500-C/R." Paragraph 4.72 of the Guide and paragraph 26 of AICPA Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans,* contain similar language. The instructions to DOL Forms 5500 and 5500-C/R permit unallocated insurance contracts to be reported at either fair value or amounts determined by the insurance company, that is, contract value. Currently, "contracts with insurance companies" include investment contracts that do not incorporate mortality or morbidity risk. The Guide specifically excludes contract value reporting for investments in similar contracts issued by banks, savings institutions, or other financial institutions. Contract value generally equals the principal balance plus accrued interest.

2. The Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* which requires defined-benefit pension plans to report investment contracts issued by either an insurance enterprise or other entity at fair value. It amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* to permit defined-benefit pension plans to report only contracts that incorporate mortality or morbidity risk at contract value. The FASB decided not to address the measurement of plan assets held by health and welfare benefit plans or defined-contribution pension plans. Instead, the FASB asked the AICPA, in view of its experience with those plans, to address further the appropriate reporting of investments held by those plans.

Scope

3. This SOP provides guidance on the reporting of investment and insurance contracts held by health and welfare benefit plans and defined-contribution pension plans. It applies to all health and welfare benefit plans and defined-contribution pension plans. The appendix provides guidance for determining the values of investment contracts held by defined-contribution plans, including both health and welfare, and pension plans; however, certain examples may also be useful in determining the fair value of investment contracts held by other types of plans.

Conclusions

Reporting of Contracts

4. Defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution plans, including both health and welfare and pension plans, should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value, and all other investment contracts at fair value. If, however, plan management is aware that an event has occurred that may affect the value of a fully benefit-responsive contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies,* disclosure of the event or reporting the investment at less than contract value may be appropriate.

5. Health and welfare benefit plans and defined-contribution pension plans should report insurance contracts in the same manner required by ERISA annual reporting requirements of DOL Form 5500 or 5500-C/R. For purposes of this SOP, the terms *insurance contract* and *investment contract* are used as those terms are described for accounting purposes in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (see paragraphs 13 and 14).

Background

6. Defined-benefit plans provide participants with a determinable benefit based on a formula provided for in the plans, whereas defined-contribution plans provide benefits based on amounts contributed to an employee's individual account plus or minus forfeitures, investment experience, and administrative expenses. The Internal Revenue Code (IRC) generally requires that all investment experience under defined-contribution plans be allocated to individual account balances.

7. Consequently, information relevant to the primary users of defined-contribution plan financial statements—plan participants—is different from that which is relevant to users of defined-benefit plan financial statements. In defined-contribution plans, plan participants have a greater vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans and plan transactions can directly affect their benefits.

8. The primary objective of a defined-contribution plan's financial statements is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they are due. In a defined-contribution plan, the plan's net assets available to pay benefits equal the sum of participants' individual account balances. Accordingly, benefits that can be paid by the plan when they are due relate to the value of the assets that may currently be made available to the individual participants.

9. Consistent with the objective of a defined-contribution plan's financial statements, plan assets of defined-contribution plans should be measured and reported at values that are meaningful to financial statement users. Informa-

tion that is useful to plan participants includes the amount they would receive currently if they were to withdraw or borrow funds from or transfer funds within the plan.

10. A fully benefit-responsive investment contract (whether with an insurance enterprise or other entity) provides a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for liquidations, transfers, loans, or hardship withdrawals initiated by plan participants exercising their rights to withdraw, borrow, or transfer funds under the terms of the ongoing plan. From the perspective of the participants, the contract value of a fully benefit-responsive investment contract held by a plan is the amount they would receive if they were to initiate transactions under the terms of the ongoing plan.

11. For purposes of this SOP, benefit responsiveness is defined as the extent to which a contract's terms or related agreement and the plan itself permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of the contracts or their proceeds to another party. Investment contracts must transfer principal and accrued interest risk to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-rate investment options to limit arbitrage among those investment options *equity wash* provisions) would not affect a contract's benefit responsiveness.

12. If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero. The appendix to this SOP includes examples of the application of fair value and contract value reporting for defined-contribution plan investments.

13. As discussed in paragraph 5, for purposes of this SOP, the terms *insurance contract* and *investment contract* are described for accounting purposes in FASB Statements No. 60 and No. 97. Paragraph 1 of FASB Statement No. 60 describes insurance contracts:

> The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruptions. Insurance transactions may be characterized generally by the following:
>
> *a.* The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.
>
> *b.* When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.

14. Paragraphs 7 and 8 of FASB Statement No. 97 describe insurance and investment contracts:

> Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.
>
> Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as life-contingent payments). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (*a*) the probability that life-contingent payments will be made is remote or (*b*) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant. [Footnote references omitted.]

Disclosure Requirements

15. Defined-contribution plans, including both health and welfare, and pension plans, should disclose the following in connection with fully benefit-responsive investment contracts in the aggregate by investment option:

a. The average yield for each period for which a statement of net assets available for benefits is presented

b. The crediting interest rate as of the date of each statement of net assets available for benefits presented

c. The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor) *d.* The fair value of investment contracts reported at contract value, in accordance with FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*.

Those plans should also provide a general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of the contracts and any limitations on guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

16. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

Amendments to the Guide

17. The Guide is amended as follows:

a. The parenthetical comment (*see paragraph 3.15 for special provisions concerning the valuation of contracts with insurance companies*) in paragraph 3.12 is replaced by (*see paragraph 3.13 for special provisions concerning the valuation of insurance contracts and paragraph 3.17 for special provisions concerning the valuation of fully benefit-responsive investment contracts*).

b. The following paragraph is inserted as paragraph 3.13:

Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

c. Paragraph 3.13 is renumbered as paragraph 3.14. The second sentence of that paragraph is replaced by the following:

Examples include real estate, mortgages, or other loans (including loans to participants of a 401(k) plan), restricted securities, unregistered securities, securities for which the market is thin, and nontransferable investment contracts.

d. Paragraph 3.14 is renumbered as paragraph 3.15.

e. Paragraph 3.15 is replaced by the following:

3.16 Defined-contribution pension plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return)

3.17 Plan assets of defined-contribution pension plans should be measured and reported at values that are meaningful to financial statement users, including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution pension plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies,* disclosure of the event or reporting the investment at less than contract value may be appropriate.

3.18 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of the contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed-income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

3.19 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

f. The phrase *contracts with insurance companies* in paragraph 3.22 is replaced by *insurance contracts*.

g. The following is added to paragraph 3.23:

o. For benefit-responsive investment contracts in the aggregate by investment option—

- The average yield for each period for which a statement of net assets available for benefits is presented
- The crediting interest rate as of the date of each statement of net assets available for benefits presented
- The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor)
- The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107.

p. A general description of the basis and frequency of determining crediting interest rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

q. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500, but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

h. The parenthetical comment (*excluding contracts with insurance companies*) in paragraph 4.71 is replaced by (*excluding insurance contracts and fully benefit-responsive investment contracts held by defined-contribution health and welfare plans*).

i. Paragraph 4.72 is replaced by the following:

4.72 Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

4.73 Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values.

4.74 Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

4.75 Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies,* disclosure of the event or reporting the investment at less than contract value may be appropriate.

4.76 *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan.

In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

4.77 If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive, provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

j. Paragraph 4.73 is renumbered as paragraph 4.77. References to 4.88f and 4.88g are changed to 4.92f and 4.92g, respectively.

k. The phrase *contracts with insurance companies* in paragraph 4.87a is replaced by *insurance contracts.*

l. The following is added to paragraph 4.88:

i. For benefit-responsive investment contracts held by defined-contribution health and welfare plans, in the aggregate by investment option—
- The average yield for each period for which a statement of net assets available for benefits is presented
- The crediting interest rate as of the date of each statement of net assets available for benefits presented
- The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the creditworthiness of the contract issuer or third-party guarantor)
- The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107

j. A general description of the basis and frequency of determining crediting interest rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).

k. For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

m. The heading that precedes paragraph 7.23, *Insurance Contracts*, is replaced by *Contracts With Insurance Companies.*

n. The second sentence in footnote 57 to paragraph 7.36 is replaced by the following:

A plan's share would be the value of its units determined in accordance with applicable guidance for valuing investment contracts, and the funds held in the separate account should be viewed as an unallocated funding arrangement. Each investment contract in the pooled account should be evaluated individually for benefit responsiveness. However, if the separate account places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive.

o. The last sentence of paragraph 7.37 is replaced by the following:

These contracts are unallocated and are generally to be included as plan assets at their contract or fair values, as appropriate (see paragraphs 3.17 and 4.75).

p. The phrase *insurance contracts* in paragraph 7.38a is replaced by *contracts with insurance companies*.

q. The phrase *insurance contracts* in paragraph 7.39 is replaced by *contracts with insurance companies*.

r. The third item of paragraph 7.39b is replaced by the following:

— The value of the funds in the general or separate account at the plan's year-end and the basis for determining such value

s. The appendix of this SOP, *Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments*, is added as Appendix I.

Amendment to SOP 92-6

18. SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, is amended as follows:

a. The parenthetical comment (*excluding contracts with insurance companies*) in paragraph 25 is replaced by (*excluding insurance contracts and fully benefit-responsive investment contracts held by defined-contribution health and welfare benefit plans*).

b. Paragraph 26 is replaced by the following:

Insurance contracts, as defined by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* should be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). Plans not subject to ERISA should present insurance contracts as if the plans were subject to the reporting requirements of ERISA.

c. The following paragraphs are inserted as paragraphs 27, 28, 29, 30, and 31:

27. Investment contracts held by defined-benefit health and welfare benefit plans should be reported at their fair values.

28. Defined-contribution health and welfare benefit plans provide benefits based on the amounts contributed to employees' individual accounts plus or minus forfeitures, investment experience, and administrative expenses. In such plans, plan participants have a vested interest in monitoring the financial condition and operations of the

plan since they bear investment risk under these plans, and plan transactions can directly affect their benefits (for example, investment mix, and risk and return).

29. Plan assets of defined-contribution health and welfare benefit plans should be measured and reported at values that are meaningful to financial statement users including plan participants. The contract value of a *fully benefit-responsive* investment contract held by a defined-contribution health and welfare benefit plan is the amount a participant would receive if he or she were to initiate transactions under the terms of the ongoing plan. Defined-contribution health and welfare benefit plans should report fully benefit-responsive investment contracts at contract value, which may or may not be equal to fair value. If, however, plan management is aware that an event has occurred that may affect the value of the contract (for example, a decline in the creditworthiness of the contract issuer or third-party guarantor—if different from the contract issuer—or the possibility of premature termination of the contract by the plan), pursuant to FASB Statement No. 5, *Accounting for Contingencies,* disclosure of the event or reporting the investment at less than contract value may be appropriate.

30. *Benefit responsiveness* is the extent to which a contract's terms permit and require withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Investment contracts frequently are negotiated directly between the plan and the issuer and generally prohibit assignment of contracts or their proceeds to another party. Investment contracts must transfer the risk of principal and accrued interest to a financially responsible third party (that is, they provide for all participant-initiated transactions permitted by an ongoing plan at contract value with no conditions, limits, or restrictions) to be considered fully benefit-responsive. The plan itself must also allow plan participants reasonable access to their funds. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. For example, if plan participants are allowed access at contract value to all or a portion of their account balances only upon termination of their participation in the plan, it would not be considered reasonable access and, therefore, investment contracts held by that plan would generally not be deemed to be fully benefit-responsive. However, in plans with a single investment fund that allow reasonable access to assets by inactive participants, restrictions on access to assets by active participants consistent with the objective of the plan (for example, retirement or health and welfare benefits) will not affect the benefit responsiveness of the investment contracts held by those single-fund plans. Also, if a plan limits participants' access to their account balances to certain specified times during the plan year (for example, semiannually or quarterly) to control the administrative costs of the plan, that limitation generally would not affect the benefit responsiveness of the investment contracts held by that plan. In addition, administrative provisions that place short-term restrictions (for example, three or six months) on transfers to competing fixed income investment options to limit arbitrage among those investment options (*equity wash* provisions) would not affect a contract's benefit responsiveness.

31. If a plan holds multiple contracts, each contract should be evaluated individually for benefit responsiveness. If a plan invests in pooled funds that hold investment contracts, each contract in the pooled fund should be evaluated individually for benefit responsiveness. However, if the pooled fund places any restrictions on access to funds for the payment of benefits, the underlying investment contracts would not be considered fully benefit-responsive. Contracts that provide for prospective interest adjustments may still be fully benefit-responsive provided that the terms of the contracts specify that the crediting interest rate cannot be less than zero.

d. Paragraph 27 is renumbered as paragraph 32.

e. The following is added to paragraph 53:

- For benefit-responsive investment contracts in the aggregate by investment option:
  - The average yield for each period for which a statement of net assets available for benefits is presented
  - The crediting interest rate as of the date of each statement of net assets available for benefits presented
  - The amount of valuation reserves recorded to adjust contract amounts (for example, due to problems with the credit-worthiness of the contract issuer or third-party guarantor)
  - The fair values of fully benefit-responsive investment contracts reported at contract value, in accordance with FASB Statement No. 107
- A general description of the basis and frequency of determining crediting interest-rate resets and any minimum crediting interest rate under the terms of fully benefit-responsive investment contracts and any limitations on related liquidity guarantees (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives).
- For ERISA-covered plans, if a fully benefit-responsive investment contract does not qualify for contract-value reporting in the DOL Form 5500 but is reported in the financial statements at contract value, and the contract value does not approximate fair value, the DOL's rules and regulations require that a statement explaining the differences between amounts reported in the financial statements and DOL Form 5500 be added to the financial statements.

Effective Date and Transition

19. This SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of this SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995. Earlier application is encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made as of the beginning of the year in which the change is adopted. The effect of initially applying this SOP should be reported in a manner similar to the cumulative effect of a change in accounting principle (Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes,* paragraph 20). Pro forma effects of retroactive application (APB Opinion 20, paragraph 21) are not required. Restatement of financial statements of prior years is not permitted.

APPENDIX

Application of Fair Value and Contract Value Reporting for Defined-Contribution Plan Investments

A.1 Fully benefit-responsive investment contracts held by defined-contribution plans, including both health and welfare, and pension plans that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for participant-initiated liquidations, transfers, loans, or hardship withdrawals under the terms of the ongoing plan, should be reported at contract value, which may or may not be equal to fair value. If access to funds is substantially restricted by plan provisions, investment contracts held by those plans may not be considered to be fully benefit-responsive. Other investment contracts should generally be reported at fair value.

A.2 Investment contracts that do not provide a liquidity guarantee as discussed in paragraph A.1 may be valued by discounting the related cash flows based on current yields of similar investments with comparable durations. In determining the similarity of investments, appropriate consideration should be given to the credit quality of the contract issuer. Generally, contract termination (penalty) clauses need not be considered unless it is probable that the plan intends to terminate the contract.

A.3 In the following examples, value is determined within the context of the objectives of financial statements for a defined-contribution plan. The valuation must reflect the ability of the plan to pay benefits from the perspective of the participants. This value is then reflected on participants' statements to disclose the amount they can expect to receive when they exercise their rights to withdraw, borrow, or transfer funds under the terms of the plan.

EXAMPLE 1

A Five-Year Public Bond (or Portfolio of Bonds) Which Is Guaranteed by a Third Party to Have a Fixed Value at the End of Three Years

A.4 The guarantee applies only to the extent that the bond (or portfolio) is not liquidated prior to the end of three years. Liquidation within three years is at market value.

A.5 Because guaranteed proceeds from the bond are not available for benefit withdrawals or transfers prior to maturity, the contract should be valued at fair value. Fair value may be determined as the amount at which the bond could be exchanged in a current transaction between parties, other than in a forced or liquidation sale, considering the guaranteed fixed value of the bond at the end of three years.

EXAMPLE 2

A Benefit-Responsive Investment Contract

A.6 This contract provides a fixed crediting interest rate, and a financially responsible entity guarantees liquidity at contract value prior to maturity for any and all participant-initiated benefit withdrawals, loans, or transfers arising under the terms of the plan, which allows access for all participants on a quarterly basis.

A.7 The contract should be reported at contract value, because the plan will receive such value and only such value if the contract is accessed to pay participant benefits or transfers.

A.8 The contract described in the preceding paragraph would be viewed as fully benefit-responsive. Examples of some variations on this contract, and their impact on the valuation, follow.

a. *Liquidity at contract value is not guaranteed for benefits that are attributable to termination of the plan, a plan spin-off to a new employer plan, or amendments to plan provisions.* The contract should be reported at contract value unless it is probable that the plan will be terminated, spun off, or amended.

b. *Liquidity at contract value is not guaranteed for benefits that are attributable to the layoff of a large group of workers or an early retirement program.* The contract should be reported at contract value unless it is probable that termination of the employment of a significant number of employees will occur.

c. *The contract will pay for benefits of up to 30 percent of the contract at contract value, and any excess benefits will be at some adjusted value.* The contract should be reported at fair value. Fair value may be determined as the guaranteed amount plus the estimated discounted cash flows related to the amount in excess of 30 percent of the contract value.

d. *The contract will pay benefits at contract value, but only if the issuer of the contract determines that there is sufficient liquidity in the portfolio of assets that backs the contract.* Because the third party has not guaranteed liquidity for participant-initiated withdrawals, the contract should be reported at fair value.

e. *The contract will not pay benefits at contract value if benefits are due to participant transfers to another fixed income investment option, unless the funds are invested in an equity option for at least three months* (equity wash *provisions*). The contract should be reported at contract value.

EXAMPLE 3

A Five-Year, Nonbenefit-Responsive Investment Contract That Has No Liquid Market for Trading

A.9 The contract should be reported at fair value because there is no guarantee of liquidity at contract value. Fair value would be determined in the same manner as for an illiquid bond. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments,* includes a discussion of methods used to determine the fair values of illiquid instruments.

EXAMPLE 4

A Benefit-Responsive, Participating, Separate Account Investment Contract

A.10 A financially responsible issuer pays contract value for participant withdrawals, regardless of the value of the assets in the separate account. The credited interest rate is a function of the relationship between the contract value and the value of the assets in the separate account. The rate is reset periodically, daily, monthly, quarterly, and so on, by the issuer and cannot be less than zero. There may or may not be a specified maturity date on the contract. The contractholder may terminate the contract at any time, and receive the value of the assets in the separate account.

A.11 The contract should be reported at contract value because participants are guaranteed return of principal and accrued interest.

EXAMPLE 5

A Synthetic Investment Contract—"Managed" Type

A.12 This contract operates similarly to a separate account guaranteed investment contract (GIC), except that the assets are placed in a trust (with ownership by the plan) rather than a separate account of the issuer and a financially responsible third party issues a *wrapper* contract that provides that participants can, and must, execute plan transactions at contract value.

A.13 Inasmuch as trust assets are owned by the plan, the wrapper contract and the assets in trust should be separately valued and disclosed. The wrapper contract would be valued at the difference between the fair value of the trust assets and the contract value attributable by the wrapper to such assets. When considered together, the trust assets and the wrapper contract should be reported at the wrapper contract value because participants are guaranteed return of principal and accrued interest.

EXAMPLE 6

A Synthetic Investment Contract—"Repurchase" Type

A.14 Under this contract, the plan purchases a bond and places it in trust. The plan then contracts with a financially responsible third party to provide benefit responsiveness. Under the contract, should the bond need to be sold to meet a participant-initiated withdrawal benefit, loan, or transfer, the plan is obligated to sell the bond to the contract issuer, and the issuer is obligated to buy the bond. The transaction price is defined under the contract (for example, amortized cost). The issuer is not obligated, however, to purchase securities that are in default.

A.15 The contract, when considered together with the bond, should be reported at contract value (refer to paragraph A.13) absent impairment of the value of the securities due to credit risk because return of principal and accrued interest has been guaranteed to participants.

A.16 If the contract provided only an *option* for the sponsor to sell the bond to the issuer, rather than an obligation to do so, contract value would only apply when the fair value of the bond was less than contract value, because the option would then have value. Fair value may be determined as the greater of the estimated discounted cash flows or the option price.

Appendix J

Practice Bulletin 12

September 1994

Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans

An Interpretation of Paragraph 3.23*k* of the Audit and Accounting Guide *Audits of Employee Benefit Plans*

Accounting Standards Executive Committee
and
Employee Benefit Plans Committee

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA practice bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this practice bulletin should be used, or the member should be prepared to justify the departure.

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Reporting Separate Investment Fund Option Information of Defined-Contribution Pension Plans

Introduction

1. The Accounting Standards Executive Committee (AcSEC) and the Employee Benefit Plans Committee of the American Institute of Certified Public Accountants (AICPA) are aware that paragraph 3.23*k* of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), regarding the reporting of separate investment fund option information of defined-contribution pension plans, is confusing to financial statement preparers and auditors and has created a divergence of practice. As a result, these Committees believe that it is desirable to provide clarification of the reporting requirements set forth in paragraph 3.23*k* of the Guide.

2. Paragraph 3.23*k* of the Guide establishes requirements for the reporting of separate investment fund option information of defined-contribution pension plans. Paragraph 3.23*k* requires plans that provide for participant-directed investment programs (for example, equity, debt, or employer securities) to disclose amounts relating to those individual programs as a separate fund, either in columnar form in the financial statements (by participant-directed and nonparticipant-directed categories) or in the related disclosures, or by separate financial statements for each program.

3. A plan provides for participant-directed investment programs if it allows participants to choose among various investment alternatives. The available alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, that provide varying types of investments—for example, equity funds or fixed-income funds. The participant can select among the various available alternatives and periodically change that selection. Each investment alternative provided is considered a separate investment fund option. For example, if the plan provides two bond funds, an equity fund, a fixed-income fund, and an employer securities fund, the plan would offer five separate investment fund options.

Conclusion

4. The plan should disclose information about the net assets and significant components of the changes in net assets for each investment fund option. If an investment fund option contains both participant-directed and nonparticipant-directed investments, the participant-directed and nonparticipant-directed portions should be disclosed separately.

5. Aggregation of investment fund options with similar investment objectives is not appropriate except that, for materiality considerations, any individual investment fund option with net assets of less than 5 percent of the plan's total net assets may be combined with funds having similar investment objectives. If investment fund options are aggregated, that fact should be disclosed. If the plan provides for self-directed investing whereby each participant selects his or her own specific investments, such as individual stocks or bonds, changes in these investments may be aggregated and presented in one column as one fund option.

6. The information about the net assets and the significant components of the changes in net assets for each investment fund option is a required part of the basic financial statements. Such information may be presented in a multicolumnar format on the face of the financial statements, in the notes to the financial statements, or in separate financial statements for each investment fund option. Single line item presentation of the net assets available for benefits may be appropriate, unless an individual investment fund option has a material asset or liability other than investments that requires disclosure. An illustration of a single line item presentation in the statement of net assets available for benefits, along with a multicolumnar presentation of the changes in net assets available for benefits for each fund option, is presented in the Appendix to this practice bulletin.

Effective Date

7. This practice bulletin is effective for plan years beginning after December 15, 1993. Earlier application is encouraged.

APPENDIX

Illustration of 401(k) Plan Financial Statements

A.1 This appendix illustrates certain applications of the provisions of chapter 3 of the Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide) that apply for the annual financial statements of the hypothetical XYZ Company 401(k) Plan. The illustration includes both a single line item presentation and an alternative multicolumnar presentation of fund information in the statement of net assets available for benefits, along with a multicolumnar presentation of the changes in net assets available for benefits for each investment fund option. It does not illustrate other provisions of chapter 3 of the Guide that might apply in circumstances other than those assumed in this example. The format presented and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

A.2 Although generally accepted accounting principles (GAAP) encourage but do not require comparative financial statements, the Employee Retirement Income Security Act of 1974 (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

A.3 ERISA and U.S. Department of Labor (DOL) regulations require that certain information be included in supplemental schedules, which are not required under GAAP, and reported on by the independent auditor. See appendix A of the Guide for a further discussion of the ERISA and DOL requirements.

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits

	December 31, 19X1	December 31, 19X0
Assets		
Investments:		
At fair value—(Note B)		
Shares of registered investment companies:		
Prosperity Investments Common Stock Fund	$1,973,000	$2,600,000
Prosperity Investments Balanced Fund	3,949,000	3,500,000
XYZ Company	655,000	200,000
Participant notes receivable	100,000	45,000
	6,677,000	6,345,000
At contract value (Note C)		
National Insurance Company Investment Contract #2012A, matures 12/31/X2	2,500,000	1,650,000
Total investments	9,177,000	7,995,000
Receivables:		
Employer's contribution	14,000	10,000
Participants' contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,243,000	8,055,000
Liabilities		
Accounts Payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits	$9,218,000	$8,035,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits With Fund Information
Year Ended December 31, 19X1
[Alternative presentation for statement of net assets available for benefits]

	Participant-Directed						Non-Participant Directed	
	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Assets								
Investments, at fair value (Note B):								
Shares of registered investment companies:								
Prosperity Investments Common Stock Fund	$ 1,973,000	$ —	$ —	$ —	$ —	$ —	$ —	$ 1,973,000
Prosperity Investments Balanced Fund	—	3,949,000	—	—	—	—	—	3,949,000
XYZ Company Stock	—	—	455,000	—	—	—	200,000	655,000
Participant notes receivable	—	—	—	100,000	—	—	—	100,000
	1,973,000	3,949,000	455,000	100,000	—	—	200,000	6,677,000
Investments, at contract (Note C):								
National Insurance Company Investment Contract #2012A, matures 12/31/X2	—	—	—	—	2,500,000	—	—	2,500,000
Total investments	1,973,000	3,949,000	455,000	100,000	2,500,000	—	200,000	9,177,000
Receivables:								
Employer's contribution	—	—	—	—	—	14,000	—	14,000
Participants' contributions	—	—	—	—	—	52,000	—	52,000
Total receivables	—	—	—	—	—	66,000	—	66,000
Total assets	1,973,000	3,949,000	455,000	100,000	2,500,000	66,000	200,000	9,243,000
Liabilities								
Accounts payable	—	—	—	—	—	10,000	—	10,000
Accrued expenses	—	—	—	—	—	15,000	—	15,000
Total liabilities	—	—	—	—	—	25,000	—	25,000
Net assets available for benefits	$ 1,973,000	$ 3,949,000	$ 455,000	$ 100,000	$ 2,500,000	$ 41,000	$ 200,000	$ 9,218,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401(k) Plan
Statement of Net Assets Available for Benefits With Fund Information
Year Ended December 31, 19X0

[Alternative presentation for statement of net assets available for benefits]

	Participant-Directed						Non-Participant Directed	
	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Assets								
Investments, at fair value (Note B):								
Shares of registered investment companies:								
Prosperity Investments Common Stock Fund	$ 2,600,000	$ —	$ —	$ —	$ —	$ —	$ —	$ 2,600,000
Prosperity Investments Balanced Fund	—	3,500,000	—	—	—	—	—	3,500,000
XYZ Company Stock	—	—	100,000	—	—	—	100,000	200,000
Participant notes receivable	—	—	—	45,000	—	—	—	45,000
	2,600,000	3,500,000	100,000	45,000	—	—	100,000	6,345,000
Investments at contract (Note C):								
National Insurance Company Investment Contract #2012A, matures 12/31/X2	—	—	—	—	1,650,000	—	—	1,650,000
Total investments	2,600,000	3,500,000	100,000	45,000	1,650,000	—	100,000	7,995,000
Receivables:								
Employer's contribution	—	—	—	—	—	10,000	—	10,000
Participants' contributions	—	—	—	—	—	50,000	—	50,000
Total receivables	—	—	—	—	—	60,000	—	60,000
Total assets	2,600,000	3,500,000	100,000	45,000	1,650,000	60,000	100,000	8,055,000
Liabilities								
Accounts payable	—	—	—	—	—	20,000	—	20,000
Net assets available for benefits	$ 2,600,000	$ 3,500,000	$ 100,000	$ 45,000	$ 1,650,000	$ 40,000	$ 100,000	$ 8,035,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401(k) Plan
Statement of Changes in Net Assets Available for Benefits With Fund Information
Year Ended December 31, 19X1

	Participant-Directed						Non-Participant Directed	
	Prosperity Stock Fund	Prosperity Balanced Fund	XYZ Company Stock	Participant Notes	Investment Contract Fund	Other	XYZ Company Stock	Total
Additions								
Additions to net assets attributed to:								
Investment income								
Net appreciation in fair value of investments	$ 107,000	$ 92,000	$ 40,000	$ —	$ —	$ —	$ 40,000	$ 279,000
Interest	—	205,000	—	10,000	224,000	—	—	439,000
Dividends	100,000	65,000	—	—	—	—	—	165,000
	207,000	362,000	40,000	10,000	224,000	—	40,000	883,000
Less investment expenses	(10,000)	(20,000)	—	—	(20,000)	—	—	(50,000)
	197,000	342,000	40,000	10,000	204,000	—	40,000	833,000
Contributions:								
Participants'	296,000	612,000	307,000	—	246,000	52,000	—	1,513,000
Employer's	—	—	—	—	—	14,000	72,000	86,000
	296,000	612,000	307,000	—	246,000	66,000	72,000	1,599,000
Total additions	493,000	954,000	347,000	10,000	450,000	66,000	112,000	2,432,000
Deductions								
Deductions from net assets attributed to:								
Benefits paid to participants	400,000	494,000	30,000	—	210,000	—	10,000	1,144,000
Administrative expenses	25,000	45,000	3,000	—	25,000	5,000	2,000	105,000
Total deductions	425,000	539,000	33,000	—	235,000	5,000	12,000	1,249,000
Net increase prior to interfund transfers	68,000	415,000	314,000	10,000	215,000	61,000	100,000	1,183,000
Interfund transfers	(695,000)	34,000	41,000	45,000	635,000	(60,000)	—	—
Net increase (decrease)	(627,000)	449,000	355,000	55,000	850,000	1,000	100,000	1,183,000
Net assets available for benefits:								
Beginning of year	2,600,000	3,500,000	100,000	45,000	1,650,000	40,000	100,000	8,035,000
End of year	$ 1,973,000	$ 3,949,000	$ 455,000	$ 100,000	$2,500,000	$ 41,000	$ 200,000	$ 9,218,000

The accompanying notes are an integral part of these financial statements.

XYZ Company 401(k) Plan
Notes to Financial Statements

A. Description of Plan

The following description of the XYZ Company (Company) 401(k) Plan (Plan) provides only general information. Participants should refer to the Plan agreement for a more comprehensive description of the Plan's provisions.

1. *General.* The Plan is a defined-contribution plan covering all full-time employees of the Company who have one year of service and are age twenty-one or older. It is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

2. *Contributions.* Each year, participants may contribute up to 12 percent of pretax annual compensation, as defined in the Plan. Participants may also contribute amounts representing distributions from other qualified defined-benefit or contribution plans. The Company contributes 25 percent of the first 6 percent of base compensation that a participant contributes to the Plan. Additional amounts may be contributed at the option of the Company's board of directors. All employer contributions are invested in XYZ Company common stock. Contributions are subject to certain limitations.

3. *Participant accounts.* Each participant's account is credited with the participant's contribution and allocations of (*a*) the Company's contribution and (*b*) Plan earnings, and charged with an allocation of administrative expenses. Allocations are based on participant earnings or account balances, as defined. Forfeited balances of terminated participants' nonvested accounts are used to reduce future Company contributions. The benefit to which a participant is entitled is the benefit that can be provided from the participant's vested account.

4. *Vesting.* Participants are immediately vested in their contributions plus actual earnings thereon. Vesting in the Company's matching and discretionary contribution portion of their accounts plus actual earnings thereon is based on years of continuous service. A participant is 100 percent vested after five years of credited service.

5. *Investment options.* Upon enrollment in the Plan, a participant may direct employee contributions in 25 percent increments in any of four investment options.

   a. Prosperity Investments Common Stock Fund—Funds are invested in shares of a registered investment company that invests mainly in common stocks.

   b. Prosperity Investments Balanced Fund—Funds are invested in shares of a registered investment company that invests in corporate bonds, common stocks, and U.S. Government securities.

   c. XYZ Company Stock—Funds are invested in common stock of XYZ Company.

   d. National Insurance Company Investment Contract—Funds are invested in a guaranteed investment contract with an insurance company.

   Participants may change their investment options quarterly.

6. *Participant notes receivable.* Participants may borrow from their fund accounts a minimum of $1,000 and to a maximum equal to the lesser of $50,000 or 50 percent of their account balance. Loan transactions are treated as a transfer to (from) the investment fund from (to) the Participant Notes fund. Loan terms range from one to five years or up to twenty-five years for the purchase of a primary residence. The loans are secured by the balance in the participant's account and bear interest at a rate commensurate with local prevailing rates as determined quarterly by the Plan administrator. Interest rates range from 6 percent to 10 percent. Principal and interest are paid ratably through monthly payroll deductions.
7. *Payment of benefits.* On termination of service due to death, disability, or retirement, a participant may elect to receive either a lump-sum amount equal to the value of the participant's vested interest in his or her account, or annual installments over a ten-year period. For termination of service due to other reasons, a participant may receive the value of the vested interest in his or her account as a lump-sum distribution.

B. Summary of Accounting Policies

Basis of Accounting

The financial statements of the Plan are prepared under the accrual method of accounting.

Investment Valuation and Income Recognition[1]

The Plan's investments are stated at fair value, except for its investment contract, which is valued at contract value (Note C). Shares of registered investment companies are valued at quoted market prices, which represent the net asset value of shares held by the Plan at year end. The Company stock is valued at its quoted market price. Participant notes receivable are valued at cost, which approximates fair value.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

C. Investment Contract With Insurance Company[1]

In 19X0, the Plan entered into an investment contract with National Insurance Company (National). National maintains the contributions in a pooled account. The account is credited with earnings on the underlying investments (principally bank certificates of deposit) and charged for Plan withdrawals and administrative expenses charged by National. The contract is included in the financial statements at contract value, which approximates fair value, as reported to the Plan by National. Contract value represents contributions made under the contract, plus earnings, less Plan withdrawals and administrative expenses.

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[1] In September 1994, the AICPA issued Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans* [appendix I], which may substantially change the way some defined-contribution pension plans report investment contracts.

D. Related-Party Transactions

Certain Plan investments are shares of mutual funds managed by Prosperity Investments. Prosperity Investments is the trustee as defined by the Plan and, therefore, these transactions qualify as party-in-interest. Fees paid by the Plan for the investment management services amounted to $105,000 for the year ended December 31, 19X1.

E. Plan Termination

Although it has not expressed any intent to do so, the Company has the right under the Plan to discontinue its contributions at any time and to terminate the Plan subject to the provisions of ERISA. In the event of Plan termination, participants will become 100 percent vested in their accounts.

F. Reconciliation of Financial Statements to Form 5500

The following is a reconciliation of net assets available for benefits according to the financial statements to Form 5500:

	December 31,	
	19X1	*19X0*
Net assets available for benefits per the financial statements	$9,218,000	$8,035,000
Amounts allocated to withdrawing participants	(50,000)	(35,000)
Net assets available for benefits per Form 5500	$9,168,000	$8,000,000

The following is a reconciliation of benefits paid to participants according to the financial statements to Form 5500:

	Year Ended December 31, 19X1
Benefits paid to participants per the financial statements	$1,144,000
Add: Amounts allocated to withdrawing participants at December 31, 19X1	50,000
Less: Amounts allocated to withdrawing participants at December 31, 19X0	(35,000)
Benefits paid to participants per Form 5500	$1,159,000

Amounts allocated to withdrawing participants are recorded on Form 5500 for benefit claims that have been processed and approved for payment prior to December 31 but not yet paid as of that date.

G. Tax Status

The Internal Revenue Service has determined and informed the Company by a letter dated August 30, 19XX, that the Plan and related trust are designed in accordance with applicable sections of the Internal Revenue Code (IRC). The Plan has been amended since receiving the determination letter. However, the Plan administrator and the Plan's tax counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC.

Appendix K

Schedule of Changes Made to Audits of Employee Benefit Plans

Reference	Change	Date
Preface	Updated to: Reflect the issuance of FASB Statement No. 110 and SOP 92-6; Delete outdated information.	May, 1993
Paragraph 1.01	Modified to update statistics.	May, 1993
Paragraph 1.02	Reference to FASB Statement No. 110 added.	May, 1993
Paragraph 1.06	Updated to reflect the issuance of SOP 92-6.	May, 1993
Paragraph 1.07	Reference to SOP 92-6 added; Outdated information deleted.	May, 1993
Paragraph 1.10	Caption added.	May, 1992
Paragraph 1.14	Paragraph added; Subsequent paragraphs renumbered.	May, 1992
Paragraph 1.14	Revised to more accurately reflect the benefits provided by an independent audit.	May, 1993
Paragraph 2.01	Reference to FASB Statement No. 110 added.	May, 1993
Paragraph 2.07(a) (footnote 3)	Footnote added.	May, 1992
Paragraph 2.12	Updated to reflect the issuance of FASB Statement No. 110.	May, 1993
Paragraph 2.16	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Paragraph 2.24(g)	Parenthetical added.	May, 1994
Paragraph 2.25	Reference to FASB Statement No. 119 added.	May, 1995
Paragraph 2.27	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Paragraph 2.28	Added to add master trust reporting & disclosure requirements.	May, 1994
Paragraphs 2.29 and 2.30	Added to conform the guide to the requirements of FASB Statement No. 107; Subsequent paragraphs renumbered.	May, 1994
Paragraphs 2.29 and 2.30	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Paragraphs 2.31 and 2.32	Added to reflect the issuance of FASB Statement No. 119; Subsequent paragraphs renumbered.	May, 1995
Paragraph 3.10 (footnote 8)	Footnote added.	May, 1992

Reference	Change	Date
Paragraph 3.15	Footnote deleted.	May, 1995
Paragraph 3.16	Modified to add "loans to participants" to the first sentence.	May, 1992
Paragraph 3.19	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Paragraph 3.23(g)	Parenthetical added.	May, 1994
Paragraph 3.23(k)	Revised to clarify the requirements.	May, 1994
Paragraph 3.23(k)	Revised to reflect the issuance of Practice Bulletin 12.	May, 1995
Paragraph 3.23(m)	Revised to clarify that benefit-related amounts shouldn't be accrued on the statement of net assets available for benefits.	May, 1993
Paragraph 3.23(m)	Penultimate sentence deleted and last sentence modified.	May, 1995
Paragraph 3.23(o)	Added.	May, 1995
Paragraph 3.24	Reference to FASB Statement No. 35 deleted.	May, 1994
Paragraph 3.24	Reference to FASB Statement No. 119 added.	May, 1995
Paragraph 3.26	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Paragraph 3.27	Added to add master trust reporting & disclosure requirements.	May, 1994
Paragraphs 3.28 and 3.29	Added to conform the guide to the requirements of FASB Statement No. 107; Subsequent paragraphs renumbered.	May, 1994
Paragraph 3.28	Reference to FASB Statement No. 119 added.	May, 1995
Paragraph 3.29	Revised to reflect the issuance of FASB Statement No. 119.	May, 1995
Paragraphs 3.30 and 3.31	Added to reflect the issuance of FASB Statement No. 119; Subsequent paragraphs renumbered.	May, 1995
Chapter 4	The chapter has been divided into chapters 4A and 4B. Chapter 4A incorporates the provisions of SOP 92-6 for plans that have adopted SOP 92-6. Chapter 4B maintains the existing guidance for those plans that have not yet adopted SOP 92-6. Former paragraphs 4.01 through 4.26 renumbered as 4.63 through 4.88. Footnotes also renumbered. Additional revisions and editorial changes have been made throughout the chapter.	May, 1995
Renumbered paragraph 4.70 (footnote 40)	Footnote added.	May, 1992

Reference	Change	Date
Renumbered paragraph 4.72	Footnote added.	May, 1993
Paragraph 5.02	Text added.	May, 1992
Paragraph 5.02	References to Exhibits added.	May, 1992
Paragraph 5.02	Sentence added relating to "limited scope exemptions."	May, 1993
Exhibits 5-1, 5-2, and 5-3	Exhibits updated.	May, 1993
Paragraph 5.04	Revised by adding reference to paragraphs 13.14 through 13.16.	May, 1994
Paragraph 5.05	References to Exhibits added.	May, 1992
Paragraph 5.06	Added; Subsequent paragraphs renumbered.	May, 1994
Exhibit 5-4	Illustrative engagement letter added.	May, 1995
Renumbered paragraph 5.09	Reference to SAS No. 22 added.	May, 1992
Paragraph 5.12	Text added.	May, 1993
Paragraph 5.14	References to SAS Nos. 36 and 66 deleted. Reference to SAS No. 71 added.	May, 1993
Paragraph 5.21	Revised to reflect the issuance of SAS No. 70.	May, 1993
Paragraph 5.25	Reference to paragraph 11.15 added.	May, 1993
Paragraphs 6.06, 6.07, and 6.08	Replaced with paragraphs 6.06 through 6.12 to clarify SAS No. 70 guidance; Subsequent paragraphs renumbered.	May, 1995
Paragraph 7.12(h)	References to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 7.12(k)	Added.	May, 1993
Paragraphs 7.15 and 7.18(c)	Revised to reflect the issuance of SAS No. 70.	May, 1993 and 1994
Paragraph 7.37	Note reference to SOP 94-4 added.	May, 1995
Paragraph 7.39	Revised to reflect the issuance of FASB Statement No. 110.	May, 1995
Paragraph 7.41	Revised to reflect the issuance of SAS No. 70.	May, 1993 and 1994
Paragraphs 7.43 and 7.44	Added to provide guidance on auditing participant loans; Subsequent paragraphs renumbered.	May, 1995
Renumbered paragraph 7.46	(f) under "For loans and mortgages" added.	May, 1993
Renumbered paragraph 7.47	Paragraph modified.	May, 1992
Renumbered paragraph 7.47	Revised for clarity.	May, 1994
Renumbered paragraph 7.48	Added.	May, 1994
Paragraph 9.03(e)	Revised.	May, 1994
Paragraphs 9.03(f) and 9.03(g)	Added.	May, 1994
Paragraph 9.04	Reference changed from SAS No. 44 to SAS No. 70.	May, 1993

Reference	Change	Date
Paragraph 10.01	Reference to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 10.07	Revised to reflect the issuance of SAS No. 73.	May, 1995
Paragraphs 10.17, 10.18, and 10.20	References to SAS No. 11 changed to SAS No. 73.	May, 1995
Paragraph 11.03	Revised to provide an example of an exempt party in interest transaction that is not required to be reported on the Form 5500 or related schedules.	May, 1994
Paragraphs 12.02 and 12.03	Revised to clarify guidance.	May, 1995
Paragraph 12.03(a)	Updated to reflect proposed changes to the tax status notes in the illustrative financial statements.	May, 1993
Paragraph 12.06	Updated to clarify the ABA/AICPA understanding with regard to attorney's letter.	May, 1993
Paragraphs 12.15 and 12.16	Added.	May, 1994
Paragraph 13.02	Revised to clarify guidance.	May, 1995
Paragraph 13.04	Note reference to SOP 93-3 added.	May, 1993
Paragraph 13.04	Corrected to cover two years of accumulated plan benefits as required by ERISA.	May, 1995
Paragraphs 13.06 and 13.07	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Paragraph 13.08	Paragraph added (illustrative auditor's report for health and welfare plans that have adopted SOP 92-6); Subsequent paragraphs renumbered.	May, 1993
Paragraphs 13.08 and 13.11	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraph 13.13	Revised to clarify the auditor's reporting responsibility in situations where he or she becomes aware of a departure from DOL filing requirements that is not related to a prohibited transaction with a party in interest.	May, 1993
Paragraphs 13.14-13.16	Added; Subsequent paragraphs renumbered.	May, 1994
Paragraph 13.16	Modified report for a limited-scope engagement corrected to be consistent with the table in paragraph 13.15.	May, 1995
Renumbered paragraphs 13.17 and 13.18	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994

Reference	Change	Date
Paragraph 13.22	Examples added.	May, 1995
Renumbered paragraphs 13.25 and 13.27	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraphs 13.31 and 13.32	Auditor's reports revised to reflect the ERISA minimum of two years audited financial statements of net assets available for benefits.	May, 1994
Renumbered paragraph 13.33	Revised to reflect the issuance of SAS No. 70.	May, 1993
Renumbered paragraph 13.34	Revised to address the auditor's responsibility for reporting on information related to separate investment fund options and to expand the discussion to relate to all situations rather than just financial statements filed with the SEC.	May, 1994
Paragraphs 13.35 and 13.36	Added; Subsequent paragraphs renumbered.	May, 1995
Paragraph 13.36	Revised to clarify guidance.	May, 1995
Renumbered paragraphs 13.39 and 13.40	Added.	May, 1993
Appendix A, paragraphs A.14 and A.20	Last sentences replaced & footnotes added.	May, 1994
Appendix A, paragraph A.22	"Tax-qualified" deleted from second sentence; Last sentence replaced.	May, 1994
Appendix A, paragraph A.23	Footnote 58 restated.	May, 1994
Appendix A, paragraph A.25	Parenthetical in first bullet under "General Exemption From Audit Requirement Only" replaced.	May, 1994
Appendix A, paragraph A.28	Penultimate sentence revised.	May, 1994
Appendix A, paragraphs A.42b and A.42c	Text added.	May, 1992
Appendix A, Exhibit A-1	Footnote deleted.	May, 1992
Appendix A	Incorporated the information contained in Exhibit A-4 into the text of Appendix A to make it more easily accessible.	May, 1993
Appendix D	Introductory material modified.	May, 1993
Appendix D	Exhibits D-1 and D-2 revised.	May, 1994
Appendix D	Exhibit D-3 presented on comparative basis to reflect ERISA's minimum disclosure requirements.	May, 1993

Reference	Change	Date
Appendix D	Exhibit D-5, D-6, D-7, D-8, and Notes to financial statements revised.	May, 1994
Appendix E	Introductory material modified.	May, 1994
Appendix E	Illustration 1 added, (401(k) Plan financial statements); Subsequent illustrations renumbered.	May, 1994
Appendix E	Notes to the financial statements of illustration 1 revised to reflect the disclosure requirements related to forfeitures.	May, 1995
Appendix E	Renumbered illustration 2 (profit-sharing plan): Statement of net assets available for benefits revised to illustrate the ERISA requirement for comparative statements; Notes to financial statements revised.	May, 1994
Appendix E	Renumbered illustration 3 (employee stock ownership plan) statements of changes in net assets available for benefits revised to reflect only one year.	May, 1994
Appendix F	Added (illustrative financial statements from SOP 92-6); Subsequent appendixes relettered.	May, 1995
Relettered Appendix G	Illustrative financial statement notes added.	December, 1991
Relettered Appendix G	Introduction clarified.	May, 1995
Relettered Appendix H	Paragraph deleted from introductory material.	May, 1992
Relettered Appendix H, Exhibits H-1 and H-2	References to SAS No. 70 added.	May, 1993
Appendix H	SOP 92-6 incorporated into chapter 4A and Appendix F.	May, 1995
Appendix I	SOP 94-4 added.	January, 1995
Appendix J	Practice Bulletin 12 added.	January, 1995
Glossary	Terms added.	May, 1994

Glossary

accrued experience-rating adjustments. The refund at the end of the policy year of the excess of premiums paid over paid claims, reserves required by the insurance company, and the insurance company's retention (fee).

accumulated eligibility credits. A liability of a plan arising from prior employee service for which employer contributions have been received.

accumulated plan benefits. Benefits that are attributable under the provisions of an employee benefit plan to employees' service rendered to the benefit information date.

act. As used in FASB Statement No. 35, the Employee Retirement Income Security Act of 1974.

actuarial asset value. A value assigned by an actuary to the assets of a plan generally for use in conjunction with an actuarial cost method.

actuarial cost method. A recognized actuarial technique used for establishing the amount and incidence of employer contributions or accounting charges for pension cost under a pension plan.

actuarial value of accumulated plan benefits. The amount as of a benefit information date that results from applying actuarial assumptions to the accumulated plan benefits, with the actuarial assumptions being used to adjust those amounts to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the benefit information date and the expected date of payment.

allocated contract. A contract with an insurance company under which related payments to the insurance company are currently used to purchase immediate or deferred annuities for individual participants.

benefit information. The actuarial present value of accumulated plan benefits.

benefit information date. The date as of which the actuarial present value of accumulated plan benefits is presented.

benefit security. As used in FASB Statement No. 35, the plan's present and future ability to pay benefits when due.

benefits. Payments to which participants may be entitled under an employee benefit plan, including pension benefits, disability benefits, death benefits, health benefits, and benefits due on termination of employment.

cash-or-deferred arrangement (section 401(k) plan). A plan that may be incorporated into a profit-sharing or stock bonus plan (a few pre-ERISA money purchase pension plans also incorporate cash-or-deferred arrangements). Under such an arrangement, a participant is permitted to elect to receive amounts in cash or have them contributed to the plan as employer contributions on the participant's behalf.

CFR. Code of Federal Regulations.

common or commingled trust. A trust for the collective investment and reinvestment of assets contributed from employee benefit plans maintained by more than one employer or a controlled group of corporations that is maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency.

contract value. The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.

contributions receivable. Amounts due as of the date of the financial statements, including legal or contractual obligations and, for a single employer plan, obligations resulting from a formal commitment.

contributory plan. An employee benefit plan under which participants bear part of the cost.

defined benefit pension plan. A pension plan that specifies a determinable pension benefit, usually based on factors such as age, years of service, and salary. Even though a plan may be funded pursuant to periodic agreements that specify a fixed rate of employer contributions (for example, a collectively bargained multiemployer plan), such a plan may nevertheless be a defined benefit pension plan.

defined contribution plan. A plan that provides an individual account for each participant and provides benefits that are based on (*a*) amounts contributed to the participant's account by the employer or employee, (*b*) investment experience, and (*c*) any forfeitures allocated to the account, less any administrative expenses charged to the plan.

deposit administration contract (DA). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees are credited to an account. For investment purposes, the monies in the account are commingled with other assets of the insurance company. The account is credited with interest at the rate specified in the contract; it is charged with the purchase price of annuities when participants retire and with any incidental benefits (death, disability, and withdrawal) disbursed directly from the account.

directed trust. An arrangement in which the trustee acts as custodian of a plan's investments and is responsible for collecting investment income and handling trust asset transactions as directed by the party named as having discretion to make investment decisions, such as the plan administrator, the plan's investment committee, or the plan's investment advisor.

discretionary trust. An arrangement in which the trustee has discretionary authority and control over investments and is authorized by the plan or its investment committee to make investment decisions.

employee. A person who has rendered or is presently rendering service.

employee stock ownership plan (ESOP). A stock bonus plan that borrows money from, or on the guarantee of, *a related party* (a *party in interest* as defined in section 3(14) of ERISA) for the purpose of acquiring securities issued by the plan sponsor and that invests primarily in such securities (a leveraged ESOP). The term "employee stock ownership plan" is also generally applied to (*a*) nonleveraged stock bonus plans that satisfy various requirements set forth in section 4975(e)(7) of the IRC and (*b*) profit-sharing plans (and certain pre-ERISA money purchase pension plans) that invest primarily in securities issued by the plan sponsor.

ERISA. The Employee Retirement Income Security Act of 1974.

ERISA plan. A plan that is subject to ERISA.

fair value. The amount that the plan could reasonably expect to receive for a plan investment in a current sale between a willing buyer and a willing seller.

Form 5500. A joint-agency form developed by the IRS, DOL, and PBGC, which may be used to satisfy the annual reporting requirements of the IRC and Titles I and IV or ERISA.

frozen plan. See *wasting trust.*

full-scope audit. An audit of the financial statements of an employee benefit plan in accordance with generally accepted auditing standards.

funding agency. An organization or individual, such as a specific corporate or individual trustee or an insurance company, that provides facilities for the accumulation of assets to be used for paying benefits under a plan; an organization, such as a specific life insurance company, that provides facilities for the purchase of such benefits.

funding policy. The program regarding the amounts and timing of contributions by the employer(s), participants, and any other sources (for example, state subsidies or federal grants) to provide the benefits a plan specifies.

general account. An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. That is, funds held by an insurance company that are not maintained in a separate account are in its general account.

guaranteed investment contract (GIC). A contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period.

health and welfare benefit plan. A plan that provides (*a*) medical, dental, visual, psychiatric, or long-term health care; severance benefits; life insurance; accidental death or dismemberment benefits; (*b*) unemployment, disability, vacation or holiday benefits; and (*c*) apprenticeships, tuition assistance, day-care, housing subsidies, or legal services benefits.

IBNR. Claims incurred by eligible participants but not yet reported to the plan.

immediate participation guarantee contract (IPG). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees, plus its share of the insurance company's actual investment income, are credited to an account. The insurance company is obligated to make lifetime benefit payments to retired employees.

individual separate account. A separate account in which only one plan participates. Also referred to as a separate-separate account.

insured plan. A plan funded through an insurance contract.

investment fund option. An investment alternative provided to a participant in a defined-contribution plan. The alternatives are usually pooled fund vehicles, such as registered investment companies or commingled funds of banks, providing varying types of investments, for example, equity funds, fixed income funds, etc. The participant can select among the various available alternatives and periodically change that selection.

investment unit. See *unit of participation.*

Keogh plan. Also called an HR 10 plan, any defined benefit or defined contribution plan that covers one or more self-employed individuals.

limited-scope audit. An audit in which ERISA allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to information prepared and certified by a bank or similar institution, or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency.

master trust. A combined trust account made up of assets of some or all of the employee benefit plans of a company that sponsors more than one plan or a group of corporations under common control. Each plan has an undivided interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation.

money purchase pension plan. A defined contribution plan under which employer contributions are based on a fixed formula that is not related to profit and that is designated as a pension plan by the plan sponsor.

multiemployer plan. A plan in which more than one employer is required to contribute that is maintained pursuant to one or more collective bargaining agreements.

multiple-employer plan. A plan that involves more that one employer and includes only plans whose contributions from individual employers are available to pay benefits to all participants.

named fiduciary. The individual responsible for the operation and administration of a plan including the identification of a plan administrator; usually an officer or other employee of the plan sponsor who reports to the plan sponsor's board of directors or management.

net asset information. Information regarding the net assets available for benefits.

net assets available for benefits. The difference between a plan's assets and its liabilities. For purposes of this definition, a plan's liabilities do not include participants' accumulated plan benefits.

noncontributory plan. An employee benefit plan under which participants do not make contributions.

nonvested benefit information. The actuarial present value of nonvested accumulated plan benefits.

participant. Any employee or former employee, or any member or former member of a trade or other employee association, or the beneficiaries of those individuals, for whom there are accumulated plan benefits.

participating contract. An allocated contract that provides for plan participation in the investment performance and experience (for example, mortality experience) of the insurance company.

participation right. A plan's right under a participating contract to receive future dividends from the insurance company.

party in interest. A fiduciary or employee of the plan, any person who provides services to the plan, an employer whose employees are covered by the plan, an employee association whose members are covered by the plan, a person who owns 30 percent or more of such an employer or employee association, or relatives of such person just listed.

PBGC. The Pension Benefit Guaranty Corporation.

pension benefits. Periodic (usually monthly) payments made to a person who has retired from employment.

pension fund. The assets of a pension plan held by a funding agency.

pension plan. See *defined benefit pension plan.*

plan administrator. The person or group of persons responsible for the content and issuance of a plan's financial statements in much the same way that management is responsible for the content and issuance of a business enterprise's financial statements.

pooled separate account. A separate account in which several plans participate.

prior service costs. See *supplemental actuarial value.*

profit-sharing plan. A defined contribution plan that is not a pension plan (as defined in the IRC) or a stock bonus plan. Employer contributions may be discretionary or may be based on a fixed formula related to profits, compensation, or other factors. Before 1987, contributions had to be made from the plan sponsor's current or accumulated profits. This requirement is no longer in effect. A profit-sharing plan must be designated as such in the plan document.

prohibited transaction. A transaction between a plan and a party in interest that is prohibited under section 406(a) of ERISA.

reporting date. The date of which information regarding the net assets available for benefits is presented.

retired life fund. That portion of the funds under an immediate participation guarantee contract that is designated as supporting benefit payments to current retirees.

self-directed plan. A defined contribution plan in which the participant authorizes specific investment transactions, such as purchases and sales of specific common stocks or bonds. A self-directed plan does not provide predetermined investment fund options.

self-funded plan. A plan funded through accumulated contributions and investment income.

separate account. A special account established by an insurance company solely for the purpose of investing the assets of one or more plans. Funds in a separate account are not commingled with other assets or the insurance company for investment purposes.

service. Periods of employment taken into consideration under an employee benefit plan.

single employer plan. A plan sponsored by one employer.

split-funded plan. A plan funded through a combination of accumulated contributions and investment income and insurance contracts.

sponsor. In the case of a pension plan established or maintained by a single employer, the employer; in the case of a plan established or maintained by an employee organization, the employee organization; in the case of a plan established or maintained jointly by two or more employers or by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other group of representatives of the parties who have established or who maintain the pension plan.

stock bonus plan. A defined contribution plan under which distributions are normally made in stock of the employer, unless the distributee elects otherwise.

supplemental actuarial value. The amount assigned under the actuarial cost method in use for years before a given date.

target benefit plan. A form of money purchase pension plan under which the employer's annual contribution on behalf of each participation is the actuarially determined amount required to fund a target benefit established by a plan formula. The target benefit is usually based on compensation and length of service. For some target benefit plans, the substance of the plan may be to provide a defined benefit.

tax credit employee stock ownership plan. A profit-sharing or stock bonus plan established before 1987 that satisfies the requirements of section 409 of the IRC. The sponsor of such a plan is allowed a tax credit, rather than a deduction, for its contributions. Before 1982 these plans were commonly known as TRASOPs (for Tax Reduction Act Stock Ownership Plan), and the maximum allowable credit was based on the plan sponsor's investments that qualified for the investment tax credit. In 1982 TRASOPs were succeeded by PAYSOPs, under which the credit was based on the plan sponsor's payroll.

third-party administrator (TPA). A party unrelated to the plan who contracts to be responsible for plan administration.

thrift plan. A profit-sharing or stock bonus plan under which participants make after-tax employee contributions that are usually matched, in whole or in part, by employer contributions.

unallocated contract. A contract with an insurance company under which related payments to the insurance company are accumulated in an unallocated fund to be used to meet benefit payments when employees retire, either directly or through the purchase of annuities. Funds in an unallocated contract may also be withdrawn and otherwise invested.

unfunded plan. A plan whereby benefits are paid directly from the general assets of the employer or the employee organization that sponsors the plan.

unit of participation. An undivided interest in the underlying assets of a trust.

vested benefit information. The actuarial present value of vested accumulated plan benefits.

vested benefits. Benefits that are not contingent on an employee's future service.

wasting trust. A plan under which participants no longer accrue benefits but that will remain in existence as long as necessary to pay already-accrued benefits.

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