Statement of Alice A. Wunderlich

Member

Employee Benefit Plans Expert Panel

American Institute of Certified Public Accountants

Before the ERISA Advisory Council

Working Group on Form 5500 Health and Welfare Plan Audits

U.S. Department of Labor

September 22, 2004

Thank you, co-chairs and members of the ERISA Advisory Council Working Group, for inviting me to testify here today. I am Alice Wunderlich, a member of the Employee Benefit Plans Expert Panel (the Expert Panel) of the American Institute of Certified Public Accountants[1] (AICPA), and an audit director with Deloitte & Touche LLP. I am Deloitte's national Employee Benefit Plan Industry Professional Practice Director and serve as the firm's national accounting and auditing technical resource for employee benefit plans. I also am leader of Deloitte's Chicago employee benefit plan audit practice and audit a wide variety of employee benefit plans, including corporate, multiemployer, public, defined benefit, defined contribution and health and welfare plans.

We commend the Working Group and the DOL for focusing attention on reporting and audit issues related to health and welfare benefit plans. Central to the accounting profession's mission is to help ensure meaningful financial reporting to protect ERISA plan participants, the investing public, and other financial statement users. In doing so, it is important to consider the financial information needs of the various users of plan financial statements, and to also evaluate the effort and cost to the plans in preparing the financial statements. The benefits to financial statement users should outweigh the administrative burden of plan financial reporting.

You have asked for testimony today to address certain questions regarding health and welfare benefit plans. My comments relate only to single-employer defined benefit health and welfare plans because they present a unique challenge to plan administrators and auditors with respect to the financial reporting and auditing process. The questions I will address include:

1. Describe the difficulties in preparing Form 5500s for health/welfare plans and having audits completed for these plans.

2. What are the costs of having an audit for a health and welfare plan?

3. How have HIPPA regulations affected the preparation of the Form 5500 and the required audit?

First, I'd like to provide some background information for your consideration. Welfare benefit plans, also known as health and welfare plans, are described in Title I of ERISA and include any plan, fund, or program that provides, through the purchase of insurance of otherwise, medical, surgical, hospital, sickness, accident, disability, severance, vacation, prepaid legal services, apprenticeship, and training benefits for employees. I would like to distinguish between two types of health and welfare plans; defined benefit health and welfare plans, and defined contribution health and welfare plans.

An example of a defined benefit health and welfare plan is a medical plan where the benefit to be provided is defined as certain medical procedures or care as covered by the plan. By contrast, a

[1] The American Institute of Certified Public Accountants (www.aicpa.org) is the national, professional organization of CPAs, with more than 340,000 members in business and industry, public practice, government, and education. It sets ethical standards for the profession and U.S. private auditing standards. It also develops and grades the Uniform CPA Examination.

defined contribution health and welfare plan is one where the contribution funding amount to an individual participant's account is defined and the benefits are limited to the available funds in that participant's account. An example of a defined contribution health and welfare plan is a medical plan where a specified dollar amount is contributed on behalf of a participant and made available for use in paying that participant's eligible medical expenses. When the participant's account is depleted, no additional benefits are available to that participant.

"Funded" health and welfare plans are required by ERISA to have annual independent financial statement audits. The Department of Labor has provided exemptions that provide certain health and welfare plans relief from the audit requirement where the plan is considered "unfunded."

Unlike pension plans, regulations do not require health and welfare plans to be funded nor establish a trust. A company may chose to pay health benefits on a pay-as-you-go basis directly from the general assets of the corporation, in which case, the plan is considered to be unfunded. It has been my observation that most single-employer defined benefit health and welfare plans are unfunded and do not require audits.

However, there are a number of such plans that are funded by the sponsor or employees or both, and do require an audit. A common way a single-employer plan may come to be subject to the ERISA audit requirement is by using a Voluntary Employees' Beneficiary Association, a 501(c)(9) trust, or "VEBA" trust, as a funding vehicle for some or all of its welfare benefits. A typical use of a VEBA trust is to pre-fund benefits and then deduct the pre-funded amount on the company's tax return, thereby gaining an accelerated tax deduction. Often there are few assets in a VEBA trust because of limitations on such accelerated deductions.

Funded plans also include multiemployer plans, sometimes referred to as "union" plans, in which more than one employer is required to contribute to the plan pursuant to one or more collective bargaining agreements, and certain plans sponsored by a single company. In multiemployer plans, the plan financial statements indicate the plan's ability to provide benefits to participants. Payment of current and future benefits depends on the amount of a plan's net assets and obligations (in other words, its funded status), and the ability of the plan to bill and collect future employer and participant contributions. Because multiemployer plans have assets against which plan obligations may be measured, they provide an indication of the plan's ability to pay benefits when due. As such, the financial statements of multiemployer plans provide value to users of those financial statements. Multiemployer plans are not the subject of my comments today.

Again, it is single-employer defined benefit health and welfare plans that are the subject of most of my comments because of their unique financial accounting and reporting challenges. In a single-employer defined benefit health and welfare plan, often both participants and the corporate sponsor contribute to the plan. Usually a set dollar amount is withheld from a participant's paycheck for employee and dependent coverage. This withholding plus the sponsor contribution are used to purchase insurance coverage or otherwise pay for benefits. Any shortfall is paid by the corporate sponsor. In a single-employer corporate-sponsored plan, the plan's financial statements may not necessarily be an indication of the future probability of the plan's ability to pay benefits because the corporate sponsor picks up the tab for the costs in excess of plan assets, including participant contributions and sponsor contributions previously

made to the plan. The plan's financial statements may well show a deficit funding position when it is in fact a financially healthy plan. Since the ultimate obligation to pay benefits rests with the corporate plan sponsor, it is the financial health of the plan sponsor, not the funded status of the plan itself, that determines the likelihood of participants receiving benefits they were promised. Thus, the picture painted by the financial statements of a single-employer corporate-sponsored plan, while reflecting plan liabilities and obligations and contributions made by the sponsor and employees, may not be fully meaningful in assessing whether the plan has the ability to pay current and future benefits.

Unlike the audited financial statements of multiemployer health and welfare benefit plans, defined contribution pension plans (a 401(k) or profit-sharing plan), or defined benefit pension plans in which investment returns and funding levels are relevant to a participant's benefit, single-employer health and welfare plan financial statements do not provide all of the information necessary upon which participants may predict the likelihood that they will receive current and future benefits.

A situation I have observed for some single-employer health and welfare plans is that several different plans are used to provide different kinds of welfare benefits to employees. For example, medical benefits may be provided from one plan while dental benefits are provided by another. One plan may be funded and require an audit while the other is not. While each plan has its own separate ERISA reporting requirement, employees may view their health and welfare benefits as all part of the same package, even though they may in fact be participating in 4 or 5 different health and welfare plans. This disaggregating arrangement is rare in 401(k) and pension plans, where an employee typically does not participate in more than one 401(k) plan or pension plan. A participant would need to look at the financial statements of all the plans to get the full financial picture of the collective plans in which all of the different health and welfare benefits are being provided to the participant.

Another issue with the financial statements for single-employer defined benefit health and welfare benefit plans is that there is a disconnect between those statements and Form 5500 reporting. Audited financial statements that are filed with the Form 5500 typically are prepared in accordance with generally accepted accounting principles (GAAP). Many health and welfare plans have obligations (such as incurred but not reported claims, postretirement benefits, and postemployment benefits) that are required by GAAP to be recorded on the audited financial statements, but are not reported on the Form 5500. Consequently, there often are numerous and substantial dollar differences between amounts reported on the Form 5500 submitted to the DOL and the audited financial statements that accompany the Form 5500. The auditor frequently spends significant resources auditing this GAAP obligation information that is neither reported to the DOL on the Form 5500 nor, in most cases, funded by the plan sponsor through the tax-exempt trust at the reporting date. The DOL may wish to consider whether this additional GAAP information would be useful for Form 5500 or other DOL reporting purposes.

I will now describe the challenges in preparing the financial statements and performing the audits of single-employer defined benefit health and welfare plans. Preparing the financial statements for those plans can be very time consuming and span several months. The plan itself is an unnatural reporting entity for the plan sponsor. The information in the financial statements is

neither available from a single source because all of the plan's activity does not flow through the trust, nor are all the plan's transactions accumulated in a single place such as the general ledger. The plan's financials statements typically are prepared once a year only for ERISA reporting purposes and, to our knowledge, not routinely used for any other purposes.

Plan financial statement preparation requires a thorough understanding of the plan, its insurance arrangements, claim payment process, and the resulting accounting. It also requires collecting information from multiple outside service providers and many sources within the plan sponsor. Many funded health plans under audit also pay benefits directly from the general assets of the corporate sponsor that do not flow through the plan's trust, and significant effort must be directed at identifying that non-trust activity for inclusion in the plan's financial statements.

Because the financial statements are quite complex and there generally is a lack of readily available information, and their preparation requires significant accounting knowledge, the auditor often is relied on to prepare the health and welfare plan's financial statements. Even when the plan sponsor drafts the financial statements, in many cases the auditor must spend considerable time assisting them in the process.

The audit itself typically requires a significant amount of time and resources. The audit procedures required in a health and welfare plan environment extend far beyond any that are required to be performed in a 401(k) plan or defined benefit pension plan. Because of the complex nature of and constant changes to the nation's medical delivery and insurance programs, auditing medical expenses incurred by a plan participant is a complicated process that requires specialized knowledge of various payment and accounting systems and medical information. When detailed health information—such as provider invoices, processing data from the administrator, and explanations of benefits—is provided to the audit team, that team rarely receives sufficient corresponding descriptions with which to interpret such information, making it extremely difficult to verify the correctness of the information. For example, auditors typically have limited capacity to evaluate the accuracy of the health care provider's procedural codes on an outpatient service, determine the propriety of the pricing of the codes given the geographical location of the provider, and ensure adequate network discounts were provided to the plan sponsor. Even when it is discovered during the audit that incorrect payments have been made, usually no adjustment is made to the financial statements because, by contract, a certain error rate typically is allowable between the plan sponsor and the claims processor and, as such, no correcting payment or reimbursement is made by the plan sponsor or provider of health care services.

It should be noted that in some situations there may be some overlap of the claims testing performed in connection with an ERISA audit and that of a specialized "claims audit," contracted externally by the corporate sponsor. Corporate sponsors of medical plans periodically contract with medical consultants to benchmark a medical claims processor's financial accuracy and timeliness of benefit payments. The consultants typically select a number of claims and re-adjudicate them, applying knowledge of medical procedures, payment systems, and reasonable costs. Generally, these procedures are usually much more in-depth than necessary for a financial statement audit.

Next I will address your question concerning what the costs are of having an audit for a health and welfare plan. Plan sponsors incur two types of costs in relation to the audit of their health and welfare plans. Internal costs, including time spent in gathering and organizing information needed to prepare the financial statements and time associated with the administration of an audit can be quite high. Because of the complexities in auditing health and welfare plans that I discussed previously, fees paid to independent auditors for those plan audits can be three to four times the amount of the audit fees for 401(k) plans, and have increased dramatically the past several years because of changes in health care system delivery and payment systems and the impact of HIPAA. Factors affecting the audit fee include plan size, type of benefits, number of outside service providers, quality of plan recordkeeping, and the plan sponsor's ability to prepare the financial statements.

Which brings me to your question of how HIPPA regulations have affected the preparation of the Form 5500 and the required audit. The HIPPA regulations have significantly affected the audit of health and welfare plan financial statements in a number of ways. In most audits of health and welfare medical plans it is necessary for the auditor to access Protected Health Information, such as information regarding claims payments. A significant amount of administrative time—as much as 30% of the total audit hours incurred—can be spent obtaining legal documentation that permits access to health claim data. Outside service providers, such as insurance companies and claims payment processors, require the auditor and the plan sponsor to sign confidentiality agreements. To comply with HIPAA provisions, the plan sponsor also requires the auditor to sign a Business Associates Agreement. It often takes months for the attorneys of all parties involved—the service provider, the auditor, and the plan sponsor—to agree on the wording of these legal agreements. Even with the legal agreements in place, service providers often withhold needed claims information from the auditors, claiming HIPAA restrictions. There is much back-and-forth between the auditor, plan sponsor, and outside service providers before agreeing on what information will be provided.

Plans often have multiple outside service providers. As a result, the negotiation processes for information and confidentiality agreements is required for each provider. To complicate matters even more, outside service providers change frequently, so the protocol established in one year will not necessarily be what is used in the next year. Even in situations where the service provider does not change, the high turnover in staff at many outside service providers often requires starting from square one the next year, or even during the middle of an audit after an initial agreement has been reached.

To comply with HIPAA privacy provisions, auditors are required to maintain the privacy of any protected health information in their workpapers. This means identifying every workpaper, both electronic and hardcopy, that contains protected health information, and implementing and monitoring restrictions on access to those workpapers for as long as they are retained, generally five years. The auditing firm must have firm-wide policies and procedures in place to make this happen, which can be quite burdensome.

In conclusion, we encourage the the DOL to evaluate whether the current financial reporting and audit requirements for single-employer defined benefit health and welfare plans cost effectively meet the needs of the DOL, participant protection, and the needs of other potential users of plan

financial statements. We also encourage the DOL to consider alternative types of independent audit assurances that could provide for more cost effective protection to plan participants, and provide the DOL with the information it needs.

The AICPA appreciates the opportunity to discuss our views on this important issue with the Working Group. We hope this information will be helpful in addressing financial reporting and audit issues related to single-employer defined benefit health and welfare plans.

This concludes my prepared remarks. I will now be pleased to answer any questions you may have.

# # # # #