EBPT22

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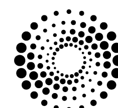
SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Audits of Employee Benefit Plans



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Interactive Self-study CPE

Companion to PPC's Guide to Audits of Employee Benefit Plans

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INTRODUCTION

Companion to PPC's Guide to Audits of Employee Benefit Plans consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Audits of Employee Benefit Plans* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Guide to Audits of Employee Benefit Plans* and other PPC products are available for purchase at **tax.tr.com/ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com/ogs** or by emailing, faxing, or mailing your completed **Examination for CPE Credit Answer Sheet** for print grading by **March 31, 2023**. Complete instructions for grading are included below and in the test instructions preceding the **Examination for CPE Credit**.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of audits of employee benefit plans. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reasoning for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions at the end of the course.** You may record your answer choices by printing the **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

Obtaining CPE Credit

Online Grading. Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. You may search for the exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. For further instructions regarding the Online Grading Center, please refer to the test instructions preceding the **Examination for CPE Credit**. A certificate documenting the CPE credits will be issued for each examination score of 70% or higher.

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You may fax your completed **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation** to **(888) 286-9070** or email them to *CPLGrading@thomsonreuters.com*. The mailing address is provided on each course's overview page and on the instructions preceding each exam.

If more than one person wants to complete this self-study course, each person should complete a separate **Examination for CPE Credit Answer Sheet**. Payment must accompany each answer sheet submitted ($109 when sent by email or fax; $119 when sent by regular mail). We would also appreciate a separate **Self-study Course Evaluation** from each person who completes an examination.

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Retaining CPE Records

For all scores of 70% or higher, you will receive a *Certificate of Completion*. You should retain it and a copy of these materials for at least five years.

COMPANION TO PPC'S GUIDE TO AUDITS OF EMPLOYEE BENEFIT PLANS

COURSE 1

PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING (EBPTG221)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses the pre-engagement and audit planning necessary for the audit of an employee benefit plan. Topics covered include engagement acceptance and continuance; understanding the plan, its environment, and its internal control; and auditing planning decisions and judgments.
PUBLICATION/ REVISION DATE:	March 2022
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Employee Benefit Plans*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	9 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **March 31, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Engagement Acceptance and Continuance and Audit Planning

Completion of this lesson will enable you to:
- Identify the engagement acceptance and continuance procedures an auditor may need to complete when auditing an employee benefit plan and how to document that decision.
- Recognize how to document the terms of an engagement with an employee benefit plan client and what audit planning procedures might be necessary.

Lesson 2—Obtaining an Understanding of the Plan, Its Environment, and Its Internal Control

Completion of this lesson will enable you to:
- Determine best practices for obtaining an understanding of an employee benefit plan and its environment.
- Recognize the best methods for obtaining an understanding of an employee benefit plan's internal control.

Lesson 3—Audit Planning Decisions and Judgments and Other Topics Related to Pre-engagement Activities and Audit Planning

Completion of this lesson will enable you to:

- Identify the audit planning decisions and judgments necessary in an employee benefit plan audit.
- Determine the best methods for dealing with issues such as audit sampling, detailed audit plans and workpapers, and initial engagements.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs**. Online grading allows you to get instant CPE credit for your exam.

Alternatively, you can submit your completed **Examination for CPE Credit Answer Sheet, Self-study Course Evaluation,** and payment via one of the following methods:

- Email to: *CPLGrading@thomsonreuters.com*
- Fax to: **(888) 286-9070**
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See the test instructions included with the course materials for additional instructions and payment information.

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Lesson 1: Engagement Acceptance and Continuance and Audit Planning

INTRODUCTION

The focus of this course is activities that should take place when deciding whether to propose for or accept a benefit plan client or to retain an existing client and the necessary activities in the early planning stages of a new or continuing audit engagement.

Pre-engagement activities involve consideration of the auditor's ability and desire to propose for, accept, or retain a particular benefit plan engagement, including the auditor's independence, technical expertise, and ability to meet ERISA audit requirements; the plan management's integrity; and the scope of the audit. Pre-engagement activities also include communicating with the predecessor auditor, if there is one, and establishing the terms of the engagement. Under ERISA, employee benefit plans generally do not have to file audited financial statements until they have 100 or more participants.

Planning activities include obtaining an understanding of the plan and its environment, including ERISA, tax, and DOL laws and regulations, and the particular plan's provisions, activities, internal control, and factors, including fraud, that affect the risk of material misstatements in its financial statements. These activities allow the auditor to make a decision about the acceptance or continuance of a client relationship, but certain pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan.

The authors have consolidated much of the audit information in *PPC's Guide to Audits of Nonpublic Companies* and tailored it specifically to address the unique issues, circumstances, and audit approaches common to employee benefit plans. The authors have also used this tailoring approach for the practice aids, where the checklists, confirmation letters, and audit programs found in *PPC's Guide to Audits of Nonpublic Companies* have been changed to fit an employee benefit plan. The authors recommend that owners of *PPC's Guide to Audits of Employee Benefit Plans* also maintain a current edition of *PPC's Guide to Audits of Nonpublic Companies* because the guidance in that book complements and amplifies this course.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the engagement acceptance and continuance procedures an auditor may need to complete when auditing an employee benefit plan and how to document that decision.
- Recognize how to document the terms of an engagement with an employee benefit plan client and what audit planning procedures might be necessary.

Authoritative Literature

Pre-engagement Activities. The authoritative pronouncements that establish requirements or provide guidance that most directly affects pre-engagement activities are as follows:

a. AU-C 210, *Terms of Engagement*, establishes the auditor's responsibilities in agreeing on the terms of the audit engagement with management and, when appropriate, those charged with governance. This includes determining that certain preconditions for an audit, for which management and, when appropriate, those charged with governance are responsible, are present.

b. AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, addresses the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements.

c. AU-C 300, *Planning an Audit*, addresses the auditor's responsibility to plan an audit of financial statements.

d. AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, establishes the auditor's responsibilities relating to opening balances in an initial audit engagement, including a reaudit engagement.

e. Statement on Quality Control Standards (SQCS) No. 8 (QC 10), *A Firm's System of Quality Control*, describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm's quality control system should encompass.

f. The AICPA *Code of Professional Conduct* (the Code) provides the ethical framework for members in the performance of their professional responsibilities. The *Independence Rule* (ET 1.200.001) provides requirements and guidance regarding an auditor's independence in relationship to an attest client. Auditors also need to comply with other ethical requirements of the Code when considering whether an engagement can be accepted or continued.

These authoritative pronouncements are explained further at the relevant points in the following discussion.

Preliminary Planning. The authoritative pronouncements that establish requirements and provide guidance that affect preliminary audit planning are as follows:

a. AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, establishes specific quality control requirements to be performed as part of an audit.

b. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks.

c. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.

d. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance.

e. AU-C 300, *Planning an Audit*, establishes requirements for audit planning, including development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether specialized skills are needed.

f. AU-C 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for performing risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement at the financial statement and assertion level and requires obtaining an understanding of various specific matters, including the aspects of internal control relevant to the audit.

g. AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality as a basis for the financial statements as a whole and performance materiality for assessing the risks of material misstatement at the assertion level, and determining the nature, timing, and extent of further audit procedures.

h. AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.

i. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.

j. AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes requirements relating to auditing accounting estimates.

k. AU-C 550, *Related Parties*, establishes specific additional audit requirements regarding related party relationships and transactions.

l. AU-C 610, *Using the Work of Internal Auditors*, provides guidance on (a) using the work of the internal audit function and (b) using internal auditors for direct assistance in the audit of financial statements.

The use of analytical procedures in audit planning is included in AU-C 315A. AU-C 520, *Analytical Procedures*, addresses the use of analytical procedures as substantive procedures and near the end of the audit. All of these authoritative pronouncements are also explained further at the relevant points in the following discussion.

In addition, the following authoritative literature is specifically or particularly relevant to employee benefit plan pre-engagement and planning activities:

a. AU-C 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, establishes requirements relating to the acceptance of an ERISA plan audit engagement and appropriately planning and performing the audit of ERISA plan financial statements, including required procedures on the certified investment information when management elects an ERISA Section 103(a)(3)(C) audit.

b. AU-C 620, *Using the Work of an Auditor's Specialist*, provides guidance on the use of a specialist that possesses expertise in an area other than accounting or auditing, and AU-C 500, *Audit Evidence*, provides guidance regarding the use of management's specialists who have expertise in a field other than accounting or auditing. Specialists (either management's or the auditor's) that are common in audits of employee benefit plans are *actuaries* related to actuarial determinations, and *appraisers* related to valuing investments that do not have a ready market.

c. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance when an entity uses services provided by a service organization that affect the client's information system relevant to financial reporting. It applies when an employee benefit plan uses a bank trust department or other third party to invest and hold plan assets, and also gives guidance relevant to the plan auditor's consideration of the effect of a service organization that executes and processes transactions for another entity (the plan) on the plan's internal control in planning the audit and in auditing investments and insurance contracts in trusteed arrangements. It also gives guidance on the plan auditor's considerations in deciding the need for, or desirability of, obtaining a SOC 1 report on the controls at the service organization and on the auditor's use of the SOC 1 report.

d. AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AEBP), discusses aspects of auditing unique to employee benefit plans, including unique planning considerations. It applies to audits of defined benefit and defined contribution retirement plans and health and welfare benefit plans. The auditing guidance included in AEBP is considered guidance from an *interpretive publication* pursuant to AU-C 200.14. AU-C 200.27 indicates that the auditor should consider applicable interpretive publications in planning and performing the audit.

e. AICPA *Code of Professional Conduct* at ET 1.200.001, the *Independence Rule*, and interpretations under the *Independence Rule* provide requirements and guidance on the effect on auditor independence of various services to, and relationships with, employee benefit plans and plan sponsors.

These pronouncements are also discussed at relevant points in the course.

Recently Issued Auditing Standards with Extended Effective Dates

SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. In July 2020, the AICPA Auditing Standards Board issued SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. The standard retained the familiar requirement that the auditor's further procedures should include one or more of three approaches: (a) obtain evidence from events occurring up to the audit report date, (b) test how management made the estimate, or (c) develop the auditor's own point estimate or range. The new SAS adds requirements and guidance regarding assessment of risk of material

misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. SAS No. 143, which is now codified at AU-C 540, supersedes *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is now codified at AU-C 540A, and amends various other AU-C sections. SAS No. 143 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 143.

SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources.* In June 2021, the AICPA issued SAS No. 144, *Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. SAS No. 144 provides enhanced guidance on (1) evaluating the work of management's specialist with regard to developing accounting estimates; (2) the use of information from third-party pricing services when evaluating estimates of fair value of financial instruments; and (3) using the work of an auditor's specialist. SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 144.

SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.* In October 2021, the AICPA issued SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. SAS No. 145 supersedes AU-C 315A and amends other auditing standards related to risk assessment. Key aspects of SAS No. 145 include requirements or clarifications related to assessment of the risks of material misstatement at the assertion level and requirements related to understanding the entity's system of internal control and the evaluation of the design of certain controls. SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 145.

ENGAGEMENT ACCEPTANCE AND CONTINUANCE CONSIDERATIONS

The auditor's broad responsibilities under professional standards regarding client acceptance or continuance decisions are as follows:

- *Establishing Policies and Procedures.* SQCS No. 8 (QC 10.27), indicates that a firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagements should only be continued or accepted when the firm—

  a. has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so;

  b. can comply with legal and relevant ethical requirements; and

  c. has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.

- *Timing of Procedures.* AU-C 300.06 and AU-C 300.A8 indicate that auditors should perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement.

- *Establishing Preconditions for an Audit.* AU-C 210.06 addresses the auditor's responsibilities in agreeing on the terms of an audit, which includes establishing that certain preconditions are present. As a precondition for an audit, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Another precondition of an audit is to obtain the agreement of management and those charged with governance, as appropriate, that it acknowledges and understands its responsibilities. If the preconditions for an audit are not met, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to accept the engagement, the auditor should not accept the proposed audit engagement (AU-C 210.08). In addition to the preconditions for an audit discussed in AU-C 210, AU-C 703.15 requires the auditor to obtain management's acknowledgement and agreement that it understands its responsibility to perform the following: (1) maintain a current plan instrument that includes all of the related plan amendments; (2) administer the plan and determine that the plan's transactions are in conformity with the plan's provisions

and are presented and disclosed in the financial statements in conformity with the plan's provisions; and (3) maintain sufficient records with respect to each of the participants to determine the benefits due or which may become due to such participants. In addition, if management elects to have an ERISA Section 103(a)(3)(C) audit, management is required to determine whether (1) the circumstances permit an ERISA Section 103(a)(3)(C) audit; (2) a qualified institution has prepared and certified the investment information as provided in 29 CFR 2520.103-8; (3) the certification meets the requirements in 29 CFR 2520.103-5; and (4) the certified investment information is appropriately measured, presented, and disclosed in accordance with GAAP (or the applicable financial reporting framework).

- *Communicating with Previous Auditors.* AU-C 210.11 notes that the successor auditor should request permission from the prospective client to inquire of the predecessor auditor, prior to final acceptance of the engagement, about matters that would assist in making the acceptance decision. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response.

- *Form 5500.* AU-C 703.17 requires auditors to obtain the agreement of management (or those charged with governance) to provide to the auditor a draft of the Form 5500 that is substantially complete prior to dating the auditor's report.

If management elects to have an ERISA Section 103(a)(3)(C) audit, AU-C 703.16 requires the auditor to inquire how management determined that the institution preparing and certifying the investment information met the requirements for a qualified institution as provided in AU-C 703.8 and AU-C 703.A6.

Client acceptance/continuance policies and procedures should provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.

- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement. However, the information gathered generally has an impact on later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and developing a detailed audit plan, as well as for other audit purposes. AU-C 500.A27 specifically notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, SQCS No. 8 (QC 10.28) requires the firm to consider whether any ethical requirements under ET 1.110.010, *Conflicts of Interest*, interpretation of the *Integrity and Objectivity Rule* at ET 1.100.001 of the AICPA *Code of Professional Conduct* apply and to document how the issues were resolved.

Risk-based Perspective

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement is declined and when the relationship with a continuing client is terminated. If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor's own business risk) and also involves a greater risk of material misstatement of the financial statements. Both AU-C 240.A27 and AU-C 315A.07 note that the auditor considers whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new employee benefit plan audit engagement, the auditor obtains a general understanding of plan management's reputation and integrity and of the employee benefit plan industry, the plan's provisions in the plan instrument, and the plan's operations and financial condition through discussions with plan management, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor's continuance decision.

The engagement acceptance or continuance decision normally focuses on factors that increase overall financial statement risk. What is the intended use of the financial statements? For example, to meet ERISA filing requirements. Do discussions with the predecessor auditor, bankers, insurance carriers, actuaries, attorneys, or others raise any concerns about plan management's integrity? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate employee benefit plan and overall audit experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. (This early identification of risks and the associated assignment of appropriate engagement team members helps meet the requirement in AU-C 220.16 that the audit partner needs to be satisfied that the engagement team and any auditor's external specialists have the appropriate competencies for the engagement. Technical expertise in the employee benefit plan area is discussed later in this section.) Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee estimates) will be affected by any risks that have been identified through client acceptance or continuance; thus, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable. Many of these matters are audit strategy issues.

Before deciding to propose for or accept a new employee benefit plan audit engagement, the auditor ought to consider his or her ability to accept the engagement, plan management's integrity, and the scope of the proposed audit. These considerations also need to be made annually in deciding whether to retain an existing client.

Ability to Accept the Engagement

An auditor ought to not propose for, or accept, an audit unless he or she will be able to meet the responsibilities and requirements related to the engagement. Factors to be considered include the following:

- Auditor independence.
- Expertise in the employee benefit plan area or ability to obtain sufficient knowledge to meet professional standards.
- Ability to meet the engagement's time requirements and deadlines.
- Ability to meet ERISA audit requirements.

These matters are discussed in the following paragraphs.

Independence

The AICPA, state boards, the Securities and Exchange Commission, the PCAOB, and the Department of Labor each have their own independence rules. (ERISA and DOL independence rules, which in some respects are more stringent than those promulgated by the AICPA, are discussed later in this section.) AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, requires the auditor to be independent, unless GAAS or law or regulation specifies otherwise. AICPA independence rules apply to engagements for attest clients, which are persons or entities with respect to which an attest engagement is performed. If the person or entity that engages the auditor is not also the attest client, the auditor should consult the *Client Affiliates* interpretation at ET 1.224.010 and also evaluate threats to compliance with the *Integrity and Objectivity Rule* at ET 1.100.001 and the related interpretations.

The Independence Rule, ET 1.200.001 and related interpretations, apply to covered members. Covered members include those who are members of an attest engagement team or able to influence the attest engagement team. The AICPA's *Code of Professional Conduct* (the Code) defines the attest engagement team as those individuals who participate in the attest engagement, including those individuals performing concurring and engagement quality reviews. The attest engagement team includes employees and contractors retained by the firm who participate in the attest engagement regardless of their functional classification as audit, tax, management consulting services, or other function. Specialists, as discussed in AU-C 620A, *Using the Work of an Auditor's Specialist*, and individuals performing only routine clerical functions are excluded from the attest engagement team. *PPC's Guide to GAAS* provides a detailed discussion of independence rules. The auditor's conclusions on compliance with independence requirements applicable to the engagement, including the identification of any threats to independence and safeguards that were applied, should be documented. Auditors contemplating an employee benefit plan engagement might be members of the plan's administrative committee or of the plan itself. They might audit the plan sponsor or provide the plan or sponsor with appraisal, actuarial, or accounting services, or other services. Thus, the auditor should consider whether such memberships or activities impair independence with respect to the potential client. Some specific considerations in applying independence rules in small employee benefit plan engagements are discussed in the remaining paragraphs of this section.

Nonattest Services. For many small employee benefit plan engagements, a frequent concern about meeting independence requirements is the effect of providing nonattest services, such as bookkeeping services, actuarial services, or preparing the Form 5500 for the plan. An auditor may be asked to provide these services to clients who are too small to employ an adequate accounting staff. Concerns may arise that an auditor's independence has been impaired in these circumstances.

According to ET 1.295, *Nonattest Services*, in the AICPA's *Code of Professional Conduct*, before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. ET 1.295.040 requires the following with respect to the performance of nonattest services:

- The auditor should not assume management responsibilities for the attest client.
- The client must agree to perform certain specific functions in connection with the nonattest services.
- The auditor should establish and document in writing the understanding with the client regarding the nonattest services.

During an audit engagement, an auditor often communicates with management about a variety of issues related to the engagement. The following types of communications are considered a normal part of an audit engagement and would not be subject to the ET 1.295 requirements:

- The selection and application by the client of accounting standards or policies and financial statement disclosure requirements.
- Whether the client's accounting and financial reporting methods are appropriate.
- Adjusting journal entries prepared or proposed by the auditor for the client's consideration.
- The form or content of the financial statements.

An auditor also has to consider whether the level of involvement constitutes a separate nonattest service. For example, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of an attest engagement and are, instead, nonattest services. Such activities would not impair independence provided the requirements of ET 1.295 are met.

Under ET 1.295.030.01, independence is considered to be impaired if an auditor (or his or her firm) assumes management responsibilities for an attest client. However, the auditor may assist management in those responsibilities. For the auditor to remain independent, before the start of the nonattest engagement, the attest client and its management should agree to perform all of the following functions in connection with the nonattest services (ET 1.295.040):

- Assume all management responsibilities.
- Oversee the services by designating an individual, preferably within senior management, who has suitable skill, knowledge, and/or experience.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.

The auditor should also assess and be satisfied that the designated individual who will oversee the services sufficiently understands the services to be performed by the auditor to ensure oversight. Also, the auditor ought to assess the suitability of their skills, knowledge, and/or experience.

In addition, the auditor should be satisfied that management will be able to meet all of the criteria in the previous paragraph, make an informed judgment on the results of the nonattest services, and be responsible for making the significant judgments and decisions that are management's responsibility. In cases where the attest client is unable or unwilling to assume its responsibilities, the auditor's performance of the nonattest services would impair independence.

ET 1.295.040.01 also requires the auditor to *establish* and *document in writing*, before performing the nonattest services, his or her understanding with the attest client regarding the following:

- Objectives of the engagement (i.e., the nonattest services).
- Services to be performed.
- Client's acceptance of its responsibilities.
- Auditor's responsibilities.
- Any limitations of the engagement.

ET 1.295.050.02 indicates that failure to prepare the required documentation does not impair independence as long as the auditor established the understanding with the attest client. The failure, however, would violate ET 1.310.001, the *Compliance with Standards Rule*.

ET 1.295 does not specify how the understanding is to be documented, so the auditor has flexibility. For example, the understanding might be documented in a separate engagement letter, in a separate form in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an audit engagement. The authors believe it is common in many employee benefit plan audit engagements for auditors to also provide nonattest services, such as preparation of the Form 5500, actuarial services, or bookkeeping services. Compliance with the requirements of ET 1.295, including the assessment that the designated individual who will oversee the services sufficiently understands the services to be performed by the auditor to ensure oversight along with the suitability of their skills, knowledge, and/or experience, should be documented. The AICPA's Professional Ethics Division has issued *Frequently Asked Questions: Nonattest Services Questions* that provides additional guidance on documentation of the understanding with the attest client, as well as the suitable skill, knowledge, and/or experience of the designated individual overseeing the nonattest service. The document can be found at **https://us.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/tools/downloadabledocuments/nonattestservicesfaqs.pdf**. Furthermore, the AICPA has issued a Nonattest Services Toolkit that auditors may find useful when considering the performance of nonattest services. The Toolkit can be found at **https://us.aicpa.org/content/dam/aicpa/interestareas/professionalethics/resources/downloadabledocuments/toolkitsandaids/nonattest-services-toolkit.pdf** The authors believe that many auditors will document the understanding with the client in the audit engagement letter.

Certain activities performed as part of a nonattest service are considered to be management responsibilities and, therefore, impair independence regardless of whether the auditor complies with the other requirements of ET 1.295. In addition, if an auditor assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. ET 1.295 identifies common nonattest service activities and provides guidance on considerations as to whether they impair

independence. ET 1.295.030.02 provides examples of activities that are management responsibilities and that, if performed for an attest client, would impair the auditor's independence. ET 1.295.115.04 provides examples of activities related to benefit plan administration that would impair the independence of a benefit plan auditor. The authors have identified the following examples as being particularly relevant to audits of employee benefit plans and stated them in terms applicable to such plans:

- Having custody of plan assets.
- Serving as a fiduciary, as defined by ERISA.
- Making disbursements on behalf of a plan.
- Making policy decisions on behalf of plan management.
- When dealing with plan participants, interpreting the plan document on behalf of plan management without first obtaining the concurrence of plan management.
- Accepting responsibility for designing, implementing, or maintaining internal controls.
- Accepting responsibility for the preparation and fair presentation of the plan's financial statements.
- Performing ongoing evaluations of the plan's internal control as part of its monitoring activities.

In addition, under ET 1.295.110, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if, according to ET 1.295.110.02, the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or a valuation related to an employee stock ownership plan, generally involves significant subjectivity, and, therefore, would impair independence if performed for financial statement purposes. On the other hand, an actuarial valuation of a client's pension or postemployment benefit liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material according to ET 1.295.110.05.

Regulatory Considerations. ET 1.295 recognizes that various other regulatory bodies (e.g., the SEC or the DOL) may have independence rules related to nonattest services that are more stringent. ET 1.295.010.07 states the failure to comply with the independence requirements of such regulatory bodies constitutes a violation of ET 1.200.001, the *Independence Rule*. Thus, auditors of employee benefit plans should be aware of the independence regulations promulgated by the DOL. Those regulations are discussed later in this section.

Independence Requirements Specific to Employee Benefit Plans. The following additional authoritative interpretations under the *Independence Rule* (ET 1.200.001) provide further requirements and guidance on auditor independence in various situations related to employee benefit plans, trusts, and plan sponsors:

a. *Affiliates of an Employee Benefit Plan.* ET 1.224.010, *Client Affiliates*, provides guidance on which entities are considered affiliates of a financial statement attest client and, therefore, subject to the independence provisions of the AICPA *Code of Professional Conduct*. It indicates that the *Independence Rule* (ET 1.200.001) and related interpretations applicable to the attest client have to be applied to their affiliates, except in limited circumstances described in ET 1.224.010.02. For example, according to ET 1.240.010.01, *Overview of Financial Interests*, a direct financial interest in an attest client by a covered member would impair independence with respect to that attest client; a direct financial interest in an affiliate of that attest client would also impair independence with respect to that attest client.

   ET 0.400, *Definitions*, at ET 0.400.02, identifies entities that are affiliates of a financial statement attest client. Among these entities are the following that are specifically relevant to employee benefit plan audits:

   - The sponsor of a single employer employee benefit plan financial statement attest client.
   - Any entity, for example, a union, a participating employer, or a group association of employers, with significant influence over a financial statement attest client that is a multiemployer employee benefit plan when that plan is material to the entity.

- •• The participating employer serving as the plan administrator of a multiple employer employee benefit plan financial statement attest client.
- •• A single or multiple employer employee benefit plan whose sponsor is either a financial statement attest client or an entity that is controlled by the financial statement attest client. Note that all participating employers in a multiple employer employee benefit plan are deemed to be sponsors of the plan.
- •• A multiemployer employee benefit plan in situations where a financial statement attest client or an entity that is controlled by the attest client has significant influence over the plan and the plan is material to the attest client.

Thus, for example, an auditor of an employee benefit plan's financial statements would not be independent if a covered member of the auditor's firm had a direct financial interest in the plan's single-employer sponsor.

An important exception to the application of independence rules to affiliates, such as plan sponsors, explained in ET 1.224.010.02, is that prohibited nonattest services can be provided, during the period of the professional engagement or during the period covered by the financial statements, as long as it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest service will not be subject to financial statement attest procedures.

b. *Simultaneous Employment or Association With an Attest Client.* ET 1.275.005.01–.02 states that independence is impaired if during the period covered by the financial statements or during the audit period, a partner or professional employee of a firm serves as an officer, director, employee, promoter, underwriter, trustee for any pension or profit-sharing trust of the audit client, or in any management capacity for an audit client. The author's believe this association extends to an auditor's membership on an employee benefit plan's administrative committee, which would similarly put the firm member in a position of making policy decisions and accepting management responsibility in relation to a plan.

c. *Participation in Employee Benefit Plan of Attest Client.* ET 1.250.010, *Plan Is an Attest Client or Is Sponsored by an Attest Client*, indicates that when a covered member participates in an employee benefit plan that is an attest client, or is sponsored by an attest client, during the period of the professional engagement or during the period covered by the financial statements, independence would be impaired except in limited circumstances described in ET 1.250.010.01. Thus, an auditor would not be independent of the plan or the plan's sponsor if a covered member of the auditor's firm participates in the plan. Participation by an immediate family member in such a plan is covered by ET 1.270.030 discussed in d.

d. *Participation in Employee Benefit Plan by Immediate Family Member.* ET 1.270.030, *Immediate Family Member Participation in an Employee Benefit Plan That Is an Attest Client or Is Sponsored by an Attest Client (Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans)*, indicates that if an immediate family member of a covered member, during the period covered by the financial statements or during the period of the professional engagement, participates in such a plan, independence would not be impaired provided specified safeguards are observed. ET 1.270.030.01 indicates that these safeguards are that the plan is offered to all employees in comparable positions, and that the immediate family member does not serve in a key position for the attest client or governance position for the plan, and cannot supervise or participate in the plan's investment decisions or selection of investment options made available to participants.

e. *Employee Benefit Plan Administration Services.* ET 1.295.115.01–.03 indicates that when an auditor provides benefit plan administration services to an attest client, independence would not be impaired if the general requirements for nonattest services are complied with and activities are restricted to those identified in ET 1.295.115.03. ET 1.295.115.02, however, makes clear that an auditor of an employee benefit plan's financial statements subject to ERISA and DOL regulations is governed by the more restrictive independence requirements of those regulations. In other words, a CPA firm could theoretically serve as a professional third-party plan administrator of a plan and audit that plan's financial statements provided the administration activities conformed with ET 1.295 on nonattest services. However, ERISA

and DOL independence requirements are more restrictive, and the auditor must also comply with those regulations, discussed below.

Other Independence Requirements. Regulatory agencies, certain state CPA societies, and state boards of accountancy may have established independence requirements applicable to CPAs under their jurisdiction that are more restrictive than those of the AICPA. An auditor should, therefore, be aware of applicable requirements before accepting an engagement.

Proposed Changes to Independence Requirements. The following paragraphs provide information about revisions recently proposed to the Code that would affect independence. The information presented is at a high level. Detailed information about the changes discussed here and other standards-related projects of the Professional Ethics Executive Committee (PEEC) may be accessed from the AICPA's website at **https://us.aicpa.org/content/aicpa/interestareas/professionalethics/community/peec-project-activity.html**

The AICPA Professional Ethics Executive Committee (PEEC), at its November 2021 meeting, due to concerns from firms, agreed to delay the effective date of independence interpretation, *Information system services* (ET 1.295.145) to January 1, 2023, with early implementation allowed. The revised interpretation provides that designing or developing a Financial Information System (FIS) for an attest client impairs independence. An FIS is a system that aggregates source data underlying financial statements or generates information significant to financial statements or financial processes as a whole.

In September 2021, PEEC proposed a revised interpretation, *Unpaid Fees* (ET 1.230.010). The interpretation would replace the current provision with a principles-based framework to determine whether threats are at an acceptable level. Among other things, the interpretation notes that threats are considered at an acceptable level when the unpaid fees are clearly insignificant and relate to services provided less than one year prior to the date of the current attest report. Other situations would require judgment to assess whether safeguards appropriately reduce the threat. The comment period ended on December 20, 2021.

In September 2021, PEEC proposed an interpretation, *Accounting Standards Implementation Services* (ET 1.295.113). The proposed interpretation would provide guidance on how independence could be affected when a member assists an attest client with implementing accounting standards. Though specific guidance does exist, this proposed interpretation combines key elements from nonattest services guidance to assist members and their compliance with independence requirements. The comment period ended on December 20, 2021.

Independence—ERISA and DOL Rules. ERISA requires accountants engaged under its audit requirements to be independent. A DOL interpretive bulletin (DOL Reg. 2509.75-9) provides guidance concerning auditor independence for ERISA audits. The regulations state that an auditor is not independent if during the engagement period, the period covered by the financial statements, or at the date of the auditor's report, the auditor, his or her firm, or any member of the firm:

- Had, or was committed to acquire, a direct or material indirect financial interest in the plan or plan sponsor. (This DOL regulation differs from ET 1.224.010 in the AICPA *Code of Professional Conduct* on client affiliates because it allows no exceptions, such as the exception for certain prohibited nonattest services as described in item a., above.)
- Was a promoter, underwriter, investment advisor, voting trustee, director, officer, or employee of the plan or plan sponsor. [This is consistent with the requirement of ET 1.224.010.02 that an auditor should apply the *Independence Rule* (ET 1.200.001) and related interpretations applicable to the financial statement attest client to their affiliates. As explained in item a., above, a plan sponsor is an affiliate of a plan.]

The DOL regulations also state that an accountant is not independent if he or she or any member of his or her firm "maintains financial records for the employee benefit plan." The meaning of "maintains financial records" is unclear, and, as discussed in the following paragraphs, the AICPA and DOL differ about its meaning.

The AICPA independence rules allow auditors to provide certain bookkeeping services and remain independent. Bookkeeping services, if provided in accordance with ET 1.295, as discussed earlier in this section, are permitted. Some DOL officials, however, disagree and more narrowly interpret permissible activities. The DOL has not issued

any definition of what specifically prohibited, however, some officials maintain that posting the general ledger from client-prepared underlying records or preparing participant account balances for a defined contribution plan impair independence. It is noteworthy that the DOL patterned its interpretive bulletin after the SEC's independence rules for auditors of public company financial statements and that the SEC rules prohibit the auditor from providing all bookkeeping services, including posting the general ledger and subsidiary ledgers from client-prepared underlying records.

The DOL position on independence poses a serious problem for plan auditors because many small plans, particularly 401(k) plans, rely on their auditors for bookkeeping services or for maintaining individual participant account balances. DOL officials have publicly stated that they take the DOL position very seriously and are reluctant to change it. In instances when the DOL concludes that the auditor is not independent, the audit report will likely be rejected and a civil penalty may be imposed against the plan administrator. The auditor may also be referred to the AICPA's ethics division. Although the DOL requirements relating to bookkeeping services appear to be more stringent than the AICPA's, auditors are required to comply with the more stringent requirements. ET 1.295.010.07 indicates that when an auditor performs nonattest services for an attest client and is required to be independent under the regulations of an applicable regulatory body, such as the DOL, independence would be impaired if the auditor does not meet the requirements of the regulatory body. In other words, violation of the DOL's independence requirements would also be considered a violation of the AICPA's requirements.

The DOL regulations do allow the plan auditor to also audit the plan sponsor and remain independent. They also allow an accountant, or his or her firm, to provide actuarial services to the plan and remain independent. This provision is similar to a provision in ET 1.295.110. However, the DOL rules do not mention whether providing appraisal or valuation services (for example, valuing real estate or securities that do not have a ready market price) would impair independence. DOL officials have publicly expressed concern about plan auditors also providing appraisal and valuation services to benefit plans. ET 1.295.110.04 indicates that valuations related to an employee stock ownership plan or appraisals of assets or liabilities generally involve significant subjectivity and would, therefore, impair an auditor's independence if material to the financial statements. A CPA providing recordkeeping, appraisal, or valuation services may need to seek a DOL interpretation about the effect on independence.

Expertise in the Employee Benefit Plan Area. Employee benefit plans are subject to complex and specialized accounting, financial reporting, tax (plan qualification), and legal requirements. Auditor expertise is especially critical because the IRS and DOL scrutinize the annual reports filed and can fine the plan administrator for a deficiency in the audited financial statements or auditor's report. The DOL can also review the audit workpapers for adherence to professional standards.

The AICPA Quality Control Standards also address competence in performing audit engagements. SQCS No. 8 (QC 10.33) requires firms to adopt quality control policies and procedures that provide reasonable assurance that the engagement partner (or other individual responsible for supervising the engagement and signing or authorizing someone else to sign the auditor's report) possesses the competencies necessary for the engagement. The necessary competencies will vary depending on the client, industry, or type of service being provided. SQCS No. 8, QC 10.A26, specifically mentions employee benefit plan engagements when discussing certain industries or engagements that require competencies that are different from those expected in performing attest services for clients in other industries. *PPC's Guide to Quality Control* provides a practice aid to assist firms in evaluating and documenting the engagement team's competencies.

The auditor contemplating a benefit plan engagement needs to consider whether he or she has the necessary experience in the area or can obtain sufficient knowledge and understanding to perform the services requested through continuing education courses; study of ERISA, IRC, IRS and DOL documents and AICPA accounting and auditing guides; attendance at relevant conferences; discussions with knowledgeable persons; etc. The AICPA and most state licensing authorities have continuing education requirements for CPAs. In fulfilling these requirements, particular attention can be given to employee benefit plan accounting, auditing, and tax matters.

Ability to Meet the Engagement's Time Requirements and Deadlines. The due date for filing IRS Form 5500 and the audited financial statements required to be filed with the Form 5500 is fairly lengthy, a minimum of seven months after the plan year end, and up to nine and one-half months after the plan year end if an extension is obtained. Nevertheless, the auditor of a plan subject to ERISA audit requirements considers his or her ability to meet the

deadline, especially since the plan administrator can be fined for a late filing. In evaluating his or her ability to meet the deadline, the auditor considers not only the lengthy filing period, but also whether the plan year end differs from the December 31 year end that is common for business enterprises. These factors mean that the auditor may be able to perform a benefit plan audit in the auditor's off-peak period and still meet the time deadline.

The auditor contemplating the audit of a defined benefit pension plan also considers whether the plan has an end-of-year benefit information date, which requires an actuarial determination at year end rather than at the beginning of the plan year. Having to obtain an end-of-year actuarial determination could delay the audit's completion date and limit the auditor's flexibility in completing the audit. It could also create an audit time crunch if the actuarial determination is not completed well enough in advance of the filing due date. (However, as discussed later in this section, use of a beginning-of-year benefit information date has implications for the financial statements and auditor's report.)

Ability to Meet ERISA Audit Requirements. The auditor contemplating an audit of a plan subject to ERISA audit requirements considers his or her ability to meet those requirements. For example, ERISA requires the auditor to report on schedules that accompany the financial statements. To report on them, the auditor needs to subject them to procedures applied in the audit of the financial statements and also determine that they contain the required information in the required format. The auditor's failure to meet the ERISA and DOL audit and reporting requirements can subject the plan administrator to substantial fines. In addition, the Employee Benefits Security Administration (EBSA) has been actively reviewing workpapers and audit reports of benefit plan audits.

In evaluating ability to meet ERISA audit requirements, if the auditor is requested to perform a non-Section 103(a)(3)(C) audit but has only performed ERISA Section 103(a)(3)(C) audits in the past, he or she ought to give due consideration to the difference between the two types of audit and consider whether he or she would be able to perform a non-Section 103(a)(3)(C) audit in a cost effective manner. Other pre-engagement considerations related to an ERISA Section 103(a)(3)(C) audit are discussed later in this section.

Another consideration is that an ERISA audit will be subjected to a peer review. Members of the AICPA must undergo peer reviews. The AICPA Peer Review Program requires at least one ERISA audit be included in the engagements selected for peer review if the firm performs one or more ERISA audits.

Management Integrity

An auditor always needs to consider the reputation and integrity of a prospective or continuing client and its management, but management integrity is especially significant for an employee benefit plan because of the responsibilities ERISA imposes on plan administrators and other fiduciaries. Plan management, that is, the plan administrator or administrative committee, is a fiduciary. ERISA requires fiduciaries, including management, to perform their duties solely in the interest of plan participants, and with due care, prudence, and diligence according to the plan documents and consistent with the provisions of ERISA. Fiduciaries also must not allow the plan to engage in certain prohibited transactions with parties in interest. Prohibited transactions must be reported on schedules accompanying the audited financial statements.

The auditor needs to evaluate any adverse information about the plan management and consider whether the CPA firm would not want to be associated with the plan's financial statements. The auditor's concern is with the client's general honesty, good faith, and forthrightness in its plan operations, administration, and financial reporting and in providing information, responses, and representations for the audit.

SQCS No. 8 (QC 10.27) indicates that a firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagements should only be continued or accepted when the firm—

a. has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so;

b. can comply with legal and relevant ethical requirements; and

c. has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.

Communication with a Predecessor. Communicating with the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement. AU-C 510.A5 notes that the predecessor auditor ordinarily permits the successor to review working papers containing several types of documentation, including documentation on related parties and significant unusual transactions. The successor auditor may discover that the predecessor auditor and the client have disagreed about accounting principles, auditing procedures, or similarly significant matters. This means that a predecessor may have reached the conclusion that (a) the client lacks integrity or (b) the client may be changing auditors because of a dispute with the predecessor about audit scope or financial statement presentation. Naturally, this kind of information could influence an auditor's decision on the desirability of accepting a prospective client.

According to AU-C 510.05, a *predecessor auditor* is an auditor from another audit firm who either reported on the most recent audited financial statements or was engaged to but did not complete an audit of the financial statements. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. Communication about management integrity and other matters should be made of all predecessor auditors.

AU-C 210.A29 clarifies the timing of the communication with the predecessor by indicating that an auditor may make a proposal before communicating with the predecessor. The communication, however, ought to happen before *final* acceptance of the engagement. In other words, the predecessor is not expected to respond to inquiries until the successor has been selected and has accepted the engagement subject to evaluation of the predecessor's response.

The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is not required—simply talking with the predecessor is enough. The essential aspects of the communication are as follows:

a. *Client Permission.* An auditor should ask the prospective client to authorize the predecessor to respond fully. (This is necessary because of the ethical requirement for confidentiality.) (AU-C 210.11)

b. *Specific Questions.* An auditor may ask specifically about certain matters such as:

   (1) Information that might bear on management's integrity.

   (2) Disagreements with management on accounting principles, auditing procedures, or similar matters.

   (3) Communications with those charged with governance regarding fraud and noncompliance with laws and regulations by the entity.

   (4) Communications with management and those charged with governance regarding internal control matters.

   (5) The predecessor's understanding of reasons for the change of auditors.

   (6) The predecessor's understanding of the nature of relationships and transactions with related parties and significant unusual transactions.

Unless the client gives authorization, the predecessor cannot ethically respond to the successor's inquiries because of the requirement for confidentiality in ET 1.700.001, the *Confidential Client Information Rule.* If the potential client refuses to give authorization, the auditor should determine why. He or she should also consider whether such refusal is sufficient reason to decline the engagement because it may signal a lack of future cooperation and may deprive the auditor of useful information only the predecessor can provide.

In addition to communication with the predecessor auditor, the AICPA's *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* suggests the following sources of information (as they might apply to an employee benefit plan):

a. Review of available financial information about the prospective client, such as the plan's most recent financial statements and Form 5500.

   [Schedule C of Form 5500 (Service Provider Information), includes a section for the client to explain the reason for terminating an accountant or actuary. It explains any material disputes or disagreements concerning the termination, even if they were resolved before termination. Form 5500 requires the terminated party to be provided with a copy of the explanation and to be notified of the terminated party's right to submit comments about the explanation to the DOL. Thus, review of Schedule C may provide information on matters related to management integrity.]

b. Specific inquiry of the plan management about the nature and purpose of services to be provided.

c. Specific inquiry of the prospective client's lawyer, banker, and others having business relationships with the plan.

Outsourcing

ET 1.150, *Use of a Third-Party Service Provider*, an interpretation under ET 1.100.001, the *Integrity and Objectivity Rule*, applies whenever the auditor uses a third-party service provider to assist in the engagement. ET 1.150.040.02 indicates that clients should be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider (that is, an entity not controlled by the audit firm or an individual not employed by the audit firm), to perform portions of the audit, the client should be informed before confidential information is shared with the service provider. If the client objects, the auditor needs to perform the services without using the third party or decline the engagement. ET 1.150 applies when another party is used, for example, to audit an element, account, or item of the financial statements, or to act as a specialist. The authors believe the ruling does not apply when another audit firm performs a separate engagement, the results of which will be used by the auditor, for example, when another firm audits the plan sponsor's contribution. In addition, according to ET 1.150.040.03, the client is not required to be informed when a third party is used only for the auditor's administrative support services, such as for record storage or software application hosting. ET 1.700.040, *Disclosing Information to a Third-Party Service Provider*, an interpretation of ET 1.700.001, the *Confidential Client Information Rule*, requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. In addition, members should be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

ET 1.300.040, *Use of a Third-Party Service Provider*, an interpretation under ET 1.300.001, the *General Standards Rule*, requires an auditor to comply with that rule and ET 1.310.001, the *Compliance With Standards Rule* when the auditor uses a third-party service provider in performing the audit. ET 1.300.040.01 indicates this can be accomplished by (a) ensuring the third-party service provider has the required professional qualifications, technical skills, and other resources before using its services, and (b) adequately planning and supervising those services to ensure they are performed with competence and due professional care.

Scope of the Audit

Information about the nature of the employee benefit plan and the scope of the audit being requested is vital in deciding whether to propose for the engagement, in preparing a proposal and reasonable fee estimate once a decision is made to do so, and in planning the audit once the engagement is obtained. Matters that affect the audit scope to be considered include the following:

- Whether management has elected to have an ERISA Section 103(a)(3)(C) audit.
- The nature of the plan.
- The type of trust arrangement.
- Whether the plan uses any third-party service organizations.
- The type of investments.
- The type of contracts with insurance companies, if any.

- The need to test participant data.
- The type of plan financial statements to be audited.
- The type of auditor's report to be issued on required supplemental schedules.
- Whether the auditor will prepare Form 5500.
- The need for an SEC filing.
- Whether the audit is an initial audit.

These matters are discussed in the following paragraphs.

ERISA Section 103(a)(3)(C) Audit. In July 2019, the ASB issued SAS No. 136, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, which was effective for audits of ERISA plan financial statements for periods ending on or after December 15, 2021, as deferred by SAS No. 141, with early adoption permitted. SAS 136, among other things, eliminates the term *ERISA-permitted limited scope audits* (or *DOL limited-scope audits*) and instead refers to these audits as ERISA Section 103(a)(3)(C) audits. When management elects to have an ERISA Section 103(a)(3)(C) audit, SAS No. 136 requires the auditor to evaluate management's assessment of whether the institution issuing the certification is a qualified institution based on the DOL rules and regulations. If the auditor has concerns about the institution being a qualified institution, the auditor should discuss the concerns with management. If management's response is not considered sufficient, they should discuss those concerns with those charged with governance and determine the implications for the audit.

As previously mentioned, DOL Regulation 2520.103-8 permits an ERISA Section 103(a)(3)(C) audit for plans with assets held for investment by a bank, similar institution (for example, a regulated savings and loan association or credit union), or insurance company, referred to as a "qualified certifying institution" or "qualified institution," that is regulated, supervised, and subject to periodic examination by a state or federal agency. AEBP, Paragraph 2.37, states that at times the plan's recordkeeper will certify investment information on behalf of the plan's qualified institution as "agent for." In such a situation, the certification would generally be acceptable if there is a contractual arrangement between a qualified institution and the recordkeeper such that the recordkeeper is able to provide the certification on the qualified institution's behalf. In addition to the plan's recordkeeper, other entities such as broker-dealers, payroll providers, or valuation firms may have an agency agreement with a qualified institution to certify on behalf of the qualified institution. If such an "agency" relationship exists, it is advisable for plan management to obtain documentation of the contractual agreement.

The DOL has noted instances where ERISA Section 103(a)(3)(C) audits were performed when the financial institution did not qualify. The auditor ought to be aware that the ERISA Section 103(a)(3)(C) audit does not apply to third-party administrators or to service organizations such as claims processors, mortgage servicing agents, etc. In an ERISA Section 103(a)(3)(C) audit, the auditor does not apply audit procedures to information on plan investment assets and related transactions that is prepared and certified to as *both* complete *and* accurate by the qualified institution. (AU-C 703.A7, states that management cannot elect an ERISA Section 103(a)(3)(C) audit unless the certification addresses both accuracy and completeness.) An example certification is included in DOL Regulation 2520.103-5(d)(2). (Do not confuse the certificate from the trustee with confirming the investments with the trustee.)

A 2002 EBSA letter clarified that the auditor may rely on a certification letter signed by an authorized agent of the trustee, rather than the trustee. For example, a recordkeeper that is an affiliate of a trustee that is a "qualified bank" based on ERISA guidelines, issues the letter certifying the completeness and accuracy of the plan's investments. According to the EBSA, such a letter may be used if "the party providing the certification [is] in fact authorized to represent the insurance carrier, bank or similar institution holding the assets of the plan." If there is a question as to whether the agent is authorized by the trustee to issue the letter, the plan administrator needs to first verify that such authority exists before authorizing the ERISA Section 103(a)(3)(C) audit. The plan auditor may need to work with the plan administrator to obtain proper assurance that the agent is properly authorized by the trustee.

As discussed at DOL Reg. 2520.103-12, the plan administrator may also request the auditor to perform an ERISA Section 103(a)(3)(C) audit of the plan's investment in a 103–12 investment entity (103–12 IE) if the 103–12 IE has properly filed its report with the DOL. Similar audit guidance applies as discussed in the previous paragraphs.

An ERISA Section 103(a)(3)(C) audit usually involves less audit work and may be less costly than a non-Section 103(a)(3)(C) audit. The auditor ought to be aware, however, that (as AEBP, Paragraph 2.33, states) while the ERISA Section 103(a)(3)(C) audit need not extend to investment information, areas such as participant data, contributions, benefit payments, participant account balances, including related earnings and their allocations to such account balance, or other information would be subject to audit procedures, even if certified by the trustee or custodian. Audit work still has to be performed on these areas. Thus, audit work would typically be required for areas such as contributions, benefit obligations, benefit payments, participant loans, participant data, etc. In addition, ERISA Section 103(a)(3)(C) audit procedures are not adequate for plan investments not certified by a qualified trustee or custodian. For example, real estate and mortgages may not be covered by a certification by a trustee or custodian. In such cases, the plan auditor needs to perform appropriate audit procedures on these assets as would be required in a non-Section 103(a)(3)(C) audit. Furthermore, occasionally a qualified trustee or custodian may provide a certification for only a portion of the year under audit. This may occur in situations in which a plan has changed trustees or custodians during the plan year. For the portion of the year not covered by that certification or a certification from another qualified trustee or custodian, the auditor would be required to perform non-Section 103(a)(3)(C) audit procedures, unless that period is considered immaterial. Finally, all of the financial statement disclosures required by GAAP and by DOL regulations and the supplemental schedules required by DOL continue to be required in an ERISA Section 103(a)(3)(C) audit.

AU-C 703.29–.32 states that in an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for investments covered by the ERISA Section 103(a)(3)(C) exception include the following:

a. Reading the certification.

b. Determining whether the certifying entity is a qualified institution under DOL regulations.

c. Comparing the certified investment information to the financial information in the plan's financial statements and disclosures, including the ERISA-required supplemental schedules.

d. Determining whether the form and content of the financial statement disclosures related to the certified investment information are in conformity with GAAP and in compliance with DOL rules and regulations.

When performing an ERISA Section 103(a)(3)(C) audit, the auditor does not need to obtain an understanding of the certifying institution's internal control over investments held and investment transactions executed on behalf of the plan. The auditor also is not required to assess control risk associated with those investments and related transactions executed by the certifying institution.

In addition, in an ERISA Section 103(a)(3)(C) audit, the auditor is not responsible for testing the accuracy or completeness of the certified investment information. However, if the auditor believes the information received from the qualified institution is incomplete, inaccurate, or otherwise unsatisfactory, the auditor should further test the information. For example, if the plan has an investment in a nonactively traded REMIC that is held by a trustee, and the fair value of the REMIC, as certified by the trustee, has not changed in three years, it would appear that the trustee has not obtained recent fair value information on the REMIC. In this case, the auditor could test the information further by having the plan administrator contact the trustee to request documentation for the fair value of the investment. If the information was not accurate, the plan administrator may request the auditor to perform a non-Section 103(a)(3)(C) audit or ask the trustee for a revised certification. The auditor may need to modify the auditor's report if unable to obtain appropriate information.

If the auditor becomes aware of errors or omissions in the supplemental schedules, or if required supplemental schedules are not presented with the financial statements, the auditor considers modifying his or her report on the supplemental schedules.

If the information on plan investments provided by the trustee is not on the GAAP basis (for example, if it is on the cash basis, uses settlement date rather than trade date accounting, or reports investment gains and losses on the "revalued method" required for Form 5500), the auditor may have to make adjustments to the information to put it on

the GAAP basis for inclusion in the financial statements and supplemental schedules. Consistent with AEBP, Paragraph 11.201, in an ERISA Section 103(a)(3)(C) audit, it is not necessary to gain an understanding of, or test, control activities related to investment assets and related transactions for which information is certified by the qualified institution.

In spite of these qualifications, there is still a significant difference between a non-Section 103(a)(3)(C) audit and an ERISA Section 103(a)(3)(C) audit. Thus, if the option of an ERISA Section 103(a)(3)(C) audit is available to the potential client, the auditor needs to determine if the audit being requested is to be so limited. The auditor needs to be sure that a client requesting an ERISA Section 103(a)(3)(C) audit is aware of the different type of opinion that will be expressed on the financial statements and supplemental schedules.

Nature of the Plan. There are various types of employee benefit plans, including single-employer and multiemployer defined benefit and defined contribution plans. The type of plan can have a significant impact on the audit procedures that may have to be applied. Thus, the nature of the plan is included in the pre-engagement considerations. Examples of considerations related to the nature of the plan include the following:

- Auditing contributions and participant data for a multiemployer plan usually is more complex than for a single-employer plan and may entail additional audit procedures and special arrangements to examine contribution records and participant data at the participating employers, or coordination with other auditors to perform these procedures.
- Auditing a defined benefit plan and some health and welfare plans necessitates communication with an actuary and consideration of actuarial determinations, while auditing a defined contribution plan generally does not entail such procedures.
- In the audit of a health and welfare benefit plan, procedures are normally applied to uninsured benefit obligations whereas liabilities for benefit claims of an insured health and welfare plan are not included in the financial statements and thus need not be audited. (Note that a health and welfare benefit plan that is fully insured or is uninsured but unfunded is not required to be audited by ERISA.)
- More complex tax requirements, and thus tax considerations during the audit, may apply to a qualified plan than to a nonqualified plan.

The need to include the procedures mentioned above generally adds complexity, cost, and time to the audit and, thus, may influence the engagement acceptance decision or fee estimate.

Type of Trust Arrangement. Employee benefit plans may have various types of investment trust arrangements with banks, insurance companies, and similar financial institutions, including discretionary and nondiscretionary trust arrangements and common or collective trusts and master trusts. The auditor determines which type of trust arrangement, if any, the plan has, because it may affect the audit approach for plan investments.

In a non-Section 103(a)(3)(C) audit, if the plan has a discretionary trust arrangement under which the trustee has authority to initiate investment transactions, the auditor may need to obtain a SOC 1 report or a report on internal control from the trust institution's auditor as a basis for accepting a confirmation from the trustee regarding the investments. If neither of these reports is available, it may be necessary to apply procedures at the institution's trust department. (Audit strategy planning with respect to service organizations is discussed in Lesson 2.) Either approach involves audit coordination and cost that ought to be factored into the audit proposal.

If a SOC 1 or internal control report is not available and it is not possible or practical to apply audit procedures at the financial institution's trust department, the auditor will usually determine that an unmodified auditor's opinion on the financial statements cannot be issued. The potential for such a situation should be discussed as early as possible with the potential client since any report other than an unmodified opinion generally does not meet the ERISA audit requirement.

Similar considerations apply to common or collective trusts if the trust does not have audited financial statements that the plan auditor can review in auditing the plan's units of participation in the trust.

Third-party Service Organizations. The auditor needs to consider whether the plan uses any third-party service organizations, such as claims administrators for health and welfare benefit plans, and, if so, whether the service organization has a valid SOC 1 report. As discussed in Lesson 2, additional procedures may be necessary if a third-party service organization is involved (even if an ERISA Section 103(a)(3)(C) audit is to be performed), and the extent of the procedures need to be considered in preparing the audit proposal and fee estimate.

Type of Investments. The auditor considers whether the plan's investments are primarily marketable securities with active markets and readily available market quotations, or are restricted securities and other securities or investments that are hard to value, such as real estate and mortgages. Valuation of such investments typically requires estimates by management that may be more difficult and costly to audit. The auditor also considers the possibility that it may be necessary to use the services of a specialist to audit such valuations. The communication and planning necessary to use a specialist ought to be factored into the audit proposal and fee estimate. (Planning considerations related to use of a specialist are discussed in Lesson 3.)

Also, the auditor considers the possibility that if securities are valued "in good faith" by management, there may be a significant uncertainty related to the valuation, or inadequate valuation procedures may have been used, that may require an auditor's report modification. The potential for such a report modification ought to be identified as early as possible and discussed with management since such a report modification generally does not meet the ERISA audit requirement.

Types of Contracts with Insurance Companies. The auditor determines whether the plan has any such contracts, and if so, whether they are allocated or unallocated contracts. Allocated contracts and plan benefits to be provided by such contracts are excluded from defined benefit plan financial statements. Unallocated contracts and related plan benefits are included, and therefore require audit attention to their measurement, valuation, and financial statement presentation.

Need to Test Participant Data. A normal audit procedure for all types of plans is to test participant payroll data and demographic information (hours worked, pay rates, earnings, hire and termination dates, age, sex, number of dependents, etc.). Such data is the basis for plan eligibility, benefit accruals for defined benefit plans, and contribution allocations for defined contribution plans. This data may be tested in auditing payroll in the audit of the plan sponsor's financial statements. If it is, the plan auditor does not have to test it, and the audit scope and fee may be reduced. The plan auditor may or may not also audit the plan sponsor's financial statements. If not, when considering audit scope for the proposed engagement, he or she needs to determine whether the other auditor has or will test participant data in auditing the plan sponsor's statements.

Type of Financial Statements—Financial Reporting Framework. Under the alternative method of reporting prescribed by the DOL, the audited financial statements may be on the cash, modified cash, or accrual basis of accounting as long as plan assets are valued at current value. (AEBP, Paragraph 14.31, states that cash basis statements that adjust investments to fair value are generally considered to be modified cash basis statements.) Thus, it is possible that the financial statements to be audited will be based on a financial reporting framework other than GAAP, and the auditor needs to determine whether that will be the case.

If the statements will be on a different basis, the auditor needs to make sure the client understands that an AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, report will be issued on such statements rather than the unmodified report appropriate for GAAP statements. The auditor may wish to review the wording of such a report with the client if the client is not familiar with it. The auditor needs to also make sure the client understands that the statements must include disclosures about benefit obligations, if applicable, or the audit report may have to be modified. Such a report modification generally does not meet the ERISA audit requirement.

Type of Financial Statements—Beginning-of-year Benefit Information Date. Defined benefit pension plans have the option of presenting information about benefit obligations as of the beginning or end of the plan year. As previously discussed, use of a beginning-of-year benefit information date may enhance the auditor's ability to meet the audit deadline.

Type of Financial Statements—Trust Fund. Although FASB ASC 960 establishes the employee benefit plan as the reporting entity, the auditor may be engaged to audit the financial statements of a plan's trust fund. The scope of

such an audit is likely to be significantly less extensive than the audit of the plan because the trust financial statements only include plan net assets and, for a defined benefit plan, do not include any plan benefit obligation information.

If requested to audit the trust instead of the plan, the auditor needs to determine whether the plan is required to have an audit under ERISA. Audited financial statements of the trust will not fulfill an ERISA requirement for audited plan financial statements, and the auditor needs to make sure the client understands this.

Type of Report on Required Supplemental Schedules. In an ERISA audit, the auditor has to report on schedules that ERISA requires to accompany the audited financial statements. Usually, the auditor is engaged to report on the schedules under AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, or AU-C 720, *Other Information in Documents Containing Audited Financial Statements*. Such a report expresses an opinion on the schedules in relation to the financial statements as a whole. Expressing such an opinion only requires that the schedules be subjected to the procedures applied in auditing the financial statements, and the materiality level is the same as that used in the audit of the basic statements.

However, the auditor might possibly be engaged to express an opinion on the information in the schedules in accordance with AU-C 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. Expressing such an opinion requires materiality to be related to each individual element, item, or account reported on, which is normally a lower materiality level than for reporting under AU-C 725. Thus, the auditor could expect to have to do more work to report on the schedules under AU-C 805. Therefore, the type of report the client desires for the supplemental schedules should be determined when proposing for the engagement.

Preparation of Form 5500. In the pre-engagement discussions with the potential client, the auditor needs to establish who will prepare Form 5500 and related schedules as applicable. The plan administrator may request the auditor to prepare Form 5500. The additional time required to prepare the form can be extensive and needs to be considered in the proposed time schedule and fee estimate.

If the auditor will prepare Form 5500, he or she needs to keep in mind that preparation does not affect the auditor's responsibility under GAAS. AU-C 703.48 indicates that the auditor should read the draft Form 5500 to identify any material inconsistencies with the audited financial statements.

Whether or not the auditor prepares Form 5500, AU-C 703.17 requires the auditor to obtain from management a draft of Form 5500 that is substantially complete prior to dating the auditor's report and any related schedules to identify any material inconsistencies with the financial statements or any material misstatements of fact. The requirement to do this before issuing the auditor's report means that the form needs to be completed before the report is issued. The auditor needs to consider the effect of this requirement when estimating the report delivery date and discuss it with the potential client if necessary. Auditors are also required, as part of engagement acceptance, to obtain the agreement of management (or those charged with governance) to provide the auditor with a draft of Form 5500 that is substantially complete prior to dating the auditor's report.

Need for SEC Filing. Some plans involve an offer to sell securities or interests in the plan that are considered securities and must report to the SEC. If the potential client has not indicated the need for an SEC filing, but the auditor believes one may be required, he or she ought to discuss the matter with the potential client and possibly suggest that the client obtain legal advice on the matter. (This course does not cover SEC filings.) SEC registration statements and annual filings typically require specific expertise and additional work that the auditor would need to factor into his or her proposal and fee estimate. Also, the SEC requires a non-Section 103(a)(3)(C) audit—an ERISA Section 103(a)(3)(C) audit would not be acceptable. Finally, shorter filing deadlines may apply to such filings. Thus, if the potential engagement involves such a filing, the auditor needs to carefully consider his or her ability and desire to undertake the engagement.

Initial Audit. A consideration that will significantly affect the scope of a new audit client is whether the plan was previously audited by another auditor or has not previously been audited. Small plans, those with just over 100 participants, are less likely to have been audited because ERISA generally doesn't require audits of plans with fewer than 100 participants. The DOL requirement to present a comparative statement of net assets available for benefits also applies at the time of the first audit. The prior year statements may, however, be compiled or reviewed if they

were not audited. Whether or not the plan was audited in the previous year, in addition to auditing the current year's ending balances and transactions during the year, the auditor will have to apply additional procedures to substantiate opening balances and to obtain assurance about the consistency of accounting principles between the current and preceding year. The proposing auditor needs to factor the cost of the extra work in the proposal and fee estimate.

If the first plan period is a short period of seven months or less, and an audit is otherwise required, the audit of the short period can be deferred until the second period (the first full year). In those instances, the initial audit report must address both the initial short period and the full second year. In other words, both the statement of net assets available for benefits and the statement of changes in net assets available for benefits present the short period and the second full year in separate columns.

The extent of the auditor's additional procedures in his or her initial audit of a plan usually is greater if the plan has never been audited than if it was audited in the preceding year. The reason is that if the plan was previously audited by another auditor, the successor can usually use the predecessor's work as a source of evidence about opening balances of plan assets, liabilities, and benefit obligations, and about the accounting principles used in the preceding period. That is not possible for a previously unaudited plan. Lesson 3 discusses special planning considerations and additional procedures in initial engagements.

DOCUMENTATION OF THE ACCEPTANCE OR RETENTION DECISION

The authors recommend that the auditor document the considerations discussed in the preceding section as they are made during the proposal, pre-engagement, or early planning stages. The documented information about independence, ability to provide the requested service, and management integrity will provide a basis for the auditor's decision about whether to accept or retain the client. Other information on the type of plan, investments, trust arrangements, report on schedules, etc., will be useful in later stages of the audit and will serve as a basis for review and update in future years. When performing client acceptance (and continuance) procedures, the auditor needs to be alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.

One method for providing this documentation is to use the practice aid in *PPC's Guide to Audits of Employee Benefit Plans* which provides space for information about the services requested and the considerations of independence, management integrity, and other matters that influence the decision to accept or retain an engagement. The form also provides space to document the acceptance or retention decision.

Much of the auditor's information about the plan's operations, organization, audit risk factors, and internal control will be obtained during later planning stages, but the auditor needs to keep these issues in mind and document any of the information identified during the pre-engagement and early planning stages.

Annual Evaluation for Continuing Engagement

An annual evaluation of clients and engagements generally is performed as part of the planning process for continuing engagements. SQCS No. 8 and AU-C 220.14 require the firm to assess its continuing association with a client and the engagement. The continuing auditor may consider the topics discussed in this course and reassess the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key plan management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in ownership of the plan sponsor, litigation status, compliance with ERISA, scope of the engagement, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, industry risk factors and other considerations may have changed since the initial client acceptance decision. The assessment also needs to consider matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules. If the firm obtains information that would have caused it to decline an engagement had that information been available previously, SQCS No. 8 (QC 10.30) notes that policies and procedures on continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship. As part of making a withdrawal decision, the firm considers whether there is a requirement to report the withdrawal decision to regulatory authorities.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision is made in light of the increased knowledge about the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. This review is generally performed at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client should be made before work commences on the engagement.

One method for documenting the continuance decision is by signing off the appropriate program steps in the general planning procedures audit program provided in *PPC's Guide to Audits of Employee Benefit Plans*. The sign-off generally is done during the planning stage of the current year engagement. Completion of that practice aid satisfies the professional requirements related to acceptance and continuance of client relationships and specific engagements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following is one of the auditor's responsibilities in relation to engagement acceptance and continuance?

   a. To only accept engagements and client relationships that will bring the firm the most profit.

   b. To determine whether the financial reporting framework used by the potential client is acceptable.

   c. To limit communication with predecessor auditors if possible due to confidentiality.

   d. To obtain a copy of a draft of the plan's Form 5500 before accepting the engagement.

2. Assuming all other conditions are met, auditors can perform nonattest services for an attest client and retain their independence if which of the following is true?

   a. The auditor assumes responsibilities for management.

   b. The understanding about the nonattest services should be obtained orally.

   c. The client must agree to perform certain specific functions related to the nonattest services.

   d. The auditor accepts responsibility for the results of the services.

3. A successor auditor should do which of the following when communicating with a predecessor during the engagement acceptance phase?

   a. Use written communication, such as a letter, for documentation purposes.

   b. Not involve the client so they cannot influence the predecessor.

   c. Hold off on proposing for the engagement until after this communication.

   d. Ask specific questions about matters such as management integrity.

4. When performing an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for investments covered by the ERISA Section 103(a)(3)(C) exception include which of the following?

   a. Reading the certification.

   b. Determining whether the auditor's firm is a qualified institution under DOL regulations.

   c. Obtaining an understanding of the institution's internal control over investments.

   d. Assessing control risk associated with the investments.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Which of the following is one of the auditor's responsibilities in relation to engagement acceptance and continuance? **(Page 6)**

   a. To only accept engagements and client relationships that will bring the firm the most profit. [This answer is incorrect. According to SQCS No. 8, a firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagements should only be continued or accepted when the firm (1) has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so; (2) can comply with legal and relevant ethical requirements; and (3) has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity. Profit to the firm is not mentioned in SQCS No. 8.]

   b. **To determine whether the financial reporting framework used by the potential client is acceptable. [This answer is correct. AU-C 210.06 addresses the auditor's responsibilities in agreeing on the terms of the audit, which includes establishing that certain preconditions are present. One precondition for the audit is that the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. If the preconditions for an audit are not met, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to accept the engagement, the auditor should not accept the proposed audit engagement.]**

   c. To limit communication with predecessor auditors if possible due to confidentiality. [This answer is incorrect. AU-C 210.11 notes that the successor auditor should request permission from the prospective client to inquire of the predecessor auditor, prior to final acceptance of the engagement, about matters that would assist in making the acceptance decision. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response.]

   d. To obtain a copy of a draft of the plan's Form 5500 before accepting the engagement. [This answer is incorrect. AU-C 703.17 requires auditors to obtain the agreement of management (or those charged with governance) to provide to the auditor a draft of the Form 5500 that is substantially complete prior to dating the auditor's report. It does not have to be obtained prior to engagement acceptance.]

2. Assuming all other conditions are met, auditors can perform nonattest services for an attest client and retain their independence if which of the following is true? **(Page 9)**

   a. The auditor assumes responsibilities for management. [This answer is incorrect. According to ET 1.295.040, the auditor should *not* assume management responsibilities for an attest client.]

   b. The understanding about the nonattest services should be obtained orally. [This answer is incorrect. Per ET 1.295.040, the auditor should establish and document in *writing* the understanding with the client regarding the nonattest services.]

   c. **The client must agree to perform certain specific functions related to the nonattest services. [This answer is correct. According to ET 1.295, *Nonattest Services,* in the AICPA *Code of Professional Conduct* (the Code), before auditors perform nonattest services, they should determine that the requirements of ET 1.295 have been met. ET 1.295.040 has three basic requirements with respect to the performance of nonattest services. One of these is that the client must agree to perform certain specific functions in connection with the nonattest services, such as overseeing the services and evaluating the adequacy of the results.]**

d. The auditor accepts responsibility for the results of the services. [This answer is incorrect. According to ET 1.295.040, the attest client and its management should accept responsibility for the results of the nonattest services, not the auditor.]

3. A successor auditor should do which of the following when communicating with a predecessor during the engagement acceptance phase? **(Page 16)**

a. Use written communication, such as a letter, for documentation purposes. [This answer is incorrect. The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is *not* required—simply talking with the predecessor is enough.]

b. Not involve the client so they cannot influence the predecessor. [This answer is incorrect. According to AU-C 210.11, an auditor should ask the prospective client to authorize the predecessor to respond fully. Unless the client gives authorization, the predecessor cannot ethically respond to the successor's inquiries because of the requirement for confidentiality in ET 1.700.001, the *Confidential Information Rule*.]

c. Hold off on proposing for the engagement until after this communication. [This answer is incorrect. AU-C 210.A29 clarifies the timing of the communication with the predecessor by indicating that an auditor may make a proposal before communicating with the predecessor. The communication, however, ought to happen before *final* acceptance of the engagement.]

d. **Ask specific questions about matters such as management integrity. [This answer is correct. An auditor may ask the predecessor specific questions about certain matters including, among others, (1) information that might bear on management's integrity; (2) disagreements with management on accounting principles, auditing procedures, or similar matters; and (3) communications with those charged with governance regarding fraud and noncompliance with laws and regulations by the entity.]**

4. When performing an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for investments covered by the ERISA Section 103(a)(3)(C) exception include which of the following? **(Page 19)**

a. **Reading the certification. [This answer is correct. AU-C 703.29–.32 states that in an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for investments covered by the ERISA Section 103(a)(3)(C) exception include reading the certification.]**

b. Determining whether the auditor's firm is a qualified institution under DOL regulations. [This answer is incorrect. In this type of audit, the auditor's responsibilities would include determining whether the certifying entity (not the auditor's firm) is a qualified institution under DOL regulations.]

c. Obtaining an understanding of the institution's internal control over investments. [This answer is incorrect. When performing an ERISA Section 103(a)(3)(C) audit, the auditor does *not* need to obtain an understanding of the certifying institution's internal control over investments held and investment transactions executed on behalf of the plan.]

d. Assessing control risk associated with the investments. [This answer is incorrect. When performing an ERISA Section 103(a)(3)(C) audit, the auditor is *not* required to assess control risk associated with those investments and related transactions executed by the certifying institution.]

ESTABLISHING THE ENGAGEMENT TERMS WITH THE CLIENT

After a new or continuing engagement has been accepted, AU-C 210.09–.10 states that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate, and document that agreement in an audit engagement letter or another form of written communication. Because practice has been to obtain such a letter, the process in this course assumes the use of an engagement letter (rather than another form of agreement). The issuance of an engagement letter may reduce the business risk to the auditor by clarifying the responsibilities of each party and the objectives and limitations of the engagement.

AU-C 210.10 indicates that the engagement letter should include the following:

- The objective and scope of the engagement.
- Management's responsibilities.
- The auditor's responsibilities.
- A statement that due to the inherent limitations of an audit, there is a risk that a material misstatement may not be detected.
- Identification of the applicable financial reporting framework.
- Reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

There also needs to be a specific understanding about the financial statements to be audited, such as whether statements of the plan or its trust will be audited; whether the audit is to meet ERISA audit requirements; whether management has elected an ERISA Section 103(a)(3)(C) audit; management agreeing to provide a substantially complete draft of the Form 5500 before the completion of the audit; and the auditor's reporting responsibility for schedules, if any, that will accompany the financial statements. The understanding may also include whether the auditor will make use of a specialist (actuary in auditing benefit obligations, appraiser in auditing securities that do not have a market price, etc.) or another auditor's report on a service organization that holds or processes plan investments. However, determining the need to obtain a service auditor's report involves considerations that may have to wait until the audit planning stage when the auditor has more information about the significance of the service organization's controls to the plan's controls. Thus, it may not be possible to reach a definitive understanding about these matters with the client at the pre-engagement stage, and the auditor may need to alert the client of this.

The understanding of the engagement terms may also include any other services to be rendered, for example, preparation of Form 5500.

Documenting the Terms of the Engagement

In addition to documenting the required matters mentioned in the preceding paragraphs, an engagement letter can be used to document the fee estimate, expected timing of fieldwork and the report delivery date, expected client clerical assistance during the audit, and arrangements with predecessor auditors, if applicable. Documenting such matters can help prevent misunderstandings. Also, an engagement letter can be an efficient way to provide audit staff with an understanding of the engagement arrangements.

AUDIT PLANNING CONSIDERATIONS

Objectives of Audit Planning

Planning an audit, according to AU-C 300.02, involves establishing the overall strategy for the engagement and developing an audit plan. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction. It includes matters such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

An overriding objective throughout the planning process is the identification of risks that should be considered and an assessment of whether the risks could result in material misstatement of the financial statements (including the individual statements and the disclosures). Obtaining an understanding of the plan and its environment, including its internal control, is an essential part of planning the audit. Auditors plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditors' understanding of the plan and its environment, including its internal control.

Audit planning also includes developing an audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The nature, timing and extent of audit planning varies with type of plan, the size and complexity of the plan, the auditor's experience with the plan, and with the auditor's understanding of the plan and its environment, including internal control. However, audit planning always includes a risk assessment process.

Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the plan and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, such as preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor performs all of these procedures when planning the audit. Further, the auditor's consideration of fraud required by AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. The key requirements of AU-C 240 are addressed at relevant points throughout this course.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the plan and its environment, including its internal control. The auditor obtains information about the following:

a. Industry, regulatory, and other external factors, including the applicable financial reporting framework.

b. Nature of the plan and its provisions.

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

d. Measurement and review of the plan's financial performance.

e. Internal control, which includes the selection and application of accounting policies.

f. Fraud risk factors.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement at the financial statement and relevant assertion levels.

Summary of Risk Assessment Process. Exhibit 1-1 summarizes the various elements in the risk assessment process in the categories of procedures performed, understanding obtained, and decisions and judgments made.

Exhibit 1-1

The Risk Assessment Process

Procedures Performed	Understanding Obtained	Decisions and Judgments Made
• Preliminary engagement activities. • Inquiries of plan management and others. • Preliminary analytical procedures. • Observation and inspection. • Discussion among the engagement team.	• Industry, regulatory, and other external factors. • Nature of the plan. • Objectives, strategies, and related business risks. • Measurement and review of the plan's financial performance. • Internal control. • Selection and application of accounting policies. • Fraud risk factors.	Decisions at the Financial Statement Level: • Materiality at the financial statement level. • Materiality for particular items of lesser amounts. • Risks of material misstatement at the financial statement level. • Overall audit strategy. Decisions at the Account Balance, Transaction Class, and Relevant Assertion Level: • Performance materiality • Risks of material misstatement at the relevant assertion level, including identification of significant risks. • Nature, timing, and extent of further audit procedures (including tests of controls and substantive procedures).

The Sequence of Audit Planning

Because an audit of financial statements is an iterative process, audit planning is not a discrete phase of the audit. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. Audit planning begins with engagement acceptance and continues throughout the remainder of the audit. Also, many of the audit planning steps and procedures can be performed simultaneously and tend to blend together. Nevertheless, having a logical sequence of steps and procedures provides a useful framework. The authors' approach is presented in Exhibit 1-2.

Exhibit 1-2

Steps in the Audit Process Related to Planning

Preliminary Engagement Activities

1. Perform procedures regarding acceptance or continuance of the client relationship and the specific audit engagement.
2. Evaluate compliance with ethical requirements, including independence.
3. Establish an understanding with the client and communicate in an engagement letter.

General Audit Planning at the Financial Statement Level

4. Establish preliminary audit strategy.

5. Determine the nature, timing, and extent of risk assessment procedures and perform the procedures.

6. Determine the materiality level for the financial statements taken as a whole (preliminary planning materiality) and materiality for particular items of lesser amounts.

7. Perform preliminary analytical procedures (a risk assessment procedure).

8. Hold a discussion among the engagement team.

9. Identify fraud risk factors, areas where special audit consideration may be necessary, and other areas where there may be higher risks of material misstatement.

10. Assess audit risk at the overall financial statement level.

11. Complete the overall audit strategy, including overall responses at the financial statement level.

Detailed Audit Planning at the Relevant Assertion Level for Account Balances, Transaction Classes, and Disclosures

12. Determine performance materiality (often in conjunction with Step 6).

13. Assess risks of material misstatement in relation to relevant assertions for transactions classes, account balances, and disclosures.

14. Develop a detailed audit plan for the nature, timing, and extent of further audit procedures.

Depending on the auditor's knowledge and past experience with the client, as well as other factors, certain planning steps might be performed at differing stages or sequences from one engagement to the next. For example, the sixth step, determine the materiality level for the financial statements taken as a whole, and the twelfth step, determine performance materiality, are often performed concurrently. Also, some auditors might choose to determine materiality (Step 6) before performing risk assessment procedures (Step 5) to help determine the areas of focus. For the eighth step, the discussion among the engagement team, the precise timing of this meeting can vary with the circumstances. It is usually more efficient and effective it if occurs relatively early in planning, but it need not occur in any particular sequence. Although planning steps may occur in a slightly different sequence than illustrated in Exhibit 1-2, it is important that the auditor revisit judgments made earlier in planning as new information becomes available throughout the audit to determine the effect on risk identification, risk assessment, materiality, and further audit procedures.

The auditor's objective, according to AU-C 315A.03, is to identify and assess the risks of material misstatement (either due to fraud or error) at both the financial statement and relevant assertion levels by understanding the entity and its environment (including its internal control) to provide a basis for the design and implementation of responses to such risks.

Obtaining an understanding of the plan and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as *risk assessment procedures* because the information obtained by performing those procedures is used to support the auditor's assessment of the risk of material misstatement. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the plan and its environment. For example, an auditor cannot limit his or her risk assessment procedures to only inquiry.

In addition to providing information about the plan and its environment, including its internal control, performing risk assessment procedures may provide audit evidence about relevant assertions related to account balances, transaction classes, or disclosures, or about the operating effectiveness of controls. Therefore, risk assessment procedures may also serve as tests of controls or substantive procedures, or may be performed concurrently with those procedures.

Types of Risk Assessment Procedures

The risk assessment and other planning procedures required by AU-C 300 and 315A to obtain information about the plan and its environment, including its internal control, and to assess the risks of material misstatement include the following:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of plan management, appropriate individuals within the internal audit function (if one exists) and others within the plan and those charged with governance.

c. Analytical procedures.

d. Observation and inspection, such as visits to the plan's or plan sponsor's premises and tracing transactions through the information system (that is, walkthroughs).

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment. However, each of those procedures need not be performed for every component of the understanding. Nevertheless, the standards are explicit in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement is required by AU-C 315A.11, and AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will require tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management responsible for financial reporting about accounting policies and other aspects of the financial reporting process. However, determining others within the plan to whom related questions may be directed will depend on the circumstances and the specific information gathered about the plan. For example, if initial inquiries reveal that the plan holds hard-to-value investments, the auditor will likely make further inquiries of personnel involved in the valuation of those investments. Thus, performing risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the plan, its provisions, and its environment. In an employee benefit plan audit, the nature and extent of risk assessment procedures generally vary based on the auditor's prior experience with the plan, the auditor's prior experience with any service providers, changes in the operating environment of the plan, the plan instrument, the type and complexity of the plan, the client's financial sophistication, and new accounting or other regulatory requirements (DOL, IRS, or PBGC).

Gathering Information Needed to Identify Fraud Risks. In connection with obtaining an understanding of the plan and the employee benefit plan industry, auditors may become aware of information that is relevant to identifying fraud risks. AU-C 240.17–.24 explains that auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of plan management and others about the risks of fraud and how they are addressed.
- Consider the results of analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Because professional standards require the performance of risk assessment procedures to obtain an understanding of the plan and provide a basis for the assessment of risks, the question naturally arises of whether the auditor can use information

gathered from procedures performed in a prior period and limit the extent of current year procedures? The answer is a qualified "yes."

The process of understanding the plan and its environment is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the plan also contributes to the understanding of the plan and its environment. Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The plan's organizational structure, operations, and controls.
- Past misstatements and whether they were corrected on a timely basis.
- Significant changes from the prior period.

Information about past misstatements assists the auditor in assessing risks of material misstatement in the current audit. Before using information obtained in prior periods, however, AU-C 315A.10 requires auditors to ascertain whether changes have occurred since the last audit that may be relevant in the current audit. The auditor is interested in identifying changes in personnel; procedures; processes; contracts; participant benefits; contingencies; nature of the plan's operations; plan management; financial condition; conditions and events or operating results that are relevant to the going concern assumption; regulatory compliance; litigation status; control environment or activities; fraud risks; plan management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the client's business risk or the auditor's assessment of risks of material misstatement. Therefore, the auditor performs risk assessment procedures in the current audit to determine whether changes have occurred that affect the relevance of information gathered in previous audits. For example, auditors might perform inquiries of key client personnel, supplemented by observation and inspection (for example, review of interim financial reports and walkthroughs) to determine if changes have occurred.

Paragraph 3.132 of the AICPA Audit Guide, *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide), specifically notes that the nature, timing, and extent of procedures performed to update the understanding of the client obtained in prior periods may depend on matters such as:

- Significance of the changes to the entity or its environment that have occurred from the prior period.
- Relative significance of the risks of material misstatement that may be affected by changes.
- Reliability of evidence available to support conclusions about any changes from the prior period.

The nature of the auditor's procedures always includes inquiries, observation, and inspection, but the authors believe the extent of risk assessment procedures will often be considerably less in continuing audit engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement or risk of material misstatement identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

COVID-19 Considerations. Many aspects of a plan's operations may have continued to change as a result of COVID-19. Operations during 2020 and 2021 may have been disrupted by work stoppages, travel and work restrictions, and the imposition and lifting of stay-at-home orders. Thus, information gathered by procedures performed in prior periods may be expected to be less relevant. An auditor may need to approach the audit in a manner more similar to the audit of a new client. Risk assessment procedures are likely to be more extensive as a result.

Inquiries of Plan Management and Others

Inquiry of plan management and others is used extensively throughout the audit planning process. In many cases, inquiry serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. For example, an auditor might ask plan management about the valuation of investments. The auditor would then evaluate the response obtained and determine if a potential risk exists. In this case, the auditor is concerned about potential inappropriate valuation of investments. If the auditor deems that there is an indication of this risk, additional inquiries might be posed to further identify the risk and determine whether other risk assessment procedures are necessary.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. Auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

COVID-19 Considerations. In the COVID-19 era, the method of conducting inquiries may be as important a consideration as who to interview and what to ask. If travel restrictions, stay-at-home orders, or safety concerns preclude face-to-face interviews, remote interviews are the only choice. Generally, videoconferencing is much more preferable than a telephone interview. Auditors typically want to see the facial expressions and body language of those being interviewed. As restrictions are eased, an auditor may be able to do some face-to-face interviews. An auditor needs to evaluate those parties for which a face-to-face interview is a priority and those parties that are to be interviewed using videoconferencing. Whether conducted face-to-face or remotely, the inquiries of management need to focus on the changes that have taken place from the prior period and those planned for the current period. Examples of questions include the following:

- Have plan management's objectives, strategy, structure, and governance arrangements been modified in response to the pandemic?
- Have new risks been identified, and if so, what are the planned responses?
- Have new or renegotiated major contracts been executed?
- Has the plan instrument been amended?

Matters and Parties of Inquiry. The auditor should inquire of management and others about the following matters:

a. The plan and its environment as enumerated in AU-C 315A.

b. Fraud-related matters as enumerated in AU-C 240.

c. Related parties and related party transactions as enumerated in AU-C 550.

d. Accounting estimates, including fair value accounting estimates, as enumerated in AU-C 540A.

e. Compliance with laws and regulations as enumerated in AU-C 250.

f. Communications from service organizations about fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the entity's financial statements, as enumerated in AU-C 402.19.

g. Plan management's preliminary evaluation of whether conditions or events exist that raise substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time, as enumerated in AU-C 570.

In addition to inquiries of plan management and those charged with governance, inquiries of others within and outside the plan are either required or can provide useful information. Examples of inquiries of others include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how financial statements are used. AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee or at least its chair) about the risks of fraud and their knowledge of actual, suspected, or alleged fraud.

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function, if the plan has an internal audit function. AU-C 315A.06 requires inquiries of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error, or who can assist in identifying such risks. AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged fraud, and activities concerning fraud detection and whether management satisfactorily responded to any findings.

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support plan management's responses. AU-C 240.A18–.A19 and AU-C 315A.A7 include discussions of the benefits of inquiry and provides examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud. These employees may actually be employees of the plan sponsor who perform procedures for the plan. Auditors may consider obtaining the perspective of employees from different functional areas (such as treasury, finance, payroll, or human resources) and at varying levels of authority when identifying risks of material misstatement.

d. *Parties Outside the Plan.* Inquiries of parties outside the plan are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of personnel at service providers that provide administrative services to the plan or of valuation experts that plan management has engaged. The auditor might also find it useful to make inquiries of plan participants or beneficiaries receiving payments to better understand the nature of the plan and its operations.

Fraud-related Inquiries. The consideration of fraud in a financial statement audit is an integral part of obtaining an understanding of the plan and its environment and assessing the risks of material misstatement. AU-C 315A.09 explains that during planning the auditor should consider the results of the fraud risk assessment along with the other information obtained as part of identifying the risks of material misstatements. AU-C 240.15 notes that the discussion among the engagement team required by AU-C 315A should include fraud brainstorming, and AU-C 315A.29 also notes that the auditor should consider fraud risks in identifying significant risks. The inquiries of plan management made in audit planning, according to AU-C 240.17–.18, should include the following specific areas of inquiry:

- Whether they have knowledge of any actual, suspected, or alleged fraud.
- Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.
- The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.
- Any specific risks of fraud that management has identified or that have been brought to its attention.
- The classes of transactions, account balances, or disclosures for which a fraud risk is likely to exist.
- Management's communications, if any, to:
  - Those charged with governance on its process for identifying and responding to fraud risks.
  - Employees on its views on appropriate business practices and ethical behavior.
- The nature, terms, and business purpose (or lack thereof) of any significant unusual transactions entered into by the entity; and whether such transactions involved related parties.

The objectives of fraud-related inquires include obtaining different perspectives on financial statement areas and organizational areas and locations with a risk of fraud. Examples of plan management and others that auditors may consider interviewing include:

- The plan administrator.
- Members of the plan's administrative committee or board of trustees.
- Members of the plan's investment committee.
- The plan's actuary.
- Employees of the plan's sponsor(s).
- Plan participants.

COVID-19 Considerations. Fraud risks may increase as a result of circumstances created by COVID-19. The stressed financial circumstances of employees also increase the risk of misappropriation of assets. The opportunity for all types of fraud is increased by breakdowns in internal control. The ability to rationalize fraud is also enhanced by the availability of justifications, such as the notion that the fraud is only temporary until the pandemic is under better control or over. Auditor's fraud antenna need to be raised to in these circumstances.

Documentation. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230 provides pertinent guidance. AU-C 230.09 states that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel.

Analytical Procedures

AU-C 315A.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315A.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information (for example, the relationship between number of participants and contributions). AU-C 315A.A15–.A16 explain that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

Knowledge of the client and its environment is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. For that reason, the auditor generally needs an understanding of the plan and its environment before performing preliminary analytical procedures. The auditor's knowledge and understanding of the plan can also be improved by applying preliminary analytical procedures in audit planning. For an employee benefit plan, a comparison of significant account balances with prior period amounts can improve the auditor's understanding of the plan and its operations. Are there significant fluctuations in contributions received and receivable, benefit payments, and investments? Do changes in contributions and benefit payments make sense in relation to changes in the number of participants, the number eligible to receive benefits, and the number of terminations? Do changes in the composition of the investment portfolio make sense in relation to the plan's investment strategy and operating needs? Is investment income reasonable considering market conditions and the composition and changes in the portfolio in comparison to prior years?

AU-C 240.22 indicates auditors should perform analytical procedures related to revenue. These procedures may identify unusual or unexpected relationships that may indicate fraudulent financial reporting. As the financial statements of employee benefit plans do not report revenues, AEBP, Paragraph 3.85, indicates the risk of misstatement due to fraudulent financial reporting may relate to investment income arising from inappropriate investment valuation and to contributions being recognized inappropriately. An example of an analytical procedure relating to revenue is the comparison of investment returns to industry benchmarks for the type of investment. Other types of analytical procedures that may be useful in considering the risk of fraudulent financial reporting include:

- *Analysis of Relationships Between Financial and Nonfinancial Amounts.* When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to other financial items and (b) could not easily be manipulated by plan management or the plan sponsor. For example, auditors may compare participant contributions (in a contributory plan) to active employees for the period. The number of active employees is an amount that is not easily manipulated, particularly when the number of active participants is obtained from an outside service provider. Changes in the number of active employees without a corresponding change in participant contributions may indicate fraudulent financial reporting.
- *Trend Analysis.* Auditors may analyze trends in the components of additions to net assets or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example a trend analysis of participant contributions by month (in a contributory plan) during and shortly after the reporting period may indicate the plan sponsor failed to timely remit participant contributions to the plan.
- *Ratio Analysis.* Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement item to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations.

When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement of the financial statements. Because an employee benefit plan audit frequently starts well after the plan's year has ended, preliminary analytical procedures can readily be performed during audit planning using a comparative trial balance and statistical data maintained on participants. This information is usually available before audit planning begins.

Audit Data Analytics. During the planning of the audit, the auditor may consider using automated tools and techniques, such as audit data analytics (ADAs). AU-C 500.A4, as amended by SAS No. 142, defines *data analytics* as, "the analysis of patterns, identification of anomalies, or extraction of other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, or visualization." An analytical procedure performed using an ADA may be a visualization of the volume and dollar amount of transactional detail to assist the auditor in performing risk assessment procedures. A detailed example of an ADA that simultaneously accomplishes the objectives of both risk assessment and substantive audit procedures is discussed at AU-C 500.A69.

The AICPA has issued *Guide to Audit Data Analytics* that provides an introduction and overview of data analytic techniques which can be used by financial statement auditors. The Guide provides a chapter on using data analytic techniques in the performance of risk assessment procedures along with relevant examples. The Guide can purchased at **www.aicpa.org/cpe-learning**.

COVID-19 Considerations. Analytical procedures that involve comparisons between the current period and prior periods may not be as useful because of disruptions in operations and the economy. Past patterns and relationships may no longer hold. Instead, an auditor may consider comparisons to budgets and forecasts that were developed by plan management in response to changes necessitated once the effects of COVID-19 have evolved.

Observation and Inspection

According to AU 315.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the plan and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, to gain an understanding of the plan's benefit obligations, the auditor might decide to review the plan document. That procedure, coupled with a review of the plan's financial statements, might be the key procedure that helps the auditor identify risks related to potential misstatement of the plan's obligations.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquires made of plan management and others. For example, through inquiries of plan management, the auditor may become aware of plan investments that may be difficult to value (such as nonreadily marketable securities). In response, the auditor

may choose to review minutes of the investment committee or the investment policy statement to identify risks of improper valuation.

Other than the requirement to perform some observation and inspection procedures related to internal control, determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. The authors believe that observation and inspection procedures are ordinarily effective in the following situations when obtaining an understanding of the plan:

- To understand the design of controls related to the audit.
- To verify that controls have been implemented, for example, as part of a walkthrough.
- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When necessary information can only or best be obtained through observation or inspection.
- When audit evidence obtained by observation and inspection substantiates a relevant assertion.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

Documentation. AU-C 230.09 requires that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the specific items or matters tested. AU-C 230.A14 provides examples of how this might be accomplished. Based on that guidance, the authors recommend documenting the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, the authors recommend referring to the report or document by the same name that the client uses to refer to it.)
- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

AU-C 315A.11 requires the key members of the audit team (including the engagement partner) to discuss the susceptibility of the plan's financial statements to material misstatements and the application of GAAP to the plan's facts and circumstances. AU-C 240.15 requires an exchange of ideas, or "brainstorming" among audit team members about how and where they believe the plan's financial statements, including disclosures, might be susceptible to material misstatement due to fraud, how plan management could perpetrate and conceal fraudulent financial reporting, and how assets of the plan could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

The focus of the audit team discussion should be on the individual members gaining a better understanding of the potential for material misstatements resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the partner and more experienced members of the audit team can share their insights based on their cumulative knowledge of the plan, the employee benefit plan industry, and the plan's environment. It is not always necessary or practical for the engagement team discussion to include all members in a single discussion, and not all members need to be informed of all decisions made. AU-C 315A.11 states that the engagement partner and key engagement members should take part in the team discussion. In addition, the engagement partner should determine what matters are to be communicated to team members who are not involved in the team discussion.

Matters to be Discussed. This discussion is aimed at the susceptibility of the financial statements to material misstatement (including the application of GAAP), that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement (including the application of GAAP). Thus, the discussion should not be a narrow one focused on risks already identified, but one that opens the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, should be communicated to the team members.

The following matters are specifically required to be discussed during the engagement team discussion:

- The susceptibility of the entity's financial statements, including disclosures, to material misstatement.
- The application of GAAP to the entity's facts and circumstances in light of its accounting policies.
- The susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.
- Fraud-related matters.
- The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

The engagement team discussion may also include the following topics:

a. Critical issues and areas of significant audit risk.

b. Unusual accounting practices used by the plan.

c. Implementation of new accounting standards.

d. Changes in the entity's environment, financial condition, or activities that may result in significant new or revised accounting or disclosures.

e. Important controls.

f. Materiality levels and how materiality will be used to determine the extent of testing.

g. Significant IT applications and how the use of IT may affect the audit.

h. Areas susceptible to cyber attacks or intrusion that may affect the audit.

i. How to introduce an element of unpredictability into the nature, timing, and extent of audit procedures.

j. Whether plan management may attempt to present disclosures in a way that obscures a proper understanding of the matters discussed, such as by the use of unclear or ambiguous language.

In addition to discussing important controls, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For smaller plans, the engagement team may consider issues regarding the background and competence of individuals in key processing and financial decision-making roles, especially if concerns had been noted in previous audits.

The authors believe the discussion also should address how the operating risks facing the plan could result in a material misstatement of the financial statements, focusing especially on changes from the prior year and new developments. Examples of other factors the engagement team might discuss that affect the likelihood of material misstatements caused by error include the following:

- Past experience with the client (including areas with audit difficulty, amounts or disclosures for which it was difficult to obtain sufficient appropriate evidence, and misstatements encountered).
- Changes in the plan's organization (for example, changes in personnel or accounting systems).

- The nature and complexity of transactions and/or disclosures (including those involving significant judgment from management on how much information to include in disclosures).
- Known accounting and auditing issues.

Related Parties. AU-C 550.13 specifically requires auditors, as part of the engagement team discussion, to consider how related-party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicates that the team discussion might include the following related party matters:

- Nature and extent of the entity's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related-party relationships or transactions.
- Types of records or documents that might indicate the existence of related-party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related-party relationships and transactions and the related risk of management override.
- How related parties might be involved in fraud.

The authors recommend that the discussion include reminding the engagement team that if related parties or significant related-party transactions are identified by the auditor that were not previously identified and disclosed by management, the engagement team is required by AU-C 550.25 to promptly communicate such information to other team members. Also, AU-C 550.25 requires that the auditor inquire of management as to why applicable controls over related-party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also include the following fraud-related matters:

- How and where the entity's financial statements (for example, which accounts or transaction classes) might be susceptible to material misstatement due to fraud.
- For areas susceptible to material misstatement due to fraud, the methods management might use to conceal the fraud.
- How the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.
- Circumstances that might be indicative of management manipulation of net assets or other financial measures.
- Practices management might use to manage earnings or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

The fraud aspect of the discussion ought to give appropriate consideration to financial statement misstatement from both fraudulent financial reporting and misappropriation of assets. A key consideration when assessing fraud risk is

what motivations may exist for plan management to intentionally misstate the financial statements or what controls may be lacking that could result in theft. By identifying the motives and opportunities for fraud, the auditor ought to be able to assess the type of potential misstatement. An important additional consideration for a benefit plan that invests in the sponsor's securities is the effect of fraudulent financial reporting of the plan sponsor on the plan's financial statements.

The discussion should include the appropriate audit response to the areas identified as susceptible to material misstatement due to error or fraud (for example, by identifying the accounts that would be affected and the nature of procedures that could be performed to address the risks). The discussion should foster an open exchange of ideas (that is, *brainstorming*). AU-C 240.15 indicates that participants should set aside their beliefs that management and others are honest and have integrity and maintain an attitude of professional skepticism throughout the discussion. AU-C 315A and AU-C 240 refer to a discussion; therefore, one-sided communication, such as a memo from the engagement partner, is not appropriate. (However, when the entire engagement is performed by a single auditor, the auditor might simply consider and document the susceptibility of the plan's financial statements to material misstatements.) The medium for discussion (for example, a meeting or a conference call) ought to encourage interaction and an appropriate exchange of ideas. AU-C 240.15 indicates that communication about the risks of material misstatement is not limited to that discussion, but should occur throughout the audit.

AU-C 240.12 indicates that, in accordance with AU-C 200, throughout the audit the auditor should exercise professional skepticism and recognize the possibility of a material misstatement due to fraud regardless of any beliefs about honesty and integrity of management and those charged with governance gained from past experience. AU-C 200.14 defines *professional skepticism* as "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." Thus, auditors ought to actively consider how management could perpetrate and conceal fraudulent financial reporting. For example, auditors may use "what if" scenarios that focus on the financial statement areas vulnerable to fraud with the presumption that management or employees are inclined (either because of incentives/ pressures or attitudes/rationalizations) to perpetrate fraud. According to AU-C 200.A26, the auditor's belief that management and those charged with governance are honest and have integrity does not mean that the auditor is allowed to be satisfied with less than persuasive audit evidence.

It is important to be mindful of potential auditor biases, whether conscious or unconscious, as these may impede the application of professional skepticism and professional judgment. When potential bias is acknowledged, the auditor is able to take steps to mitigate its effects, thus improving the application of professional skepticism. AU-C 200.A27, as amended by SAS No. 142, lists the following as examples of potential auditor biases:

- Availability bias, which is a tendency to weight events or experiences that immediately come to mind more heavily.
- Confirmation bias, which is a tendency to weight corroborative evidence more heavily than contradictory evidence.
- Overconfidence bias, which is a tendency to overestimate one's ability to make accurate assessments or decisions.
- Anchoring bias, which is a tendency rely too heavily on initial information to make a decision without considering subsequent information.
- Automation bias, which is a tendency to favor information gathered from automated systems even when reasoning or contradictory evidence calls into question the reliability or relevance of the information.

<u>COVID-19 Considerations.</u> The engagement team discussion should consider fraud risk factors related to both fraudulent financial reporting and misappropriation of assets. Breakdowns in internal control may create greater opportunities for management override and false entries. Similar risk factors are present for misappropriation of assets. Personal economic hardships, anticipated layoffs, reduced staffing that combines functions normally separated, and the hoped-for temporary nature of the deception create incentives, opportunities, and rationalizations, respectively. An auditor's appropriate responses include healthy professional skepticism; assigning more experienced personnel; greater unpredictability; and linking the nature, timing, and extent of substantive procedures to the specific fraud risk factors identified.

Effect on Significant Audit Areas. After discussing the risks that could result in a material misstatement of the financial statements and determining how those risks affect specific audit areas, the authors recommend that the engagement team then discuss each significant audit area. The team needs to discuss the real risks affecting each area and determine the most effective and efficient audit procedures that address those risks. Members of the audit team ought to avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. In fact, it may be best to ignore the prior year workpapers when initially discussing each significant area. That way, the audit team starts with a clean slate when developing the audit approach and avoids the temptation to just rely on "what we did last year." The result is usually a more effective and efficient audit approach. However, after the team has discussed each significant area, the prior year workpapers ought to be reviewed to make sure there are not any issues that were overlooked.

Who Attends the Discussion? As previously discussed, key members of the engagement team need to participate in a single discussion, and the engagement partner determines what matters will be communicated to other team members. Also, it may be appropriate to include specialists, such as actuaries, assigned to the engagement team and personnel assigned to the audit of the plan sponsor. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the plan's accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statement to material misstatements from error or fraud. For audits involving multiple locations, such as multi-employer plans, there may be several discussions so that team members in all locations are involved. The authors recommend that all members of the engagement team, including specialists with an ongoing role in the engagement, participate in the discussion. The engagement team, however, does not include external specialists engaged by the auditor or individuals within the internal audit function who provide direct assistance to the auditor on the audit engagement.

When Does the Discussion Occur? Before holding the discussion with the engagement team, the authors recommend that the engagement partner have preliminary planning discussions with the client. Issues to discuss with the client include the services to be provided, scheduling, and other administrative matters. In addition, the auditor can discuss the plan's environment (particularly changes from the prior year), the client's view of the risks that the client is addressing, and other specific issues facing the client. The auditor can also obtain additional information to be used in the planning process prior to meeting with the engagement team.

AU-C 240 and AU-C 315A, make clear that the discussion among the engagement team is expected to occur during the performance of risk assessment procedures as part of audit planning, but the exact timing is not specified. The authors recommend holding the discussion prior to performing the information-gathering procedures discussed in Lesson 2. The authors believe it is important to set the proper tone of professional skepticism and to inform less experienced staff members about the risks of material misstatement before performing those procedures. However, nothing prevents the firm from holding discussions both before and during the information-gathering process. These decisions are normally made by engagement partners, and auditors need to exercise professional judgment to determine what works best in the particular circumstances. In any case, engagement team members communicate and share information obtained throughout the audit about the risks of material misstatement due to error or fraud.

Other Matters That May Be Discussed. The engagement team discussion also provides an opportunity for the engagement partner to remind the audit team members of the audit documentation requirements of AU-C 230. Among the matters that might be covered are the following:

a. Inclusion of abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant unusual transactions.

b. Identification of items tested in tests of operating effectiveness of controls.

c. Identification of documents inspected or items confirmed in substantive tests of details.

d. Documentation relating to substantive analytical procedures.

e. Documentation relating to consideration of the plan's ability to continue as a going concern.

f. Documentation of the nature and effect of aggregated misstatements and the conclusion as to whether they cause material misstatement of the financial statements.

g. Documentation of who performed and reviewed the audit work and the date the work was performed and reviewed.

Documentation of the Discussion. AU-C 315A.33 requires that the following items be documented regarding the discussion among the audit team:

- How and when the discussion occurred.
- Participating audit team members.
- Significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.

AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

COVID-19 Considerations. The engagement team discussion needs to focus on the ways in which COVID-19 risks and developments have increased the risks of material misstatement. The discussion should stress the heightened need for exercising professional skepticism and vigilance. Areas of particular vulnerability to material misstatement due to increased incentives and opportunities for fraud and the effects of increased uncertainty have to be discussed. Risks of material misstatement identified in prior years will likely be intensified and new ones will be added. Simultaneously, audit evidence and sources of evidence relied on in prior years may be much more difficult to obtain and, in some cases, unobtainable. The discussion needs to explore new approaches and procedures to obtain evidence. If the audit firm plans to make greater use of automated tools and techniques, the discussion may need to include the comfort level of the team with those tools and techniques and the possible need for on-the-job training of their use. Staff using new equipment, tools, and techniques need to be aware of how to obtain prompt technical support if difficulties are encountered. Engagement team members in supervisory positions also need to understand the need for increased direct supervision and review of lesser experienced team members.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Which of the following is considered a preliminary engagement activity?

   a. Assessing audit risk at the overall financial statement level.

   b. Determining performance materiality.

   c. Evaluating compliance with ethical requirements, including independence.

   d. Holding a discussion among the engagement team.

6. Which of the following statements describes the use of analytical procedures as risk assessment procedures when planning the audit of an employee benefit plan?

   a. They are not required if other risk assessment procedures are sufficient.

   b. They can cover both financial and nonfinancial information.

   c. They provide detailed information about the existence of material misstatement.

   d. They can be performed without prior knowledge of the client and its environment.

7. Which of the following is specifically required to be covered during the engagement team discussion?

   a. How susceptible the client's financial statements are to material misstatement.

   b. Any changes in the entity's environment or financial condition.

   c. How materiality will be used to determine the extent of testing needed.

   d. Whether copies of significant contracts need to be included in the workpapers.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

5. Which of the following is considered a preliminary engagement activity? **(Page 30)**

   a. Assessing audit risk at the overall financial statement level. [This answer is incorrect. Based on the framework provided in this course, assessing audit risk at the overall financial statement level is considered part of general audit planning at the financial statement level, not a preliminary engagement activity.]

   b. Determining performance materiality. [This answer is incorrect. Per the framework provided by this course, detailed audit planning at the relevant assertion level for account balances, transaction classes, and disclosures includes (1) determining performance materiality; (2) assessing risk of material misstatement in relation to relevant assertions for transaction classes, account balances, and disclosures; and (3) developing a detailed audit plan for the nature, timing, and extent of further audit procedures. These actions are typically taken later in the process, after the preliminary engagement activities.]

   c. **Evaluating compliance with ethical requirements, including independence. [This answer is correct. Audit planning continues throughout the audit even though many of the planning steps and procedures necessarily are performed at the beginning of the audit process. However, a logical sequence of steps provides a useful framework. Based on the steps provided in this course, preliminary engagement activities include (1) performing procedures regarding acceptance or continuance of the client relationship and the specific audit engagement; (2) evaluating compliance with ethical requirements, including independence; and (3) establishing an understanding with the client and communicating it in an engagement letter.]**

   d. Holding a discussion among the engagement team. [This answer is incorrect. According to the framework provided by this course, holding a discussion among the engagement team is considered part of general audit planning, not a preliminary engagement activity.]

6. Which of the following statements describes the use of analytical procedures as risk assessment procedures when planning the audit of an employee benefit plan? **(Page 36)**

   a. They are not required if other risk assessment procedures are sufficient. [This answer is incorrect. AU-C 315A.06 specifies that risk assessment procedures should include analytical procedures.]

   b. **They can cover both financial and nonfinancial information. [This answer is correct. AU-C 315A.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information (for example, the relationship between number of participants and contributions).]**

   c. They provide detailed information about the existence of material misstatement. [This answer is incorrect. AU-C 315A.A15–.A16 explain that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.]

   d. They can be performed without prior knowledge of the client and its environment. [This answer is incorrect. Knowledge of the client and its environment is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships.]

7. Which of the following is specifically required to be covered during the engagement team discussion? **(Page 39)**

   a. **How susceptible the client's financial statements are to material misstatement. [This answer is correct. Certain matters are specifically required to be discussed during the engagement team discussion, including the susceptibility of the entity's financial statements, including disclosures, to material misstatement and the application of GAAP to the entity's facts and circumstances in light of its accounting policies.]**

   b. Any changes in the entity's environment or financial condition. [This answer is incorrect. The engagement team discussion may include topics such as changes in the entity's environment, financial condition, or activities that may result in significant new or revised accounting or disclosures. However, this is not one of the required topics.]

   c. How materiality will be used to determine the extent of testing needed. [This answer is incorrect. Materiality levels and how materiality will be used to determine the extent of testing is one topic that the engagement team might discuss, but it is not one of the required topics.]

   d. Whether copies of significant contracts need to be included in the workpapers. [This answer is incorrect. The engagement team discussion provides an opportunity for the engagement partner to remind audit team members of the audit documentation requirements of AU-C 230. One of the matters that might be included is whether abstracts or copies of significant contracts or agreements examined to evaluate the accounting for significant unusual transactions should be included in the workpapers. However, this is not one of the required components of the engagement team discussion.]

Lesson 2: Obtaining an Understanding of the Plan, Its Environment, and Its Internal Control

INTRODUCTION

Lesson 2 takes a look at the understandings an employee benefit plan auditor needs to obtain with the plan, its environment, and its internal control. Each of these understandings provides base knowledge that is necessary to complete the engagement.

The understanding of the plan and its environment touches on industry, regulatory, and other external factors, as well as internal factors such as measurement and review of the plan's financial performance and the selection and application of accounting policies.

The understanding of the plan's internal control, on the other hand, focuses more on the five elements of internal control and how they are addressed by the plan. Other topics covered include information technology, documentation, and service organizations.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine best practices for obtaining an understanding of an employee benefit plan and its environment.
- Recognize the best methods for obtaining an understanding of an employee benefit plan's internal control.

AN UNDERSTANDING OF THE PLAN AND ITS ENVIRONMENT

The auditor, according to AU-C 315A.05, should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. AU-C 315A.03 explains that the objective of the auditor is to make this assessment through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks. The auditor's focus in obtaining the required level of understanding should be on attaining a knowledge level sufficient to identify the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. The understanding is a purpose-driven audit focus and not a general knowledge level that might be appropriate for some other purpose such as managing the plan.

Obtaining a solid in-depth understanding of the plan and how it operates is fundamental to both audit efficiency and effectiveness. This understanding is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. It includes not only understanding the risks the plan faces in operating, but ideally, understanding what plan management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains. The auditor's process in obtaining this understanding is focused on those matters that could cause material misstatements in the financial statements, including potential fraud risk factors, undisclosed related-party or party-in-interest transactions, violations of laws or regulations, uncertainties, or going-concern problems.

The auditor's understanding of the plan also assists in:

- Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit.
- Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make sense and indicate possible risk considerations.

- Considering fraud risk factors, for example, the existence of significant or complex related-party or party-in-interest transactions. Knowledge of key personnel might help the auditor identify employees who could provide relevant information in response to fraud risk inquiries.
- Evaluating the appropriateness and sufficiency of audit evidence.

The audit personnel working on the engagement need to understand the plan and its environment sufficiently to effectively analyze the risks and plan and perform an efficient and effective audit in response to those risks. The level of understanding that is attainable by individual members of the audit team will vary with the experience, training, and assigned engagement duties of the personnel, but the partner and manager need to spend sufficient time in audit team meetings or on-the-job supervision to convey to the assigned staff the insight needed for effective performance of the audit.

The process of understanding the plan and its environment is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. Also, there are always important new developments with the client and within the employee benefit plan industry. For this reason, each member of the audit team needs to continually try to improve client and industry knowledge by such measures as reading industry publications, taking self-study courses, and above all, talking to client personnel, including personnel outside the accounting department.

In a continuing engagement, the auditor updates knowledge of the plan and its environment by focusing on identifying changes from the prior year in internal or external conditions that might be of audit significance and affect the plan's business risk or the auditor's assessment of audit risk. (Lesson 1 addresses the auditor's use of the results of risk assessment procedures performed in prior periods.)

Components of the Understanding

AU-C 315A.12 indicates that the auditor's understanding of the plan and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors, including the applicable financial reporting framework.

b. Nature of the plan.

c. Objectives, strategies, and related business risks.

d. Measurement and review of the plan's financial performance.

e. Selection and application of accounting policies.

Consideration of fraud risk factors is an important objective of performing risk assessment procedures, and occurs simultaneously with obtaining information about the plan and its environment. Nevertheless, it merits separate and focused attention. A discussion of the identification and assessment of fraud risk factors that is typically accomplished as part of obtaining an understanding of the entity and its environment appears later in this section.

Industry, Regulatory, and Other External Factors

AU-C 315A.12 indicates that the auditor should obtain an understanding of the industry, regulatory, and other external factors, including the applicable financial reporting framework, relevant to the audit. The objective of the auditor's understanding is to evaluate whether the plan is subject to specific risks of material misstatement arising from the nature of the plan, the industry, the degree of regulation, or other external forces, such as political, economic, social, or technological. In addition to the matters discussed in the following paragraphs, the auditor incorporates the information on the scope of the audit obtained in performing preliminary engagement activities.

Economic Concerns. Developments in the United States economy may affect employee benefit plans and the sponsors of those plans. Accordingly, auditors need to consider the risks caused by the economic environment when planning and performing an audit of an employee benefit plan. Auditors need to understand both the economic conditions affecting the industry in which a plan sponsor operates and the effect of those conditions on an employee

benefit plan. Economic conditions and regulatory actions in response to those conditions may present additional risk factors or may increase the effect of such factors on an audit of an employee benefit plan.

AEBP, Paragraph 2.64, points out that the nature, timing, and extent of planning varies with the type of plan; size and complexity of operations; prior experience with the plan; and understanding of the plan and its environment, including its internal control (and any restrictions placed on the audit). To understand the significance of these matters, the auditor needs a sufficient understanding of the regulatory and economic environment of employee benefit plans.

COVID-19 Considerations. The effects of COVID-19 on the economic and regulatory environments of some plan sponsors has been significant. An auditor may need to consider these effects at the industry, local, regional, national, or international level. Some industries and geographic areas have been affected severely by travel restrictions and stay-at-home orders. The applicability and severity of such restrictions and orders has varied on a state-by-state basis. Some states have relaxed them and reopened, only to reinstate them in response to new outbreaks. An auditor needs to discuss with plan management, and those charged with governance, their assessment of and planned response to these recent changes in the economic and regulatory environments. An auditor may also find current and forecasted industry statistics of government-supplied information helpful in assessing a plan sponsor's planned responses and the effects on the risks of material misstatement of the plan's financial statements.

Review of Laws and Regulations. The auditor needs some familiarity with ERISA, applicable sections of the IRC, and related DOL and IRS regulations and the potential effect on the plan before proposing for an ERISA audit and in deciding whether the firm can meet the requirements of such an audit before accepting the engagement. To plan the audit, the auditor needs to become more familiar with the complex legal requirements that affect plan structure and operations, financial accounting and reporting, and the related requirements concerning parties in interest and prohibited transactions.

Though outside the scope of this course, *PPC's Guide to Audits of Employee Benefit Plans* explains ERISA and tax requirements and their significance in an audit of the financial statements of an employee benefit plan. AEBP, Appendix A, presents a description of important provisions of ERISA and related regulations. The auditor needs to be acquainted with these sources before audit planning begins. This knowledge base can then be extended in conjunction with other audit planning procedures. For example, the auditor can read the instructions to the current Form 5500 in conjunction with reading the plan's most recent financial statements and previously filed Form 5500. The instructions to Form 5500 provide many informative details and can be a significant aid in understanding relevant laws and regulations. The auditor needs to identify areas in which noncompliance with laws and regulations could have a significant effect on the plan's financial statements or operations, for example, loss of tax exempt status. The auditor needs to also monitor the status of any proposed legislation that could affect ERISA requirements.

Inquiry of Plan Management and Others. The auditor inquires about the plan's key personnel, advisors, etc., and the nature, location, and safekeeping arrangements of its assets. The auditor needs to identify the plan administrator and principal members of management, actuaries, investment advisors, members of the administrative committee or board of trustees, service organizations, and all known related parties and parties in interest. AEBP, Paragraph 3.35b, suggests that the auditor consider inquiring of plan management about whether:

- The plan's financial statements will be prepared in conformity with generally accepted accounting principles or with a special purpose framework permitted by ERISA or DOL regulations (such as modified cash basis).
- Investment assets are held internally or by outside custodians and related matters, such as, the location of investments, the nature of safekeeping arrangements, and the nature and type of investments and whether there are any unusual or hard to value investments or any changes in the types of investments or investment arrangements.
- 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.
- Periodic financial statements are prepared.

- The plan maintains a list of *parties in interest*, as defined by ERISA [Title I] 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 with responsibility for oversight of the financial reporting process.
- There is a present intention to terminate or curtail the plan or transfer assets (related to a plan merger, spin-off, or other transfer).
- The frequency at which transactions are processed and the frequency at which they are valued are the same (daily, for example).
- The plan allows participants to initiate transactions by telephone or in an electronic means (such as the Internet or intranet).
- There were any significant amendments or changes to the plan operations during the year or subsequent to year-end.
- They acknowledge their responsibilities for uncorrected misstatements.
- There have been any changes in service providers.
- There have been significant changes in the number of participants or participating employers in a multiemployer plan.

As indicated above, the auditor may inquire about the nature of the plan's investment assets and, if investment assets are held by outside custodians, identify the location of the assets and the nature of the safekeeping arrangements. Are the investments held in the name of the plan? Is the custodian in possession of the investments or does the custodian use another entity's facilities? What investigation has the plan administrator made of the custodian's reputation and financial capability? Is the custodian independent or is it related to the plan or sponsor?

Review of Plan Documents. AEBP, Paragraph 3.35, includes the following procedures involving plan documents that the auditor may consider applying to plan the audit and obtain an understanding of the plan and its environment:

- Read the plan instrument, including amendments, to determine, among other things, whether the plan is (a) a single employer, multiemployer, or multiple employer plan, (b) a contributory or noncontributory plan, (c) required to be funded or not, and (d) the nature of benefits promised.
- Read agreements with trustees, investment advisers, 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).
- Review the prior-year financial statements, Form 5500, filings with the 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.
- 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 preparer of these reports to determine the extent of audit procedures or the ability to rely on the content of any of these reports.
- Read minutes of trustee, benefits committee, or board of directors meetings applicable to the plan.

This information is necessary for understanding the plan's organization and operations and is useful in considering audit risk (for example, there is usually a greater risk of material misstatement of contributions for a multiemployer plan). Exhibit 2-1 lists examples of information the review of plan documents may provide the auditor.

Exhibit 2-1

Information Obtained from Review of Plan Documents

- Decisions to enter, modify, or terminate agreements with custodians; investment advisors or trustees; insurance companies; mortgage servicing agents; real estate managers; actuaries, appraisers, or other specialists; third-party administrators, etc.
- Decisions or intentions to amend or terminate the plan.
- Employers entering or withdrawing from a multiemployer plan.
- Decisions to enter into or modify collective bargaining agreements.
- Unusual terminations of plan participants, such as ones resulting from layoffs or a sale of a division.
- Changes in actuarial assumptions or methods.
- Review and approval of valuations of investments that do not have a readily available market price.
- Approval of the employer contribution and payment or receipt of it.
- Authorization of significant purchases or sales of investments.
- Lease agreements entered into.
- Bank accounts opened or closed.
- Debt agreements made and related terms, collateral, pledged assets, guarantees, etc.
- Guarantees, compensating balances, or similar financial arrangements entered into.
- Identification of related parties, parties in interest, or transactions with such parties.
- Approval of significant operating expenses (either borne by the plan or absorbed by the plan sponsor).
- Fidelity bonding for plan fiduciaries and others for whom ERISA requires such bonds.
- Existing or pending lawsuits.
- Examinations by, communication with, or reports from, the IRS, DOL, or other regulatory agencies.
- Failure to pay or receive the employer contribution.
- The plan sponsor's request for, or receipt of, a funding waiver.
- Disposition of the current period's forfeitures, that is, to allocate them to plan participants or to reduce employer contributions.
- Request for, or receipt of, IRS determination letters.

Pending Amendments. In obtaining an understanding of plan operations, the auditor needs to be aware that a plan may appropriately operate differently than the plan instrument indicates. The auditor needs to ask the plan administrator about pending amendments that have already been incorporated in plan operations but which, as of yet, have not been included in a plan amendment. Generally, the auditor needs to request a formal resolution that reflects the plan sponsor's intent to make the amendments and that describes the required plan amendments. The auditor can then plan audit procedures to test whether plan transactions are executed in accordance with the pending amendments rather than the provisions of the plan instrument.

Plan Defects. The auditor may discover defects in the plan while reviewing the plan documents or performing engagement acceptance or planning procedures. Plan defects include the following:

- Form defects, which occur when the plan's provisions do not satisfy the qualification requirements of the IRC.
- Operational defects, which occur when the plan fails to operate in accordance with the plan provisions.
- Demographic defects, which occur when the plan fails to satisfy the nondiscrimination requirements of the IRC due to a shift in the demographics of the employer's workforce.

If the auditor discovers operational defects in the plan, he or she ought to notify the plan administrator and provide assistance as necessary. The auditor ought to consider discussing the IRS's Employee Plans Compliance Resolution System with the plan administrator. If the operational defects are considered *reportable findings*, as defined in AU-C 703.25, the auditor should communicate those items in writing to those charged with governance.

Review of Financial Statements and Form 5500. As mentioned above, the auditor's review of plan documents may include review of prior years' financial statements and Forms 5500 filed. This review is useful in obtaining an understanding of recent operations and identifying matters of audit significance. For example, the Form 5500 requires reporting of loans or leases in default or considered uncollectible in Schedule G filed with the Form. Such information would be relevant in auditing the allowance for uncollectible accounts. The auditor ought to identify significant financial statement areas, the names of parties in interest, and prior problem areas.

The Health Insurance Portability and Accountability Act. The Health Insurance Portability and Accountability Act (HIPAA) affects all health care providers and other entities that manage or have access to health or medical records, referred to as "covered entities." HIPAA contains an "Administrative Simplification" provision that essentially acts as a federal medical records privacy and security law and governs the storage, use, release, and transmission of confidential patient health information. One of the sets of regulations under HIPAA, known as the "Privacy Rule," addresses the privacy of medical information. Employer-administered health plans with less than 50 participants are not subject to the HIPAA privacy rules. Additional information is available on the U.S. Department of Health and Human Services website at **www.hhs.gov/hipaa/index.html**.

The Privacy Rule requires covered entities to obtain assurances from their *business associates* that the business associate will appropriately safeguard the health information they receive. A *business associate* is a person or entity that performs certain functions or activities that involve the use or disclosure of protected health information. For example, a TPA that processes claims is a common business associate of health plans. Additionally, a CPA firm auditing a health plan will generally be considered a business associate of the plan because of the needed access to claim information.

AEBP, Paragraph 8.14, explains that HIPAA requires that plan sponsors enter into business associate agreements with any of their service providers, including a plan auditor, that have access to any protected health information (PHI). The contract must be in writing and include certain specific protections for the information. After an auditor has entered into a business associates agreement, the auditor would be permitted access to the information necessary to issue an opinion on the plan's financial statements.

In addition to signing business associate agreements, some TPAs or health plans may ask auditors to sign confidentiality or indemnification agreements before granting access to claims records. Auditors need to carefully read and review any similar type of agreement before signing because some agreements may include statements that contradict the arrangements between the plan and the auditor covered in the engagement letter. For example, a statement may be included whereby the auditor would indemnify the TPA or plan for any errors detected during testing. Thus, because of the potential for legal issues, the auditor ought to also consider having his or her legal counsel review the agreement before signing. If the auditor and TPA are unable to agree on the language in the confidentiality agreement, the TPA could refuse access to necessary information, thereby creating a scope limitation for the auditor.

Auditors of health plans covered by HIPAA need to consider the following issues when planning their audits:

- The impact of the plan's or the TPA's privacy measures on the auditor's access to the plan's records.
- If the plan or the TPA will require the auditor to sign a business associate agreement or confidentiality agreement.
- The extent of details of the protected health information examined during testing that should be documented.

Because the auditor's workpapers may be subject to review by peer reviewers, the Department of Labor, and other regulatory bodies, the auditor needs to specifically consider the extent of documentation necessary when performing audit procedures related to protected health information. HIPAA regulations permit the auditor's workpapers to contain protected health information. However, by including protected health information in the workpapers, the auditor's firm is required to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of that information. Accordingly, the audit firm needs to:

- Restrict access to the workpapers.
- Provide an accounting of disclosures of protected health information.
- Report any misuse of protected health information by the audit firm to the sponsor.

The auditor needs to avoid including information in the workpapers that may identify an individual participant or a participant's protected health information. De-identified health information is not subject to HIPAA; to be de-identified, the information in workpapers may not contain: (a) names, (b) dates (such as birth date, admission date, discharge date, and date of death), (c) age if 90 or over, (d) complete social security numbers (or block out all except last four digits), (e) telephone and fax numbers, (f) email addresses, (g) medical record numbers, (h) health plan beneficiary numbers, or (i) account numbers. Audit documentation is discussed further in Lesson 3.

Objectives, Strategies, and Related Business Risks

AU-C 315A.12 indicates that the auditor should obtain an understanding of the plan's objectives, strategies, and related business risks. The basic concept here is that most business risks eventually have financial consequences and, thus, an effect on the financial statements. Not all business risks create risks of material misstatement, so the auditor needs to focus on those risks that have financial reporting implications in the plan's particular circumstances. For example, a plan's investment strategies usually would have financial statements implications.

The auditor obtains an understanding of plan management's objectives and strategies to identify the related business risks. Plan management determines the plan's objectives. Plan management's strategies are the operational approaches adopted to achieve the objectives. The related business risks are the significant conditions, events, circumstances, actions, or inactions that could adversely affect the plan's ability to achieve its objectives or implement its strategies.

When obtaining an understanding of plan management's objectives and strategies to identify the related business risks, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the plan. Smaller employee benefit plans generally do not have formal plans or processes that are documented, which forces the auditor to rely primarily on inquiries. When making inquiries, the auditor will generally restrict questioning to upper management of the plan given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt plan management to describe the plan's future trends, expectations, objectives, and strategies.

Measurement and Review of the Plan's Financial Performance

AU-C 315A.12 indicates that the auditor should obtain an understanding of the measurement and review of the plan's financial performance made by plan management and external parties. Information used for measurement and review might include the following:

a. Key performance indicators (KPI), both financial and nonfinancial (e.g., investment returns or employee participation rates).

b. Trends.

c. Key ratios and other operating and financial statistics.

d. Forecasts, budgets, and variance analyses.

e. Period-on-period financial performance.

f. Comparisons to performance of comparable plans or investments (i.e., benchmarking).

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement in several ways, including the following:

a. The pressure to meet performance targets could motivate plan management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.

b. Use of performance measures might highlight unexpected results or trends such as unusually high benefit payments, which upon investigation result in detection of misstatements.

c. The auditor might be able to use key performance indicators or other measures used by plan management when performing analytical procedures. However, the auditor needs to consider whether the information used by plan management is reliable and provides the degree of precision that is needed for the analytical procedures.

A small plan might not have a formal process to measure and review financial performance, but plan management will still likely be aware of key performance indicators that it uses and that can be helpful to the auditor.

Selection and Application of Accounting Policies

AU-C 315A.12 states that the auditor should obtain an understanding of plan management's selection and application of accounting policies and evaluate whether the policies are appropriate for the plan and consistent with the applicable financial reporting framework and with policies used in the employee benefit plan industry. This understanding is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels, including both misstatements due to fraud and those due to error. The auditor's assessment of the appropriateness of the accounting policies that plan management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements and, hence, in assessing risks of material misstatement. For an employee benefit plan, significant accounting policies are often those for actuarial valuations and investment valuations.

The auditor's understanding of plan management's selection and application of accounting policies includes the following:

a. Relevant accounting standards and industry specific practices.

b. The methods the plan uses to account for significant unusual transactions.

c. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

d. Changes in the plan's policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP.

e. Financial reporting standards and regulations that are new to the plan and management's plans to adopt such requirements, including new accounting standards.

f. The process used by plan management in formulating particularly sensitive accounting estimates.

g. The methods used to identify matters for disclosure and how the plan achieves clarity in disclosure.

The auditor uses the understanding of these aspects of plan management's selection and application of accounting policies to identify audit areas of higher risk and to identify what could go wrong at the relevant assertion level. For example, if the plan has to measure fair value for hard-to-value investments, there ordinarily is a higher risk of material misstatement for the valuation of those assets. For items of disclosure, many auditors of smaller plans assist plan management in preparing the financial statements. In those cases, identification and clarity of disclosures are often heavily influenced by the auditor. Therefore, the potential for risk may be mitigated with respect to disclosure.

The auditor uses the understanding of plan management's selection and application of accounting policies along with the identification of fraud risk factors to evaluate whether an overall response is necessary. In establishing the overall audit strategy, the auditor focuses on whether the accounting principles selected and policies adopted are being applied in an inappropriate manner. If the auditor identifies a risk in this area, it is often addressed by an overall response, such as the assignment of more experienced personnel and a higher level of supervision, as well as by the selection of specific further audit procedures.

The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as:

- The auditor's knowledge and experience with the employee benefit plan industry.
- The auditor's knowledge and past experience with the client.
- The degree of financial reporting sophistication of the client.
- The extent of new accounting standards that are recently effective for the client.
- The auditor's participation in assisting the client with the selection of accounting policies and the preparation of the financial statements.

For many small employee benefit plan clients, the auditor is instrumental in assisting with the selection of accounting principles and choosing the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process since the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application. For other situations where the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may inquire about the matters listed above. Also, the auditor may supplement inquiries with a review of prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to the employee benefit plan industry or the plan's transactions.

Fraud Risk Factors

AU-C 240.25 states that the auditor should identify and assess the risk of material misstatement due to fraud at both the financial statement and assertion level. For employee benefit plans, the assessment of the risk of material misstatement due to fraud may include the following areas, according to AEBP, Paragraph 3.83:

- Investments valued based on unobservable inputs.
- Use of forfeitures and late remittances of employee deferrals for defined contribution plans.
- Actuarial present value of accumulated plan benefits for defined benefit plans.
- Benefit obligations for postretirement, postemployment, claims incurred but not reported, and claims payable for defined benefit health and welfare plans.
- Amount and collectibility of contributions receivable and withdrawal liabilities for multiemployer plans.

This fraud risk assessment should be ongoing throughout the audit, but the initial assessment made while obtaining an understanding of the plan and its environment includes identification and assessment of fraud risk factors.

Fraud risk factors are conditions or events that indicate an incentive or pressure to perpetuate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present. The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the plan and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor is present and needs to be considered in identifying and assessing risks of material misstatement due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and needs to be considered in identifying and assessing the risks of material misstatement due to fraud is a matter of the auditor's exercise of professional due care and professional skepticism.

Examples of Fraud Risk Factors. AU-C 240.A76 (Appendix A) and Appendix H of AEBP provide examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The examples of risk factors presented in AU-C 240.A76 (Appendix A) and Appendix H of AEBP are classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the illustrative risk factors are further classified into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. These risk factors are only examples and the auditor also may consider other risk factors not specifically listed in the guidance. In fact, AU-C 240.A76 (Appendix A) specifically points out that the examples may not be all inclusive, may not apply in all instances, or may be more or less significant depending on the nature, size, or ownership characteristics of the entity.

Auditors need to consider the importance of the modifying language in the risk factors (such as inappropriate means, unduly aggressive, etc.). For example, a fraud risk factor might be, "There is an excessive interest by plan management to maintain or increase the plan's net assets or to reduce required contributions." Many plan sponsors may have an interest in reducing their required contributions to increase the sponsor's income. The primary consideration, however, is whether plan management has shown an interest in reducing contributions through inappropriate means.

For misappropriation of assets, the consideration of fraud risk factors is influenced by the degree to which assets susceptible to misappropriation are present. However, some consideration should be given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. One of the primary fraud risks in employee benefit plans is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. Therefore, there always needs to be some consideration of fraud risk factors related to misappropriation. In addition, when considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting occurs.

If fraud risk factors are present, in accordance with AU-C 330, 240.28, and 240.30, the auditor considers whether the assessment of the risk of material misstatement due to fraud calls for an overall response, one that is specific to a particular account balance, class of transaction, or disclosures at the relevant assertion level, or both. An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

COVID-19 Considerations—Fraud

The three conditions that are generally present when fraud occurs, as outlined in the bulleted list above, may be more likely because of the effects of COVID-19. These COVID-19-related conditions are conducive to both types of intentional misstatement as described in the same paragraph—fraudulent financial reporting and misappropriation of assets. With respect to fraudulent financial reporting, incentives/pressures as a result of the downturn in the economy may increase the fraud risks related to a plan sponsor fraudulently reducing required contributions to increase income. Opportunities for misstating earnings and financial condition may be increased due to breakdowns in internal control and enhanced ability to override controls. COVID-19 may also supply the rationalization that the fraud is only temporary until the current crisis is over and the economy improves, or is necessary to save the jobs of employees.

With respect to misappropriation of assets, employees may be experiencing extreme financial pressure. Savings may be gone and other family members may have been terminated or temporarily suspended. The opportunity and rationalization are essentially the same as for fraudulent financial reporting; that is, internal control is less effective and the stolen funds "can be returned later." The exercise of heightened professional skepticism should pervade every phase of the audit from planning steps, such as the brainstorming discussion of the audit team, through the challenging of the authenticity of documents and the persuasiveness of all types of evidence. The audit procedures planned and performed need to be linked to the risks of specific types of fraudulent misstatement identified and assessed. Of particular importance is remaining alert to conditions that indicate fraudulent activities.

Documentation of the Understanding of the Entity and Its Environment

AU-C 315A.33 indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the plan and its environment.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures performed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. Which of the following statements best describes an auditor's understanding of an employee benefit plan and its environment?

   a. The understanding is formed during the initial audit engagement with the client and will serve for the duration of the association.

   b. Obtaining this understanding comes from the client itself; other outside sources do not factor into the process.

   c. Obtaining this understanding is a separate process from considering fraud risk factors in relation to the audit.

   d. This understanding is key to discovering where risks may have resulted in material misstatement of the financial statements.

9. How might the Health Insurance Portability and Accountability Act (HIPAA) affect an employee benefit plan?

   a. Plans must obtain assurance from business associates that they will safeguard any health information they receive.

   b. Auditors will lose their independence from the audit client if they sign a business associate agreement.

   c. Auditors will violate HIPAA rules if they retain protected health information in their engagement workpapers.

   d. Employer-administered health plans are exempt from the HIPAA rules, so such an audit will not be affected by this legislation.

10. How might the use of performance measures affect the audit and the auditor's assessment of the risks of material misstatement?

    a. The auditor's risk assessment will go down because management is less likely to intentionally misstate the financial statements.

    b. Unexpected results or trends could be highlighted that, when investigated, lead to the auditor detecting misstatements.

    c. As information about performance measures from management is never considered reliable, the auditor cannot use it when performing analytical procedures.

    d. If a plan does not have a formal measurement and review process, the auditor should not make inquiries about performance measures.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

8. Which of the following statements best describes an auditor's understanding of an employee benefit plan and its environment? **(Page 49)**

   a. The understanding is formed during the initial audit engagement with the client and will serve for the duration of the association. [This answer is incorrect. The process of understanding the plan and its environment is continual. It cannot be developed once and then ignored for the duration of the association with the client.]

   b. Obtaining this understanding comes from the client itself; other outside sources do not factor into the process. [This answer is incorrect. There are always important new developments with the client and within the employee benefit plan industry. For this reason, each member of the audit team needs to continually try to improve client and industry knowledge by such measures as reading industry publications, taking self-study courses, and above all, talking to client personnel, including personnel outside the accounting department. Therefore, the understanding is affected both by the client and other, outside sources.]

   c. Obtaining this understanding is a separate process from considering fraud risk factors in relation to the audit. [This answer is incorrect. Consideration of fraud risk factors is an important objective of performing risk assessment procedures and occurs simultaneously with obtaining information about the plan and its environment. Nevertheless, it merits separate and focused attention.]

   d. **This understanding is key to discovering where risks may have resulted in material misstatement of the financial statements. [This answer is correct. Obtaining a solid, in-depth understanding of the plan and how it operates is fundamental to both audit efficiency and effectiveness. This understanding is the key to knowing what the risks are and where to look to see if the risks have resulted in a material misstatement of the financial statements. It includes not only understanding the risks the plan faces in operating, but ideally, understanding what plan management's response is to those risks, and, consequently, what residual risk of material misstatement of the financial statements remains.]**

9. How might the Health Insurance Portability and Accountability Act (HIPAA) affect an employee benefit plan? **(Page 54)**

   a. **Plans must obtain assurance from business associates that they will safeguard any health information they receive. [This answer is correct. One set of HIPAA regulations, known as the "Privacy Rule," requires covered entities (such as employee benefit plans) to obtain assurances from their *business associates* that the business associate will appropriately safeguard the health information they receive. A *business associate* is a person or entity that performs certain functions or activities that involve the use or disclosure of protected health information.]**

   b. Auditors will lose their independence from the audit client if they sign a business associate agreement. [This answer is incorrect. AEBP, Paragraph 8.14, explains that HIPAA requires that plan sponsors enter into a business associate agreement with any of their service providers, including a plan auditor, that have access to any protected health information (PHI). In addition to such agreements, some TPAs or health plans may ask auditors to sign confidentiality or indemnification agreements before granting access to claims records. Auditors need to carefully read and review any similar type of agreement before signing because some agreements may include statements that contradict the arrangements between the plan and the auditor covered in the engagement letter. None of these agreements, however, will cause the auditor to lose independence automatically.]

   c. Auditors will violate HIPAA rules if they retain protected health information in their engagement workpapers. [This answer is incorrect. HIPAA regulations permit the auditor's workpapers to contain

PHI. However, by including PHI in the workpapers, the auditor's firm is required to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of that information, so the audit firm will then need to take other actions.]

d. Employer-administered health plans are exempt from the HIPAA rules, so such an audit will not be affected by this legislation. [This answer is incorrect. Employer-administered health plans with less than 50 participants are not subject to the HIPAA privacy rules. Other plans, however, are, so their audits would be affected.]

10. How might the use of performance measures affect the audit and the auditor's assessment of the risks of material misstatement? **(Page 56)**

a. The auditor's risk assessment will go down because management is less likely to intentionally misstate the financial statements. [This answer is incorrect. The pressure to meet performance targets could motivate plan management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment. Therefore, auditors should not assume that risk will go down if performance measures are used.]

b. **Unexpected results or trends could be highlighted that, when investigated, lead to the auditor detecting misstatements. [This answer is correct. Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement in multiple ways. For example, the use of performance measures might highlight unexpected results or trends such as unusually high benefit payments, which upon investigation result in detection of misstatements.]**

c. As information about performance measures from management is never considered reliable, the auditor cannot use it when performing analytical procedures. [This answer is incorrect. The auditor might be able to use key performance indicators or other measures used by plan management when performing analytical procedures. However, the auditor needs to consider whether the information used by plan management is reliable and provides the degree of precision that is needed for the analytical procedures.]

d. If a plan does not have a formal measurement and review process, the auditor should not make inquiries about performance measures. [This answer is incorrect. A small plan might not have a formal process to measure and review financial performance, but plan management will still likely be aware of key performance indicators that it uses and that can be helpful to the auditor. Therefore, it would be helpful to the engagement for the auditor to make such inquiries.]

AN UNDERSTANDING OF INTERNAL CONTROL

AU-C 315A.13–.25 establishes requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the plan's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit.

Components of Internal Control

AU-C 315A.15–.25 requires an understanding of five interrelated components of internal control. These five components are also defined and described in more detail in COSO's *Internal Control—Integrated Framework*. The five components are as follows:

a. Control environment

b. Risk assessment

c. Information and communication

d. Monitoring

e. Control activities

Each of these components is discussed further in the following paragraphs.

AICPA Technical Question and Answer, *Obtaining an Understanding of Internal Control Relevant to the Audit* (Q&A 8200.18), points out that the AU-C 315A requirement to obtain an understanding of internal control relevant to the audit applies to each of the five components of internal control. In other words, each of the five components is relevant in all audits and is required to be understood, and that understanding of each component is required to be documented in every audit engagement.

AU-C 315A.A58 notes that the five components provide a useful framework for auditors when considering different aspects of internal control. AU-C 315A.A59 indicates that auditors may use different terminology or frameworks to describe various aspects of internal control providing that the five components are addressed. As such, AU-C 315A.A59 recognizes that entities may design, implement, or maintain internal control using terms different from those five components and AU-C 315A.A53 recognizes that the five components may not be clearly distinguished in smaller, less complex entities. Those entities might not have extensive or formal descriptions of internal controls, descriptions of accounting procedures, or detailed policies.

Throughout this discussion, the authors refer to the internal control components of control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-level" controls. These controls typically have a pervasive effect on the plan's system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. The IT environment and general IT controls also have a pervasive effect and are considered at the entity level. The authors refer to the financial reporting system and the control activities component of internal control as "activity-level" controls.

COSO Internal Control Framework. Several internal control frameworks exist internationally, but the most widely used framework in the U.S. is COSO's *Internal Control—Integrated Framework* (the COSO framework), as revised in 2013. The five components of internal control listed above are the same five components defined and described in the COSO framework. Smaller employee benefit plans may not have formally adopted or even be familiar with the COSO framework, but the authors believe that auditors turn to the COSO framework as a reference and guide for understanding and evaluating internal control.

The COSO framework helps entities design, implement, and evaluate internal control in light of current business and regulatory environments and operations by articulating 17 principles, associated with the five components of internal control. The principles aid in understanding the requirements for effective internal control and provide clarity when designing and implementing systems of internal control. Each principle has several underlying points of focus for evaluating the principle. COSO has also issued several related documents that provide tools, approaches, and

examples to assist entities when designing, implementing, and assessing effectiveness of a system of internal control.

Consideration of the COSO Framework in this Course. This course does not provide a detailed discussion of the COSO framework. However, reference is made throughout this course to certain of the COSO principles that are associated with the five components of internal control. These principles are provided as considerations for the auditor when obtaining an understanding of the plan's internal control.

Nature of the Auditor's Understanding

AU-C 315A.13–.14 requires auditors to obtain an understanding of internal control relevant to the audit. As noted in the nonauthoritative AICPA Technical Question and Answer, *Ineffective Controls* (Q&A 8200.11), auditors obtain a sufficient understanding of the five components of internal control to evaluate the design of controls and determine whether they have been implemented, even if the auditor believes, prior to performing risk assessment procedures, that controls are nonexistent or ineffective. AICPA Technical Question and Answer, *Obtaining an Understanding of the Controls Relevant to the Audit* (Q&A 8200.19), also notes that the requirement to evaluate design and determine whether the controls have been implemented applies to each of the five components and is required every year. A key consideration is whether and how the plan's internal control prevents, or detects and corrects, material misstatements in relevant assertions related to transaction classes, account balances, or disclosures.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to management and those charged with governance.

The documentation of a control procedure, however, does not demonstrate that the control is actually being used. The auditor, therefore, also determines if the control, as documented or described, actually exists and the plan is using it. In other words, an auditor uses risk assessment procedures to obtain audit evidence that the control has been implemented. Determining whether a control has been implemented confirms the auditor's understanding of control design and helps ensure that the risk assessment is based on complete and accurate information. Generally, the auditor uses procedures such as observation or inspection, combined with inquiries, to verify implementation. Inquiry alone is not sufficient to evaluate the design of a control and determine if it has been implemented.

Normally, the auditor's understanding of internal control design and implementation is not sufficient to reach a conclusion on the operating effectiveness of controls. The same types of procedures performed to determine if a control has been implemented (e.g., observation, inspection of documents, reperformance, and walkthroughs) are also used when testing controls for operating effectiveness. However, the extent of the procedures to determine implementation may fall short of what is needed to determine operating effectiveness because tests of operating effectiveness need to provide audit evidence about how controls were applied throughout the period under audit and the consistency with which they were applied. However, in some cases, the auditor's procedures may serve both purposes. For example, a walkthrough can serve as a test of operating effectiveness and in some cases, along with other procedures that test operating effectiveness, can provide a valid basis for assessing control risk at less than high. In addition, for an automated control where consistency of application would normally occur assuming the existence of effective IT general controls, the auditor may be able to determine operating effectiveness based on procedures performed to establish that the control has been implemented and the auditor's assessment and testing of the related general controls.

Extent of the Auditor's Understanding

The overriding criterion for the understanding of internal control is that it be *sufficient* to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor develop a fairly thorough and robust knowledge of all five of the components of internal control. AU-C 315A.26–.27 indicates that to provide a basis for designing and performing audit procedures, the auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the plan and its environment, including the relevant controls that relate to the risk. The auditor is not permitted to simply default to high control risk. In most situations, the auditor's understanding of internal control will

be more comprehensive than the understanding of the other elements of the plan and its environment. In addition, for initial audit engagements, the effort and time to gather information on the components of internal control that is sufficient to assess risk will most likely exceed that necessary for engagements in following years.

Determining the Extent of the Understanding. While the professional standards indicate that the understanding should include the five components of internal control (listed earlier) and a variety of other matters that are discussed throughout this section, auditors will often struggle over what controls or combinations of controls to assess.

The auditor needs to remember that it is not necessary to obtain an understanding of every control at the client. To do so would be cost prohibitive and simply unnecessary for most audit engagements. Rather, the auditor's focus is on those key controls that are relevant to the audit. The auditor makes an informed judgment as to the controls or combination of controls to assess. In general terms, the extent of the understanding, along with the nature, timing, and extent of the risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor's prior experience with the client.
- Materiality.
- Significance of the related risk.
- Size of the plan.
- Type of plan.
- Nature and complexity of systems within the plan or plan sponsor, including the use of service organizations.
- Number of participants and/or employers.
- Applicable legal and regulatory requirements.
- Financial sophistication of the client.
- The facts and circumstances relevant to the applicable control component.
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

The auditor's understanding of the plan and its environment other than internal control (as well as the results of the preliminary engagement activities discussed in Lesson 1) generally influence the extent of the understanding of internal control components. Most of the factors listed in the previous paragraph are determined to a major degree when the auditor performs risk assessment procedures to understand the plan and its environment. Furthermore, that understanding will often result in the identification of risks of material misstatement that will further shape the direction, extent, and depth of the auditor's understanding of internal control. (However, the auditor needs to be aware that additional risks of material misstatement may be identified when obtaining an understanding.) The auditor ought to perform risk assessment procedures related to understanding the plan and its environment before obtaining an understanding of internal control.

Using the Results of the Understanding of Internal Control

As noted earlier, the understanding of internal control needs to be sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

- Identify types of potential misstatements.
- Consider factors that affect the risks of material misstatement.
- Design tests of controls, when applicable, and substantive procedures.

In addition, the auditor remains alert for risks that may be identified during the process of obtaining an understanding of internal controls. Identified risks should be documented.

COVID-19 Initial Considerations for Understanding Internal Control

An initial consideration for the effect of COVID-19 on obtaining an understanding of internal control is determining the number of internal control systems in effect from the beginning of the financial statement period through the completion of the audit. A plan may have experienced several levels of operation during that period. A plan may have been under a full lockdown order, allowed to reopen with restrictions or fully, or ordered to close again. From an audit perspective this means an auditor may be dealing with two or more effectively different internal control systems, and an auditor needs to obtain an understanding of the design and implementation of controls in those differing environments An auditor needs to obtain a thorough understanding of the conditions that prevailed during the financial statement and subsequent period.

Another early consideration is the access an auditor will have to management, personnel, records, and operations when the understanding is being obtained. Interviews, observations, and document inspection related to internal control design and implementation may need to be done remotely. As previously discussed, video conferencing is superior to telephone interviews. If an auditor is unable to visit a site because of travel restrictions, but some of the plan's employees are on site, those employees may be able to use a camera and perform procedures at an auditor's direction. For this purpose, internal auditors or the plan's employees not involved in the area under review ought to be used.

Effect of Information Technology (IT) on Internal Control

IT systems may include packaged applications provided by vendors; custom developed applications; or end-user computing, such as spreadsheets, that provide accounting data used to generate financial reporting. Many small employee benefit plans have simple IT operations or engage a computer service center to process transactions. However, some employee benefit plans, or their third-party administrators, may have internal control that is heavily dependent on information technology. AU-C 315A indicates that auditors should consider how IT affects a plan's control activities. The effects can be extensive, but the effect on the client's internal control is related more to the nature and complexity of the system than to the client's size. Information that may be useful in understanding the effect of IT on internal control includes understanding the role of IT in initiating, authorizing, recording, processing, and reporting transactions. While information systems may use off-the-shelf software packages or custom-developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.

Benefits and Risks of IT. The use of IT may enhance the effectiveness and efficiency of the plan's internal control because of the consistency, timeliness, and accuracy inherent in automated systems. Use of IT also offers benefits in terms of data analysis, monitoring the plan's performance, reduced risk of override, and systems and data security. For example, in an IT system, security controls can help achieve segregation of duties. However, the use of IT also poses certain risks to a plan's internal control, such as:

- Reliance on systems or programs that are inaccurately processing data or processing inaccurate data.
- Unauthorized access to data that may result in destruction of data or improper changes to data.
- Unauthorized changes to master file data.
- Unauthorized changes to systems or programs.
- Failure to change systems or programs when necessary.
- Inappropriate manual intervention.
- Loss or inability to access data.

The extent and nature of those risks depends on the nature and characteristics of the plan's system. In many systems, users can access a common database of information that affects financial reporting. A lack of control at a single user entry point could compromise the security of the database and result in improper changes to or destruction of data.

In many IT environments, the processing of information is often decentralized. For example, in a "server-client" arrangement, a central server hosts various clients and processing occurs both centrally on the server and remotely by various clients. These environments can present a higher element of risk given a wider range of access to data and processing by a variety of users. Threats to data and financial reporting may range from unauthorized access to data and processing to the introduction of viruses.

In today's IT environments, the processing of financial data often is not confined within formally developed or vendor supplied software applications. In many cases, users may access a database warehouse and import data into a spreadsheet program for processing outside of a "formal" application. Among other things, the output of the spreadsheet application might be used as data inputs into a standard software application, support for journal entries, or support for disclosure information. However, in many cases, unlike the controls over the development or integration of standard software applications, spreadsheet applications developed by users might not be subject to any formalized controls. For example, spreadsheet results may not be subjected to formalized testing or there may be no controls over access, development, modification, or the use of multiple versions of a spreadsheet application.

AU-C 315A.22 indicates that in understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. Relevant controls include both properly designed and implemented application controls and the general controls upon which application controls depend. Auditors test general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive procedures. The auditor also ought to be aware that the use of IT may affect the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of the transaction. For example, in highly automated processing with little or no manual intervention when transactions are initiated, authorized, recorded, processed, or reported, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors need to consider whether specialized IT skills are needed to determine the effect of IT on the audit, identify and assess IT risks, understand IT controls, design and perform tests of IT controls or substantive procedures, or identify IT control deficiencies. That determination ought to be made relatively early in the planning process to assure that the necessary resources are available on a timely basis. AU-C 300.A20 states that auditors may consider the following factors in determining whether the audit team needs to include individuals that possess specialized IT skills:

- Complexity of the plan's systems and IT controls and the manner they are used in the plan's operations.
- Significance of changes to existing systems or implementation of new systems.
- Extent to which systems share data.
- Extent of use of emerging technologies.
- Significance of audit evidence available in electronic form only.

An IT specialist may be either a member of the auditor's firm or an outside professional.

If the auditor uses an IT specialist on the engagement team, according to AU-C 300.12, the auditor should be knowledgeable enough to communicate the audit objectives to the specialist, evaluate whether the procedures performed by the specialist meet the auditor's objectives, and determine the results of the procedures on the nature, timing, and extent of other planned procedures. That does not mean auditors have to be experts in information technology. Typically, the auditor's responsibility when using an IT specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of computer applications and controls, especially those most relevant to particular client systems. That understanding can be

gained from experience with the client or from attending training classes or seminars. The extent of the understanding will vary with the nature of the plan's IT environment.

The authors believe there may be circumstances when the IT specialist will be considered an auditor's specialist rather than a member of the engagement team. In those cases, the auditor also needs to follow the requirements of AU-C 620A, *Using the Work of An Auditor's Specialist*. That guidance requires the auditor to evaluate the specialist's competence, capabilities, and objectivity; obtain a sufficient understanding of the specialist's field; reach agreement with the specialist about the work to be performed; and evaluate the adequacy of the specialist's work.

Cybersecurity. Cybersecurity risks have increased as entities have increasingly migrated to use of digital technologies in business and financial operations. Cybersecurity encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. Cybersecurity risk is the risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

General Effects of Cybersecurity Issues on the Audit. Cybersecurity risks and controls affect the audit of financial statements primarily with respect to the auditor's assessment of the risks of material misstatement of the financial statements, obtaining an understanding of IT controls and their effect on financial reporting, and assessing the effect on the financial statements of known cyber incidents. The auditor's concern about cybersecurity relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way. If certain control deficiencies are identified during the review of the entity's controls relevant to cybersecurity, the auditor should follow the requirements of AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

Inquiries of Management About Cybersecurity Risks and Controls. The auditors' inquiries of management need to include identification of the primary types of sensitive information the plan creates, uses, or stores that is susceptible to cybersecurity risk and management's process for dealing with these risks. Examples of inquiries that may be made include the following:

- The steps management has taken in designing and implementing controls at both the entity and activity level to assess and respond to the risks.
- The steps management has taken to monitor the effectiveness of those controls.
- The internal processes management has designed and implemented for identifying and communicating security events and/or security incidents.
- How management has responded to any security events and/or security incidents.

Engagement Team Discussion on Cybersecurity. In connection with the engagement team discussion, the engagement team needs to discuss the areas in the IT platform relevant to financial reporting that are vulnerable to cyber attacks or intrusion. The discussion could include the following matters:

- What are the primary types of sensitive information that the plan creates, uses, and stores?
- Are the control policies and procedures at both the entity and activity level sufficient to safeguard the integrity of this data?
- How would a cyber attack affect the reliability of the plan's financial reporting or result in a material loss or impairment of the plan's assets?

Documentation

AU-C 315A.33 requires documentation of the understanding of the plan and its environment, including internal control. The auditor is required to document the understanding obtained for the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

AU-C 315A permits auditors flexibility in the manner of documentation. The form and extent of documentation is influenced by factors such as the complexity, size, and nature of the plan and the use of technology. Some auditors

supplement their documented understanding with existing documentation of control systems prepared by the plan. Due to the increasing visibility of the importance of controls, many plan and plan sponsors have developed or enhanced their internal documentation and evaluation of internal controls. Auditors may consider inquiring of the client about the existence of such documentation along with any supporting evaluation of the effectiveness of controls. In those cases, the auditor may gain additional audit efficiencies and a better understanding of the plan's internal control.

PPC's Guide to Audits of Employee Benefit Plans provides practice aids that can be used to document the understanding of internal control, including the evaluation of design and implementation.

Control Environment

The control environment of an employee benefit plan includes the overall attitude, awareness, and actions of the plan administrator and those charged with governance concerning the importance of control and its emphasis in plan operations. The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable financial reporting.

The auditor needs to inquire about the plan administrator's controls for identifying parties in interest, communicating rules concerning prohibited transactions to those parties, and detecting noncompliance with prohibited transaction rules. The plan administrator ought to maintain a list of parties in interest, and the auditor needs to obtain this list during audit planning and communicate its contents to the audit team. The auditor needs to 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 and FASB ASC 850 require disclosure.

In general, the procedures performed to identify and audit parties-in-interest transactions parallel those for related-party transactions. AEBP, Paragraph 2.128, observes that many of the audit procedures for related-party transactions will also help the auditor identify party-in-interest transactions but that there are other audit procedures specifically directed to party-in-interest transactions. AEBP, Paragraph 2.133, provides the following examples of audit procedures that may be performed to determine the existence of parties in interest:

- Obtain an understanding of the procedures and controls used by the plan administrator for identifying and properly accounting for and disclosing party-in-interest relationships and transactions.
- Determine how the plan administrator authorizes and approves significant transactions and arrangements with parties in interest, including those outside the plan's normal course of business.
- Evaluate controls to determine the appropriateness of party-in-interest transactions before those transactions close.
- Request the identity of the plan's parties in interest, including changes from the prior year, from appropriate personnel. (Appropriate personnel may include individuals who are familiar with the plan's service agreements and organizational structure, the plan administrator, human resources director, plan committee chairs, the plan's trustee, in-house legal counsel, and those charged with governance.)
- Inquire about—
    - The nature of relationships between the plan and parties in interest.
    - Whether the plan entered into any transactions with the parties during the period.
    - If so, the type and purpose of the transactions.
- Review filings with the DOL and other regulatory agencies, such as Form 5500 and Form LM-2 (for multiemployer plans with labor unions), for names of parties in interest.
- Review prior year's working papers for the names of known parties in interest.
- If applicable, inquire of the plan's predecessor auditor about his or her knowledge of relationships and the extent of management involvement with parties in interest.

- Inquire of plan management about whether DOL, IRS, or other governmental examinations have identified prohibited transactions.
- Review service provider agreements.
- Review leasing and compensation arrangements, if applicable (more common in multiemployer plans).

The plan administrator's attitude, awareness, and actions about these compliance matters as revealed by responses to the auditor's inquiries shape the auditor's understanding of the control environment.

A plan's control environment is normally enhanced by the existence of an audit committee; however many employee benefit plans do not have audit committees and, therefore the auditor may consider whether the plan's investment or administrative committee has been formally designated with responsibility for oversight of the financial reporting process and, in effect, functions as an audit committee. The auditor has additional communication responsibilities as established by AU-C 260 and AU-C 703 on communication with those charged with governance.

Bonding of employees with financial responsibilities is also generally considered an enhancement of the control environment. ERISA, Title I, Section 412(a), requires bonding of every fiduciary and person who handles plan funds or property. ERISA establishes the amount of the bonding, the type of bond, the type of bonding company that may be used, and exceptions to the bonding requirements. However, the auditor ought to be aware that the bonding of the plan administrator or administrative committee as fiduciaries does not reduce the auditor's need to inquire about the integrity and reputation of plan management. A bonding company does not necessarily investigate the background of bonded individuals and the auditor ought to not assume there has been such an investigation.

All plans need to be proactive in reducing fraud opportunities by identifying and measuring fraud risks, taking steps to mitigate identified risks, and implementing and monitoring appropriate preventive and detective controls and other antifraud measures. However, the nature and extent of these risk assessment and monitoring activities needs to be commensurate with the size and complexity of the plan. It is important for the plan administrator to understand his or her responsibility for establishing and monitoring the plan's fraud risk assessment process. That process needs to include a sufficient degree of fraud awareness on the part of the plan administrator, and appropriate fraud risk management activities with oversight from the board of trustees, administrative committee, or those charged with governance. The fraud risk assessment and monitoring process for a typical plan may include:

a. communicating to employees of the plan or plan sponsor the plan administrator's views on business practices and ethical behavior, either orally or by example,

b. thoroughly investigating any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the plan's values and expectations through appropriate communication,

c. considering standards of ethical behavior and appropriate business practices in the plan or plan sponsor's employee training and evaluation procedures,

d. identifying and assessing fraud risks and taking appropriate action to reduce or eliminate the risks, and

e. exercising appropriate oversight of the plan's fraud risk assessment and monitoring activities by the board of trustees, administrative committee, or those charged with governance.

Risk Assessment

Risk assessment for financial reporting purposes refers to the plan's identification, analysis, and management of the risks of material misstatement of the financial statements. More simply, it can be described as identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements.

A key step in the risk assessment process is identifying changed conditions (for example, adopting plan amendments, appointing a new trustee, or hiring a new plan administrator) and taking necessary actions. This involves identifying and communicating both external and internal events or activities that may affect the plan's financial reporting objectives and analyzing the associated risks. Risks relevant to the financial reporting process may arise due to the following:

- Changes in the plan's operations.
- New personnel.
- New or revised information systems.
- Rapid growth by the plan.
- New technology.
- New activities.
- Restructuring by the plan sponsor.
- New accounting standards or new DOL or IRS regulations.

The earlier those risks can be identified, the more effectively they can be dealt with.

The auditor needs to gain an understanding of how plan management identifies and takes action to address risks relevant to the plan's financial reporting objectives. This includes gaining an understanding of how the plan administrator estimates the significance of those risks and assesses the likelihood of their occurrence. For example, if the plan is amended, the auditor needs to gain an understanding of the plan administrator's assessment of the effect on internal control and the steps he or she is taking to address that impact. For risks related to fraud, the auditor needs to gain an understanding of whether the plan has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements) and whether the plan has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risks. Gaining an understanding of plan management's risk assessment is not a complex process. Normally, the auditor can gain this understanding based on his or her experience with the plan, general observations of its operations, and discussions with the plan administrator.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the plan's transactions. It also includes the accountability over the plan's net assets. An information system may be automated, manual, or a combination of the two depending on the size and complexity of the plan. Communication is the process of providing an understanding of roles and responsibilities to individuals within the plan regarding internal control over financial reporting.

Auditors are typically very familiar with the process of understanding the financial reporting system. When obtaining an understanding of the plan's internal control, auditors often spend most of their time in this area since it provides the auditor with other key information needed for the audit. For example, the understanding of the financial reporting system contributes to the auditor's ability to design and conduct efficient and effective substantive procedures since the auditor gains knowledge of the types, sources, and locations of documents and other evidence along with the individuals who are responsible for processing them. However, auditors cannot lose sight of the importance of the communication of accounting and financial reporting roles within the plan. Achievement of the objectives of a well-designed financial reporting system can easily fail if accounting personnel do not fully understand their roles and how proper performance mitigates the risks of material misstatement. Although part of the same internal control component, the authors discuss the financial reporting system and communication process separately in the following paragraphs.

During the process of obtaining an understanding about the financial reporting system, auditors typically gain some knowledge about various monitoring controls or control activities that relate to the processing of transactions and the financial reporting process. In other words, as the auditor learns about how transactions flow through the accounting system and how those transactions are reported in the financial statements, a by-product of that knowledge is an understanding of how plan management monitors internal control and how certain control activities are applied to achieve accuracy, completeness, cutoff, and other relevant assertions. As a result, many auditors find that it is efficient to gain an understanding of the financial reporting system, internal control monitoring, and control activities components of internal control at the same time. In fact, after the auditor obtains an understanding of the control

environment, risk assessment, information and communication, and monitoring, it may not be necessary to devote additional attention to obtaining an understanding of control activities.

Financial Reporting System. AU-C 315A.19 states the auditor should obtain sufficient knowledge of the financial reporting system, including related processes, as a result of applying risk assessment procedures to understand the following:

a. *Classes of Transactions.* The classes of transactions in the plan's operations that are significant to the financial statements.

b. *Accounting Procedures.* The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. *Accounting Records.* The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions.

d. *Other Events and Conditions.* The methods used to capture events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include commitments and contingencies, concentrations, subsequent events, compliance with regulatory matters, related party and party-in-interest transactions, going concern uncertainties, and fair values of investments.

e. *Financial Reporting Process.* The financial reporting process (including the closing process) used to prepare the plan's financial statements, including significant accounting estimates and disclosures.

f. *Journal Entries.* The controls over standard and nonstandard journal entries.

This understanding of the information system relevant to financial reporting should include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside the general or subsidiary ledgers.

A financial reporting system includes methods and records that:

- Identify and record all valid transactions.
- Resolve incorrect processing of transactions.
- Provide, on a timely basis, sufficient detailed information about transactions to permit proper classification for financial reporting.
- Allow for the recording of transactions at their proper monetary value in the financial statements.
- Provide sufficient information to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

The auditor's understanding is at a high level but sufficiently detailed to identify the significant accounting applications, how information technology is used in those applications, and the relative complexity and importance of use of IT. The auditor also considers the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors.

Auditors need to be satisfied that they have a sufficient understanding of the plan's financial reporting system to understand how material misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation of the financial statements. The auditor should obtain an understanding of how the plan has responded to risks arising from IT. This typically means that when obtaining an understanding of the financial reporting system, the auditor obtains knowledge of relevant computer application controls. Application controls apply to a specific application, such as accounts payable, payroll, or the general accounting application. They apply to the processing of individual transactions and help ensure that the transactions occurred, are authorized, and are

completely and accurately recorded and processed. In a simple financial reporting system, the authors believe understanding the financial reporting system generally will involve:

- Understanding the financial close and reporting process.
- Identifying the plan's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.

The auditor usually can obtain an adequate understanding of the financial reporting system by discussing it with plan personnel and reviewing documents at the plan administrator's office. A feature of benefit plan financial reporting systems is that the accounting records are often maintained at several locations. AEBP, Paragraph 1.38, describes the following accounting records that employee benefit plans generally maintain in addition to the basic, or general, accounting records:

- Investment asset records.
- Participant records.
- Contribution records.
- Claim records.
- Distribution records.
- Individual participant account information.
- Administrative expense records.
- Reconciliations.

AEBP, Paragraph 1.37, observes that the complexity of the accounting records and who maintains them will vary depending on "the type of plan, decentralization of operations, complexity of plan provisions, and delegation of administrative functions." The accounting records may be maintained by the employer or third-party administrators and outside service organizations. These include trustees, insurance companies, consulting actuaries, service bureaus, and contract administrators. Employee payroll records, for example, that provide information used to accrue individual participants' benefits are usually maintained by the employer. The employer's payroll system is a separate system from the plan's financial reporting system, but the auditor normally has to gain an understanding of the payroll system to plan the audit of participant data and benefit obligations.

If the plan uses a third-party administrator or other outside service organization to execute transactions and maintain records on its behalf, the auditor may have to consider the third-party administrator's or service organization's internal control in addition to the internal control of the plan. The examples of services provided by service organizations that may be relevant to an employee benefit plan audit, according to AEBP, Paragraph 4.15, include maintaining accounting records, managing investments, processing investment transactions, safeguarding assets held by custodians, maintaining individual participant accounts, processing benefit payments, processing and maintaining participant loans, adjudicating and paying claims, processing payroll, processing enrollment of participants, and maintaining participant data. AEBP, Paragraph 4.16, notes that the service organizations that provide such services include bank trust departments, recordkeeping companies, claims processing companies, actuarial firms, insurance companies, and payroll processing companies.

Risk Assessment Procedures. Risk assessment procedures that are ordinarily performed to understand the financial reporting system include inquiries of plan management and others, observation of plan procedures and controls, inspection of documents and records, and tracing transactions through the system (i.e., walkthroughs). The nature and extent of the procedures performed are affected by factors such as the size of the plan, its complexity, and most certainly, the number of significant transaction classes that exist within the plan.

The existence of any internal documentation that describes classes of transactions and the transaction flow in the accounting system is a key factor that may influence the risk assessment procedures used when obtaining an

understanding of the financial reporting system. Typically, such documentation exists for larger and more complex plans and may consist of the following:

- Training manuals for employees.
- Policy and procedure manuals.
- Formal memoranda and flowcharts.
- Internal audit analyses.

When such documentation exists, the auditor's risk assessment procedures typically include inspection and review of this documentation, corroborated by inquires of various personnel to determine if the information is current, observation, and walkthroughs to verify that procedures are being followed. While the client's internal control documentation is an excellent source for understanding and evaluating the design of the financial reporting system, risk assessment procedures consisting of inquiry, observation, and inspection are necessary to ensure that the system has been implemented as designed.

However, for many small plans, the range of control and day-to-day involvement of plan management frequently makes written documentation of the processing systems unnecessary. For those plans the auditor often relies on inquiries of plan management and accounting personnel to understand the design of the financial reporting system. The auditor determines that the system as described has been implemented by performing observation and inspection procedures, such as walkthroughs.

Walkthroughs. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps from initiation to inclusion in the general ledger and the financial statements. This is commonly referred to as a "walkthrough" or "cradle-to-grave" procedure. Walkthroughs may be used to confirm information obtained by inquiry or from prior years' audits. Walkthroughs are also commonly used in gaining an understanding of related control activities.

Walkthroughs of transactions usually involve document inspection, inquiry, and observation. The auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions and related controls through the system from cradle to grave, that is, from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements. The auditor inspects the documents and accounting records used in processing, talks to the personnel involved, and observes the handling of records and related assets. At each step, the auditor does the following:

- Observes the demonstration of, or reperforms, the prescribed manual and automated processing procedure(s) or control(s).
- Identifies and examines the document(s) and IT involved.
- Identifies the name(s) and position(s) of the person(s) who perform(s) the procedure(s) or control(s) and considers the competence and understanding of the person(s) performing the procedure(s) or control(s).
- Determines whether the procedure(s) is (are) performed as prescribed and on a timely basis.
- Identifies the kinds of errors found by the client and the client's responses to correct them.
- Determines whether the person(s) has (have) been asked to override the procedures or controls.
- Identifies exceptions to the prescribed procedure(s) or control(s).

Some auditors also query individuals about the preceding or succeeding processing step or control activity as a means of obtaining corroborating information about each step in the process. In performing a walkthrough, the auditor follows the transaction through all of the processing steps in the system. A walkthrough may not be effective if a different transaction is used to test each control separately rather than walking a single transaction through the entire process or if the auditor does not use the same documents and IT that client personnel use. (However, it may be necessary to select additional transactions to verify certain processing steps that may apply for some transactions

but not for others. For example, certain of the processing steps and control activities might be different for an employer contribution versus an employee contribution.)

Communication. The auditor needs to obtain a sufficient understanding of how plan management communicates financial reporting roles and responsibilities and other significant matters. The communication process includes both internal and external elements. For example, it includes communications between plan management and employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the plan. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities within the financial reporting system and are encouraged to report any exceptions.
- Any areas where communication does not occur.

Communication is another way that plan management conveys the tone at the top. Management ought to communicate the information necessary for employees to perform their assigned tasks, for managers to supervise, and for responsible parties to make key operating and financial decisions. Communication also relates to the flow of information upstream in a plan. For upstream communication to occur, there must be open channels of communication and a willingness on the part of plan management to deal with problems. For control activities to be effective, individuals should be able to report exceptions or fraud to the appropriate levels of plan management.

When considering whether a plan has communication controls in place, auditors consider whether plan management has clearly communicated the following:

- That internal control responsibilities are a critical part of employee job duties.
- The role and responsibilities that each employee has in the internal control system.
- That unexpected events should be investigated, including determining the cause of the event.
- How job activities relate to the work of others.
- That communication from employees or participants to plan management regarding exceptions, problems, controls, potential fraud, or other issues is welcomed and expected.
- That, if an employee or participant feels that taking an issue through the normal upstream communication methods would not be effective, alternative channels of communication are available (such as a direct communication to senior management).

Risk Assessment Procedures and Factors to Consider. Communication may be written, electronic, oral, or through the direct actions and involvement of plan management. As a result, auditors often use a combination of risk assessment procedures to understand the communication process. In addition to inquiries of plan management, the auditor may consider the following types of procedures to corroborate plan management's responses and determine if the communication process as designed has been implemented:

- Inquire of employees regarding the communication that they have received regarding their duties and plan management's expectations as they relate to financial reporting.
- Review policy and procedures manuals or similar documents that have been provided to employees regarding their duties.
- Review for the existence of training materials or programs on job functions and responsibilities.
- Discuss with human resources personnel the evaluation process and how job knowledge and the performance of responsibilities are incorporated into personnel reviews.
- Inquire of the audit committee and review minutes of meetings regarding the communication between plan management and those charged with governance.

- Inquire of employees regarding how upstream financial communication is received and implemented by plan management.
- Review of whistleblower policies and inspection of documentation regarding reported instances of suspected financial improprieties.
- Inquiry and review of related documentation of how communication from external parties is processed.

Monitoring

Monitoring is a process by which a plan assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the plan. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of a plan's monitoring process include (a) ongoing and/or separate evaluations and (b) evaluation and reporting of internal control deficiencies.

Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. For example, the plan administrator may question reports that differ significantly from his or her knowledge of operations. Because these activities are performed in the normal course of business, ongoing monitoring procedures usually adapt to changing conditions and may be timely in detecting problems. Separate evaluations may involve any aspect of the plan's system of internal control such as plan management's review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function.

According to AU-C 315A.23, the auditor should obtain an understanding of the major types of activities that plan management uses to monitor internal control over financial reporting, including control activities relevant to the audit. AU-C 315A.25 further indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which plan management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. For example, plan participants, by implicitly corroborating individual participant statements, assist the plan in its monitoring.

Consideration of Internal Audit Function. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. Many small employers and their employee benefit plans do not have internal auditors. AU-C 315A.24 indicates that if the entity has an internal audit function, the auditor should obtain an understanding of the nature of the function's responsibilities, how the function fits into the organizational structure, and the activities performed or to be performed by the function.

AU-C 610 differentiates between two types of assistance provided by the internal audit function. Specifically, it addresses the external auditor's responsibilities when using the work of the internal auditor function to obtain audit evidence, and using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor. However, the authors believe it is fairly uncommon for auditors to use the assistance of internal audit in smaller employee benefit plan audits.

AU-C 240 and AU-C 315A, require auditors to inquire of appropriate individuals in the internal audit function about their understanding of the risks of error and fraud within the entity, and AU-C 240.19 goes on to require inquiry about whether the internal audit function has performed any procedures to identify or detect fraud during the year, whether management has satisfactorily responded to any findings resulting from their procedures, whether they have knowledge of any actual or suspected fraud, and whether the entity has entered into any significant unusual

transactions. The auditor ought to explain that fraud includes both misappropriation of assets and fraudulent financial reporting. The results of those inquiries should be considered when identifying risks of material misstatement due to fraud. The auditor's inquiries should be documented. See *PPC's Guide to Audits of Nonpublic Companies* for additional discussion of issues to consider when using the work of internal auditors.

Control Activities

Control activities are the policies and procedures that help ensure that plan management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the plan's ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what ought to be done and (b) the procedure that implements the policy. AU-C 315A.21 requires the auditor to obtain an understanding of control activities relevant to the audit and explains that they are those which "the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to the assessed risks."

AU-C 315A.A166 provides examples of categories of control activities that are relevant to the audit as follows:

- *Performance Reviews.* Comparisons of current financial reports to other information.
- *Information Processing.* Control activities that are performed to check accuracy, completeness, and authorization of transactions. For information processing systems, there are two broad categories of control activities—application controls and general controls.
- *Physical Controls.* Controls that pertain to the physical security of assets, including adequate safeguards that limit access to assets, authorization safeguards for access to software, including coding and files, and periodic counting and comparison of assets to control records.
- *Segregation of Duties.* The assignment of different people to authorize transactions, record transactions, and maintain custody of assets.
- *Accountability.* Controls relating to reconciliations of the detailed records to the general ledger.

Auditing standards do not require an understanding of all control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every assertion. The auditor's emphasis is on understanding control activities that allow the auditor to assess risks of *material* misstatement at the *relevant* assertion level and to design and perform further audit procedures that are responsive to those risks. Thus, after considering the control activities previously identified, the auditor evaluates whether a sufficient understanding of control activities has been obtained for those areas where the auditor considers material misstatements more likely to occur. The auditor's evaluation will be focused on significant transaction classes and accounts. The auditor may need to devote additional attention to obtaining an understanding of control activities in certain circumstances.

In obtaining an understanding of who maintains a plan's investment records and the physical location of securities, for example, the auditor is likely to become aware of control activities concerning safeguarding investments and periodic reconciliation of the investments with the accounting records. The auditor considers this knowledge about control activities in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit and in determining whether additional attention is likely to produce support for an assessed level of control risk below the maximum.

The necessity or desirability of devoting additional attention to obtaining an understanding of control activities naturally varies depending on the type of plan, whether the plan is a single-employer or multi-employer plan, whether plan provisions require sponsor or participant contributions or both, the allocation of fiduciary responsibilities, the delegation of administrative duties, the location of records and assets, and whether the plan uses a third-party administrator or outside service organization.

Most likely, the auditor will have to devote additional attention to obtaining an understanding of control activities relevant to participant data, that is, demographic and payroll data. This is always a key audit area because it affects so many other areas of the audit, for example, contributions, plan obligations, etc. Also, the volume of data and level of processing activity is usually relatively high. In contrast, although plan investments are normally significant to a

plan's financial status and are a principal income-generating asset, the auditor is likely to take a primarily substantive approach in that audit area. The same is true for the contributions area for a single-employer plan, for which a primarily substantive approach is usually more efficient. For a multiemployer plan, because of the added complexity, the auditor may devote more attention to control activities in the contributions area. The attention devoted to control activities in the payments area varies considerably depending on the circumstances. Frequently, the level of activity is extremely low and a primarily substantive approach is more efficient.

A primarily substantive approach may be more efficient in the investments area because tests of details are generally more effective than a combination of tests of controls and substantive procedures. However, the auditor ought to recognize that in some circumstances a more extensive understanding of control activities may be necessary to design effective substantive procedures. AEBP, Paragraph 11.10, points out that "custody of a plan's investments is typically entrusted to a bank, insurance entity, or a member of a national securities exchange that is responsible for their receipt, delivery, and safekeeping under a contract, commonly referred to as the *custodial agreement*." In that case, the auditor normally confirms the existence of investments with the custodian. When, however, custodial and investment advisory activities are combined in one service organization, all the information available to the auditor comes from one party, and there is an increased risk of material misstatement. Thus, the auditor needs to consider whether an understanding of control activities is necessary in the investments area to adequately identify potential misstatements and select appropriate substantive procedures. The considerations related to service organizations and internal control and their effect on audit strategy are discussed below.

Understanding Controls Related to Significant Risks

AU-C 315A.30 indicates that the auditor's understanding of internal control should include the plan's programs and controls that address risks of material misstatement that are considered *significant risks*. Fraud risks are always considered to be significant risks. Significant risks often relate to significant unusual transactions, for example, with related parties and judgmental matters, such as estimates. Programs and controls addressing fraud risks or other significant risks may relate to any of the five components of internal control; thus, the auditor needs to use care not to isolate the understanding to only the control activities component. The auditor needs to be alert to the fact that fraud risks or other significant risks may not be subject to routine controls given the nature of the risks. Also, the auditor's understanding extends to whether and how plan management responds to those risks. (Lesson 3 includes a discussion of significant risks.) Controls that address fraud risks frequently relate to the following:

a. *Control Environment.* Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities.* Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

As with other controls, the auditor evaluates whether the programs and controls that relate to significant risks are suitably designed and implemented and assesses the risks of material misstatement due to error or fraud in light of this evaluation. The existence (or lack) of these programs and controls might either mitigate or increase the risks of material misstatement.

Documentation

As previously discussed, the auditor should document the understanding of internal control, and the evaluation of design and implementation, including whether a control that addresses a fraud or significant risk is effectively designed and implemented.

If the auditor devotes additional attention to control activities because he or she believes an assessment of control risk below the maximum level is appropriate (which would permit modification of substantive procedures), the auditor will need to perform tests of controls. The performance of tests of controls and the results of those tests should be documented.

Use of the activity and entity-level control forms and the tests of controls forms is considered optional. In many cases, these forms are the most convenient means of documenting an understanding of control activities or an assessment of control risk at less than the maximum level. However, in some cases, the auditor may find it more convenient

simply to prepare a narrative memorandum that describes certain control activities the auditor believes permit an assessment of control risk at below the maximum level and the results of tests of controls that support that assessment.

Internal Controls, Service Organizations, and Audit Strategy

The variety of services that might be provided to a plan and the types of organizations that might provide such services were explained earlier in this section.

There is a tendency to think of the auditor's responsibilities related to a client's use of a service organization as limited to situations such as use of an outside data processing center, or circumstances in which it is known that a report on controls at a service organization is available. That is not the case. AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, is applicable when the services provided are relevant to the audit because those services, and controls over them, affect the user entity's information system and related business processes relevant to financial reporting, including controls over safeguarding of assets. AEBP, Paragraph 4.13, states that a service organization's services are part of a plan's information system relevant to financial reporting if they affect any of the following:

- The classes of transactions in the plan's operations that are significant to the plan's financial statements.
- The procedures, both automated (within IT) and manual, by which the plan's transactions are initiated, authorized, recorded, processed and reported from their occurrence to their inclusion in the financial statements.
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the plan's financial statements involved in initiating, authorizing, recording, processing and reporting the plan's transactions.
- How the plan's information system captures other events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the plan's financial statements including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including nonstandard journal entries to record nonrecurring, unusual transactions, or adjustments.

Whenever the audit client outsources a significant activity or business process, the auditor needs to evaluate the effect on internal control and financial reporting. AU-C 402 emphasizes the importance of obtaining an understanding of how the entity uses the services of a service organization and how those services and the activities of the service organization affect the risks of material misstatement. The procedures to obtain that understanding include specifically reading the relevant contractual terms. For example, does the agreement with a broker give discretion to the broker to initiate securities trades? The requirements emphasize obtaining a broad and deep understanding of the role of the service organization in the plan's financial reporting system and making a rigorous assessment of information about the service organization, including a probing analysis of a SOC 1 report if one is used by the user entity's auditor.

AU-C 402 is relevant when an organization such as a bank trust department invests and services assets for an employee benefit plan. Other service organizations relevant to an employee benefit plan include third-party administrators, insurance companies that process employee benefit claims, mortgage servicing agents, and data processing service centers that process transactions and related data for a plan. AU-C 402 does not apply to transactions executed by the service organization that are individually specifically authorized by the plan, such as checking and cash accounts, the investment of funds in insurance and investment contracts, and the execution of securities transactions by a broker.

Obtaining an Understanding of the Service Organization's Services and Internal Control. When a plan uses a service organization, transactions are processed through the service organization's financial reporting system and are subject to the service organization's controls. If the use of the service organization is significant to planning and

performing the audit, the auditor obtains an understanding of the plan's financial reporting system and internal controls for information produced by the service organization. The significance of the services performed by the service organization are affected by the materiality of the account balances and transaction classes affected by the services and the inherent risk associated with the financial statement assertions of those balances or classes.

The understanding of the nature of services provided by the service organization can be obtained from a variety of sources, such as—

a. User manuals.

b. System overviews.

c. Technical manuals.

d. The contract between the plan and the service organization.

e. Reports by service auditors, the internal audit function, or regulatory authorities on the information system and other controls placed in operation by the service organization.

f. Inquiring of or observing personnel at the client or at the service organization.

g. If the service organization's services and the controls over those services are highly standardized, information obtained through the auditor's prior experience with the service organization may be used.

After considering the degree of interaction between the user organization's and the service organization's controls and the available information, the auditor needs to determine whether he or she has the means to obtain a sufficient understanding of internal control to plan the audit. If there is not sufficient information to plan the audit, the auditor needs to consider contacting the service organization (through the plan) to obtain specific information or request that a service auditor be engaged to perform procedures to supply the necessary information. In the authors' experience, except for the situation described below involving some third-party administrators, a SOC 1 report is generally available for review by the plan auditor. The plan auditor ought to obtain the most recent SOC 1 report to gain an understanding of the service organization's controls.

AEBP, Paragraph 11.06, notes that due to the increased complexity of employee benefit plan investment portfolios, inherent risk in such investment portfolios has also risen. It is the plan auditor's responsibility to review the SOC 1 report and to determine whether these investments were subject to the service auditor's audit scope. If the SOC 1 report is unclear as to scope of coverage, or the plan auditor does not understand the audit scope, the plan auditor ought to consider supplementing his or her understanding by discussing with the service auditor the scope and conclusions of its work. Alternatively, the plan auditor may decide to visit the service organization and perform such procedures. If the plan auditor is unable to obtain sufficient information by one of these means, he or she would qualify or disclaim an opinion because of a scope limitation. The primary types and related scope of SOC 1 reports are discussed later in this section.

In anticipation of the needs of plan auditors and to avoid the need to respond to numerous individual auditors, a fiduciary may engage a service auditor to report on a description of the aspects of its internal control that are related to employee benefit plan accounts. This type of report is sometimes called a "single audit report" because it is prepared by one auditor for use by many other auditors. That term is not used in this course to describe such reports because of the potential confusion with the concept of single audit that applies to governmental units or nonprofit organizations that receive federal financial awards.

In the experience of the authors, some third-party administrators (TPAs) do not have SOC 1 reports available. In such cases, the plan auditor should consider aspects of the TPA's internal control that may be relevant to the plan's internal control. That is, those aspects of the TPA's internal control that directly affect the services the TPA provides the plan. Examples include the TPA's controls over modification of computer programs and involvement of internal auditors in the review of internal controls. The auditor then needs to determine the significance of the TPA's internal control on the plan's internal control. If an understanding of the TPA's internal control is necessary and a SOC 1 report is not available, the auditor needs to consider the procedures listed above or a site visit of the TPA's facility.

Assessing Control Risk. After obtaining an understanding of internal control, the plan auditor assesses control risk. If the plan auditor wants to assess control risk at below the maximum level, he or she needs to obtain evidence about the operating effectiveness of the relevant controls. These controls may exist at the plan or at the service organization. According to AU-C 402.16, when reliance on controls at the service organization is planned, the auditor should obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

- Obtaining and reading a type 2 report.
- Performing appropriate tests of controls at the service organization.
- Using another auditor to perform tests of controls at the service organization.

An important step for the auditor after obtaining a copy of a SOC 1 report is to read the entire report, including the body of the document that details the individual tests and results. Simply obtaining a copy of the report and placing it in the workpapers by no means constitutes applying sufficient audit procedures. A common finding in peer reviews of employee benefit plan audits is the auditor's failure to obtain, or properly use, a SOC 1 report. A SOC 1 report should not be the sole basis for an assessment of control risk below the maximum. Neither a type 1 nor a type 2 report is designed to provide a basis for assessing control risk sufficiently low to eliminate the need for performing any substantive tests for all of the assertions relevant to significant account balances or transaction classes.

While reading the report, the auditor focuses on the services the report covers, as well as any instances of noncompliance with controls. The procedures to be performed if instances of noncompliance are noted in the SOC 1 report are discussed later in this section. Additionally, the auditor may consider asking the plan's management whether the service organization has reported any uncorrected errors to the user organization and evaluate whether such errors will affect the nature, timing, and extent of his or her audit procedures. The auditor may need additional information from the service organization and the service auditor to make this assessment.

Obtaining an Understanding or Testing Service Organization Controls. AU-C 402.11 requires the auditor to ensure that he or she has obtained a sufficient understanding of the nature and significance of services provided by a service organization and their effect on the client's internal control to provide a basis for identifying and assessing risks of material misstatement. In some cases, the understanding obtained at the user entity may be sufficient for that purpose. That is, depending on the facts and circumstances, the auditor may not need to obtain an understanding or test the service organization's controls to assess the risk of material misstatement and plan and perform the audit. That may be, for example, because the client has effective user controls and the services provided by the service organization are generally limited to processing and recording the transactions, as contrasted to transaction initiation and authorization.

A SOC 1 report may identify user controls that the service organization's control objectives rely on. User controls are those that exist at the plan or plan sponsor level. When user controls are identified in the report, the auditor considers whether those controls are required and relevant to the services performed for the plan. If they are, the auditor performs procedures to determine if the user controls are in place and are functioning as intended.

Types of SOC Reports. A service auditor is an auditor who reports on controls at a service organization. There are a number of different types of SOC (service auditor's) reports and engagements. The primary reports that relate to obtaining an understanding of controls at a service organization that are likely to be relevant to user entities' internal control over financial reporting are as follows:

a. *Report on Management's Description of a Service Organization's System and the Suitability of the Design of Controls.* This type of report expresses an opinion on whether (1) management's description of the service organization's system fairly presents the service organization's system that was designed and implemented as of a specified date and (2) the controls related to the control objectives stated in management's description of the service organization's system were suitably designed to achieve those control objectives as of the specified date. This type of report, also known as a "type 1 report," may be helpful in providing a sufficient understanding of the service organization controls. However, this type of report has the following limitations:

(1) This type of report is not intended to provide any evidence of the operating effectiveness of controls that would support assessing control risk as either low or moderate.

(2) The report gives assurance only with respect to the control objectives specified in the description. There is no assurance that the specified objectives include all those that would be relevant to the user.

(3) The report may contain a caveat that the stated control objectives may be achieved only if the user entity applies controls contemplated in the design by the service organization. (The auditor needs to be alert to this type of caveat and determine whether the user entity has implemented the necessary procedures. For example, completeness of processing payroll transactions may depend on the user entity's validating that all payroll records sent were processed by checking a control total.)

b. *Report on Management's Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls.* This type of report expresses an opinion on whether (1) management's description of the service organization's system fairly presents the service organization's system that was designed and implemented throughout the specified period, (2) the controls related to the control objectives stated in management's description of the service organization's system were suitably designed throughout the specified period to achieve those control objectives, and (3) the controls related to the control objectives stated in management's description of the service organization's system operated effectively throughout the specified period to achieve those control objectives. In other words, it adds tests of the operating effectiveness of controls to the report on the service organization's system and design (item a) and covers a specified period rather than being as of a specified date. This type of report, also known as a "type 2 report," may be helpful in determining whether controls have been implemented and assessing control risk at either a low or moderate level when relevant controls are applied only at the service organization. This type of report is subject to the same limitations as the report on design with respect to specified control objectives [items a.(2) and a.(3)].

c. *Report on Agreed-upon Procedures.* A report on agreed-upon procedures may cover tests of controls, substantive tests, or both. If the service auditor is engaged to perform procedures at the request of the auditor of the user entity, the appropriate form of report is an agreed-upon procedures report. Agreement needs to be reached among the user entity and its auditor and the service organization and service auditor on the specific procedures to be performed. This type of report may be more effective for the user entity auditor than the more general reports on internal control because it can be directed to those policies and procedures or financial statement assertions of direct interest to the user entity's auditor in the circumstances.

AEBP, Paragraph 4.25 indicates that when determining whether the audit evidence provided by a SOC 1 report is sufficient and appropriate, the auditor should be satisfied that (a) the service auditor is competent and independent from the service organization and (b) the standards under which the report was issued are adequate. The auditor normally finds it necessary to make inquiries about the service auditor of other practitioners and the service auditor's professional organization, such as the AICPA. In addition, the auditor typically determines if the service auditor is subject to licensing requirements and peer reviews. In certain cases, the auditor might use a SOC 1 report that is issued under standards other than those established by the AICPA. For example, the service auditor may practice outside of the United States. In those instances, it is particularly important that the auditor be satisfied about the adequacy of such standards.

It is usually not necessary for a plan auditor to visit the service organization if the plan auditor determines that the service organization's controls were in place and effective. However, additional procedures or site visits may be necessary in the following situations:

a. The service auditor issued a report on controls placed in operation, and the plan auditor would like to reduce the assessed level of control risk at the service organization. In this situation, the plan auditor has the option of trying to reduce the assessed level of control risk at the service organization or performing additional procedures on the plan's financial statements. If the plan auditor determines that testing the operating effectiveness of the controls in place at the service organization is more efficient, then appropriate tests of those controls would be performed, normally at the service organization's location.

b. The SOC 1 report addresses a different period than the plan's financial statements. For example, the SOC 1 report may address the year ended September 30, and the plan's financial statements are for the year ended December 31. In this example, the plan auditor needs to determine, through inquiries of the service organization or its auditors, whether the service organization changed any of its controls during the three month period not covered by the SOC 1 report. If changes were made in the controls or if the audit period not addressed by the SOC 1 report is significant, the plan auditor needs to gain an understanding of the controls affecting the plan during that period.

c. The service organization only obtains a SOC 1 report on a rotating basis, such as once every two or three years. If the period covered by the SOC 1 report is different from the plan's reporting period, the plan auditor may obtain a preliminary understanding of controls at the service organization and extend that understanding with additional current information. In this example, the plan auditor needs to determine, through inquiries of the service organization and its auditors, whether there have been any system changes, significant changes in controls, or mergers or acquisitions that affected the services provided. If these or similar changes have occurred, the plan auditor needs to gain an understanding of the changes and their effects on controls.

d. The SOC 1 report does not cover all of the services used by the plan, or the report does not address the activities of a subservice organization provided indirectly to the plan. In this situation, the plan auditor needs to gain an understanding of those controls applicable to the plan that are not covered in the report. The procedures discussed in a. above ought to be performed if the plan auditor would like to assess control risk below the maximum. If a SOC 1 report for the subservice organization is available, the plan auditor would obtain a copy and perform the procedures discussed earlier.

e. The service organization performs multiple functions, such as acting as investment advisor and holding and servicing securities as custodian, so that all information available to the auditor on securities trading is controlled by the service organization, and there are additional risk factors, such as the service organization being controlled by dominant management without effective oversight, so that the risk of management override of controls is significant.

Additional procedures may also be necessary if the SOC 1 report notes instances in which the service organization did not comply with its controls. In this situation, the plan auditor would determine whether these instances of noncompliance affect the assessment of control risk at the service organization. If the instance of noncompliance related to a control not applicable to the plan, the plan auditor needs to apply no further procedures. However, if the instance of noncompliance related to a control directly related to the services provided to the plan, the plan auditor may need to perform additional procedures on the plan's financial statements or at the service organization.

Auditors may consider the following to determine if it is necessary to expand the scope of detailed testing when a SOC 1 report contains exceptions (only a type 2 report will have tests of controls and any resulting exceptions) or is qualified:

- Whether the exception or qualification is related to activities of the plan.
- Based on details in the SOC 1 report and inquiries of plan personnel and/or the service auditor, the nature of the exception or qualification.
- Whether the plan or service organization has performed any follow-up procedures and additional testing to address the exception or the reason for the qualification.
- Whether compensating controls exist that would mitigate the effect of the exception or qualification.

Auditors may not be able to rely on a qualified SOC 1 report or may be unable to rely on controls at the service organization if the SOC 1 report contains exceptions. Exceptions should be considered both individually and in the aggregate. Auditors should consider all relevant facts and circumstances when making that determination.

A service organization might use another independent service organization to process information. For example, a bank trust department may use an independent computer processing service to process investment transactions. In this example, the bank trust department is a service organization and the computer processing service is a

subservice organization. Plan auditors that rely on a SOC 1 report to assess a plan's control risk should be alert to such arrangements and may need to consider controls at both the service organization and the subservice organization. If such an agreement exists, the auditor needs to obtain an understanding of the how the relationship between the service providers affects the plan's internal control. Consideration ought to be given to the significance of the relationship between the providers (i.e., what type of transactions occur between the providers and how material are they to the plan?). If services relevant to the audit of the plan's financial statements are provided by a subservice organization and are excluded or carved out from the SOC 1 report, the plan auditor should apply the requirements in AU-C 402 to the services provided by the subservice organization. It may be necessary to obtain and evaluate more than one SOC 1 report from a single service organization. For example, trust department services and recordkeeping services may be in separate reports. IT general controls or activities may also be covered in a separate report.

The plan auditor should not make reference to the report of the service auditor as a basis, in part, for the opinion on the plan financial statements. The service auditor is not responsible for examining any portion of the plan financial statements. Even when a service auditor performs substantive tests, the decisions on the nature, timing, and extent of those procedures are not made by the service auditor.

COVID-19 Considerations for Internal Control

An auditor needs to determine how senior management and those charged with governance responded to the changes in operations and controls necessitated by COVID-19 travel restrictions, work stoppages, or stay-at-home orders. Were adequate new policies and procedures adopted to maintain the reliability of financial information during periods of remote working and reduced work force? Were personnel that were assigned new or additional control-related responsibilities trained sufficiently and provided appropriate technology and related support to perform control duties effectively? How did management identify, assess, and communicate new business risks and the related effects on risks of material misstatement? How did management monitor operations and controls during periods of remote working or reduced work force?

An auditor may use inquiry, observation, and inspection of documents to obtain an understanding of internal control. Through video conferences with personnel, when face-to-face interviews are not possible, an auditor may inquire about the institution of new policies and procedures and how compliance was monitored. For key controls, such as system access controls, an auditor may be able to observe attempts of unauthorized access. An auditor may inspect new policy and procedure manuals, training materials, and reports used by management to monitor operations and controls, including remedial actions taken in response to noncompliance. In evaluating the design and implementation of controls, auditors need to keep in mind that well-designed control activities may not operate effectively unless the control environment is effective.

An auditor needs to consider the effects of the travel restrictions, stay-at-home orders, layoffs, furloughs, and illnesses during the financial-statement and audit period on control activities. Breakdowns in control may have occurred as a result of personnel being assigned unfamiliar processing responsibilities for which they are not prepared by training or experience. There may have been too few personnel to have an adequate segregation of duties. As previously discussed, control breakdowns may have created increased opportunities for both fraudulent financial reporting and misappropriation of assets. The time period of interest extends beyond the financial-statement period because of the critical importance of the financial reporting and close process to reliable financial reporting. Breakdowns in preventive controls, such as segregation of duties, may have occurred during the period, but careful attention to the financial reporting and close process after year end may compensate for these control deficiencies.

The authors believe walkthroughs are an effective procedure for obtaining an understanding of the design and implementation of activity-level controls. The conditions observed in walkthroughs in prior years are likely to be of little to no use for the current year. Thus, more audit effort on walkthroughs will generally be appropriate even though circumstances caused by COVID-19 may make them more difficult if the entity has not reopened. A video conference of all the personnel involved in the processing of a significant transaction class might be useful. The video conference might also involve screen sharing of the documents and reports involved in processing. If some entity personnel are on site, but circumstances preclude the presence of audit team members, an entity employee might use a camera or carry a laptop through the process with an auditor observing and making inquiries.

Walkthroughs may also facilitate corroborative inquiries in which responses of those interviewed may be compared. In that case, a video conference might be conducted separately with key people involved in processing.

If an auditor has in the past used a SOC 1 report from a service organization, such a report may be delayed or unavailable. An auditor may ask management to contact the service organization and inquire about the availability of relevant information.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. How might a plan's information technology (IT) affect the auditor's understanding of internal control?
    a. Information processing will likely be centralized for lower risk.
    b. The effect of IT is typically based on the size of the plan.
    c. An understanding of more than just a software package may be needed.
    d. The plan's response to risks affects the control environment element of internal control.
12. The overall attitude, awareness, and actions of a plan administrator about the importance of internal control is part of what component of internal control?
    a. Control activities.
    b. Control environment.
    c. Monitoring.
    d. Risk assessment.
13. An employee benefit plan's financial reporting system comes under what component of internal control?
    a. Control activities.
    b. Communication.
    c. Information.
    d. Risk assessment.
14. Effective monitoring does which of the following?
    a. Ensures that internal controls are modified annually.
    b. Consists solely of separate evaluations.
    c. Is comprised of a variety of activities.
    d. Excludes the internal audit function.
15. An auditor's understanding of the controls related to significant risks includes which of the following?
    a. All fraud risks.
    b. Risks related to routine transactions.
    c. Control activities.
    d. The application of routine controls.

16. A service organization's services are considered part of a plan's information system relevant to financial reporting if they affect any of the following **except:**

    a. Any classes of transactions that are included in the financial statements.

    b. Automated transaction initiation or authorization procedures.

    c. Controls related to journal entries.

    d. The financial reporting process used to prepare the financial statements.

17. Which of the following is a characteristic of a type 1 service auditor's (SOC) report?

    a. It provides enough evidence on the operating effectiveness of controls to allow auditors to assess control risk as moderate or low.

    b. It provides assurance on all of the control objectives at the service organization that may be relevant to a plan's audit.

    c. It covers tests of controls, substantive tests, or both, depending on what was agreed upon by the service auditor and the organization.

    d. It expresses an opinion on whether management's description fairly presents the service organization's system as of a specific date.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

11. How might a plan's information technology (IT) affect the auditor's understanding of internal control? **(Page 67)**

    a. Information processing will likely be centralized for lower risk. [This answer is incorrect. In many IT environments, the processing of information is often *decentralized*. For example, in a "server-client" arrangement, a central server hosts various clients and processing occurs both centrally on the server and remotely by various clients. These environments can present a higher element of risk given a wider range of access to data and processing by a variety of users.]

    b. The effect of IT is typically based on the size of the plan. [This answer is incorrect. AU-C 315A indicates that auditors should consider how IT affects a plan's control activities. The effects can be extensive, but the effect on the client's internal control is related more to the nature and complexity of the system than to the client's size.]

    c. **An understanding of more than just a software package may be needed. [This answer is correct. While information systems may use off-the-shelf software packages or custom-developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.]**

    d. The plan's response to risks affects the control environment element of internal control. [This answer is incorrect. AU-C 315A.22 indicates that in understanding the entity's control activities (not the control environment), the auditor should obtain an understanding of how the entity has responded to risks arising from IT. Relevant controls include both properly designed and implemented application controls and the general controls upon which the application controls depend.]

12. The overall attitude, awareness, and actions of a plan administrator about the importance of internal control is part of what component of internal control? **(Page 70)**

    a. Control activities. [This answer is incorrect. *Control activities* are the policies and procedures that help ensure that plan management directives are carried out. This is a different concept and does not fit in with the element of internal control described above.]

    b. **Control environment. [This answer is correct. The *control environment* of an employee benefit plan includes the overall attitude, awareness, and actions of the plan administrator and those charged with governance concerning the importance of control and its emphasis in plan operations. The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable financial reporting.]**

    c. Monitoring. [This answer is incorrect. *Monitoring* is a process by which a plan assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. This is a different element of internal control from the one discussed above.]

    d. Risk assessment. [This answer is incorrect. *Risk assessment* for financial reporting purposes refers to the plan's identification, analysis, and management of the risks of material misstatement of the financial statements. The items discussed above fall under the auspices of a different element of internal control.]

13. An employee benefit plan's financial reporting system comes under what component of internal control? **(Page 72)**

    a. Control activities. [This answer is incorrect. *Control activities* are those actions that are taken to address risks that threaten the plan's ability to achieve its objectives, one of which is reliable financial reporting. However, the financial reporting system as a whole falls under one of the other components of internal control outlined in the COSO Framework.]

    b. Communication. [This answer is incorrect. *Communication* is the process of providing an understanding of the roles and responsibilities to individuals within the plan regarding internal control over financial reporting. The financial reporting system as a whole is covered by a different component.]

    c. **Information. [This answer is correct. *Information* refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the plan's transactions. It also includes the accountability over the plan's net assets.]**

    d. Risk assessment. [This answer is incorrect. *Risk assessment* can be described as identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements. This does not include the financial reporting system as a whole.]

14. Effective monitoring does which of the following? **(Page 77)**

    a. Ensures that internal controls are modified annually. [This answer is incorrect. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the plan.]

    b. Consists solely of separate evaluations. [This answer is incorrect. Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. Separate evaluations may involve any aspect of the plan's system of internal control such as plan management's review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function.]

    c. **Is comprised of a variety of activities. [This answer is correct. Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. For example, plan participants, by implicitly corroborating individual participant statements, assist the plan in its monitoring.]**

    d. Excludes the internal audit function. [This answer is incorrect. One method some entities use to monitor internal control is through separate evaluations by the internal audit function. AU-C 315A.24 indicates that if the entity has an internal audit function, the auditor should obtain an understanding of the nature of the function's responsibilities, how the function fits into the organizational structure, and the activities performed or to be performed by the function.]

15. An auditor's understanding of the controls related to significant risks includes which of the following? **(Page 79)**

    a. **All fraud risks. [This answer is correct. AU-C 315A.30 indicates that the auditor's understanding of internal control should include the plan's programs and controls that address risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks.]**

    b. Risks related to routine transactions. [This answer is incorrect. Significant risks often relate to significant unusual transactions, for example, with related parties and judgmental matters, such as estimates. They are less likely to be related to routine transactions.]

    c. Control activities. [This answer is incorrect. Programs and controls addressing significant risks may relate to *any* of the five components of internal control; thus, the auditor needs to use care not to isolate the understanding to only the control activities component.]

d. The application of routine controls. [This answer is incorrect. The auditor needs to be alert to the fact that significant risks may *not* be subject to routine controls given the nature of the risks. Also, the auditor's understanding extends to whether and how plan management responds to those risks.]

16. A service organization's services are considered part of a plan's information system relevant to financial reporting if they affect any of the following **except: (Page 80)**

    a. **Any classes of transactions that are included in the financial statements. [This answer is correct. AEBP, Paragraph 4.13, states that a service organization's services are part of a plan's information system relevant to financial reporting if they affect any of a certain list of items. One of those items is classes of transactions in the plan's operations that are *significant* to the plan's financial statements. Merely affecting any transaction class is not enough to put the services in this category.]**

    b. Automated transaction initiation or authorization procedures. [This answer is incorrect. Per AEBP, Paragraph 4.13, a service organization's services are considered part of the plan's information system relevant to financial reporting if they affect the procedures, both automated (within IT) and manual, by which the plan's transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements.]

    c. Controls related to journal entries. [This answer is incorrect. As discussed in AEBP, Paragraph 4.13, a service organization's services are part of a plan's information system relevant to financial reporting if they affect the controls surrounding journal entries, including nonstandard journal entries to record nonrecurring, unusual transactions, or adjustment.]

    d. The financial reporting process used to prepare the financial statements. [This answer is incorrect. If the service organization's services affect the financial reporting process used to prepare the plan's financial statements including significant accounting estimates and disclosures, they are considered part of the plan's information system relevant to financial reporting, per AEBP, Paragraph 4.13.]

17. Which of the following is a characteristic of a type 1 service auditor's (SOC) report? **(Page 82)**

    a. It provides enough evidence on the operating effectiveness of controls to allow auditors to assess control risk as moderate or low. [This answer is incorrect. This type of report is *not* intended to provide any evidence of the operating effectiveness of controls that would support assessing control risk as either low or moderate.]

    b. It provides assurance on all of the control objectives at the service organization that may be relevant to a plan's audit. [This answer is incorrect. This type of report gives assurance only with respect to the control objectives specified in the description. There is *no* assurance that the specified objectives include all those that would be relevant to the user.]

    c. It covers tests of controls, substantive tests, or both, depending on what was agreed upon by the service auditor and the organization. [This answer is incorrect. A report on agreed-upon procedures (not a type 1 report) may cover tests of controls, substantive tests, or both. If the service auditor is engaged to perform procedures at the request of the auditor of the user entity, the appropriate form of report is an agreed-upon procedures report.]

    d. **It expresses an opinion on whether management's description fairly presents the service organization's system as of a specific date. [This answer is correct. This type of report expresses an opinion on whether (1) management's description of the service organization's system fairly presents the service organization's system that was designed and implemented as of a specified date and (2) the controls related to the control objectives stated in management's description of the service organization's system were suitably designed to achieve those control objectives as of the specified date.]**

Lesson 3: Audit Planning Decisions and Judgments and Other Topics Related to Pre-engagement Activities and Audit Planning

INTRODUCTION

Lesson 3 takes a look at more pre-engagement activities and audit planning procedures that are necessary for employee benefit plan audits. First, it discusses the various audit planning decisions and judgments that auditors may need to make in these types of engagements. Then, it covers several other related topics including timing and coordination, audit sampling, detailed audit plans and workpapers, and initial engagements.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the audit planning decisions and judgments necessary in an employee benefit plan audit.
- Determine the best methods for dealing with issues such as audit sampling, detailed audit plans and workpapers, and initial engagements.

MAKING AUDIT PLANNING DECISIONS AND JUDGMENTS

The information the auditor obtains about the plan and its environment by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments based on this information are as follows:

a. The materiality level for the financial statements taken as a whole (preliminary planning materiality).

b. Materiality for particular items of lesser amounts than planning materiality.

c. The risks of material misstatement at the financial statement level.

d. The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).

e. Performance materiality at the individual class of transactions, account balance, or disclosure level.

f. Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.

g. The specific nature, timing, and extent of further audit procedures.

Because the audit planning process is iterative and continuous, some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

Determining Materiality at the Financial Statement Level

According to AU-C 320.10, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements. The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. These

two perspectives of the concept are usually referred to in practice as (a) *planning materiality* and (b) *evaluation materiality*.

Understanding the similarities and differences between planning materiality and evaluation materiality provides helpful background for making materiality decisions and judgments. AU-C 320.06 explains that planning materiality is not necessarily the amount below which uncorrected misstatements, individually or in the aggregate, will be evaluated as immaterial. Because of surrounding circumstances, the auditor may evaluate an amount as material even if it is below planning materiality. AU-C 320.06 observes that it is not practical to design audit procedures to detect misstatements that could be material solely because of their nature (qualitative considerations), but when evaluating the effect of uncorrected misstatements on the financial statements, the auditor considers not only the size but also the nature of uncorrected misstatements and the particular circumstances of their occurrence. The consideration of the nature of the misstatement may be particularly important for matters of disclosure. The implication of these matters explained in AU-C 320 is that determination of planning materiality is primarily a quantitative consideration, even though qualitative considerations influence evaluation decisions and judgments significantly.

Establishing Planning Materiality. The auditor's determination of materiality, according to AU-C 320.04, is a matter of professional judgement and is affected by the auditor's perception of the financial information needs of users of the financial statements. AU-C 200.07 observes that generally misstatements or omissions are viewed as material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. AU-C 320 does not adopt or provide a specific definition of materiality. AU-C 320.02 refers the auditor to the discussion of materiality in the financial reporting framework applicable to the preparation and fair presentation of the financial statements under audit.

If the financial reporting framework is GAAP, for example, then the pronouncements of the FASB would provide a frame of reference for making materiality decisions and judgments. For GAAP, the conceptual touchstone for determining materiality is the following discussion of the concept from the nonauthoritative FASB Statement of Financial Accounting Concepts (SFAC) No. 8, *Conceptual Framework for Financial Reporting—Chapter 3, "Qualitative Characteristics of Useful Financial Information:"*

> Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

SFAC No. 8 also states that the magnitude of an item by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, generally is not a sufficient basis for a materiality judgment. In other words, materiality judgments always involve consideration of both quantitative factors (the magnitude of the item) and qualitative factors (the nature of the item and the surrounding circumstances). In establishing planning materiality, however, the primary focus is on quantitative factors, and auditors have historically used common rules of thumb for that purpose.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A6 suggests the following factors that may affect the identification of an appropriate benchmark:

- Elements of the financial statements.
- Focus of financial statement users' attention on particular items (for evaluating financial performance, for example, net assets).
- Nature of the entity and the industry and economic environment in which it operates.
- Relative volatility of the benchmark.

The appropriateness of a benchmark and the related appropriate percentage vary with the circumstances. For an employee benefit plan, 0.5–2.0% of total (or net) plan assets might be an appropriate rule of thumb. Many auditing firms prefer to use an approach to planning materiality that allows the firm to establish planning materiality as a

matter of firm-wide policy to achieve consistency in application and year-to-year stability and predictability in audit approach. To achieve these objectives, the firm may preselect the benchmark and percentage to be used across all of the firm's audits.

Desirability of a Single Benchmark. The desirability of a single benchmark arises from the practical requirements of audit planning. To understand the use of materiality in planning, it is helpful to contrast planning with evaluation. When the auditor is evaluating the materiality of misstatements at the conclusion of the audit, different materiality levels may be used for different financial statements. In planning, however, the auditor does not know in advance whether the misstatements that will be detected by a particular audit procedure will affect the statement of net assets, statement of changes in net assets, or both statements. Thus, using several levels of materiality is impractical in planning. Also, the auditor ought to use a specific amount in making decisions about the scope of a test; for example, examine all cash disbursements in the subsequent period above a specific dollar amount. A range is not useful for making scope decisions but may be helpful in evaluation; for example, deciding that in particular circumstances an error over $10,000 is material, an error under $5,000 is immaterial, and an error between $5,000 and $10,000 may be material. That type of guide can be useful in evaluation, but it does not work well in planning. The auditor needs to decide whether an audit test must be extensive enough to detect misstatements over $5,000 or over $10,000.

AEBP, Paragraph 3.09, indicates benchmarks for employee benefit plans may include the following:

- Total assets.
- Total additions.
- Changes in net assets available for benefits.
- Net assets available for benefits.
- Net assets available for benefits at the beginning of the year when a plan has been merged out of existence or completely terminated during the audit period.
- Benefit payments for a terminating plan.
- Total plan contributions or total benefits paid for health and welfare plans that do not accumulate assets.
- Allocated net assets or outstanding loan balances for an ESOP with negative net assets available for benefits.

The Note at AEBP, Paragraph 3.09 observes that for defined benefit plans and defined contribution plans, total assets are often used as a benchmark and that, for a health and welfare plan, contributions or benefits paid are often used because such plans have few assets.

Recommended Benchmark. The authors' recommended approach for determining an amount material to the financial statements for planning purposes for an employee benefit plan is to use either total (or net) plan assets or total additions to plan assets as the benchmark. This benchmark has the advantages of relative stability, predictability, and representativeness of plan size. Using these criteria, total (or net) plan assets or total additions to plan assets often provides a sound benchmark. Nevertheless, the auditor needs to identify whether there are financial statement items on which, for the particular plan, users' attention tends to be focused. If a financial statement item is more important to users than total additions to plan assets or total (or net) plan assets, then the auditor ought to estimate the planning materiality amount using that financial statement element as the benchmark. Regardless of the benchmark used for planning the extent of audit testing, the auditor ought to be satisfied that the combined effects of the nature, timing, and extent of planned procedures will be adequate to obtain reasonable assurance that the financial statements are free from material misstatement, even if a different materiality benchmark is used for evaluation of audit differences.

It is important to note that a planning materiality benchmark is used primarily to plan the extent of audit testing, but does not necessarily purport to provide a basis for determining the adequacy of other aspects of audit planning; namely, the nature and timing of procedures. Also, the choice of a benchmark for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit.

Selecting a Percentage. There are no authoritative percentage guides for materiality. AU-C 320.A10 explains that a relationship exists between the percentage and the chosen benchmark. AU-C 320, however, contains no guidance or specific examples of appropriate percentages. Nevertheless, certain guidelines have evolved in audit practice. Using total (or net) plan assets or total additions to plan assets as a benchmark means the audit scope will be driven by the size of the plan. Many auditors believe intuitively that this is appropriate because it agrees with their own past experience in making judgments about audit scope. Also, for intuitive reasons, many auditors believe that the materiality percentage should be adjusted in relation to the size of a plan. They believe the percentage should be larger for a very small plan to recognize the practical limits on the effectiveness of audit procedures and smaller for a very large plan to recognize the increased risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material. *PPC's Guide to Audits of Employee Benefit Plans* provides a sliding scale that can be applied to total (or net) plan assets or total additions to plan assets that should be suitable for the circumstances of the typical nonpublic plan.

PPC's Guide to Audits of Employee Benefit Plans also provides a rule of thumb that may produce a realistic amount for the preliminary judgment about materiality. The reduction of the percentages as the benchmark amount increases serves to prevent the planning materiality amount from becoming disproportionately large in relation to the statement of changes in net assets. The auditor, however, needs to exercise judgment and use the recommended rule of thumb as a tool rather than a rigid requirement. The auditor's judgment about the client and its circumstances and uses of financial statements may in some cases result in modification of the planning materiality amount calculated by a rule of thumb. Or, as indicated above, a rule of thumb of 0.5%–2.0% of total (or net) assets may also be used.

Planning materiality decisions need to be reconsidered as the audit progresses. Because the calculation made during initial planning often uses unadjusted financial information, the amounts in the annual audited financial statements might differ. AU-C 320.12 states that the auditor should revise materiality levels if the auditor becomes aware of information during the audit that would have caused the auditor to determine a different amount(s) initially. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments are made. AU-C 320.13 indicates that if the auditor concludes a lower materiality than initially determined is appropriate, the auditor should determine whether performance materiality has to be revised and whether the nature, timing, and extent of further audit procedures remain appropriate. If planning materiality based on unadjusted amounts is too large, then audit scope might not have been sufficient. If planning materiality based on unadjusted amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Materiality for Particular Items of Lesser Amounts

AU-C 320.10 indicates that in addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular classes of transactions, account balances, or disclosures of lesser amounts than planning materiality would influence the judgement made by a reasonable user. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor determines whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. Many auditors believe, for example, that a lower materiality threshold is appropriate for related party transactions and balances.

AU-C 320.A13 suggests factors such as the following to consider in making this planning decision:

a. Whether accounting standards, laws, or regulations affect users' expectations regarding the measurement or disclosure of certain items.

b. The key disclosures in relation to the industry and the environment in which the entity operates.

c. Whether attention is focused on the financial performance of a particular aspect of the entity's business that is separately disclosed in the financial statements.

The auditor might consult with management and those charged with governance about whether there are particular financial statement items of lesser amounts than planning materiality that users would regard as material. Lower levels of materiality for particular items in the financial statements should be documented.

Determining Performance Materiality

The auditor's objective is to perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. For this purpose, the auditor needs to establish performance materiality amount(s) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Performance materiality is distinguishable from tolerable misstatement. As explained in AU-C 320.A3, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality. *Performance materiality* is materiality at the account balance or transaction class level. *Tolerable misstatement* is materiality at the test or procedure level for a specific account balance or transaction class when that procedure or test is applied using audit sampling.

AU-C 320.A15 explains that determination of performance materiality is not a simple mechanical calculation. It involves the exercise of professional judgment and is affected by the following:

- The auditor's understanding of the entity.
- Any need for revision identified in the performance of risk assessment procedures.
- The nature and extent of misstatements identified in previous audits.
- The auditor's expectations regarding misstatements in the current period.

The authors believe it is also helpful to consider the following:

- Performance materiality is a planning concept.
- Performance materiality is less than planning materiality.
- Performance materiality relates to the materiality level for a particular class of transactions, account balance, or disclosure.
- Performance materiality is set in a manner that reduces to an appropriately low level the probability that the aggregate of *uncorrected and undetected* misstatements exceeds the materiality level for the particular class of transactions, account balance, or disclosure.

A Practical Approach to Determining Performance Materiality. Professional standards do not discuss precisely how performance materiality is to be determined. At the conclusion of the audit, the auditor needs to be able to reach the judgment that the risk is relatively low that the financial statements as a whole are materially misstated. This ultimate objective can provide a general conceptual framework for determining performance materiality.

Conceptually, the aggregate of misstatements for a particular class of transactions, account balance, or disclosure, which consists of detected but uncorrected misstatements and undetected misstatements, cannot exceed the amount for that class, balance, or disclosure that would materially misstate the financial statements as a whole. The aggregate amount for the financial statements as a whole at the planning stage of the audit is planning materiality.

Thus, the residual of planning materiality less aggregate detected and uncorrected misstatement would be performance materiality, which in this framework is an allowance for undetected misstatement. The uncorrected misstatement is the aggregation of factual misstatement plus projected and judgmental misstatement from the application of audit procedures using audit sampling and analytical procedures, respectively, less the misstatement the client agrees to correct.

At the planning stage, the auditor cannot know the amounts of *factual misstatements* that will be detected and that the client will not correct, or the *projected or judgmental misstatements* that will result from the application of audit procedures using audit sampling or analytical procedures. However, the auditor may be able to make reasonable estimates of those amounts. In that case, the auditor could deduct the sum of those estimates from planning materiality to estimate performance materiality. However, because of the difficulty of making these estimates, many auditors prefer to use a rule of thumb approach that produces satisfactory results in most circumstances as discussed in the following paragraph.

The approach suggested by the authors using the framework described above is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases.

The 50% guideline is based on the maximum adjustment normally made in monetary unit (MUS) sampling application to allow for the projected misstatements expected in sample results. Usually this 50% adjustment is conservative, that is, the extent of testing will be greater than necessary. Typically, for the plans of most nonpublic entities the authors believe that the larger adjustment of 75% will be satisfactory. When the auditor expects a relatively large amount of factual misstatements to remain uncorrected or relatively large judgmental or projected misstatements, an adjustment closer to 50% is necessary. Although this rule of thumb was developed for sampling applications, the authors believe that it is also useful and produces appropriate results for audit areas for which a nonsampling audit approach is used. This is true, in large part, because the performance materiality amount is a planning tool used to determine that adequate audit work is performed to achieve audit objectives and not an amount used to evaluate whether the misstatement of a particular class, balance, or disclosure is material.

In contrast to this general approach, performance materiality in an employee benefit plan engagement is often equal to planning materiality because all misstatements detected during the audit are generally corrected. That is, uncorrected misstatement is zero and sampling is rarely used for substantive tests of transactions or balances, so projected misstatement is negligible. All misstatements are likely to be corrected because of the DOL's potential enforcement action against the plan for failing to properly calculate and maintain individual participant accounts in a defined contribution plan. Uncorrected misstatements, even if immaterial to the plan, could lead to incorrect calculations of income accruals and distributions at the participant level. If the misstatements are detected by the DOL during an audit, the plan could be required to pay additional benefits and possibly fines. Also, any differences between Form 5500 and the audited financial statements need to be reported. Thus, the fiduciary responsibilities generally lead plan management to be conservative and all detected misstatements are normally corrected. The use of audit sampling in the audit of a plan's financial statements is explained later in this lesson.

A concept closely related to performance materiality is individually significant items. This term encompasses two types of items in a financial statement component. These include:

a. Unusual items (that is, items that have audit significance by their nature).

b. Individually significant dollar items.

Generally, when performing tests of details, the auditor might typically examine at least all items that equal or exceed performance materiality. Accordingly, the cutoff amount for determining individually significant dollar items generally should not exceed performance materiality. As a rule of thumb, the auditor may use one-third of performance materiality as the cutoff for individually significant dollar items. However, the auditor may choose any lesser amount to limit the remaining balance to an amount that reduces the risk of material misstatement to an acceptable level. In

an employee benefit plan engagement, the concept of individually significant items is usually a more important driver of audit scope than the concept of performance materiality.

COVID-19 Considerations—Materiality

Several aspects of establishing planning materiality may change as a result of COVID-19 considerations. Selecting a benchmark and related percentage may be affected because different elements of the financial statements may have more influence on users as a result of COVID-19. There may have been significant changes in the current period in the economy or industry, and the plan's financial position and operating results and conditions. An auditor needs to evaluate how the changes caused by COVID-19 are likely to influence the benchmarks and related percentages from the perspective of users of the plan's financial statements. As noted in AU-C 320.A7, when there are unusual increases or decreases in a benchmark, an auditor may conclude that a normalized benchmark based on amounts in prior periods is more appropriate. If COVID-19 has caused unusual increases or decreases in the typical benchmark, such as net assets available for benefits, an auditor may consider the average net assets available for benefits over the last three years to be a more appropriate benchmark.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

AU-C 315A.03 observes that the auditor's objective is to identify and assess the risks of material misstatement, whether due to error or fraud, at both the financial statement and relevant assertion levels. These risks are identified and assessed by obtaining an understanding of the plan and its environment including its internal control, and this understanding provides a basis for designing and implementing responses to the assessed risks of material misstatement. AU-C 315A.26 specifically requires the auditor to identify and assess risks of material misstatement at both the (a) financial statement level, and (b) for classes of transactions, account balances, and disclosures at the relevant assertion level. AU-C 315A.27b requires that, for this purpose, the auditor should assess the identified risks and evaluate whether they relate more pervasively to the financial statements and potentially affect many assertions.

The Nature of Risks at the Financial Statement Level

Risks of material misstatement at the financial statement level often relate to the plan's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. These overall risks are often especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through plan management override of internal control. Risks at the financial statement level might also relate to the process of preparing the financial statements, the selection and application of significant accounting policies, entity-level controls other than the control environment, and IT general controls. As with risks at the assertion level, the auditor needs to relate identified risks at the financial statement level to what can go wrong in preparing the financial statements.

At the individual account balance, class of transaction, or disclosure level, the risk of material misstatement consists of inherent risk and control risk. Some auditors have questioned whether these risk model components also need to be considered at the financial statement level. The answer is, "No." The authors believe the risk assessment at the financial statement level is directed to an overall or combined assessment of the risk of material misstatement. There is no requirement to separately assess inherent risk and control risk at the financial statement level. The overall assessment of risk of material misstatement at the financial statement level is made relatively early in audit planning, based on information such as the effectiveness of the plan's control environment and identification of fraud risk factors.

Responding to Risks at the Financial Statement Level

AU-C 330.05 requires that the auditor design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include—

- Emphasizing to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills or using specialists.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

To introduce an element of unpredictability, the authors believe the auditor needs to avoid always selecting only items above a cutoff dollar amount, particularly when that cutoff amount does not vary significantly from year to year. The auditor can make a haphazard selection to test items below the cutoff amount to avoid providing client personnel with a roadmap of how to circumvent the audit approach.

Because there is a risk of management override of controls, AU-C 240.29 states that certain overall responses are required in every audit, as follows:

- Auditors should consider the knowledge, skill, and ability of individual engagement team members and the fraud risk assessment when assigning and supervising personnel.
- Auditors should evaluate the client's selection and application of accounting principles, especially in subjective areas.
- Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks.

AU-C 200.19 notes that auditors should perform their audits to reduce audit risk to an acceptably low level. The auditor's consideration of audit risk at the individual account balance, transaction class, or disclosure level directly assists the auditor in determining the nature, timing, and extent of further audit procedures for relevant assertions related to balances, classes of transactions, or disclosures. Before considering how to assess the risk of material misstatement at the assertion level the auditor needs to understand several basic concepts, including:

- The audit risk model;
- The risk of material misstatement;
- Relevant assertions.

The Audit Risk Model

AU-C 200.14 explains that audit risk is a function of the risks of material misstatement and detection risk. AU-C 200.14 defines these terms as follows:

- *Risk of Material Misstatement*—The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:

- - *Inherent Risk*—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
  - *Control Risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- *Detection Risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

The way the auditor considers these component risks and combines them involves professional judgment and depends on the auditor's approach or methodology.

The audit risk model can be expressed in formula form using the following symbols:

- RMM—Risk of Material Misstatement
- IR—Inherent Risk
- CR—Control Risk
- DR—Detection Risk

DR is determined by the effectiveness of the nature, timing, and extent of substantive procedures applied and is composed of the following two components:

- TD—Tests of Details Risk
- AP—Substantive Analytical Procedures Risk

The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor.

Risk of Material Misstatement

The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

$$RMM = IR \times CR$$

The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks affect both inherent and control risk. Therefore, the auditor's assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud.

Inherent risk and control risk are the plan's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor may make an overall, or combined, assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. In either approach, the AICPA Risk Assessment Audit Guide (Paragraph 5.22) cautions the auditor to assess both components.

At the relevant assertion level, the audit risk model is as follows:

$$AR = RMM \times DR, \text{ where } DR = TD \times AP$$

The greater the risks of material misstatement, the less detection risk that can be accepted, and, as a result, the auditor would need to obtain more persuasive audit evidence.

In planning a particular test of details, the detection risk is established by the following relationship:

$$TD = \frac{AR}{RMM \times AP}$$

This model is not intended to be a mathematical formula including all factors that influence the substantive procedures planned and performed. For example, AU-C 330.18 requires that no matter what the assessed risks of material misstatement are, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balances, and disclosures. Further, AU-C 315A.05 indicates that risk assessment procedures, by themselves, do not provide sufficient appropriate evidence on which to base an opinion. Thus, inherent risk or control risk cannot be assessed at a level so low that detection risk calculated using the formula would be maximum, or 100%, resulting in no substantive procedures.

AEBP, Paragraph 2.82, notes that areas with particular risks of material misstatement in audits of employee benefit plans are (a) fair value of investments, (b) new types of investments, (c) benefit amounts requiring complex calculations, (d) transactions initiated by telephone or electronic means (such as the Internet or Intranet), and (e) the basis for calculating employer and employee contributions.

Relevant Assertions

AU-C 315A.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." Determination of whether an assertion is relevant is made without regard to the effect of internal controls. A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for doubtful accounts.

AU-C 315A.A137 indicates that for each significant class of transactions, account balance, and disclosure, the auditor determines the relevance of each financial statement assertion. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the plan processes and controls information supporting the assertions.

By determining the relevance of assertions for an account balance, class of transactions, or disclosure and how identified risks relate to them, the auditor can effectively design and link further audit procedures that are responsive to the assessment of the risk of material misstatement.

When designing and performing audit procedures, AU-C 703.20 indicates the auditor should consider relevant plan provisions that affect the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures.

Assessing the Risks of Material Misstatement at the Relevant Assertion Level

The risks of material misstatement may be assessed in quantitative or qualitative terms. The assessment at the relevant assertion level, whether made in quantitative terms (e.g., percentages) or nonquantitative terms (e.g., high, moderate, or low), is a judgment rather than a precise measurement of risk. The auditor needs an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the plan and its environment.

The only time that specific percentages are necessary is when statistical sampling is used, but the formula depicts directional relationships among audit risk, risks of material misstatement, and detection risk that are valid and useful

in responding to assessed risks of material misstatement. The auditor can determine an acceptable audit risk and subjectively quantify his or her judgment of the risk of material misstatement (consisting of inherent risk and control risk), and the risk that substantive analytical procedures and other relevant substantive procedures would fail to detect misstatements that could occur in an assertion.

The auditor's determination of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation. Whether quantitative or qualitative, the auditor's assessment of risks at the relevant assertion level is a judgment rather than a precise measurement of risk.

AEBP, Paragraph 3.06, indicates an employee benefit plan may include the following risks of material misstatement at the assertion level:

- Valuation of investments, especially those with unobservable inputs.
- Accounting and disclosure of investments specific to plans, such as insurance products, stable value products, derivatives, and securities lending.
- Accuracy of contribution and benefit payment amounts.
- Whether claims paid or denied are consistent with plan provisions.
- Accuracy and completeness of census data the actuary used to determine benefit obligations.
- Accuracy and completeness of transactions initiated by telephone or electronic means, such as the internet or an intranet.
- Accuracy and completeness of the obligation for claims incurred but not reported.
- Accuracy and completeness of opening balances in initial audits and reaudits and record availability.
- Accuracy and completeness of participant data.
- Availability of appropriate service organization reports.
- Appropriate disclosure of related party and party in interest transactions.
- For single employer health and welfare benefit plans, accuracy, completeness, and consistency of activity presented in the financial statements with benefits provided by the plan.
- Regulatory implications of plan design and operation, including legal and regulatory compliance.

The authors believe the following are also particular risks of material misstatement at the assertion level for plans:

- Investments do not exist or are not shown properly by investment type in the statement of net assets available for benefits and are not properly disclosed.
- Employer contribution income is not properly recognized and is not complete with respect to accruals, including amounts due at the end of the period, a valuation for amounts deemed uncollectible, and the present value of any employer withdrawal liability (for multiemployer plans).
- Plan expenses have not been recorded in the proper amount, in the proper accounting period and in accordance with the plan document.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. The following factors need to be considered in determining which audit areas are significant:

- Relative materiality of the account balance, transactions, or disclosures to the overall financial statements.
- Relative significance of the transaction classes to the plan's operations or the overall financial statements (for example, because of either the materiality of account balances affected or volume of transactions flowing through the accounts during the period).

- The susceptibility of the account balances, transaction classes, or disclosures to fraud, including both misappropriation and similar loss of related assets and intentional misstatement by plan management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.
- Disclosures that require additional effort at the account balance level in an audit area to ensure accuracy and completeness.

Materiality of Reported Amounts to the Financial Statements. One element of significance is the dollar amount of an account balance, transaction, or quantitative disclosure in relation to the auditor's judgment of the amount material to the financial statements taken as a whole. Any audit area that includes one or more material reported amounts is a significant audit area. Judgment is needed in making quantitative comparisons because reported amounts may not be completely misstated.

Relative Significance to the Financial Statements. As indicated at AU-C 315A.28–.31, the auditor's risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Those risks are discussed in the following two subsections.

Significant Risks Requiring Special Audit Consideration. According to AU-C 315A.29 the auditor should evaluate whether risks are significant risks by considering the following:

- Is the risk a risk of fraud or theft?
- Is the risk related to recent significant economic, regulatory, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties or parties in interest?
- Is there a relatively high degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant unusual transactions?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature. The authors recommend that in making this evaluation the auditor ask, hypothetically, if there were a time constraint to perform the audit, would the risk be one that would absolutely need to be addressed through substantive procedures.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor's risk assessment, he or she might identify risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the plan's information is initiated, authorized, recorded, processed, or reported electronically. An example of this situation could be participant accounts in a defined contribution plan that are maintained by a third-party administrator and allow participants to enroll, change elections, and withdraw electronically. In such situations, it might not be possible or practicable to perform only substantive procedures in response to a risk because of the importance of effective controls over the accuracy and completeness of available audit evidence.

Significant Risks in an Employee Benefit Plan Audit

Employee benefit plans are typically subject to significant risks. Several potential significant risks relevant to employee benefit plan audits are summarized in Exhibit 3-1.

Exhibit 3-1

Potential Significant Risks in an Employee Benefit Plan Audit

For all plans:

- Hard-to-value investments not valued at fair value.
- Insufficient disclosure of the basis for valuation of hard-to-value investments.
- The net asset value (NAV) (or its equivalent) used as a practical expedient to estimate fair value of investments is not as of the plan's reporting date or the NAV (or its equivalent) is not calculated in accordance with GAAP for investment companies.
- New accounting guidance not properly applied.
- Improper accounting for and disclosure of derivatives.
- Improper presentation or disclosure of securities lending transactions.
- Incomplete transfer of assets when a plan has received a transfer of assets from another plan.
- A SOC 1 report is not available when significant transactions are processed by an outside service provider.
- A SOC 1 report includes qualifications, exceptions, or carve-outs when significant transactions are processed by an outside service provider.

For defined contribution plans:

- Incorrect calculation of employee and employer contributions due to the use of an improper definition of compensation.
- The plan has not complied with the DOL's regulations for the timely remittance of participant contributions to the trustee or custodian.
- When a plan has changed recordkeepers or there is a transfer of assets from another plan, the individual account balances are not properly maintained.
- The company stock in a private company ESOP is not correctly valued at fair value.

For health and welfare benefit plans:

- Not reflecting all activity of a health and welfare plan in the financial statements.
- Improper determination or recording of IBNR claims.

For defined benefit plans:

- Inaccurate accounting for the hypothetical balances in an ongoing cash balance defined benefit pension plan due to the improper application of the interest rate, service credits, or beginning balances.
- Misstating the beginning balance of the hypothetical accounts in the year a defined benefit pension plan is converted to a cash balance benefit formula.
- Using incorrect demographic information in a frozen plan.
- Improper calculation of benefit payments, including lump-sums.

- Incorrect calculation of benefit payments for a terminated plan.
- Incorrect calculation of benefit payments when the plan uses different benefit formulas for various time periods for employee groups.
- Improper recording or valuation of an employer contribution receivable when the plan sponsor is experiencing financial difficulty.

Accounting Estimates. Another area of risk of material misstatements at the balance or class level is accounting estimates. AEBP, Paragraph 2.152, indicates that some areas of plan operations require accounting estimates that could be significant in financial statement preparation and presentation. The following are examples of such estimates:

a. Fair value of securities with no readily available market quotation, such as restricted securities and real estate.

b. Actuarial assumptions used in the actuarial present value of accumulated plan benefits, such as the assumed rate of return on plan assets.

c. Claims incurred but not reported for an uninsured (self-insured) health and welfare benefit plan.

d. Postretirement and postemployment benefit obligations.

e. Accumulated eligibility credits for health and welfare benefit plans.

f. Accrued experience rating adjustments on insurance contracts.

Investments are usually very significant to the financial status of an employee benefit plan. Also, there are numerous risks associated with investments as described above. For these reasons, investments is a critical audit area in an employee benefit plan engagement. AEBP, Paragraph 11.06, draws attention to the changing nature of benefit plan investment portfolios and the related increase in risk. Plans were once expected to follow conservative investment policies and approaches. Now plans invest in newer forms of investments with increased inherent risk, for example, repurchase or reverse repurchase agreements, futures and options, collateralized mortgage obligations, real estate mortgage investment conduits (REMICs), and other securitized portfolio investments. AEBP, Paragraph 11.114, emphasizes the importance of obtaining an understanding of the plan's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.

Parties in Interest and Prohibited Transactions. AEBP, Paragraph 2.118, points out that ERISA requires disclosure of all prohibited transactions whether or not material, in the plan's annual report Form 5500. In addition, AU-C 703.22 requires the auditor to evaluate whether prohibited transactions identified by management or as part of the audit have been appropriately reported in the applicable ERISA-required supplementation schedules. DOL officials place a great deal of emphasis on the reporting of prohibited transactions and believe that auditors have a significant role in encouraging compliance with ERISA and related regulations. For these reasons, parties in interest and prohibited transactions are very significant audit risk areas in an employee benefit plan engagement. As explained earlier in this section, the auditor may conclude that misstatements in this area require use of a lower planning materiality amount.

The definition of parties in interest is very broad. Parties in interest include the plan sponsor or employer, fiduciaries (including those who provide investment advice or who have discretionary control over plan assets), and those who provide services to the plan. This means that virtually everyone who normally engages in transactions with the plan is a party in interest. Transactions with these parties are prohibited transactions if ERISA specifically identifies them as prohibited, such as loans to a sponsor. Transactions with these parties are generally prohibited except for transactions that are specifically permitted (those that are exempt from the prohibition). Exemptions can be by fiduciary or transaction or by classes of fiduciaries or transactions. Exemptions are discussed in ERISA Section 408. Certain transactions are specifically prohibited as discussed at ERISA Section 406. (In addition to such statutory or administrative exemptions, a plan may request a specific exemption from the DOL.)

The auditor's responsibilities for identifying parties in interest and prohibited transactions parallels the responsibilities with respect to related parties. Parties in interest include related parties, but the concept of parties in interest is broader than related parties. For example, an independent investment advisor normally is not a related party under the FASB ASC 850 definition, but is specifically defined as a party in interest under ERISA.

During audit planning, the auditor considers the potential for material prohibited transactions. During the performance of the audit, when examining transactions, the auditor considers whether they involve parties in interest and are prohibited transactions. When prohibited transactions are detected, the auditor ought to consider whether they have adverse implications for other aspects of the audit, particularly on the auditor's ability to rely on management representations. AEBP, Paragraph 2.144, points out that "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." For example, a prohibited transaction engaged in by a high level plan official would have more serious audit implications.

Documenting Audit Risk Considerations. The assessment of the risk of material misstatements and planned responses should be documented.

Establishing an Overall Audit Strategy

AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach and it includes the identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. Determination of audit strategy would normally be the responsibility of more senior and experienced members of the audit team, including the audit partner, given the judgments that are required. AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the following:

   (1) Significant factors that will determine the focus of the engagement team's efforts.

   (2) Results of preliminary engagement activities.

   (3) If applicable, the knowledge from other engagements performed for the entity.

d. Determine the nature, timing, and extent of resources needed to perform the audit.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be needed. Step c.(1) is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level. Steps c.(2) and c.(3) concern additional information that also may affect the focus of the engagement team's efforts. Finally, Step d. concerns the personnel resources that will be necessary to accomplish audit objectives, including the need for the involvement of specialists and other experts.

Important aspects of overall audit strategy that determine the focus of the engagement team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Preliminary identification of material classes of transactions, account balances, and disclosures.

- Preliminary identification of areas where there may be higher risks of material misstatement, including those due to fraud.
- Effect of assessed risks of material misstatement at the overall financial statement level.
- Auditors' responsibilities when service organizations provide services that are part of a plan's information system.
- Auditors' responsibilities when specialists are used in an audit. (For example, valuation specialists that value securities with no ready market or actuaries that estimate benefit obligations.)
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and action taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the plan.
- Evidence of management's commitment to sound internal control, and importance attached to internal control, including appropriate documentation.
- Volume of transactions.
- Significant changes in accounting standards.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having a higher risk of material misstatement.
- Determination of the extent of involvement of professionals possessing specialized skills.
- Manner of emphasizing the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the financial statement date rather than at an interim date.
- Identification of recent significant developments affecting the plan, the employee benefit plan industry, the plan's financial reporting, or its legal or economic environment.
- Determination of areas where client assistance is expected to be minimal.
- Determination of whether the work of the internal audit function will be used to obtain audit evidence or whether internal auditors will be used to provide direct assistance.
- Identification of the processes management uses to identify and prepare the disclosures, including those containing information obtained from outside of the general and subsidiary ledgers.

In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the plan and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or other auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information

throughout the performance of the risk assessment procedures to complete the overall audit strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260.11 requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communicating the significant risks identified by the auditor. This helps those charged with governance to perform their oversight duties with regard to the financial reporting process. When these discussions occur, the auditor needs to be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures. According to AEBP, Paragraph 2.50, "For a single employer employee benefit plan, the individual charged with governance may include the individual with the level of authority and responsibility equivalent to an audit committee, such as the named fiduciary, which is often the plan sponsor, or an officer thereof; the sponsor's board of directors or audit committee; or a committee overseeing the activities of the employee benefit plan, such as the employee benefit committee, employee benefit administrative committee, employee benefit investment committee, plan administrator, or other responsible party." For a multiemployer plan, those charged with governance will ordinarily be the joint board of trustees, which will include both labor and management members.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. The auditor can effectively establish the overall audit strategy through the completion of various steps in a practice aid. Professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document in one place all matters that affect audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the plan and its environment.

However, AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, and any significant changes made to them during the audit and the reasons. An efficient approach to documenting the audit strategy in the audit of a small, noncomplex plan is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and then update and change it in the current period to provide a basis for planning the current audit. The update can be based on discussions with the plan administrator.

COVID-19 Considerations—Risk Response and Audit Strategy

In light of the increased risks of material misstatement due to both fraud and error and the increased difficulty of testing the operating effectiveness of controls, an entirely substantive approach to the audit may be necessary. Even if a combination of tests of controls and substantive tests had been used in prior periods, a substantive approach is likely a more effective response to the increased potential for fraud and error created by reduced segregation of duties, other possible control breakdowns, including the increased ability for management override. Because of the increased risks of material misstatement, typically all of the responses to risks at the financial statement level would be appropriate. An auditor would consider: emphasizing to the audit team to exercise heightened professional skepticism; assigning team members with more experience and with specialized skills, such as valuation or forensic specialists; increasing the level of supervision; increasing unpredictability in selection and application of audit procedures; and attempting to modify the nature, timing and extent of substantive procedures to obtain more persuasive evidence.

In the circumstances of a particular plan, the responses to identified and assessed risks of material misstatement discussed in the immediately prior paragraph may not be sufficient and an auditor may conclude that there is a scope limitation that cannot be overcome. An auditor needs to anticipate that situation and attempt to adjust the expectations of plan management and those charged with governance. Neither the plan nor the auditor may be able to avoid a modified audit opinion.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. Materiality at the account balance or transaction class level is called what?

    a. Evaluation materiality.

    b. Performance materiality.

    c. Planning materiality.

    d. Tolerable misstatement.

19. The susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material—either on its own or when aggregated with others—before consideration of any related controls is called what?

    a. Audit risk.

    b. Control risk.

    c. Detection risk.

    d. Inherent risk.

20. Which of the following is a significant risk for any employee benefit plan audit?

    a. IBNR claims have been determined improperly.

    b. Incorrect demographic information has been used for a frozen plan.

    c. Investments that are difficult to value have not been correctly valued.

    d. An improper definition of compensation led to incorrect contribution calculations.

21. Which of the following will help an auditor establish the overall audit strategy?

    a. Determine the engagement's key characteristics to define its scope.

    b. Consider what preliminary engagement activities are needed.

    c. Adopt the deadlines requested by the audit client.

    d. Note in the workpapers that information from no other engagements will be used.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

18. Materiality at the account balance or transaction class level is called what? **(Page 97)**

    a. Evaluation materiality. [This answer is incorrect. The auditor uses the concept of materiality both in (1) planning and performing the audit and (2) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. *Evaluation materiality* refers to the second of those concepts.]

    b. **Performance materiality. [This answer is correct. *Performance materiality* is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. In other words, it is materiality at the account balance or transaction class level.]**

    c. Planning materiality. [This answer is incorrect. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements.]

    d. Tolerable misstatement. [This answer is incorrect. As explained in AU-C 320.A3, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. In other words, tolerable misstatement is materiality at the test or procedure level for a specific account balance or transaction class when that procedure or test is applied using audit sampling.]

19. The susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material—either on its own or when aggregated with others—before consideration of any related controls is called what? **(Page 100)**

    a. Audit risk. [This answer is incorrect. AU-C 200.14 explains that *audit risk* is a function of the risks of material misstatement and detection risk, as those items are defined in that guidance.]

    b. Control risk. [This answer is incorrect. As defined in AU-C 200.14, *control risk* is the risk that a misstatement could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.]

    c. Detection risk. [This answer is incorrect. This is defined by AU-C 200.14 as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.]

    d. **Inherent risk. [This answer is correct. According to AU-C 200.14, *inherent risk* is the susceptibility of an assertion about a class of transactions, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.]**

20. Which of the following is a significant risk for any employee benefit plan audit? **(Page 105)**

    a. IBNR claims have been determined improperly. [This answer is incorrect. The improper determination or recording of IBNR claims is a significant risk for health and welfare benefit plans specifically, not all employee benefit plans.]

b. Incorrect demographic information has been used for a frozen plan. [This answer is incorrect. The use of incorrect demographic information in a frozen plan is a significant risk for defined benefit plans, not all employee benefit plans.]

c. **Investments that are difficult to value have not been correctly valued. [This answer is correct. Employee benefit plans are typically subject to significant risks. Some significant risks apply to any employee benefit plan, while others are associated with a particular plan type. Several significant risks that apply to all types of employee benefit plans include (1) hard-to-value investments not valued at fair value, (2) insufficient disclosure of the basis for valuation of hard-to-value investments, and (3) improper accounting for and disclosure of derivatives.]**

d. An improper definition of compensation led to incorrect contribution calculations. [This answer is incorrect. The incorrect calculation of employee and employer contributions due to the use of an improper definition of compensation is a significant risk for a defined contribution plan, not all employee benefit plans.]

21. Which of the following will help an auditor establish the overall audit strategy? **(Page 107)**

a. **Determine the engagement's key characteristics to define its scope. [This answer is correct. AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. AU-C 300.08 provides that in establishing the overall audit strategy, the auditor should complete several tasks, one of which being to determine the key characteristics of the engagement that define its scope.]**

b. Consider what preliminary engagement activities are needed. [This answer is incorrect. As discussed in AU-C 300.08, to establish the overall audit strategy, the auditor should consider items such as the results of preliminary engagement activities. Therefore, the overall audit strategy is established *after* the preliminary engagement activities have been performed.]

c. Adopt the deadlines requested by the audit client. [This answer is incorrect. According to AU-C 300.08, the auditor should determine the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Therefore, the auditor is required to make judgments about this, not merely accept the deadline and communications proposed by the client.]

d. Note in the workpapers that information from no other engagements will be used. [This answer is incorrect. Per AU-C 300.08, when establishing the overall audit strategy, the auditor should consider several items, including, if applicable, the knowledge from other engagements performed for the entity. This engagement need not be performed in a vacuum, if other engagements have been performed for this client.]

USING A SPECIALIST

During planning, according to AU-C 300.12, the auditor should determine whether it will be necessary to use the work of an actuary or other specialist. Use of a specialist is relatively common for an employee benefit plan. The plan administrator of a defined benefit pension plan normally engages an actuary to prepare the actuarial present value of benefit obligations for financial statement presentation. Some health and welfare plans and defined benefit pension plans also use an actuary to determine contribution rates or benefit obligations. The IRC requires independent appraisals of certain employer securities acquired by an ESOP. Also, if a plan has significant investments in restricted securities or other assets without a ready market value, the auditor may decide it is necessary to use the work of an appraiser to examine management's valuation.

In the context of the audit of an employee benefit plan, a "specialist" may fall into one of three categories:

a. *Auditor's Specialist.* This term is applied to individuals or organizations that possess expertise in an area other than accounting or auditing whose work is used by the auditor. An auditor's specialist can either be an internal specialist within the auditor's firm or a network firm or an external specialist. The auditor's responsibilities when using the work of these specialists are primarily addressed in AU-C 620A, *Using the Work of an Auditor's Specialist*. AU-C 260.A21 notes that the planned scope and timing of an audit may include the nature and extent of specialized skills or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.

b. *Management's Specialist.* These are individuals or organizations that have expertise in a field other than accounting or auditing who are used by the plan to assist in preparing the financial statements. The auditor's responsibilities when using the work of these specialists are primarily addressed in AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*.

c. *Other Specialist.* The authors use this term to refer to individuals on the engagement team or other individuals or organizations with whom the auditor consults who possess expertise in a specialized area of accounting or auditing. Situations involving those specialists are addressed in AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and AU-C 300, *Planning an Audit*.

The requirements that apply to using the work of an *auditor's specialist* or an *other specialist* are not unique to audits of employee benefit plans and are discussed in detail in *PPC's Guide to Audits of Nonpublic Companies*. The following discussion focuses on the requirements in the normal circumstances of a plan that engages an actuary to present the actuarial present value of benefit obligations.

When the work of a management's specialist is used in the preparation of its financial statements, the auditor may use the specialist's work as audit evidence. In those situations, AU-C 501.27 requires the auditor to:

a. Evaluate the competence, capabilities, and objectivity of the specialist.

b. Obtain an understanding of the specialist's work.

c. Evaluate the appropriateness of the work as audit evidence for the relevant assertion.

AEBP, Paragraph 2.109, describes the following procedures that are commonly performed when auditing management's process for developing fair value estimates using a pricing specialist:

a. Evaluate the qualifications and experience of the valuation specialist used by the plan (whether a third party or employee).

b. Inquire about any relationship of the specialist to the entity (if not an employee).

c. Identify, review, and document the following:

   (1) The objectives and scope of the specialist's work.

   (2) The methods and assumptions used by the specialist.

d. Compare the specialist's methods and assumptions with those used in previous periods, and determine if they are appropriate in the circumstances considering the nature of the investments. (Often there is a specialist's report that discloses specific methods and assumptions used to value each investment.)

e. Agree the fair values used by the plan to the specialist's results on a test basis.

f. Test the data used by the specialist and document the results and conclusions.

g. Document the conclusions regarding the specialist's work, including whether the specialist's findings and auditor's procedures provide sufficient evidence to support the auditor's conclusions in light of the auditor's assessment of the risks of material misstatement.

h. Assess whether there is management bias in recording fair value estimates.

The procedures the auditor may apply in accordance with AU-C 501.27 when a defined benefit pension or health and welfare plan engages an actuary to prepare the actuarial present value of benefit obligations are as follows:

a. Inquire about the actuary's qualifications, reputation, and relationship to the client. AEBP, Paragraph 7.188a, for defined benefit pension plans and AEBP, Paragraph 8.231, for health and welfare benefit plans suggest the following factors to consider:

    (1) Whether the actuary is an "enrolled actuary" under ERISA.

    (2) The actuary's membership in a recognized professional organization.

    (3) The opinion of other actuaries known to the auditor.

    (4) The actuary's prior experience working on employee benefit matters. (Footnote 41 to AEBP, Paragraph 8.231, and footnote 23 to AEBP, Paragraph 7.188a caution that some actuaries concentrate in areas other than pension matters, and that qualification to practice in another area does not necessarily mean qualification in the pension area.)

b. Consider the actuary's objectivity. The work of a specialist having no relationship with the plan will provide the auditor with a greater degree of reliability than the work of a specialist who is related to the plan.

    (1) If the actuary is related, and the auditor believes the relationship might impair the actuary's objectivity, the auditor (or a second, unrelated, actuary) might apply additional procedures to some or all of the actuary's assumptions, methods, or findings.

    (2) AU-C 500A.A43 observes that a specialist who is an employee of an entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

c. Reach an understanding with the client and the actuary about the nature of the actuary's work, including:

    (1) The objectives and scope of the actuary's work.

    (2) The methods and assumptions.

    (3) A comparison of the methods and assumptions with those used in the preceding period.

    (4) The actuary's understanding of the auditor's corroborative use of the actuary's findings in relation to the representations in the financial statements.

    (5) The form and content of the actuary's report that would enable the auditor to evaluate whether the actuary's findings are suitable for corroborating the financial statement representations and to support them.

d. Obtain audit evidence of the accuracy and completeness of census data provided by the plan and used by the actuary in the actuarial valuation. (The auditor may coordinate these procedures with procedures to be applied to plan contributions and participant data.)

e. Consider whether the actuary's findings support the related representations in the financial statements.

f. Consider including a representation in the management representation letter for the plan to assume responsibility for the actuary's findings.

As stated in the previous paragraph, the auditor evaluates whether the actuary's findings support the related financial statement representations. AEBP, Paragraphs 7.188b and 8.231b, suggests the auditor determine whether the methods and assumptions used in the accumulated plan benefit information and postretirement benefit information are in conformity with FASB ASC 960 for defined benefit pension plans and FASB ASC 965 for health and welfare benefit plans. Also, the auditor assesses 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, whether amounts contributed by employees and earnings thereon are properly included as vested benefits, and whether the funding method and assumptions are in accordance with ERISA.

The auditor ought to document the inquiries made of the actuary and the information obtained. AEBP. Paragraph 7.189, for defined benefit pension plans, and AEBP. Paragraph 8.232, for health and welfare benefit plans, suggest the types of information the auditor may consider confirming with the plan actuary.

In those cases in which the actuary's findings differ materially from the amounts or disclosures in the financial statements, or if the actuary's assumptions or findings appear to be unreasonable, the auditor would apply additional procedures. Normally, the auditor engages another actuary to perform these additional procedures. If the matter cannot be resolved, the auditor may need to issue a qualification or disclaimer of opinion.

Although the preceding paragraphs refer to using the work of an actuary, essentially the same considerations apply to using the work of any specialist the client engages to prepare amounts or disclosures that are material to the financial statements.

Planning Considerations When Specialists Are Not Used

Health and welfare benefit plans are required by GAAP to provide certain disclosures including the actuarial present value (as applicable) of claims payable, premiums due under insurance arrangements, claims incurred but not reported, accumulated eligibility credits, postretirement benefits, postemployment benefits, and changes therein, for the period. The calculation of some of these obligations requires the assistance of an actuary. The auditor determines in the planning process if the plan intends to engage an actuary and makes required note disclosures. Health and welfare plans may consider not making these required disclosures for postretirement or postemployment benefits, or for claims incurred but not reported because they do not want to pay an actuary, and involvement of an actuary is generally required for the determination of these benefit obligations. As an alternative, plans may make the required disclosures based on estimates developed by management of the plan. If the plan does not make the required disclosures, or the disclosures are materially inadequate, the auditor generally should express a qualified or adverse opinion due to the material departure from GAAP.

If the plan makes required benefit obligation disclosures based on estimates made by plan management, without the use of an actuary, the auditor considers the need to consult an actuary in evaluating the reasonableness of the estimates. When the auditor decides to consult an actuary as a specialist, and the plan refuses to provide the data necessary for the actuary to complete his or her work, the auditor's opinion needs to be modified for a scope limitation.

CONSIDERATIONS FOR AUDIT TIMING AND COORDINATION

Because of the many interrelationships of a plan's financial statements and activities with other entities, for example, the sponsor, trustees, or insurance companies, the auditor needs to give careful consideration to the timing and coordination of procedures and audit areas in scheduling fieldwork.

Audit of Plan Sponsor

If the plan auditor also audits the sponsor's financial statements, efficiencies can be achieved by coordinating audit procedures for employee benefit costs in the sponsor's financial statements and benefit obligation information in the plan's financial statements. One example is coordination of audit procedures for payroll and participant data. If the audit of the plan sponsor's payroll expense includes selection and testing of individual payroll transactions, the

auditor may expand the test to include testing of additional participant data related to accumulated plan benefits, such as hire date, age, sex, etc. Another example is coordination of audit procedures for the sponsor's contribution with testing of the plan's contributions received and receivable, such as tracing contribution amounts to the resolutions in the minutes of meetings of the sponsor's board of directors. Performance and documentation of such audit procedures need not be duplicated. The plan auditor may simply cross-reference to the relevant documentation in the other set of workpapers or include photocopied portions of those workpapers in his or her workpapers.

One important area for coordination is the plan benefit obligation and the sponsor's presentation of benefit information. The auditor needs to consider the benefit information date used for the plan sponsor's defined benefit pension— plan cost and the plan's presentation of benefit obligations. FASB ASC 960 permits the benefit information date to be as of the beginning of the plan year, that is, the prior year end. In that case, the plan auditor usually can make use of audited information on pension costs in the plan sponsor's prior year end financial statements. According to FASB ASC 715, plan sponsors are required to measure plan assets and benefit obligations as of the date of the sponsor's fiscal year end balance sheet, with certain exceptions. (Further discussion of employers' accounting for pensions can be found in *PPC's Guide to Preparing Financial Statements*.)

Public Company Plan Sponsor. If the plan sponsor is a public company that is required to comply with Section 404 of the Sarbanes Oxley Act, the plan auditor may be able to use the documentation and compliance work related to internal control over financial reporting of the sponsor or its auditors. The plan auditor may be able to rely on key controls tested by the auditor or the sponsor or the sponsor's internal auditor. For example, tests of controls and control documentation in the payroll area may be useful to the plan auditor in reducing the scope of testing.

SOC 1 Report

The auditor may decide to obtain the report of another auditor on the internal control of a service organization as discussed in Lesson 2. In that case, the timing of audit procedures for the areas to which the SOC 1 report is relevant will be dependent on receipt of the report. Thus, the auditor will need to request the report on a timely basis and coordinate the performance of procedures. Also, the auditor needs to consider whether the time period covered by the SOC 1 report is suitable, considering the period covered by the plan's financial statements. In those cases in which the auditor plans to request that the service auditor be engaged to apply specific procedures, the request ought to be made to the service organization by the plan administrator on a timely basis and the work should be coordinated.

Financial Statements of Trustees or Insurance Companies

The auditor may need to obtain the audited financial statements of trustees or insurance companies holding plan assets or with which the plan has insurance or investment contracts. The auditor needs to determine whether such financial statements are necessary and make the request on a timely basis. Audit areas in which audited financial statements of trustees or insurance companies may be considered to be necessary include the following:

- In considering the financial capability of trustees holding plan investment assets.
- In auditing investments in common/collective trusts or master trusts.
- In considering the financial capability of insurance companies with which the plan has guaranteed investment contracts (GICs), deposit administration (DA), or immediate participation guarantee (IPG) contracts.
- In examining plan investments in insurance separate accounts.

Multiemployer Plans

It may be necessary for the auditor of a multiemployer plan to apply procedures to contribution and participant data records at several employers or to rely on employers' auditors to apply such procedures. The auditor ought to consider the need to apply audit procedures at employers participating in a multiemployer plan and coordinate the timing of the work. The auditor ought to either make arrangements to visit participating employers or request the other auditors to apply the procedures and report on the results.

Reading Form 5500

AU-C 703.48 requires the auditor to read a substantially complete draft of Form 5500 (including any related schedules) to identify any material inconsistencies with the audited financial statements (including the required supplemental schedules) prior to the report release date. If a material inconsistency is identified when reading the draft form 5500, the auditor should determine whether the Form 5500 or the audited financial statements need to be revised.

THE USE OF AUDIT SAMPLING

The authoritative pronouncement that applies when the auditor has decided to use audit sampling in performing audit procedures is AU-C 530, *Audit Sampling*. AU-C 530.01 addresses the auditor's use of statistical and nonstatistical sampling when:

a. Designing and selecting the audit sample.

b. Performing tests of controls and tests of details.

c. Evaluating the results of the sample.

AU-C 530 complements the guidance in AU-C 330B, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, on the means available to the auditor for selecting items for testing. One of the means of selecting items for testing is audit sampling.

AU-C 530.05 defines *audit sampling* as "the selection and evaluation of less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. In this context *representative* means that evaluation of the sample will result in conclusions that, subject to the limitations of sampling risk, are similar to those that would be drawn if the same procedures were applied to the entire population."

Determining Audit Sampling Applications

Because the auditor usually has several alternatives in designing the mix of audit procedures to be applied to a particular account balance or transaction class, the auditor may design a particular procedure as a sampling or a nonsampling application based primarily on considerations of audit efficiency. Generally, sampling will be more efficient in an employee benefit plan engagement when the audit area is a critical area based on consideration of audit risk and materiality, the volume of transactions is relatively high, and individual items within the balance or class do not differ significantly in dollar amount or the details of processing. In many cases, one of these features will tip the scales for or against designing the procedure as a sampling application.

In many instances, the auditor may rely on evidence obtained and conclusions reached in prior audits thereby reducing the number of transactions or data that needs further testing in the current year. For example, much of the participant data (such as date of birth and hire date) does not change. In some instances, the benefit payments do not change. In some cases, the auditor can simply compare the information for the current year to the prior year and apply procedures to some or all of the changes. In these circumstances, the auditor would need to apply procedures only to determine that the listings are complete and accurate as to the number of participants; that is, new participants that are added and those that are deleted.

One important feature in deciding whether to use sampling is the size of the population. Consider the following situation:

Example 3-1: An example of a nonsampling application.

The Woodsman Quarry employs about 125 operating and clerical personnel. Woodsman has been in business for more than 40 years, but the pension plan is relatively new and the workforce is relatively young. Only 12 former employees are receiving benefit payments. This is the first audit of the plan. Should the auditor sample benefit payments? The small size of the population dictates that audit procedures in the benefits area be designed as a nonsampling application. The auditor obtains a schedule of benefits by participant and scans it

for reasonableness. (Based on an understanding of the plan and the sponsor, the auditor has an idea as to what the range of the benefits ought to be.) By inquiry, observation, and inspection of plan documents, the auditor determines the controls relating to benefit payment elections and benefit disbursements. The auditor tests four or five of the benefit amounts, assesses eligibility, and examines the benefit election forms. The auditor may decide to confirm the largest two or three benefit payments with the former employees and compare the signatures on the returned confirmations with the employee signatures on the benefit payment election forms. The auditor notes the agreement of the payments with the form of payment requested and other details such as hire date. The auditor concludes that his or her procedures corroborate his or her understanding of the controls for determining employee eligibility and the form and amount of payment.

In subsequent years, the auditor may obtain a comparative schedule of benefits by participant and review the propriety of changes from the amounts paid in the prior year. For example, the auditor may test the benefit amount, eligibility, and benefit election forms for all or selected new retirees. The auditor may also confirm selected benefit amounts or perform other procedures as a test for retirees who should no longer be receiving benefits.

Even though the auditor has tested less than all the benefit payments, this is not an audit sampling application. This result is due primarily to the auditor's approach rather than the inherent characteristics of the audit procedures. In other words, confirmation of less than all the benefit payments is not considered a sampling application in this circumstance because of the way the auditor defined the objective of the test. Confirmation of benefit payments might also be a sampling application when the volume of payments is high and the auditor's conclusion depends on projecting the results concerning the accuracy of payments confirmed to the entire amount of benefit payments.

Likelihood of Using Audit Sampling by Audit Area. Considering the normal characteristics of the various audit areas of employee benefit plans, it is possible to generalize about the likelihood of audit sampling. Exhibit 3-2 presents the authors' conclusions about the likelihood of using audit sampling in the typical audit areas of an employee benefit plan. This exhibit also includes an indication of the type of sampling that is likely to be used as either balance testing or transaction testing. These types of sampling are further discussed below.

Exhibit 3-2

Likelihood of Using Audit Sampling in a Benefit Plan Audit

Audit Area	Likelihood of Audit Sampling	Type of Sampling Approach
Employer Contributions Received and Receivable[a]	Rare	Balance
Investments and Related Income[b]	Rare to Moderate	Balance or Transaction Testing
Contracts with Insurance Companies	Rare	Balance
Participant Data and Employee Contributions	Likely	Transaction Testing
Benefit Payments	Moderate	Balance or Transaction Testing
Benefit Obligations	Rare	Balance or Transaction Testing
Other Assets, Liabilities, and Operating Expenses	Rare	Balance or Transaction Testing

Notes:

[a] For a multiemployer plan, there is a moderate likelihood of sampling of employer contributions.

[b] For a situation where investment transactions are numerous and there is no trustee, sampling of investment transactions would be likely.

The most likely areas for use of audit sampling in a benefit plan audit are participant data and employee contributions. An important reason for this is that the volume of items is more likely to be relatively high. Also, the nature and objectives of the audit procedures applied in this area are readily susceptible to being efficiently designed as audit sampling applications. Generally, the audit procedures are applied to employer payroll and personnel records. The auditor selects individual payroll transactions and tests the details for accuracy of pay rate, hours, computations, and demographic data such as birth and hire dates, sex, termination date, etc. Tests of employee eligibility and employee contributions can be readily applied to the same selection of payroll transactions. The same is generally true for tests of withdrawals and terminations, but more items may have to be selected if there are insufficient withdrawals and terminations in the individual payroll transactions. For example, the auditor may select more items if the original selection does not include at least five withdrawals or terminations.

Use of audit sampling for benefit payments is moderately likely. The likelihood is heavily dependent on the volume of benefit payments. Normally there are far fewer people receiving benefits than are currently employed. Thus, the likelihood of using sampling is less than for participant data. The primary audit procedures in the benefit payments area involve testing payments to selected recipients for eligibility and accuracy of method and amount of payment. When sampling is used, the auditor needs to evaluate whether the sample includes a sufficient number of employees who retired in the current year, for example, at least five current retirees unless the number of retirees is too small for this to be practical.

Investments is always an important audit area in an employee benefit plan engagement, but the likelihood of sampling depends on the number of individual investment balances and the volume of individual investment transactions. Generally, for investment balances, the most efficient and effective approach is to select all items above an established cutoff amount for substantive testing, that is, for confirmation, physical examination, etc. In these circumstances, it is advisable to vary the cutoff amount and to scan items below that amount. Sampling is rarely used except for those engagements in which the dollar amount and number of individual investments after testing individually significant items is relatively large. However, the auditor also has to consider the need to test individual investment *transactions*. When investments are nontrusteed or are held in a nondiscretionary trust, and trading activity is relatively high, the auditor normally would select a sample of individual transactions and test the details for authorization and proper accounting, including use of the trade date to record purchases and sales. (When investments are held in a discretionary trust, the plan auditor usually does not examine transactions but relies on a service auditor's report.)

In other benefit plan audit areas, use of audit sampling is relatively rare. For employer contributions received and receivable, contracts with insurance companies, and benefit obligations, the auditor normally takes a primarily substantive approach and frequently can confirm aggregate amounts with another party. However, for a defined contribution plan, the auditor may test individual participant accounts using audit sampling, depending on the number of participants and the complexity of investment medium elections. Also, for a multiemployer plan, sampling of employer contributions is more likely. For other assets, liabilities, and operating expenses the balances and level of activity are normally relatively small and use of sampling is relatively rare. In many cases, the plan sponsor absorbs most operating expenses, and account balances in this area are negligible.

Sampling Approaches and Methods

AU-C 530 discusses audit sampling in two categories—sampling in substantive tests of details and sampling in tests of controls. Although AU-C 530 applies equally to statistical and nonstatistical sampling and uses audit rather than statistical terminology, it is helpful to recognize that sampling for tests of details corresponds to the statistical method known as variables sampling, including monetary unit sampling (MUS) (also called probability-proportional-to-size sampling or PPS), and that sampling for tests of controls corresponds to attribute sampling. This correspondence of approaches is worth noting because in practice the attribute sampling approach is efficient and effective to use for transaction testing, which may include both substantive and control aspects (a dual-purpose test). That is, attribute sampling can be used to test the accuracy of recording transactions as to account, amount, and period as well as the

effective performance of controls related to approvals and recomputation. For this reason, the discussion in this section is divided into two basic types of sampling referred to as balance testing and transaction testing.

Balance Testing. A substantive test of details using audit sampling, referred to here as balance testing, involves evaluation of the results of the sample in monetary terms. In planning this type of sample, the auditor considers how much monetary misstatement in the related account balance may exist without causing the financial statements to be materially misstated (tolerable misstatement) and the allowable risk of incorrectly accepting a balance misstated by that amount. In evaluating sample results for this type of sample, the auditor normally considers the upper dollar limit on the amount of misstatement of the balance at the planned allowable risk of incorrect acceptance. When statistical sampling is used, both the dollar amount of misstatement and the effect of the sampling risk are quantified. When nonstatistical sampling is used, dollar amounts can be quantified, but the effect of sampling risk can only be approximated and considered in qualitative terms.

Though outside the scope of this course, *PPC's Guide to Audits of Nonpublic Companies* explains a practical nonstatistical sampling approach that can be used in an employee benefit plan audit for substantive tests of details using audit sampling. That guide also explains an approach to avoid the use of sampling by determining the extent of testing using individually significant amounts. This approach is normally useful in the investments area of a benefit plan audit.

Transaction Testing. Transaction testing using audit sampling ordinarily takes the form of what is sometimes called a dual-purpose test because it is directed to both the accounting accuracy of transaction processing and the operating effectiveness of related internal controls. The auditor designs a sample that will be used for dual purposes: testing the operating effectiveness of an identified control and testing whether the recorded monetary amount of transactions is correct. The correctness of the monetary amount usually includes whether the transaction is recorded correctly as to account, amount, and period. The auditor also ordinarily tests transaction details for compliance with plan requirements and controls, for example, whether participant eligibility has been approved and whether the participant meets plan requirements for eligibility.

Although the auditor is concerned with certain substantive aspects of transactions in this type of testing, the sampling approach used is analogous to attribute sampling rather than variables sampling. The primary distinction is that the auditor's planning and evaluation of the sample is focused on the rate rather than the monetary amount of misstatement. For this approach to be appropriate, all transactions in the class from which the sample is selected need to be processed through the same financial reporting system and the likelihood of a mistake being made in processing a particular transaction should be independent of its dollar amount.

Designing Substantive Tests of Transactions Using Audit Sampling

AU-C 530 establishes requirements for the sample design, size, selection, performance, and evaluation of sampling in tests of transactions. The authors have developed an efficient nonstatistical sampling approach that meets these requirements that approximates a statistical attribute sampling method that is sometimes referred to as stop-or-go sampling.

Planning. Two basic conditions for using this approach are (a) that the audit procedure being applied using sampling is not the only procedure that contributes to the objective of the test and (b) a relatively low rate of monetary misstatement is expected. These conditions are intended to compensate for the fact that judgments about sample size and sample results using this approach are approximations rather than exact statistical computations. Normally, using this approach, the auditor need only make a choice between a sample size of 60 and a sample size of 25. A sample of 25 with no misstatements or deviations would approximate an upper limit on the rate of misstatement of 10% and allowable sampling risk of 10%. A sample of 60 with no misstatements or deviations would approximate an upper limit rate of 5%–8% and a sampling risk of 5%.

The basic condition that requires that there be other audit procedures that contribute to the same objective as the procedure being applied using sampling is normally satisfied by performing analytical procedures, for example, scanning a comparative schedule of benefit payments for reasonableness in light of the number of participants eligible to receive benefits in both periods.

The condition that permits a sample of 25 rather than 60 is that, based on the auditor's understanding of internal control, there are controls that are pertinent to the aspects of transaction processing being tested that appear to be effective and that are being tested simultaneously. These controls may exist even though the auditor may have assessed the control risk at maximum and may not have performed tests of controls.

Sample Selection. AU-C 530.08 requires a representative sample for audit sampling applications. This means in practical terms that the items are selected in such a manner that all items have an opportunity to be selected. Among the methods that meet this requirement are simple random selection using random numbers, systematic selection (every *n*th item), or haphazard selection. The first two methods are explained in detail in sampling textbooks. The AICPA Audit Guide, *Audit Sampling*, explains all three methods in paragraph 3.30–.34 and explains additional considerations of selecting the sample for a substantive test of details, such as stratification.

Whenever practical, the auditor ought to use random selection (with computer-generated random numbers or a random number table) or systematic selection with a random start. Using these approaches does not make the audit sampling application a statistical sample. Haphazard selection may be used when the population is not numbered or when other circumstances make use of one of the other methods impractical. The concept of haphazard selection is explained in the AICPA Audit Guide, *Audit Sampling*, paragraphs 3.33–.34. as selecting without conscious bias for or against any items in the population. In other words, to achieve haphazard selection, the auditor's selection should not be influenced by the size, location, or appearance of the item. The authors recommend using computer-generated random numbers because it is more efficient than using a table. Several templates for software packages are available, including PPC's *Workpapers for Employee Benefit Plan Audits*.

Evaluation. The evaluation of sample results for the transaction testing approach differs for a sample size of 25 versus a size of 60. The sample size of 25 is used when the auditor is simultaneously testing internal controls that help ensure accounting accuracy or compliance with plan and ERISA requirements. The auditor needs to identify and test only those controls that are pertinent to these matters and that would make a difference to the auditor's control risk assessment. To support an assessment of control risk below the maximum, the sample results for a sample of 25 need to contain no deviations from the identified controls. In qualitative terms, no deviations in a sample of 25 may be interpreted as a moderate level of control risk. For this reason and for reasons of efficiency, the auditor need not identify and test control activities that would not change the control risk assessment, and any deviations from unimportant controls that turn up in sample results can be ignored. Generally, a mistake in accounting processing, that is, recording in the wrong account, amount, or period, is treated in the same manner as a deviation from internal controls. The reason for this is that a misstatement can usually be traced to a deficiency in the system. However, it is always important to make a qualitative analysis of the nature and cause of the misstatement. The auditor needs a good understanding of the cause of the misstatement to consider what steps ought to be taken to help ensure that there is not an unacceptable risk that similar misstatements could accumulate to a material amount. In the rare case when a misstatement is an isolated instance and there are no indications of a deficiency in controls, the auditor need not change the control risk assessment. However, most misstatements are not isolated incidents, and the auditor ought to make this judgment carefully. For example, a keying error not detected by the system is a deficiency in the system and not an isolated incident simply because it occurred randomly.

When the auditor has initially selected a sample of 25 and sample results include one deviation from controls that are important to the control risk assessment, the sample size for the test ought to be expanded to 60. The reason for this is that a sample size as small as 25 to assess accounting accuracy is only appropriate when control risk can be assessed below the maximum level. When sample results do not support a control risk assessment below the maximum, expanded testing of accounting accuracy is necessary.

When the auditor has initially selected a sample of 60 or expanded the sample size to 60, the focus of the evaluation shifts primarily to a qualitative analysis of the nature and cause of any misstatements detected. Based on the understanding obtained of why the misstatements occurred, the auditor can assess whether there is an unacceptable risk of similar misstatements accumulating to a material amount. This type of analysis necessitates a good understanding of the client and its industry and internal control. No quantitative analysis can substitute for a seasoned qualitative assessment of the nature and cause of misstatement and the steps that ought to be taken in the particular case to detect additional misstatements if they exist. In accordance with AU-C 450.A12, if the auditor evaluates the amount of projected misstatement from a sample in a class of transactions as material, either

individually or in the aggregate with other misstatements, the auditor should request management to examine the class of transactions to identify and correct misstatements therein.

Documentation of Transaction Testing

Auditors should document the decisions and sample results for transaction testing using audit sampling. One method for doing so is by using the practice aids provided in *PPC's Guide to Audits of Employee Benefit Plans*.

DEVELOPING DETAILED AUDIT PLANS AND WORKPAPERS

AU-C 300.09 indicates that the auditor should develop an audit plan that includes a description of the following:

a. The nature and extent of planned risk assessment procedures.

b. The nature, timing, and extent of planned further procedures at the relevant assertion level.

c. Other planned procedures required by GAAS.

AU-C 300.10 requires the auditor to update and change the audit plan as needed during the audit. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

As part of developing the overall audit strategy, the auditor will ordinarily have identified material account balances and audit areas where there may be higher risks of material misstatement. Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The audit plan is commonly referred to as the audit program.

Determining the Audit Approach

The purpose of the risk assessment is to determine the nature, timing, and extent of further audit procedures to be performed. The auditor identifies risks (including risks of material misstatement due to fraud), considers management's response to those risks through operating decisions and controls, and assesses the risk of material misstatement at the relevant assertion level. Based on that risk assessment, the auditor determines what audit procedures need to be performed. For simplicity in the discussions throughout this course, the authors refer to the overall decision of which further audit procedures will be performed as the selection of an audit "approach." In this course, the approach selected by the auditor to respond to the risk assessment and documented on the "Risk Assessment Summary Form" (if the practice aids in *PPC's Guide to Audits of Employee Benefit Plans* are used) for each audit area involves the following decisions:

- Performing only limited procedures and not developing a separate audit program,
- Performing basic procedures from the audit program, or
- Performing basic procedures plus certain extended procedures from the audit program.

The following paragraphs include initial considerations involved in choosing the appropriate audit approach and using the chosen approach. The authors anticipate that auditors will tailor all PPC audit programs for individual financial statement audit areas to respond to their client's specific risks and circumstances.

Performing Only Limited Procedures. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures approach and will be appropriate only for audit areas that are not significant and have a low combined risk of material misstatement for all relevant assertions. For audit areas that are not significant but have a risk of material misstatement other than low for all relevant assertions or require audit attention for other reasons such as client or regulatory expectations, an audit program will be

needed. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Using the Audit Programs. The PPC audit programs include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include a combination of substantive analytical procedures and tests of details.
- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.
- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other audit procedures are considered Extended Procedures when completing the "Risk Assessment Summary Form.")

Auditors decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. This analysis is not a simple determination based on whether risk is high, moderate, or low. A low or moderate risk of material misstatement for an assertion indicates that a Basic Procedures approach may be appropriate for that assertion. The auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks, as well as client expectations. The particular tests selected, whether basic or extended, should be tailored to the nature, cause, and direction of expected potential misstatements at the relevant assertion level.

As previously explained, the Basic Procedures section of the audit programs contains certain tests of details, many of which are required by auditing standards or considered relevant by AEBP. If applicable, the auditor performs those procedures. The performance of those procedures may also be a response to a higher assessed level of risk for the related assertions. In other words, those procedures may provide additional assurance even though they are included in the Basic Procedures section rather than in the Extended Procedures section.

The Extended Procedures section of the audit programs, which includes procedures for additional assurance, is a source list of possible audit procedures. It is not an alternative audit program. It is arranged by topic and includes a column indicating the assertions that are primarily and secondarily addressed by the procedure. The auditor selects procedures from the list that are needed to respond to the risk assessment. The selection of extended additional assurance procedures needed to address a particular risk is a matter of auditor judgment. Particularly in audits of employee benefit plans, if the auditor has a higher level of assessed risk and wants to perform extended procedures, he or she may want to consider extending the level of detail testing performed in the Basic Procedures section of the audit program.

Documenting the Approach Selected. The auditor should document which approach has been selected (Limited = "L", Basic = "B", Extended = "E"). When using the practice aids provided in *PPC's Guide to Audits of Employee Benefit Plans*, space is provided to document comments that may be appropriate concerning the audit program, including the linkage between risks and responses. Of particular importance is the explanation of how the planned procedures are responsive to the specific assessed risks of material misstatement at the relevant assertion level. For significant risks (both fraud and other risks), an auditor may decide to prepare a separate memo that documents the manner in which the selected approach and procedures are responsive to the assessed risks of material misstatement. The separate memo may be cross-referenced in the linkage/comments column of the practice aid.

Audit Documentation (Workpapers)

AU-C 230, *Audit Documentation*, requires the auditor to prepare and retain workpapers, addresses the form, content, and extent of audit documentation, and specifies requirements for revisions made to documentation after the date of the auditor's report. The main purpose of workpapers, as identified in AU-C 230.02, is to provide the principal support for the auditor's report that includes:

- The representation that the audit was performed in accordance with generally accepted auditing standards.

- The opinion expressed (or disclaimed) on the financial statements.

In addition to this primary purpose, audit documentation can be used for a variety of other purposes, as discussed below.

Support for Auditor's Report. Auditors should prepare audit documentation with an appropriate amount of detail that provides a clear understanding of the work performed, the evidence obtained along with its source, and the conclusions reached. The primary need to support the representations in the audit report arises in internal and external quality control reviews. Another less frequent, but important, use arises if the quality of the audit is questioned in litigation, regulatory proceedings, or ethics disciplinary actions. The workpapers are the principal record of the work done and conclusions reached, but an auditor, in defending the quality of the audit, might supplement the audit documentation by other means. According to AU-C 230.A7, on their own, the auditor's oral explanations do not constitute adequate support for the work performed or conclusions reached, but may be used to explain or clarify information contained in the audit documentation. An auditor does not document every consideration during the course of the audit, but auditors should ensure that the audit documentation provides a clear understanding of what was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained. As noted above, the possible use of oral explanations is not a substitute for sufficient, appropriate audit documentation that supports the auditor's report.

Auditors ought to be aware that certain states and regulatory agencies may have stringent requirements for audit documentation. For example, California has adopted rules applicable to both public and nonpublic company audits containing a rebuttable presumption that an audit procedure not documented was not performed. The burden of proof lies with the auditor. Recent comments by DOL officials indicate the DOL has adopted a similar approach relating to employee benefit plan audits. The presumption can be overcome by a preponderance of the evidence, which ordinarily requires more than just an oral explanation.

Other Purposes of Workpapers. While audit workpapers need to achieve the primary purpose noted above, audit documentation that is thoroughly prepared with a sufficient amount of detail can be useful for a number of purposes. In fact, firms that adopt documentation policies that encourage well-designed and prepared workpapers will often achieve a higher degree of audit effectiveness and efficiency in their engagements. Some additional purposes of workpapers include:

- Aids in the planning and performance of the current and future engagements.
- Provides guidance for newer team members.
- Assists in the conduct of quality control reviews and inspections.
- Reinforces and demonstrates accountability.
- Aids in internal supervision and review.
- Aids in external review.

Basic Requirements for Content. An auditor has some discretion in deciding on the specific workpapers to prepare; however, AU-C 230 provides the key criterion auditors should use in making documentation decisions. According to AU-C 230.08, workpapers should enable an *experienced auditor with no previous connection to the audit* to understand:

a. The nature, timing, and extent of auditing procedures that were performed to comply with professional standards and applicable legal or regulatory requirements.

b. The results of the audit procedures that were performed, along with the evidence gathered.

c. The significant judgments made and conclusions reached on significant findings or issues.

This criterion is sometimes referred to as a "reviewability" requirement. The use of the term *experienced auditor with no previous connection with the audit* reinforces a documentation concept practiced by many auditors that workpapers need to "stand by themselves," and need little or no oral explanation as to what was done, who

performed the work, and the reasons for the conclusions reached. AU-C 230.06 considers an experienced auditor to be an individual with practical audit experience and the necessary competence and skill to perform the audit, including an adequate knowledge of professional standards and applicable legal or regulatory requirements, the audit process, the client's business environment, and the audit and financial reporting issues that apply to the employee benefit plan industry.

The requirement for reviewability by an experienced auditor *with no previous connection to the audit* means that evaluating the adequacy of the audit work performed by inspecting the documentation of that work should not require knowledge of matters known to the audit team, but not recorded in the workpapers.

There is no requirement for an auditor to document every item considered during the course of the audit. To do so would be impractical, if not impossible. The form, content, and extent of the workpapers will be dependent on factors that are unique to the engagement. In determining the documentation appropriate for a particular engagement, according to AU-C 230.A4, auditors may consider:

a. The size and complexity of the entity.

b. The audit methodology and tools used.

c. The identified risks of material misstatement.

d. The nature of the auditing procedures performed.

e. The amount of judgment involved in carrying out the procedure and evaluating the results.

f. The significance of the audit evidence obtained.

g. The nature and extent of exceptions.

h. The need to document or support a conclusion not readily apparent from the documentation of the work performed or evidence gathered.

AU-C 230 provides the following specific audit documentation requirements:

a. *Departures from the Requirements in the Auditing Standards.* In the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement of the auditing standards, documentation *must* be made justifying the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.

b. *Abstracts or Copies of Contracts.* The workpapers should include abstracts or copies of significant contracts or agreements inspected.

c. *Identification of Items Tested.* Documentation of procedures performed should identify the items tested.

d. *Individuals Performing and Reviewing the Work, and Associated Dates.* When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date and extent of the review.

e. *Significant Findings or Issues.* Auditors are required to document information related to significant audit findings or issues.

f. *Revisions after the Date of the Auditor's Report.* Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report. Revisions may be attributable to:

   •• Omitted procedures that would have been considered necessary at the time of the audit.

   •• Subsequent discovery of facts that existed at the date of the report.

   •• Other reasons an auditor considers it necessary to make an addition or change to the workpapers after the documentation completion date.

g. *Report Release Date.* The report release date should be recorded in the audit documentation.

Documenting Specific Items Tested and Other Procedures. Audit documentation of the procedures performed should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls, substantive tests of details involving inspection of documents or confirmation, and inquiry and observation procedures. For inspection of documents and confirmation procedures, the authors believe items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria. For example:

- For tests of significant items, documentation may describe the auditor's scope and the source of the items (for example, all benefit payments greater than $5,000 from the December cash disbursements records).
- For haphazard or random samples, documentation may identify the items by their dates and specific check numbers, employee numbers, etc.
- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

For inquiry and observation procedures, the identifying characteristics may be recorded as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.
- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

When an analytical procedure is used as a substantive procedure, AU-C 520, *Analytical Procedures* at AU-C 520.08, requires the auditor to document (a) the expectation and the factors considered in its development (unless readily determinable from the work performed), (b) the results of the comparison between the expectation and recorded amounts, and (c) any additional procedures performed to address significant unexplained differences and the results of those procedures. Although not required by authoritative literature, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation (for example, a percentage of tolerable misstatement).

Documenting the Identification of Preparer and Reviewer. According to AU-C 230.09, auditors should record who performed the audit procedures and when such work was completed. In most situations, this is a simple process; normally, the individual who performs the procedure initials and dates the specific workpaper, checklist, or program step that specifies the work performed. The checklists and audit programs included in *PPC's Guide to Audits of Employee Benefit Plans* provide spaces to facilitate this documentation. If a program step is supported by workpapers, there may be no point in dating both the program step and the supporting workpapers. Doing so creates the possibility of discrepancies in the dating. When completing audit program steps that are supported by workpapers, some auditors may choose to sign, but not date, such program steps because the supporting workpapers indicate the date the procedures were performed. In such cases, it is preferable to cross-reference the program steps to the supporting workpapers.

AU-C 230.09 also requires documentation of who reviewed *specific* audit documentation and the *date* and extent of the review. AU-C 230 does not indicate the exact manner or form of recording the evidence of these "who and when" components of the review. However, reviewers are *not* required to evidence their review on each working paper. For detailed reviewers, a practical and efficient way of indicating who reviewed the audit work and when is for the reviewer to initial and date the specific workpapers reviewed. However, auditors may adopt other documentation methods to evidence this review as long as it is clear who reviewed specified elements of the work and when the review occurred. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in a memo that indicates the workpaper sections reviewed and the date(s) of their review. Checklists may also be used to assist reviewers in performing and documenting their reviews of the audit work performed.

Documenting Significant Findings or Issues. On some employee benefit plan audits the engagement team may be faced with difficult issues that require significant professional judgment to resolve. Examples of significant audit findings or issues include the following:

- Significant matters involving the appropriate selection, application, and consistency of accounting principles, such as:
  - The reasonableness of significant accounting estimates and underlying assumptions.
  - The likelihood of significant contingencies occurring.
  - Complex or unusual transactions and the application of GAAP to those transactions.
- Results of procedures that indicate the financial statements or disclosures could be materially misstated.
- Results of procedures that indicate a need to revise prior assessments of the risks of material misstatement and the auditor's responses to such risks.
- Circumstances that cause significant difficulty in applying procedures considered necessary.
- Other findings that could result in modification of the auditor's report.
- Audit adjustments identified by the auditor, whether or not recorded by the client, that could, either individually or when aggregated with others, have a material effect on the financial statements.

AU-C 230.08 requires auditors to document significant audit findings or issues such as those outlined in the previous paragraph, actions taken, evidence obtained in addressing them, and significant professional judgments made in reaching conclusions.

Discussions of significant findings, or issues that occur between the auditor and plan management should also be documented in a timely manner, including the items discussed and when and with whom they were discussed. In addition, the auditor should document similar information regarding any discussions of significant findings or issues with internal or external parties other than plan management including board or audit committee members (if applicable), lower level employees, trustees, record keepers, or other third-party service providers. Minutes of meetings attended by the auditor at which these matters were discussed can satisfy this documentation requirement.

According to AU-C 230.12, auditors should also document how they addressed information that was contradictory or inconsistent with their final conclusion on a significant finding or issue. Such documentation might include the auditor's procedures to address the information or consultations regarding differences in professional judgment among audit team members or between the team and others consulted.

Significant findings or issues may be documented in a separate memorandum. The authors recommend that such a memorandum begin with a description of the facts giving rise to the issue, followed with a discussion of the factors considered and evidence gathered in formulating the conclusion. The auditor's conclusion needs to be clearly stated, along with the reasoning process supporting the conclusion. Other items that ought to be documented include any discussions as noted in the two preceding paragraphs, the existence of conflicting evidence or guidance supporting contrary points of view, and any consultation that occurred in resolving the issue.

Documenting Reportable Findings. AU-C 703.27 requires the auditor to communicate to those charged with governance any *reportable findings* based on the audit procedures performed if the auditor identifies items that are not in accordance with the plan's provisions that would affect the risk of material misstatement at the relevant assertion level for classes of transactions, account balances, and disclosures. According to AU-C 703.25, reportable findings are matters that include one or more of the following: (1) noncompliance or suspected noncompliance with laws and regulations (based on AU-C 250), (2) a finding that, in the auditor's professional judgment, is significant and relevant to those charged with governance regarding their responsibility to oversee the financial reporting process (based on AU-C 260), and (3) an indication of internal control deficiencies identified during the audit that have not been previously communicated to management by other parties and that the auditor determines are sufficiently important to merit management's attention (based on AU-C 265). The communication with those charged with

governance should be in writing and should be made on a timely basis so appropriate action can be taken, if necessary.

Documenting Revisions after the Date of the Auditor's Report. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor needs to strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. When concluding the audit, the auditor should ensure that the documentation meets the objectives outlined earlier in this section, in the "Audit Documentation (Workpapers)" discussion. Professional standards also include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.
- The documentation completion date.

Those dates, as well as the requirements for assembling and completing the audit file and making changes to the workpapers, are discussed in the following paragraphs.

The *audit report date* represents the date that the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements. Typically, such evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor cannot simply use the date that the audit team left the field unless the requirements of this paragraph have been satisfied at that date.

AU-C 220.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220.A17 observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

AU-C 230.06 defines the *report release date* as the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most audits of employee benefit plans, this will be the date the auditor delivers the report to the client. AU-C 230.15 requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's report.

SQCS No. 8 (QC 10.49) specifies that firms "should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been released." Those policies and procedures ought to comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. Professional standards require workpapers to be completed on a timely basis as the engagement progresses. The final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to this date as the *documentation completion date*. According to AU-C 230.17, after that date, the auditor should not delete or discard any documentation prior to expiration of the required five-year retention period. (ERISA requires the auditor to maintain workpapers for at least six years.) Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's policy of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

At any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. The auditor ought not make changes after the report date that would have affected the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

When the auditor determines that it is necessary to make additions or other changes to the audit workpapers after the date of the auditor's report for other than those activities noted in the previous paragraph, the auditor changes the audit documentation to record the performance of the new procedure or the new conclusions that were reached. In addition, according to AU-C 230.18, the documentation of the changes should include:

- When and by whom the changes were made and reviewed.
- The specific reasons for the change.

The auditor also needs to consider whether there are regulatory or state requirements that differ from GAAS.

Audit Documentation Recommendations. There are a number of practical workpaper documentation techniques that the authors recommend auditors follow, including the following:

- Always identify the individuals who performed and reviewed the audit work and the dates completed and reviewed.
- Clearly describe the purpose of the workpaper and the nature of the audit steps performed. For example, state "Examined employee payroll records and compared totals to the contribution calculation to determine the accuracy of the employee contribution calculation" rather than simply "Vouched."
- Identify client prepared schedules, including, if applicable, the title of the report, the period covered, and the date prepared.
- Initial and cross-reference from the work program to the documentation supporting the completion of the related program step.
- Document the resolution of all significant questions and issues raised during the audit, including discussions with management and others.

Workpaper Indexing. In practice, workpaper files normally fall into three categories (a) the general file, (b) the account balance file, and (c) the permanent file. There is a great deal of flexibility and individuality in the contents of files and the way they are indexed and cross-referenced. The most important consideration is to use some type of well-organized, but simple, system that can be uniformly adopted on all engagements. One simple scheme is to use one folder or binder for general file items, for example, the audit planning form, planning materiality worksheet, etc., with the individual items indexed alphabetically, and a series of binders or folders for the work file. The material for each audit program area can be indexed numerically with a prefix to indicate it is a work file; for example, contributions received and receivable would be WF-1, and the workpapers within that file would be WF-1-1, WF-1-2, etc. Many auditors assign an alphabetic code to each account balance or audit program area, for example, A for contributions received and receivable, B for investments and related income, etc., and numerically index supporting

schedules within each alpha code, for example, A-1, A-2, B-1, B-2, etc. These are just two possible approaches to workpaper indexing, but the authors encourage adoption of a simple indexing approach.

Additional Workpaper Considerations for an ERISA Audit. When the engagement needs to meet ERISA requirements, there are several unique workpaper considerations. The DOL may decide to review the auditor's workpapers if it concludes that there are inadequacies in the auditor's report, financial statements, or required schedules submitted with Form 5500. Auditors also need to be aware of the DOL's position on undocumented audit procedures.

While the DOL does not have any explicit requirements for workpaper documentation more extensive than required by GAAS, the auditor needs to anticipate the increased potential for review of ERISA audit workpapers in making decisions about the extent of documentation. Such a review may be made by the DOL or by a peer reviewer. Under the AICPA peer review program, greater weight is given to selecting an ERISA audit for review if a firm has audit clients subject to ERISA audit requirements.

ERISA, Title I, Section 107, requires the auditor to maintain workpapers for at least six years.

SPECIAL PLANNING CONSIDERATIONS FOR INITIAL ENGAGEMENTS

Because ERISA generally does not require plans to be audited until they have 100 or more participants, the audit of many small plans may be an initial audit.

In an initial audit, the auditor needs to apply sufficient auditing procedures to prior years' information to be satisfied about opening balances and the consistency of application of accounting principles with the preceding year. Considerations with respect to consistency include whether the accrual basis and current value accounting were used in the preceding year and whether the actuarial assumptions and methods used in the preceding year to determine a defined benefit plan's actuarial present value of benefit obligations were consistent with those used for the current year. The auditor also needs to consider whether the plan's procedures in the preceding year for authorizing transactions; determining eligibility, vesting, and benefits; accumulating participant data; etc., are consistent with those used in the current year. With respect to consistency of accounting policies, the authors believe that a change in the format of presentation of accumulated benefit information (from the notes to the financial statements, or vice versa) or in the date as of which it is presented (from the beginning to the end of the year) is not a change that requires modification of the audit report with respect to consistency.

AEBP, Paragraph 2.165, indicates that areas of special consideration in an initial audit of a plan's financial statements may include the completeness and accuracy of participant data and records of prior years, especially as they relate to the following: (a) participant contributions and eligibility, (b) amounts and types of benefits, (c) eligibility for benefits, (d) participant account balance, and (e) census data maintained by the plan's actuary. The nature, timing, and extent of auditing procedures to be applied in an initial audit will vary with the adequacy of plan records, the materiality of opening balances, the complexity of plan operations, and whether the plan was previously audited. If the plan was audited previously, the auditor may rely on the predecessor auditor's work, but if the plan was not previously audited, a more extensive audit will usually be necessary.

Initial Audit of a Previously Unaudited Plan

Generally, the initial audit of a previously unaudited plan presents fewer problems than the initial audit of a small business. There are several reasons for this. Opening balances are relatively more easy to reconstruct; for example, opening investment balances can be rolled back from ending balances, and prices can be traced to prior year end market quotations. There are no opening account balances that present the type of problems created by inventory of a small business. Usually the accounting records are adequate for establishing opening balances and consistent application of accounting policies because the plan is concerned about adhering to ERISA requirements. ERISA, Title I, Section 209, requires plans to keep sufficient records to determine and report an employee's benefits. Although these conditions usually make an initial audit with an unqualified opinion feasible, the amount of work required will make the initial audit time consuming and costly. For example, it can be time consuming to test the opening participant account balances. When the plan has previously been audited, the amount of work can be reduced if reliance on the predecessor is feasible.

Procedures to Test Opening Balances. Some procedures that would be applied to the opening balances include examining support for the acquisition, cost, and fair value of investments, and examining support for any employer contribution receivable and its subsequent collection. For a defined benefit plan, preceding years' actuarial reports ought to be reviewed for indications of the consistency and reasonableness of actuarial assumptions and methods used in determining the actuarial present value of benefit obligations. Procedures similar to those in the audit program for participant data may be applied with respect to prior year participant data and eligibility.

Significant work may be necessary to test the opening balances of individual participant accounts for a defined contribution plan. The auditor obtains an analysis of the participant accounts for as many years as necessary to build up the opening balances, possibly from inception of the plan. The analysis ought to show, for each year, the additions and deductions to the individual participant accounts, in total and by individual participant, for the employer contribution, withdrawals, forfeitures, investment income and realized and unrealized gains and losses, and plan expenses. On a test basis, significant additions and deductions for selected years (for example, the total employer contribution for a particular year) can be traced to support such as that year's general ledger, financial statements, Form 5500, etc. The account balances and allocations for a selected number of employees can be tested from the start of their participation in the plan. Procedures similar to those in the Basic Procedures section of the audit programs for participant data, benefit payments, and participant accounts can be applied for an appropriate number of prior years to test the information in the analysis and individual account balances. If results of procedures applied in those areas for the current year are satisfactory and procedures have not changed significantly, it may be possible to reduce the extent of procedures on the opening participant account balances.

Financial Statement and Auditor's Report Implications. For a defined contribution plan, it is particularly important to test the allocation of the employer contribution, forfeitures, and investment income, gains, and losses to the individual participant accounts for a sufficient number of preceding years to obtain satisfaction that the opening balance is correct. The reason is that allocation misstatements made in preceding years would have resulted in incorrect distributions to participants who terminated in preceding years, and, thus, to misstatement of the opening balance. If adequate tests of allocations to the opening balance of individual participant accounts cannot be performed because of inadequate records or for other reasons, a report modification may be necessary because of the scope limitation. The report modification could continue indefinitely because the ability to reach an opinion on each succeeding year's closing balance could continue to be affected by the scope limitation on the preceding year's opening balance.

Typically, the auditor of a previously unaudited small entity audits only the current year's financial statements. However, DOL regulations require presentation of a comparative statement of net assets by the plan. DOL officials have publicly stated that, in these circumstances, the prior year statement can be compiled or reviewed.

Audit of a Previously Audited Plan

When a plan has been audited previously, certain communications with the predecessor auditor are required by professional standards, and other communications can facilitate the successor's audit. AU-C 210.11 notes that the successor auditor should request permission from the prospective client to inquire of the predecessor auditor, prior to final acceptance of the engagement, about matters that would assist in making the acceptance decision. In determining whether to accept the engagement the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response. AU-C 510.07 states that, in instances in which the prior period financial statements were audited by a predecessor auditor, the auditor should request management to authorize the predecessor auditor to allow a review of the predecessor auditor's audit documentation. Thus, there are two aspects of communication with a predecessor: (a) inquiring about matters that bear on acceptance of the engagement, and (b) obtaining audit documentation to facilitate the audit of opening balances in initial audits. AU-C 510.A5 notes that the predecessor auditor ordinarily permits the successor to review working papers containing several types of documentation, including documentation on related parties and significant unusual transactions.

According to AU-C 510, a *predecessor auditor* is an auditor from another audit firm who either reported on the most recent audited financial statements or was engaged to but did not complete an audit of the financial statements. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor

auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. Communication about management integrity and other matters is made of all predecessor auditors. However, when a predecessor did not complete the audit, it is less likely the auditor will consider it appropriate to review the predecessor's workpapers.

Communications after acceptance that may facilitate the successor's audit generally fall in the following categories:

- Inquiries of the predecessor regarding matters that the successor believes may affect the conduct of the audit, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the financial reporting system and records.
- Review of the predecessor auditor's workpapers.

If the auditor believes information from the predecessor's audit documentation can be used, considerable audit time can be saved. However, according to AU-C 510.14, the successor auditor cannot make reference to the report or work of the predecessor auditor as the basis, in part, for his or her own opinion. This type of report reference divides responsibility among auditors for the opinion on the financial statements. Because the predecessor's work is considered as part of the evidence for beginning balances and consistent application of accounting policies, there is no identifiable portion of the financial statements for a meaningful division of responsibility.

The successor auditor has to request the client to authorize the predecessor auditor to allow a review of the predecessor's workpapers. Generally, it is more efficient to make this request at the same time permission is requested concerning the inquiries to be made before acceptance.

The successor's review of the predecessor's workpapers has two aspects. The first is a general review to make a preliminary assessment of whether the predecessor's audit was made in accordance with GAAS. During this phase, the auditor would review the audit plan and audit programs (unless the predecessor considers the programs proprietary in nature), including particularly the analysis of the risk of material misstatements and the understanding of internal control. The auditor would consider the apparent understanding of the client, its systems, its operations, and its accounting policies obtained by the predecessor and the general quality of the documentation of these matters. If there is a summary memorandum of significant accounting and auditing issues, the successor would consider it carefully.

The second aspect of the successor's review is a detailed consideration of trial balances, account balance analyses, adjusting journal entries, and items from the permanent files such as contracts, carryforward schedules, and other workpapers in important audit areas. The successor would consider particularly the audit work done on participant data and records, individual account balances, and investments, and the results of procedures undertaken to identify parties in interest and prohibited transactions and to determine the tax-exempt status of the plan. The successor requests copies of workpapers of continuing accounting significance.

ERISA requires presentation of a comparative statement of net assets available for benefits. This means that the successor auditor needs to decide on one of the two following reporting options concerning the prior year's statements:

a. have the predecessor reissue his or her report on the prior year's statements, or

b. refer to the predecessor's report in the scope paragraph of the successor's report.

When a predecessor's report is reissued, according to AU-C 560.19, a predecessor auditor should (a) read the financial statements of the current period, (b) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (c) obtain representation letters from management of the former client and from the successor auditor. The letter from the successor auditor ought to state whether the successor has detected any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor. The representation letter from management addresses whether any prior management representations made have changed and whether any subsequent events have occurred that affect the prior period financial statements.

Audits of Plan Financial Statements Previously Audited (Reaudits)

An auditor may be asked to audit and report on a plan's financial statements for a period that was previously audited and reported on by a predecessor auditor (a reaudit). This differs from the situation discussed earlier in this section in which the auditor is reporting on the financial statements for a period subsequent to the period audited and reported on by the predecessor auditor. As discussed earlier, the auditor's procedures when he or she intends to use information from the audit documentation of the predecessor auditor for substantiating opening balances will differ from when the auditor does not intend to use the work of the predecessor auditor.

The following questions have arisen in practice about the responsibilities of the successor and predecessor auditor in a reaudit:

- What communications are required between the successor and predecessor auditors, and when?
- How much audit evidence can be obtained from the work of the predecessor auditor?
- What is the effect on the successor auditor's report?

AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, applies essentially the same requirements to reaudits with respect to opening balances, as apply to auditing the current period financial statements when the prior period was audited by a predecessor. AU-C 510 does not address using information from the predecessor's audit documentation in reaching a conclusion on ending balances. The successor auditor's opinion on the reaudited financial statements is solely the responsibility of the successor auditor.

Communications with the Predecessor Auditor. As discussed in Lesson 1, the successor auditor is required to communicate with the predecessor auditor prior to accepting the prospective client. These communications should also be made when engaged to audit and report on financial statements previously audited and reported on by a predecessor auditor. When making the inquiries, the successor auditor needs to clearly communicate that the purpose of his or her communications is to obtain information about whether to accept an engagement to report on financial statements previously audited and reported on by the predecessor auditor.

When the auditor has been engaged to audit and report on financial statements for a period previously audited by a predecessor auditor, the successor would normally request access to and review the predecessor's workpapers for the period under audit (the reaudit period) and the period prior to the reaudit period. As previously discussed, after accepting a new engagement, the successor auditor usually requests access to the predecessor's workpapers for the prior period to substantiate beginning balances and to evaluate the consistency in application of accounting principles. In a reaudit situation, the auditor reviews the workpapers for the period to be reaudited for purposes of obtaining information to be used in planning his or her reaudit. Before requesting permission from the predecessor auditor, the successor auditor needs to obtain the client's consent to review the predecessor's workpapers.

AU-C 210.11 indicates that the inquiries of the predecessor regarding matters that will assist in making the engagement acceptance decision should be made *before* accepting the engagement. Thus, a successor auditor may issue a proposal to a prospective client before making these required inquiries of the predecessor auditor. The authors encourage successor auditors to include a statement in the proposal advising prospective clients that final acceptance may occur only after the necessary communications with the predecessor auditor. However, the standards do not require such a statement. AU-C 510.A3 indicates that the auditor may initiate communications with management to authorize review of the predecessor's audit documentation and for the predecessor to respond fully to related inquiries by the auditor, either *before* or *after* accepting the engagement.

Reliance on the Work of the Predecessor. With respect to opening balances of the reaudited financial statements, the predecessor's audit documentation may be used as audit evidence in the same manner as audit documentation of the audit of the prior period. AU-C 510 does not directly address using information in the predecessor's audit documentation as audit evidence for closing balances. When performing a reaudit, the successor auditor reviews the predecessor's workpapers for the reaudit period and the period prior to the reaudit period. However, the purpose of the successor's review of the predecessor's workpapers for the reaudit period cannot be to "rely" on the predecessor's workpapers as evidence. Instead, the purpose for reviewing the workpapers for the reaudit period is to obtain information that might be useful in planning and performing the reaudit. Because the successor auditor has been

engaged to perform a reaudit, the audit work performed and the conclusions reached are solely the responsibility of the successor auditor. If the successor were to rely on the predecessor's workpapers to support his or her opinion, the successor would not have obtained sufficient evidence for expressing an opinion. In other words, the successor auditor has to perform the procedures considered necessary to report on the financial statements as if they had not been audited by the predecessor auditor. For example, the successor auditor cannot rely on the confirmation procedures documented in the predecessor's workpapers as evidence to support the existence of investments. Additional procedures, such as sending additional confirmations or testing of participant data, would have to be performed by the successor auditor.

Effect on the Successor's Audit Report. When an auditor is reporting on plan financial statements that have been previously audited and reported on by a predecessor auditor, the successor auditor cannot assume responsibility for the work of the predecessor or make reference to the report of the predecessor auditor. However, if the financial statements of the reaudit period and the period *prior to* the reaudit period (which were not reaudited by the successor auditor) are presented, the ERISA requirements discussed earlier in this section would apply. Additional guidance on reporting in these circumstances may be found in *PPC's Guide to Auditor's Reports*.

Providing Access to Workpapers in a Reaudit Situation. When the predecessor auditor is requested to provide access to workpapers in a reaudit situation, it is generally considered a professional courtesy to provide that access. However, there may be circumstances in which the request would not be accommodated. This option is acknowledged in AU-C 510.A7. It states that the predecessor auditor determines the extent, if any, of access a successor auditor may have to the workpapers. One solution is for the predecessor to provide access only to workpapers for the period *prior* to the reaudit period. Another is for the predecessor to obtain written confirmation from the successor that its work will not be relied upon as a basis for the successor's report on the reaudited periods.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. When a defined benefit pension plan uses an actuary to prepare the actuarial present value of benefit obligations, the auditor should apply all of the following procedures **except**:
    a. Make inquiries about the actuary's qualifications.
    b. Consider whether the actuary is objective.
    c. Review the client's understanding with the actuary.
    d. Obtain audit evidence about the accuracy and completeness of census data.
23. If an auditor is auditing investments in a master trust as part of the audit of an employee benefit plan, which of the following timing or coordination issues might occur?
    a. The auditor may need to obtain the trustees' audited financial statements.
    b. The auditor may need to obtain a SOC 1 report from another auditor.
    c. The auditor may need to apply procedures on records located at different employers.
    d. The auditor is obligated to read the plan's Form 5500 and consider the information.
24. The auditor of an employee benefit plan is most likely to use audit sampling in which of the following audit areas?
    a. Employer contributions received and receivable.
    b. Investments and related income.
    c. Participant data and employee contributions.
    d. Benefit payments and obligations.
25. Which of the following is an audit documentation requirement provided in AU-C 230?
    a. Workpapers should include original copies of significant contracts or agreements.
    b. The identity of items tested should be hidden for confidentiality reasons.
    c. Justification for departing from presumptively mandatory requirements should be included.
    d. Once the auditor's report is released, no revisions should be made to the workpapers.
26. What occurs on the *audit report date*?
    a. The auditor will no longer delete or discard any of the audit documentation.
    b. The client has permission to use the auditor's report in connection with the financial statements.
    c. The audit team has completed all fieldwork associated with the audit engagement.
    d. The auditor has obtained sufficient appropriate evidence to support the opinion on the financial statements.

27. Which of the following occurs when an auditor is engaged to audit a previously audited employee benefit plan?

    a. The auditor should request permission to review the predecessor auditor's audit documentation.

    b. Only successor auditors who actually completed an audit should be contacted.

    c. The predecessor's work can be used as the basis for the successor auditor's opinion.

    d. The successor only needs to determine that the predecessor's audit was done in accordance with GAAS.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

22. When a defined benefit pension plan uses an actuary to prepare the actuarial present value of benefit obligations, the auditor should apply all of the following procedures **except**: **(Page 115)**

    a. Make inquiries about the actuary's qualifications. [This answer is incorrect. One of the procedures that an auditor may apply in this situation, according to AU-C 501.27, is to inquire about the actuary's qualifications, reputation, and relationship to the client.]

    b. Consider whether the actuary is objective. [This answer is incorrect. As discussed in AU-C 501.27, the auditor should consider the actuary's objectivity. The work of a specialist having no relationship with the plan will provide the auditor with a greater degree of reliability than the work of a specialist who is related to the plan.]

    c. **Review the client's understanding with the actuary. [This answer is correct. Per AU-C 501.27, the auditor is supposed to reach an understanding with the client and the actuary about the nature of the actuary's work, including things such as (1) the objectives and scope of the actuary's work, (2) the methods and assumptions, and (3) a comparison of the methods and assumptions with those used in the preceding period. Based on this guidance, the auditor is a part of forming this understanding, not merely reviewing the understanding already made by the client and the actuary.]**

    d. Obtain audit evidence about the accuracy and completeness of census data. [This answer is incorrect. The auditor, according to AU-C 501.27, should obtain audit evidence of the accuracy and completeness of census data provided by the plan and used by the actuary in the actuarial valuation. The auditor may coordinate these procedures with procedures to be applied to plan contributions and participant data.]

23. If an auditor is auditing investments in a master trust as part of the audit of an employee benefit plan, which of the following timing or coordination issues might occur? **(Page 117)**

    a. **The auditor may need to obtain the trustees' audited financial statements. [This answer is correct. The auditor may need to obtain the audited financial statements of trustees or insurance companies holding plan assets or with which the plan has insurance or investment contracts. The auditor needs to determine whether such financial statements are necessary and make the request on a timely basis. Audit areas in which audited financial statements of trustees or insurance companies may be considered necessary include (1) in considering the financial capability of trustees holding plan investment assets and (2) in auditing investments in common/collective trusts or master trusts.]**

    b. The auditor may need to obtain a SOC 1 report from another auditor. [This answer is incorrect. SOC 1 reports are associated with service organizations, which is a different consideration than the master trust issue discussed above.]

    c. The auditor may need to apply procedures on records located at different employers. [This answer is incorrect. If auditing a multiemployer plan, it may be necessary for the auditor to apply procedures to contribution and participant data records at several employers or to rely on employers' auditors to apply such procedures. This, however, is a different timing and coordination issue than the one related to master trusts discussed above.]

    d. The auditor is obligated to read the plan's Form 5500 and consider the information. [This answer is incorrect. AU-C 703.48 requires the auditor to read a substantially complete draft of Form 5500 to identify any material inconsistencies with the audited financial statements prior to the report release date. However, this obligation is not related to the master trust issue described above but is a separate consideration.]

24. The auditor of an employee benefit plan is most likely to use audit sampling in which of the following audit areas? **(Page 119)**

    a. Employer contributions received and receivable. [This answer is incorrect. It is rare for sampling to be used in this audit area.]

    b. Investments and related income. [This answer is incorrect. It is rare to moderate for sampling to be used in this audit area. While more likely than some, there is a better answer choice.]

    c. **Participant data and employee contributions. [This answer is correct. Considering the normal characteristics of the various audit areas of employee benefit plans, it is possible to generalize about the likelihood of audit sampling. According to the guidance in this course, it is likely that a plan auditor would use audit sampling for his or her audit of participant data and employee contributions. The most likely sampling approach would be transaction testing.]**

    d. Benefit payments and obligations. [This answer is incorrect. These are two different audit areas. It is rare that an auditor would use sampling in relation to benefit obligations, although there is a moderate chance that the auditor might use audit sampling in relation to benefit payments. However, there is a likelier audit area listed.]

25. Which of the following is an audit documentation requirement provided in AU-C 230? **(Page 126)**

    a. Workpapers should include original copies of significant contracts or agreements. [This answer is incorrect. According to AU-C 230, the workpapers should include *abstracts or copies* of significant contracts or agreements inspected, not the originals.]

    b. The identity of items tested should be hidden for confidentiality reasons. [This answer is incorrect. As discussed in the guidance provided in AU-C 230 about audit documentation, the documentation of procedures performed should identify the items tested.]

    c. **Justification for departing from presumptively mandatory requirements should be included. [This answer is correct. Per AU-C 230, in the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement of the auditing standards, documentation *must* be made justifying the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.]**

    d. Once the auditor's report is released, no revisions should be made to the workpapers. [This answer is incorrect. According to AU-C 230, auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report. Therefore, in those instances, the workpapers would have to be changed.]

26. What occurs on the *audit report date*? **(Page 129)**

    a. The auditor will no longer delete or discard any of the audit documentation. [This answer is incorrect. This is the *documentation completion date*. According to AU-C 230.17, after this date, the auditor should not delete or discard any documentation prior to the expiration of the required five-year retention period, and ERISA requires auditors to maintain workpapers for at least six years.]

    b. The client has permission to use the auditor's report in connection with the financial statements. [This answer is incorrect. AU-C 230.06 defines the *report release date* as the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements.]

    c. The audit team has completed all fieldwork associated with the audit engagement. [This answer is incorrect. The auditor cannot use the date that the audit team left the field as the audit report date unless certain conditions are already met as of that date. Therefore, there is a better answer to this question.]

    d. **The auditor has obtained sufficient appropriate evidence to support the opinion on the financial statements. [This answer is correct. The *audit report date* represents the date that the auditor obtained sufficient appropriate evidence to support his or her opinion on the financial**

statements. Typically, such evidence includes evidence that (1) the audit work has been reviewed; (2) the financial statements, including disclosures, have been prepared; and (3) management has taken responsibility for the financial statements.]

27. Which of the following occurs when an auditor is engaged to audit a previously audited employee benefit plan? **(Page 132)**

    a. **The auditor should request permission to review the predecessor auditor's audit documentation. [This answer is correct. AU-C 510.07 states that, in instances in which the prior period financial statements were audited by a predecessor auditor, the auditor should request management to authorize the predecessor auditor to allow a review of the predecessor auditor's audit documentation.]**

    b. Only successor auditors who actually completed an audit should be contacted. [This answer is incorrect. According to AU-C 510, a *predecessor auditor* includes one who was engaged to but did not complete an audit of the financial statements. Communication about management integrity and other matters is made of *all* predecessor auditors (not successor auditors).]

    c. The predecessor's work can be used as the basis for the successor auditor's opinion. [This answer is incorrect. According to AU-C 510.14, the successor auditor *cannot* make reference to the report or work of the predecessor auditor as the basis, in part, for his or her own opinion.]

    d. The successor only needs to determine that the predecessor's audit was done in accordance with GAAS. [This answer is incorrect. The successor's review of the predecessor's workpapers has two aspects. The first is a general review to make a preliminary assessment of whether the predecessor's audit was made in accordance with GAAS. The second is a detailed consideration of trial balances, account balance analyses, adjusting journal entries, and items from the permanent files such as contracts, carryforward schedules, and other workpapers in important audit areas.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 1—Pre-engagement Activities and Audit Planning (EBPTG221)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     EBPTG221 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **March 31, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 1—Pre-engagement Activities and Audit Planning (EBPTG221)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. When should auditors perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements?

   a. At the end of the prior-year's engagement.

   b. Prior to performing significant audit activities for the current engagement.

   c. Prior to completing the fieldwork for the current engagement.

   d. Before the audit report for the current engagement is released.

2. When an auditor performs nonattest services for an attest client, which of the following is required?

   a. The understanding must be documented in a separate engagement letter.

   b. The understanding must be documented in a separate form in the workpapers.

   c. The understanding must be documented in the engagement letter for the audit engagement.

   d. The understanding must be established and documented in writing.

3. Which of the following statements best reflects the relationship between the AICPA, ERISA, and DOL independence rules?

   a. The DOL rules related to performing nonattest services are narrower than the AICPA rules.

   b. A violation of the DOL's rules does not affect auditors' compliance with the AICPA rules.

   c. Unlike the AICPA and DOL, ERISA rules do not require auditors to be independent from their clients.

   d. Auditors can choose to comply with the rules that are least stringent for their particular engagement.

4. Which of the following acceptance and continuance considerations takes on special significance in an employee benefit plan audit due to the fact that plan management is considered a fiduciary?

   a. Communication with a successor auditor.

   b. The auditor's expertise with benefit plans.

   c. Outsourcing record storage and software hosting.

   d. Management's integrity.

5. The assets of Hammer Health, an employee benefit plan, are held for investment by First National Bank. How might this affect Hammer Health's audit?

   a. The plan will be eligible to undergo an ERISA Section 103(a)(3)(C) audit.

   b. The audit engagement is likely to be more costly to perform than if the plan held its own assets.

   c. The financial statement disclosures normally required by GAAP and by DOL are not needed.

   d. The auditor will not be able to complete the engagement by the Form 5500 filing deadline.

6. Which of the following may occur if the auditor is asked to prepare the plan's Form 5500?
   a. The audit timeline will not be affected as preparing Form 5500 is simple.
   b. The auditor will be exempted from all of the normal audit responsibilities under GAAS.
   c. The auditor must obtain from management a substantially completed draft to identify any material inconsistencies.
   d. The auditor is prohibited from completing this form and should not accept the engagement.
7. According to SQCS No. 8 and AU-C 220.14, how often should a firm evaluate its continuing clients and engagements?
   a. Quarterly.
   b. Annually.
   c. Biannually.
   d. Prior to peer review.
8. What is an engagement letter typically used for?
   a. To provide general, nonspecific information about the audit engagement.
   b. To report the sale of securities or interests to the SEC.
   c. To document the auditor's engagement acceptance or continuance decision.
   d. To document the terms of the engagement with the client.
9. A high-level description of the audit scope, timing, and direction that makes up the auditor's operational approach is called what?
   a. Audit procedure.
   b. Audit program.
   c. Audit risk.
   d. Audit strategy.
10. Which of the following statements best describes the types of risk assessment and other planning procedures that an auditor may perform?
    a. The nature, timing, and extent of risk assessment procedures is identical from audit to audit, without the need to tailor them to each specific entity.
    b. Identifying fraud risks is a separate consideration that does not factor into the performance of risk assessment and other planning procedures.
    c. If risk assessment and planning procedures are performed for a new engagement, the results can be used in future years with no additional procedures needed.
    d. Inquiries, observation, and inspection will always be part of these procedures, but the extent of procedures will be less for a continuing engagement.

11. What is the best way to conduct inquiries in the COVID-19 era?

    a. Auditors are still required to conduct inquiries in person.

    b. Inquiries can be sent in writing with the engagement letter.

    c. Telephone interviews are preferred for convenience.

    d. Videoconferencing is preferred for expressions and body language.

12. During the audit planning phase, observation and inspection are often used for what purpose?

    a. To analyze the relationships between financial statement items.

    b. To corroborate the results of inquiries of plan management and others.

    c. To determine what matters are covered by the engagement team discussion.

    d. To meet the requirements for observation and inspection in the professional guidance.

13. Per AU-C 315A.11, when the engagement team meets to discuss how susceptible the plan's financial statements are to material misstatement, who is required to attend that discussion?

    a. The audit team's key members, including the engagement partner.

    b. Members of the audit team with little knowledge or experience with the plan.

    c. Every engagement team member, so that they are kept informed of all decisions.

    d. The external IT specialist who assists the team in uploading files to a new server.

14. How does an auditor's understanding of an employee benefit plan's industry, regulatory, and other external factors affect the audit engagement?

    a. Information on the scope of the audit obtained during preliminary engagement activities is incorporated into this understanding.

    b. Because plan sponsors operate in different industries, U.S. economic developments are unlikely to affect employee benefit plans.

    c. Familiarity with ERISA is enough to determine whether the auditor can meet the requirements of an employee benefit plan audit.

    d. Typically, the nature, timing, and extent of planning will be the same for any employee benefit plan audit so this understanding is cursory in nature.

15. How should an auditor address a plan's pending amendments?

    a. Request a formal resolution from the plan sponsor.

    b. Make a note to test the amendment in future audits.

    c. Have a casual conversation with the plan sponsor about them.

    d. If amendments are not fine, the auditor has no responsibility for them.

16. When a plan fails to achieve the Internal Revenue Code's (IRC) nondiscrimination requirements due to a shift in the makeup of the employer's workforce, what type of plan defect has occurred?

    a. A discovered defect.

    b. A demographic defect.

    c. A reportable defect.

    d. An operational defect.

17. Reviewing the plan's key performance indicators (KPI), trends, key ratios, forecasts, and budgets will help an auditor obtain an understanding of which of the following?

    a. Industry, regulatory, and other external factors.

    b. Measurement and review of financial performance.

    c. Objectives, strategies, and related business risks.

    d. Selection and application of accounting policies.

18. Auditors are often instrumental in assisting small employee benefit plan clients with their selection of accounting principles. How will this affect the audit engagement?

    a. The auditor will lose his or her independence in relation to the plan because they have taken on the responsibilities of management.

    b. The auditor cannot perform the engagement if he or she did not also choose the methods by which the principles are applied.

    c. The auditor will need to extend the timeline for the audit substantially due to the addition of this time-consuming process.

    d. The auditor may be able to limit his or her procedures in this area as he or she will already possess most of the needed knowledge.

19. What are the five components of internal control, as outlined in COSO's *Internal Control—Integrated Framework*?

    a. Control environment, the financial reporting system, information technology (IT), monitoring, and control activities.

    b. Control environment, information and communication, IT, monitoring, and control activities.

    c. Control environment, risk assessment, the financial reporting system, monitoring, and control activities.

    d. Control environment, risk assessment, information and communication, monitoring, and control activities.

20. Which of the following responsibilities do auditors have regarding the nature and extent of their understanding of a plan's internal control?

    a. If the plan's controls are nonexistent or ineffective, auditors are exempt from obtaining this understanding.

    b. The evaluation of the design and implementation of the plan's controls for all five components is required annually.

    c. Understanding the design and implementation of a plan's internal controls is sufficient enough to reach a conclusion about operating effectiveness.

    d. This understanding is typically less involved and takes less time than other elements of understanding the plan and its environment.

21. How detailed should the auditor's understanding of internal control be in order to assess the risk of material misstatement due to error or fraud and design further audit procedures?

    a. Complete.

    b. Cursory.

    c. Reasonable.

    d. Sufficient.

22. A plan's *cybersecurity* consists of which of the following?

    a. The complexity of the IT systems and how they are used in plan operations.

    b. Packaged applications, custom developed applications, and end-user computing.

    c. IT-related controls that guard against unauthorized access.

    d. The processing of financial data in an IT environment.

23. A employee benefit plan's control environment is normally enhanced by the existence of which of the following?

    a. An audit committee.

    b. An internal audit function.

    c. A service organization.

    d. Training manuals.

24. An auditor's understanding of the financial reporting system is generally—

    a. independent of IT.

    b. at a high level.

    c. focused on fraud, not material misstatement.

    d. focused on entity controls, not application controls.

25. Walkthroughs are generally helpful with obtaining an understanding of which of the following?

    a. The plan administrator's attitude and awareness.

    b. The financial reporting system.

    c. Plan management's communication.

    d. Monitoring activities.

26. Performance reviews, information processing, physical controls, segregation of duties, and accountability are categories of what?

    a. Control activities.

    b. Internal auditing activities.

    c. Monitoring activities.

    d. Risk assessment activities.

27. Who is responsible for reading a SOC 1 report to determine whether an employee benefit plan's investments were subject to the service auditor's audit scope?

    a. The service auditor.

    b. The plan's auditor.

    c. Plan management.

    d. A third-party administrator.

28. Why might a plan auditor need to visit a service organization?

    a. The SOC 1 report addresses the same financial period as the plan's financial statements.

    b. The service organization obtains a SOC 1 report every year instead of on a rotating basis.

    c. The SOC 1 report addresses the activities of a subservice organization provided indirectly to the plan.

    d. The plan auditor would like to reduce the assessed level of control risk at the service organization.

29. How might COVID-19 affect a plan's internal control?

    a. Too many personnel might be assigned to the same task.

    b. Personnel might be assigned to unfamiliar tasks.

    c. Fewer opportunities for fraudulent financial reporting.

    d. Rushed or early access to SOC 1 reports from service organizations.

30. Which of the following statements best describes an aspect of determining materiality at the financial statement level?

    a. If an amount is lower than planning materiality, it is never considered material to the financial statements.

    b. Determining planning materiality is primarily quantitative, though decisions and judgments are influenced by qualitative considerations.

    c. A specific definition of planning materiality is outlined in AU-C 320, so little professional judgment is required in the determination.

    d. The audit engagement will be easier if multiple benchmarks are used to determine planning materiality.

31. When determining planning materiality, auditors should do which of the following?

    a. Choose a single amount and apply it to the financial statements as a whole without regard for transaction classes, account balances, or disclosures.

    b. Choose a series of amounts and apply them to transaction classes, account balances, and disclosures without regard for the financial statements as a whole.

    c. Choose one amount for the financial statements as a whole and higher amounts for specific transaction classes, account balances, and disclosures, as needed.

    d. Choose an amount for the financial statements as a whole and lower amounts for specific transaction classes, account balances, and disclosures, as needed.

32. Which of the following statements best describes performance materiality?

    a. It is a higher amount than planning materiality.

    b. It is determined using steps outlined in the professional standards.

    c. It is a planning concept.

    d. It is set to ensure that misstatements do not occur.

33. A common rule of thumb is to calculate performance materiality as a fraction between what two percentages of materiality at the financial statement level?

    a. 25% and 50%.

    b. 25% and 75%.

    c. 50% and 75%.

    d. 75% and 90%.

34. In the audit risk model, the combined effect of inherent risk and control risk is which of the following?

    a. Audit risk.

    b. Detection risk.

    c. The risk of material misstatement.

    d. Substantive analytical procedures risk.

35. In an employee benefit plan audit, disclosure of which of the following is of particular interest to DOL officials and considered a significant risk area in relation to ERISA compliance?

    a. Parties in interest and all prohibited transactions.

    b. The overall audit strategy.

    c. The effects of COVID-19.

    d. Relevant assertions.

36. When communicating with those charged with governance, what element(s) of the audit are required to be discussed by the auditor?

    a. The auditor is prohibited from discussing any elements of the audit with those charged with governance.

    b. The auditor is required to communicate the detailed nature of the audit procedures but must omit any identified significant risks.

    c. The auditor is required to communicate the planned scope and timing of the audit as long as the effectiveness of the audit is not compromised.

    d. The auditor is not required to discuss any audit-related issues with those charged with governance and should avoid it if possible.

37. An individual used by the plan to assist in preparing the financial statements would most likely be categorized as which of the following?

    a. An external specialist.

    b. A management's specialist.

    c. An actuarial specialist.

    d. The plan administrator.

38. An auditor would need to apply additional procedures if which of the following occurs?

    a. An actuary is not used.

    b. The actuary's findings are reasonable.

    c. The actuary's findings differ materially from the financial statements.

    d. Information obtained by the actuary needs to be documented.

39. How might the plan audit be affected if the plan auditor is also engaged to audit the sponsor's financial statements?

    a. The plan auditor will lose his or her independence in relation to the plan.

    b. Efficiencies can be achieved by coordinating audit procedures between the two.

    c. Both engagements will take longer as additional audit procedures are needed.

    d. Duplicate workpapers are needed—one set for each audit engagement.

40. Which of the following terms can be defined as the selection and evaluation of less than 100 percent of a population such that the auditor expects the items selected to be representative of the entire population?

    a. Audit sampling.

    b. Nonsampling applications.

    c. Limited procedures.

    d. Departure from mandatory requirements.

41. Dual-purpose tests are considered what type of audit sampling?

    a. Balance testing.

    b. Transaction testing.

    c. Nonstatistical sampling.

    d. Sampling in substantive tests of details.

42. When might an auditor expand his or her sample size from 25 to 60?

    a. The auditor is simultaneously testing internal controls.

    b. The auditor assesses control risk below the maximum.

    c. The auditor has to meet specific ERISA requirements.

    d. One deviation from an important control has occurred.

43. According to AU-C 230.02, what is the primary purpose of workpapers?

    a. They aid in the planning and performance of current and future engagements with the audit client.

    b. They reinforce and demonstrate accountability for the performance of the audit engagement.

    c. They aid in both internal supervision and review and external review of the audit engagement.

    d. They provide the principle support for the auditor's report including the opinion expressed on the financial statements.

44. One key criterion for documentation decisions is to ensure the audit documentation does which of the following?

    a. Allows the general public to understand the documentation.

    b. Provides understanding to experienced auditors.

    c. Requires extensive explanation to the documentation users.

    d. Conceals the identity of the preparer and the reviewer.

45. ERISA generally does not require plans to be audited until they have how many participants?

    a. 50.

    b. 100.

    c. 250.

    d. 500.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 1—Pre-engagement Activities and Audit Planning (EBPTG221)

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You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	13.	○	○	○	○	24.	○	○	○	○	35.	○	○	○	○
2.	○	○	○	○	14.	○	○	○	○	25.	○	○	○	○	36.	○	○	○	○
3.	○	○	○	○	15.	○	○	○	○	26.	○	○	○	○	37.	○	○	○	○
4.	○	○	○	○	16.	○	○	○	○	27.	○	○	○	○	38.	○	○	○	○
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7.	○	○	○	○	19.	○	○	○	○	30.	○	○	○	○	41.	○	○	○	○
8.	○	○	○	○	20.	○	○	○	○	31.	○	○	○	○	42.	○	○	○	○
9.	○	○	○	○	21.	○	○	○	○	32.	○	○	○	○	43.	○	○	○	○
10.	○	○	○	○	22.	○	○	○	○	33.	○	○	○	○	44.	○	○	○	○
11.	○	○	○	○	23.	○	○	○	○	34.	○	○	○	○	45.	○	○	○	○
12.	○	○	○	○															

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GLOSSARY

Attest engagement team: According to *The Independence Rule* in the AICPA's *Code of Professional Conduct* (the Code), this includes those individuals who participate in an attest engagement, including those performing concurring and engagement quality reviews. It includes employees and contractors retained by the firm who participate in the attest engagement regardless of their functional classification as audit, tax, management consulting services, or other function. It does not include specialists or individuals performing only routine clerical functions.

Auditor's specialists: Individuals or organizations that possess expertise in an area other than accounting or auditing whose work is used by the auditor. They can either be internal specialists within the auditor's firm or network firms or external specialists.

Audit plan: This is more detailed than the *audit strategy* and documents the nature, timing, and extent of procedures to be performed to obtain sufficient audit evidence. It is also called an *audit program*.

Audit report date: The date that the auditor has obtained sufficient appropriate evidence to support his or her opinion on the financial statements.

Audit risk: The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit. A high-level description of the audit scope, timing, and direction.

Brainstorming: An open exchange of ideas, such as what should occur in the discussion among members of the engagement team during the audit planning phase.

Business associate: According to the Privacy Rule set by the Health Insurance Portability and Accountability Act (HIPAA), this is a person or entity that performs certain functions or activities that involve the use of or disclosure of protected health information.

Communication: The process of providing an understanding of roles and responsibilities to individuals within the plan regarding internal control over financial reporting. Combined with *information,* this is one of the five components of internal control.

Control activities: One of the five components of internal control. These are the policies and procedures that help ensure that plan management directives are carried out. They are those actions that are taken to address risks that threaten the plan's ability to achieve its objectives, one of which is reliable financial reporting. They usually involve (1) a policy that establishes what ought to be done and (2) the procedure that implements the policy.

Control environment: One of the five components of internal control. It includes the overall attitude, awareness, and actions of the plan administrator and those charged with governance concerning the importance of control and its emphasis in plan operations.

Control risk: The risk that a misstatement that could occur in an assertion about a class of transactions, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

COSO Framework: *Internal Control—Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This framework defines and describes the five components of internal control.

Covered members: According to *The Independence Rule* in the Code, these are members of an *attest engagement team* or able to influence the attest engagement team.

Cybersecurity: All IT-related controls in an entity's IT platform that guard against unauthorized access.

Cybersecurity risk: The risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

Demographic defect: This is a plan defect that occurs when the plan fails to satisfy the nondiscrimination requirements of the Internal Revenue Code (IRC) due to a shift in the demographics of the employer's workforce.

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Document completion date: This is the date of the final assembly of the audit file, typically within 60 days of the *report release date*. After this date, the auditor should not delete or discard any documentation prior to expiration of the required five-year retention period.

Form defect: This is a plan defect that occurs when the plan's provisions do not satisfy the qualification requirements of the IRC.

Information: The financial reporting system, including the accounting system and encompassing the procedures and records established to initiate, authorize, record, process, and report a plan's transactions. Combined with *communication,* this is one of the five components of internal control.

Inherent risk: The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Management's specialists: Individuals or organizations that have expertise in a field other than accounting or auditing who are used by the plan to assist in preparing the financial statements.

Monitoring: One of the five components of internal control. It is a process by which a plan assesses the quality of its internal control over time. It involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Such activities can also reveal evidence or symptoms of fraud.

Operational defect: This is a plan defect that occurs when the plan fails to operate in accordance with the plan provisions.

Other specialists: Term used by this course to refer to individuals on the engagement team or other individuals or organizations with whom the auditor consults who possess expertise in a specialized area of accounting or auditing.

Performance materiality: Materiality at the account balance or transaction class level.

Planning materiality: The auditor's preliminary judgment about materiality at the financial statement level.

Predecessor auditor: An auditor from another audit firm who either reported on the most recent audited financial statements or was engaged to but did not complete an audit of the financial statements. This may include an auditor who was engaged to perform an initial audit but did not complete the audit or an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit.

Report release date: The date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most audits of employee benefit plans, this will be the date the auditor delivers the report to the client.

Relevant assertion: One that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.

Risk assessment: One of the five components of internal control. It refers to the plan's identification, analysis, and management of the risks of material misstatement of the financial statements. Risk assessment is identifying types of potential misstatements and designing control activities to prevent or promptly detect those misstatements.

Risk of material misstatement: The risk that the financial statements are materially misstated prior to the audit. It consists of *inherent risk* and *control risk*.

Service auditor: An auditor who reports on controls at a service organization.

Tolerable misstatement: Materiality at the test or procedure level for a specific account balance or transaction class when that procedure or test is applied using audit sampling.

Walkthrough: A method for obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class that involves tracing a transaction through the various processing steps from initiation to inclusion in the general ledger and the financial statements. Also known as a *cradle-to-grave* procedure.

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COMPANION TO PPC'S GUIDE TO AUDITS OF EMPLOYEE BENEFIT PLANS

COURSE 2

ACCOUNTING AND FINANCIAL REPORTING STANDARDS AND SPECIAL AUDITING CONSIDERATIONS FOR EMPLOYEE BENEFIT PLANS (EBPTG222)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at two subjects that affect audits of employee benefit plans. Lesson 1 examines the accounting and financial reporting standards that are applicable to all employee benefit plans, as well as those that are unique to defined contribution retirement plans, defined benefit retirement plans, and health and welfare plans. Lesson 2 discusses special auditing considerations that apply in employee benefit plan audits, including how to deal with investments, participant data, and benefit payments and obligations.
PUBLICATION/REVISION DATE:	March 2022
RECOMMENDED FOR:	Users of *PPC's Guide to Employee Benefit Plans*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of auditing
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours
	This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*.
FIELD OF STUDY:	Auditing
EXPIRATION DATE:	Postmark by **March 31, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Accounting and Financial Reporting Standards for Employee Benefit Plans

Completion of this lesson will enable you to:
- Identify the financial reporting entity for an employee benefit plan and the accounting and financial reporting standards that apply to all types of plans.
- Determine which accounting and financial reporting standards apply specifically to defined contribution retirement plans, defined benefit retirement plans, or health and welfare benefit plans.

Lesson 2—Special Auditing Considerations

Completion of this lesson will enable you to:

- Recognize what special auditing considerations apply to an employee benefit plan's contributions received and receivable and its investments.
- Determine how an employee benefit plan's insurance company contracts and participant data should be addressed during an audit.
- Identify what special auditing considerations apply when an employee benefit plan has benefit payments and obligations.
- Determine how to address other assets, liabilities, and operating expenses, as well as other audit considerations (such as analytical procedures) in an employee benefit plan audit.

TO COMPLETE THIS LEARNING PROCESS:

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Lesson 1: Accounting and Financial Reporting Standards for Employee Benefit Plans

INTRODUCTION

This lesson discusses the accounting and financial statement presentation standards unique to employee benefit plans. Those standards are generally consistent, in many respects, among the different types of plans (defined benefit or defined contribution retirement plans or health and welfare benefit plans) where appropriate. For example, all types of plans must generally report investment securities at fair value.

This lesson first discusses accounting and reporting standards common to all types of plans and then discusses standards unique to the different types of plans in separate sections.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the financial reporting entity for an employee benefit plan and the accounting and financial reporting standards that apply to all types of plans.
- Determine which accounting and financial reporting standards apply specifically to defined contribution retirement plans, defined benefit retirement plans, or health and welfare benefit plans.

Authoritative Literature

Accounting and financial reporting standards applicable to employee benefit plans primarily reside in the FASB Accounting Standards Codification (FASB ASC). Additionally, the AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AEBP), contains guidance on accounting and financial reporting related to employee benefit plans. The following paragraphs briefly describe the authoritative literature applicable to the various types of employee benefit plans.

AEBP, Paragraphs 1.03 and 1.04, state that it applies to plans subject to ERISA and those that are not, and that it applies to plans sponsored by either commercial entities or nonprofit organizations in the private sector, but that its accounting provisions are not intended to apply to governmental plans. (This course does not specifically discuss governmental retirement plans.) Finally, AEBP does not specifically address accounting, auditing, and reporting for employee benefit trusts as separate entities.

Defined Contribution Retirement Plans. FASB ASC 962 provides the accounting and financial reporting standards for defined contribution retirement plans. Defined contribution retirement plans are similar to defined benefit retirement plans, except for differences in determining plan benefits. Thus, the accounting and financial reporting standards for defined contribution retirement plans are generally consistent with the standards for defined benefit pension plans. Chapter 5 of AEBP provides guidance specific to defined contribution retirement plans. Chapter 6 of AEBP provides guidance specific to employee stock ownership plans (ESOPs).

Defined Benefit Retirement Plans. FASB ASC 960 establishes the accounting and financial reporting standards for defined benefit retirement plans. FASB ASC 960-10-15-2 indicates that it applies to ongoing plans. Guidance on terminating defined benefit retirement plans is included in FASB ASC 960-40. FASB ASC 960 also applies to plans that are and are not subject to ERISA. Chapter 7 of AEBP provides guidance on defined benefit pension plans.

Health and Welfare Benefit Plans. FASB ASC 965 establishes the accounting and reporting standards for health and welfare benefit plans. In addition, Chapter 8 of AEBP provides guidance on the application of FASB ASC 965.

FASB ASC 965-10-20 distinguishes between defined benefit and defined contribution health and welfare plans and specifies different standards for each type of plan. The guidance on defined benefit health and welfare plans is generally consistent with guidance in FASB ASC 960 for items that are similar between defined benefit pension

plans and defined benefit health and welfare plans. The guidance requires benefit obligations of a defined benefit health and welfare plan to be reported separately. These requirements are discussed in more detail later in this lesson.

FASB ASC 965 also provides guidance for the determination of accumulated eligibility credits and the recognition of claims incurred but not reported to the plan (IBNR). IBNR claims include the present value of the *estimated* ultimate cost of settling the claims to or for participants (e.g., continuing health care or long-term disability), and the obligation for accumulated eligibility credits considers mortality, turnover, and other actuarial assumptions. Finally, it establishes relevant measurement standards for postretirement health and welfare benefits similar to measurement standards in FASB ASC 715-60, *Defined Benefit Plans—Other Postretirement*. These standards are also discussed later in this lesson.

UNDERSTANDING THE FINANCIAL REPORTING ENTITY

It is important for employee benefit plan financial statement preparers and auditors to understand that the financial reporting entity is the plan, not the trust fund established to hold plan assets. Trust fund financial statements give information about plan net assets but not about benefit obligations. Plan financial statements give information about the benefit obligations and the net assets.

The reason for this position on the financial reporting entity is that the plan has many attributes of a legal entity. For example, it can be sued. Also, the plan, not the trust fund, gives rise to participant benefits. FASB ASC 960 concludes that a primary reporting objective is to give information about plan benefits as well as assets available for benefits.

AEBP, Paragraph 1.08, also states that the plan is the reporting entity under ERISA and GAAP.

ACCOUNTING AND FINANCIAL REPORTING STANDARDS THAT APPLY TO ALL TYPES OF EMPLOYEE BENEFIT PLANS

Defined benefit and defined contribution retirement plans and health and welfare benefit plans have many similarities. For example, they all receive contributions from their plan sponsors and may have investments in similar types of securities. The major differences among the plans relate to the nature, measurement, and presentation of benefit obligations.

This section discusses the following areas that are common to all types of employee benefit plans:

- Contributions.
- Investments.
- Contracts with insurance companies and other financial institutions.
- Operating assets.
- Accrued liabilities and operating expenses.
- Financial instruments.
- Terminating plans.
- Basis of accounting other than GAAP.
- Disclosure of fines.
- Risks and uncertainties.
- Employee Plans Compliance Resolution System.

Contributions

Employee benefit plans receive contributions from their sponsors, that is, from employers, and also from plan participants (also referred to as employees) if the plan is a contributory plan. FASB ASC 960-310-25-1 and AEBP state that plans may receive contributions from other sources such as state subsidies or federal grants. These other sources relate to plans of state and local governments.

Contributions may be in cash or noncash forms, for example, real estate, or employer stock contributed to an ESOP. FASB ASC 960-30-45-2, FASB ASC 962-205-45-7, and FASB ASC 965-20-30-1 state that noncash contributions should be recorded at fair value. For health and welfare plans, this is net of costs to sell, if significant.

Contributions are reported as additions to net assets in the statement of changes in net assets available for benefits.

Contributions Receivable. Plans should record a contribution receivable as of the reporting date for amounts due from employers, participants, or others. FASB ASC 960-310-25-2 and FASB ASC 962-310-25-1 state that contributions receivable should include amounts due "pursuant to formal commitments as well as legal or contractual requirements." FASB ASC 965-310-25-1 and AEBP, Paragraph 8.63, indicate the same is true for health and welfare plans. The authoritative accounting literature gives the following indicators of an employer's formal commitment to make a contribution:

- A resolution by the employer's governing body approving a specified contribution.
- A consistent pattern of making payments after the plan's year end under an established funding policy that attributes such payments to the preceding plan year.
- The employer's deduction of a contribution on its federal income tax return for periods ending on or before the reporting date.
- The employer's recording of a contribution payable to the plan as of the reporting date. The accounting pronouncements warn, however, that the existence of an accrual in the employer's financial statements is not in itself sufficient support for the plan's recognition of a receivable.

  One reason is that the employer's pension cost reported in its financial statements under FASB ASC 715 may differ from amounts formally committed to the plan and required to be funded, that is, the amount to be contributed to the plan during the reporting period. The employer's accrued pension liability is only a by-product of the employer's accounting for pension costs. Also, differences may be caused by differences in the actuarial cost method required by the literature to determine the normal cost and the cost methods allowed by Form 5500 to determine the minimum funding.
- AEBP, Paragraph 8.63, on contributions for health and welfare plans, states that "the existence of . . . 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."

For defined benefit pension plans, the plan's Form 5500 Schedule SB or MB may be useful in determining the contribution receivable at year-end.

FASB ASC 960-310-25-3, FASB ASC 962-310-35-1, and FASB ASC 965-310-35-1 state that an allowance should be provided for estimated uncollectible contribution receivable amounts.

Investments

Types of Investments. Employee benefit plans may own numerous types of investments, including the following:

- Marketable debt or equity securities, for example, common or preferred stocks, bonds, notes, shares of registered investment companies (mutual funds), or exchange-traded funds.
- Securities that do not have a ready market, for example, restricted or unregistered securities.
- Real estate, mortgages, or leases.

- Units of participation in real estate investment pools or limited partnerships.
- Units of participation in common/collective trusts.
- Repurchase or reverse repurchase agreements.
- Futures, options, and other derivative financial instruments.
- Contracts with insurance companies that are investment vehicles, such as separate or pooled accounts.
- Stable value funds.

For purposes of applying accounting valuation standards, a significant distinction for the various types of investments is whether the investment has a market quotation. Generally, only the first category of marketable securities listed above can be valued by market quotations; more complex valuation methods are usually necessary for the other categories of investments.

Accounting for Investment Transactions. Securities purchases and sales should be recorded on a trade-date basis. This is the requirement of FASB ASC 960-325-25-1, FASB ASC 962-325-25-1, and FASB ASC 965-320-25-1. The settlement date may be used for transactions if the settlement date is after the reporting date and the following conditions exist:

a. the fair value of the securities does not significantly change from the trade date to the reporting date, and

b. the purchases and sales do not significantly affect the composition of the plan's assets available for benefits.

Securities Lending Transactions. Some plans may participate in securities lending transactions by lending certain securities to borrowers in exchange for cash collateral or some other form of collateral, such as securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. Securities lending activities occur most in defined contribution profit sharing plans or plans that hold separately managed funds or funds in a master trust. Typically, the borrower may have the right, by custom or contract, to sell or repledge the securities borrowed. Similarly, if the plan receives securities as collateral, it may have the right to sell or repledge those securities. If cash collateral is received, the plan invests the cash to generate income. If other forms of collateral are received, the borrower usually pays the lender (the plan) a fee.

FASB ASC 860-10 provides requirements for accounting and reporting of transfers of financial assets, including securities lending transactions. In addition, AEBP discusses securities lending transactions beginning at Paragraphs 7.38, 11.79, and 11.164. One of the primary considerations in determining the proper accounting for transfers of financial assets is whether the transferor (the plan) has surrendered control over the assets transferred. Generally, if the transferor surrenders control over the transferred financial assets, the transfer is accounted for as a sale and the related assets are removed from the transferor's statement of net assets. According to FASB ASC 860-10-40-5, a transferor is considered to have surrendered control over transferred financial assets if all of the following conditions are met:

a. The transferred financial assets have been isolated from the transferor (that is, put beyond the reach of the transferor and its creditors).

b. Each transferee (or third-party holder of beneficial interests if the transferee solely engages in securitization or asset-backed financing activities and is constrained from pledging or exchanging the assets it receives) has the right to pledge or exchange the transferred assets (or beneficial interests) it received, and no condition both (1) constrains the transferee (or third-party holder) from taking advantage of that right, and (2) provides more than a trivial benefit to the transferor.

c. Effective control over the transferred financial assets (or related third-party beneficial interests) is not maintained by the transferor or its agents.

If the transfer does not meet the conditions for sale accounting, the transferor and the transferee should account for the transfer as a secured borrowing with pledge of collateral. In such cases, the transferor continues to report the transferred financial assets in its statement of net assets without changing how the assets are measured.

Transfers of financial assets may involve transfers of an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset. GAAP provides different accounting guidelines for transfers of participating interests than for transfers involving entire financial assets or groups of entire financial assets. Accordingly, it is important to understand what constitutes a participating interest. According to FASB ASC 860-10-40-6A, a participating interest has all of the following characteristics:

a. It represents, from the date of the transfer, a proportionate ownership interest in an entire financial asset. The transferor's percentage of ownership interests may change over time if certain conditions are met.

b. From the transfer date, all cash flows received from the entire financial asset are divided between the participating interest holders in proportion to their ownership share. Certain cash flows allocated as compensation for services performed, if any, and some proceeds received by the transferor for the transferred portion are excluded from this determination.

c. Each participating interest holder (including the transferor) has rights of equal priority and no interest is subordinated to another participating interest holder's interest.

d. The entire financial asset may not be pledged or exchanged without the agreement of all participating interest holders.

If a transfer involves part of an entire financial asset and that partial transfer does not have these characteristics of a participating interest, the transfer also should be accounted for as a secured borrowing with pledge of collateral. That accounting requires the transferor to continue to report the transferred financial assets on its statement of net assets without changing how it measures those assets.

FASB ASC 860 requires certain disclosures related to transfers of financial assets. Transfers of financial assets are discussed in more depth in *PPC's Guide to Preparing Financial Statements*.

Accounting for Investment Income. Dividend income should be recorded on the ex-dividend date, rather than on the record or payment date. Interest and rent income and other investment income should be recorded as earned and accrued if necessary. These requirements are consistent with the FASB ASC 960 and AEBP requirements for the accrual basis of accounting and trade-date recording.

Realized and Unrealized Gains and Losses. Investments can give rise to either realized or unrealized gains and losses. Realized gains and losses are incurred when investments are sold. Unrealized gains and losses are recorded to reflect the increase or decrease in the value of investments held over time. For GAAP purposes, realized gains and losses are calculated as the difference between the proceeds received and the historical cost of the investment, whereas unrealized gains and losses are calculated as the difference between the fair value of the investment at the prior reporting date (or its cost if purchased in the current period) and the fair value at the reporting date. Note that the GAAP calculation of realized gains and losses differs from the methodology prescribed by Form 5500.

GAAP financial statements are not required to present realized gains and losses separate from unrealized gains and losses. When realized and unrealized gains and losses are reported in the aggregate in GAAP financial statements, the resulting net gain or loss is generally reported in the statement of changes in net assets available for benefits with a caption such as "net appreciation in fair value of investments" or "net depreciation in fair value of investments." Some plans present the net amount along with other items related to investment activity in the additions section of the statement of changes in net assets, regardless of whether the net amount is a gain (appreciation) or a loss (depreciation). Other plans choose to include the net amount as an addition only when it is net appreciation. When the net amount is a loss, those plans report the net depreciation as a deduction in the statement of changes in net assets.

GAAP does not provide specific requirements for the presentation of net appreciation or depreciation in the fair value of investments within the statement of changes in net assets. The illustrative financial statements at FASB ASC 960-205-55 include the net amount in the additions portion of the statement of changes in net assets. Most of the illustrations present only a single year statement of changes with each showing net appreciation in fair value of investments as an addition. However, one example illustrates a comparative statement of changes in net assets where one year presents net appreciation and the other presents net depreciation in fair value of investments. In that example, the line item is described as "net appreciation (depreciation) in fair value of investments" and is reported in the additions section of the statement of changes in net assets.

The illustrative financial statements of defined contribution plans in FASB ASC 962-325-55 and of health and welfare benefit plans in FASB ASC 965-205-55 also present only net appreciation in fair value of investments and include that caption in the additions section of the statements of changes in net assets. The authors prefer to present net appreciation or net depreciation in fair value of investments with other investment activity (such as interest and dividend income) in the additions section of the statement of changes in net assets available for benefits. However, either method of presentation is acceptable to the DOL.

Investment Valuation. All types of employee benefit plans are required, with certain exceptions, to report investments at fair value in the financial statements. FASB ASC 960-325-35-1, FASB ASC 962-325-35-1, and FASB ASC 965-325-35-1 all state that plan investments should generally be presented at their fair value at the reporting date. However, different accounting rules apply to insurance contracts and fully benefit-responsive investment contracts. (Accounting for contracts with insurance companies is discussed later in this section. Additional valuation and presentation requirements for fully benefit-responsive investment contracts held by defined contribution retirement plans as well as for defined contribution health and welfare plans are discussed in later sections of this lesson.) FASB ASC 960-325-35-2 states that an investment's fair value should be reduced by significant brokerage commissions and other costs typically incurred in a sale, similar to fair value less cost to sell. That same requirement also applies to defined contribution and health and welfare plan investments.

Fair Value Measurements. FASB ASC 820 provides a common definition of fair value, establishes a framework to measure fair value within generally accepted accounting principles, and requires disclosures about fair value measurements. It applies under other existing accounting literature that requires or permits fair value measurements, such as FASB ASC 960.

Fair value is defined as the price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction involving market participants at the measurement date. Attributes that are specific to an asset or liability, such as the condition and location of the asset and restrictions on the asset's sale or use, need to be considered when measuring fair value, if market participants would take those attributes into account when pricing the item at the measurement date.

The measurement should also assume that the asset or liability is exchanged in an orderly transaction. That means the hypothetical transaction to sell the asset or transfer the liability is assumed to be usual and customary for the type of asset or liability and not a forced liquidation or distress sale. Further, the transaction is considered from the perspective of the entity holding the asset or owing the liability to determine the price that would be received or paid to sell the asset or transfer the liability. That is, fair value is based on an exit price, which may differ from the price paid to acquire the asset or received to assume the liability (i.e., an entry price). If there is a principal market for the asset or liability, fair value represents the price in that market. According to the FASB ASC Glossary, the principal market is the market with the greatest volume and level of activity for the asset or liability.

Valuation techniques consistent with the following approaches should be used to measure fair value:

- *Market Approach.* This approach uses prices or relevant information derived from market transactions for identical or comparable assets or liabilities. Valuation techniques that are consistent with a market approach include techniques that use market multiples derived from transactions in comparable assets or liabilities. In addition, matrix pricing is frequently used to value debt securities.

- *Income Approach.* This approach converts future cash flows or income and expenses to a single current amount (i.e., discounted). The fair value measurement is based on current market expectations about

those future amounts. Present value techniques are an example of valuation techniques consistent with the income approach.

- *Cost Approach.* This approach reflects the amount that would be currently required to replace the service capacity of an asset. The fair value of an asset using this approach is the cost to a market participant to acquire or construct a substitute asset of comparable utility adjusted for obsolescence. The cost approach is likely to be used infrequently by employee benefit plans.

The use of valuation techniques requires the identification of inputs or assumptions that market participants would use to price the asset or liability. FASB ASC 820 provides the following fair value hierarchy for use in prioritizing valuation inputs:

- Level 1—quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2—observable inputs other than the quoted prices included in Level 1; for example, quoted prices for similar assets or liabilities in active markets. Level 2 inputs also include inputs for identical or similar assets or liabilities in markets that are not active [that is, markets in which there are few transactions for the asset or liability, the prices are not current, price quotations vary substantially either over time or among market makers (for example, some brokered markets), or in which little information is publicly available (for example, a principal-to-principal market)]. Adjustments to level 2 inputs may be necessary and will vary depending on factors specific to the asset or liability, such as the condition or location of the asset, the extent to which inputs relate to items that are comparable to the asset or liability, and the volume or level of activity in the markets within which the inputs are observed.
- Level 3—unobservable inputs.

Generally, a quoted price in an active market provides the most reliable evidence of fair value and should be used without adjustment whenever available. Additionally, valuation techniques should maximize the use of observable inputs and minimize the use of unobservable inputs. In the event that the inputs used in a fair value measurement fall within different levels of the fair value hierarchy, the entire fair value measurement is categorized at the same level as its lowest level significant input.

FASB ASC 820-10 provides a practical means of measuring the fair value of alternative investments, such as hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds, that do not have readily determinable fair values because the investments are not listed on national exchanges or over-the-counter markets. The investee may provide the plan with a net asset value per share (NAV) or its equivalent (for example, member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) as of the plan's measurement date that has been calculated at fair value in a manner consistent with GAAP for investment companies. When this is the case, the plan is allowed to value the alternative investment on the basis of the NAV provided by the investee as of the plan's measurement date without further adjustment. The practical expedient applies only if the alternative investment does not have a readily determinable fair value and is in an entity within the scope of FASB ASC 946, *Financial Services—Investment Companies*, or in certain real estate funds measured using methods consistent with the principles in FASB ASC 946. The plan is required to consider whether an adjustment to the NAV is necessary to estimate the fair value of the investment. Adjustments may be necessary when the NAV (or its equivalent) provided by the investee is not as of the plan's measurement date or does not represent the fair value of the plan's investment in all circumstances. For example, restrictions on redemption at the measurement date and transaction prices from principal-to-principal or brokered transactions may indicate that adjustments are necessary. Also, the practical expedient does not apply to portions of investments for which it is probable that the plan will sell the portion of the investment for an amount different from the NAV (or its equivalent).

FASB ASC 820 requires numerous disclosures about fair value measurements, depending on whether the measurements are made on a recurring or nonrecurring basis. Those disclosures are in addition to disclosures about fair value required by other accounting pronouncements. Additional information on applying the fair value measurement guidance is included in *PPC's Guide to GAAP* and *PPC's Guide to Preparing Financial Statements*.

Loan Impairment. FASB ASC 310 requires loss recognition when a loan receivable is considered impaired. A loan is considered impaired when it is probable that the creditor is unable to collect all amounts due under the contractual terms of the loan agreement. If the loan is impaired, one of the following methods should be used to determine the amount of loan loss:

- *Fair Value of the Collateral.* This method is used when foreclosure is probable, or the loan is collateral-dependent. Collateral-dependent loans are defined as loans for which the collateral is the sole source of repayment.
- *Expected Cash Flows.* Under this method, the loan loss is the amount needed to reduce the recorded loan investment to the expected cash flows to be received from the loan, discounted at the effective rate of the loan.
- *Aggregate Collection Experience.* Under this method, loans with similar risk characteristics are aggregated, and historical data is used to determine the loan loss for the group. This approach may be the most practical to use for plans with a large number of loans that are similar in size, repayment terms, and collateral. Most plans, however, do not have large numbers of such loans and this approach will not be appropriate.
- *Market Value of the Loan.* FASB ASC 310 allows loan losses to be determined based on the market value of the loan. However, in the authors' experience, such market prices are rarely available. Thus, this alternative will rarely be used.

According to FASB ASC 310-40-35-9, a loan that is modified in a troubled debt restructuring should be accounted for analogous to an impaired loan. If the expected cash flows method is used to determine the loss allowance, the discount rate should be determined based on the original contract rate rather than the rate on the modified loan. Accordingly, the authors believe the expected cash flows ought to be discounted using the effective rate of the loan immediately before the restructuring.

Depreciation of Investment in Real Property. Fixed assets are generally reported at cost less an allowance for depreciation that is provided to allocate the cost of income producing assets over their estimated useful lives in a manner that matches the cost of the assets to the related income. Since real estate held as an investment by employee benefit plans is reported at fair value rather than at cost, there is no requirement to provide for depreciation. This accounting is consistent with the AICPA Technical Question and Answer at Q&A 6931.04.

Presentation of Investments in the Financial Statements. FASB ASC 960-325-45-2, 962-325-45-5, and 965-325-45-2 require all investments measured using fair value in the statement of net assets available for benefits or in the notes to be presented by general type. General types include the following:

- Government securities.
- Short-term securities.
- Corporate bonds.
- Common stocks.
- Mortgages.
- Real estate.
- Self-directed brokerage accounts.
- Registered investment companies (mutual funds).
- Common/collective trusts.
- Pooled separate accounts.

The presentation should indicate whether an investment's fair value has been measured by quoted market price in an active market or by another method.

Presentation and Disclosure of an Interest in a Master Trust. For each master trust in which a plan holds an interest, the interest is required to be presented in a separate line item in the statement of net assets available for benefits. In addition, the change in the plan's interest must be presented in a separate line item in the statement of changes in net assets available for benefits. Plans are also required to disclose the net appreciation or depreciation in the fair value of the investments of the master trust as well as any investment income (not including the net appreciation or depreciation in the fair value of the investments) for each period in which a statement of changes in net assets available for benefits is presented. FASB ASC 960-325-50-8, 962-325-50-8, and 965-325-50-6 indicate the notes to the financial statements should also include both a description of the method used to allocate the net assets and the total investment income. Additionally, plans with an undivided interest in the master trust (i.e., when the plan has a proportionate, and not a specific, interest in the master trust), are also required to disclose the plan's percentage interest in the master trust as of the date of each statement of net assets available for benefits presented. The notes should also include disclosure of the investments of a master trust measured using fair value presented by the general type of investment as of the date of each statement of net assets available for benefits presented. Additional required disclosures include the dollar amount of the plan's interest in each general type of investment held by the master trust and the master trust's other assets and liabilities, along with the dollar amount of the plan's interest in each of those other assets and liabilities.

Contracts with Insurance Companies and Other Financial Institutions

Employee benefit plans may have various types of contracts with insurance companies such as allocated and unallocated contracts. Briefly, an allocated contract transfers the obligation to pay benefits to the insurance company whereas an unallocated contract is an investment vehicle and does not transfer any obligation to pay benefits.

GAAP distinguishes between two broad types of contracts with insurance or other companies; that is, it distinguishes between *insurance* contracts and *investment* contracts. *Insurance contracts* are described as contracts that transfer a significant amount of risk from the plan to the insurance company. *Investment contracts* are described as long-term contracts that do not subject the insurance company to risks related to the mortality or morbidity of the policyholder.

Defined benefit pension plans are required to report investment contracts at fair value. According to FASB ASC 960-325-35-3, insurance contracts held by defined benefit pension plans are reported at either fair value or at amounts determined by the insurance company (contract value).

Investment contracts of health and welfare plans and defined contribution retirement plans are generally reported at fair value, unless they are fully benefit-responsive investment contracts, which are required to be measured at contract value. Insurance contracts held by defined contribution retirement plans and health and welfare plans are reported at either fair value or at amounts determined by the insurance company (contract value).

The valuation of contracts issued by insurance companies and other financial institutions may be affected by financial difficulties faced by the issuers. That is, there may be a credit risk to consider. For investment contracts issued by troubled insurance companies and other financial institutions, such as ones that have been taken over by state insurance or other regulators, the accounting or disclosure requirements of FASB ASC 450 and FASB ASC 275 may apply. Another valuation consideration is whether the insurance company can continue to provide the return specified in a GIC and whether to continue to accrue interest on such contracts.

Demutualization of Insurance Companies. The Employee Benefits Security Administration (EBSA) issued guidance on accounting and reporting issues related to the receipt of demutualization proceeds by an ERISA-covered benefit plan. The guidance was the result of concerns raised to the EBSA regarding the potential conversion of a mutual life insurance company to a stock life insurance company (a process known as "demutualization"). At issue was the fact that many of the insurance company's policyholders were employee benefit plans traditionally exempt from the trust and reporting requirements of ERISA. Certain benefit plans funded completely, or in part, by insurance contracts are not required to either file a Form 5500 or to have an annual audit of the plan's financial statements. Further, the DOL exempts certain benefit plans which provide benefits through insurance contracts or policies issued by an insurance company from the requirement to hold the assets of an employee benefit plan in a trust. In connection with the proposed demutualization, policyholders of the insurance companies (including benefit plans) could potentially receive distributions in the form of stock, cash, or policy credits. Certain interested

parties asked the EBSA to rule on whether such distributions would subject the receiving plans to the trust and financial reporting requirements of ERISA.

The EBSA letter contained the following conclusions:

- If participants of an unfunded or insured welfare plan pay a portion of the premiums, the portion of the demutualization distributions attributable to participant contributions should be considered plan assets.
- The entire amount of demutualization distributions would be considered plan assets in the case of a pension plan, when any plan or trust is the policyholder, or when premiums are paid out of trust assets.
- Although current regulations require all plan assets to be held in a qualifying trust, pending further guidance, the DOL will not penalize a plan solely for the failure to maintain plan assets received because of a demutualization in a trust. However, to qualify for this exemption, the plan must meet certain requirements relating to use of the proceeds, control over the assets, and the maintenance of certain documentation and records.
- The DOL will also not penalize plans for failing to comply with the DOL's reporting requirements due to the plan's inability to qualify for an exception to the reporting requirements solely as a result of receiving demutualization distributions which constitute plan assets.

Operating Assets

Plan operating assets, such as buildings, furniture, equipment, and leasehold improvements, are reported at cost less accumulated depreciation and amortization. Note that buildings held as an investment, rather than used in plan operations, should be reported at fair value with other investments.

IRS Form 5500 requires operating assets to be reported at current, that is, fair, value rather than cost. DOL officials have publicly commented that the GAAP requirement conflicts with the ERISA requirement to present plan assets at current value, and have publicly stated that the DOL will reject Form 5500 filings that report operating assets at cost. Thus, the authors believe the DOL would expect operating assets to be reported at cost in the audited GAAP financial statements and at current value in Schedule H of the Form 5500, with a reconciliation between the two amounts being presented in the notes to the financial statements.

Accrued Liabilities and Operating Expenses

Liabilities for items *other than benefits* should be accrued, for example, amounts owed for security purchases, third-party administrative fees, refund of excess contributions, audit fees, trustee fees, etc. Based on AEBP, Paragraphs 6.75 and 7.69, and FASB ASC 962-205-50-1i, benefits payable, including accrued benefits and amounts allocated to accounts of persons who have elected to withdraw from the plan but have not yet been paid, should not be recorded for retirement plans. However, these amounts may need to be disclosed in the notes to the financial statements. (As discussed later in this lesson, obligations for benefits are recorded for health and welfare plans.)

Many plan sponsors absorb plan administrative expenses, for example, accounting and legal fees, the insurance premium for defined benefit plans that are insured by the PBGC, etc. The plan does not report such costs in its financial statements, but should disclose the fact that the sponsor is absorbing significant costs.

Administrative expenses that the plan absorbs should be reported as a deduction in the statement of changes in net assets available for benefits. However, only appropriate expenses should be paid by the plan. The Department of Labor issued Advisory Opinion No. 2001-01A to clarify the types of expenses that are properly paid by the plan and those that should be paid by the plan's sponsor as follows:

- Settlor functions, which generally include decisions relating to the formation, design, and termination of plans, should be paid by the plan sponsor.
- Expenses that relate to the administration or management of a plan such as expenses to calculate participant benefits, to maintain the plan's tax-qualified status, and to communicate plan information to participants and beneficiaries, are considered reasonable expenses of a plan.

Plan administrators need to remember that determining whether to pay a particular expense out of plan assets is a fiduciary act governed by ERISA's fiduciary responsibility provisions.

Financial Instruments

Authoritative Literature. The following authoritative literature provides accounting and disclosure guidance for financial instruments and derivatives:

a. FASB ASC 815 establishes accounting and reporting standards for derivative instruments and hedging activities.

b. AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AEBP), primarily summarizes the guidance as provided by FASB ASC 825 and FASB ASC 815 as it relates to each type of plan.

c. FASB ASC 820 requires disclosures about fair value measurements of assets and liabilities. Those disclosures may be, but are not required to be, combined with the fair value disclosures required by FASB ASC 825 and other accounting pronouncements.

Derivative Instruments under FASB ASC 815. FASB ASC 815 establishes accounting and reporting standards for derivative instruments and hedging activities. A summary of the literature is provided in the following paragraphs.

GAAP uses the terms *underlyings*, *notional amounts*, and *payment provisions* in defining derivative instruments. FASB ASC 815-10-20 defines those terms as follows:

- An *underlying* is "a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself."
- A *notional amount* is "a number of currency units, shares, bushels, pounds, or other units specified" in the contract.
- A *payment provision* "specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner."

A derivative instrument is a financial instrument or other contract that has *all three* of the following characteristics:

a. One or more underlyings, and—

    (1) one or more notional amounts, or

    (2) payment provisions, or

    (3) both.

b. No initial net investment is required or a smaller investment is required than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. The terms require or permit net settlement; it can be readily settled net outside the contract; or it provides for delivery of an asset that puts the recipient in a position not substantially different from a net settlement.

Derivative instruments do not, however, include items such as normal purchases and normal sales, "regular-way" security trades (trades providing for delivery of a security that is readily convertible to cash within customary timeframes established by marketplace regulations), certain investments in life insurance, certain loan commitments, certain insurance and investment contracts, certain financial guarantee contracts, certain contracts that are not traded on an exchange, or derivatives that serve as impediments to sales accounting. In addition, derivative instruments do not include contracts that are issued as contingent consideration in a business combination; contracts issued or held by the reporting entity, indexed to its own stock, and classified in stockholders' equity in its balance sheet; contracts issued that are subject to FASB ASC 718 or certain forward contracts accounted for under FASB ASC 480.

Certain contracts that do not, in their entirety, meet the criteria in the previous paragraph may have embedded derivative instruments; that is, instruments that have implicit or explicit terms that affect some or all of the cash flows or value of other exchanges required by the contract, similar to derivative instruments. Contracts that have embedded derivative instruments may include items such as bonds, insurance policies, or leases. An embedded derivative instrument should be separated from the host contract only if all of the following conditions are met:

a. The economic characteristics and risks of the embedded instrument are not clearly and closely related to those of the host contract.

b. The hybrid contract (the one that contains both the embedded and host instrument) is not remeasured at fair value with changes recognized as a change in net assets when they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would meet the derivative instrument definition in the previous paragraph, with certain exceptions.

Derivative instruments are often used to manage risks caused by fluctuations in foreign currency exchange rates, interest rates, and general market risks. In response to the current state of the economy, many employee benefit plans may begin to use or increase their use of derivatives. Examples of common derivatives include call options, commodity futures, forwards, foreign exchange contracts, financial futures contracts, put options, and swaps.

All derivative instruments subject to the provisions of FASB ASC 815 should be measured at fair value and recognized in the statement of net assets as either assets or liabilities, depending on the rights or obligations under the contracts. Changes in the fair value of all derivative instruments should be recognized as a change in net assets in the period of change.

FASB ASC 815 also establishes disclosure requirements related to derivative instruments and hedging activities.

Terminating Plans

Employee benefit plans may be terminated in a standard or distress termination. In either case, the plan sponsor must notify plan participants and beneficiaries of an intent to terminate the plan at least several months before the intended termination date. FASB ASC 960-40, FASB ASC 962-40, and FASB ASC 965-40 provide guidance regarding terminating plans.

Liquidation Deemed Imminent Before Year-end. FASB ASC 960-40, FASB ASC 962-40, and FASB ASC 965-40 require a plan to prepare its year-end financial statements using the liquidation basis of accounting when liquidation of a plan is *deemed to be imminent*, before the end of the plan year. Additionally, the AICPA has issued several Technical Questions and Answers at Q&A 6931.18–.30 to provide nonauthoritative guidance about the liquidation basis of accounting for employee benefit plans. While the subjects of the inquiries and replies in Q&A 6931.18–.30 each relate to a specific type of plan, the responses are, in most cases, relevant across plan types and to single and multiemployer plans.

As noted above, a plan is required to prepare its financial statements using the liquidation basis of accounting when liquidation is deemed imminent. Liquidation is deemed to be imminent in two types of circumstances. The first is when parties with authority to do so adopt or approve a plan for liquidation and the likelihood that execution of the plan will be blocked by other parties is remote. The second is when a plan for liquidation is imposed by others, such as an involuntary bankruptcy proceeding. In both circumstances, the likelihood that the entity will return from liquidation also has to be remote. Q&A 6931.18 notes that parties that might block execution of the termination of a plan include the Pension Benefit Guarantee Corporation (PBGC) and IRS. It also provides detailed guidance on making the judgment as to when liquidation of a plan is imminent.

FASB ASC 960-40, FASB ASC 962-40, and FASB ASC 965-40 indicate that if liquidation of a plan is deemed to be imminent, the plan's year-end financial statements and subsequent year's financial statements are required to be prepared using the liquidation basis of accounting. In other words, if the actions required for liquidation of a plan to be deemed imminent occur before the plan's year end, then the financial statements for that year end, and subsequent years, are required to be on the liquidation basis of accounting and measured and presented in accordance with FASB ASC 205-30.

FASB ASC 960-40-35-2 and FASB ASC 965-40-35-2 state that accumulated plan benefits and benefit obligations of terminating defined benefit or health and welfare plans should be determined using the liquidation basis, and the values may differ from the actuarial present value reported for ongoing plans. One reason is that the actuarial determination for a terminating plan would use a settlement rate on invested assets rather than an expected long-term rate of return on invested assets as for an ongoing plan, and the actuarial determination would assume that plan obligations were to be settled currently rather than being settled over time. Also, all benefits of a terminating defined benefit plan generally become fully vested upon termination and should be reported as such.

The Technical Questions and Answers at Q&A 6931.18–.30 provide more detailed interpretive guidance on the presentation and disclosure of liquidation basis financial statements of employee benefit plans.

Q&A 6931.26 notes that it is appropriate to present comparative statements of net assets available for benefits even when one year is presented on an ongoing plan basis and the other is presented on a liquidation basis. It also notes that the financial statements need to be clearly labeled so the reader can distinguish between the two bases, and that they should include the disclosures required by FASB ASC 205 concerning changes affecting comparability. Q&A 6931.27 indicates that because ERISA requires full year presentation of financial statements, a plan would typically present a full year statement of changes in net assets on the liquidation basis, regardless of when the plan entered liquidation. The plan would not present a stub period for the time period prior to when liquidation was deemed to be imminent. Therefore, even if liquidation is deemed imminent late in the year, the financial statements for that entire year would be prepared using the liquidation basis.

Following is an example of a note that may be included in the financial statements for a defined contribution plan that the plan sponsor has decided before year end to terminate. This example is not intended to imply that other information does not need to be disclosed in other circumstances:

> The governing body of ABC Company Employee Benefit Plan approved a plan of liquidation on November 30, 20X2, and management determined liquidation is imminent. Final distributions will be determined based on all participants being 100% vested, and will be made as soon as possible after the termination date. As a result, the Plan has changed its basis of accounting from the going concern basis used in presenting the 20X1 financial statements to the liquidation basis used in presenting the 20X2 financial statements.

Liquidation Deemed Imminent After Year-end. If liquidation of a plan is deemed imminent after the plan year end, but before the financial statements are issued, the decision is disclosed as a nonrecognized subsequent event, and the basis of accounting is not changed. FASB ASC 855-10 identifies two types of subsequent events, recognized subsequent events and nonrecognized subsequent events. Nonrecognized subsequent events should not be recognized in the financial statements but should be considered for disclosure if disclosure is considered necessary to keep the financial statements from being misleading. Disclosure is also required for the date through which subsequent events have been evaluated and that date is the date the financial statements were available to be issued, regardless of whether the reporting entity recognizes or discloses a subsequent event in its financial statements. The authors believe that many plans make the disclosure of the date of management's review as part of the summary of significant accounting policies note.

Plan Mergers. Little is written about plan mergers. DOL officials have indicated that most plan mergers are accounted for by the surviving plan reporting the net assets transferred-in as a one line addition item in the statement of changes in net assets available for benefits. The Financial Reporting Executive Committee (FinREC) of the AICPA recommends that the net assets transferred into a plan be presented on the statement of changes in net assets available for benefits below the net increase or decrease for the period. The prior year is not restated. If two or more plans are terminated and the net assets are transferred to a new plan, the new plan reports the net assets transferred-in in a similar manner. A description of the merger needs to be disclosed in a note. Most plans include the details (significant assets and liabilities) of the net assets transferred-in in the disclosure.

For the terminated plan, the net assets transferred to the surviving plan are reported as a one line deduction in the statement of changes in net assets available for benefits. The Financial Reporting Executive Committee (FinREC) of the AICPA recommends that the net assets transferred out of a plan be presented on the statement of changes in net assets available for benefits below the net increase or decrease for the period. The prior year is not restated. As

mentioned in the preceding paragraph, a description of the merger needs to be disclosed in a footnote. Further, the terminating plan is required to continue to file a Form 5500 for each plan year until all of the assets of the plan have been transferred to the successor plan.

Determining the actual merger date for purposes of the financial statements and the Form 5500 is often difficult because the plan documents may indicate one date, the net assets may be transferred on a different date, and the plan administrator may believe the merger occurred on yet another date. Unfortunately, there is no one correct source to provide the actual merger date. The auditor needs to perform several procedures, including questioning the plan's management and any service providers as to the intended merger date, reviewing all of the merger documentation, reading minutes of plan meetings and plan sponsor meetings, and testing the actual transfer of assets. After these procedures have been performed, all of the information needs to be considered and the auditor ultimately uses judgment to evaluate the merger date.

An illustrated note describing the merger of one plan into a second plan (from the point-of-view of the surviving plan) follows. This illustration is not intended to imply that other information does not need to be disclosed in other circumstances.

> On July 1, 20X2, the XYZ 401k Plan was merged into the ABC 401k Plan. Prior to the merger, the plans covered eligible employees at the ABC Corporation and its subsidiary, the XYZ Company. The transferred net assets have been recognized in the accounts of the ABC plan as of July 1, 20X2, at their balances as previously carried in the accounts of the XYZ plan. The changes in net assets of the combined plans are included in the accompanying statement of changes in net assets available for benefits from July 1, 20X2. A summary of the transferred net assets follows:

Investments, at fair value	$ XXX
Receivables:	
Employer contributions	XXX
Others	XXX
Accounts payable and accrued liabilities	(XXX)
	$ XXX

In the rare instance when an employer terminates a defined benefit plan and contributes the net assets to a defined contribution plan or an employee stock ownership plan (ESOP), the transfer of assets is accounted for in accordance with FASB ASC 718.

Basis of Accounting Other Than GAAP

This lesson discusses standards for financial statements presented on the GAAP basis. However, IRS and DOL regulations allow employee benefit plans to file financial statements prepared on a basis of accounting other than GAAP (referred to in this course as special purpose financial statements). According to the instructions to Schedules H and I of Form 5500, the statements included in the form may be on the cash, "modified cash," or accrual basis as long as assets and liabilities are presented at current value. Authoritative literature on auditing financial statements prepared according to a special purpose framework at AU-C 800.07 refers to "modifications of the cash basis having substantial support." AEBP, Paragraph 14.31, states that cash basis statements that adjust securities investments to fair value are considered to be on the modified cash basis of accounting.

Certain note disclosures may be needed for special purpose financial statements. According to AEBP, Paragraph 14.34, one disclosure that should be made in special purpose financial statements is information about accumulated plan benefits, if applicable. The paragraph states that if the disclosure is omitted from special purpose financial statements, the auditor may modify the auditor's report because of the omission. Benefit obligation information for defined benefit retirement plans and health and welfare plans is discussed later in this lesson.

When the plan changes from one basis of accounting to another, the prior year financial statement(s) must be restated to conform with the current year presentation. To satisfy DOL regulations [Reg. 2520.103-1(b)(3)], the

differences between the prior year Form 5500 assets and liabilities and those in the restated financial statements would need to be disclosed in the notes to the financial statements. The prior year Form 5500 need not be restated and refiled.

Disclosure of Fines

The question is sometimes asked whether a plan needs to disclose in the plan's financial statements fines assessed by the DOL against the plan administrator or sponsor. This question is not answered in the accounting or professional standards. It is also not covered in the DOL or IRS regulations. The auditor and the plan administrator, in consultation with the plan's attorney, need to consider the question and conclude whether the disclosure is necessary to keep the plan's financial statements from being misleading.

Risks and Uncertainties

FASB ASC 275 requires disclosures about certain risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. The literature attempts to accomplish its objectives not by requiring disclosure of all risks and uncertainties, which would be an impossible task, but by requiring disclosure of the risks and uncertainties that meet specified criteria. Specifically, disclosures should be considered in the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Vulnerability resulting from concentrations.

The first two disclosures, nature of operations and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria. The literature does not prohibit additional disclosures about risks and uncertainties even if they are specifically excluded from its scope or do not meet the literature's criteria for requiring disclosure.

Certain risks and uncertainties are explicitly excluded from the requirements. These include risks and uncertainties that might be associated with the following:

- Management or key personnel (for example, loss of the plan administrator or owner/manager of the sponsor).
- Proposed changes in government regulations.
- Proposed changes in accounting principles.
- Deficiencies in a plan's internal control.
- Acts of God, war, or sudden catastrophes.

An extensive discussion of FASB ASC 275 is outside the scope of this course. Instead, the next several paragraphs provide an overview of the four areas where disclosure needs to be considered and discuss how those disclosures might be applied to employee benefit plans. Additional information on applying the literature is included in *PPC's Guide to Audits of Nonpublic Companies*.

Nature of Operations. All financial statements are required to include a description of the major products or services the reporting entity sells or provides. The authors believe this requirement is generally consistent with the requirement in AEBP to include a plan description in the disclosures. A plan description will generally include the type of plan, whether the plan is a single employer plan, multiple employer plan, or multi-employer plan, and the employees covered.

Use of Estimates. GAAP requires financial statements to include an explanation that preparing the financial statements requires the use of management's estimates. Although the auditor's report states that the audit includes

assessing significant estimates made by management, that relates more to the purpose of the audit, not the nature of the financial statements. The literature's disclosure requirement, on the other hand, is related more directly to the nature of the financial statements themselves.

The literature acknowledges that the disclosure will usually be standardized (that is, boilerplate). The following example illustrates how the disclosure might be made for an employee benefit plan.

> The preparation of financial statements in conformity with generally accepted accounting principles requires the plan administrator to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results may differ from those estimates.

Certain Significant Estimates. In addition to the general disclosure that estimates are used in preparing financial statements, the literature also requires disclosures about estimates resulting from certain conditions, situations, or circumstances that existed at the date of the financial statements and affect the amounts reported in the financial statements. The disclosures are required only when both of the following criteria are met:

- It is at least reasonably possible that the estimate will change in the near term (period of time not to exceed one year from the date of the financial statements) due to one or more future "confirming events."
- The change in the estimate would have a material effect on the financial statements.

When applying the criteria it is important to only consider conditions, situations, or circumstances that already exist. It is not appropriate or necessary to speculate about new events. This helps to narrow the range of possibilities when disclosure might be appropriate. For example, assume that the plan sponsor of an ESOP is a small company that develops and sells computer software in the shipbuilding industry. Assume further that there are rumors that a major public company is developing similar but better software. Although the plan is concerned about the effect the new software might have on the value of the sponsor's capital stock in which the plan is invested, it is only a rumor and need not be disclosed in the financial statements. If, on the other hand, the software has been released, the plan needs to consider disclosing the possible effect on the value of the plan's asset.

While the "existing condition" requirement helps to narrow the range of estimates that meets the criterion, the range is still very broad. This is primarily due to how the term *reasonably possible* is interpreted and applied. The term means the chance of the future event or events occurring is more than remote but less than likely. Deciding where to apply the threshold within that range is very subjective. Professional judgment needs to be used when deciding whether a change in an estimate is reasonably possible.

If an estimate meets the criteria for disclosure, the disclosure must:

- Describe the nature of the uncertainty, and
- Indicate that it is at least reasonably possible a change in the estimate will occur in the near term.

Using the example introduced above, the following disclosure might be made:

> Recently, a large public software company released new software that will compete with the software developed and sold by the plan's sponsor. Due to the potential effect on the sponsor's business, it is reasonably possible the fair value of the plan's investment in the sponsor's stock might change materially in the near future.

The authors believe it will be good practice to document conclusions about significant estimates that could change in the near term. Such documentation can be done informally (such as on the relevant work paper or in a separate memo). If more formal documentation is desired, a checklist can be used.

Vulnerability Resulting from Concentrations. An entity can subject itself to increased risks solely due to a lack of diversification which is referred to as concentrations. The literature requires that concentrations be disclosed if

certain criteria are met. The types of concentrations for employee benefit plans to consider for disclosure include the following:

- Concentrations in sources of contributions received by the plan.
- Concentrations in the volume of business the plan's sponsor(s) transacts with a particular customer, supplier, or lender.
- Concentrations in the volume of the plan's sponsor(s) revenue from particular products or services.
- Concentrations in the available sources of supply of materials, labor, services licenses, or other rights used in the sponsor's operations.
- Concentrations in the market or geographic area in which a plan's sponsor(s) conducts its operations.

All single employer plans and most multiemployer plans will have the concentration discussed in the first bullet. The authors believe, however, that it will be unusual for the remaining disclosure criteria described in the following paragraph to be met, and therefore, unusual for certain other disclosures to be required. The authors believe disclosure of the situation referred to in the first bullet might arise and needs to be disclosed when the plan sponsor or sponsors are in or may be placed in a financial condition placing further contributions or contributions at the present level at risk. Situations described in the remaining bullets or other situations may place the sponsor(s) in such a position.

A concentration is of concern when it involves something that cannot be easily replaced. For example, a sponsor contractor purchases most of its lumber from a single supplier. This is not a concentration unless the supplier cannot be easily replaced. Disclosure of concentrations is only required when the following criteria are met:

- A concentration exists at the financial statement date.
- The concentration makes the plan vulnerable to the risk of a near term severe impact.
- It is reasonably possible that the events able to cause the severe impact could occur in the near term (within the next year).

Some accountants may question the inclusion of concentrations that relate to the business of the sponsor(s). Whether or not they should be included is not specifically covered in the literature. However, the authors believe that in some instances the risk of the concentrations at the sponsor(s) could be such that the above criteria for disclosure in the plan's financial statements are met. The authors also believe, however, that the risk of a near term severe impact on the sponsor(s) does not necessarily and may in most cases not result in a similar impact on the plan. The auditor and the plan administrator need to consider the question and conclude whether the disclosure is necessary to keep the plan financial statements from being misleading.

The criteria are similar in some ways and use some of the same wording as the criteria for disclosing certain significant estimates. For example, the concentration must meet "existing condition" and "reasonably possible" criteria. A new term relevant to concentrations is "severe impact." Severe impact is a significant, financially disruptive effect on the normal functioning of a plan. It is more than just material but less than catastrophic. An example of a catastrophic event is one that would result in sponsor bankruptcy.

For concentrations meeting the literature's criteria, disclosures must include a description of the concentration and information about the general nature of the risk associated with the concentration. The requirements of FASB ASC 275 often overlap with other FASB ASC disclosure requirements. FASB ASC 275 disclosures may be grouped together or spread out through various parts of the financial statements or notes.

Audit Procedures. Audit procedures related to risks and uncertainties due to significant estimates and vulnerability resulting from concentrations, although outside the scope of this course, are discussed in *PPC's Guide to Audits of Employee Benefit Plans*.

Employee Plans Compliance Resolution System

The Employee Plans Compliance Resolution System (EPCRS) was developed by the IRS to provide a single, comprehensive system to allow plan sponsors to correct plan qualification problems. In addition, the EBSA offers a Voluntary Fiduciary Correction Program (VFCP) to encourage plan officials to voluntarily correct certain ERISA violations. Some accountants have asked if the financial statements need to disclose the fact that a plan is participating in the EPCRS or the VFCP. This question is not answered in the accounting or professional standards. It is also not covered in the DOL or IRS regulations. The authors do not believe there is an answer that applies in every case. The auditor and the plan administrator, in consultation with the plan's attorney, need to consider the question and conclude whether disclosure is necessary to keep the plan's financial statements from being misleading.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following indicates that an employer has made a formal commitment to make a contribution to an employee benefit plan?
   a. An employee joins the plan, triggering the need for a contribution.
   b. The employer has a history of making contributions at irregular times during the year.
   c. The employer deducts the contribution on its federal income tax return before the reporting date.
   d. The plan reports contributions as additions to net assets on its statement of changes in net assets available for benefits.
2. Which of the following is a characteristic of a participating interest?
   a. It represents the entire ownership of a financial asset.
   b. All cash flows received from the asset are divided proportionally between the interest holders.
   c. The transferor of the participating interest has priority over other interest holders.
   d. The financial asset may be exchanged for another as long as one interest holder agrees.
3. When measuring fair value, which of the following is considered a *level 1 input*?
   a. An unobservable input.
   b. A quoted price for an identical asset in an inactive market.
   c. A quoted price in an active market for a similar asset.
   d. A quoted price in an active market for an identical asset.
4. Bushels, shares, and pounds are considered which of the following?
   a. A derivative instrument.
   b. A notional amount.
   c. A payment provision.
   d. An underlying.
5. What is one of the criteria that must be met before a plan is required to disclose a concentration?
   a. It must come into existence within a month of the financial statement date.
   b. It must make the plan vulnerable to the risk of a near term severe impact.
   c. It must be reasonably possible that the related events will occur within five years.
   d. It must be in relation to something that the plan can easily replace.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Which of the following indicates that an employer has made a formal commitment to make a contribution to an employee benefit plan? **(Page 169)**

   a. An employee joins the plan, triggering the need for a contribution. [This answer is incorrect. The authoritative accounting literature gives specific indicators of an employer's formal commitment to make a contribution. One such indicator is a resolution by the employer's governing body approving a specified contribution, not simply an employee joining the plan.]

   b. The employer has a history of making contributions at irregular times during the year. [This answer is incorrect. According to the authoritative accounting literature, one indicator of an employer's formal commitment to make a contribution is a consistent pattern of making payments after the plan's year end under an established funding policy that attributes such payments to the preceding plan year. Irregular contributions would not meet these conditions.]

   c. **The employer deducts the contribution on its federal income tax return before the reporting date. [This answer is correct. Plans should record a contribution receivable as of the reporting date for amounts due from employers, participants, or others. One of the indicators of an employer's formal commitment to making a contribution, as outlined in the authoritative accounting literature, is the employer's deduction of a contribution on its federal income tax return for periods ending on or before the reporting date.]**

   d. The plan reports contributions as additions to net assets on its statement of changes in net assets available for benefits. [This answer is incorrect. This reporting is correct when a plan receives a contribution; however, this is not one of the indicators of an employer's formal commitment to make a contribution, as outlined in the authoritative accounting literature.]

2. Which of the following is a characteristic of a participating interest? **(Page 171)**

   a. It represents the entire ownership of a financial asset. [This answer is incorrect. According to FASB ASC 860-10-40-6A, a participating interest represents, from the date of the transfer, a proportionate ownership interest in an entire financial asset. The transferor's percentage of ownership interests may change over time if certain conditions are met.]

   b. **All cash flows received from the asset are divided proportionally between the interest holders. [This answer is correct. One of the characteristics of a participating interest, as explained in FASB ASC 860-10-40-6A, is that, from the transfer date, all cash flows received from the entire financial interest are divided between the participating interest holders in proportion to their ownership share. Certain cash flows are allocated as compensation for services performed, if any, and some proceeds received by the transferor for the transferred portion are excluded from this determination.]**

   c. The transferor of the participating interest has priority over other interest holders. [This answer is incorrect. As discussed in FASB ASC 860-10-40-6A, each participating interest holder (including the transferor) has rights of equal priority and no interest is subordinated to another participating interest holder's interest.]

   d. The financial asset may be exchanged for another as long as one interest holder agrees. [This answer is incorrect. Per FASB ASC 860-10-40-6A, one of the characteristics of a participating interest is that the entire financial asset may not be pledged or exchanged without the agreement of all participating interest holders.]

3. When measuring fair value, which of the following is considered a *level 1 input*? **(Page 173)**

   a. An unobservable input. [This answer is incorrect. Unobservable inputs are considered level 3 inputs, per the fair value hierarchy in FASB ASC 820.]

   b. A quoted price for an identical asset in an inactive market. [This answer is incorrect. According to the fair value hierarchy outlined in FASB ASC 820, this is an example of a level 2 input.]

   c. A quoted price in an active market for a similar asset. [This answer is incorrect. This is considered a level 2 input based on the fair value hierarchy in FASB ASC 820.]

   d. **A quoted price in an active market for an identical asset. [This answer is correct. FASB ASC 820 provides a fair value hierarchy for use in prioritizing valuation inputs. It is made up of three levels of inputs. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.]**

4. Bushels, shares, and pounds are considered which of the following? **(Page 177)**

   a. A derivative instrument. [This answer is incorrect. A derivative instrument is a financial instrument or other contract that meets three specific characteristics. Notional amounts, payment provisions, and underlyings make up derivative instruments. The items listed above can be part of a derivative instrument, but they are not derivative instruments on their own.]

   b. **A notional amount. [This answer is correct. According to FASB ASC 815-10-20, a *notional amount* is "a number of currency units, shares, bushels, pounds, or other units specified" in a contract.]**

   c. A payment provision. [This answer is incorrect. Per FASB ASC 815-10-20, a *payment provision* "specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner." This is a different concept from the items listed above.]

   d. An underlying. [This answer is incorrect. As defined in FASB ASC 815-10-20, an *underlying* is "a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself." The items listed above are, therefore, not classified as underlyings.]

5. What is one of the criteria that must be met before a plan is required to disclose a concentration? **(Page 183)**

   a. It must come into existence within a month of the financial statement date. [This answer is incorrect. One of the criteria that must be met for a concentration to be required to be disclosed is that the concentration exists at the financial statement date. If it comes into existence after the financial statement date, disclosure is not required.]

   b. **It must make the plan vulnerable to the risk of a near term severe impact. [This answer is correct. Disclosure of a concentration is only required when certain criteria are met. One of those criteria is that the concentration makes the plan vulnerable to the risk of a near term severe impact. In this case, the plan would be required to disclose the concentration.]**

   c. It must be reasonably possible that the related events will occur within five years. [This answer is incorrect. One of the criteria that must be met for a plan to be required to disclose a concentration is that it is reasonably possible that the events able to cause the severe impact could occur in the near term (within the next year, not the next five years).]

d. It must be in relation to something that the plan can easily replace. [This answer is incorrect. A concentration is of concern when it involves something that *cannot* be easily replaced. For example, a sponsor contractor purchases most of its lumber from a single supplier. This is not a concentration unless the supplier cannot be easily replaced. If the supplier could be easily replaced, then no concentration exists and disclosure would not be required.]

ACCOUNTING AND FINANCIAL REPORTING STANDARDS THAT ARE UNIQUE TO DEFINED CONTRIBUTION RETIREMENT PLANS

There are different types of defined contribution retirement plans, including profit-sharing plans, ESOPs, and 401k plans. Particular features of such plans may differ, but a common feature is that all defined contribution retirement plans limit benefits to the net assets that are available for benefits. Thus, there is no need to measure and report information on benefit obligations, so the accounting and financial reporting is much simpler than for defined benefit retirement plans. This section discusses the accounting and financial reporting standards for defined contribution retirement plans as described in FASB ASC 962.

Required Financial Statements and Financial Presentation for Defined Contribution Retirement Plans

FASB ASC 962-205-45-1 requires GAAP financial statements of a defined contribution retirement plan to include the following:

- A statement of net assets available for benefits as of the end of the plan year. (Note that DOL regulations and Schedules H and I to Form 5500 require a comparative statement of net assets available for benefits.)
- A statement of changes during the year in net assets available for benefits. (DOL regulations and IRS instructions do not require a comparative statement of changes in net assets available for benefits.)

Statement of Net Assets Available for Benefits. A defined contribution retirement plan's statement of net assets available for benefits includes plan assets and liabilities such as accrued administrative expenses and payables for securities purchased. There is no information equivalent to accumulated plan benefits on the statement of net assets or anywhere else in defined contribution plan statements. This is because, as previously mentioned, benefits of a defined contribution plan are not defined as they are for a defined benefit plan, but are limited to the plan net assets.

FASB ASC 962-205-50-1 states that amounts allocated to participants who have withdrawn from the plan but who have not yet been paid should not be recorded as a liability but (if material) should be disclosed. While not mentioned in the FASB ASC, the authors recommend the disclosure also include when the amounts will be paid. An illustrated note to the financial statements follows:

> Net assets available for benefits at December 31, 20X2, include $315,000 allocated to the accounts of persons who as of or prior to that date had withdrawn from participating in the earnings and operations of the Plan. The $315,000 is payable to the former participants in February and March, 20X3.

However, these amounts are normally included in the Form 5500 Schedule H, line 1g, as a liability.

Notes Receivable from Participants. According to FASB ASC 962-310-45-2, loans to participants should be classified in the statement of net assets available for benefits as notes receivable from participants, and FASB ASC 962-310-35-2 states that they should be measured at their unpaid principal balances plus any accrued but unpaid interest.

Self-directed Investment Programs. In addition to participant-directed programs, some plans allow participants to self-direct their investments. AEBP, Paragraph 5.28, indicates that a self-directed program is one that allows participants to invest their account balances in any investment desired, within certain plan and ERISA limitations. (The instructions to Form 5500 refer to these investment programs as "participant-directed brokerage accounts.") Participants are allowed to place investments into the self-directed program in addition to or in place of the various formal investment programs offered by the plan. The Form 5500 allows certain self-directed accounts to be presented either individually or in the aggregate. However, aggregate reporting is not available for investments made through self-directed brokerage accounts that are loans, partnerships or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction.

Fully Benefit-responsive Investment Contracts. FASB ASC 962-325-35-5 through 35-11 give guidance on the measurement of fully benefit-responsive investment contracts held by defined contribution retirement plans.

FASB ASC 946-210-45-10 identifies the following types of investment contracts that are subject to FASB ASC 962:

- Traditional or separate account guaranteed investment contracts (GIC).
- Bank investment contracts (BIC).
- Synthetic GICs.
- Contracts with characteristics similar to the preceding contracts.

Typically, documentation underlying the preceding types of investment gives an indication of the type of investment.

According to FASB ASC 962-325-20 an investment contract is considered fully benefit-responsive if it meets *all* of the following conditions:

a. The contract is entered into directly between the plan and the issuer and the plan is not allowed to assign or sell the contract or the proceeds from the contract to another party without the issuer's consent.

b. Either the issuer of the contract has a financial obligation to repay the principal and interest credited to participants in the plan, or participants in the plan are provided prospective interest crediting rate adjustments on a designated pool of investments (either held by the plan or the issuer of the contract) through which a financially responsible third party provides assurance that adjustments to the interest crediting rate will not result in a rate less than zero. In the latter case, the third party generally provides the assurance through a contract referred to as a "wrapper." If a situation occurs, such as a significant decline in the creditworthiness of the issuer or provider of the wrapper, and it becomes no longer probable that full contract value will be realized for a particular investment contract, that contract would no longer be considered fully benefit-responsive.

c. The contract must require all participant-initiated transactions with the plan (such as withdrawals, loans, or transfers allowed by the plan) to be made at contract value, without limitations, conditions, or restrictions.

d. It must be probable that an event would not occur that would limit the plan's ability to conduct transactions with the issuer at contract value and that would also restrict the plan's ability to conduct transactions with plan participants at contract value. Such events may include the plan's premature termination of the contracts, layoffs, termination of the plan, plant closings, bankruptcy, mergers, or early retirement incentives.

e. The plan must allow participants to have reasonable access to their funds. For example, if plan participants are allowed access at contract value to all or a portion of account balances only upon termination of their participation in the plan, this would not be considered reasonable access and the contract would not be considered fully benefit-responsive.

If a plan holds multiple investment contracts, each contract is evaluated individually for benefit responsiveness.

Defined contribution plans are required to measure, present, and disclose fully benefit-responsive investment contracts at contract value and to disclose certain information regarding the contracts. Additionally, AEBP, paragraph 5.87, indicates that these disclosures are also applicable to any fully benefit-responsive investment contracts held by a master trust. The contracts are not included in the fair value disclosures required under FASB ASC 820 and 825, as they are not reported at fair value.

Statement of Changes in Net Assets Available for Benefits. FASB ASC 962-205-45-7 requires that the statement of changes in net assets available for benefits of a defined contribution retirement plan present the effects of significant changes in net assets during the period. FASB ASC 962-205-45-8 requires separate presentation of other changes, if they are significant. For example, assets transferred from another plan (a roll-over) may be included in "contributions from participants" or, if significant, as a separate line item. Disclosure may also be made in a note to the financial statements.

Statement of Cash Flows. FASB ASC 230-10-15-4 exempts defined benefit pension plans and other benefit plans that present financial information similar to that required by FASB ASC 960 from the requirement to present a

statement of cash flows. FASB ASC 962-205-45-9 refers to this exemption with respect to presentation of a statement of cash flows for defined contribution plans. However, FASB ASC 962-205-45-9 indicates employee benefit plans are encouraged to consider presenting a statement of cash flows if it would provide relevant information about the plan's ability to meet future obligations, for example, when plan assets are not highly liquid or are obtained with financing. The authors believe that most plans do not present cash flows statements.

Comparative Financial Statements. GAAP does not require defined contribution retirement plans to present comparative financial statements. However, AEBP, Paragraph 5.11, indicates that comparative financial statements may provide more useful information for determining the future ability of the plan to pay benefits. (Note that, as previously mentioned, DOL regulations and Schedules H and I to Form 5500 require a comparative statement of net assets available for benefits but only the current year's statement of changes in net assets available for benefits to be presented in the form and also attached to it.)

Excess Contributions

A 401(k) plan may have excess contributions if the plan fails to satisfy the actual deferral percentage (ADP) test. Several remedies are available to satisfy the ADP test, including refunding the excess contributions. (See *PPC's 5500 Deskbook* for a discussion of other remedies.) If excess contributions and any related earnings are refunded within 2½ months following the end of the plan year, the amounts ought to be included in the participant's gross income as of the earliest dates any 401(k) contributions made by the participant during the plan year would have been received by the participant had he or she originally elected to receive the amounts in cash. For example, if a plan is a calendar year plan and excess contributions made during 20X1 are distributed to a participant in February 20X2, the excess contributions would be included in the participant's 20X1 taxable income. (Amounts aggregating less than $100 are considered *de minimis* for tax purposes and may be treated as a distribution in the following year.)

If the amount of excess contributions to be refunded is material, the plan's financial statements should include a liability with a description such as "Excess Contributions Payable." The liability should be reflected in the financial statements for the plan year in which the excess contributions were made (20X1 in the example above). This is consistent with AEBP, Paragraph 5.65, which indicates the refund of excess contributions is an example of a liability a plan may have to accrue. However, there is presently diversity in practice regarding how the plan should report the entry to offset the liability. The authors believe such amounts need to be reported as a reduction of contributions received during the year. This approach is consistent with AEBP, Paragraph 5.67, which states that FinREC recommends that such corrective distributions be netted against contributions received on the statement of changes in net assets available for benefits because they represent ineligible contributions for the plan year. Another approach is to report the amounts as a distribution. In AEBP, Paragraph 5.78a, FinREC recommends that the accounting policy for corrective distributions be disclosed. The authors also believe the nature and amount of the refund ought to be disclosed, if material.

Notes illustrating both approaches discussed in the previous paragraph are as follows (adapted from AEBP, Appendix C):

> Amounts payable to participants totaling $XX,XXX for contributions in excess of amounts allowed by the IRS are recorded as a liability with a corresponding reduction to contributions. The Plan distributed the 20X1 excess contributions to the applicable participants prior to March 15, 20X2.
>
> Amounts payable to participants totaling $XX,XXX for contributions in excess of amounts allowed by the IRS are recorded as a liability and are included in benefits paid to participants. The Plan distributed the 20X1 excess contributions to the applicable participants prior to March 15, 20X2.

Distribution of excess employer matching contributions to satisfy the ACP test should be treated in the same manner as distributions to satisfy the ADP test.

Required Note Disclosures for Defined Contribution Retirement Plans

FASB ASC 962-205-50-1 requires financial statements of defined contribution retirement plans to disclose matters such as plan provisions, amendments, employer contribution basis, funding policy (for defined contribution retirement plans subject to ERISA minimum funding requirements, such as money purchase plans and target benefit plans), the policy for purchasing insurance contracts that are excluded from the financial statements, and the federal tax status.

As previously discussed, amounts allocated to accounts of persons who have withdrawn from participation in the plan's earnings and operations should be disclosed, if material.

ESOP Financial Reporting Issues

ESOPs, especially leveraged ESOPs, often encounter reporting issues not relevant to other types of defined contribution plans. An ESOP is a type of stock bonus plan. A leveraged ESOP borrows money to purchase shares of the employer. The loan is usually obtained from one of three sources:

- Direct loans from a third party, such as a bank. (Direct loans are often guaranteed by the employer.)
- Indirect loans from the employer, and the employer obtains a third-party loan.
- Employer loans, and the employer obtains no related outside loan.

The leveraged ESOP therefore has an obligation to a financial institution or a related-party lender. If the ESOP debt is reported at fair value, the guidance on fair value measurements would apply. As discussed earlier in this lesson, a quoted price (unadjusted) in an active market is Level 1 in the valuation hierarchy established by the authoritative literature. The ESOP generally repays the loan from contributions received from employees and the employer, and from dividends received on the employer stock.

Employer shares are classified by the plan as unallocated shares when initially purchased. As the shares are allocated to employees, the plan classifies the shares as allocated shares. FinREC recommends that a leveraged ESOP report the allocated and unallocated shares in separate columns in its financial statements. This is consistent with the requirements of FASB ASC 962-205-50-1, which requires the disclosure of the amount of unallocated assets as well as the basis for allocation if that basis differs from the one used to record assets in the financial statements. The dual column presentation segregates ESOP shares available to creditors (i.e., collateral for plan debt) from those belonging to participants. The plan usually pledges the unallocated shares as collateral for the outstanding loan balance. As a result, the loan is included in the unallocated column in the plan's financial statements.

For nonleveraged ESOPs, FinREC recommends a single column presentation. Because none of the assets are serving as collateral in a nonleveraged ESOP, there is no need to distinguish between allocated and unallocated shares.

If an employer guarantees the loan of an ESOP, the employer is required to record a liability for the outstanding loan balance. Some have questioned whether the plan needs to record an "offsetting receivable" equal to the liability recorded by the employer. The answer is "no," because a valid receivable does not exist for the plan. Although this question is not addressed in the authoritative literature, the financial statements illustrated in AEBP do not include a receivable from the employer related to the guarantee, nor any specific disclosures.

Typically, an ESOP has an annual appraisal of the shares to estimate fair value. An ESOP with *nontraded* securities typically obtains an independent appraisal of the securities. In the context of ESOPs, the IRS considers any securities not traded on an exchange registered under Section 6 of the Securities Exchange Act of 1934 (or similar foreign exchange) to be nontraded. This means that Over-the Counter Bulletin Board securities are deemed *nontraded* and may require an independent appraisal. If the fair value of the unallocated shares falls below the outstanding loan balance, the plan reports a deficit in the unallocated shares column of the statement of net assets available for benefits, causing the plan to be referred to as an "underwater" leveraged ESOP. The authoritative literature does not mention any specific disclosures required for underwater ESOPs. The notes of an ESOP should,

however, provide a description of the plan, including a statement that the lender has no rights to the shares after they are allocated to the participants.

The fair value of ESOPs of nonpublicly traded employers are generally measured using unobservable inputs and are therefore categorized within Level 3 of the fair value hierarchy under FASB ASC 820. FASB ASC 820-10-50-2(bbb)(2) requires disclosure of quantitative information about the significant unobservable inputs used in Level 3 fair value measurements. However, FASB ASC 820-10-50-2(bbb)(2) states that employee benefit plans, other than those that are subject to the SEC's filing requirements, are not required to disclose quantitative information about the significant unobservable inputs that are used in the fair value measurement of investments held by an employee benefit plan in its own sponsor's nonpublicly traded equity securities or those of its nonpublic affiliates. It is important to note, however, that the remainder of the disclosure requirements under FASB ASC 820 are still applicable to ESOPs and other employee benefit plans with investments in their nonpublicly traded plan sponsor's equity securities.

Illustrative Defined Contribution Retirement Plan Financial Statements

AEBP, Appendix C, illustrates financial statements, including notes, of a 401(k) plan with a profit-sharing feature.

ACCOUNTING AND FINANCIAL REPORTING STANDARDS THAT ARE UNIQUE TO DEFINED BENEFIT RETIREMENT PLANS

Because defined benefit retirement plans promise participants a defined level of income when they retire, complex measurements are necessary to determine the value of that promise at the plan reporting date. FASB ASC 960 includes standards for measuring and reporting information on pension benefit obligations. This section discusses the accounting and financial reporting standards for defined benefit retirement plans contained in FASB ASC 960 and summarized in AEBP, Chapter 7.

Actuarial Present Value of Accumulated Plan Benefits

FASB ASC 960-20-20 defines the actuarial present value of accumulated plan benefits as follows:

> The amount as of a benefit information date that results from applying actuarial assumptions to the benefit amounts determined pursuant to [plan provisions] (that is, 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.

FASB ASC 960-20-20 defines the *benefit information date* as "the date as of which the actuarial present value of accumulated plan benefits is presented." As discussed later, that date may be the plan year end or a date as of the beginning of the plan year.

FASB ASC 960 establishes standards for measuring accumulated plan benefits and for determining the actuarial present value of those benefits for financial reporting purposes. The plan sponsor is responsible for seeing that these standards are followed for conformity with GAAP, even though actuaries determine the actuarial present value of accumulated plan benefits.

Measuring Accumulated Plan Benefits. FASB ASC 960-20-25-3 requires the plan provisions to be applied, to the extent possible, in measuring accumulated plan benefits. For example, the plan may provide that a participant accrue a specified amount of benefit for each year of service. Suppose that a plan provides for an annual benefit equal to 2% of the average annual salary for the five years preceding retirement for each year of employment, up to a maximum of 30 years. The accumulated plan benefit for a plan participant who has been employed for 15 years and whose salary during the last five years has averaged $45,000 would be $13,500. (This is calculated as $45,000 times 2% times 15 years.)

FASB ASC 960-20-25-5 states that plan amendments adopted after the benefit information date should not be recognized in measuring accumulated plan benefits. However, AEBP, Paragraph 7.82, states that plan amendments

adopted before the benefit information date should be recognized, even if some of the changes to the plan caused by the amendments take effect only in future periods.

FASB ASC 960-20-25-5 also states that if the plan specifies automatic benefit increases, such as automatic cost-of-living increases, then those increases that are expected to occur after the benefit information date should be recognized in measuring accumulated plan benefits. For example, suppose that a plan provides for an adjustment (increase) in retirement income each January 1st equal to one-half the increase in the Consumer Price Index during the year ending on the preceding September 30. Suppose also that the Consumer Price Index increased by 4% during the year ended September 30, 20X1, and that the benefit information date is as of December 31, 20X1. In this case, the $13,500 accumulated plan benefit calculated above would be adjusted to $13,770 (this is $13,500 times 102%). Because it is automatic, the cost-of-living increase would be reflected in the December 31, 20X1, determination even though it would not take effect until January 1, 20X2.

FASB ASC 960-20-25-4 states that if the benefit for each year of service is not stated by the plan or clearly determinable from its provisions, the benefit should be considered to accumulate in proportion to the following:

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), 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).

A major principle in measuring accumulated plan benefits is that they should be measured based on history of employees' pay and service and other appropriate factors as of the benefit information date. FASB ASC 960-20-25-5 states this principle and also states that projected years of service should only be considered in determining employees' expected eligibility for particular benefits, such as the following:

- 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).
- Early retirement benefits.
- Death benefits.
- Disability benefits.

FASB ASC 960-20-25-5 notes that it may be necessary to take future pay into account in determining Social Security benefits in an integrated plan. If so, employees' pay as of the benefit information date should be assumed to remain unchanged during their assumed future service. Also, no effect should be given to scheduled, or possible, future increases in the wage base or benefit level under the Social Security law.

Finally, FASB ASC 960-20-25-5 states that the measure of accumulated plan benefits should not include benefits that are to be provided by a contract that is excluded from the plan financial statements, for example, by an allocated insurance contract.

Determining Actuarial Present Value. To determine the actuarial present value of accumulated plan benefits as of the benefit information date, actuarial assumptions are applied to the accumulated plan benefit amount. FASB ASC 960-20-35-1 requires that each individual assumption "reflect the best estimate of the plan's future experience solely with respect to that individual assumption." It establishes the following requirements for the assumptions:

- Assumed rates of return on plan assets should reflect expected rates of return during the periods for which payment of benefits is deferred. The assumed rates of return should be consistent with returns realistically achievable on the types of assets the plan holds and with the plan's investment policy.

- Expected inflation rates used in determining automatic benefit increases for plans with such a provision should be consistent with the assumed rates of return on plan assets.
- Administrative expenses the plan expects to pay (not those the plan sponsor absorbs) that are associated with providing accumulated plan benefits should be reflected either by adjusting the assumed rates of return or by assigning the expenses to future periods and discounting them to the benefit information date.

In selecting assumptions, FASB ASC 960-20-35-1A allows use of assumptions that are inherent in the estimated cost at the benefit information date of an insurance contract to provide the accumulated plan benefits. This approach may be particularly appropriate for small plans because the assumptions would be tailored to a specific size plan. Also, use of insurance company premium rates may be a less expensive approach to making assumptions. However, it may be difficult to obtain the information from an insurance company.

Minimum Funding Standards. Actuaries are also required to consider the minimum funding standards to certify the plan's funded percentage. The Pension Protection Act implemented complex rules around the minimum funding of defined benefit plans. Thus, the plan administrator needs to verify that the actuary properly considered those requirements and that the plan is operating according to any benefit limitations that may apply.

Example of Determining Present Value of Accumulated Plan Benefits. The actuarial present value of accumulated plan benefits results from adjusting accumulated plan benefits for the time value of money and the probability of payment. An example earlier in this section calculates an accumulated plan benefit of $13,500 based on a plan's benefit accrual provisions. The calculation means that as of the benefit information date, the plan participant has accrued an annual pension benefit of $13,500 to be received each year during his or her retirement. (The cost-of-living adjustment is ignored for simplicity in the following example.)

How much is this promise of a future benefit worth today? That is, what is the actuarial present value of the obligation? To determine the actuarial present value of the accumulated plan benefit, one needs to know, among other things, the plan's normal retirement age (assume it's age 65), the participant's current age (assume it's age 40), and his or her life expectancy after retirement (assume the participant will live for 20 years after retirement). Based on these assumptions, the $13,500 annual benefit will begin to be paid in 25 years (65 retirement age minus the participant's current age of 40) and will be paid for 20 years after that.

To determine the present value of a stream of 20 annual $13,500 payments, one needs to choose an appropriate discount rate (assume it's 10%) and term; in this case 20 periods. The result yields a present value of $114,933. This means that by the time the participant retires in 25 years, the plan needs to have $114,933 on hand to make the 20 annual pension payments, assuming that during those 20 years, the plan could earn 10% annually on the balance remaining after each year's $13,500 payment.

But, the stream of 20 payments will not begin for 25 years. To determine the present value of $114,933 to be needed in 25 years, one again selects an appropriate discount rate (say 10%) and the related factor for the present value of a lump sum after a given period. The factor for a 10% discount rate and a period of 25 years is .09230. Multiplying $114,933 by .09230 yields a present value of $10,608. This means that if, at the benefit information date, the plan invests $10,608 at a 10% annual return for 25 years, it will have $114,933 after 25 years to meet the 20 annual pension payments that will begin at that time. Thus, the present value of the $13,500 annual accumulated benefit obligation is $10,608. Exhibit 1-1 summarizes this example.

Exhibit 1-1

Determining Present Value of Accumulated Plan Benefit

Plan Provisions:

Normal retirement age	65

Participant Data at Benefit Information Date:	
Age	40
Life expectancy	85
Years to retirement	25 (= 65 minus 40)
Expected years of retirement	20 (= 85 minus 65)
Accumulated plan benefit	$13,500 annually
Present Value Factors:	
Assumed discount rate	10%
Discount factor for present value of annuity for 20 periods and 10% discount rate (from a present value table)	8.51356
Discount factor for present value of lump sum due after 25 years and 10% discount rate (from a present value table)	.09230
Present Value of Accumulated Plan Benefit at Benefit Information Date:	
Present value of 20-year annuity starting in 25 years	$114,933 (= $13,500 × 8.51356)
Present value of $114,933 required in 25 years	$10,608 (= $114,933 × .09230)

Note that in reality, the plan would not be given $10,608 on the benefit information date to invest. Instead, the plan sponsor would contribute an amount each year during the 25 years. Discount factors and assumed rates of return would be used to determine the amount that the plan sponsor would have to contribute each year to accumulate $114,933 after 25 years. This would determine the plan sponsor's minimum required annual funding contribution.

The example in the preceding paragraphs only shows the effect of the time value of money on the present value of an accumulated benefit obligation. In addition, actuaries apply discount factors to take into account the probability of payment of the accumulated benefit. For example, the participant might withdraw from the plan when he or she is not fully vested in the accumulated benefit because of employment termination or death, or the participant might not live for 20 years after retirement (he or she might live a significantly shorter or longer time). These or other occurrences would affect the amount of the pension that would actually be paid.

Actuaries use discount factors that take into account the average employment years, mortality, and other experience of very large groups of people of similar sex, age, etc. Including an actuarial discount factor would change the $10,608 present value to an actuarial present value of some other amount.

The example in the preceding paragraphs includes several simplifying assumptions, such as annual lump sum pension payments (instead of the more typical monthly payments) and no possibility of early retirement or other plan provisions that might affect the accumulated benefit obligation and its actuarial present value.

Plan administrators typically engage an actuary to calculate the accumulated benefit and its actuarial present value based on plan provisions and on salary, employment, and demographic data the plan administrator supplies. The actuary may advise the plan about the choice of a discount rate, but plan management is responsible for the reasonableness of the assumptions, particularly the assumed rates of return on plan assets.

Changes in the Actuarial Present Value of Accumulated Plan Benefits. The actuarial present value of accumulated plan benefits may change from one benefit information date to another because of changes in actuarial assumptions to reflect changes in the plan's expected experience. For example, the expected rate of return on plan

assets may change. FASB ASC 960-20-35-4 views such changes as changes in estimates. Thus, it states that the effects of such changes should be accounted for in the year of change, or in the year of change and future years if the change affects current and future years. The change should not be reflected by restating prior-period financial statements or by reporting pro forma amounts for prior years.

401(h) Accounts

A current practice for many defined benefit retirement plans and health and welfare benefit plans is to allow the plan sponsor to fund postretirement health benefits through a 401(h) account. The contributions to the 401(h) account (the name refers to the respective IRC section) must be used solely to pay medical obligations for retirees and their spouses and dependents. The assets held in the 401(h) account may not be used to pay pension benefits.

FASB ASC 960-30-45 and FASB ASC 965-205-45 provide accounting, reporting, and disclosure requirements for defined benefit retirement plans and health and welfare benefit plans, respectively.

For defined benefit retirement plans, the net assets of the 401(h) account should be reported in one line item in the investments section of the statement of net assets available for benefits. The same amount should also be presented as a liability in the statement of net assets available for benefits. Thus, the net assets of the pension plan related to the 401(h) account should equal zero, which properly presents the nature of the account, that is, the funds are held by the pension plan but are not available to pay pension benefits. None of the activity in the 401(h) account should be reported in the pension plan's statement of changes in net assets available for benefits. (The changes in the account are presented in the health and welfare plan's financial statements.) The notes to the financial statements should appropriately describe the 401(h) feature of the plan, the nature of the assets, and the fact that the assets may only be used to pay retiree health benefits. The accounting and reporting of 401(h) accounts by health and welfare benefit plans is discussed in the next section of this lesson.

Required Financial Statements and Financial Presentation for Defined Benefit Retirement Plans

Required Financial Statements. FASB 960-205-45-1 requires a defined benefit plan's annual financial statements to include the following:

- A statement of net assets available for benefits as of the plan's year end. (Note that DOL regulations and Schedules H and I to Form 5500 require a comparative statement of net assets.)
- A statement of changes during the year in net assets available for benefits. (DOL regulations and IRS instructions do not require a comparative statement of changes in net assets available for benefits.)
- Information about the actuarial present value of accumulated plan benefits as of either the beginning or end of the plan year.
- Information about significant factors affecting the change during the year in the actuarial present value of accumulated plan benefits.

Statement of Net Assets Available for Benefits. The statement of net assets available for benefits includes plan assets and liabilities such as payables for securities purchased and accrued administrative expenses. However, this statement does not include the actuarial present value of accumulated plan benefits in plan liabilities. That information is separately presented elsewhere.

Statement of Changes in Net Assets Available for Benefits. FASB ASC 960-30-45-1 requires the statement of changes in net assets available for benefits to identify the significant changes and to disclose certain items.

Information about the Actuarial Present Value of Accumulated Plan Benefits. Information about the actuarial present value of accumulated plan benefits (also called "benefit obligation information") is separately presented, and is not included in liabilities on the statement of net assets available for benefits. The reason is that FASB ASC 960 does not resolve whether the benefit obligation is a liability of the plan or of the employer. The FASB decided that as long as the information is presented somewhere in the financial statements, it was not necessary to resolve the issue of its nature. However, the information is not included in plan liabilities to avoid any implication that the FASB has concluded that it is a plan liability.

The information about the actuarial present value of accumulated plan benefits may be presented as a separate statement, on the face of another statement, or in the notes to the financial statements, as long as it is presented all in one place and is classified as (a) vested benefits of participants currently receiving benefits, (b) other vested benefits, and (c) nonvested benefits. The information may be presented on the statement of net assets available for benefits only if the information is as of the same date.

FASB ASC 960-205-45-4 states that it is preferable to present the benefit obligation information as of the plan year end. However, it can be difficult to obtain actuarial determinations made as of the plan year end in time to present timely financial statements. Thus, the literature allows the option of a beginning-of-year benefit information date.

If the benefit obligation information is presented as of the beginning of the plan year, a statement of net assets available for benefits as of the beginning of the plan year must be presented in addition to the required year-end statement of net assets. Also, a statement of changes in net assets available for benefits during the preceding year must be presented in addition to the required statement of changes during the current year. The literature requires these additional statements because it considers it important to present information about net assets available for plan benefits and the actuarial present value of accumulated plan benefits as of the same date, and to present information on changes in net assets available for benefits and changes in the actuarial present value of accumulated plan benefits as of the same date.

FASB ASC 960-20-45-3 requires the statement or note on the actuarial present value of accumulated plan benefits to present the benefit obligation information in the following categories:

- Vested benefits of participants currently receiving payments, including benefits due and payable as of the benefit information date.
- Other vested benefits.
- Nonvested benefits.

Information about Changes in the Actuarial Present Value of Accumulated Plan Benefits. According to FASB ASC 960-20-45-2, information about changes in the actuarial present value of accumulated plan benefits may be presented as a separate statement, on the face of another statement, or in notes to the financial statements, as long as it is presented all in one place. The information may be presented on the statement of changes in net assets available for benefits only if it is for the same period.

The statement or note on changes in the actuarial present value of accumulated plan benefits must separately identify significant factors affecting the change. FASB ASC 960-20-50-3 and 50-4 require the significant effects of the following factors to be disclosed:

- Plan amendments.
- Changes in the nature of the plan, for example, a plan spin-off or merger with another plan.
- Changes in actuarial assumptions. If actuarial assumptions are determined based on assumptions inherent in the cost of an insurance contract, the effects of changes in actuarial assumptions reflected in changes in the insurance rates must be disclosed if it is practical to do so. If such disclosure is not practical, the effects should be included in the otherwise optional disclosure of benefits accumulated.
- Actuarial present value of accumulated plan benefits as of the preceding benefit information date, if the three preceding items are presented in other than a statement format.

FASB ASC 960-20-45-8 and 45-9 note that if only this minimum required information on changes in the actuarial present value of accumulated plan benefits is presented in a statement that accounts for the change between two benefit information dates, then an unidentified "other" category will have to be presented to reconcile the beginning and ending amounts.

Optional disclosures in the statement or note on benefit obligations include the significant effects of the following factors:

- Benefits accumulated, with actuarial experience gains or losses either included with the effects of additional benefits accumulated or separately disclosed.
- The increase (for interest) as a result of the decrease in the discount period.
- Benefits paid. This item should not include benefit payments made by an insurance company under a contract that is excluded from plan assets, that is under an allocated contract. But, this item should include payments the plan made to an insurance company under such a contract, including purchasing annuities with amounts allocated from existing contracts with the insurance company.

Statement of Cash Flows. FASB ASC 230-10-15-4 and 960-205-45-6 exclude defined benefit pension plans that follow FASB ASC 960 from the requirement to present a statement of cash flows. However, they encourage such a statement when it would provide relevant information about a plan's ability to meet future obligations, for example, when plan assets, such as real estate, are not highly liquid or when the plan obtains financing for investments. The authors believe that most plans do not present cash flow statements.

Comparative Financial Statements. As previously explained, FASB ASC 960 requires comparative financial statements if the actuarial present value of accumulated plan benefits is presented as of the beginning of the plan year. Otherwise, comparative financial statements are not required. Nevertheless, FASB ASC 960-205-10-1 states the desirability of presenting financial statements for several plan years. (Also note that DOL regulations and IRS Schedules H and I to Form 5500 require a comparative statement of net assets but only the current year's statement of changes in net assets to be presented in the form and also attached to it.)

Summary of Financial Statement Requirements and Presentation Options. Exhibit 1-2 summarizes the financial statement requirements and options for defined benefit retirement plans discussed in the preceding paragraphs.

Exhibit 1-2

Summary of Defined Benefit Plan Financial Statement Requirements and Presentation Options

	Current Year End or Period	**Prior Year End or Period**
Year End Benefit Information Date		
Statement of Net Assets Available for Benefits	Yes	No (but required by DOL regulations and in Form 5500)
Statement of Changes in Net Assets Available for Benefits	Yes	No
Information about Actuarial Present Value of Accumulated Plan Benefits [may be presented in: • Separate statement, • Face of another statement (may be presented in statement of net assets available for benefits only if information is as of the same date), or • Notes]	Yes	No

	Current Year End or Period	Prior Year End or Period
Information about Changes in Actuarial Present Value of Accumulated Plan Benefits [may be presented in: • Separate statement, • Face of another statement (may be presented in statement of changes in net assets available for benefits only if for the same period), or • Notes]	Yes	No
Beginning-of-year Benefit Information Date		
Statement of Net Assets Available for Benefits	Yes	Yes (also required by DOL regulations and in Form 5500)
Statement of Changes in Net Assets Available for Benefits	Yes	Yes
Information about Actuarial Present Value of Accumulated Plan Benefits [may be presented in: • Separate statement, • Face of another statement (may be presented in statement of net assets available for benefits only if information is as of the same date), or • Notes]	No	Yes
Information about Changes in Actuarial Present Value of Accumulated Plan Benefits [may be presented in: • Separate statement, • Face of another statement (may be presented in statement of changes in net assets available for benefits only if for the same period), or • Notes]	No	Yes

Employer Contributions Receivable. As discussed earlier, ERISA establishes minimum funding standards for defined benefit plans. Annual minimum contribution requirements are established based on a plan's funded status and are determined based on ratios set forth in the Pension Protection Act of 2006. ERISA requires that an actuary certify a plan's funded percentage and determine the plan sponsor's minimum contribution requirement for each year. In AEBP, Paragraph 7.64, FinREC recommends that the minimum required contribution be recorded as a contribution receivable by the plan if not paid by year-end. The authors believe that this contribution is often paid by the plan sponsor closer to the extended corporate tax return deadline (8½ months after year-end), and therefore an employer contribution receivable may be applicable for many defined benefit plans.

Often, an employer makes a contribution in excess of the minimum funding requirement, and for corporate tax deduction purposes, the entire contribution is attributed to the prior year. The amount over the minimum required contribution, if not the result of a formal commitment made prior to year-end, may be considered a nonrecognized, or type 2, subsequent event and would not be recorded as a contribution receivable by the plan. The Form 5500, Schedule SB (or Schedule MB for multiemployer plans) may prove helpful in determining the portion of the funding received attributable to the minimum required contribution for the plan year.

Employer Withdrawal Liability. As mentioned in AEBP Paragraph 7.69, an employer that partially or completely withdraws from a multiemployer defined benefit plan must continue to fund a proportional share of the plan's unfunded vested benefits. This withdrawal liability is payable over not more than 20 years. These amounts should be reported in the financial statements as a receivable and a contribution. While other descriptions may be equally acceptable, the authors suggest "Employer withdrawal liability receivable" and "Employer withdrawal contribution." The authors also suggest that the withdrawal and any significant terms be disclosed in the plan year the withdrawal

occurs. Payment terms of the receivable should be disclosed as long as the receivable amount is significant. If the effect of the withdrawal is not material, it need not be disclosed and the amounts need not be disclosed separately. An illustrated note to the financial statements follows:

> GHI Contractors, Inc. withdrew from the Plan during 20X1 and agreed to pay a withdrawal liability of $315,000. $15,000 was paid at the date of withdrawal; the remaining $300,000 is payable in equal annual installments over the next 10 years. The employer withdrawal liability receivable at December 31, 20X1, consists of the following:

ABC Construction Co.	$ 140,000
DEF Construction Co.	100,000
GHI Contractors, Inc.	300,000
Total	$ 540,000

> The $540,000 is receivable as follows: 20X2, $58,000; 20X3, $58,000; 20X4, $58,000; 20X5, $58,000; 20X6, $58,000; 20X7–Y1, $230,000; and 20Y2–Y4, $20,000.

There may be need for an allowance recorded against the withdrawal liability receivable. For example, if the employer left the plan due to bankruptcy or totally ceased operations, or if the employer cannot be located, the receivable may be deemed uncollectible.

Required Note Disclosures for Defined Benefit Retirement Plans

FASB ASC 960 requires numerous note disclosures about defined benefit plan provisions, amendments, funding policy, and federal tax status; accounting policies, including investment and insurance contract valuation methods and assumptions and actuarial methods and assumptions; the policy related to insurance contracts excluded from plan assets; and significant plan real estate or other transactions with the plan sponsor, employer, or employee organization.

Illustrative Defined Benefit Retirement Plan Financial Statements

The AICPA in AEBP at Appendix E presents illustrative financial statements and disclosures that illustrate certain reporting requirements of FASB ASC 960. FASB ASC 960-205-55 also presents illustrative defined benefit plan financial statements.

ACCOUNTING AND FINANCIAL REPORTING STANDARDS THAT ARE UNIQUE TO HEALTH AND WELFARE BENEFIT PLANS

Types of Health and Welfare Benefit Plans

Health and welfare benefit plans may be defined benefit plans or defined contribution plans. Also, they may be uninsured (also called self-insured or self-funded) or insured under a variety of insurance arrangements. Finally, they may offer postretirement or postemployment benefits.

Defined Contribution Health and Welfare Plans. Defined contribution health and welfare plans maintain an account for each individual participant and specify how contributions to participants' accounts are determined. But, they do not specify the amount of benefits that participants are to receive. Rather, an individual's benefits are limited to the amount in his account. In this respect, a defined contribution health and welfare plan is similar to a defined contribution retirement plan.

Defined Benefit Health and Welfare Plans. Defined benefit health and welfare plans specify a determinable benefit that may be in the form of a reimbursement to the covered participant or a payment to service providers or insurers for the cost of the covered service. In this respect, a defined benefit health and welfare plan is similar to a defined benefit retirement plan.

Features of Health and Welfare Benefit Plans

Accumulated Eligibility Credits. Health and welfare plans may provide for the payment of insurance premiums or benefits during periods of unemployment of employees who have accumulated sufficient eligibility credit hours, when employer contributions for such coverage or benefits otherwise would not be made, and thus, benefits would not be available to the unemployed participant.

Postretirement Benefits. Health and welfare plans may continue to offer benefits to participants, and their dependents and beneficiaries, after retirement. Such benefits may include benefits through COBRA, which are discussed later in this section.

Postemployment Benefits. Health and welfare plans may continue to offer benefits to participants, and their dependents and beneficiaries, after employment, but prior to retirement. Such benefits may include benefits through COBRA.

Insured Health and Welfare Benefit Plans. Health and welfare benefit plans may be uninsured, or they may have insurance contracts in which the insurance company assumes all or part of the risk related to providing benefits. Under fully insured contracts, the plan generally has no obligation for covered benefits, and is obligated only to pay premiums. Some fully insured, experience-rated contracts provide the possibility of an experience-rated refund or dividend if benefits incurred, risk charges, and administrative charges are less than premiums paid. However, in a fully insured, experience-rated arrangement (as opposed to one that is not fully insured), the insurance company generally bears any additional obligation if the benefits incurred, risk charges, and administrative charges exceed premiums paid.

Other health and welfare insurance contracts include a minimum premium plan arrangement and a stop-loss arrangement, both of which apportion risk between the plan and the insurance company.

Note that some contracts with insurance companies may provide for administrative services only (such as claims processing), and not provide any benefits coverage.

Maintenance of Benefit Requirements. In some instances, a self-insured plan may be required to maintain a cash reserve. For example, a cash reserve equal to approximately one month's cost of operations (principally claims) may be required. In these instances, the cash reserve balance should be presented separate from other cash and disclosed as to its nature. There should be adequate disclosure of the maintenance of benefit requirements. Claim obligations should be presented as discussed below.

Accounting and Reporting Standards

The following paragraphs discuss matters unique to various types of health and welfare benefit plans and then discuss the financial statements and presentation standards. The discussion is based on the guidance contained in FASB ASC 965.

Deposits and Reserves with Insurance Companies

Some insurance contracts held by health and welfare benefit plans require a deposit against which the insurance company can apply possible future losses in excess of current premiums. Similarly, certain insurance companies retain premiums paid in excess of the total amount of claims paid and other charges. The amounts retained are often called premium stabilization reserves and are used to reduce future premium payments. FASB ASC 965-310-25-3 states that such deposits and reserves should be reported as plan assets until they are used to pay premiums. The financial statements should disclose the nature of the deposit or reserve.

Experience-rated Refunds or Dividends

Some group insurance contracts held by health and welfare benefit plans provide for an "experience-rated refund" (or dividend) if premiums the plan paid during the year exceed claims the insurance company paid, reserves the insurance company requires, and administrative fees the insurance company charges. The refund or dividend may not be determined for several months after the policy year end. Also, the policy year end may differ from the plan year

end. In such cases, FASB ASC 965-310-25-3 requires the plan to report a refund receivable if the amount can be reasonably estimated and it is probable that a refund is due. If the amount cannot be reasonably estimated, the financial statements should disclose that fact.

Fully Benefit-responsive Investment Contracts

Defined contribution health and welfare benefit plans may also hold fully benefit-responsive investment contracts. Specific disclosures relevant to such contracts held by a defined contribution health and welfare benefit plan may be needed.

Benefit Obligations of Health and Welfare Benefit Plans

The financial statements of health and welfare benefit plans should report the actuarial present value of the following benefit obligations as applicable:

a. Claims that are payable, claims incurred but not reported (IBNR), and premiums payable to insurance companies.

b. Accumulated eligibility credits and postemployment benefits, net of current amounts payable.

c. Postretirement benefits for:

    - Retired plan participants, their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR.

    - Other fully eligible plan participants.

    - Plan participants that are not fully eligible for benefits.

If claims IBNR are calculated for active participants and retirees in the aggregate, the total should be included with the amounts in a. above. However, claims IBNR for retirees should be included in the postretirement benefit obligation if calculated separately.

Note that the financial statements of self-insured (that is, uninsured) plans do not include obligations for insurance premiums but do include obligations for claims payable for active and retired participants (and their dependents and beneficiaries), and the IBNR for active participants. The IBNR for retired participants is included in the postretirement benefit obligation. Insured plans report obligations for premiums and accumulated eligibility credits but do not report obligations for claims payable and claims IBNR because the insurance company pays such claims and benefits. The obligations listed above are discussed in the following paragraphs.

Premiums Payable under Insurance Contracts. Group insurance contracts for health and welfare benefit plans are usually written for a one-year period, but may provide for annual renewal. The contract usually specifies premium rates per eligible participant and the premium due date. FASB ASC 965-30-25-2 states that the benefit obligations of insured plans should include an obligation for unpaid premiums due to insurance companies. If the insurance contract requires payment of additional premiums when the loss ratio exceeds a specified percentage, an obligation for the estimated additional premiums, if any, should be reported.

Experience-rated Premium Deficits. An experience-rated arrangement may result in a premium deficit (the excess of benefits paid by the insurance company plus risk charges and administrative cost over premiums paid by the plan). FASB ASC 965-30-25-5 requires premium deficits to be included in benefit obligations if it is probable that the deficit will be applied against future experience-rating refunds or added to future premiums, and if the amount can be reasonably estimated. The literature states that in determining probability, consideration should be given to the extent to which the contract requires payment of such deficits and to whether the plan intends to transfer coverage to another insurance company. If the conditions for recording a liability are not met, or if an exposure exists for a deficit greater than the amount accrued, the premium deficit should be disclosed in the notes if it is reasonably possible that a loss or additional loss has been incurred.

Stop-loss Arrangements. Health and welfare plans may enter into stop-loss arrangements with insurance companies. Under such an arrangement, a plan's obligation is capped at either a fixed amount per participant or a

maximum percentage of expected claims for the plan in total. For example, a stop-loss policy may state that a plan will pay no more than $100,000 for any individual participant, or it may state that total claims are not to exceed 120% of expected claims for the year. The insurance company assumes all risk beyond the stated limit.

In AEBP, Paragraph 8.84, FinREC recommends that stop-loss premiums be recorded as an expense of the plan, whether paid by the plan or the plan sponsor. They also recommend that amounts due to the plan or related trust from insurers under a stop-loss agreement be recorded as an asset of the plan, with a corresponding offset to benefit payments (assuming participants have already received the related benefit payments). Finally, they recommend that the total stop-loss recoveries netted against benefit payments be disclosed.

In AEBP, Paragraph 8.85, FinREC acknowledges that there are rare circumstances when recording stop-loss activity in the plan financials is not appropriate. If amounts due to the plan sponsor under a stop-loss agreement do not ultimately reduce the amount of benefits to be covered by current or future plan assets, then such an asset may not need to be recorded by the plan. Instead, FinREC recommends that in such an instance, the plan consider disclosure of the existence of the arrangement and that no amounts associated with the arrangement are included in the financial statements.

Claims Reported and Payable. Insured health and welfare benefit plans do not report a benefit obligation for claims because they are the insurance company's obligation and will be paid by it. FASB ASC 965-30-45-2 requires the financial statements of uninsured plans to include in benefit obligations any claims payable to participants (both active and retired) and their dependents and beneficiaries.

Claims Incurred but Not Reported (IBNR) to the Plan. At the health and welfare benefit plan's reporting date, there likely will be claims that participants have incurred but not yet reported to the plan or (for an insured plan) to the insurance company. Such claims may include self-insured benefits provided under COBRA. Insured plans do not report an obligation for these claims because they are the insurance company's obligation.

FASB ASC 965-30-45-2, however, requires the financial statements of uninsured plans to include an estimate of IBNR claims of active participants in the benefit obligations. IBNR for retired participants is included in the postretirement benefit obligation, if calculated separately.

The authors believe that such claims are often not reported for an extended period of time, and while claims of this nature cannot be determined on an individual basis, the aggregate amount may be estimated based on past loss experience or an actuarial determination. However, in past (and possibly current) practice, the estimate often has been limited to the amount of claims reported between plan year end and the time the financial statements are prepared (the "lag effect"), and an actuarial determination often had not been obtained. Some plan administrators have considered this practice sufficient because the financial statements may not be prepared or audited until seven or even nine and one-half months after year end.

However, an illness, accident, or disability incurred before the plan year end may result in health care or disability claims for many months or even years beyond the date when the financial statements are prepared. FASB ASC 965-30-35-1A states that for an uninsured plan the cost of IBNR claims:

> shall be measured *at the present value*, as applicable, *of the estimated ultimate cost* to the plan *of settling the claims* (emphasis added) and
>
> estimated ultimate cost shall reflect the plan's obligation to pay claims to or for participants . . . beyond the financial statement date pursuant to the provisions of the plan . . . .

Death Benefits. FASB ASC 965-30-35-4 states that benefit obligations should not include "benefits expected to be earned for future service by active participants . . . during the term of their employment." The authors believe that death benefits actuarially expected to be paid during the active service period of participants would not be included in benefit obligations because death benefits do not vest and are not attributable to employment rendered prior to death. Plans that provide postretirement death benefits must include them in the obligation for postretirement benefits. However, plans that provide death benefits but no postretirement benefits will not report any death benefits until the benefits are paid.

Accumulated Eligibility Credits. Health and welfare benefit plans that have provisions for accumulated eligibility credits pay insurance premiums (for an insured plan) or benefits (for an uninsured plan) of unemployed participants who have accumulated sufficient credits, when employer contributions for such coverage or benefits would otherwise cease during the period of unemployment (and thus, when the unemployed participant would not be entitled to any benefits).

At the plan reporting date, accumulated eligibility credits represent an obligation arising from prior employee service for which employer contributions have been made. Thus, FASB ASC 965-30-35-12 requires the plan to report an obligation for accumulated eligibility credits. This obligation for an insured plan is determined by applying current insurance premium rates to accumulated credits. The amount for a self-insured plan is determined by applying the average cost of benefits per eligible participant to accumulated credits.

In addition, according to FASB ASC 965-30-35-12, "in either case, the obligation for accumulated eligibility credits shall consider assumptions for mortality and expected employee turnover, or other appropriate adjustments, to reflect the obligation at the amount expected to be paid." That is, not all accumulated credits at the financial statement date will ultimately result in a benefit obligation—some employees with accumulated credits may not experience periods of unemployment requiring them to draw on all their accumulated credits. Thus, the probability that accumulated credits will ultimately result in a benefit obligation should be considered. This provision may require plans to obtain actuarial determinations to measure the obligation for accumulated eligibility credits.

An illustration of the computation of the obligation for accumulated eligibility credits follows:

Example 1-1: Computation of the obligation for accumulated eligibility credits.

Assumptions The plan is an insured plan and receives $50 each month per participant. Eligibility credits have accumulated as follows: 400 members have three months each, 500 members have six months each, 800 members have nine months each.

Computations

Members	×	Months Accumulated	=	Total Months Accumulated
400	×	3	=	1,200
500	×	6	=	3,000
800	×	9	=	7,200
				11,400
			Rate per month	× 50
		Obligation before actuarial considerations		$ 570,000

Mortality, employee turnover, and other appropriate assumptions should then be applied to this amount to determine the ultimate obligation for accumulated eligibility credits.

Postretirement Benefits. FASB ASC 965-30-35-1 and 965-30-45-1 require that the financial statements or notes to the financial statements of defined benefit plans report the actuarial present value of the following postretirement benefits as of the plan year end, if the plan provides such benefits:

- Postretirement benefits for retired participants, including their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR.
- Postretirement benefits for other plan participants who are fully eligible to receive benefits.
- Postretirement benefits for plan participants not yet fully eligible to receive benefits.

Claims payable for retired participants are reported along with claims payable for active participants rather than being reported with postretirement benefits. Also, FASB ASC 965-30-35-1 states that IBNR claims for retired

participants may be included with IBNR claims for active participants instead of being included in the postretirement benefit obligation. FASB ASC 965-30-50-1 states that it may be appropriate to separately disclose each type of postretirement benefit, for example, medical and death benefits. FASB ASC 965-30-35-20 states that benefits that are provided through an insurance contract should be excluded from postretirement benefits, but also notes that at present, few insurance contracts (except for single-premium life insurance contracts) unconditionally obligate an insurance company to provide most forms of postretirement benefits.

FASB ASC 965 applies concepts from FASB ASC 715 to the measurement and reporting of such benefits in the plan financial statements. FASB ASC 965-30-35-16 defines the *postretirement benefit obligation* as of the measurement date as "the actuarial present value of all future benefits attributed to plan participants' services rendered to that date . . ." Thus, the obligation for postretirement benefits expected to be paid to or for an active participant (or his or her beneficiary or covered dependent) who is not yet fully eligible for the benefit should be measured over the participant's credited period of service up to the date when full eligibility for benefits is attained. FASB ASC 965-30-35-18 gives the following example of this concept:

> If a participant has worked eight years and must work another 16 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 16 years.

FASB ASC 965-30-35-16 also states that "Postretirement benefits comprise benefits expected to be paid to or on behalf of any *retired* (emphasis added) or active participant, terminated participant, beneficiary, or covered dependent who is expected to receive benefits under the . . . plan." This means that, for retired participants, the ultimate benefit expected to be paid should be reported.

Another concept from FASB ASC 715 that FASB ASC 965 refers to is the consideration of expected participant contributions from active and retired employees to the plan. FASB ASC 715-60-35-57 requires the actuarial present value of expected participant contributions to be netted against the actuarial present value of the total benefits to be provided by the plan to determine the plan's postretirement benefit obligation. The plan's demonstrated and authorized ability to change the amount of future participant contributions should also be considered. FASB ASC 965-205-50-1 requires health and welfare plans to disclose a description of the benefit obligation that is expected to be funded by participant contributions.

The actuarial present value of a health and welfare postretirement benefit obligation is determined by first measuring the postretirement benefit obligation based on the plan provisions and then applying actuarial assumptions to that measure to reflect the probability of payment and the time value of money. FASB ASC 965-30-35-21 states that each assumption used must represent the best estimate of the particular future event. It also states that measuring postretirement benefit obligations requires assumptions that should include the following matters:

- Timing and amount of future postretirement benefit payments, taking into consideration—
    a. per capita claims cost by age,
    b. health care cost-trend rates,
    c. current Medicare reimbursement rates,
    d. retirement age,
    e. dependency status, and
    f. mortality.
- Salary progression, for pay-related plans.
- Participation rates, for contributory plans.

- Probability of payment, including—
  a. turnover,
  b. retirement age,
  c. dependency status, and
  d. mortality.
- 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.

FASB ASC 715-60-35 describes the measurement of the postretirement benefit obligation.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), among other things, provided a federal subsidy to sponsors of certain retiree health care benefit plans. The AICPA issued two Technical Questions and Answers to provide accounting and disclosure guidance for health and welfare benefit plans related to the Act. The first, Q&A 6931.05, *Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, addresses single-employer health and welfare benefit plans. The second, Q&A 6931.06, *Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*, addresses multiemployer health and welfare benefit plans.

Q&A 6931.05 states that a single-employer health and welfare plan should *not* include the effects of the subsidy when calculating the postretirement benefit obligation of the plan. As a result, the plan's postretirement benefit obligation *should not* be reduced by the subsidy. Q&A 6931.06, on the other hand, states a multiemployer health and welfare plan *should* include the effects of the subsidy when calculating the plan's postretirement benefit obligation. Multiemployer plans should include the impact of the subsidy because it is paid directly to the trust and not to the plan sponsors/participating employers. For a single-employer plan, the subsidy is paid directly to the plan sponsor. It does not flow into the plan and the plan sponsor has no obligation to use the subsidy to fund postretirement benefits. Both Q&As include specific disclosure requirements relating to the Act.

Postemployment Benefits. Postemployment benefits relate to promises employers make to provide employees with benefits after employment but before retirement. Postemployment benefits represent obligations of the plan and should be reported in the plan's financial statements or notes to financial statements. FASB ASC 965-30-25-3 states that plans should recognize a benefit obligation for postemployment benefits for current participants, based on amounts expected to be paid in future years, if all the following requirements are met:

a. Rights to receive benefits are attributable to services already rendered by the participants.
b. Benefits vest or accumulate.
c. Payment of benefits is probable.
d. The amount can be reasonably estimated.

FASB ASC 965-30-35-9 requires the obligation to be calculated by determining the actuarial present value of the future benefits attributed to plan participants' services rendered as of the measurement date, less the actuarial present value of the estimated future contributions from the current plan participants. Thus, the benefit obligation is the estimated amount to be paid from plan assets and contributions from the participating employers. The discount rate to use in the present value calculation of the obligation should be based on the rates currently available on high-quality, fixed-income investments with cash flows similar to the estimated benefit payments and participant contributions for postemployment benefits.

If postemployment benefits are not attributable to services that have been rendered and do not vest or accumulate, an obligation should still be recognized if the event causing the obligation has occurred and the amount of the benefit can be estimated. Again, the obligation should be reduced by the present value of the estimated participant

contributions. A disclosure should be included in the notes to the financial statements if a postemployment benefit obligation is not recorded only because a reasonable estimate of the amount cannot be made.

COBRA Benefits. Many health and welfare plans are required under COBRA to provide participants the opportunity to elect temporary continuation of benefits upon termination of employment when coverage would otherwise be lost due to the termination. The plan may require the participant to pay the estimated full cost of the health benefits provided under COBRA, or the plan sponsor may subsidize all or part of the cost. A third-party administrator may perform duties related to collection of COBRA contributions and payment of benefits. Depending on the terms of participation, the continuation benefits may be considered a postemployment obligation or a postretirement obligation.

The benefit obligation related to COBRA would be equal to the actuarial present value of the cost of the benefit, less the present value of expected participant contributions. The Audit Risk Alert, *Employee Benefit Industry Developments—2009*, states that if the participants pay the estimated full cost, there is no net cost to the plan sponsor, and the plan would not recognize an obligation. If the plan sponsor subsidizes all the cost of COBRA benefits, the *plan* should recognize an obligation to the extent that the criteria of FASB ASC 712-10, FASB ASC 715-60, or both, are met. That literature is discussed in *PPC's Guide to GAAP* and *PPC's Guide to Preparing Financial Statements*. If the benefits provided by COBRA are self-insured, the plan should consider COBRA participants when determining the obligation for claims incurred but not reported.

401(h) Accounts

The current uses of 401(h) accounts by health and welfare benefit plans and defined benefit plans and the accounting and reporting requirements for 401(h) accounts in defined benefit plans were discussed earlier in this lesson. For health and welfare benefit plans, the 401(h) assets and the changes in those assets should be reported in the respective financial statements because the assets will be used to pay benefits of the health and welfare benefit plans. The 401(h) account amounts may be presented as a one-line item or included in the applicable individual line items in the financial statements. If the amounts are not shown separately on the statements, the notes to the financial statements must disclose the 401(h) amounts included in those line items.

The presentation style must be consistent between the statement of net assets available for benefits and the statement of changes in net assets available for benefits; that is, if the amounts are presented as one line item in the statement of net assets, the changes should also be presented as one line item in the statement of changes in net assets. The 401(h) obligations should be included in the plan's statement of benefit obligations. The footnote disclosures should include the significant components of net assets and changes in net assets of the 401(h) account, the fact that the assets may only be used to pay retiree health costs, and the name of the defined benefit pension plan that allocated the funds to the plan and that provides the related investment disclosures.

Required Financial Statements for Defined Contribution Health and Welfare Plans

FASB ASC 965 distinguishes between defined benefit health and welfare plans and defined contribution health and welfare plans. FASB ASC 965-205-45-3 requires the following financial statements for defined contribution health and welfare plans:

- A statement of net assets available for benefits as of the end of the plan year. (Note that DOL regulations and IRS Schedules H and I to Form 5500 require a comparative statement of net assets to be presented.)
- A statement of changes during the year in net assets available for benefits. (DOL regulations and IRS instructions do not require a comparative statement of changes in net assets available for benefits.)

Required Financial Statements and Financial Presentation for Defined Benefit Health and Welfare Plans

FASB ASC 965 requires benefit obligation information of a defined benefit health and welfare plan to be reported similarly to benefit obligation information of a defined benefit retirement plan. Thus, the obligations are not to be reported as liabilities in the statement of net assets available for benefits. Instead, information about benefit obligations and the change in them are to be presented in separate statements, on the face of one or more other statements, or in the notes to the financial statements. Also, all the information must be located in one place. FASB

ASC 965-30-35-5 requires the benefit obligation information to be as of the plan year end. However, FASB ASC 965-30-35-6 does allow plans to use a measurement date prior to the plan's year end for the actuarial determination and roll forward that amount to year end if the results would not be expected to differ materially from the obligation if calculated at year end. Thus, health and welfare benefit plans do not have the option of presenting the information as of the beginning of the plan year, as FASB ASC 960-205-45-4 gives for the accumulated plan benefits of a defined benefit pension plan.

The required financial statements for defined benefit health and welfare plans are as follows:

- A statement of net assets available for benefits as of the plan year end. (Note that DOL regulations and IRS Schedules H and I to Form 5500 require a comparative statement of net assets to be presented.)
- A statement of changes during the year in net assets available for benefits. (DOL regulations and IRS instructions do not require a comparative statement of changes in net assets available for benefits.)
- Information about benefit obligations as of the end of the plan year, presented in a separate statement, on the face of one or more other statements, or in the notes to the financial statements.
- Information about the significant factors affecting the change during the year in benefit obligations, presented in a separate statement, on the face of one or more other statements, or in the notes to the financial statements. This information is discussed in the following paragraph.

FASB ASC 965-30-45-6 requires that the information about the change in benefit obligations during the year include the significant effects of the following factors:

- Plan amendments.
- Changes in the nature of the plan (mergers or spin-offs).
- Changes in actuarial assumptions (health care cost-trend rate or interest rate).

If only this minimum information is presented in a statement format, then an unidentified "other" category will have to be presented to reconcile the initial and ultimate amounts. FASB ASC 965-30-45-5 states that it is generally sufficient to present the information in the three major classifications of benefit obligations. This disclosure should be presented in the financial statements or notes to the financial statements and may be presented in either a reconciliation or narrative format.

Optional disclosures may be made about the significant effects of the following:

- Benefits accumulated, with actuarial experience gains or losses either included with the effects of additional benefits accumulated or separately disclosed.
- The effects of the time value of money (for interest).
- Benefits paid. This item should not include benefit payments made by an insurance company under a contract that is excluded from plan assets. But, this item should include payments the plan made to an insurance company under such a contract, including purchasing annuities with amounts allocated from existing contracts with insurance companies.

Statement of Cash Flows

FASB ASC 230-10-15-4 exempts defined benefit pension plans and other benefit plans that present financial information similar to that required by FASB ASC 960 from the requirement to present a statement of cash flows. FASB ASC 965-205-45-5 refers to the exemption with respect to health and welfare plans. However, FASB ASC 965-205-45-5 indicates employee benefit plans are encouraged to consider presenting a statement of cash flows if it would provide relevant information about the plan's ability to meet future obligations, for example, when plan assets are not highly liquid or are obtained with financing. The authors believe that most plans do not present cash flow statements.

Required Note Disclosures for Health and Welfare Benefit Plans

FASB ASC 965-20-45-1; 965-30-50-5; 965-205-50-1; and 965-325-50-1 and 50-2 require numerous note disclosures for health and welfare plans.

Disclosures Required in Supplemental Schedules. A Note following AEBP, Paragraph 8.133(u), states that information required by ERISA to be disclosed in the supplemental 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.

Disclosure of Benefit Obligation Information in Special Purpose Financial Statements of Defined Benefit Health and Welfare Plans. Form 5500 and the alternative method of reporting under DOL regulations allow the financial statements to be presented on a basis of accounting other than GAAP (called a special purpose framework), for example, on the modified cash basis that adjusts investment securities to current value. AEBP, Paragraph 8.27, footnote 4, states that special purpose financial statements should disclose information regarding benefit obligations. Thus, modified cash basis statements of a defined benefit health and welfare plan must disclose the information about benefit obligations and changes in benefit obligations as discussed earlier in this section.

Illustrative Financial Statements

FASB ASC 965-205-55 illustrates financial statements of hypothetical health and welfare plans.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Which of the following is a characteristic of defined contribution retirement plans?
   a. Benefits are limited to available net assets.
   b. Benefit obligations must be measured and reported.
   c. Benefit-responsive investment contracts are presented at purchase value.
   d. They are all accounted for as ESOPs.
7. Which of the following conditions must be met for an investment contract to be considered fully benefit-responsive?
   a. The plan is allowed to assign or sell the investment contract without the issuer's consent.
   b. The amounts of participant-initiated transactions can be limited or restricted to amounts other than contract value.
   c. Participants can only have access to their funds when their participation in the plan is terminated.
   d. The issuer of the contract is obligated to repay the principal and interest credited to participants.
8. Which of the following statements best describes the measurement of accumulated plan benefits for a defined benefit retirement plan?
   a. Accumulated plan benefits are measured based on the history of employees' pay and service.
   b. Projected years of service is the basis for all of an employee's benefits and payment amounts.
   c. All plan amendments will affect the measurement of accumulated plan benefits.
   d. Contracts excluded from a plan's financial statements must still be included in accumulated plan benefits.
9. Defined benefit retirement plans are required to disclose the significant effects of which of the following?
   a. Interest increase resulting from a decrease in the discount period.
   b. Changes in actuarial assumptions.
   c. Benefits accumulated.
   d. Benefits paid.
10. An employee benefit plan needs to recognize a benefit obligation for postemployment benefits if certain requirements are met, including which of the following?
    a. Rights to receive benefits come from services to be rendered in the future.
    b. The benefits vest or accumulate.
    c. It is unlikely that the benefits will be paid.
    d. The amount cannot be estimated.

11. Which of the following statements best describes the financial statement presentation of a defined benefit health and welfare plan?

    a. They should present benefit obligation information as of the beginning of the plan year.

    b. A minimum of five classifications are needed to show information about changes in benefit obligations during the year.

    c. Information about obligations and related changes are presented in separate statements.

    d. Optional additional disclosures about changes in benefit obligations during the year are prohibited.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

6. Which of the following is a characteristic of defined contribution retirement plans? **(Page 189)**

   a. **Benefits are limited to available net assets. [This answer is correct. There are different types of defined contribution retirement plans, including profit-sharing plans, ESOPs, and 401k plans. Particular features of such plans may differ, but a common feature is that all defined contribution retirement plans limit benefits to the net assets that are available for benefits.]**

   b. Benefit obligations must be measured and reported. [This answer is incorrect. Due to the nature of this type of plan, there is no need to measure and report information on benefit obligations, so the accounting and financial reporting is much simpler than for defined benefit retirement plans.]

   c. Benefit-responsive investment contracts are presented at purchase value. [This answer is incorrect. Defined contribution plans are required to measure, present, and disclose fully benefit-responsive investment contracts at *contract* value and to disclose certain information regarding the contracts.]

   d. They are all accounted for as ESOPs. [This answer is incorrect. ESOPs, especially leveraged ESOPs, often encounter issues not relevant to other types of defined contribution plans; therefore, they have certain unique financial reporting issues.]

7. Which of the following conditions must be met for an investment contract to be considered fully benefit-responsive? **(Page 190)**

   a. The plan is allowed to assign or sell the investment contract without the issuer's consent. [This answer is incorrect. Per FASB ASC 962-325-20, one condition of a fully benefit-responsible investment contract is that the contract is entered into directly between the plan and the issuer, and the plan is not allowed to assign or sell the contract or the proceeds from the contract to another party without the issuer's consent.]

   b. The amounts of participant-initiated transactions can be limited or restricted to amounts other than contract value. [This answer is incorrect. According to FASB ASC 962-325-20, a fully benefit-responsive investment contract must require all participant-initiated transactions with the plan (such as withdrawals, loans, or transfers allowed by the plan) to be made at contract value, without limitations, conditions or restrictions.]

   c. Participants can only have access to their funds when their participation in the plan is terminated. [This answer is incorrect. As discussed in FASB ASC 962-325-20, an investment contract may be considered fully benefit-responsive if the plan is required to allow participants to have reasonable access to their funds. For example, if plan participants are allowed access at contract value to all or a portion of account balances only upon termination of their participation in the plan, this would *not* be considered reasonable access and the contract would not be considered fully benefit-responsive.]

   d. **The issuer of the contract is obligated to repay the principal and interest credited to participants. [This answer is correct. Per the guidance in FASB ASC 962-325-20, an investment contract is considered fully benefit-responsive if it meets all of the relevant conditions. One such condition is that either the issuer of the contract has a financial obligation to repay the principal and interest credited to participants in the plan, or participants in the plan are provided prospective interest crediting rate adjustments on a designated pool of investments through which a financially responsible third party provides assurance that adjustments to the interest crediting rate will not result in a rate less than zero. If either of those situations outlined in FASB ASC 962-325-20 exists (and the other conditions are met) the contract can be considered fully benefit-responsive.]**

8. Which of the following statements best describes the measurement of accumulated plan benefits for a defined benefit retirement plan? **(Page 194)**

   a. **Accumulated plan benefits are measured based on the history of employees' pay and service. [This answer is correct. A major principle in measuring accumulated plan benefits is that they should be measured based on history of employees' pay and service and other appropriate factors as of the benefit information date. This principle is stated in FASB ASC 960-20-25-5.]**

   b. Projected years of service is the basis for all of an employee's benefits and payment amounts. [This answer is incorrect. FASB ASC 960-20-25-5 states that projected years of service should only be considered in determining employees' expected eligibility for particular benefits, such as increased benefits granted for those with a certain amount of years of service or early retirement benefits.]

   c. All plan amendments will affect the measurement of accumulated plan benefits. [This answer is incorrect. FASB ASC 960-20-25-5 states that plan amendments adopted after the benefit information date should *not* be recognized in measuring accumulated plan benefits.]

   d. Contracts excluded from a plan's financial statements must still be included in accumulated plan benefits. [This answer is incorrect. FASB ASC 960-20-25-5 states that the measure of accumulated plan benefits should not include benefits that are to be provided by a contract that is excluded from the plan financial statements, for example, by an allocated insurance contract.]

9. Defined benefit retirement plans are required to disclose the significant effects of which of the following? **(Page 198)**

   a. Interest increase resulting from a decrease in the discount period. [This answer is incorrect. An optional disclosure for defined benefit plans is any significant effects of the increase (for interest) as a result of the decrease in the discount period. This disclosure is not required, however.]

   b. **Changes in actuarial assumptions. [This answer is correct. FASB ASC 960-20-50-3 and 50-4 require that defined benefit plans disclose the significant effects of the following factors: (1) plan amendments; (2) changes in the nature of the plan; (3) changes in actuarial assumptions; and (4) the actuarial present value of accumulated plan benefits as of the preceding benefit information date, if the three preceding items are presented in other than a statement format.]**

   c. Benefits accumulated. [This answer is incorrect. Defined benefit plans may disclose the significant effects of benefits accumulated, with actuarial experience gains or losses either included with the effects of additional benefits accumulated or separately disclosed. However, this disclosure is not required.]

   d. Benefits paid. [This answer is incorrect. The significant effects of benefits paid is an optional disclosure for defined benefit plans; it is not required. If made, this disclosure should not include benefit payments made by an insurance company under a contract that is excluded from plan assets, that is under an allocated contract. But, this item should include payments the plan made to an insurance company under such a contract, including purchasing annuities with amounts allocated from existing contracts with the insurance company.]

10. An employee benefit plan needs to recognize a benefit obligation for postemployment benefits if certain requirements are met, including which of the following? **(Page 207)**

    a. Rights to receive benefits come from services to be rendered in the future. [This answer is incorrect. Per FASB ASC 965-30-25-3, one requirement that must be met for plans to recognize such an obligation is that the rights to receive benefits are attributable to services *already rendered* by the participants.]

    b. **The benefits vest or accumulate. [This answer is correct. Postemployment benefits relate to promises employers make to provide employees with benefits after employment but before retirement. Postemployment benefits represent obligations of the plan and should be reported. FASB ASC 965-30-25-3 states that plans should recognize a benefit obligation for**

postemployment benefits for current participants based on amounts expected to be paid in future years if all relevant requirements are met. One such requirement is that the benefits vest or accumulate.]

c. It is unlikely that the benefits will be paid. [This answer is incorrect. One of the requirements that must be met under FASB ASC 965-30-25-3 for plans to recognize such an obligation is that payment of benefits is *probable*.]

d. The amount cannot be estimated. [This answer is incorrect. According to FASB ASC 965-30-25-3, the plan is required to recognize this type of obligation if, among other things, the amount *can be* reasonably estimated.]

11. Which of the following statements best describes the financial statement presentation of a defined benefit health and welfare plan? **(Page 208)**

a. They should present benefit obligation information as of the beginning of the plan year. [This answer is incorrect. FASB ASC 965-30-35-5 requires the benefit obligation to be as of the plan year end. Health and welfare benefit plans do *not* have the option of presenting the information as of the beginning of the plan year, as FASB ASC 960-205-45-4 gives for the accumulated plan benefits of a defined benefit pension plan.]

b. A minimum of five classifications are needed to show information about changes in benefit obligations during the year. [This answer is incorrect. FASB ASC 965-30-45-6 requires that the information about the change in benefit obligations during the year include the significant effects of (1) plan amendments, (2) changes in the nature of the plan, and (3) changes in actuarial assumptions. FASB ASC 965-30-45-5 states that it is generally sufficient to present the information in the *three* major classifications of benefit obligations.]

c. **Information about obligations and related changes are presented in separate statements. [This answer is correct. FASB ASC 965 requires benefit obligation information of a defined benefit health and welfare plan to be reported similarly to benefit obligation information of a defined benefit retirement plan. Thus, the obligations are not to be reported as liabilities in the statement of net assets available for benefits. Instead, information about benefit obligations and the change in them are to be presented in separate statements, on the face of one or more other statements, or in the notes to the financial statements.]**

d. Optional additional disclosures about changes in benefit obligations during the year are prohibited. [This answer is incorrect. Plans may make optional disclosures about the significant effects of (1) benefits accumulated, (2) the effects of the time value of money, and (3) benefits paid. Additional disclosures are not prohibited.]

Lesson 2: Special Auditing Considerations

INTRODUCTION

Lesson 1 describes the accounting standards for the various types of plans, investments, and insurance contracts. This lesson discusses specific audit considerations and procedures related to the unique or significant account balances and transaction classes of employee benefit plans.

Some of the topics discussed include:

- Contributions.
- Investments.
- Contracts with insurance companies.
- Participant data.
- Benefit payments.
- Benefit obligations.
- Other assets, liabilities, and operating expenses.
- Other audit considerations.

Some procedures discussed in this lesson are not necessary in an ERISA Section 103(a)(3)(C) audit. They relate primarily to investments held by a bank or similar institution, or insurance company (known as qualified institutions), that prepares and certifies to the information on the investments as both complete and accurate.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize what special auditing considerations apply to an employee benefit plan's contributions received and receivable and its investments.
- Determine how an employee benefit plan's insurance company contracts and participant data should be addressed during an audit.
- Identify what special auditing considerations apply when an employee benefit plan has benefit payments and obligations.
- Determine how to address other assets, liabilities, and operating expenses, as well as other audit considerations (such as analytical procedures) in an employee benefit plan audit.

Authoritative Literature

The following authoritative literature gives audit guidance that is specifically or particularly relevant to employee benefit plan audits:

- AU-C 500, *Audit Evidence*, provides guidance regarding the use of management's specialists who have expertise in a field other than accounting or auditing.
- AU-C 620A, *Using the Work of an Auditor's Specialist*, provides guidance on the use of a specialist that possesses expertise in an area other than accounting or auditing.
- AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance when a plan uses services provided by a service organization that affect the plan's information system relevant to financial reporting.

- AU-C 703, *Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA*, provides guidance on reporting on audits of financial statements of employee benefit plans and other auditing nuances of employee benefit plans subject to ERISA.
- AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AEBP), discusses aspects of auditing unique to employee benefit plans. It applies to audits of all types of benefit plans.

CONSIDERATIONS FOR CONTRIBUTIONS RECEIVED AND RECEIVABLE

As discussed in Lesson 1, plans receive contributions from the plan sponsor (employer) and contributory plans also receive voluntary or mandatory contributions from plan participants (employees). Contributions may be in the form of cash or in noncash forms such as real estate or stock. Noncash contributions should be recorded at fair value. For health and welfare benefit plans, the fair value of noncash contributions must be reduced by the cost to sell, if significant.

This section only discusses auditing employer contributions. Auditing considerations for employee contributions are discussed in the section on participant data later in this lesson.

Implications of ERISA Requirements for the Audit of Contributions

ERISA requires minimum annual funding of defined benefit retirement plans. Certain defined contribution plans (money purchase plans and target benefit plans) are also subject to ERISA minimum funding requirements and must make the contribution required by the plan's contribution formula.

ERISA may also require sponsors of single-employer defined benefit retirement plans to fund the annual contribution in quarterly installments. If quarterly installments are required, each installment must be at least 25% of the required annual payment, as defined. (A plan may receive a funding waiver to postpone funding in certain circumstances.) Timing of payment of contributions to qualified defined contribution retirement plans is influenced by the fact that the sponsor's payment applicable to a particular year is deductible on that year's tax return if it is paid by the return's due date (including extensions).

ERISA limits the employer contribution to a defined benefit retirement plan to the amount necessary to fund the ERISA-specified maximum annual benefit that the plan may provide an individual participant. There is also a limit on the maximum annual contribution to a defined contribution retirement plan's individual participant accounts from all sources, that is, employer and employee contributions and allocated forfeitures.

These rules mean that there is a minimum and maximum employer contribution and receivable that the auditor may expect to be reflected in the plan's financial statements.

Auditing Procedures for Contributions

Analytical Procedures. Analytical procedures can be effective in auditing contributions to all types of employee benefit plans. Such procedures may include comparison of the current year and prior year contribution and comparison of the current and prior year ratios of contribution to number of plan participants. (Analytical procedures are further discussed later in this lesson.)

Other analytical procedures can be developed by referring to plan provisions related to the employer contribution. The rates and bases specified in the plan and the sponsor's board resolution can be applied to data from the employer's records. For example, for a profit-sharing plan that provides for an employer contribution equal to a specified percentage of the employer's net income, an overall test can be performed by applying the contribution rate to the relevant income amount. The auditor would test the income amount by referring to audited financial statements of the plan sponsor. Also, if the auditor of such a profit-sharing plan does not audit the plan sponsor's financial statements, he or she may need to arrange for the sponsor's auditor to apply necessary procedures to test or calculate the employer contribution. (If the sponsor's financial statements are not audited or a report of the other auditor's test or calculation of the contribution cannot be obtained, the plan auditor may need to modify his or her report because of the scope limitation.)

Vouching and Confirmation. The contribution may be traced to the employer's board of directors' minutes authorizing the contribution and to the plan's cash receipts, deposits as evidenced on bank statements or trustee reports, or accounts receivable. The auditor may also be able to trace the contribution to the employer's tax return or audited financial statements. When auditing multiemployer plans, the auditor may also decide to confirm contributions (and any related receivables) with the participating employers. Some sponsors of health and welfare benefit plans transmit the contribution directly to a third-party administrator; in such a case, the auditor may confirm the contribution with the third-party administrator. If the auditor has audited the employer's financial statements, he may be able to trace the contribution to those audit workpapers.

Noncash Contributions. The fair value at the date of contribution should be tested for any significant noncash contributions. Procedures would be similar to those for auditing the fair value of plan investments. For health and welfare plans, the cost to sell also needs to be considered, if significant.

Rollover Contributions. Rollover contributions are contributions to the plan resulting from a distribution received from another qualified plan [or from a traditional or SEP individual retirement account (IRA) or a SIMPLE IRA after two years]. Many plans allow rollover contributions from employees. Some plans allow employees to roll over contributions before they are eligible to participate in the plan. If the plan allows for rollover contributions, the auditor considers performing one or more of the following procedures:

- Determine that the rollover was made according to plan provisions.
- Determine that the rollover is properly reflected in the participant's account.
- Test the transfer of the assets from the prior trustee/custodian to the current trustee/custodian. If the plan provides for participant-directed investments, determine that the individual investments were transferred according to the participant's instructions.

Defined Benefit Plan Contribution. For a defined benefit pension plan, the auditor should compare the employer contribution to information in the actuary's report and determine that the contribution meets ERISA's minimum funding requirements. Also, if the actuary has already prepared the Schedule MB or Schedule SB to Form 5500, the auditor can review it for information about the minimum required funding. The auditor should also assess whether contributions are properly reflected in the appropriate fiscal period in compliance with GAAP. Some or all of these procedures may also be appropriate for a defined benefit health and welfare plan that uses an actuary to determine the employer contribution amount.

Poor financial conditions may cause some sponsors of defined benefit plans to apply for a funding waiver. In these situations, AEBP, Paragraph 7.64, states that FinREC recommends that plans record a contribution receivable for the minimum required contribution and consider the need for an allowance for doubtful accounts for the uncollectible portion. This treatment appears consistent with the guidance in FASB ASC 960-310-25-2 because it states that receivables include required amounts due under contractual or legal obligations. Appropriate disclosures should also be made in the notes to the financial statements.

The auditor should test the data provided to the actuary upon which the actuarial calculation of the required contribution is based as part of the test of participant data. This is discussed later in this lesson.

Health and Welfare Benefit Plan Contribution. Sponsors of defined benefit health and welfare plans often fund their plans as claims are incurred. Such plans may have few investments because the employer periodically contributes just enough to cover claims payable. In some cases, the employer has a legal or contractual obligation to fund claims incurred but not reported (IBNR) as of the financial statement date. This is especially common among multiemployer plans. If this is the case, AEBP, Paragraph 8.65, indicates that FinREC recommends that an employer receivable be recorded for estimated IBNR claims as of the financial statement date.

Defined Contribution Plan Contribution. Some defined contribution plan documents provide for using nonvested participant accounts that are forfeited when the participant terminates service (referred to as forfeitures) to reduce the employer contribution. If such a provision exists, the auditor should determine that the employer contribution was appropriately reduced by the amount of the forfeitures. (Testing employer matching contributions is discussed later in this lesson.)

Multiemployer Plan Contribution. Employer contributions to multiemployer plans are usually self-assessed by the participating employers based on uniform contribution rates and the number of hours or days worked or the number of employees. The contributions are usually remitted to the plan administrator with preprinted contribution reports containing information that supports the contribution amount.

To audit contributions to a multiemployer plan, the auditor needs to obtain a schedule of all participating employers and consider its completeness by referring to plan documents or collective bargaining agreements. The auditor can test amounts on the individual employer contribution reports by tracing the basis for the contribution to provisions in the plan document or collective bargaining agreement and by tying into the total contribution for all employers. The total contribution for all employers should be related to the actuary's report, if applicable, and tied into the plan's cash receipts and accounts receivable.

The base upon which the individual employer's contribution is determined, for example, payroll, ought to be traced to the employer's supporting documents and tested, if necessary. The auditor may be able to arrange for the employer's auditor to apply the necessary procedures. Additional guidance is provided later in this lesson.

The auditor may decide to confirm the contribution (and any related receivable) with the individual employers. Confirmation alone, however, is generally not sufficient evidence of completeness and accuracy, and additional procedures may be necessary.

Contribution Receivable from Employer

Lesson 1 provided the criteria for an employee benefit plan to record a contribution receivable for amounts due from the employer. The basic criterion is that the receivable represent a formal commitment and legal or contractual requirement for the employer to make a contribution.

Evidence of a formal commitment that the auditor may consider includes the following:

- A resolution by the employer's governing body approving a specified contribution.
- A consistent pattern of making payments after the plan's year end under an established funding policy that attributes such payments to the preceding plan year.
- The employer's deduction of a contribution on its federal income tax return for periods ending on or before the reporting date.
- The employer's recording of a contribution payable to the plan as of the reporting date. However, as previously explained, the existence of an accrual is not in itself sufficient support for recognizing a receivable.

The auditor needs to obtain support for these evidences of a formal commitment by applying procedures to the employer's records, referring to the audit workpapers if the auditor has audited the plan sponsor, or arranging for the plan sponsor's auditor to apply the procedures. For example, the auditor could examine the appropriate minutes of the employer's board of directors or make copies of minutes contained in the workpapers for the audit of the employer's financial statements. Or, the auditor might examine support for the employer's payment of the contribution after the plan's year end or arrange for the employer's auditor to vouch such a payment during the audit of the employer's financial statements.

The auditor may consider confirming the receivable with the employer. AU-C 330.20 states the presumption that the auditor will confirm "accounts receivable" unless the use of confirmations would be ineffective, accounts receivable are immaterial, or the combined assessment of inherent risk and control risk is low, and that assessment, along with evidence provided by analytical procedures and other substantive procedures, reduces audit risk related to receivables to an acceptably low level. However, AU-C 330.A55a defines accounts receivable as "the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business." The authors believe that contributions receivable by an employee benefit plan do not fall within this definition and therefore the presumption in AU-C 330.20 does not apply. In some cases, such as audits of multiemployer plans, the auditor may consider confirming contributions received and receivable with participating employers to be preferable to alternative

procedures. It is important to note, however, that confirmation alone is generally not sufficient evidence of completeness and accuracy, and other procedures may also be necessary.

Some factors to consider in deciding whether to confirm contributions received or receivable include the following:

- The effectiveness of internal controls related to contributions and cash receipts.
- Whether any risks relating to employer contributions were identified during the risk assessment.
- Whether the contribution is paid directly into a plan bank account or whether it is paid to a trustee or third-party plan administrator or a central bank account that receives deposits related to several unrelated plans.
- Whether the plan is a multiemployer plan or a single-employer plan.
- Whether the plan auditor audits the plan sponsor's financial statements and can trace contributions to those audit workpapers or can arrange for another auditor of the plan sponsor to do so.
- Whether the plan auditor can trace the contribution to the plan sponsor's records.
- The materiality of the unpaid receivable balance after subsequent receipts are examined.
- Whether other items will also be confirmed, such as disbursements made by a third-party administrator to pay claims, expenses, and insurance premiums.

The auditor should examine support for any subsequent receipts of the contribution receivable. This procedure can provide evidence about the existence of the receivable and also indicate whether there is a need to consider an allowance for uncollectible receivables.

Allowance for Uncollectible Receivable. An allowance for estimated uncollectible contributions receivable should be provided in the plan's financial statements. Thus, the auditor needs to consider whether there is a need for an allowance and the adequacy of any allowance.

In considering the need for an allowance for uncollectible contributions receivable, the auditor would first determine whether the receivable was collected in the subsequent period. If quarterly installments are required for single-sponsor defined benefit plans, each installment is due two weeks after each quarter ends. Also, an allowance may be necessary when a defined benefit plan sponsor has applied for a funding waiver. Contributions to a defined contribution plan may be made as late as the due date of the sponsor's tax return. Thus, the contribution receivable may not have been fully collected at the time of the plan audit. If it has not, the auditor needs to determine whether any required quarterly installments were received on time, and also consider the employer's economic condition for any indication of possible collectibility problems. This consideration needs to be made for the sponsor of a single-employer plan and for all the employers in a multiemployer plan from which a receivable is due.

Also, an employer that partially or completely withdraws from a multiemployer plan must continue to fund a proportional share of the plan's unfunded vested benefits. This withdrawal liability is payable over 20 years. The auditor needs to ask whether any such receivable is due to the plan and has been reported as a receivable and consider its collectibility.

AUDITING A PLAN'S INVESTMENTS

Factors That Influence the Audit of Investments

As discussed in Lesson 1, the major accounting requirements for investments of employee benefit plans are to generally present investments at fair value and to use the trade date and ex-dividend date to record securities transactions and income. There is increased audit risk associated with fair valuation of securities that do not have a market price and with complex and riskier types of investments such as real estate investment trusts and junk bonds. The auditor needs to take such risk into account when planning the audit of investments.

In addition to the risk assessment, the nature and extent of auditing procedures for investments depends on factors such as the following:

- The physical location of the investments and related records.
- Whether the investments are administered by the plan (and merely held by a custodian) or are administered by a trustee, and if there is a third-party trustee, whether the trust arrangement is discretionary or nondiscretionary.
- Whether the audit is a non-Section 103(a)(3)(C) audit or an ERISA Section 103(a)(3)(C) audit.

These factors are explained in the following paragraphs. The section then discusses basic auditing procedures for investments, followed by discussions of specific audit considerations for the following types of investments:

- Investments held in discretionary trusts.
- Investments in common/collective trusts.
- Investments in master trusts.
- Other types of investments, such as real estate, mortgages, limited partnership interests, loans, and derivatives.

Physical Location of Investments and Records. The audit procedures for plan investments are influenced by their location. An employee benefit plan's investment securities may be held in the plan's safe deposit box at a bank or in a vault at the plan or plan sponsor's location. These situations are rare, but if either is the case, the auditor's procedures likely will include examining the securities and observing the count of the securities by client personnel. Records relating to the plan's investments are more likely to be located off premises if the plan has a third-party plan administrator.

Type of Investment Administration and Trust Arrangement. A significant influence on the audit approach for investments is whether the investments are administered by the plan (and merely held by a custodian) or are administered by a trustee, and if there is a third-party trustee, whether the trust arrangement is discretionary or nondiscretionary.

With nontrusteed investments or nondiscretionary trust arrangements, the auditor can usually obtain adequate audit evidence about investments by applying procedures to the plan's investment records. The reason is that in a nondiscretionary (also called "directed") trust arrangement, the trustee merely executes investment transactions at the plan's specific direction and holds the investments. The trustee provides the plan with a report of investment activity, but the plan usually maintains the documents supporting the transactions, such as investment transaction authorizations, brokers advices, etc., that the auditor can examine.

With discretionary trust arrangements, the trustee has discretion to initiate investment transactions within the broad authority granted to the trustee under the trust agreement without specific authorization of individual transactions. The plan receives a trustee report of investment activity but usually does not have independent records of the transactions or supporting documents. Thus, the auditor may need to obtain a SOC 1 report or apply procedures at the trustee's location. This audit approach is discussed later in this section.

ERISA Section 103(a)(3)(C) Audit. In an ERISA Section 103(a)(3)(C) audit, no procedures are applied to information on plan investments (and related transactions) held by a qualified institution (such as a bank or similar institution (i.e., a regulated savings and loan association or credit union) that is prepared and certified to as both complete *and* accurate by the qualified institution. AEBP, Paragraph 11.204, notes that in an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for the investments covered by the ERISA Section 103(a)(3)(C) exception include the following:

a. Reading the certification.

b. Considering whether the certifying entity is a qualifying institution under DOL regulations.

c. Comparing the certified investment information to the financial information in the plan's financial statements and disclosures, including ERISA-required supplemental schedules.

d. Performing procedures to determine that contributions received and benefit payments made, as reported by the trustee or custodian, comply with the provisions of the plan.

e. Assessing the form and content of the financial statement disclosures related to the certified investment information for conformity with GAAP and compliance with DOL rules and regulations.

If, while performing the procedures discussed in the preceding paragraph, the auditor becomes aware that the information provided in the certification report is incomplete, incorrect, or somehow unsatisfactory, the auditor should perform additional procedures. For example, if the trustee's certified fair value of a nonactively-traded investment has remained the same for three years, the auditor needs to consider having the plan administrator ask the trustee how the investment was valued and, if appropriate, obtain a copy of a valuation report, if any. If necessary, the trustee should correct and recertify the report or the auditor should record any necessary adjustments. The auditor also needs to determine that the investment information supplied by the trustee is on the same basis of accounting as the financial statements. If not, appropriate adjustments should be made to the information. If the plan holds other investments that are not certified by the trustee, they should be subjected to appropriate audit procedures because they are not covered by the ERISA Section 103(a)(3)(C) scope exemption. Likewise, if the certification covers only a portion of the year under audit, the auditor should apply non-Section 103(a)(3)(C) audit procedures to the portion of the year not covered by the certification if such information is not covered by the certification of another qualified institution unless that period is considered immaterial. This situation may occur when a plan has changed trustees or custodians during the plan year.

Basic Auditing Procedures for Investments

The basic audit assertions and procedures for employee benefit plan investments are similar to those in any audit, although the manner of obtaining the evidence may differ for investments held in discretionary trusts versus nontrusteed investments or investments in nondiscretionary trusts. Also, in an ERISA audit, basic audit procedures include procedures directed to compliance with ERISA requirements related to investments. The following paragraphs summarize those assertions and procedures.

The guidance in AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items*, discusses considerations for auditing the valuations of certain types of investments and derivative instruments. In addition, AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides guidance on auditing fair value measurements and disclosures in financial statements. The following discussion of auditing procedures for employee benefit plan investments is based on the guidance in AEBP and AU-C 501A and 540A.

Auditing Investment Existence. The auditor should test existence of the plan's investments as of the financial statement date by examining evidence of ownership on hand at the plan such as stock certificates, deeds (for real estate owned), etc., or by confirmation with the custodian. (As previously mentioned, it is uncommon for the plan to have physical custody of the investments; even when the plan administers its investments, a custodian typically holds them in safekeeping.) The auditor may also consider obtaining confirmation of the same information from the party named as having discretion to make investment decisions such as the plan administrator, investment committee, or investment advisor.

AEBP, Paragraph 11.130b, states that if the plan's investments are held by a bank's trust department, a confirmation from the bank ordinarily is acceptable evidence of existence and ownership. The paragraph also states that the auditor may obtain information about the trustee's responsibility and financial capability. The paragraph indicates the auditor may consider the following procedures:

- Review the trust instrument to determine the trustee's responsibilities.
- Determine whether the trustee has insurance covering the plan assets under its control.
- Read recent financial statements of the trustee.

- Confirm additional items, such as:
  - When-issued transactions, and the value of such transactions on the valuation date, with the underwriter.
  - Commodity futures, put options, call options, financial futures, swap agreements, and other exchange-traded or directly negotiated derivative contracts with the broker or counterparty.
  - Forward contracts, repurchase agreements, and standby commitment contracts with the counterparty.
  - Short securities positions with the broker.
  - Loaned or borrowed securities and related collateral with the broker or counterparty.

Other procedures to consider include reviewing credit bureau ratings, if available, and reviewing financial or trade publications for relevant information about the trustee or custodian.

When confirming investments held by a third party (such as a trustee or a hedge fund), the auditor needs to carefully evaluate the adequacy of the confirmation. Occasionally, a third party may confirm the total amount of investments in the aggregate rather than on an individual investment basis. For instance, a confirmation from a trustee may indicate the plan has "total investments of $145,000" or "$110,000 of total investments in private equity securities, $25,000 of total investments in interests in limited partnerships, and $10,000 of total investments in debt securities." The authors believe a confirmation that is disaggregated, in other words, one that includes details on an investment-by-investment basis is a best practice. The following is an example of a disaggregated confirmation:

> 100 shares of common stock of private company A with a fair value of $60,000; 75 shares of preferred stock of private company B with a fair value of $50,000; 45 units of limited partnership interest XYZ with a fair value of $25,000; real estate property ABC with a fair value of $75,000.

The confirmation to the custodian or trustee should include an inquiry about the status of any securities in transit on the financial statement date and the existence of any liens, pledges, or other encumbrances.

Auditing Investment Activity. The auditor should test investment activity by obtaining an analysis of the change in the investments during the period under audit and by examining authorizations and documentation supporting purchases, sales, and realized gains and losses.

As previously explained, transaction testing by examination of documents at the plan location usually is possible for nontrusteed investments or for investments in nondiscretionary trusts. (Earlier, this section explained why it may not be possible to examine documents at the plan location in support of investment transactions in a discretionary trust arrangement. The audit approach for investment transactions in a discretionary trust is discussed later in this section.) Audit sampling may be necessary in testing investment transactions if there are numerous investment transactions during the year and gives guidance on the type of audit sampling that would be used.

In auditing investment transactions, the auditor should determine that the trade date is used to record purchases and sales. If the settlement date is used, the auditor needs to determine that unrecorded transactions made just before the financial statement date do not significantly affect the composition of the plan's assets and that their fair value has not changed from the trade date to the financial statement date.

Auditing Investment Income. Analytical procedures can be effective for testing investment income, such as comparing investment income and investment yield (ratio of income by category of investment to the average current value during the year by category) for the current and prior year and to industry indexes for similar types of investments. Another analytical procedure is to recompute income for specific investments by applying dividend or interest rates to average investment balances outstanding during the period.

The auditor should determine that dividends declared close to the financial statement date are recorded as of the ex-dividend date and not the record or payment date, and that any necessary interest or dividends are accrued.

Many firms perform detail testing on at least a small selection of investment income, including accrued investment income, even on engagements with low to moderate risk assessments. The authors believe that peer reviewers often look for detail testing in this area.

Auditing Investment Valuation. With the exception of plan investments in unallocated insurance contracts and fully benefit-responsive investment contracts, GAAP requires employee benefit plan investments to be presented at fair value. Thus, the auditor should test investment valuation and the calculation of the unrealized gain or loss during the period. Audit procedures to test fair value are relatively simple if the investments have a quoted market price. Fair value may be determined by reference to market quotations for the identical item in an active market. The auditor can refer to the last sales or bid price of stocks and bonds, or net asset value of mutual fund shares, published in market listings of publicly traded securities and mutual funds. GAAP requires the fair value of investments to be reduced for brokerage commissions and normal costs to sell, if significant. Such costs need to be taken into account when testing valuation.

Investments that do not have a readily available market price include restricted or unregistered securities, securities with a thin market, interests in limited partnerships or LLCs, real estate, and mortgages. Such investments may include employer securities held by an ESOP established by a small, closely held company. Restricted securities and other investments without a ready market must be valued in good faith by the plan's board of trustees, administrative committee, or a specialist engaged by the plan to make the valuation. IRC provisions require ESOPs to obtain independent appraisals of certain employer securities that are not readily tradeable on an established securities market.

In auditing the fair valuation, the auditor does not act as an appraiser, but reviews and assesses the reasonableness and appropriateness of the plan's valuation methods and underlying data and assumptions. Based on AEBP, Paragraph 11.130i, and other generally accepted auditing procedures, the auditor may consider the following procedures:

- Determine and evaluate the plan's valuation methods and procedures and whether they are specified by GAAP and whether they were followed.
- Test underlying data and assumptions supporting the estimates.
- Inquire whether the plan's board of trustees, administrative committee, or other designated party has reviewed and approved the valuation estimates. Read supporting minutes or other documentation evidencing such review and approval and the fair valuation determined.
- Test portfolio valuations as of the financial statement date.
- Compare transactions for dates selected from the period under audit to values computed by the plan.
- Follow the requirements in AU-C 500A, *Audit Evidence*, regarding use of management's specialist, or AU-C 620A, *Using the Work of an Auditor's Specialist*, if the plan engaged a specialist to value the investments or if the auditor considers a specialist necessary to help audit the plan's valuation.
- If the fair value of investments or other investment performance criteria are used to determine compensation for the investment manager (or equivalent) and the compensation is material, perform adequate testing of the fair values or other criteria to support the compensation testing.

AEBP, Paragraph 11.126, cautions that confirming the fair values of investments with a plan's trustee, custodian, or investment manager does not constitute valuation testing. Independent corroboration of fair values is required even if the confirmation includes fair values. However, the authors believe there can be situations when a confirmation with a third party containing fair values may provide sufficient audit evidence about valuation. FASB ASC 820-10-35-59 through 35-62 provide a practical means of measuring the fair value of alternative investments, such as hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds, that do not have readily determinable fair values because they are not publicly traded. The investee may provide the plan with a net asset value per share (NAV) (or its equivalent, for example, member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) as of the plan's measurement date that has been calculated at fair value in a manner consistent with GAAP for investment companies. When this is

the case, the plan is allowed to value the alternative investment on the NAV basis provided by the investee as of the plan's measurement date without further adjustment. This applies only if the alternative investment does not have a readily determinable fair value and the investment is in an entity within the scope of FASB ASC 946, *Financial Services—Investment Companies*, or in certain real estate funds measured using methods consistent with the principles in FASB ASC 946.

The plan is required to consider whether an adjustment to the NAV is necessary to estimate the fair value of the investment. Adjustments may be necessary when the net asset value per share (or its equivalent) provided by the investee is not as of the plan's measurement date or does not represent the fair value of the plan's investment in all circumstances. For example, restrictions on redemption at the measurement date and transaction prices from principal-to-principal or brokered transactions may indicate that adjustments are necessary. Also, this practical expedient does not apply to portions of investments the plan will probably sell at amounts that differ from the net asset value per share (or its equivalent). The nonauthoritative guidance at AICPA Technical Question and Answer at Q&A 2220.27 discusses determining fair value when the NAV practical expedient is not used or is not available.

AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, establishes standards and provides guidance on auditing fair value measurements and disclosures in financial statements. It does not address specific types of assets, liabilities, transactions, or industry-specific practices. Because fair values are essentially estimates, the auditor should understand and apply the approach and procedures in AU-C 540A on auditing estimates. For example, the auditor might inquire of management whether the fair value estimate is based on quoted prices in active markets, private trades, trades of similar instruments, a cash flow model, or some combination of inputs.

According to AU-C 540A.08–.09, the auditor should perform the following steps when auditing fair value measurements and disclosures:

- Obtain an understanding of the process for determining fair value measurements and disclosures and the related internal controls, and assess risk.
- Consider the need for a specialist.
- Test the fair value measurements.
- Evaluate whether fair value measurements and disclosures conform to GAAP.
- Evaluate the results of audit procedures.
- Obtain management representations about fair value measurements and disclosures.
- Make appropriate communications with those charged with governance.

<u>Understanding the Process and Assessing Risk.</u> AEBP, Paragraph 11.18, notes that meeting the requirements of FASB ASC 820 requires coordination among plan management, custodians, investment fiduciaries, and plan auditors, and that plan sponsors and administrators need to determine whether they have the appropriate valuation processes and sufficient data to determine the fair value of the plan's investments and related disclosures in accordance with the framework and requirements provided in FASB ASC 820. The auditor should obtain an understanding of the plan's process for determining fair value measurements and disclosures and of the related controls sufficient to develop an effective audit approach. The auditor obtains this understanding by considering matters such as:

- Controls over the measurement and disclosure process and the underlying data.
- The experience and expertise of those involved, including whether specialists or service organizations are used. AEBP, Paragraph 11.18, states that even though plan management can outsource the mechanics of the valuation process, management needs to retain responsibility for the oversight of the final valuations and adequacy of related disclosures.
- The application of information technology in the process.
- The significant assumptions used and the documentation supporting them.

- The process used to develop, apply, and monitor changes in assumptions.

The auditor then assesses the risk of material misstatement in fair values by considering the complexity of the related accounting and reporting requirements. Risk generally increases along with complexity. The auditor's risk assessment affects the nature, timing, and extent of audit procedures.

Evaluating Measurements for Conformity with GAAP. In determining whether the fair value measurements conform to GAAP, the auditor should consider the following:

- Plan management's intent and ability to carry out specific courses of action, where relevant.
- When a valuation method is used, the appropriateness of the method, including plan management's rationale for choosing the method and whether plan management has determined the range of values resulting from different methods and investigated the reasons for the differences.
- Whether the fair values have been determined consistently and if, in the case of changing circumstances, that is appropriate.

Engaging a Specialist. The auditor should assess the need to use a specialist to evaluate fair value measurements and disclosures. If an auditor plans to use a specialist, the auditor should consider whether the specialist's understanding of the definition of fair value and the method to be used to determine fair value are consistent with those of the plan's management and GAAP. The auditor should also understand the assumptions and methods used by the specialist.

Testing Fair Value Estimates. The auditor uses his or her assessment of the risk of material misstatement and understanding of the fair value measurements provided and processes used by the plan to determine the nature, timing, and extent of audit procedures to perform. To obtain evidence supporting a fair value estimate, the auditor may consider the following approaches:

- Test the client's valuation, including significant assumptions, the valuation model, and the underlying data.
- Develop an independent estimate and compare it to the client's valuation.
- Review subsequent events and transactions to corroborate the client's valuation. However, the auditor only needs to consider those events or transactions that reflect circumstances existing at the financial statement date.

According to AEBP, Paragraph 11.126, receiving a confirmation from a trustee, custodian, or investment manager is not adequate audit evidence regarding the fair value of the related investments.

When testing the client's valuation or developing an independent estimate based on plan management's assumptions, the auditor should evaluate whether those assumptions are reasonable and consistent with market information. The auditor should also consider the source and reliability of evidence supporting the assumptions, paying special attention to assumptions that are highly sensitive and susceptible to misapplication or bias. Consideration also needs to be given to the sensitivity of the valuation to changes in assumptions and market conditions. To be reasonable, the assumptions, individually and taken as a whole, need to be realistic and consistent with the following:

- Economic and market information.
- The plan's objectives, including plan management's expectations regarding the outcome of specific plans and strategies.
- Prior period assumptions, if appropriate.
- Past experience of the plan, as applicable.
- Other matters relating to the financial statements, for example assumptions used in accounting estimates for other financial statement accounts unrelated to fair value.

- Risk associated with cash flows, if applicable, including the potential variability in amount and timing and the related effect on the discount rate.

The accuracy, completeness, and relevancy of the underlying data should be tested, and the auditor ought to ensure the resulting valuation properly reflects both the assumptions and the data. Tests may include verifying the source of the data, recomputing, and reviewing information for internal consistency.

If the auditor independently develops assumptions for use in evaluating the client's estimate, he or she should understand plan management's assumptions to assess whether any significant matters have been omitted and to evaluate any significant differences between plan management's and the auditor's estimates. This evaluation needs to also be performed if a valuation specialist develops the fair value estimate.

Evaluating Disclosures for Conformity with GAAP. To evaluate whether fair value measurements and disclosures are adequate and conform to GAAP, the auditor should:

- Obtain evidence that the method of estimation is appropriate under GAAP and applied consistently.
- Consider whether the method of estimation and significant assumptions are adequately disclosed.
- Assess whether the disclosures are sufficient to inform users of the degree of measurement uncertainty.
- Evaluate the adequacy of disclosure when fair value information is omitted because it is not practical to determine fair value with sufficient reliability.

Other Procedures. During summarization and evaluation procedures, the auditor should evaluate the sufficiency and competence of the evidence obtained and its consistency with other evidence obtained during the audit. Regardless of the audit approach used, the auditor ordinarily obtains management representations about the reasonableness of significant assumptions. The auditor might also obtain representations about the appropriateness and consistency of the valuation method used, the completeness and adequacy of disclosures, and whether subsequent events require adjustment to the fair value measurements or disclosures. Furthermore, the auditor should determine that those charged with governance are informed about plan management's process for developing sensitive fair value estimates and about the basis for the auditor's conclusions regarding their reasonableness.

Considering Liens and Pledges on Investments. An employee benefit plan may have pledged investments. For example, real estate held as an investment may secure a mortgage loan. A leveraged ESOP pledges stock of the employer entity to collateralize debt incurred to acquire that employer stock. The auditor should consider whether there are any liens, pledges, or other security interests on investments by inquiry of the plan administrator and by review of information on confirmations, minutes, loan agreements, etc.

Considering Compliance with ERISA and Plan Provisions. The auditor should also consider whether the investments comply with requirements of ERISA and the plan documents. ERISA requires that fiduciaries diversify plan investments to minimize risk. ERISA also prohibits plans from selling, exchanging, or leasing property, or extending credit, to parties in interest, or acquiring qualifying employer securities or qualifying employer real estate, as defined, exceeding, at the time of acquisition, 10% of the fair value of plan assets. (There are certain exceptions to these prohibitions.) The U.S. Supreme Court has held that the contribution of real property to a qualified benefit plan *to satisfy the minimum required plan contribution* is a prohibited transaction and, therefore, is subject to an excise tax under IRC Sec. 4975. The ruling does not prohibit the contribution of real property to plans that have no minimum contribution requirements. For plans with minimum requirements, if the employer meets the minimum requirement with a cash contribution, additional contributions including real property may be made up to the maximum deduction limit. ERISA requires disclosure of prohibited transactions and certain other matters such as loans or leases in default and transactions, or a series of transactions, exceeding 5% of the current value of the plan's assets. In addition, the plan documents or minutes of the administrative or investment committee may specify an investment policy or prohibit or limit certain types of investments.

The auditor should determine that investment transactions were properly authorized and not in violation of plan provisions or investment policies. He or she should consider whether transactions involved parties in interest, result in excess holdings of employer securities or real estate, or exceed the threshold for a reportable transaction. These considerations can be made when reviewing the analysis of investment activity and when examining supporting

documents for specific transactions during the audit of investments. The auditor should also ask plan personnel whether any transactions involved parties in interest, violated ERISA requirements, plan provisions, or investment policy, or require reporting in supplemental schedules accompanying the financial statements.

The auditor should review the list of investments and consider whether it reflects undue investment concentration that might be considered a violation of the ERISA diversification requirement.

Auditing Investments Held in a Discretionary Trust

When investments are held in a discretionary trust, the trustee has authority to initiate investment transactions within the framework specified in the trust agreement without specific authorization of individual transactions. Usually, the plan administrator's only records of investment transactions and balances are those that the trustee has provided, and the plan administrator may not have documents supporting specific transactions. Thus, the auditor may not be able to obtain an independent record of investment transactions and balances at the plan location, yet cannot rely solely on the trustee's report for evidential matter.

Although outside the scope of this course, *PPC's Guide to Audits of Employee Benefit Plans* contains information on planning considerations when a trustee invests and holds plan assets, as well as guidance on determining the plan auditor's need for a service auditor's report on the trustee's (the trust department's) internal controls as part of obtaining an understanding of internal control and assessing control risk related to the plan's investments in the discretionary trust.

A SOC 1 report may allow the plan auditor to use the trust department's report of plan transactions as evidential matter. Obtaining and using a SOC 1 report is an example of a substantive procedure to be applied when transactions are executed by the discretionary trust.

If the plan auditor concludes that it is necessary to obtain information on the service organization's accounting procedures that is relevant to the plan's internal control, the information may be obtained by using a SOC 1 report or by applying the necessary procedures at the trust department. If a SOC 1 report is not available and the auditor is unable to perform or have another CPA perform the necessary procedures, the plan auditor ordinarily will have to qualify or disclaim an opinion on the plan's financial statements because of the scope limitation.

The authors believe that ordinarily the plan auditor need not review the trust department auditor's workpapers related to the SOC 1 report if he or she is satisfied about that auditor's professional reputation and independence.

Auditing Investments in Common/Collective Trusts

A common/collective trust involves the pooling of assets of two or more unrelated plans at a bank or similar financial institution for investment purposes. The bank does not own the assets in the trust but only holds them in trust for the participating plans. Each participating plan owns units of participation in the fair value of the assets underlying the trust. Many common/collective trusts issue audited financial statements.

The plan auditor's procedures for investments held in common/collective trusts may include confirming the plan's units of participation with the trustee and examining the plan's approvals and other documents supporting the plan's transactions in the units of participation during the period (for instance, investment committee minutes, trust agreements, and investment guidelines).

As noted earlier, many common/collective trusts issue audited financial statements. When available, the auditor may obtain and review the financial statements and related auditor's report, taking into account the reputation of the audit firm. If the net asset value per share (NAV), or its equivalent, of the investment reported in the financial statements is used by the plan as a practical expedient to estimate the fair value of the trust investment, the auditor should consider whether the criteria for using the NAV have been met. The auditor should also consider whether an adjustment to the most recent NAV is necessary and compare the reasonableness of the most recent NAV in the financial statements plus any adjustments to the NAV recorded by the plan.

If audited financial statements of the trust are not available, or do not cover a period sufficiently recent to meet the auditor's objectives, the auditor may obtain a copy of the current financial statements of the trust, if available, and

consider the reasonableness of unit information in those statements in comparison to unit information recorded by the plan. Information to consider includes market values, purchase and sales values, and income earned and accrued. The auditor may also be able to obtain and review a SOC 1 report on the trust's internal controls relevant to aspects of the trust, such as determination of unit values and control over share transactions, if such a report is available.

If the auditor is unable to perform the auditing procedures described in this section, a qualification or disclaimer of opinion on the plan's financial statements may be necessary because of the scope limitation.

Auditing Investments in Mutual Funds

Investments in registered investment companies, commonly referred to as mutual funds, are very common in employee benefit plans, especially in profit sharing plans and 401(k) plans. In addition, technology of third-party administrators or service divisions of mutual fund companies allow participants to initiate automated transactions, such as electing and changing investment options, by the Internet or an Intranet, leaving no "paper trail" for the plan.

The audit procedures discussed earlier in this section may be applied to investments in mutual funds. In addition, if "paperless transactions" occur, as described in the preceding paragraph, the auditor may consider performing one or more of the following procedures:

- If available, obtain a SOC 1 report on the internal controls relevant to aspects of the mutual funds. Consider the results discussed in the report and the type of report in determining the extent of substantive procedures to be performed.
- Confirm account balances and/or individual transactions, such as transfers or contributions, with individual participants.

Auditing Investments in Exchange-traded Funds

Like mutual funds, exchange-traded funds (ETFs) offer plan participants a simple method of investing in portfolios of stocks that closely track the performance and dividend yield of specific indexes. ETFs allow for the purchase or sale of an entire portfolio of stocks in a single security, as easily as buying or selling a share of stock. ETFs are similar to traditional mutual funds in that they are an investment structure that pools the assets of its investors and uses professional managers to invest the money to meet clearly identified objectives, such as current income or capital appreciation. Unlike a mutual fund, ETFs are traded like other listed stocks.

An ETF is created when an institutional investor deposits securities into the fund in exchange for creation units. In return for the deposit, the institutional investor receives a fixed amount of shares, some or all of which may be traded and priced throughout the day on a stock exchange. Non-institutional investors (e.g., individual investors) do not purchase or redeem ETF shares directly from the fund. They buy or sell ETF shares on the stock exchange in the same manner they would purchase or sell any other listed stock. The price of an ETF usually approximates, but is not directly linked to, the underlying net asset value of the fund. When demand for fund shares exceeds supply, the market price at which an ETF trades may be higher than its underlying net-asset-value, and vice-versa.

The audit procedures for investments discussed earlier in this section may be applied to investments in exchange-traded funds.

Auditing Investments in Master Trusts

A master trust is a trust in a regulated and supervised financial institution (bank, trust company, or similar financial institution) where the trustee or custodian is required to have periodic examination by a state or federal agency. Master trusts are similar to common/collective trusts, except that the plans participating in the trust are sponsored by a single employer or by members of a controlled group of companies. It is important for both regulatory and financial reporting purposes to discern whether a trust meets the DOL's definition of a master trust, as set forth in the instructions to Form 5500. Plans may commingle assets in an investment account that their administrators erroneously refer to as a "master trust." In other instances, due to mergers, spin-offs, or terminations, a trust that was formerly a true master trust may no longer meet the DOL's criteria. In these cases, plan administrators may need to consult legal counsel to make the determination.

The master trust agreement generally provides a description of the nature of the master trust. A plan's interest in a master trust may be an undivided interest, a divided interest, or a combination of both. An undivided interest is when the plan holds no specific interest in any of the master trust's individual balances but instead holds a proportionate interest in the net assets of the master trust, otherwise plan interests are considered to be divided. Because defined contribution plans include more participant-directed investments, defined contribution plans more commonly have a divided interest in a master trust. Alternatively, as investments are more likely directed by the plan sponsor, defined benefit pension and health and welfare benefit plans generally hold more undivided interests in master trusts.

If the master trust issues audited financial statements, the plan auditor may choose to review them. If the plan auditor also audits the master trust, the basic auditing procedures listed earlier in the "Auditing Investment Existence" paragraph may be applied. (If the trustee for the master trust has discretionary control over the trust's assets, the procedures for a discretionary trust may be applied.) Then, the allocation of the ownership to the participating plans may be tested based on the provisions of the master trust instrument or the agreement of the administrators of all the participating plans. If audited financial statements of the master trust are not available, the plan auditor may perform the procedures necessary to obtain sufficient audit evidence to support the financial statement assertions relevant to the investments in the master trust. The auditor also needs to be familiar with the fair value measurement disclosure requirements for master trusts. If the plan auditor is unable to perform the necessary procedures, the plan auditor may have to qualify or disclaim an opinion on the plan's financial statements because of the scope limitation.

Master trusts have specific accounting and disclosure requirements. The disclosure requirements for master trusts were discussed in more detail in Lesson 1.

In AEBP, Paragraph 11.47, FinREC recommends that plan level activity that impacts the trust, such as contributions and benefit payments, be recorded at the plan level, and then only reflected as transfers in and out of the master trust on the statement of changes in net assets of the master trust. Plan level activities that are specific to the plan, however, such as legal and audit fees, should be reported at the plan level only. Likewise, master trust specific activity, such as investment management fees, should be reported as such at the master trust level.

ERISA Section 103(a)(3)(C) Audits. If an ERISA Section 103(a)(3)(C) audit is being performed on a plan with an investment in a master trust or a similar arrangement, the plan administrator needs to obtain from the trustee or custodian of the master trust a certification of the investments and related activity attributable only to that plan. For example, if three plans (Plan A, Plan B, and Plan C) invest in Master Trust I, the certification from the trustee or custodian of Master Trust I to the administrator of Plan A would only cover the investments and related activity attributable to Plan A rather than the investments and activity of the Master Trust I, which would include all three plans.

Auditing Investments in Omnibus Accounts

Employee benefit plans may have investments in omnibus accounts. *Omnibus accounts* are institutional accounts in which transactions are made for a number of beneficial owners, such as employee benefit plans, combined for trading purposes. Those transactions are subsequently allocated to the beneficial owners. Omnibus accounts may be held in the name of a custodian bank or an investment advisor and may use an affiliated recordkeeper to document the activity of individual owners within the account. AEBP, Paragraph 5.229, suggests auditors may consider performing the following steps when auditing investments in omnibus accounts:

- Obtain a confirmation from the transfer agent of the overall values of each investment fund holding at the omnibus level at the end of the period.
- For each investment fund held by the plan, review a period-end reconciliation of the combined balances of all plans participating in the fund to the omnibus account of the transfer agent and test reconciling items as necessary.
- For each investment fund, agree the plan's balances as reported by the recordkeeper to the balances in the listing of participating plans at the end of the period.
- Test the investments' fair values by comparing each investment fund holding's net asset value at the omnibus level to audited financial statements or market quotations.

- Analytically review changes in the fair value of the investment in the omnibus account through comparison to overall changes in the fair value of the investment fund as reported in financial statements or other sources of published information.
- If available, obtain a type 2 SOC 1 report for the recordkeeper or transfer agent, and consider any applicable information presented in the report about the omnibus account and reconciliation procedures. If SOC 1 reports are not available, consider confirming transactions at the omnibus level with participating plans, tracing transactions per the recordkeeper's or transfer agent's records to the statements of the omnibus account investment fund, and/or testing other transactions at the omnibus account level.

According to the Note at AEBP, Paragraph 5.229, if the auditor is unable to obtain sufficient appropriate audit evidence related to the omnibus accounts, the auditor may need to modify his or her opinion because of the scope limitation.

Auditing Other Investments

Other investments that employee benefit plans may own include real estate, mortgages, limited partnership interests, loans, etc. Plans may engage real estate management companies and mortgage servicing agents to manage those investments. The same basic auditing procedures discussed earlier in this section are appropriate for other investments. Specific considerations in applying those procedures to particular types of other investments follow.

Real Estate. For real estate, evidence of existence and ownership that the auditor may examine includes deeds, title policies, closing documents, and leases. Also, the auditor can compare property descriptions in real estate tax bills for the current year to the property recorded in the plan's financial statements. When examining documents pertaining to real estate, the auditor needs to be alert for indications of liens, pledges, or other security interests.

Real estate income can be tested analytically by comparing amounts to prior year amounts and by recomputing rental income based on rates in leases. The auditor needs to determine that rental income is accrued if necessary. Expenses such as maintenance and property taxes may be reviewed for reasonableness, analytically tested, related to tax bills and agreements with management agents, etc.

Real estate usually is not readily marketable. Thus, the auditor may evaluate the fair valuation of real estate and should consider whether the fair valuation gave appropriate consideration to a possible decline in the property's value. If the plan engages an appraiser to value its real estate, the auditor should test the data provided to the specialist for reasonableness and consider the appraiser's objectivity and relationship to the plan. Sometimes a plan's professional real estate manager also appraises the property it manages (or engages the appraiser) and bases its management fee on the property's value. The auditor may have concerns about the objectivity of a real estate valuation made under such circumstances and may need to apply additional procedures to the appraiser's assumptions, methods, or findings, or engage another appraiser, to determine that the appraisal is not unreasonable.

In addition, the auditor needs to consider whether sales of real estate investments are properly reported in the plan's financial statements. Real estate investments should be reported at fair value and any related income, expenses, net appreciation, or net depreciation should be reported in the statement of changes in financial status or the statement of changes in net assets available for benefits.

As previously mentioned, ERISA prohibits real estate transactions with parties in interest and limits plan acquisition of employer real estate. The auditor needs to apply procedures to determine possible violations of ERISA or other requirements.

Limited Partnerships. The auditor may test investments in limited partnerships for evidence of existence and ownership by examining limited partnership agreements, minutes from meetings of the plan's management or the limited partnership, copies of the financial statements of the limited partnership, if available, and the subscription agreement for recent investments in limited partnerships. Consideration may also be given to confirming the plan's investment with the investment manager or advisor of the limited partnership.

An investment in a limited partnership is generally difficult to value. The plan auditor may obtain and review audited financial statements of the limited partnership, if available, and consider the reasonableness of the limited partnership's value in those statements to the investment valuation included in the plan's financial statements. Information to consider includes purchase and sales values, income earned and accrued, and appraisals, if available. If net asset value (NAV) is used as a practical expedient to estimate fair value, see the guidance earlier in this section.

If audited financial statements are not available for the limited partnership or such statements are inadequate, the plan auditor should perform additional procedures. In addition to basic auditing procedures, AEBP, Paragraph 11.162 (under Alternative Investments Note item d.), lists the following procedures the auditor may consider performing:

- Obtain and review information regarding the investment holdings of the limited partnership. Discuss with the limited partnership's management the methods used to value the investments.
- Perform valuation procedures or review copies of appraisals, if available. The auditor needs to consider the guidance in AU-C 500, *Audit Evidence*, regarding use of a management's specialist, or AU-C 620A, *Using the Work of an Auditor's Specialist*.
- Assess the control risk related to the limited partnership. A SOC 1 report may be useful in making this assessment.

The Note after AEBP, Paragraph 11.162, Alternative Investments, indicates that the trustee or custodian may not have timely or accurate information regarding the amount and valuation of investments in limited partnerships. In those situations, the auditor may need to perform additional procedures.

Auditors also need to be aware that the financial statements or appraisal prepared for a limited partnership may be as of a different year end than that of the plan. The authors believe that the financial statements or appraisal do not have to cover the exact period covered by the plan's financial statements but should be sufficiently recent to satisfy the auditor. Auditors may consider performing additional procedures to address the gap in reporting periods such as—

- Requesting information about the partnership's monthly financial activity since the date of the financial statements or valuation and performing substantive analytical procedures.
- Asking the investment adviser about monthly valuation procedures and any unusual investment activity which may significantly impact market value.
- Assessing the need to obtain additional evidence to determine the investment's fair value.

Mortgages and Loan Investments. These types of investments include mortgages and loans to third parties. Evidence about the existence and terms of such investments is obtained by examining mortgage, loan, and note agreements, deeds, and insurance policies supporting the investments. The amounts and terms of significant loans and mortgages should be confirmed with the borrowers.

If the plan uses a mortgage servicing agent, the auditor may consider obtaining a SOC 1 report on the servicing agent's controls or applying procedures at the servicing agent's location. The auditor may also consider the agent's financial condition by inquiring about the adequacy of its bonding and insurance coverage and by reviewing any available audited financial statements. The auditor may consider the accounting for any escrow accounts the servicing agent may maintain.

Mortgage and loan interest income can be tested analytically on an overall basis by relating income to average loan or mortgage balances outstanding during the period or by applying interest rates in loan or mortgage agreements to the balances. The auditor should determine that appropriate interest accruals are made, if necessary.

The auditor should consider the collectibility of loan and mortgage receivables and the need for, and adequacy of, an allowance for uncollectible balances. The auditor should also consider the existence and adequacy of related collateral.

The fair value of mortgages and loans may be determined and will generally be based on discounted cash flows of comparable loans.

The auditor should consider whether any loans or mortgages violate ERISA, tax, or plan provisions, and consider whether there are any matters that ERISA requires to be disclosed, for instance, loans in default.

Nonpublicly-traded Stock and Employer Securities. For nonpublicly-traded stock and employer securities, evidence of existence and ownership may be tested by physical count or confirmation of the trustee or custodian. In addition to confirmations, minutes from meetings and agreements may be reviewed for the existence of liens, pledges, or other security interests on investments.

The fair value of nonpublicly-traded stock and employer securities should be audited in accordance with AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. The IRC requires independent appraisals of certain employer securities acquired by an ESOP. Also, if a plan has significant investments in nonpublicly-traded stock and employer securities without a ready market value and the fair value is determined by plan management, the auditor may decide it is necessary to use the work of a specialist to test management's valuation. If a specialist is used, the auditor should test the underlying data provided to the specialist and review the specialist's qualifications, reputation, and relationship to the client.

When testing investment transactions in nonpublicly-traded stocks and employer securities, the auditor may verify proper authorization, examine appropriate supporting documentation such as cash records, and agree the purchase or sale prices to supporting documentation such as valuation information provided by a specialist at or near the trade date.

Derivatives. FASB ASC 815, *Derivatives and Hedging*, provides disclosure requirements for derivative financial instruments and nonderivative instruments that are designated and qualify as hedging activities.

Some employee benefit plans use derivative instruments as part of their investment portfolios. When they are material, derivatives present unique auditing considerations to practitioners due to the complex nature of derivative transactions and the accounting rules that apply to them.

The guidance in AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items*, discusses considerations for auditing the valuations of derivative instruments. The AICPA Audit Guide, *Special Considerations in Auditing Financial Instruments*, provides guidance for complying with GAAS. The audit guide includes a general discussion of derivatives and securities, related accounting considerations, and various case studies.

Auditors may need special skills or knowledge to audit complex derivative instruments and hedging activities. The auditor may choose to obtain those skills or that knowledge from other individuals within the auditor's firm or from specialists following the guidance in AU-C 620A, *Using the Work of an Auditor's Specialist*.

Key considerations when auditing derivatives and hedging activities include:

a. Identifying derivative instruments.

b. Evaluating whether derivative instruments are properly designated as hedging instruments and, if so, the type of hedge.

    - For derivatives designated as a hedge, evaluating whether the plan has assessed the effectiveness of the hedging relationship when financial statements are prepared (or at least every three months).

    - For a fair value hedge, evaluating whether the changes in fair value of the hedged item are properly accounted for.

c. Evaluating whether derivative instruments are properly valued at fair value and assessing the proper treatment of changes in fair value.

The first step in auditing derivatives is to assess whether all derivative instruments have been identified by the plan's management and recorded in the plan's financial statements. The auditor may use inquiries of plan management and reviews of the plan's financial records to identify derivative instruments. However, auditors should not focus

exclusively on evidence relating to cash receipts and disbursements when designing tests for completeness because derivatives may not involve an initial net investment. Common procedures performed to identify derivative instruments include:

a. Inquiry of the plan's management to determine if the plan has entered into any contracts that meet the definition of a derivative. The auditor should gain an understanding of the extent of derivative use, the types of derivatives used, the plan's purpose in using derivatives, and plan management's control over derivative transactions.

b. Requesting information regarding the existence of derivatives with counterparties who are frequently used, but with whom the plan's accounting records indicate there are currently no derivatives.

c. Inspecting documentation for activity after year end that may indicate the existence of derivatives at year end.

d. Inspecting financial instruments and other agreements for embedded derivatives and determining whether they should be accounted for separately from the host contract.

e. Reading other information such as the minutes of administrative or investment committees, or board of trustees.

After identifying financial instruments subject to the accounting and reporting provisions of FASB ASC 815, the auditor may consider the following common audit procedures to validate the completeness and accuracy of amounts, if any, recorded in the plan's financial statements:

a. Physically inspecting the derivative contract.

b. Requesting information from the counterparty to an identified derivative. The auditor may inquire regarding the significant terms of the derivative and the nature and existence of any settled and unsettled transactions between the plan and the counterparty. Auditors may also consider confirming with counterparties the derivative activity during the year. Any activity confirmed may be reviewed and compared with the description of the plan's use of derivatives provided by plan management to their description.

c. For derivative instruments designated as a hedge, inspect management's documentation of the hedging relationship to determine that the derivative qualifies for hedge accounting. The auditor should also verify the timeliness of the documentation of the hedging relationship. For derivatives designated as hedges, the plan must comply with specific documentation requirements at the inception of the hedge.

d. Reading and inspecting any related agreements, underlying agreements, and other forms of documentation for amounts reported, unrecorded repurchase agreements, and other evidence.

e. Testing and assessing the reasonableness of the fair value of the derivative. The fair value of derivatives may be based on quoted market prices, fair value estimates from broker-dealers or other third-party sources, or determined by the plan's management using a valuation model. If the fair value is obtained from a third-party source, such as a pricing service, the guidance in AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, may apply. If the third-party source derives fair value by using modeling or similar techniques, the guidance in AU-C 500, *Audit Evidence*, regarding use of a management's specialist, or AU-C 620A, *Using the Work of an Auditor's Specialist*, may apply. If the plan determines the fair value by using a modeling technique, procedures the auditor may perform to assess the reasonableness of the fair value include:

  - Assessing the reasonableness and appropriateness of the model. For example, determining whether the market variables and other assumptions used are reasonable.
  - Calculating the fair value using a model developed by the auditor or a specialist to develop an independent expectation to corroborate the reasonableness of the plan's valuation.
  - Comparing the fair value with recent or subsequent transactions.

- •• For changes in fair value during the period, considering whether the changes are properly recorded in the plan's financial statements.

The guidance in AU-C 540A ought to be considered when auditing fair value of derivatives.

f. Testing to ensure that derivative transactions are initiated within the guidelines established by the plan's management and documented in its investment policies.

Self-directed Investment Programs. In addition to participant-directed programs, some plans allow participants to self-direct their account balances in any investment that they desire, subject to certain limitations. The auditor needs to review the underlying investments in any self-directed account and determine the appropriate audit procedures to perform to adequately test those investments.

If the auditor plans to rely on a SOC 1 report with regard to the testing of self-directed investment programs, the auditor needs to ensure that the report addresses the self-directed investment program. AEBP, Paragraph 5.225, indicates SOC 1 reports often do not address such self-directed investments. Auditors may consider obtaining a reconciliation of the balances of self-directed investments per the plan's trustee or custodian to the amounts reported in the plan's financial statements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Which analytical procedure would provide an auditor appropriate information about noncash contributions to an employee benefit plan?
    a. Determining that the contribution was made according to plan provisions.
    b. Tracing the contribution to the board of directors' minutes.
    c. Testing the transfer of assets from the prior owner.
    d. Testing fair value at the date of the contribution.
13. An auditor should consider which of the following factors when determining whether to confirm contributions received or receivable?
    a. The effectiveness of the plan's internal control over liabilities.
    b. The number of participants involved in the plan.
    c. To whom the contribution is paid.
    d. The materiality of the plan's paid receivables.
14. Which of the following should be taken into account when determining the nature and extent of auditing procedures for an employee benefit plan's investments?
    a. The length of the audit.
    b. Risk assessment.
    c. Who purchased the investments.
    d. The number of records for each investment.
15. Wanda is engaged to perform an ERISA Section 103(a)(3)(C) audit on an employee benefit plan. When might she need to perform additional procedures on the plan's investments?
    a. The plan's investments are held by a qualified bank that provides a certification report.
    b. She considers whether the entity that certified the investments is a qualifying institution.
    c. The financial institution holding the investments has had the same trustee for more than five years.
    d. She becomes aware that information provided in the certification report is incomplete.
16. Which of the following statements best describes an aspect of auditing an employee benefit plan's investment income?
    a. The auditor acts as an appraiser when auditing the fair value of investments.
    b. The auditor should test investment valuation and the calculation of unrealized gain or loss.
    c. The auditor will have more difficulties when investments have a quoted market price.
    d. Confirming an investment's fair value with the trustee is considered appropriate valuation testing.

17. Transactions in which of the following are made for a number of beneficial owners, such as employee benefit plans, combined for trading purposes?

    a. Common/collective trust.

    b. Master trust.

    c. Mutual funds.

    d. Omnibus account.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

12. Which analytical procedure would provide an auditor appropriate information about noncash contributions to an employee benefit plan? **(Page 219)**

    a. Determining that the contribution was made according to plan provisions. [This answer is incorrect. If an employee benefit plan allows for rollover contributions (not noncash contributions) one of the procedures an auditor should consider performing is to determine that the rollover was made according to plan provisions.]

    b. Tracing the contribution to the board of directors' minutes. [This answer is incorrect. Contributions may be traced to the employer's board of directors' minutes authorizing the contribution and to the plan's cash receipts, deposits as evidenced on bank statements or trustee reports, or accounts receivable. However, this type of vouching and confirmation procedures would be more appropriate for cash contributions. It is not specifically necessary for noncash contributions.]

    c. Testing the transfer of assets from the prior owner. [This answer is incorrect. When a plan allows rollover contributions (not noncash contributions) one procedure the auditor should consider is testing the transfer of the assets from the prior trustee/custodian to the current trustee/custodian.]

    d. **Testing fair value at the date of the contribution. [This answer is correct. The fair value at the date of contribution should be tested for any significant noncash contributions. Procedures would be similar to those for auditing the fair value of plan investments. For health and welfare plans, the cost to sell also needs to be considered, if significant.]**

13. An auditor should consider which of the following factors when determining whether to confirm contributions received or receivable? **(Page 221)**

    a. The effectiveness of the plan's internal control over liabilities. [This answer is incorrect. One of the factors that an auditor should consider when deciding whether to confirm contributions received or receivable is the effectiveness of internal controls related to *contributions and cash receipts*.]

    b. The number of participants involved in the plan. [This answer is incorrect. One of the factors that an auditor should consider when making the determination about confirming contributions received or receivable is whether the plan is a multiemployer plan or a single-employer plan. The number of plan participants is not included in the factors to consider.]

    c. **To whom the contribution is paid. [This answer is correct. There are multiple factors that auditors might consider when deciding whether to confirm contributions received or receivable. One such factor is whether the contribution is paid directly into a plan bank account or whether it is paid to a trustee or third-party plan administrator or a central bank account that receives deposits related to several unrelated plans. The answer to this question will affect the auditor's procedures.]**

    d. The materiality of the plan's paid receivables. [This answer is incorrect. The auditor's decision on whether to confirm contributions received or receivable is based on certain factors. One of those factors is the materiality of the *unpaid receivable balance* after subsequent receipts are examined.]

14. Which of the following should be taken into account when determining the nature and extent of auditing procedures for an employee benefit plan's investments? **(Page 221)**

    a. The length of the audit. [This answer is incorrect. The length of the audit engagement is not pertinent to this determination, but the scope of the audit—whether it is a non-Section 103(a)(3)(C) audit or an ERISA Section 103(a)(3)(C) audit—will affect the auditing procedures performed.]

b. **Risk assessment. [This answer is correct. There is increased audit risk associated with fair valuation of securities that do not have a market price and with complex and riskier types of investments such as real estate investment trusts and junk bonds. The auditor needs to take such risk into account when planning the audit of investments and determining the nature and extent of auditing procedures.]**

c. Who purchased the investments. [This answer is incorrect. Who purchased the investments is not typically relevant when determining the nature and extent of audit procedures. However, the auditor will want to take into account who administers the investments—i.e., whether the investments are administered by the plan (and merely held by a custodian) or are administered by a trustee. If there is a third-party trustee, the auditor will also want to take into account whether the trust arrangement is discretionary or nondiscretionary.]

d. The number of records for each investment. [This answer is incorrect. The number of investments is not typically relevant to the nature and extent of audit procedures, but the physical location of the investments and the related records is a factor.]

15. Wanda is engaged to perform an ERISA Section 103(a)(3)(C) audit on an employee benefit plan. When might she need to perform additional procedures on the plan's investments? **(Page 223)**

a. The plan's investments are held by a qualified bank that provides a certification report. [This answer is incorrect. In an ERISA Section 103(a)(3)(C) audit, no procedures are applied to information on plan investments (and related transactions) held by a qualified institution (such as a bank or similar institution) that is prepared and certified to as both complete *and* accurate by the qualified institution. If Wanda has that certification, she does not need to perform additional procedures.]

b. She considers whether the entity that certified the investments is a qualifying institution. [This answer is incorrect. In an ERISA Section 103(a)(3)(C) audit, the auditor needs to consider whether the certifying entity holding the plan's investments is a qualifying institution under DOL regulations. This and a few other limited procedures are needed to audit the investments under these circumstances. However, making this consideration would not require Wanda to add additional procedures to her audit of the plan's investments.]

c. The financial institution holding the investments has had the same trustee for more than five years. [This answer is incorrect. If the plan changed trustees or custodians during the plan year, Wanda might need to perform additional procedures on the investments. If the trustee or custodian remains the same throughout the plan year (not five years), she would not need to perform additional procedures.]

d. **She becomes aware that information provided in the certification report is incomplete. [This answer is correct. If, while performing the limited procedures on investments required by this type of audit, Wanda becomes aware that the information in the certification report provided by the financial institution holding the investments is incomplete, incorrect, or somehow unsatisfactory, then she should perform additional procedures.]**

16. Which of the following statements best describes an aspect of auditing an employee benefit plan's investment income? **(Page 225)**

a. The auditor acts as an appraiser when auditing the fair value of investments. [This answer is incorrect. In auditing fair valuation, the auditor does not act as an appraiser, but reviews and assesses the reasonableness and appropriateness of the plan's valuation methods and underlying data and assumptions.]

b. **The auditor should test investment valuation and the calculation of unrealized gain or loss. [This answer is correct. With the exception of plan investments in unallocated insurance contracts and fully benefit-responsive investment contracts, GAAP requires employee benefit plan investments to be presented at fair value. Thus, the auditor should test investment valuation and the calculation of the unrealized gain or loss during the period.]**

c. The auditor will have more difficulties when investments have a quoted market price. [This answer is incorrect. Audit procedures to test fair value are relatively simple if the investments have a quoted market price. Fair value may be determined by reference to market quotations for the identical item in an active market. The auditor can refer to the last sales or bid price of stocks and bonds, or net asset value of mutual fund shares, published in market listings of publicly traded securities and mutual funds.]

d. Confirming an investment's fair value with the trustee is considered appropriate valuation testing. [This answer is incorrect. AEBP, Paragraph 11.126, cautions that confirming the fair values of investments with a plan's trustee, custodian, or investment manager does *not* constitute valuation testing. Independent corroboration of fair values is required even if the confirmation includes fair values.]

17. Transactions in which of the following are made for a number of beneficial owners, such as employee benefit plans, combined for trading purposes? **(Page 231)**

a. Common/collective trust. [This answer is incorrect. A common/collective trust involves the pooling of assets of two or more unrelated plans at a bank or similar institution for investment purposes. The difference between this type of trust and the situation described above is that all the members of the common/collective trust are employee benefit plans.]

b. Master trust. [This answer is incorrect. A master trust is a trust in a regulated and supervised financial institution where the trustee or custodian is required to have periodic examination by a state or federal agency. Plans participating in this type of trust are sponsored by a single employer or by members of a controlled group of companies. This is different from the members in the situation described above.]

c. Mutual funds. [This answer is incorrect. Investments in registered investment companies, commonly referred to as mutual funds, are very common in employee benefit plans. However, the transactions described above are not specific to this type of investment, so there is a better answer choice.]

d. **Omnibus account. [This answer is correct. Employee benefit plans may have investments in omnibus accounts. *Omnibus accounts* are institutional accounts in which transactions are made for a number of beneficial owners, such as employee benefit plans, combined for trading purposes. Those transactions are subsequently allocated to the beneficial owners.]**

AUDITING CONTRACTS WITH INSURANCE COMPANIES

Employee benefit plans may have different types of contracts with insurance companies and similar institutions. The accounting standards for such contracts were discussed in Lesson 1. Essentially, allocated contracts are excluded from plan financial statements and unallocated contracts are included in plan financial statements. Certain contracts are reported at fair value and others at contract value.

Unallocated contracts include deposit administration (DA) contracts, immediate participation guarantee (IPG) contracts, guaranteed investment contracts (GICs), and synthetic GICs. The contracts may be general accounts, separate-separate accounts (also called individual separate accounts), or pooled separate accounts. Certain investment contracts are often referred to as "stable value funds," including GICs, synthetic GICs, individual separate accounts, and pooled separate accounts.

This section refers only to insurance companies, but similar considerations apply to similar contracts at noninsurance companies. In addition, some defined contribution plans invest in common/collective trusts that in turn invest in contracts with insurance companies and/or GICs. The Note at AEBP, Paragraph 11.43, indicates determining whether the plan's investment is a common/collective trust or an account established to hold investment or insurance contracts specifically for one plan takes careful consideration of the agreement. Audit procedures for investments held in common/collective trusts were discussed earlier. This section first discusses basic auditing procedures for all types of insurance contracts and then discusses additional considerations for various specific types of contracts.

Basic Auditing Procedures for All Types of Contracts

In auditing contracts, the first step is to read the contract to determine its nature and terms, for instance, whether the account is allocated or unallocated; guarantees interest rates or not; and is a general account or separate (individual or pooled) account. The auditor needs to note whether the contract is with an insurance company or other financial institution, since, in some instances, this determines whether it is valued at contract or fair value.

The auditor should consider whether provisions in the contract that restrict the use of assets (for example, termination clauses that assess a penalty against contract value for premature termination or withdrawals) require adjustment or disclosure in the plan's financial statements. The auditor may also read the financial statements of the insurance company (or other relevant published information) and consider the insurance company's credit worthiness, responsibility, and financial capability, and consider any events or conditions related to the insurance company that may require financial statement disclosure or cause plan management to conclude that an adjustment should be made to the contract's reported value. For investment contracts issued by troubled insurance companies, the auditor should consider whether the accounting or disclosure requirements of FASB ASC 450, *Contingencies*, and the disclosure requirements of FASB ASC 275, *Risks and Uncertainties*, may apply. Those requirements were discussed in Lesson 1. Considerations include whether interest should continue to be accrued on such contracts, whether there is a probable and estimable loss on the contract that should be recorded, or whether a possible loss or an inestimable (and therefore unrecorded) probable loss should be disclosed in the financial statements. (Some plan sponsors take actions to restore losses on plan investments in GICs. The auditor would include such an action in his or her considerations.)

The auditor may confirm with the insurance company information such as the contract or fair value, as appropriate; contributions and premiums paid into the contract account during the period; interest, dividends, and experience-rated credits credited to the contract during the period; annuities purchased or benefits paid from unallocated contracts during the period; management fees and other expenses charged to the contract during the period; and any transfers between various funds and accounts.

If management fees and other expenses charged to the contract are significant, the auditor may examine documents supporting the charges and relate them to the terms of the contract.

The auditor should consider whether the contracts or transactions in them violate requirements, limitations, or prohibitions of ERISA or the plan.

Auditing Contract Valuation. Certain contracts with insurance companies must or are permitted to be carried at fair value (rather than contract value). Generally such contracts do not have a readily available market. Bases for

determining fair values of investments without a ready market were provided in Lesson 1. Generally these bases can also be applied to contracts and include the selling prices of similar investments and the expected cash flow discounted at a rate commensurate with the risk involved. Often the insurance company can provide an appropriate fair value. In these instances, the authors suggest the auditor also inquire as to the method used by the insurance company to determine the fair value. AEBP, Paragraph 11.145f(i), indicates that the auditor may assess the appropriateness and reasonableness of the model and assumptions used. To do this, the auditor may use a specialist or independently calculate the value for comparison.

ERISA Section 103(a)(3)(C) Audit. In an ERISA Section 103(a)(3)(C) audit, formerly referred to as an *ERISA-permitted limited scope audit* (or *DOL limited-scope audit*), no procedures are applied to information on contracts maintained as investment vehicles (separate and pooled accounts, DA and IPG contracts, and GICs), and related transactions, that are prepared and certified to as both complete *and* accurate by the qualified institution. In an ERISA Section 103(a)(3)(C) audit, the auditor's responsibilities for contracts with insurance contracts covered by the ERISA Section 103(a)(3)(C) exception are the same as those for other investments.

Additional Procedures for Deposit Administration (DA) Contracts

Deposit administration (DA) contracts guarantee a rate of interest and a rate at which benefit annuities may be purchased with funds from the account. A DA contract may be a general account, in which the assets in the contract are commingled with the insurance company's other assets, or it may be an individual or pooled separate account.

Auditing procedures specific to DA accounts in addition to the basic auditing procedures for all types of insurance contracts discussed at the beginning of this section include evaluating the reasonableness of interest credited to the account in relation to any minimum rate guaranteed in the contract. AEBP, Paragraph 11.61, states that experience-rated interest credits or dividends are paid at the insurance company's discretion based on the company's internal records of an experience fund related to the DA contract. The plan has no right to demand an accounting of the experience fund or credits, and the auditor has no obligation to audit the fund.

The auditor may also compare rates paid for any annuities purchased from the contract fund with rates guaranteed in the contract. He or she may also test any benefits paid from the fund; this can be done as part of the test of benefit payments discussed later in this lesson.

Additional Procedures for Immediate Participation Guarantee (IPG) Contracts

Immediate participation guarantee (IPG) contracts may be a general account or a separate account and are similar to DA contracts described above, except that IPGs do not guarantee a minimum interest rate or a rate for purchasing annuities from the fund. Those rates are based on the insurance company's actual investment experience or annuity experience rate at the time interest is credited to the account or annuities are purchased.

Because IPG contracts do not specify an interest rate, in addition to the basic procedures, the auditor may refer to investment yield information provided to the plan by the insurance company to test the reasonableness of interest credited to the IPG contract. AEBP, Paragraph 11.145b, indicates that an evaluation of the yield information from the insurance company is usually all that the auditor needs to do if the yield appears reasonable. However, if the income does not appear reasonable, the auditor may ask the insurance company whether the method used to calculate investment return for purposes of crediting it to the contract complies with the method specified in the contract. If necessary, the auditor may consider arranging for the insurance company's auditor to apply agreed-upon procedures to the insurance company's determination of investment income credited to the contract and issue a report in accordance with AT-C 215, *Agreed-Upon Procedures Engagements*.

The rates paid for any annuities purchased from the contract's funds may be traced to the rates in the annuity contracts, and any benefits paid from the contract may be tested as part of auditing benefit payments.

Additional Procedures for Guaranteed Investment Contracts (GIC)

A guaranteed investment contract normally is a general account that guarantees a rate of return on the principal invested. Various types of GICs may have multiple maturities and interest rates, may have floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the insurance company's

discretion. Thus, in addition to the basic procedures, the auditor may evaluate the reasonableness of interest credited to the contract in relation to any minimum guaranteed interest rate stated in the contract.

Additional Procedures for Synthetic GICs

In synthetic GICs, the assets underlying the contract are placed in a trust and are owned by the plan rather than the contract issuer. The plan purchases a "wrapper" contract from a third party (often the same entity that issues the investment contract), which protects the plan from the risk of declines in the market value and cash flow potential of the covered assets. The underlying assets and the "wrapper" contract are to be separately valued and included in the "Schedule of Assets (Held at End of Year)" in the Form 5500. Thus, in addition to the basic procedures, the auditor may also test the fair values of the underlying assets and the value of the "wrapper" contract to be disclosed in the supplemental schedule.

Additional Procedures for Separate-separate Accounts

Separate-separate accounts are similar to discretionary trust accounts. The separate account pertains to a single plan. The account's investment assets are owned and managed by the insurance company, but they are separately identified within the separate account and are not commingled with the insurance company's other assets.

Audit procedures include testing transactions and testing any benefits paid directly from the account (this can be done as part of the test of benefit payments). In addition, the audit procedures for discretionary trusts are also appropriate for separate-separate accounts. That is, the auditor may read audited financial statements of the separate account if they are available, taking into account the reputation of the audit firm. If they are not available, or do not cover a period sufficiently recent to meet the auditor's objectives, he or she may obtain and use a SOC 1 report on the insurance company's controls over the separate account's activities (including controls over the determination of unit values and over share transactions), or apply procedures at the insurance company if a SOC 1 report cannot be obtained.

Additional Procedures for Pooled Separate Accounts

Pooled separate accounts are similar to common/collective trusts, except that pooled separate accounts are at insurance companies instead of financial institutions. Unlike a separate-separate account, a pooled separate account pertains to two or more unrelated plans. Each participating plan's units of participation represent rights to the separate account assets. (The assets are the insurance company's property but are not commingled with its other assets.)

Audit procedures include testing transactions in units of participation and testing any benefits paid directly from the account (this can be done as part of the test of benefit payments). In addition, pooled separate accounts may be audited similarly to common/collective trusts. That is, the auditor may be able to use the audited financial statements of the separate account or may have to perform alternative procedures if audited financial statements of the account are not available.

CONSIDERATIONS RELATED TO PARTICIPANT DATA

Participant data includes information such as age, sex, hire date, salary, service years, hours worked in the current period, etc. It should be audited because it is used in determining material amounts presented in the financial statements. This section also discusses audit procedures for employee contributions since such contributions are usually made by payroll deductions and may be conveniently audited along with other payroll data.

Participant data is used in accruing benefits in a defined benefit pension plan. For example, a defined benefit plan may provide for benefit accruals as a specified percentage of a participant's salary for each year of employment. (Determining accumulated plan benefits is a preliminary step to determining the actuarial present value of accumulated plan benefits reported in defined benefit plan financial statements.)

A defined contribution plan may provide for an employer's contribution equal to a specified percentage of each participant's salary. The total of all such determined contributions would be reported in the plan's financial statements.

Participant data is often used in determining health and welfare benefits. For example, the number of dependents may affect the participant's contribution for health insurance, age may affect the participant's contribution for life insurance, and hire date may affect vacation accruals.

In addition to its use in determining amounts presented in the plan financial statements, participant data is used in determining the individual participant account balances that ERISA requires defined contribution plans to maintain. Such account balances may be used to allocate total plan contributions, income and losses, and forfeitures to individual participants and record individual participant activity such as a participant's own contributions.

If the plan auditor also audits the plan sponsor's (employer's) financial statements, the plan auditor may be able to coordinate with, and rely on, work performed during the plan sponsor's audit. This is especially helpful as it relates to pension demographic data and health and welfare benefit plan participant data (including claims data), and postretirement benefit obligation actuarial valuations. For example, if the plan sponsor's payroll system was evaluated as effective, and was tested during the plan sponsor's audit by tracing information to the original records, such as personnel files, the plan auditor could trace participant data to the payroll records previously tested rather than original records. If another auditor audits the plan sponsor (especially for multiemployer plans), the plan auditor may be able to arrange for the other auditor (or auditors) to apply agreed-upon procedures during the audit of the employer's payroll costs and to issue a report in accordance with AT-C 215, *Agreed-Upon Procedures Engagements*.

If the auditor tested participant data in the prior year, consideration may be given to carrying forward this work to the current year audit and each subsequent audit. For example, demographic data such as plan participant name, hire date, birth date, and sex would only need to be tested for current year additions and deletions. If the plan auditor's firm also audits the plan sponsor's financial statements, participant payroll data could be updated each year by reviewing payroll journals rather than original records, if tested by the auditor, as described above.

The plan auditor needs to keep in mind that if the benefit information date for a defined benefit pension plan is as of the beginning of the plan year, the participant data audited would also need to be as of the beginning of the plan year. This date corresponds to the plan sponsor's prior year end. Thus, the plan auditor may be able to refer to the prior year's audit workpapers of the plan sponsor.

Basic Auditing Procedures for Participant Data

The first step in auditing participant data is to determine by reviewing the plan documents (and collective bargaining agreements for multiemployer plans) what data is pertinent and thus will have to be tested. For example, service years or hours would be relevant if the plan accrues benefits or determines eligibility for benefits based on the number of service years or hours. This preliminary step can be performed during the review of minutes, plan documents, contracts, and agreements at the start of the audit.

The auditor may test the employer's payroll journal and, if considered necessary, trace gross pay postings to the employer's general ledger. He or she may test payroll data for one or more payroll periods for a number of participants by tracing payroll data to and from participants' earnings records; tracing pay rates to authorizations or union contracts; tracing hours worked to time cards, production records, etc.; and recalculating earnings for the period. Demographic data, such as birth and hire dates, sex, termination dates, number of dependents, investment election, etc., may be traced to personnel files. Sampling is likely and efficient in testing payroll transactions and demographic data.

Employee Contributions. If the plan document calls for voluntary or mandatory employee contributions, auditing procedures include tracing the basis for the employee contribution to the plan document, collective bargaining agreement, or employee authorization, recomputing the tested individuals' contribution deduction in the payroll journal when testing the payroll journal, and tracing contributions to and from the individual participant accounts. If the plan provides for participant-directed investment programs, the auditor should determine that the tested individuals' contribution was allocated in accordance with the individuals' investment option(s) elections. The auditor may also trace contributions to the plan's cash receipts or trustees reports and to the recording in the plan's general ledger and records of employee contributions received.

Many defined contribution plans have an automatic enrollment feature so that eligible employees are automatically enrolled in the plan at a specific pretax contribution percentage, unless they take the appropriate action to opt out. For those plans, auditors need to understand the enrollment process and the opt out action, and be aware of the rules surrounding automatic enrollment. In addition, defined contribution plans may also provide for an automatic deferral percentage increase on a specified date, such as the participant's anniversary date, unless the participant declines the increase. If so, it is important for the auditor to understand the process to be sure plan provisions are being followed. For employees that opt out, the auditor may test that any amounts due to be refunded were paid back to the participant in the correct amount and in a timely manner.

As noted above, auditors generally recompute deferrals for a sample of participants when testing contributions. It is important to understand the definition of compensation specified by the plan document when performing those procedures. Certain elements, such as bonus, overtime, severance pay, or fringe benefits may be expressly included or excluded from compensation according to plan provisions. The Note at AEBP, Paragraph 5.247 states that misapplication of eligible compensation is one of the most common operational errors for defined contribution plans. In addition to being an operational error, use of the incorrect definition of compensation may result in a material misstatement of the financial statements as these issues are often systemic in nature. Events that may increase the risk of the incorrect definition of compensation being applied include frequent use of manual checks or off-cycle payroll items, changes in the payroll system, mergers with other plans, and turnover in the human resources and payroll departments. The auditor may consider confirming employee contributions with the employees.

Finally, the auditor should determine that all employee contributions attributable to the period under audit have been received by the plan or accrued as a receivable. Many employers withhold employee contributions from the employee's payroll check and remit the total contribution for all employees to the plan. DOL Regulation 2510.3-102 requires employers to remit the employee contributions to the plan *as soon as they can be reasonably segregated* from the employer's general assets.

DOL Reg. 2510.3-102 provides a safe harbor for plans with fewer than 100 participants at the beginning of the plan year and applies to participant loan repayments. Under the safe harbor, as long as amounts are deposited with a plan no later than the seventh business day after the date on which the amounts were either received by the employer or such amounts would otherwise have been payable to the participant in cash, the amounts are considered contributed or repaid to the plan on the earliest date such amounts could reasonably be segregated from the employer's general assets. The safe harbor is optional for small plans and no safe harbor exists at this time for large plans (those with 100 or more participants). However, the DOL may consider a safe harbor for large plans in the future.

Although under DOL Reg. 2510.3-102, the general rule is that amounts a participant or beneficiary pays to an employer or amounts that a participant has withheld from his wages by an employer become plan assets on the earliest date on which those contributions or repayments can reasonably be segregated from the employer's general assets, the DOL regulation includes the following maximum time limits for transmitting funds to an employee benefit plan:

- For most pension benefit plans, including defined contribution and defined benefit retirement plans, amounts must be transmitted to the plan no later than "the 15th business day of the month following the month in which the participant contribution or participant loan repayment amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages)."

- For SIMPLE plans with SIMPLE IRAs, amounts must be transmitted to the plan no later than the 30th calendar day after the month in which the amounts would otherwise have been payable in cash to the participant.

- For welfare benefit plans, the date can be no later than 90 days from when the amounts are received by the employer or when such amounts would otherwise have been payable in cash to the participant.

The regulation includes provisions by which pension plans may receive an extension of the maximum time period in certain circumstances.

This regulation continues to be an area of concern for the DOL. EBSA officials stress that employee contributions are due to the plan "as soon as they can be reasonably segregated" from the employer's general assets. EBSA officials have suggested auditors compare the timeliness of the employer's remittance of participant contributions to the plan to the timeliness of the employer's remittance of FICA and FIT withholdings to appropriate sources.

If the employer does not comply with the regulation, such occurrences are considered a prohibited transaction, regardless of materiality. In addition, EBSA officials have stated that a prohibited transaction would occur if the employer normally remits the participant contributions to the plan within five days of being withheld (demonstrating the time the contributions can be reasonably segregated), but one time during the year remits the contributions 15 days after being withheld. The 15 and 90 day maximum periods for remittance are not safe harbors for large plans. In other words, plan sponsors (and auditors) cannot assume contributions are in compliance with the regulations so long as they are remitted prior to the 15 or 90 day limit. The defining characteristic is the earliest date on which contributions can reasonably be segregated from the employer's general assets. Plans are required to report all participant contributions that were not transmitted to the plan in accordance with the time period required by DOL Reg. 2510.3-102 on line 4a to Schedule H or I of Form 5500.

Determining when a contribution can be reasonably segregated is a matter of professional judgment. The nonauthoritative guidance at AICPA Technical Question and Answer at Q&A 6932.02 provides guidance on considering whether remittances are delinquent. According to the Technical Question and Answer, auditors should gain an understanding of the employer's process for remitting employee contributions. Determining when an employer is able to reasonably segregate employee contributions from its general assets depends on the facts and circumstances surrounding the plan. For instance, employers with complex corporate structures and payroll processes may require more time to segregate and remit employee contributions than other employers with simpler structures and processes. Therefore, determining what is reasonable will vary from plan to plan. Auditors should also consider whether the employer has experienced any changes that may affect the process of segregating and remitting employee contributions (such as a change in payroll processing or the hiring of a new service provider). If the auditor encounters any instances during the plan year in which the employer has deviated from its established process for remitting employee contributions, the auditor needs to obtain a further understanding of that deviation and consider whether it resulted in a violation of DOL regulations. Plan sponsors may wish to consult with legal counsel if they have questions regarding application of this DOL regulation.

Considering the emphasis by the EBSA regarding this issue, the auditor may consider applying the following procedures in addition to those discussed previously to address the possibility of untimely remittance of participant contributions:

- Determine whether the plan is eligible for the safe harbor for the transfer of participant contributions and has elected to comply with that provision.
- Make inquiries of plan management regarding whether participant contributions are remitted to the plan on a timely basis as required by the DOL regulations and whether plan management has policies and procedures in place to ensure the timely remittance of contributions.
- Request that plan management prepare a schedule of participant contributions for the year under audit. The schedule would include the date contributions were either withheld or received by the employer and the date the contributions were remitted to the plan. The auditor can then test the schedule for completeness and accuracy. The auditor would also review the listing of contributions and inquire about any contribution(s) that appear(s) to be in violation of DOL regulations.
- If late remittances are discovered, either through inquiry of plan management or the analysis of participant contributions for the year, the auditor should consider performing additional procedures to ensure all instances of late remittances are properly identified. Additional procedures may include requesting that the plan sponsor analyze all payroll remittances for the period to identify other later remittances. The auditor then reviews the results of the sponsor's additional analysis and considers further testing as necessary. The auditor should also consider whether late remittances are properly reported on the plan's Form 5500.

Withdrawals, Terminations, and Forfeitures. Withdrawals (including hardship withdrawals), terminations, and forfeitures may be tested by tracing terminated or withdrawing participants to and from the employer's payroll records and the plan's termination or withdrawal records. Support such as termination notices and withdrawal requests may be examined. Income tax withholding may also be tested. The withdrawal or forfeiture amounts for individual participants may be recalculated. Payments for withdrawals may be traced to cash disbursements records and to information on annuity purchases tested in the audit of insurance contracts. The disposition of forfeitures needs to be determined, that is, traced to the record of forfeited amounts and either reallocated to remaining participants or returned to the plan sponsor in accordance with plan provisions, board resolutions of the plan sponsor, and authorizations of the plan's trustees or administrative or investment committee.

Tests of withdrawals and terminations can be applied to the same selection of payroll transactions tested in the employer's payroll records, but that more items may have to be tested if there are insufficient (e.g., fewer than five) withdrawals and terminations in the individual payroll transactions selected.

Additional Procedures for Defined Benefit Pension and Health and Welfare Plan Participant Data

If the plan is a defined benefit plan for which an actuarial determination of benefit obligations is obtained, the information tested needs to be traced to the participant data given to the plan actuary. Information about selected participants also needs to be traced from the actuary's report or from a confirmation letter from the actuary to the employer's personnel records.

Additional Procedures for Cash Balance Plans. If the plan is a cash balance plan, the auditor needs to perform additional procedures relative to the participants' hypothetical accounts. A cash balance plan maintains a hypothetical account for each participant which is credited with a contribution credit based on a prescribed employer contribution rate and an interest credit as specified in the plan. The auditor needs to obtain an understanding of the plan's provisions for crediting participant accounts, including the interest rate used in the current year and how contribution credits are determined. If the contribution credit is based on participant earnings, the auditor may select a sample of participants and test the earnings used to determine their contribution credit. The auditor may also ensure any factor used for the contribution credit and the interest rate used in the current year's interest credit comply with the provisions of the plan.

Additional Procedures for Defined Contribution Plan Participant Data

The employer contribution to a defined contribution plan may be based on individual participant data such as salary in a 401(k) plan and some health and welfare benefit plans. The auditor may test such an employer contribution by obtaining a schedule of the employer contribution by participant, checking its clerical accuracy, recomputing the employer contribution for participants selected in the test of payroll data based on the contribution rate specified in the plan and the relevant participant data, and relating the total contribution for all participants to the total employer contribution income recorded by the plan.

If the plan provides for participant-directed investment programs, the auditor also determines that the employer's contribution was allocated to the investment option(s) selected by individual participants. Many third-party service providers now maintain enrollment and allocation forms, or allow participants to enroll or change their investment allocations or contribution amounts electronically, such as by the Internet or an Intranet. These services leave the plan sponsor no documentation of the enrollment or changes. In such instances, the auditor may choose to obtain and read a SOC 1 report for the service provider. If a SOC 1 report is not available, the auditor may consider requesting copies of the enrollment or fund election forms from the service provider, if available. If the enrollment or allocation changes are made electronically, the auditor may consider confirming the information directly with the participant or performing appropriate procedures to test internal controls at the service provider's location.

When testing participant data and employer and employee contributions for selected individuals, the auditor should determine that ERISA's annual contribution limits to a defined contribution retirement plan are not exceeded. ERISA limits the annual amount of an employee's elective deferral, and it limits the total annual contribution from the employer, employee, and forfeitures to the lesser of 100% of the employee's compensation or $61,000 and $58,000 for 2022 and 2021, respectively. Also, when testing hardship withdrawals from a 401(k) arrangement, the auditor needs to give consideration to, and examine support for, adherence to the relevant requirements, including indication of the financial need for the hardship withdrawal, that only the participant's elective deferral was withdrawn

(and not any plan earnings), income tax withholding, and, if applicable, that the participant made no voluntary contributions or elective deferrals during the six months following the withdrawal.

Individual participant account balances do not appear in the plan financial statements. However, AEBP, Paragraph 5.214, includes a list of procedures the auditor may apply to individual participant accounts (in addition to the plan level). Thus, the auditor may test the allocation of employer and participant contributions, plan income, gains and losses, administrative expenses, and forfeitures to individual accounts, agree or reconcile the sum of individual account balances to the net assets available for benefits and review the account balances for reasonableness. The auditor may be able to rely on a SOC 1 report of the plan's recordkeeper, if one is available and it addresses participant allocations, to *reduce* the amount of substantive testing necessary when testing allocations to participant accounts. These procedures should be performed even for an ERISA Section 103(a)(3)(C) audit. The auditor may also determine that all plan participants have an individual account balance, that is, that the number of account balances agrees with, or reconciles to, the number of participants.

Many defined contribution plans allow participants to execute transactions on a daily or weekly basis. If the plan assets are publicly traded and valued daily, such as many mutual funds, the recording and testing of the daily valuations used in the transactions is fairly straightforward. However, if the plan assets include hard to value investments, such as limited partnerships, the auditor should determine how the assets are valued and the frequency of the valuations when testing participant transactions. If the assets are incorrectly valued, the participant's account could be misstated, resulting in potential DOL penalties.

Additional Procedures for Multiemployer Plans

Generally, the plan administrator in a multiemployer plan is the record keeper for participant census data, while the underlying records may be maintained by the plan administrator, participating employers or union, or an administrating entity. According to AEBP, Paragraph 9.219, to obtain sufficient appropriate audit evidence that the participant data is adequate and complete, the auditor should test an adequate number of participating employers each year.

According to the Note at AEBP, Paragraph 9.215, the auditor may utilize the multiemployer plan's *payroll compliance audit*, if available, for the purpose of testing participant census data. The term payroll compliance audit does not refer to an audit in accordance with AU-C 935, *Compliance Audits*, or a financial statement audit, but to the procedures performed at the participating employers regarding participant census data. If the plan auditor obtains audit evidence from the work performed by the payroll compliance audit function, the auditor should reperform some of the payroll compliance audit procedures.

One or more of the following procedures may provide audit evidence to obtain reasonable assurance in forming a conclusion about participant data:

a. If the participant data on which contributions and/or actuarially determined amounts are based is maintained by the plan administrator, the data can be verified by direct confirmation with the participant, or by comparison with duplicate participant data records maintained by the participating employers or union, if available.

b. If periodic visits to employers are made by a representative of the plan to test participant and other related data, these procedures may be reviewed for thoroughness and tested.

c. When available, agreed-upon procedures reports may be obtained from the employer's auditor describing the procedures applied to the participant data and the findings. Those procedures may usually include tests to determine that all appropriate employees and payments are properly reported to the plan. The plan auditor may also instruct the employer's auditor to apply additional procedures the plan auditor considers necessary in the circumstances. (Involvement by the plan auditor in the initial planning for the agreed-upon procedures will usually negate the need for additional procedures and ensure that the agreed-upon procedures meet the needs of the auditor.)

The plan auditor may engage other auditors to test participant data. In these instances, the plan auditor normally provides the other auditor with a program detailing the procedures to be performed, the number of selections to be

tested, materiality (when applicable), and other necessary information to complete the tests. (If complete information is maintained by the plan administrator, the plan auditor may select the items to be tested and forward the selections to the other auditor.) In these instances, the other auditor generally provides the plan auditor with the workpapers and no report is issued.

There are also other procedures the auditor may consider performing for multiemployer plans, including:

a. Comparing the employers' contribution reports to the participants' earnings records.

b. Reviewing the employee information in the participants' records to verify that participants were properly included in or excluded from the employers' contribution reports.

c. If the plan administrator does not keep participant information, inquiring about the procedures used to obtain the data and determining the adequacy of those procedures.

Procedures Performed by Other Auditors. The plan auditor needs to determine early in the planning process if other auditors will be needed to perform certain audit procedures at participating employers locations. AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides guidance when another auditor audits a division, branch, or subsidiary that is consolidated (either by a full consolidation or by the equity method) into the financial statements audited by the group auditor. AU-C 600 does not apply to engagements where another auditor performs procedures on financial statements that are not group financial statements. Therefore, if another auditor was engaged to perform procedures such as those in item c. above (related to agreed-upon procedures) or the paragraph below that (related to engaging other auditors to test participant data), AU-C 600 would not apply, and technically the requirements set forth below are not mandatory. However, the authors recommend complying with the requirements of AU-C 600 whenever the work of another auditor is used.

According to AU-C 600.22, when a group auditor makes use of the work of another auditor, the group auditor is required to obtain an understanding of the following:

a. Whether the component auditor understands and will comply with ethical requirements, in particular, independence.

b. The component auditor's professional competence.

The group auditor is also required to request communication from the component auditor indicating that he or she has complied with relevant ethical requirements, including independence and professional competence.

Despite the lack of applicability of AU-C 600 to other auditors who perform procedures on financial statements that are not group financial statements, it is doubtful that the auditor can justify not assuming full responsibility for the work of the other auditor. That is, the other auditor is essentially a temporary member of the engagement team. Accordingly, as a team member, the other auditor would be subject to quality control requirements even though AU-C 600 technically does not apply. Therefore, the firm should have a quality control procedure that requires the independence of another auditor to be confirmed any time another auditor is used, regardless of that use. The confirmation should also consider the other auditor's integrity (for example, based on the other auditor's professional reputation). In addition, the requirements of ET 1.150.040, *Use of a Third-Party Service Provider*, of the AICPA's *Code of Professional Conduct* may apply.

The plan auditor may be able to work with the plan administrator and develop a rotation plan to avoid performing certain audit tests at each participating employer every year. Several factors affect the decision, including the number of employers involved in the plan, the number of participants at each location, whether the plan periodically visits employers to test data, and the prior year results. In a rotation plan, testing is performed only at selected locations each year, with every location being tested at least once every two or more years. While some plans may by design require such audits more often than the auditor considers necessary, the auditor needs to use professional judgment to determine whether a rotation plan meets the minimum audit requirement. The rotation plan, if implemented, needs to be documented or updated during planning.

If the procedure in item c. above (related to agreed-upon procedures) will be followed, the other auditors will generally be engaged by the plan and/or the employers. (This is not to say that the plan auditor cannot recommend an auditor if requested or assist in engaging the other auditor.) The auditor of each employer is commonly used to perform the procedures based on his or her familiarity with the employer.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

18. What type of insurance contract guarantees a rate of interest and a rate at which benefit annuities can be purchased with funds from the account?

    a. Deposit administration (DA) contract.

    b. Guaranteed investment contract (GIC).

    c. Immediate participation guarantee (IPG) contract.

    d. Synthetic GIC.

19. Which of the following statements best describes participant data and how that data may be used by employee benefit plans?

    a. Participant data cannot be audited because of privacy concerns and related laws.

    b. Participant data is often used to determine benefit amounts in different types of plans.

    c. Participant demographic data is subject to change so it must be tested anew every year.

    d. Participant data should be accurate as of the end of the plan year.

20. What is the maximum time limit by which an employer must transmit funds to a welfare benefit plan?

    a. 90 days.

    b. The 15th business day of the next month.

    c. The 30th calendar day of the next month.

    d. The date funds can be reasonably segregated from the employer's general assets.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

18. What type of insurance contract guarantees a rate of interest and a rate at which benefit annuities can be purchased with funds from the account? **(Page 243)**

    a. **Deposit administration (DA) contract. [This answer is correct. DA contracts guarantee a rate of interest and a rate at which benefit annuities may be purchased with funds from the account. A DA contract may be a general account in which the assets in the contract are commingled with the insurance company's other assets, or it may be an individual or pooled separate account.]**

    b. Guaranteed investment contract (GIC). [This answer is incorrect. A GIC normally is a general account that guarantees a rate of return on the principal invested. Various types of GICs may have multiple maturities and interest rates, may have floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the insurance company's discretion. This is different from the type of contract described above.]

    c. Immediate participation guarantee (IPG) contract. [This answer is incorrect. IPG contracts may be a general account or a separate account. They do *not* guarantee a minimum interest rate or a rate for purchasing annuities from the fund, unlike the type of contract described above. In an IPG contract, those rates are based on the insurance company's actual investment experience or annuity experience rate at the time interest is credited to the account or annuities are purchased.]

    d. Synthetic GIC. [This answer is incorrect. In synthetic GICs, the assets underlying the contract are placed in a trust and are owned by the plan rather than the contract issuer. The plan purchases a "wrapper" contract from a third party (often the same entity that issues the investment contract), which protects the plan from the risk of declines in the market value and cash flow potential of the covered assets. This is different from the type of contract described above.]

19. Which of the following statements best describes participant data and how that data may be used by employee benefit plans? **(Page 244)**

    a. Participant data cannot be audited because of privacy concerns and related laws. [This answer is incorrect. Participant data includes information such as age, sex, hire date, salary, service years, hours worked in the current period, etc. It *should be audited* because it is used in determining material amounts presented in the financial statements.]

    b. **Participant data is often used to determine benefit amounts in different types of plans. [This answer is correct. Participant data (e.g., salary or years of service) is used in accruing benefits in a defined benefit pension plan. A defined contribution plan may provide for an employer's contribution equal to a specified percentage of each participant's salary. Finally, participant data (e.g., age, number of dependents, and hire date) is often used in determining health and welfare benefits.]**

    c. Participant demographic data is subject to change so it must be tested anew every year. [This answer is incorrect. If the auditor tested participant data in the prior year, consideration may be given to carrying forward this work to the current year audit and each subsequent audit. For example, demographic data such as plan participant name, hire date, birth date, and sex would only need to be tested for current year additions and deletions.]

    d. Participant data should be accurate as of the end of the plan year. [This answer is incorrect. If the benefit information date for a defined benefit pension plan is as of the beginning of the plan year, the participant data audited would also need to be as of the beginning of the plan year. This date corresponds to the plan sponsor's year end.]

20. What is the maximum time limit by which an employer must transmit funds to a welfare benefit plan? **(Page 246)**

    a. **90 days. [This answer is correct. According to DOL Reg. 2510.3-102, for welfare benefit plans, the date of transmission can be no later than 90 days from when the amounts are received by the employer or when such amounts would otherwise have been payable in cash to the participant.]**

    b. The 15th business day of the next month. [This answer is incorrect. For most pension benefit plans (not welfare benefit plans), including defined contribution and defined benefit retirement plans, amounts must be transmitted to the plan no later than "the 15th business day of the month following the month in which the participant contribution or participant loan repayment amounts are received by the employer or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash.]

    c. The 30th calendar day of the next month. [This answer is incorrect. For SIMPLE plans with SIMPLE IRAs (not welfare benefit plans), amounts must be transmitted to the plan no later than the 30th calendar day after the month in which the amounts would otherwise have been payable in cash to the participant.]

    d. The date funds can be reasonably segregated from the employer's general assets. [This answer is incorrect. Under DOL Reg. 2510.3-102, although the general rule is that amounts a participant or beneficiary pays to an employer or amounts that a participant has withheld from his wages by an employer become plan assets on the earliest date on which those contributions or repayments can reasonably be segregated from the employer's general assets, the DOL also includes maximum time limits for transmitting funds to an employee benefit plan, including welfare benefit plans. Therefore, there is a better answer to this question.]

A PLAN'S BENEFIT PAYMENTS

Benefit payments may be paid directly from plan assets or by the purchase of annuity contracts with insurance companies. The actual payments may be made by the bank or insurance company that holds the plan assets, upon the plan administrator's authorization. For defined contribution retirement plans, benefit payments include withdrawals of employee voluntary after-tax contributions and payments of individual participants' account balances to terminating employees. All these types of payments are reported as deductions in the statement of changes in net assets available for benefits.

Disbursements for benefit payments do not include loans to participants. Employee benefit plans that have individual participant accounts are allowed to provide for loans to participants if, among other things, the loan is adequately secured. To meet this requirement, a plan may limit the amount of the loan to a percentage of a participant's vested account balance. Loans to plan participants are reported as plan assets (loans receivable) in the statement of net assets available for benefits rather than as deductions in the statement of changes in net assets available for benefits. Such loans are audited as described later in this lesson.

Audit Procedures

Audit procedures for benefit payments start with obtaining a schedule of benefit payments and tracing its totals to the plan's general ledger or trial balance and reports of trustees who made the payments and to the plan financial statements. Analytical procedures can be applied such as considering the reasonableness of current and prior-year payment amounts in relation to the number of people who received payments and investigating any unusual fluctuations.

The primary audit procedures for benefit payments involve testing payments to selected recipients for eligibility and accuracy of method and amount of payment. Sampling in such tests is moderately likely, depending on the volume of payments. According to the Notes at AEBP, Paragraphs 5.277 and 7.199, when auditing a terminating plan, auditors may consider performing additional benefit payment testing during the period the termination benefits are paid because of the significance of the payments.

For selected payments, the auditor examines approvals and supporting documents, such as an approved benefit election form for a retiring participant, a withdrawal request or employment termination notice, a statement from a health provider like a doctor's bill, or a death certificate supporting a death benefit paid. The auditor tests the participant's eligibility to receive the benefit under the plan's provisions by examining evidence of age, years or hours of service, etc. He recomputes the benefit amount based on the participant's eligibility and plan provisions, taking into account vesting and forfeited amounts, and traces the payment to cash disbursements or the trustee's report of payments. For defined contribution retirement plans, or cash balance plans, the amount should also be traced to the individual participant's account. The auditor may also trace amounts from trustee reports to the plan's records and supporting documents. The auditor may test receipt of benefit payments by examining supporting documents, such as canceled checks or images of canceled checks, or by confirming payments directly with participants or beneficiaries. When applicable, signatures on cancelled checks, etc., may be compared to cash disbursement or other records.

Termination of Benefit Payments. An important auditing consideration is the plan's procedures for stopping payments at the appropriate time, for example, at the recipient's death. An audit procedure that may disclose that payments are being made to deceased persons is comparison of the signature on canceled checks with that on the application for benefits. Also, the auditor can investigate long-outstanding checks for possible indication that the intended recipient has died. Finally, the auditor needs to check that when death benefit payments are made, the deceased's name is removed from the benefit rolls. The auditor may also consider confirming payments with participants or their beneficiaries, depending on the result of these procedures.

Service Organizations. If an outside service organization such as a bank, insurance company, or third-party administrator determines or makes benefit distributions, the plan auditor may have to obtain a SOC 1 report on the organization's controls or apply auditing procedures at the service organization. The auditor also considers testing the accuracy of the claims eligibility data used by the claims administrator to pay or reject claims. Since an ERISA

Section 103(a)(3)(C) audit only limits the scope relative to investments and related transactions (and not benefits paid), this procedure would apply even in an ERISA Section 103(a)(3)(C) audit.

ERISA and Tax Requirements

The auditor needs to keep in mind relevant ERISA and tax requirements to be tested when testing benefit payments. For example, IRC Sec. 401(a)(11) requires retirement plans that provide benefits in the form of an annuity to provide a joint and survivor annuity unless the participant, with spousal consent, elects otherwise. Also, a qualified domestic relations order (QDRO) may be issued by a state court as part of a divorce settlement specifying that a former spouse is to receive all or part of the participant's benefits payable. In such a case, the former spouse must consent to waiving the joint and survivor benefit form of payment. The auditor needs to check for compliance with these requirements and examine consent forms when examining benefit election documents. Income tax withholding also needs to be tested. Finally, the maximum benefit paid from a qualified defined benefit plan should not exceed the IRC limit.

Locating Missing Participants. The auditor also needs to be aware of the plan administrator's fiduciary duty to locate missing participants or beneficiaries so that applicable benefit payments may be made. Title 1 of ERISA does not provide specific procedures fiduciaries must follow to locate missing participants, but the fiduciary must use reasonable efforts to locate the participant such as sending a letter to the last known address. In addition, the plan may contact one or more government agencies, such as the Social Security Administration, the IRS, and the PBGC, for assistance in locating the missing participant. If the auditor notices payments not being made because of missing participants or if this risk was identified during the risk assessment process, he or she needs to inquire about the efforts made to locate them. DOL Field Assistance Bulletin (FAB) 2014-01 provides guidance to plan fiduciaries related to locating missing participants in terminated defined contribution plans subject to ERISA. FAB 2014-01 is available on Checkpoint and on the EBSA website at **www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2014-01**. Additional guidance on procedures for locating missing participants is included in *PPC's Guide to Small Employer Retirement Plans*, which may be ordered by calling Thomson Reuters at (800) 431-9025 or by accessing **tax.thomsonreuters.com**.

Rollover Distributions

Rollover distributions are transfers from a qualified plan to another qualified plan or to an individual retirement account. If the plan allows for rollover distributions, the auditor should verify that the rollover was made according to the provisions of the plan, and the rollover account is in the participant's or beneficiary's name. Generally, distributions from a qualified retirement plan may be rolled over to *any* other tax-favored retirement plan, such as a Section 403(b) annuity plan. Further, after-tax contributions can be included in an eligible rollover distribution to a qualified plan or an IRA.

A PLAN'S BENEFIT OBLIGATIONS

Lesson 1 discussed the accounting standards for defined benefit plan obligations. As discussed, the actuarial present value of accumulated plan benefits is determined by first calculating accrued benefit obligations and then applying actuarial assumptions and methods to account for the time value of money and the probability of payment. The plan actuary usually computes both the accumulated plan benefits from participant census data supplied by the plan administrator and the actuarial present value of accumulated plan benefits.

Thus, the actuarial present value of accumulated plan benefits is audited by reviewing the actuary's work. Certain planning considerations are necessary when using an actuary's work. (Such procedures include considering the actuary's qualifications and relation to the plan, understanding the nature of the work, and testing data provided to the actuary.) This section discusses additional audit procedures to test:

a. Actuarial determinations for defined benefit pension plan obligations.

b. Benefit obligations for health and welfare plans.

This section does not apply to defined contribution plans because such plans limit benefits to their net assets and do not have a separately determined benefit obligation.

Defined Benefit Pension Plan Obligations

The main audit procedure for the actuarially determined plan obligations of a defined benefit pension plan is to obtain a confirmation from the plan actuary. The actuary may provide a copy of the actuarial report as part of the response to the confirmation request. Or, the auditor may use a report provided by the actuary to the client and then determine that the information obtained from the client agrees with or reconciles to the information in the confirmation or report received directly from the actuary. (Electronic confirmations are discussed later in this lesson.

The auditor may determine the completeness of the census data the actuary used in the actuarial determination by reconciling the aggregate census data (number of participants and total compensation) from the employer's records tested to the actuary's report and confirmation.

The auditor may determine that only eligible employees are included in the census data by comparing the number of participants and the ratio of participants to total employees for the current and prior year and investigating any unusual fluctuations.

It is important to determine that the actuary used the appropriate plan provisions in making the actuarial determination. Thus, the auditor may compare the most recent applicable plan provisions and amendments to those the actuary used in the actuarial determination and summarized in the actuary's report or confirmation.

The auditor needs to be aware that the plan may be operating in accordance with changes required by recent laws and regulations (and the actuarial valuation may reflect such changes), but that the plan may not have been formally amended for such changes. Thus, the auditor may not be able to just compare formal plan provisions and amendments, but may also have to consider any resolutions of the plan's administrative board that affect the valuation.

After considering the completeness of census data and appropriateness of the plan provisions the actuary used in a defined benefit pension plan actuarial determination, the auditor should consider whether the actuary's assumptions and methods conform to FASB ASC 960 and ERISA requirements and appear reasonable in relation to the plan's provisions and experience.

For example, the auditor needs to consider whether the assumed rates of return on plan assets used in the actuarial determination are consistent with the plan's investment policy and the types of investments the plan holds. Also, FASB ASC 960-20-35-1A allows the selection of certain assumptions based on the assumptions inherent in the cost of an insurance contract at the benefit information date to provide the accumulated plan benefits. If a defined benefit pension plan uses this approach to selecting assumptions for financial reporting purposes, the auditor compares them to the insurance company premium rates the plan used.

Other items the auditor may consider include the trends and nature of benefit distributions (for example, lump sum or annuity), turnovers and retirements, the effects of any recent mergers or acquisitions, and the effects of any plan amendments (such a benefit formula change or a freezing of the plan).

The auditor may also give consideration to the mortality tables and projections scales used by the actuary. There are several mortality tables that are commonly used in FASB ASC 960 calculations (for example, RP-2014, RP-2000, etc.). In addition, actuaries use projection scales (such as, MP-2021, MP-2020, Scale AA, or Scale BB), in conjunction with the mortality tables to bring the mortality experience to a more current level. Mortality tables and projection scales are updated at various times, sometimes annually. Accordingly, it is important for the plan's actuary to use appropriate information. Further, plan management should consider the specific demographics of their plan when evaluating the appropriate mortality tables to use. FASB ASC 960 does not require the use of a particular mortality table and/or projection scale. Rather, it requires that the assumptions used, including mortality, represent a best estimate of the plan's future experience solely with respect to that individual assumption. However, if the decision is made to use an older table, or to use no projections or older projections, the plan should provide substantial support for that decision. Considering the current mortality tables used by the actuary, auditors ought to determine whether newer tables have been released by the Society of Actuaries (SOA). If so, the auditor would consider and document management's and the actuary's consideration of the newer tables in light of the current tables used in the valuation.

The auditor may review the actuarial present value of accumulated plan benefits for reasonableness. For example, the auditor may determine whether there are unusual fluctuations from the prior-year valuation and consider their causes, such as the effect of changes in actuarial assumptions and in circumstances like plant closings, etc. The auditor carefully reviews the actuarial interest rate assumption for discounting benefit obligations. For example, a larger plan benefit obligation will result when the actuary uses a lower discount rate. Thus, auditors should determine that the plan's actuary used a realistic interest rate in discounting the plan's benefit obligations. FASB ASC 960-20-35-6 requires that the interest rate assumption be based on the expected rates of return for the plan's investment portfolio during the benefit deferral period.

The auditor may review the latest Schedule MB ("Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information") or Schedule SB ("Single-Employer Defined Benefit Plan Actuarial Information") to Form 5500 and review any qualifications the actuary has attached to the schedule. (The instructions to Form 5500 allow the actuary to qualify his or her statement.) The auditor needs to consider the audit or accounting significance of any qualifications.

Finally, the actuarial present value of accumulated plan benefits in the actuary's report or confirmation needs to be traced, or reconciled, to the information in the plan's financial statements.

Benefit Obligations for Defined Benefit Health and Welfare Plans

Health and welfare benefit plans may be insured or uninsured and a variety of arrangements exist under which an insurance company may assume all or part of the risk related to providing benefits of an insured plan. An uninsured, self-funded plan pays benefits out of a fund of accumulated contributions and income. A plan may be partly insured and partly self-funded. As discussed in Lesson 1, the financial statements of health and welfare benefit plans should include the actuarial present value of the following benefit obligations, as applicable:

a. Claims payable, claims incurred but not reported (IBNR) to the plan, and premiums payable to insurance companies.

b. Accumulated eligibility credits and postemployment benefits, net of current amounts payable, for active participants.

c. Postretirement benefits for—

    (1) Retired participants, their beneficiaries and covered dependents, net of amounts currently payable and claims IBNR.

    (2) Other fully eligible plan participants.

    (3) Plan participants that are not fully eligible to receive benefits.

If claims IBNR are calculated for active participants and retirees in the aggregate, the total should be included with the amounts in a. above. However, claims IBNR for retirees should be included in the postretirement benefit obligation if it is calculated separately.

Note that the financial statements of self-insured (that is, uninsured) plans do not include obligations for premiums but do include obligations for claims payable for active and retired participants (and their dependents and beneficiaries), and the IBNR for active participants. The IBNR for retired participants is included in the postretirement benefit obligation. Insured plans report obligations for premiums and accumulated eligibility credits but do not report obligations for claims payable and claims IBNR because the insurance company pays such claims. This section discusses audit procedures for these obligations.

Because of the variety of insurance arrangements that a health and welfare benefit plan may have, it is important that the auditor read the plan document and underlying insurance contracts to determine the nature of the arrangement and the extent to which the insurance company assumes the obligation for plan benefits, and to identify the types of obligations for premiums, experience-rating adjustments, and plan benefits that should be reported in the plan's financial statements. This section refers to plans as either insured or uninsured, but the guidance in this section applies to plans that are partially insured to the extent that they are insured.

The audit procedures will depend, in part, on whether a specific benefit obligation is determined by an actuary or by the plan. Postretirement benefits will generally be determined by an actuary. Insurance premium obligations (payables) will generally be determined by the plan. The remaining obligations may be determined by the plan or the actuary. However, GAAP requires that all amounts be at present value (that is, the value of time and money must be considered); that accumulated eligibility credits consider mortality, expected employee turnover, and other adjustments that may affect the actual amounts paid; and that postretirement and postemployment benefits be included.

GAAP requires disclosures of the actuarial present value of benefit obligations. The calculation of some of these obligations may require the assistance of an actuary. Health and welfare plans may consider not making these required disclosures because of the required involvement of an actuary. As an alternative, plans may make the required disclosures based upon estimates developed by management of the plan. If the plan does not make the required disclosures, or the disclosures are materially inadequate, the auditor generally should express a qualified or adverse opinion due to the material departure from GAAP.

If the plan makes required benefit obligation disclosures based upon estimates made by plan management without the use of an actuary, the auditor should consider the need to consult an actuary in evaluating the reasonableness of the estimates. When the auditor decides to consult an actuary as a specialist, and the plan refuses to provide the data necessary for the actuary to complete his or her work, the auditor's opinion should be modified for a scope limitation.

The main audit procedure for the actuarially determined benefit obligations of a defined benefit health and welfare plan is to obtain a confirmation from the plan actuary. The actuary may provide a copy of the actuarial report as part of the response to the confirmation request. Or, the auditor may use a report provided by the actuary to the client and then determine that the information obtained from the client agrees with or reconciles to the information in the confirmation or report received directly from the actuary.

The auditor may determine the reliability and completeness of the census data the actuary used in the actuarial determination by reconciling the number of participants from the employer's records to the actuary's report and/or confirmation and by reconciling claims and accumulated eligibility credit information used by the actuary to the employer's records. These steps may be coordinated with the test of participant data. The auditor also determines that only eligible employees are included in the census data.

It is also important to determine that the actuary used the appropriate plan provisions in making the actuarial determination. Thus, the auditor may compare the most recent applicable plan provisions and amendments to those the actuary used in the actuarial report or confirmation. The auditor needs to be aware that the plan may be operating in accordance with changes required by recent laws and regulations (and the actuarial valuation may reflect such changes), but that the plan may not have been formally amended for such changes. Thus, the auditor may not be able to just compare formal plan provisions and amendments, but may also have to consider any resolutions of the plan's administrative board that affect the valuation.

After considering the completeness of census data and appropriateness of the plan provisions the actuary used in actuarial determinations, the auditor should consider whether the actuary's actuarial assumptions and methods conform to GAAP and ERISA requirements and appear reasonable in relation to the plan's provisions and experience. For example, the auditor considers whether the assumed rates of return on plan assets used in the actuarial determination are consistent with the plan's investment policy and the types of investments the plan holds. Other actuarial assumptions the auditor reviews for reasonableness and consistency with, if applicable, the prior year's actuarial determination include the current and ultimate health care cost trend rates, the salary progression for pay-related plans, and mortality.

The auditor should review the actuarial present value of benefit obligations for reasonableness. For example, the auditor may determine whether there are unusual fluctuations from the prior-year valuation and consider their causes, such as the effect of changes in actuarial assumptions and in circumstances like plant closings, etc. The interest rate assumption used can greatly affect the calculation of the actuarial present value of benefit obligations.

The auditor may review the latest Schedule MB ("Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information") or Schedule SB ("Single-Employer Defined Benefit Plan Actuarial Information") to Form 5500 and review any qualifications the actuary has attached to the schedule. (The instructions to Form 5500 allow

the actuary to qualify his or her statement.) The auditor needs to consider the audit or accounting significance of any qualifications.

Finally, the actuarial present value of benefit obligations in the actuary's report or confirmation needs to be traced or reconciled to the information in the plan's financial statements.

Auditing Insurance Premium Obligations. The financial statements of insured health and welfare benefit plans should report a benefit obligation for unpaid premiums payable to insurance companies. The amount of such premiums is determined by participant eligibility and premium rates.

Audit tests for premiums payable include performing analytical procedures such as considering the reasonableness of the current and prior-year premiums payable in relation to the number of participants and investigating unusual fluctuations. The auditor may also make an overall calculation of premiums by multiplying the number of eligible participants (as determined from eligibility records) by the premium rate in the insurance contract. The auditor may decide to confirm premiums paid and payable with the insurance company. He or she may also examine support for the plan's subsequent payment of the premium payable. The auditor may also consider tracing individual participants per the premium computation list to plan records to verify eligibility.

The auditor needs to determine that any experience-rated premium deficits or refunds that pertain to the plan year are properly recorded or disclosed.

Auditing Unpaid Claims Reported to Uninsured Plans. Uninsured plans do not have any obligations to insurance companies, but instead assume the obligation for unpaid claims incurred as of the financial statement date. The audit of these claims depends in part on whether an actuary is used to estimate the obligation. When an actuary is used, the procedures described above for actuarially determined benefit obligations may be completed. When the plan estimates the obligation, the following procedures may be followed:

a. Obtain a trial balance of such claims and agree the total to the financial statements.

b. Review all or selected supporting documents (claims reports filed by participants prior to the financial statement date).

c. Trace subsequent payments of claims filed prior to the financial statement date to the trial balance.

Auditing Claims Incurred but Not Reported (IBNR) to Uninsured Plans. The obligation for claims incurred before the financial statement date but not reported to an uninsured plan at that date is estimated on an overall basis based on prior loss experience. The obligation is based on the present value of the ultimate cost to settle the claims. When the plan estimates the obligation, the auditor considers the estimate's reasonableness and the estimation method's consistency with the method used in prior periods. The auditor also considers factors such as new circumstances, increasing claims costs, a changing trend of recent experience, catastrophic losses, plan amendments, etc.

FASB ASC 965-30-35-1A states that the estimated ultimate cost of IBNR claims should reflect the plan's obligation to pay claims beyond the financial statement date. In practice, some plans may improperly be using a lag approach to record IBNR claims only for amounts reported subsequent to year-end but before the issuance of the financial statements. This method may not consider all future obligations to the plan relating to conditions that existed at the date of the financial statements. For example:

a. A plan participant who has a life-threatening accident in December may be unable to report all medical claims prior to the issuance of the December 31, 20XX, financial statements. The IBNR obligation reflected in those financial statements should include the present value of the estimated ultimate cost to settle all future medical claims relating to the accident.

b. A plan participant who is diagnosed in December as having a very serious illness may be unable to report all medical claims relating to the illness prior to the issuance of the December 31, 20XX, financial statements. The IBNR obligation reflected in those financial statements should include the present value of the estimated ultimate cost to settle all future medical claims relating to the illness.

c. A plan participant who is ill in December and is diagnosed in early January as having a very serious illness may be unable to report all medical claims relating to the illness prior to the issuance of the December 31, 20XX, financial statements. Would the IBNR obligation reflected in those financial statements include the present value of the estimated ultimate cost to settle all future medical claims relating to the illness? The answer is not clear; however, the authors believe the answer is yes.

The IBNR calculation is often complex. If an actuarial valuation is necessary, the auditor needs to discuss this with the plan administrator at, or before, the beginning of the audit. When an actuary estimates the obligation, the procedures described earlier for actuarially determined benefit obligations need to be completed. The above procedures also apply to testing the reasonableness of the estimates provided by the actuary.

If management estimates IBNR, the auditor may also consider the following procedures:

a. Evaluate management's methodology, taking into consideration consistency with prior periods and the impact of any recent changes, such as rising costs or recent trends in claims experience.

b. Trace key data used in the calculation to source documents.

c. Perform analytical procedures, such as comparing the ratio of IBNR to the number of participants to prior periods and investigating unexpected variances.

Auditing the Obligation for Accumulated Eligibility Credits. Accumulated eligibility credits provide benefits coverage to eligible participants during periods of unemployment. An insured plan's obligation is for the insurance premiums related to the credits, and an uninsured plan's obligation is for the benefits related to the credits. The obligation at the plan financial statement date is the number of credits times the current insurance premiums rate for insured plans or times the plan's average benefits cost for uninsured plans, adjusted for the effect of assumptions for mortality, expected employee turnover, and other adjustments that may be necessary based on the provisions of the plan.

The audit of these claims depends in part on whether an actuary is used to estimate the obligation. When an actuary is used, the procedures described earlier for actuarially determined benefit obligations need to be completed. When the plan estimates the obligation, the following procedures may be considered:

a. Test the accuracy of the compilation of the number of credits by referring to participants' credited service hours on a test basis and to the applicable accumulated rates in the plan.

b. Test the participant credited service hour records by referring, on a test basis, to payroll or similar type records.

c. Review the reasonableness of the mortality and other assumptions.

d. Check the computation.

The above procedures may also be appropriate to test census data provided to the actuary by the plan administrator.

Auditing the Obligation for Postretirement Benefits. Postretirement benefits consist of those benefits expected to be paid on behalf of retired or active participants, beneficiaries or covered dependents, and terminated participants who are expected to receive benefits under a health and welfare benefit plan. If a plan provides postretirement benefits, an estimated amount for those benefits should be included in the benefit obligations. An actuary will be required to determine the postretirement benefit obligation. In addition to performing procedures, the auditor may confirm the postretirement benefit obligation with the actuary. The auditor reviews the actuarial assumptions used by the actuary for reasonableness and, if applicable, consistency with assumptions used in the prior year actuarial determination. The auditor also verifies that the postretirement benefit obligation is reduced by the actuarial present value of estimated future contributions of current plan participants. In addition, if the actuarial valuation date was other than the plan's year end, the auditor reviews the roll forward of the obligation for reasonableness and perform any tests considered necessary.

Auditing the Obligation for Postemployment Benefits. Postemployment benefit obligations are the benefits expected to be paid by health and welfare benefit plans to employees after employment but before retirement. GAAP

requires that an estimate of that obligation be included in the plan's benefit obligations. In addition to the procedures noted at the beginning of this section, the auditor may also perform the following:

a. Confirm the postemployment benefit obligation with the actuary.

b. Review the actuarial assumptions for reasonableness.

c. Verify that estimated future contributions of current plan participants are considered in the calculation.

d. Verify that an obligation was recognized if the event causing the obligation had occurred and the amount could be reasonably estimated.

e. Inquire if there were instances where an obligation was not recorded only because the amount could not be reasonably estimated.

Liabilities for Benefits of Defined Contribution Health and Welfare Plans

Little is said in FASB ASC 965 regarding the accounting for benefits of defined contribution health and welfare plans. However, the authors believe the accounting would, to the extent applicable, be essentially the same as that for defined benefit plans except that claims filed, claims incurred but not reported, insurance premiums, and accumulated eligibility credits will be reported in the statements of net assets available for benefits, and changes in net assets available for benefits.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following statements best describes an employee benefit plan's benefit payments?

    a. They must be paid directly from the plan's assets.

    b. They are reported as liabilities on the statement of changes in net assets available for benefits.

    c. Loans to participants are considered disbursements of benefit payments.

    d. The bank or insurance company that holds plan assets can make benefit payments.

22. What is the main audit procedure for the actuarially determined plan benefit obligations of a defined benefit pension plan?

    a. Obtaining a confirmation from the plan actuary.

    b. Obtaining a copy of the actuary's report from the actuary.

    c. Requesting that the plan confirm that only eligible employees are included in the data received.

    d. Determining that the actuary fulfilled ERISA requirements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

21. Which of the following statements best describes an employee benefit plan's benefit payments? **(Page 256)**

    a. They must be paid directly from the plan's assets. [This answer is incorrect. Benefit payments may be paid directly from plan assets or by the purchase of annuity contracts with insurance companies.]

    b. They are reported as liabilities on the statement of changes in net assets available for benefits. [This answer is incorrect. These payments are reported as *deductions* in the statement of changes in net assets available for benefits.]

    c. Loans to participants are considered disbursements of benefit payments. [This answer is incorrect. Disbursements for benefit payments do *not* include loans to participants. Employee benefit plans that have individual participant accounts are allowed to provide for loans to participants if, among other things, the loan is adequately secured.]

    d. **The bank or insurance company that holds plan assets can make benefit payments. [This answer is correct. The actual benefit payments may be made by the bank or insurance company that holds the plan assets, upon the plan administrator's authorization.]**

22. What is the main audit procedure for the actuarially determined plan benefit obligations of a defined benefit pension plan? **(Page 258)**

    a. **Obtaining a confirmation from the plan actuary. [This answer is correct. The main audit procedure for the actuarially determined plan obligations of a defined benefit pension plan is to obtain a confirmation from the plan actuary.]**

    b. Obtaining a copy of the actuary's report from the actuary. [This answer is incorrect. The actuary may provide a copy of the actuarial report as part of the response to the confirmation request, or the auditor may use a report provided by the actuary to the client and then determine that the information obtained from the client agrees with or reconciles to the information received directly from the actuary.]

    c. Requesting that the plan confirm that only eligible employees are included in the data received. [This answer is incorrect. The auditor may determine that only eligible employees are included in the census data by comparing the number of participants and the ratio of participants to total employees for the current and prior year and investigating any unusual fluctuations. Therefore, merely requesting a confirmation of this information would not be enough work on the auditor's part.]

    d. Determining that the actuary fulfilled ERISA requirements. [This answer is incorrect. It is important to determine that the actuary used the appropriate plan provisions in making the actuarial determination (not ERISA requirements).]

ADDRESSING OTHER ASSETS, LIABILITIES, AND OPERATING EXPENSES

Cash

Cash balances of an employee benefit plan are usually immaterial, representing residual uninvested amounts. AEBP, Paragraphs 5.218, 7.150, and 8.185, state that if cash balances are material, audit procedures used in audits of other entities, such as confirmation of the balance, are normally appropriate.

If the plan maintains cash accounts apart from any trust agreement or insurance contract, the same audit procedures applied in any audit are appropriate. That is, the balance may be confirmed, and procedures may be applied to the bank reconciliation using a cutoff statement if there are numerous or large reconciling items.

Notes Receivable from Participants

Participant loans are required to be classified as notes receivable from participants and measured at their unpaid principal balances plus any accrued but unpaid interest. Audit procedures for notes receivable from participants may include performing analytical procedures, examining individual loan agreements, and confirming the amounts and terms of significant loans with participants. When reviewing the loan agreement, the auditor needs to test for spousal consent, if required by the plan document. The auditor also determines that appropriate interest accruals are made, if necessary, and considers the collectibility of the loans and the need for, and adequacy of, an allowance for uncollectible balances.

The auditor should consider whether any participant loans violate ERISA, tax, or plan provisions. For example, the plan document must authorize loans to participants, and the loans must bear a reasonable rate of interest and be adequately secured. Also, individual income tax rules treat the portion of loans that exceed certain limits or that are not repaid within a specified time as a distribution to the plan participant. (For GAAP purposes, however, the plan document provides the guidance to determine whether delinquent loans are to be reclassified as distributions.) The auditor also needs to determine whether the plan should reclassify any delinquent loans as distributions based on the provisions of the plan document and the plan's policies, and that delinquent loans are properly reported on Schedule G of Form 5500, if appropriate. Finally, the auditor needs to consider if any differences between Form 5500 reporting and GAAP reporting of participant loans results in a reconciling item between the financial statements and the Form 5500, which should be disclosed.

Rebates Receivable

If health and welfare plans have rebates receivable from a service provider, such as rebates from a prescription drug program or excess premiums paid for claims incurred, the audit procedures that may be applied include examining the rebates to determine if the correct amounts have been reflected in the proper periods. The auditor may consider confirming amounts directly with third-parties or examining support for subsequent receipt of payment. In addition, it is important for the auditor to gain an understanding of the service contracts and to apply procedures to determine if all rebates have been properly accounted for, and to consider the propriety of the rebates.

Operating Assets (Property and Equipment)

Employee benefit plans usually own or lease only immaterial amounts of property and equipment used in operations. Even large, single-employer plans may not have any such property. The plan sponsor often provides operating facilities and space (and may not charge the plan for the use of such facilities and space). Multiemployer plans, which are more likely to own or lease operating property and equipment, may not have material amounts. Also, plans that use third-party administrators may have little, if any, need for operating assets.

Material amounts of property and equipment used in plan operations would be audited in the same manner as in any audit. The audit of real estate, including real property, held as a plan investment was discussed earlier in this lesson.

The auditor needs to be aware that while GAAP requires plan operating property and equipment to be recorded at cost less accumulated depreciation and amortization, Form 5500 requires buildings and other property used in operations to be presented at current value. The instructions to Schedule H, "Financial Information," state that such property should be presented at "current (not book) value." DOL officials have stated their expectation that current

value will be used in the Form 5500 schedules and that the notes to the financial statements will disclose and reconcile the difference between the two amounts.

As discussed in the previous paragraph, property and equipment used in plan operations generally are carried in financial statements at cost less accumulated depreciation or amortization, unless an asset becomes impaired. The auditor needs to consider whether the asset is impaired and the carrying amount of the asset should be written down. FASB ASC 360-10-35-17 provides guidance on determining when long-lived assets are considered to be impaired and how to determine losses. *PPC's Guide to Preparing Financial Statements* and *PPC's Guide to GAAP* provide guidance regarding measuring impairment losses for various types of assets.

Accounts Payable (for Securities Purchased, Management Fees, and Operating Expenses)

A plan's statement of net assets available for benefits may need to include a liability to brokers and dealers for securities purchased shortly before the financial statement date. Confirmations of investments may include a request for the amount of any payables as of the financial statement date. When testing investment transactions, the auditor needs to consider whether related payables have been recorded.

Liabilities for management fees and other administrative expenses are discussed later in this section.

Loans Payable

Employee benefit plans may have debt. For example, a plan may have a mortgage on real property it owns. A leveraged ESOP borrows money from banks or other lenders to finance its acquisition of employer securities. Usually, the employer guarantees the debt. Tax rules provide that the employer's stock is the only collateral that the ESOP may use as collateral on the debt. The collateral stock must be placed in a suspense account and released for allocation to the ESOP participant accounts as the loan is repaid. Also, the ESOP may repay the loan only from employer contributions made to enable the ESOP to meet its loan obligation and from the earnings on those contributions.

The audit procedures for loans payable are the same as in any audit, that is, confirmation of the loan balance, terms, and collateral with the lender and tests of interest expense and accruals. A major audit objective is evaluation of the adequacy of disclosure of matters related to the loan, such as an employer's guarantee of the debt or the restriction on the stock being used as collateral.

Operating (Administrative) Expenses

Operating expenses (also called administrative expenses) of an employee benefit plan may include items such as legal, actuarial, accounting, consulting, and data processing fees, investment trustee and advisory fees, fees to a third-party plan administrator, etc. Operating expenses may also include the PBGC insurance premium of a defined benefit pension plan.

Many single-employer plan sponsors absorb part or all of the plan's operating expenses. Such expenses are not reported in the plan's statement of changes in net assets. However, FASB ASC 960-205-50-1, 962-205-50-1, and 965-205-50-1 require financial statement disclosure of the fact that the plan sponsor is absorbing significant plan expenses, if applicable. (The authors believe that in accordance with customary practice, the amount of such absorbed expenses need not be disclosed.)

Audit procedures are similar to those for similar expenses in any audit. They include comparison of amounts with those of the prior period and investigation of significant fluctuations; examination of supporting invoices, contracts, and other documents; and overall analytical calculation of amounts based on the terms of agreements, leases, contracts, etc. In addition, the auditor may examine authorizations in the plan document or minutes of the administrative committee or board of trustees and consider whether expenses paid by the plan are permitted by the plan document. Auditors need to gain an understanding of the expenses that the plan document allows to be paid by the plan as well as those permitted by DOL rules and regulations. AEBP, paragraphs 5.76, 7.77, and 8.90 provide examples of typical expenses for defined contribution, defined benefit, and health and welfare plans, respectively. DOL Advisory Opinion No. 2001-01A may also serve as a source for guidance on proper plan expenses. If a plan

pays expenses that are disallowed or that are excessive, without regard to materiality, additional testing may be required and such transactions may be deemed prohibited transactions.

Revenue-sharing Accounts. Administrative service fees to the plan that would have otherwise been charged directly to the plan sponsor, the plan, or participants, may be reduced if the investment manager shares a portion of its investment management fees with a service organization (such as the plan's recordkeeper). If the plan has such an account, the auditor may obtain detail of the activity in the account and determine if the funds are being used timely (by offsetting expenses or being allocated as income to participants), with no excess unallocated funds. DOL Advisory Opinion No. 2013-3a may also serve as a source of guidance on such ERISA spending or revenue-sharing accounts.

When auditing the expense for GAAP financial statements, the auditor determines that accruals and payables for operating expenses are properly recorded.

OTHER APPLICABLE AUDIT CONSIDERATIONS

Analytical Procedures

Many of the previous sections in this lesson address substantive analytical procedures that may be used to obtain audit evidence about potential misstatements. The following discussion expands on those procedures and provides further guidance for evaluating fluctuations and results from analytical procedures.

Selecting Appropriate Analytical Procedures. Analytical procedures include comparing actual results with industry statistics or anticipated results. However, auditors of employee benefit plans may not often make such comparisons because relevant information needed for a particular analytical procedure is either not available or not relevant to the plan. For audits of financial statements of plans affected by COVID-19, auditors need to consider how prior approaches to designing and applying analytical procedures should change in response to the effect of COVID-19 on the general effectiveness of substantive analytical procedures. Auditors generally use their experience with the plan and their knowledge of the relationships that are significant in the industry to determine which relationships can be studied. The following guidelines may be helpful in selecting appropriate analytical procedures:

a. To avoid applying unnecessary analytical procedures, determine the relationships that are significant to the plan. For example, the relationship of employer contributions to employer net income would not be significant to a plan where the employer contributions are based on a set amount for each hour worked.

b. Misstatements in an account can be distributed throughout the period or occur solely in one or a few months. Analytical procedures need to be designed to detect at least part of any material error that has occurred. For example, comparing monthly contributions and benefits over several years is generally more useful than comparing annual contributions and benefits for the same period.

Exhibit 2-1 describes factors that affect the expected effectiveness of an analytical procedure.

Exhibit 2-1

Factors Affecting the Expected Effectiveness of an Analytical Procedure

- *Nature of the Account.*
- *Nature of the Assertion Being Tested.* (Analytical procedures can be more effective than tests of details for testing the completeness assertion.)
- *Likely Cause of Potential Misstatement.* (Analytical procedures typically are more effective when the risk of misstatement is assessed as being primarily from error rather than from fraud.)
- *Degree of Relationship Among the Data to Which the Analytical Procedure is Applied.* (Analytical procedures are more effective when there is a close relationship between the account and the data used to predict the balance.)

- *The Stability of the Client Environment.* (Analytical procedures are generally more effective in a stable environment.)
- *Existence of Offsetting Factors* that affect the amount being tested. (Analytical procedures are generally more effective when offsetting factors are taken into consideration.)
- *The Source and Reliability of Data Used in the Test.* (Examples of reliable data include internal financial information from comparable prior periods, budgets, extrapolations from interim or annual data, or data developed under a reliable system with adequate controls; internal nonfinancial or operating data from sources independent of those responsible for the amount being audited; and external industry statistics or comparable plan data.)
- *The Level of Detail Used to Develop the Expectation.* (For instance, a more effective test generally results from use of monthly rather than annual data, or data by investment or employer rather than plan-wide data.)

Examples of Analytical Procedures. The types of analytical procedures applied will vary with the auditor's previous experience with the plan, the nature and materiality of the accounts involved, and the nature of financial and other nonfinancial data available. Although common ratios can be very helpful, they cannot substitute for professional judgment. As conditions change from one plan to another or one period to another, the auditor needs to challenge any standard checklist or list of prior-period procedures. However, the following paragraphs give some examples of analytical procedures that may be appropriate in certain circumstances.

Trend analysis compares either the absolute dollar amount or percentage change in accounts over time. When the auditor reads comparative financial statements and questions the fluctuations in accounts between years, he or she is applying a form of trend analysis. Other examples include comparing monthly contributions and benefits for the current period with those of prior periods or analyzing a five-year contribution and benefit trend.

Reasonableness tests estimate a financial statement amount or the change in an amount from the prior year. Some reasonableness tests involve ratios. For example, the reasonableness of investment income can be estimated by dividing income by the average investment during the period. Other reasonableness tests involve estimating account balances by using nonfinancial data. For example, the reasonableness of benefits can be evaluated by dividing the total benefits paid by the average number of retired participants during the period.

Ratio analysis involves the study of the relationship between two financial statement amounts. Some of the common ratios and relationships considered for employee benefit plans are as follows:

a. *Contribution Ratios.* These ratios help determine contribution trends and the reasonableness of contributions when compared to prior periods and to other applicable criteria. Some of the common contribution ratios include:

   (1) *Contributions per Active Employee for the Period*—used to review the reasonableness of the employer and employee contributions for each active employee for the current period and when compared to prior periods. The ratio can be computed using the total number of employees or the total number of active participants and can be useful for both retirement and health and welfare plans.

   (2) *Contributions as a Percentage of Total Compensation*—used to review the reasonableness of the employer and employee contributions in relation to total compensation for the current period and when compared to prior periods. The ratio can be computed using total compensation for all employees or total compensation for just the participants and can be useful for both retirement and health and welfare plans. This ratio is generally used only for single employer plans but can be used for multi-employer plans if the information is available.

   (3) *Contributions for Each Eligible Hour*—used to review the reasonableness of the employer and employee contributions in relation to eligible hours for the current period and when compared to prior periods. This ratio is especially useful when contributions are based on an amount per eligible hour usually based on a collective bargaining agreement and can be useful for both retirement and health and welfare plans.

(4) *Employer Contribution as a Percentage of Net Income*—used to review the reasonableness of the employer contribution in relation to the net income of the sponsor for the current period and when compared to prior periods. This ratio is generally used only for single employer plans but can be used for multiemployer plans if the information is available. It is generally useful only for retirement plans.

(5) *Employer Matching Contributions as a Percentage of Employee Contributions*—used to review the reasonableness of employer matching contributions in relation to employee contributions for the current period and when compared to prior periods. This ratio is generally used only for contributory retirement plans that feature employer matching of employee contributions.

b. *Investment Ratios.* These ratios help assess the effectiveness of the investment program. Some of the common investment ratios include:

(1) *Investments as a Percentage of Total Assets*—indicates how efficient the plan invests its assets. The greater the percentage, the stronger the plan. This ratio is useful for all types of plans.

(2) *Return on Investments*—indicates the effectiveness of the investment program. This ratio is useful for all types of plans.

(3) *Return on Total Assets*—indicates the effectiveness of the investment strategy and the investment program. This ratio is a combination of the previous two and is used by some auditors in lieu of the other two. This ratio is useful for all types of plans.

c. *Benefit Ratios—Retirement Plans.* These ratios help assess benefit trends and the reasonableness of benefit amounts when compared to prior periods and when compared to other applicable criteria. Some of the common benefit ratios include:

(1) *Average Benefit Payment per Retired Participant*—used to review the reasonableness of the average benefit payment for each retired participant for the current period and when compared to prior periods.

(2) *Vested Benefit per Retired Participant*—used to review the reasonableness of the average vested benefit for each retired participant at the end of the current period and when compared to prior periods.

(3) *Vested Benefit per Active Employee*—used to review the reasonableness of the average vested benefit for each active employee at the end of the current period and when compared to prior periods.

(4) *Average New Benefit Payments to New Retirees*—used to review the reasonableness of the average retirement payments to new retirees for the current period and when compared to prior periods.

d. *Health and Welfare Plan Claims and Premium Ratio.* These ratios help assess benefit trends and the reasonableness of claim amounts when compared to prior periods and to other applicable criteria. Some of the common ratios include:

(1) *Premium Expense per Participant in an Insured Plan*—used to review the reasonableness of the premium expense for each active participant based on the average number of participants during the current period and when compared to prior periods.

(2) *Claim Expense per Participant in an Uninsured Plan*—used to review the reasonableness of claim expense for each active participant based on the average number of participants during the current period and when compared to prior periods.

(3) *Claims Payable per Participant in an Uninsured Plan*—used to review the reasonableness of claims payable for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(4) *Estimated Liability for Claims Incurred But Not Reported per Participant*—used to review the reasonableness of the estimated liability for claims incurred but not reported for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(5) *Postretirement Benefit Obligation per Participant*—used to review the reasonableness of the estimated postretirement benefit obligation for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

(6) *Postemployment Benefit Obligation per Participant*—used to review the reasonableness of the estimated postemployment benefit obligation for each active participant based on the number of participants at the end of the current period and when compared to prior periods.

The calculations for these ratios are presented in Exhibit 2-2. In addition, PPC's *Workpapers for Employee Benefit Plans* are Excel®-based practice aids and templates that may be used to automatically calculate many of the ratios discussed in this section. Macros have also been utilized to simplify rolling forward information from year to year. For order information, please call (800) 431-9025. As previously discussed, ratios do not need to be computed just for the sake of computing them. Generally, auditors select only those ratios that provide information about assertions or accounts that are considered significant.

Exhibit 2-2

Common Activity Ratios—Employee Benefit Plans

Ratio	Computation
All Plans:	
Contribution per active employee for the period	Contributions / Average Number of Active Employees
Contribution as a percent of total compensation	Contributions / Total Compensation
Contribution for each eligible hour	Contributions / Total Eligible Hours
Employer contribution as a percent of net income	Employer Contributions / Employer Net Income Before Income Taxes
Invested assets as a percent of total assets at end of period	Net Investments / Total Assets
Return on investments for the period	Investment Income / Average Fair Value of Investments During the Period
Return on assets for the period	Investment Income / Average Assets During the Period
Retirement Plans:	
Average benefit payment per recipient for the period	Benefit Payments / Average Number of Recipients
Vested benefits per retired employee at end of period	Actuarial Present Value of Vested Benefits / Number of Retired Employees
Vested benefits per active employee at end of period	Actuarial Present Value of Vested Benefits / Number of Active Employees
Average new benefit payments to new retirees	Amount of New Benefit Payments / Number of New Retirees
Employer matching contributions as a percent of employee contributions	Employer Matching Contributions / Employee Contributions

Ratio	Computation
Health and Welfare Plans:	
Premium expense per participant in an insured plan	$\frac{\text{Insurance Premium Expense}}{\text{Average Number of Participants}}$
Claim expense per participant in an uninsured plan	$\frac{\text{Claims Expense}}{\text{Average Number of Participants}}$
Claims payable per participant in an uninsured plan	$\frac{\text{Claims Payable}}{\text{Number of Participants}}$
Estimated liability for claims incurred but not reported per participant	$\frac{\text{Estimated Liability}}{\text{Number of Participants}}$
Postretirement benefit obligation per participant	$\frac{\text{Postretirement Obligation}}{\text{Number of Participants}}$
Postemployment benefit obligation per participant	$\frac{\text{Postemployment Obligation}}{\text{Number of Participants}}$

Evaluating the Results of Analytical Procedures. Results of analytical procedures are usually evaluated against a plan's past performance, taking into account expected performance. Professional judgment is applied in deciding when the results of analytical procedures indicate significant fluctuations from expected amounts that need to be investigated further. The authors recommend that auditors determine the magnitude of changes that will be considered significant before applying analytical procedures so that those judgments will be as objective as possible. In making that decision, the following factors generally need to be considered:

a. *Expected Size of the Fluctuation.* Some fluctuation from prior years (or expected results) often would be considered reasonable based on the plan and the circumstances. However, fluctuations in excess of expected amounts are generally considered significant.

b. *Materiality.* Fluctuations are considered in light of materiality for the financial statements, by financial statement line as well as in the aggregate.

c. *Percentage Change.* Usually the percentage change rather than the absolute amount of the change is considered in deciding whether a change in an account balance is significant, especially in smaller accounts.

d. *Precision of the Analytical Procedure.* Relationships that are more direct and involve fewer variables can be expected to provide more accurate estimates of actual account balances.

When the Fluctuations from Expected Amounts Are Significant. When fluctuations from expected amounts are significant, the auditor typically reconsiders the methods used to develop the expectation and the plausibility of the relationships. Discussions with management may provide explanations for the variances. However, in most instances, auditors will combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations. If the fluctuations cannot be explained, the auditor needs to perform other audit procedures to determine if the differences are likely misstatements.

The auditor should document the matters covered in the analytical procedures. Although not required, many auditors document analytical procedures, particularly the results of ratio and trend analysis, in carryforward workpapers or in a permanent file to facilitate historical comparisons.

Limitations of Analytical Procedures. Applying analytical procedures can be an effective method of identifying misstatements in financial statements. However, they do have certain limitations, including the following:

a. Inquiries may be more effective for certain assertions or accounts. For example, analytical procedures are ineffective when accounts are subject to significant management discretion, such as those involving

estimates, because relationships are unpredictable. Similarly, it is difficult to obtain assurance about the assertions of existence or ownership through analytical procedures.

b. Analytical procedures are ineffective when factors affecting accounts are not constant over time.

c. Analytical procedures are less precise and accurate as account relationships become more remote.

d. Reasonableness tests usually depend to some extent on operating data, which may not be available.

e. Ratios may not be comparable with industry statistics, with ratios computed for other clients, or within the same client over time because of changes in accounting principles or because of differences in the way they are computed.

Required Documentation. When substantive analytical procedures have been performed, under AU-C 520, *Analytical Procedures*, the auditor should document:

- the expectation and the factors considered in its development (unless readily determinable from the work performed),
- the results of comparing recorded amounts to the expectation, and
- any additional procedures performed in response to significant unexpected differences and the results of those procedures.

Although not required by authoritative literature, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation (e.g., a percentage of performance materiality).

Electronic Confirmations

Auditors often use electronic confirmations rather than a mailed, written communication. Electronic confirmations may be in the form of an email submitted directly to the respondent by the auditor or a request submitted through a designated third-party provider like Confirmation. Confirmation is a secure, online platform at **www.confirmation.com** for auditors to submit confirmation requests for cash, accounts receivable, accounts payable, employee benefit plans, and legal confirmations.

Some financial institutions no longer respond to paper confirmation requests. Instead, they respond only to electronic confirmation requests submitted via Confirmation. Validated financial institutions, considered "in-network", will respond to requests directly through the platform by confirming the requested information, requesting more information from the auditor, or denying the request. Confirmation has over 4,000 financial institutions in-network and also provides electronic and paper-based confirmation services for out-of-network responding parties.

Electronic confirmations can be considered reliable audit evidence. With traditional confirmations, AU-C 505.A13 indicates auditors need to consider the following risks to the reliability of such information:

- The response might not be from an authentic source
- The responder may not be knowledgeable about the information
- Integrity of the transmission might be compromised

However, with Confirmation, auditors can be sure that—

- Response is from an authentic source
- Responder has been validated and will be certified and knowledgeable about the information
- Fraud will not occur during the confirmation process, as Confirmation is ISO 27001 certified

Confirmation's online platform can be considered a sufficient, valid confirmation response if the auditor is satisfied that the electronic confirmation process is secure and properly controlled. In determining whether Confirmation's

platform is secure, the auditor might review the ISO 27001 certificate, TRUSTe certificate, or the SOC examinations all found by visiting **www.confirmation.com**. Typically, the auditor would determine if the reports address the three risks noted in the previous paragraph. If not, the auditor may perform additional procedures to address those risks such as reviewing Confirmation's Help Center or contacting the Support Team at 1-866-325-7201.

Terminating Plans

For plans terminated during the year, the auditor would consider the effective date, specific terms, and conditions for the termination, as well as whether the termination was properly authorized.

If termination benefits were paid during the current audit period, in addition to the procedures discussed in the preceding paragraph and previous sections of this lesson, auditors would consider the following:

- Evaluating that final termination payments comply with plan provisions, related documents, and applicable regulations.
- Verifying that all benefit payments are calculated based on all participants being 100% vested.
- Determining that benefit payments were made solely to, or on behalf of, individuals entitled to them.
- Evaluating the proper recording of transactions as to account, amount, and period.
- Verifying that any plan asset reversions to the plan sponsor comply with the plan provisions and IRS regulations.
- Evaluating whether the liquidation basis of accounting has been appropriately applied to the financial statements, if applicable.

If the plan is a defined benefit plan, in addition to the procedures discussed above, the auditor would consider performing the following:

- Determining that all notices required by the PBGC were made on a timely basis.
- Evaluating the methods and assumptions used by the actuary and considering whether the board resolutions and/or amendments were properly considered by the actuary in the valuation.

Partial Terminations. Partial terminations may occur if 20% or more of the plan participants are terminated because of an action taken by the plan sponsor, such as closing a plant, terminating a product or line of products, or downsizing. If the auditor is considering whether a partial termination has occurred, it may be necessary to consult with the plan's legal counsel or other qualified legal counsel.

If a partial termination occurs, full vesting is required for the part of the plan that has been terminated, but not for the entire plan. Therefore, the terminated participants are to be considered fully vested, but the remaining participants' vesting status would continue to be determined according to the plan provisions. For a partial termination, the auditor would consider the relevant procedures discussed above.

Frozen Plans

Defined benefit plans and health and welfare plans may be frozen by the plan sponsor. ESOP plans may also be frozen by the plan sponsor. When a plan is frozen, no new participants are allowed into the plan. A frozen plan will continue to exist until all accrued benefits have been paid. The plan must be formally amended to define the terms of the freeze. The effective date of the freeze may be the amendment date or may be specified by the amendment. Participants in the plan as of the date of the freeze may be allowed to continue earning or accruing benefits depending on the type of freeze as follows:

- *Soft freeze.* In a *soft freeze*, participants may continue to accrue benefits or may cease accruing new benefits, while existing benefits continue to be adjusted for increases in participants' wages.
- *Partial freeze.* In a *partial freeze*, benefits cease accruing for some, but not all existing participants. This determination is generally based on criteria such as tenure, age, and job classification.

- *Hard freeze.* In a *hard freeze*, participants no longer earn benefits and all benefit accruals cease.

If a plan is frozen during the year, the auditor would consider the effective date, specific terms, and conditions of the freeze, as well as whether the freeze was properly authorized. The auditor would also evaluate the methods and assumptions used by the actuary and whether board resolutions and/or amendments were properly considered by the actuary in the valuation, if applicable. For a frozen ESOP, the auditor would also evaluate the appraiser's methods and assumptions used in the appraisal.

Additionally, the auditor would consider the following procedures related to frozen plans, as applicable:

- Obtaining a roll forward of the participant data to determine its reliability and completeness.
- Performing an analysis to determine that no new entrants have been admitted into the plan, as applicable.
- Testing the service accrual for appropriate cut-off as of the freeze effective date, as applicable.
- Evaluating, if applicable, whether salary increases have been appropriately discontinued (or properly updated for a soft freeze).
- For health and welfare plans, testing payments to evaluate whether they relate to claims incurred prior to the cut-off date (either the effective date of the freeze or a date specified by the terms of the freeze).

Audit data analytics (ADA) may be useful in analyzing large volumes of frozen plan account activity.

According to AEBP, Paragraph 6.271, a frozen ESOP will continue to operate after it is frozen, except no additional contributions will be made. The reporting requirements remain in place. Any debt in the case of a leveraged ESOP ought to be settled. Privately-held ESOPs still need to obtain an annual appraisal and the participants' accounts are still affected by stock appreciation or depreciation.

Changes in Service Organizations

Plan administrators may change service organizations to reduce administrative expenses, offer participants improved services, improve the accuracy or efficiency of services, or for other reasons. Due to the competition among third-party service organizations such as trustees, recordkeepers, and custodians, it is not uncommon for plans to change service organizations. Auditors need to be alert for any change in service organizations when performing the audit planning. In addition, Form 5500 Schedule C must disclose changes in actuaries or independent auditors.

If the plan changes service organizations during the period under audit, additional procedures are usually necessary to ensure the proper transition of assets, records, etc. from the former or predecessor service organization to the new or successor service organization. If the change in service organizations occurred at the beginning or end of the plan's fiscal year, only the service organization performing services during that period for the plan needs to be considered for testing. However, many plans change service organizations during the plan year to avoid transition issues at or close to year-end. If the change occurs during the period, the auditor needs to consider each of the service organizations when selecting transactions or services for testing.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. Which of the following other assets, liabilities, and operating expenses is least likely to be pertinent to an employee benefit plan?

    a. Notes receivable from participants.

    b. Rebates receivable.

    c. Property and equipment.

    d. Accounts payable for securities purchased, management fees, and operating expenses.

24. Which of the following is a limitation of analytical procedures?

    a. They are effective at identifying financial statement misstatements.

    b. They are never as effective as inquiries.

    c. They are ineffective when accounts are constant over time.

    d. They are less precise when account relationships become more remote.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

23. Which of the following other assets, liabilities, and operating expenses is least likely to be pertinent to an employee benefit plan? **(Page 267)**

    a. Notes receivable from participants. [This answer is incorrect. Participant loans are required to be classified as notes receivable from participants and measured at their unpaid principal balance plus any accrued but unpaid interest. It is likely that a plan will need to deal with the effects of such loans at some point.]

    b. Rebates receivable. [This answer is incorrect. Health and welfare plans are likely to have rebates receivable from a service provider, such as rebates from a prescription drug program or excess premiums paid for claims incurred. Even if other plans are less likely to have such rebates, this is still something that can occur with employee benefit plans.]

    c. **Property and equipment. [This answer is correct. Employee benefit plans usually own or lease only immaterial amounts of property and equipment used in operations. Even large, single-employer plans may not have any such property. The plan sponsor often provides operating facilities and space (and may not charge the plan for the use of such facilities and space). Multiemployer plans, which are more likely to own or lease operating property and equipment, may not have material amounts. Also, plans that use third-party administrators may have little, if any, need for operating assets.]**

    d. Accounts payable for securities purchased, management fees, and operating expenses. [This answer is incorrect. A plan's statement of net assets available for benefits may need to include a liability to brokers and dealers for securities purchased shortly before the financial statement date. Confirmations of investments may include a request for the amount of any payables as of the financial statement date. When testing investment transactions, the auditor needs to consider whether related payables have been recorded.]

24. Which of the following is a limitation of analytical procedures? **(Page 273)**

    a. They are effective at identifying financial statement misstatements. [This answer is incorrect. The fact that applying analytical procedures can be an effective method of identifying misstatements in financial statements is an advantage of analytical procedures, not a limitation.]

    b. They are never as effective as inquiries. [This answer is incorrect. One of the limitations of analytical procedures is that inquiries may be more effective for certain assertions or accounts. However, this is not the case for all inquiries. It depends on which assertions or accounts are being audited at the time.]

    c. They are ineffective when accounts are constant over time. [This answer is incorrect. One of the limitations of analytical procedures is that they are ineffective when factors affecting accounts are *not* constant over time.]

    d. **They are less precise when account relationships become more remote. [This answer is correct. Though they can be effective, analytical procedures do have certain limitations. One such limitation is that they are less precise and accurate as account relationships become more remote.]**

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 2—Accounting and Financial Reporting Standards and Special Auditing Considerations for Employee Benefit Plans (EBPTG222)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.
2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.
3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
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     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     EBPTG222 Self-study CPE
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     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **March 31, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 2—Accounting and Financial Reporting Standards and Special Auditing Considerations for Employee Benefit Plans (EBPTG222)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. What is the financial reporting entity for an employee benefit plan?

   a. The plan itself.

   b. The trust fund that holds plan assets.

   c. The employer that sponsors the plan.

   d. The plan participants.

2. Which of the following is the major difference between defined benefit retirement plans, defined contribution retirement plans, and welfare benefit plans?

   a. Receiving contributions from plan sponsors.

   b. Holding investments in similar types of securities.

   c. Accruing liabilities and operating expenses.

   d. Measuring and presenting benefit obligations.

3. Typically, securities purchases and sales should be recorded on what basis?

   a. The trade date.

   b. The reporting date.

   c. The settlement date.

   d. The ex-dividend date.

4. Winter Inc.'s defined contribution profit sharing plan lends certain securities to a borrower in exchange for a slightly higher amount of cash collateral. The plan invests the cash to generate income, and the borrower has the right to sell or repledge the securities. What type of transaction is this?

   a. A contract with an insurance company.

   b. A derivative financial instrument.

   c. A reverse repurchase agreement.

   d. A securities lending transaction.

5. *Fair value* is defined as which of the following?

   a. The amount received to sell an asset in a forced liquidation or distress sale.

   b. A single, current, discounted amount that represents the future cash flows or income and expenses of the item being valued.

   c. The price that would be received to sell an asset or the price paid to transfer a liability in an orderly transaction between market participants at the measurement date.

   d. The cost of a plan's operating assets (buildings, furniture, equipment, and leasehold improvements) minus accumulated depreciation and amortization.

6. Which of the following is one approach that can be used to determine the amount of loss on an impaired loan?

   a. Fair value of the collateral.

   b. The income approach.

   c. The cost approach.

   d. Certain significant estimates.

7. Assuming all the other qualifications are met, a financial instrument would be considered a derivative if it has which of the following?

   a. A required initial net investment.

   b. The inability to settle outside of the contract.

   c. Two notional amounts and no underlyings.

   d. An underlying and a payment provision.

8. When would an employee benefit plan prepare its year-end financial statements using the liquidation basis of accounting?

   a. It will merge with another employee benefit plan.

   b. It will terminate before the end of the plan year.

   c. It needs to disclose fines that were assessed by the DOL.

   d. It will present comparative financial statements.

9. FASB ASC 275 requires disclosures about certain risks and uncertainties that may significantly affect financial statements. Which of the following is an additional area that should be considered for disclosure?

   a. Proposed changes in government regulations.

   b. A proposed change in accounting principle.

   c. Acts of God, war, or sudden catastrophes.

   d. The use of estimates when preparing the financial statements.

10. A defined contribution plan's GAAP financial statements are required to include which of the following?
    a. A statement of gross assets available for benefits at the beginning of the plan year.
    b. A statement of changes during the year in net assets available for benefits.
    c. A statement of cash flows.
    d. Comparative financial statements.
11. If a plan returns excess contributions (and related earnings) within what length of time, the contribution amounts will be included in the participants' gross income?
    a. Two and a half months.
    b. Three months.
    c. Five and a half months.
    d. Six months.
12. How should a leveraged ESOP classify employer shares at initial purchase?
    a. As unallocated.
    b. As allocated.
    c. In a single column.
    d. As an offsetting receivable.
13. For a defined benefit retirement plan, the measurement of the promised value at the plan reporting date is what?
    a. Simple.
    b. Complex.
    c. Efficient.
    d. The same as for a defined contribution retirement plan.
14. According to FASB ASC 960-20-20, what is a defined benefit plan's *benefit information date*?
    a. The date the plan amendments are adopted.
    b. The date that plan provisions are used to measure accumulated plan benefits.
    c. The date actuarial present value of accumulated plan benefits is presented.
    d. The date actuarial present value of accumulated plan benefits changes.
15. Which of the following guidance applies to determining a defined benefit plan's actuarial present value?
    a. Administrative expenses paid by the plan are excluded from the calculation of actuarial present value.
    b. Expected inflation rates cannot be used when determining automatic benefit increases.
    c. Assumed rates of return reflect expected rates of return during periods for which payments are deferred.
    d. Administrative expenses absorbed by the plan sponsors should be reflected in the actuarial present value.

16. Contributions to a 401(h) account are used solely to pay which of the following for retirees, their spouses, and dependents?
    a. Retirement income.
    b. Home insurance premiums.
    c. College tuition.
    d. Medical obligations.
17. If an employer partially or completely withdraws from a multiemployer defined benefit plan, it will have to pay a withdrawal liability. What is the maximum number of years this liability may be payable?
    a. Five.
    b. Ten.
    c. Twenty.
    d. Thirty.
18. When might an employee use accumulated eligibility credits for a health and welfare benefit plan?
    a. During a period of unemployment.
    b. When the plan is uninsured.
    c. When the plan has fully insured, experience-rated contracts.
    d. When the plan does not maintain a cash reserve.
19. When might a health and welfare benefit plan receive an experience-rated refund?
    a. The plan made a deposit with the insurance company against which it can apply future losses in excess of premiums.
    b. The plan enters into a stop-loss arrangement with an insurance company, and its obligation is capped at a fixed amount per participant.
    c. The plan's group insurance contracts are written for a period of one year and provide for annual renewal.
    d. Insurance premiums paid exceed claims paid by the insurance company, required reserves, and administration fees.
20. Which of the following statements best describes COBRA benefits under a health and welfare plan?
    a. Plan sponsors are required to pay the entire cost of COBRA benefits for the participant.
    b. If participants pay the estimated full cost, the plan would not recognize a benefit obligation.
    c. COBRA benefits are for active employees and expire upon termination of employment.
    d. COBRA benefits are not available under health and welfare plans.
21. What types of plans are subject to ERISA's minimum annual funding requirements?
    a. Target benefit plans only.
    b. Defined contribution retirement plans only.
    c. Defined benefit retirement plans and certain defined contribution retirement plans.
    d. Money purchase plans only.

22. Are analytical procedures effective for auditing contributions to employee benefit plans?

    a. Yes, analytical procedures are typically effective for auditing contributions in all types of employee benefit plans.

    b. No, analytical procedures typically provide little evidence and should not be used for this purpose.

    c. Analytical procedures are effective for defined benefit and defined contribution plans, but not for health and welfare benefit plans.

    d. Analytical procedures are effective for health and welfare benefit plans, but not for defined benefit and defined contribution plans.

23. ShieldCo maintains a single-sponsor defined benefit plan. It is required to make quarterly installment payments on its contributions receivable. When is each installment payment due?

    a. At the beginning of each quarter.

    b. Two weeks prior to the end of the quarter.

    c. The last day of each quarter.

    d. Two weeks after the end of the quarter.

24. An auditor can typically obtain enough information about investments by applying procedures to the plan's investment records if those investments are—

    a. Held for investment by a nonqualified institution.

    b. Part of a nondiscretionary trust arrangement.

    c. Part of a trust arrangement controlled by a trustee.

    d. Administered by anyone outside of the plan.

25. Obtaining an analysis of changes in investments during the audit period and examining authorizations and documentation for purchases, sales, and realized gains and losses will help provide an auditor information on what?

    a. Investment activity.

    b. Investment existence.

    c. Investment income.

    d. Investment valuation.

26. During an audit engagement, many firms do which of the following on at least a small selection of investment income?

    a. Request a confirmation from the bank.

    b. Act as an appraiser.

    c. Perform detail testing.

    d. Engage a specialist.

27. Consideration of all of the following will help an auditor determine whether fair value measurements conform to GAAP **except**:

    a. The intent and ability of plan management to carry out specific courses of action.

    b. Whether the trustee has obtained insurance that covers the plan assets under its control.

    c. The appropriateness of the valuation method used and plan management's rationale for choosing it.

    d. Whether fair values were determined consistently and appropriately, considering changing circumstances.

28. Under ERISA, a plan is prohibited from acquiring qualifying employer securities in amounts that exceed what percentage of the fair value of plan assets?

    a. 10%.

    b. 20%.

    c. 30%.

    d. 50%.

29. What type of fund, account, or trust allows plan participants to purchase or sell an entire portfolio of stocks in a single security as effortlessly as buying or selling a share of stock?

    a. A common/collective trust.

    b. An exchange-traded fund (ETF).

    c. A master trust.

    d. An omnibus account.

30. What is the auditor's first step when auditing derivatives?

    a. Physically inspecting derivative contracts and requesting any necessary information from appropriate counterparties.

    b. Determining whether a derivative is also a hedge and inspecting relevant documentation from management about the hedging relationship.

    c. Ascertaining whether the derivatives in question are part of a self-directed investment program.

    d. Determining whether all of the plan's derivatives were identified by management and recorded in the financial statements.

31. What is the first thing an auditor should do when auditing a plan's insurance contracts?

    a. Determine whether any provisions that restrict assets require adjustment.

    b. Confirm the fair value of the contract with the insurance company.

    c. Read the contracts to determine their nature and terms.

    d. Consider whether the contracts violate ERISA requirements, limitations, or prohibitions.

32. Which of the following statements describes a *separate-separate account*?

    a. It is similar to a common/collective trust account.

    b. It pertains to multiple plans.

    c. Its assets are owned by the insurance company.

    d. Its assets are commingled with other assets.

33. Which of the following is accurate regarding auditing procedures for participant data?

    a. The auditor may trace demographic data back to the employer's personnel files.

    b. The auditor is required to recompute deferrals for all plan participants when testing contributions.

    c. Sampling is not efficient for testing payroll transactions.

    d. No testing is required if the plan has an automatic enrollment feature.

34. Testing income tax withholding and tracing participants to and from payroll records may help an auditor obtain information about which of the following?

    a. Withdrawals, terminations, and forfeitures.

    b. Participants' hypothetical accounts in a cash balance plan.

    c. Participant census data in a multiemployer plan.

    d. Conditions for meeting the DOL Reg. 2510.3-102 safe harbor.

35. Comparing signatures on canceled checks to the application for benefits can help an auditor determine what?

    a. Whether a service organization is using correct claims eligibility data.

    b. Whether payments are being made to deceased persons.

    c. Whether missing participants need to be located.

    d. Whether any qualified domestic relations orders (QDROs) have been upheld.

36. Which of the following statements best describes the benefit obligations of defined benefit health and welfare plans?

    a. Such plans must be insured so that at least part of the risk of providing benefits is assumed by the insurance company.

    b. Their financial statements should include the actuarial present value of certain benefit obligations, including claims payable and premiums payable to insurance companies.

    c. The audit procedures required will be the same whether a specific benefit obligation is determined by an actuary or by the plan itself.

    d. The auditor is required to consult an actuary as a specialist for all engagements.

37. Which of the following statements is correct regarding an uninsured employee benefit plan?

    a. The plan is prohibited from estimating claims incurred but not reported (IBNR).

    b. Authoritative standards require an actuary to estimate the plan's unpaid claims obligation.

    c. The participants will be forced to pay their own unpaid claims since the plan is uninsured.

    d. The plan assumes the obligations of unpaid claims incurred as of the financial statement date.

38. Which of the following is correct related to a plan's operating (administrative) expenses?

    a. PBGC insurance premiums must be excluded from operating expenses.

    b. They may be absorbed, all or in part, by a single-employer plan sponsor.

    c. The audit procedures required for such expenses are very different than for other expenses.

    d. Sponsor-absorbed expenses must be disclosed in the plan's statement of changes in net assets.

39. What type of analytical procedure compares absolute dollar amounts or percentage of change in accounts over time?

    a. Benefit ratios.

    b. Contribution ratios.

    c. Reasonableness tests.

    d. Trend analysis.

40. What happens when a defined benefit plan or a health and welfare plan is put into soft freeze by the plan sponsor?

    a. Participants may or may not still accrue new benefits, while existing benefits continue to be adjusted for increases in participants' wages.

    b. Benefits cease accruing for some participants, but others will still receive benefits based on tenure, age, and job classification.

    c. Participants in the plan will no longer earn benefits of any type, and all benefit accruals will cease.

    d. New participants will be allowed into the plan on a limited basis until all accrued benefits have been paid.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 2—Accounting and Financial Reporting Standards and Special Auditing Considerations for Employee Benefit Plans (EBPTG222)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State/ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

Credit Card Number: ______________________________ Expiration Date: ______________

Birth Month: ______________________________ Licensing State: ______________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: ⊘ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: March 31, 2023

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 2—Accounting and Financial Reporting Standards and Special Auditing Considerations for Employee Benefit Plans (EBPTG222)

Your Name (optional): ______________________ Date: ______________

Email: ______________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this: ● not like this: ⦸ ⊗ ✓

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant, and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ____________

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can. (Please print legibly):

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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
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GLOSSARY

Allocated contract: This type of contract with an insurance company transfers the obligation to pay benefits to the insurance company, unlike an *unallocated contract*.

Benefit information date: This is the date an actuarial present value of accumulated plan benefits is presented. It may be a plan year end or a date as of the beginning of the plan year.

Benefit obligation information: Information about the actuarial present value of accumulated plan benefits.

Common/collective trust: This involves the pooling of assets of two or more unrelated plans at a bank or similar financial institution for investment purposes. The bank does not own the assets in the trust by only holds them in trust for the participating plans.

Demutualization: The conversion of a mutual life insurance company to a stock life insurance company.

Deposit administration (DA) contracts: Insurance contracts that guarantee a rate of interest and a rate at which benefit annuities may be purchased with funds from the account. A DA contract may be a general account in which the assets in the contract are commingled with the insurance company's other assets, or it may be an individual or pooled separate account.

Derivative instrument: This is a financial instrument or other contract that has all three of the following characteristics: (1) one or more *underlyings* and (a) one or more *notional amounts*, or (2) payment provisions, or (c) both; (2) no initial net investment is required or a smaller investment is required than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (3) the terms require or permit net settlement, it can be readily settled net outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from a net settlement.

Discretionary trust: An investment trust in which the trustee has the authority to initiate the investment transactions within the framework specified in the trust agreement without specific authorization of individual transactions.

Fair value: The price that would be received to sell an asset or the price that would be paid to transfer a liability in an orderly transaction involving market participants at the measurement date.

Frozen plan: Defined benefit plans, health and welfare plans, and ESOPs may be frozen by the plan sponsor. When a plan is frozen, no new participants are allowed into the plan. The plan will continue to exist until all accrued benefits have been paid. Plans can be under a soft freeze, a partial freeze, or a hard freeze.

Guaranteed investment contract (GIC): This insurance contract normally is a general account that guarantees a rate of return on the principal invested. Various types of GICs may have multiple maturities and interest rates, may have floating rates, and may offer a combination of a guaranteed minimum interest rate and additional interest at the insurance company's discretion.

Immediate participation guarantee (IPG) contracts: These insurance contracts may be a general account or a separate account and are similar to *DA contracts*, except that IPGs do not guarantee a minimum interest rate or a rate for purchasing annuities from the fund. Those rates are based on the insurance company's actual investment experience or annuity experience rate at the time interest is credited to the account or annuities are purchased.

Insurance contracts: According to GAAP, these contracts transfer a significant amount of risk from an employee benefit plan to the insurance company.

Investment contracts: According to GAAP, these are long-term contracts that do not subject an insurance company to risks related to the mortality or morbidity of the policyholder.

Master trust: A trust in a regulated and supervised institution (bank, trust company, or similar financial institution) where the trustee or custodian is required to have periodic examination by a state or federal agency.

Notional amount: This is a number of currency units, shares, bushels, pounds, or other units specified in a contract.

Operating expenses: For an employee benefit plan, these may include legal, actuarial, accounting, consulting, and data processing fees; investment trustee and advisory fees; fees to a third-party plan administrator; or the PBGC insurance premium of a defined benefit retirement plan. They are also called *administrative expenses*.

Participant data: This includes information such as age, sex, hire date, service years, hours worked in the current period, etc. It is used in determining material amounts presented in the financial statements of an employee benefit plan.

Payment provision: This specifies a fixed or determinable settlement to be made if an *underlying* behaves in a specific way.

Postemployment benefits: Benefits offered to participants, and their dependents and beneficiaries, by a health and welfare plan after employment but prior to retirement.

Postretirement benefit obligation: As of the measurement date, this is the actuarial present value of all future benefits attributed to plan participants' services provided to that date.

Postretirement benefits: Benefits offered to participants, and their dependents and beneficiaries, by health and welfare benefit plans after retirement.

Principle market: According to the FASB ASC Glossary, this is the market with the greatest volume and level of activity for an asset or liability.

Ratio analysis: This involves the study of the relationship between two financial statement amounts.

Realized gains and losses: These are incurred when investments are sold. Under GAAP, they are calculated as the difference between the proceeds received and the historical cost of the investment.

Reasonableness tests: These estimate a financial statement amount or the change in an amount from the prior year. Some reasonableness tests involve ratios. Others involve estimating account balances by using nonfinancial data.

Rollover distributions: Transfers from a qualified plan to another qualified plan or to an individual retirement account.

Special purpose financial statements: Financial statements prepared on a basis of accounting other than GAAP.

Synthetic GICs: In these insurance contracts, the assets underlying the contract are placed in a trust and are owned by the plan rather than the contract issuer. The plan purchases a "wrapper" contract from a third party (often the same entity that issues the investment contract), which protects the plan from the risk of declines in the market value and cash flow potential of the covered assets.

Trend analysis: This compares the absolute dollar amount or percentage change in accounts over time.

Unallocated contract: This type of contract with an insurance company is an investment vehicle and does not transfer any obligation to pay rights like in an *allocated contract*.

Underlying: A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). It may be a price or rate of an asset or liability, but it is not the asset or liability itself.

Unrealized gains and losses: These are recorded to reflect the increase or decrease in the value of investments hold over time. Under GAAP, they are calculated as the difference between the fair value of the investment at the prior reporting date (or its cost if purchased in the current period) and the fair value at the reporting date.

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COMPANION TO PPC'S GUIDE TO AUDITS OF EMPLOYEE BENEFIT PLANS

COURSE 3

ERISA AND CERTAIN TAX REQUIREMENTS (EBPTG223)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course takes a look at requirements for employee benefit plans put forth by the Employee Retirement Income Security Act of 1974 (ERISA), as well as certain tax requirements. Topics covered include plan design and operation, fiduciary responsibilities, and reporting to entities such as the Department of Labor (DOL), Internal Revenue Service (IRS), and Pension Benefit Guaranty Corporation (PBGC).
PUBLICATION/ REVISION DATE:	March 2022
RECOMMENDED FOR:	Users of *PPC's Guide to Audits of Employee Benefit Plans*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of the auditing and taxation of employee benefit plans
CPE CREDIT:	6 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **IRS Enrolled Agents (EA) and Non-Credentialed Return Preparers (NCRP):** This course is designed to enhance professional knowledge for IRS EAs and IRS NCRPs. Checkpoint Learning is an IRS Continuing Education Provider that is approved to deliver continuing education to IRS Enrolled Agents and IRS Non-Credentialed Return Preparers.
CTEC CREDIT:	3 CTEC Federal Tax Law Hours
IRS EA CREDIT:	3 Federal Tax Law/Tax Related Matters Hours
IRS NCRP CREDIT:	3 Federal Tax Law Hours
FIELD OF STUDY:	Auditing, 3; Taxes, 3
EXPIRATION DATE:	Postmark by **March 31, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—ERISA and Tax Requirements for Plan Design and Operation

Completion of this lesson will enable you to:

- Recognize the ERISA and tax requirements that affect the design and operation of employee benefit plans.

Lesson 2—Fiduciary Responsibilities, Reporting, and Other ERISA and Tax Requirements

Completion of this lesson will enable you to:

- Determine who is the fiduciary of an employee benefit plan and what responsibilities that role entails.
- Identify required disclosures that must be made to plan participants and what information must be reported to the DOL, IRS, and PBGC.
- Recognize other requirements that affect employee benefit plans, including those related to plan termination and correcting violations.

TO COMPLETE THIS LEARNING PROCESS:

Log onto our Online Grading Center at **cl.tr.com/ogs**. Online grading allows you to get instant CPE credit for your exam.

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See the test instructions included with the course materials for additional instructions and payment information.

ADMINISTRATIVE POLICIES

For information regarding refunds and complaint resolutions, dial (800) 431-9025 (Option 2) for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: ERISA and Tax Requirements for Plan Design and Operation

INTRODUCTION

The Employee Retirement Income Security Act of 1974 (ERISA) and the tax rules for employee benefit plans are interrelated to a great extent. Specifically, Title II of ERISA contains provisions for plan tax qualification that are identical to the Title I provisions required for all covered plans as a matter of law. [Additional Internal Revenue Code (IRC) requirements apply for plan qualification.] Also, ERISA is administered by the Department of Labor (DOL), the Pension Benefit Guaranty Corporation (PBGC), and the Department of Treasury (DOT), of which the IRS is a part. Finally, the Form 5500 satisfies the reporting requirements of ERISA, the IRS, and the PBGC. This lesson discusses ERISA, tax, and DOL laws and regulations imposed on employee benefit plans and their fiduciaries *with which the auditor needs to be familiar*. Tax requirements that do not relate to the financial statements or an audit of the financial statements are not discussed.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the ERISA and tax requirements that affect the design and operation of employee benefit plans.

Significance of ERISA, Tax, and DOL Laws and Regulations in the Audit of an Employee Benefit Plan

The auditor of an employee benefit plan needs to be familiar with ERISA, tax, and DOL laws and regulations. ERISA, Form 5500, and DOL regulations impose certain reporting responsibilities on the plan auditor, for example, to report on supplemental schedules of delinquent participant contributions, investments, prohibited transactions, and other matters in addition to reporting on the financial statements, and to disclose any exceptions to DOL regulations of which the auditor is aware in the audit report. There are very specific requirements for the form and content of these schedules, disclosures, and reports. In addition, the client may engage the auditor to prepare the Form 5500 as an additional service.

The DOL reviews reports filed with it and rejects those with deficiencies in the Form 5500, financial statements, supplemental schedules, or auditor's report. It may fine the plan administrator if the deficiency is not corrected in a timely manner. The fine may be imposed on the plan administrator even though the deficiency may have occurred in the auditor's report or statements or schedules for which the auditor had a reporting responsibility.

The AICPA Audit and Accounting Guide, *Employee Benefit Plans*, (AEBP), Paragraph 2.140, states that the auditing standards on consideration of laws and regulations apply with respect to prohibited party-in-interest transactions. AEBP, Paragraph 2.144, indicates the auditor should consider the implications of any identified prohibited party-in-interest transactions on other aspects of the audit, particularly on the reliability of management representations. To meet these GAAS requirements, the auditor has to understand the ERISA definitions of parties in interest and prohibited transactions, which are provided in Lesson 2.

AEBP, Paragraph 12.26, states that assertions for the auditor to consider include whether the employee benefit trust is qualified as tax exempt under the IRC and whether there is proper recording and disclosure of any asserted and unasserted claims and assessments affecting plan assets due to the loss of tax exemption. Under AU-C 250, the auditor has certain responsibilities to inquire about management's compliance with those tax laws and regulations relating to plan qualification and to apply additional procedures if he becomes aware of a possible violation affecting the financial statements.

To achieve the audit objectives and responsibilities mentioned in the preceding paragraphs, the auditor needs to be familiar with ERISA, tax, and DOL laws and regulations relating to plan qualification. Lesson 1 discusses ERISA and tax requirements for plan design and operation, while Lesson 2 covers the following topics:

- Fiduciary responsibilities.
- Required disclosures to plan participants.
- Required reporting to the DOL, IRS, and PBGC.
- Plan termination, reportable events, and reversion.
- Unrelated business income.
- Options for correcting violations.

Practice Aids. The laws and regulations referred to in the preceding paragraph and discussed in this course are referred to at numerous points in the chapters and practice aids that make up *PPC's Guide to Audits of Employee Benefit Plans*. That guide includes pertinent excerpts of ERISA and DOL regulations, checklists, worksheets, and audit programs that auditors can use, if desired, when auditing employee benefit plans.

Auditors who prepare the Form 5500 may wish to obtain *PPC's 5500 Deskbook*. The book discusses and illustrates completed Form 5500s and related schedules for retirement and welfare benefit plans. In addition, *PPC's Guide to Small Employer Retirement Plans* provides detailed discussions of the plan qualification requirements summarized in this course.

ERISA AND TAX REQUIREMENTS FOR THE DESIGN AND OPERATION OF EMPLOYEE BENEFIT PLANS

Title I of ERISA and various IRC sections contain requirements for the following matters:

- Minimum plan participation.
- Minimum plan coverage.
- Minimum vesting.
- Minimum funding.

The IRC and related regulations also contain other requirements for a plan to qualify as tax exempt. Those requirements relate to the following matters:

- Accrual of benefits.
- Nondiscrimination in benefits or contributions.
- Minimum distributions.
- Maximum benefits and contributions.
- Social Security integration.
- Top-heavy plans.

This section first discusses applicability of ERISA, Title I, and the meaning of plan qualification and then discusses the requirements listed above. *The following summary of ERISA and IRC provisions is necessarily a general overview that does not include the numerous special provisions, complexities, and exceptions embedded in the laws and regulations. Thus, it is not intended to be a substitute for the ERISA statute, Internal Revenue Code, or IRS or DOL regulations. Also, the discussion is not intended as a specific guide to tax return preparation. Nor is this course intended as a specific guide to determination of plan qualification or compliance with ERISA requirements. Such determinations are legal matters that go beyond the auditor's responsibilities or expertise.*

Plans Covered and Not Covered by ERISA, Title I

ERISA, Title I, covers employee benefit plans established or maintained by an employer (or employee organization—see Lesson 2 for the definition of an employee organization) engaged in interstate commerce or in any industry or activity affecting commerce.

The following plans are not covered by Title I of ERISA:

- Governmental plans.
- Church plans not electing IRC Sec. 410(d).
- Plans maintained solely to comply with workers' compensation, unemployment compensation, or disability insurance laws.
- Plans maintained outside the United States for nonresident aliens.
- Excess benefit unfunded plans (plans maintained to provide benefits in excess of the IRC limitations on contributions and benefits).
- Deemed IRAs under a pension plan for plan years beginning after December 31, 2002. A qualified employer plan may set up separate accounts or annuities as deemed IRAs, which will be treated as IRAs rather than as part of a qualified retirement plan.

Some sections of ERISA, Title I, do not apply to health and welfare benefit plans. For example, the participation, benefit accrual, and vesting standards do not apply because those standards relate to plans providing retirement income benefits, which health and welfare benefit plans do not provide.

Plan Qualification

The major tax advantages of a qualified employee benefit plan are as follows:

- The employer's contributions, within statutory limits, are deductible for its federal income tax purposes when they are made.
- The employer's contributions to a retirement plan, although considered compensation to employees, are not taxed to the employees until they receive distributions from the plan.
- For 401(k) plans and some IRC Sec. 125 cafeteria plans, the portion of compensation that the employees elect to have contributed to the plan, within statutory limits, also is not taxed to them currently.
- All, or part, of the value of the benefit provided by a health or welfare plan is excluded from employees' income.

A qualified employee retirement benefit plan is a stock bonus, pension, or profit-sharing plan that meets the requirements of IRC Sec. 401(a), and a nonqualified plan is one that does not meet those requirements. IRC Sec. 401(a) qualification requirements, discussed in this section, do not apply to health and welfare benefit plans. Other IRC sections apply to various types of fringe benefit plans that may also be health and welfare plans. For example, IRC Sec. 79 applies to group term-life insurance plans; IRC Sec. 105–106 apply to health and accident plans; IRC Sec. 125 applies to cafeteria plans; and IRC Sec. 501(c)(9) applies to voluntary employees' beneficiary associations (VEBAs), which may be established to fund a welfare benefit plan. Requirements specific to several different types of welfare plans are briefly discussed later in this lesson. Also, the fiduciary responsibilities and reporting requirements discussed in Lesson 2 apply to health and welfare plans as well as to retirement benefit plans.

Qualified retirement plans must be funded and plan assets must be kept in trust. The plan trust is tax-exempt; that is, the net investment income and realized gains on its invested assets are not currently taxed. Such income is taxed to retirement plan participants when it is distributed to them. IRC Sec. 401(a)(2) contains an exclusive benefit rule that the plan instrument must provide that no part of the trust may be used for any purpose other than the provision of benefits to plan participants. The main objective of the Section 401(a) qualification rules is that a qualified plan not

discriminate in favor of highly compensated employees in terms of participation [Sections 401(a)(3) and 401(a)(26)], contributions or benefits [Section 401(a)(4)], or vesting [Section 401(a)(7)].

IRS Determination Letter Program. Determination letters may provide evidence that the design of an employer-sponsored retirement plan satisfies the IRC qualification requirements as of the date of issuance of the letter. The IRS issues determination letters regarding the qualified status of retirement plans under Section 401(a) of the IRC and the status of related trusts under Section 501(a). AEBP cautions that the existence of a favorable determination letter does not, by itself, provide evidence that the plan is qualified.

Rev. Proc. 2016-37, provides requirements for when plans with individually designed plan (IDP) documents must adopt amendments under IRC Sec. 401(b). Under Rev. Proc. 2016-37, plan sponsors may rely on determination letters regarding plan provisions that have been subsequently amended or subsequently affected by a change in law. However, they may continue to rely on determination letters regarding provisions that have not been amended or changed by law. An IDP's remedial amendment period for required amendments is tied to a Required Amendment List (RA list), unless other guidance states otherwise. IDPs are not required to make interim amendments. The RA List identifies all of the amendments that must be made to an IDP for it to retain its qualified plan status and is published after October 1 of each year. Plan sponsors generally have until the end of the second calendar year following the year the RA List is published to adopt any item on the list. For example, plan amendments for those items on the 2020 RA List must be adopted by December 31, 2022. See **www.irs.gov/retirement-plans/required-amendments-list**.

Under Rev. Proc. 2016-37, plan sponsors may request a determination letter only under very limited circumstances, including (a) initial plan qualification, (b) qualification upon plan termination, or (c) under certain circumstances determined by the IRS, based on program capacity and need, and announced annually in the Internal Revenue Bulletin (no additional circumstances apply in calendar year 2019).

Rev. Proc. 2016-37 does not change when discretionary amendments are required to be made and put into effect under Rev. Proc. 2007-44. Those amendments will still be required by the end of the plan year in which the plan amendment is put into effect operationally. It also does not change a plan's operational compliance standards. Plans need to be operated in compliance with any change in qualification requirements from the effective date of the change, regardless of the plan's 401(b) period for adoption of amendments. However, Rev. Proc. 2020-9 makes an exception by extending the deadline to December 31, 2021 for all statutory plan amendments related to hardship distributions that were required by the Bipartisan Budget Act of 2018 (BBA 2018) and the Tax Cuts and Jobs Act (TCJA), even if the amendments were adopted prior to January 1, 2020. (The regulations may be applied to distributions made in plan years beginning after December 31, 2018.) The IRS publishes an Operational Compliance List on an annual basis to identify changes in qualification requirements each calendar year. The list can be found on at **www.irs.gov/retirement-plans/operational-compliance-list**.

Minimum Age and Service Requirements

ERISA, Title I, Section 202, and IRC Sec. 410(a) establish minimum standards for plan participation as a matter of law and as a requirement for plan qualification. A plan may require a minimum age and years of service for participation in the plan, but these minimums may not exceed the later of age 21 or one year of completed service. Thus, for example, a 21-year old with three months of service can be made to wait nine more months to participate, or a 20-year old can be made to wait one more year. A year of service is defined as at least 1,000 hours in a 12-month period. There are detailed rules for computing the service period and breaks in service for the purpose of determining eligibility to participate in the plan. Also, a plan may not exclude employees from participating solely on the basis that they are too old.

Benefit Accrual

The benefit accrual is the rate at which plan participants earn benefits under the plan. The method of benefit accrual depends on whether the plan is a defined contribution plan or defined benefit plan.

Defined Contribution Plan. In the case of a defined contribution plan, the benefit accrual is the amount of contributions, forfeitures, earnings, gains, and losses allocated to the participant's account. In general, the benefit

accrual rule can require both a minimum number of hours of service (of no more than 1,000 hours) and employment at the end of the plan year. The partial accrual concept applies only to defined benefit plans.

Defined Benefit Plan. The benefit obligation disclosed in a defined benefit plan's financial statements is determined by applying actuarial methods and assumptions to the measurement of accumulated plan benefits. For a defined benefit plan, the accrued benefit is determined by the plan's benefit accrual formula as the periodic pension payable as of the normal retirement date. For example, a defined benefit plan may provide that a participant will earn a benefit equal to .5% of compensation averaged over the highest five consecutive years for each year of service with the employer, limited to a maximum of 30 years.

The IRC and ERISA contain similar rules restricting a plan's ability to "back-load" defined benefit accruals. Back-loading refers to the practice, commonly used prior to ERISA, of weighting the benefit formula so that a participant accrues proportionately greater benefits in later years of service. The rules relating to benefit accruals, found in IRC Sec. 411(b), generally result in ratable benefit accruals over the employee's period of service. However, a small degree of back-loading is permissible under IRC Sec. 411(b) and its related regulations.

In general, any participant in a defined benefit plan having 1,000 hours or more of service during the year must accrue a benefit. However, a participant may receive a partial year's accrual on a prorata basis if an employee's service during a computation period is more than 1,000 hours but less than the service required for a full year of participation in the plan [DOL Reg. 2530.204-2(c)]. If the participant does not work full-time, the benefit accrued may be a proportionate part of the benefit accrued by a full-time employee [IRC Sec. 411(b)(4)].

Minimum Vesting Requirements

Vesting relates to the rate at which an employee's accrued benefit becomes nonforfeitable if the employee terminates employment. ERISA, Title I, Section 203, and IRC Sec. 411(a) set minimum vesting schedules. Vesting schedules relevant to defined benefit plans and defined contribution plans are discussed below.

Defined Benefit Plans. Unless the plan is deemed to be top-heavy, an employee's accrued benefit derived from employer contributions in defined benefit plans must vest in one of the following schedules [IRC Sec. 411(a)(2)]:

a. *Five-year Cliff Vesting.* 100% after five years of service (0% vested until the fifth year).

b. *Seven-year Graded Vesting.* 100% after seven years of service on a graded schedule of 20% after three years followed by an additional 20% after each of years four through seven (that is, 40% vested after four years, 60% vested after five years, 80% vested after six years, and 100% vested after seven years).

In top-heavy defined benefit plans, an employee's accrued benefit derived from employer contributions are subject to accelerated vesting and must vest in one of the following schedules [IRC Sec. 416(b)(1)]:

a. *Three-year Cliff Vesting.* 100% after three years of service (0% vested until the third year).

b. *Six-year Graded Vesting.* 100% after six years of service on a graded schedule of 20% after two years followed by an additional 20% after each of years three through six (that is, 40% vested after three years, 60% vested after four years, 80% vested after five years, and 100% vested after six years).

Defined Contribution Plans. Generally, all employer contributions (both nonelective employer contributions and employer matching contributions) made to a defined contribution plan (whether or not the plan is deemed to be top-heavy) must vest using either a three-year cliff vesting or a six-year graded vesting as described as follows [IRC Sec. 416(b)(1) and IRC Sec. 411(a)(2)(B)]:

a. *Three-year Cliff Vesting.* 100% after three years of service (0% vested until the third year).

b. *Six-year Graded Vesting.* 100% after six years of service on a graded schedule of 20% after two years followed by an additional 20% after each of years three through six (that is, 40% vested after three years, 60% vested after four years, 80% vested after five years, and 100% vested after six years).

All plans must provide 100% vesting for participants who attain normal retirement age. Plans must also provide for 100% vesting if they are terminated or if contributions not subject to the minimum funding requirement are

discontinued. Finally, plans must provide that employee contributions and accrued benefits attributable to such contributions are 100% vested at all times.

There are detailed rules for determining years of service and normal retirement age for applying the vesting rules.

Minimum Funding Requirements

The minimum funding standard is an actuarial calculation of an employer's annual contribution to ensure the amount contributed covers the annual cost of future benefits and administrative expenses. For a single-employer defined benefit plan, the calculation of the minimum required contribution for a plan year will be determined by whether the value of the plan assets exceed the plan's funding target [Reg. 1.430(a)-1(b)(1)].

Funding Standard Account Requirement and Accumulated Funding Deficiencies. The funding requirements provide for a single minimum required contribution calculation for plans other than multiemployer plans. Although actuaries will be needed to deal with the details of the calculation, a basic understanding of the following terms contained in the rules may be helpful:

a. *Funding Target.* The present value of all benefits accrued, earned, or otherwise allocated to years of service under the plan as of the beginning of the plan year. The *funding target* is used to determine if the plan has a funding shortfall [IRC Sec. 430(d)(1) and Reg. 1.430(d)-1(b)(2)].

b. *Target Normal Cost.* The present value (determined as of the valuation date) of all benefits that accrue or are earned during or are otherwise allocated to service for the current plan year [IRC Sec. 430(b); Reg. 1.430(d)-1(b)(1)].

c. *Funding Shortfall.* If the plan's funding target for the year exceeds the value of the plan assets (on the valuation date), the plan has a funding shortfall for the year [IRC Sec. 430(c)(4)].

d. *Shortfall Amortization Installment.* The *shortfall amortization installment* is the amount necessary to amortize the shortfall amortization base for any plan year over a 7-plan-year period using specified interest rate rules [IRC Sec. 430(c)(2)].

e. *Waiver Amortization Base.* The *waiver amortization base* for a plan year is the amount of waived funding deficiency [IRC Sec. 412(c)(3), IRC Sec. 430(e)(4), and Reg. 1.430(a)-1(f)(2)].

f. *Accumulated Funding Deficiency.* The excess of the total amount that must be contributed under the plan formula over the total amount actually contributed [IRC Sec. 431(a)]. Accumulated funding deficiencies are subject to excise tax.

The minimum required contribution (MRC) depends on whether the plan has a funding shortfall for the plan year and is determined as follows:

a. If the plan has a funding shortfall, the MRC is the sum of the plan year's—

 (1) the target normal cost,

 (2) the shortfall amortization charge, and

 (3) the waiver amortization charge, if any.

b. If the plan has no funding shortfall, the MRC is the target normal cost for the plan year, reduced by the excess of total assets over the funding target.

Multiemployer Plans. Multiemployer plans meet the minimum funding standards under IRC Sec. 431. The funding deficiency for multiemployer plans provides that the deficiency is equal to the excess (if any) of total charges for all plan years to the plan's funding standard account as of the end of the plan year over the total credits to the account. Special rules apply if the plan is in reorganization or is determined to be in endangered or critical status.

Waiver. Under certain circumstances, the minimum funding standards can be waived. Money purchase plans and target benefit plans are also subject to the ERISA funding requirement. These plans must make the contribution

required by the plan's contribution formula. Profit-sharing, 401(k), stock bonus, and welfare benefit plans are exempt from the funding requirement.

Actuarial Methods. Recognized actuarial methods must be used to determine normal cost and other aspects of the minimum funding requirement. Also, an enrolled actuary must prepare and sign the Schedule SB or MB of the Form 5500 that defined benefit plans subject to the minimum funding requirement file. An *enrolled actuary* is one that is enrolled in the Joint Board for the Enrollment of Actuaries, which the DOT and DOL established to set standards and qualifications for the plan actuary.

Funding Payments. Sponsors of single-employer defined benefit plans may be required to make quarterly installments of the contribution, based on the guidance of IRC Sec. 430(j)(3). (Money purchase plans are not required to make installment payments.) Generally, contributions are required to be made quarterly. Each installment, if required, must be at least 25% of the required annual payment, as defined. If a plan sponsor fails to make a required contribution or installment payment and unpaid contributions, including interest, exceed $1 million, the sponsor must file PBGC Form 200, "Notice of Failure to Make Required Contributions," within 10 days after the payment due date.

Funding Waiver. If a plan sponsor cannot meet a year's minimum funding requirement without temporary substantial business hardship, the IRS may issue a funding waiver. The IRS determines what is a substantial hardship and whether it would be adverse to participants' interest not to waive the requirement. For example, if the plan sponsor were operating at a loss and were likely to terminate the plan in the absence of a waiver, the IRS might conclude it would be in the plan participants' best interest to grant a waiver. Note that a waiver only postpones the plan sponsor's funding; it does not eliminate it.

The IRS has the authority to lengthen the amortization periods for unfunded past service liability and experience losses if there is a risk of plan termination or adverse affect on benefit levels or employee compensation.

Excise Tax on Funding Deficiency. An employer who maintains a plan subject to the minimum funding requirements that has an accumulated funding deficiency for any year must pay an excise tax. A multiemployer plan must pay 5% (10% for a non-multiemployer plan) of the accumulated funding deficiency unpaid as of the end of any plan year ending with or within the taxable year [IRC Sec. 4971(a)]. If the funding deficiency is not corrected by the time the initial tax is assessed or by the time the IRS mails a tax deficiency notice, the employer is liable for an additional excise tax of 100% of the amount of the funding deficiency [IRC Sec. 4971(b)]. A funding deficiency is corrected by making a contribution to the plan of the amount needed to reduce the deficiency to zero [IRC Sec. 4971(c)(2)]. Payment of the 100% excise tax does not void the funding deficiency; it is still owed to the plan. However, a waiver of the additional 100% excise tax may be requested.

Minimum Plan Coverage

The IRC Sec. 410(b) provision on minimum plan coverage relates to plan qualification for tax purposes only and does not have a counterpart in ERISA. To be a qualified plan, a plan must cover a minimum percentage of employees or class of employees. The plan must meet one of the following minimum coverage tests:

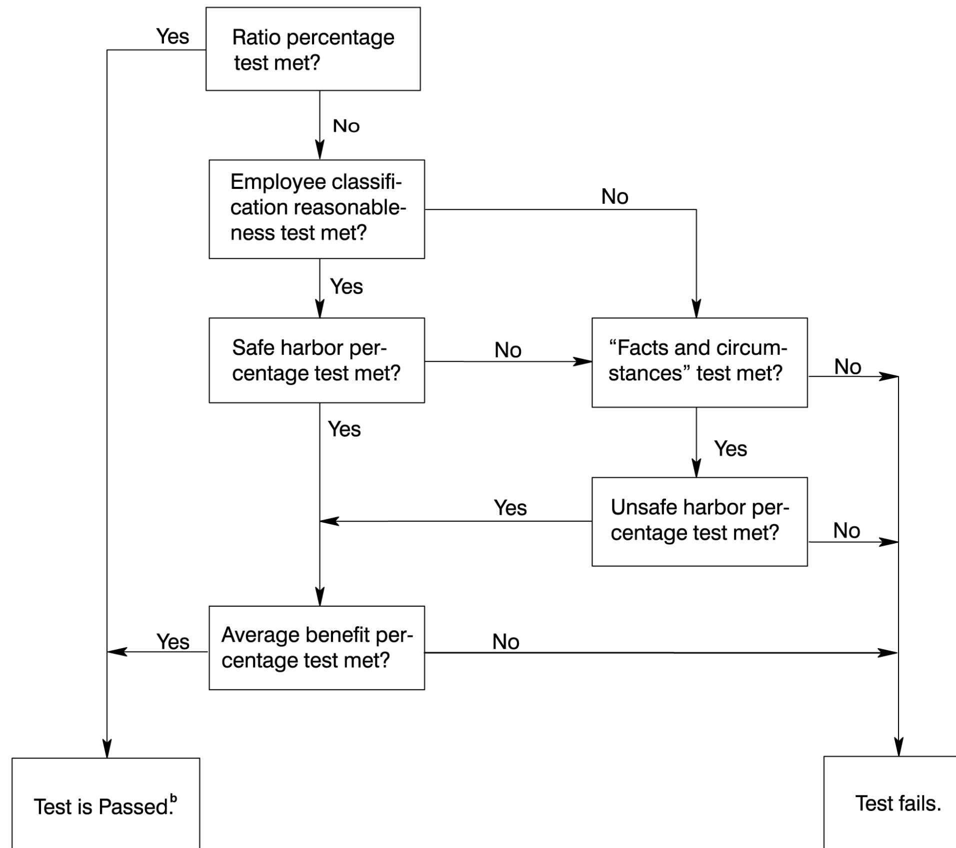
a. the ratio percentage test, or

b. the average benefit test (which consists of a nondiscriminatory classification test and an average benefit percentage test).

Exhibit 1-1 is a flowchart that illustrates the minimum coverage test. In addition to the minimum coverage test, qualified defined benefit plans must meet the minimum number of participants requirement discussed later in this lesson.

Exhibit 1-1

Minimum Coverage Test[a]



Notes:

[a] The minimum coverage test applies to both defined contribution and defined benefit plans.

[b] Defined benefit plans must also pass a minimum participation test.

Application of Minimum Coverage Tests to Employee Groups and Portions of Plans. In applying the ratio percentage test or average benefit test, which are described in the following paragraphs, the calculations may exclude the following employees:

a. *Minimum Age and Service Requirements.* ERISA, Title I, Section 202, and IRC Sec. 410(a) establish minimum standards for plan participation as a matter of law and as a requirement for plan qualification. A plan may require a minimum age and years of service for participation in the plan, but these minimums may not exceed the later of age 21 or one year of completed service.

b. *Employees of a 501(c)(3) Organization.* Reg. 1.410(b)-6(g) allows employees of a Section 501(c)(3) organization who are eligible to make salary reduction contributions under an IRC Sec. 403(b) plan, under certain conditions, to be treated as excludable employees for the purpose of testing whether a IRC Sec. 401(k) or (m) plan that is provided under the same general arrangement as the 401(k) plan meet the minimum coverage requirements.

c. *Nonresident Aliens.* Nonresident aliens who receive no earned income from U.S. sources are excludable employees [Reg. 1.410(b)-6(c)]. Also, nonresident aliens receiving income from U.S. sources are excludable if the income is exempt from U.S. income tax under a tax treaty.

d. *Collectively Bargained Employees.* These individuals are excludable when testing a plan or a portion thereof that does not benefit members of the unit [Reg. 1.410(b)-6(d)]. However, if more than 2% of the employees covered by the plan are professionals, none of the employees covered by the plan are excludable as collectively bargained employees [Reg. 1.410(b)-6(d)(2)(iii)(B)]. See Reg. 1.410(b)-9 for the definition of a "professional."

e. *Noncollectively Bargained Employees.* These individuals are excludable when testing a plan or a portion thereof that does not benefit noncollectively bargained employees [Reg. 1.410(b)-6(d)].

f. *Employees of Qualified Separate Lines of Business.* Employees of qualified separate lines of business (QSLOB) are excludable employees. However, this rule does not apply when satisfying the nondiscriminatory classification portion of the average benefit test when that test must be applied on an employer-wide basis [Reg. 1.410(b)-6(e)].

g. *Certain Terminating Employees.* An employee who terminates employment before the last day of the plan year with less than 501 hours of service (or the lesser of 91 consecutive calendar days or three consecutive calendar months if the elapsed time method is used for determining years of service) is excludable if the following applies [Reg. 1.410(b)-6(f)]:

   (1) The employee does not benefit under the plan for the plan year.

   (2) The employee is eligible to participate in the plan.

   (3) The plan has a minimum period of service requirement or a requirement that an employee be employed on the last day of the plan year to accrue a benefit or receive an allocation for the plan year.

   (4) The employee fails to accrue a benefit or receive an allocation only because of the failure to satisfy the minimum period of service or last-day requirement.

   A safe harbor 401(k) plan cannot exclude terminated employees with 500 or fewer hours of service, in evaluating coverage. The exclusion for terminating employees is optional. However, if one employee is excluded under these rules, all employees meeting the criteria of this exclusion must be excluded. In other words, the employer cannot pick and choose who will be excluded under these rules; if the rules are used to exclude one employee, they must be applied to exclude all applicable employees. However, certain fail-safe language may be contained in a plan document that will allow the administrator to add specified employees terminated or active who would normally be excluded in order to pass coverage. The employees must be identified by employment criteria, such as employment date, termination date, job title, or compensation.

The minimum coverage tests are also separately applied to former employees who are receiving a current benefit under the plan, that is, a current contribution or benefit accrual. (The most common situation resulting in such a current benefit for former employees is a cost-of-living provision in a plan that results in a benefit increase for retired participants.) In addition, the coverage tests may be separately applied to each separate line of business that meets IRS requirements for a qualified separate line of business. Finally, the ratio percentage test or the nondiscriminatory classification portion of the average benefit test must be separately applied to the following groups or portions of a plan:

- Union and nonunion employees, if the plan covers both union and nonunion employees.
- Each collective bargaining unit, if there are two or more collective bargaining units covered by the plan.
- The portion of the plan that is an ESOP, if the plan includes an ESOP.
- The portion of the plan that consists of elective contributions (that is, elective deferrals), if the plan includes a qualified cash or deferred arrangement such as a 401(k) arrangement. [The IRC considers the elective deferral to be an employer contribution made on behalf of the employee at the employee's election instead of the employee receiving cash currently. This course refers to such an employer contribution as an elective deferral, which includes employee pre-tax contributions and Roth contributions. It should be

distinguished from employee voluntary after-tax contributions (other than Roth contributions) or employer matching contributions made under a 401(m) arrangement.]

- The portions of the plan that consist of employee voluntary after-tax contributions or employer matching contributions, if the plan includes such 401(m) arrangements.
- The portions of a plan maintained by more than one employer, for example, the portions of a multiple employer plan (not *multiemployer*) that pertain to the separate unrelated employers.

However, the average benefit percentage portion of the average benefit test may not be separately applied to the portions of a plan that are an ESOP or that consist of 401(k) elective deferrals or 401(m) employer matching contributions or employee voluntary contributions—such portions must be aggregated for the test.

Leased Employees. Certain leased employees must generally be considered for minimum coverage purposes if they have performed services for the employer (recipient) under the "primary direction or control" of the employer and have performed those services for the employer on a substantially full-time basis for at least one year [IRC Sec. 414(n)(1), (2), and (3)]. Whether the leased employee is under the primary direction or control of the recipient is based on facts and circumstances. These include determining whether the recipient employer directly supervises the actions of the leased employee and whether the leased employee performs services in accordance with the directions of the recipient employer (i.e., how, when, and where services are to be performed). Leased employees may, however, be excludable for minimum coverage purposes if they make up less than 20% of the recipient's nonhighly compensated work force and are covered by a nonintegrated, money purchase pension plan maintained by the leasing organization. Though outside the scope of this course, *PPC's Guide to Small Employer Retirement Plans* includes a more detailed discussion of leased employees.

The Ratio Percentage Test. Under this test, the percentage of active, nonhighly compensated employees (NHCEs) who are benefiting under the plan must equal at least 70% of the percentage of active, highly compensated employees (HCEs) who are benefiting under the plan. (Highly compensated employees are defined later in this lesson.) An employee benefits under the plan if the employee [Reg. 1.410(b)-3]—

a. receives an allocation of contributions or forfeitures under a defined contribution plan [other than a 401(k) or 401(m) arrangement].

b. is eligible to make an elective deferral to a 401(k) plan [or to the portion of a plan that includes a 401(k) feature], whether or not he or she actually makes such an elective deferral.

c. is eligible to make voluntary, nondeductible contributions or receive employer matching contributions under a 401(m) arrangement, whether or not such contributions are made.

d. receives a benefit accrual under a defined benefit plan.

e. receives no benefit accrual or makes no annual additions because of the IRC Sec. 415 limitations or because of the plan's uniformly applicable benefit limit as to maximum years of service and/or maximum retirement benefits.

f. receives no benefit accrual because it is offset by the contributions or benefits of another plan.

Employees who have allocations or benefit accruals from prior years but who do not receive an allocation or benefit accrual in the current year only because they do not meet a plan requirement for a minimum number of service hours in the year or for employment on the last day of the plan year are not benefiting in the current year. However, employees who did not benefit in the current year because they terminated without meeting a plan requirement for at least 500 service hours prior to termination may be excluded from the ratio percentage test. Excluded employees were discussed earlier in this lesson

Assume, for example, that a company has 150 nonhighly compensated employees who must be considered for purposes of the ratio percentage test, and 115 of them are benefiting under the plan. Then, 77% (115 divided by 150) of these nonhighly compensated employees are benefiting. If the company also has 20 highly compensated employees who must be considered for purposes of this test, and 18 of them are benefiting under the plan, then 90% of the highly compensated employees are benefiting (18 divided by 20 equals 90%). The plan meets the ratio

percentage test because the 77% of nonhighly compensated employees who are benefiting exceeds 70% of the 90% of the highly compensated employees who are benefiting (77% exceeds 70% times 90%, or 63%).

If the plan fails the ratio percentage test, it may be permissively aggregated with one or more other plans of the employer to see if the aggregated plans in total pass the test. However, the aggregated plans must also be tested for nondiscrimination under IRC Sec. 401(a)(4) on a combined basis. A plan that fails the ratio percentage test, even if it is permissively aggregated with another plan, must meet the coverage requirements under the average benefit test.

The Average Benefit Test. This two-part test is met if (a) the plan is benefiting a classification of employees that does not discriminate in favor of highly compensated employees, and (b) the "average benefit percentage" for the group of NHCEs is at least 70% of the average benefit percentage for the group of HCEs. (Highly compensated employees and the "nondiscriminatory classification of employees" are discussed later in this lesson.) The *benefit percentage* is the employer-provided contribution (including forfeitures) or benefit for an employee under all qualified plans as a percentage of the employee's compensation. The percentage is calculated for each employee, even those who do not participate in the plan. The *average benefit percentage* for a group of employees is the average of the separately calculated benefit percentages.

For example, assume that a plan benefits a nondiscriminatory classification of employees and provides highly compensated employees participating in the plan with benefits that average 15% of all highly compensated employees' compensation. Assume that the plan provides nonhighly compensated employees participating in the plan with benefits that average 9% of all nonhighly compensated employees' compensation. The plan does not meet the average benefit percentage test because it does not provide the nonhighly compensated participants with an average benefit percentage equaling 70% of the average benefit percentage provided to highly compensated participants. That is, the 9% average benefit percentage provided to the nonhighly compensated participants is only 60% of the 15% average benefit percentage provided to the highly compensated participants. Note that because the plan fails the average benefit percentage test, it fails the average benefit test, even though the plan passes the nondiscriminatory classification portion of the test.

Definition of *Highly Compensated Employee*. For purposes of applying the ratio percentage and average benefit tests described above, a *highly compensated employee* or *HCE* is defined as one who [IRC Sec. 414(q)]:

a. during the current or preceding year owned directly or indirectly more than 5% of the employer, or

b. for the previous year received compensation of more than $135,000 for 2022 and $130,000 for 2021 (as adjusted for inflation) from the employer. The employer can elect to have this rule apply only if the employee's compensation in the prior year ranks in the top 20% of all employees' compensation for that year. When determining highly compensated employees, compensation is the same definition as used for the annual addition limitation for defined contribution plans.

In applying the 5% ownership criteria, an employee is considered to own any stock that is owned directly or indirectly by the employee's spouse, children, grandchildren, or parents. Thus, an employee who is a family member of an individual with a more-than-5% interest in the employer is treated as an HCE regardless of the employee's compensation level.

Nondiscriminatory Classification of Employees. IRS Regulations [Reg. 1.410(b)-4] include a three-part test for determining what is a "nondiscriminatory classification of employees" for the average benefit test described above. The three parts of the test consist of the following—

a. A reasonableness test.

b. An objective test.

c. A "facts and circumstances" test.

These three tests are discussed in the following paragraphs.

Reasonableness Test. Under the reasonableness test of Reg. 1.410(b)-4, the classification of employees in the average benefit test must be reasonable, that is, a bona fide business criteria, such as salaried or hourly employees,

geographic location, or job categories. A listing of employees by name is not considered a reasonable classification. Additionally, the IRS has also informally indicated that participants employed at the end of the year (i.e., last day requirement) is not a reasonable classification.

Objective Test (Safe Harbor). Reg. 1.410(b)-4 provides a safe harbor and an "unsafe harbor" that may be used to test the classification of employees in the average benefit test. The safe harbor is met if the percentage of nonhighly compensated employees benefiting under the plan is 50% or more of the percentage of highly compensated employees benefiting under the plan. (This required percentage is adjusted downward as the concentration of nonhighly compensated employees in the employer's workforce increases.) If this safe harbor test is met, the classification is nondiscriminatory. The regulation provides an incremental "unsafe harbor" under which a classification is discriminatory if the percentage of nonhighly compensated employees benefiting under the plan is less than 40% of the percentage of highly compensated employees benefiting. The required minimum "ratio percentage" decreases from 40% to 20% as the concentration of nonhighly compensated employees in the employer's workforce increases. (If the ratio percentage is less than 20%, the classification is discriminatory, no matter how great the concentration of nonhighly compensated employees.) The following paragraph illustrates the safe and "unsafe" harbors. If the plan falls between the safe harbor and the "unsafe harbor," the "facts and circumstances" test described below is applied to determine whether the classification of employees is nondiscriminatory.

As an example of the safe harbor and "unsafe harbor" described in the preceding paragraph, assume that a plan has 125 employees who must be considered for the minimum coverage test, of which 50 are highly compensated and 75, or 60%, are nonhighly compensated. Assume that 45 of the 50 highly compensated employees are benefiting under the plan; thus, 90% (45 divided by 50) are benefiting. Assume that 60 of the 75 nonhighly compensated employees, or 80%, are benefiting. The ratio percentage of nonhighly compensated to highly compensated employees who are benefiting is 89% (80% divided by 90% equals 89%). The 50% safe harbor for a nondiscriminatory classification of employees is met, since 89% exceeds 50%. If, however, only 25 of the 75 nonhighly compensated employees (33%) were benefiting, the ratio percentage of nonhighly compensated to highly compensated employees benefiting would be 37% (33% divided by 90%). Since this 37% ratio percentage is less than the 40% "unsafe harbor," the plan would have a discriminatory classification of employees.

"Facts and Circumstances" Test. Reg. 1.410(b)-4 includes a "facts and circumstances" test that is applied to determine whether the classification of employees is nondiscriminatory in the average benefit test for plans that fall between the safe and unsafe harbors described above. The facts and circumstances the IRS considers include factors such as the underlying business reason for the classification of employees covered by the plan (is it merely to affect benefit disparities?), how close the plan is to the safe harbor limit, and whether the number of covered employees in each salary range is representative of the total number of employees in each range, etc.

Minimum Number of Participants Requirement

In addition to the minimum coverage requirements discussed in the preceding paragraphs, IRC Sec. 401(a)(26) requires a qualified *defined benefit plan* to benefit at least the lesser of the following:

a. 50 employees, or

b. the greater of: 40% of all employees or two employees (one employee if there is only one).

This requirement is called the small plan minimum rule, or the 50-40 rule, and is *only applicable to defined benefit plans, not to defined contribution plans*. In applying the 50-40 rule, the groups or portions of a plan listed in the "Application of Minimum Coverage Tests to Employee Groups and Portions of Plans" paragraph earlier in this lesson must be separately tested. The definition of when an employee is benefiting under a plan is the same as the one discussed previously in relation to the ratio percentage test. The 50-40 rule is satisfied if it is met for any single day of the plan year that is reasonably representative of the employer's workforce and the plan's coverage. The rule may be separately applied to an employer's line of business if it otherwise qualifies as a separate line of business. The 50-40 rule is interpreted in Reg. 1.401(a)(26).

Consequence of Failing the Minimum Coverage or Number of Participants Tests

If a plan is not qualified because it fails the minimum coverage or number of participants tests described in the preceding paragraphs, highly compensated employees are taxed on the value of their entire vested accrued benefit not previously included in income, not just the current vested plan contributions. However, nonhighly compensated employees are not taxed. The regulations on both the 50-40 rule and on minimum plan coverage allow an employer to take retroactive steps to correct the failure within a period extending through the fifteenth day of the tenth month following the plan year end, for example, up to October 15 for a plan with a calendar year end. This provides the employer with time to make the tests and take any necessary corrective action, such as amending the plan retroactively to expand coverage or benefits.

Nondiscrimination in Plan Contributions and Benefits

As discussed in the preceding paragraphs, a qualified plan's coverage provisions must not discriminate in favor of highly compensated employees. In addition, its contribution provisions (for defined contribution plans) or benefit provisions (for defined benefit plans) may not discriminate in favor of highly compensated employees. The following paragraphs discuss special nondiscrimination rules for plans with 401(k) or 401(m) features and regulations for other types of defined contribution plans and for defined benefit plans. In addition to not discriminating in coverage and contributions or benefits, other plan provisions, such as ancillary insurance; death or disability benefits; availability of plan loans; investment, distribution, and early retirement options; etc., must not discriminate in favor of highly compensated employees.

Special Nondiscrimination Requirements for 401(k) Plans and Arrangements—ADP Test. 401(k) plans and portions of other plans that contain 401(k) features are called a "cash or deferred arrangement" because, under it, participants may elect to defer wages in the form of a contribution to the plan. Many lower-paid employees elect not to make such a deferral. Thus, a special nondiscrimination test considers the "actual deferral percentage" (ADP) of highly compensated and nonhighly compensated employees eligible to participate. The definition of a highly compensated participant is the same as the one given earlier in this lesson. The ADP test is applied to a 401(k) plan or to the 401(k) portion of another type of plan that has such a feature. With respect to the 401(k) arrangement, satisfaction of the ADP test is considered to be satisfaction of the Reg. 1.401(a)(4) nondiscrimination test discussed starting in the "Other Nondiscrimination Regulations" paragraph later in this lesson. Other portions of plans that include 401(k) features must also meet the IRC Sec. 401(a)(4) nondiscrimination requirements.

The ADP for each participant is the participant's pretax elective deferral divided by the participant's compensation. (Roth 401(k) contributions, although made with after-tax dollars, should be included as part of ADP testing, not ACP testing.) The participant's elective deferral includes his or her elective deferrals and any qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) made by the employer. (See *PPC's Guide to Small Employer Retirement Plans* for a discussion of QNECs and QMACs.) The definition of compensation used for ADP testing is the same as that used for nondiscrimination testing. The maximum permitted ADP for highly compensated employees (HCEs) for a year will be determined based on the ADP for nonhighly compensated employees (NHCEs) for the preceding year, rather than the current year. However, the employer may elect to continue using the current year percentages, if desired. For the first year testing of a new plan, the ADP for the NHCEs will be assumed to be 3%, unless the employer chooses to use the actual ADP for the first plan year. The rule is that the average ADP of the group of HCEs may not exceed—

a. 200% of the average ADP for the group of NHCEs, if the average ADP of the NHCEs is 2% or less,

b. the average ADP for the group of NHCEs plus two percentage points, if the average ADP of the NHCEs is between 2% and 8%, or

c. 125% of the average ADP for the group of NHCEs if the average ADP of the NHCEs is 8% or more.

As an example of these rules, assume the following information for a company with two highly compensated employees and two nonhighly compensated employees:

	(A) Compensation	(B) Amount Deferred	(B ÷ A) ADP
HCEs:			
John	$ 135,000	$ 10,800	8.0%
Linda	130,000	13,000	10.0
Average HCE ADP: (8% + 10%) ÷ 2 = 9%			
NHCEs:			
Frank	25,000	1,800	7.2
Lisa	30,000	1,500	5.0
Average NHCE ADP: (7.2% + 5%) ÷ 2 = 6.1%			

Because the average ADP of the NHCEs (6.1%) is between 2% and 8%, the test described in step b. in the preceding paragraph must be used.

Result: ADP test is failed because 9% exceeds 8.1% (6.1% + 2%).

ADP Safe Harbor. A safe harbor is available for 401(k) plans. Under this safe harbor, a plan passes the ADP test if it meets either of the following requirements:

a. A nonelective contribution of at least 3% of the employee's compensation is made to any defined contribution plan [not necessarily the 401(k) plan] on behalf of each NHCE who is eligible to participate in the 401(k) arrangement (without regard to whether the employee actually makes elective contributions).

b. The matching contribution requirement is met using either the basic matching formula or the enhanced matching formula. Under the *basic matching formula*, the employer makes matching contributions on behalf of NHCEs equal to 100% of the employee's elective contributions up to 3% of compensation, and 50% of the employee's elective contributions from 3% to 5% of compensation. In addition, the matching contribution rate for HCEs must not exceed that for NHCEs. Under the *enhanced matching formula*, the employer's matching contribution does not increase as an employee's rate of elective contribution increases and the aggregate amount of matching contributions at any elective contribution rate is at least equal to the aggregate amount of matching contributions required under the basic matching formula (that is, 100% of contributions up to 3% of compensation and 50% of contributions from 3%–5% of compensation).

Other requirements for employer matching and nonelective contributions that must be met to satisfy the safe harbor rules include the following:

a. Such contributions must be immediately vested.

b. Such contributions must be subject to the same withdrawal restrictions applicable to employee elective deferrals.

c. Within a reasonable period before any year, each participant must be given written notice of their rights and obligations under the 401(k) arrangement. The notice must be accurate, comprehensive, and written in understandable language.

Failure to meet the ADP test can be corrected after the plan year end by recharacterization of the excess elective deferral as an employee after-tax contribution or catch-up contribution or by timely distribution of excess contributions to the appropriate HCEs. Recharacterization of the deferral must be made no later than 2½ months after the plan's fiscal year end, and distribution of excess contributions must be made within 12 months of the plan's year end.

However, if the excess contributions are distributed later than 2½ months after the end of the plan year, the plan sponsor must pay a 10% excise tax (IRC Sec. 4979).

Special Nondiscrimination Requirements for 401(m) Arrangements—ACP Test. Many defined contribution plans, including 401(k) plans, and some defined benefit plans, provide for voluntary or mandatory after-tax employee contributions and an employer matching contribution. For example, a plan may provide for a voluntary employee after-tax contribution and an employer match of the employee voluntary after-tax contribution. Portions of plans that have such IRC Sec. 401(m) arrangements must meet a special nondiscrimination test that considers the "actual contribution percentage" (ACP) of HCEs and NHCEs. The definition of a HCE is the same as the one provided earlier in this lesson. With respect to the 401(m) arrangement, satisfaction of the ACP test is considered to be satisfaction of the Reg. 1.401(a)(4) nondiscrimination test discussed later in this lesson. Other portions of plans that include 401(m) features must also meet the IRC Sec. 401(a)(4) nondiscrimination requirements.

The ACP for each participant is the sum of the participant's after-tax contributions, the employer's matching contributions, and any qualified nonelective contributions (QNECs) divided by the participant's compensation. (Roth 401(k) contributions, although made with after-tax dollars, should be included as part of ADP testing, not ACP testing.) In computing the ACP, elective deferrals may be included in the employer's matching contributions. The definition of compensation used for ACP testing is the same as that used for nondiscrimination testing. The maximum permitted ACP for HCEs for a year is determined based on the ACP for NHCEs for the preceding year, rather than the current year. However, the employer may elect to continue using the current year percentages, if desired. For the first year testing of a new plan, the ACP for the NHCEs will be assumed to be 3%, unless the employer chooses to use the actual ACP for the first plan year. The rule is that the average ACP for the group of HCEs may not exceed—

a. 200% of the average ACP for the group of NHCEs, if the average ACP of the NHCEs is 2% or less,

b. the average ACP for the group of NHCEs plus two percentage points, if the average ACP of the NHCEs is between 2% and 8%, or

c. 125% of the average ACP for the group of NHCEs if the average ACP of the NHCEs is 8% or more.

In applying the test, the ACP is first computed for each participant, and then the average ACP is computed for the group of HCEs and for the group of NHCEs.

For example, assume that a plan provides for voluntary employee after-tax contributions and for a 50% employer match of such contributions. Assume the following information for a company with two highly compensated employees and two nonhighly compensated employees:

	(A) Compensation	(B) Employee Contribution	(C) Employer Match	[(B + C) ÷ A] ACP
HCEs:				
John	$ 125,000	$ 5,000	$ 2,500	6.0 %
Linda	120,000	6,000	2,520	7.1
Average HCE ACP: (6% + 7.1%) ÷ 2 = 6.55%				
NHCEs:				
Frank	40,000	1,000	500	3.75
Lisa	30,000	1,500	750	7.50
Average NHCE ACP: (3.75% + 7.5%) ÷ 2 = 5.625%				

Because the average ACP of the NHCEs (5.625%) is between 2% and 8%, the test described in step b. in the preceding paragraph must be used.

Result: ACP test is passed because 6.55% does not exceed 7.625% (5.625% + 2%).

ACP Safe Harbor. Under the ACP safe harbor, a plan is treated as meeting the ACP test if the following requirements are met:

a. Each NHCE eligible to receive matching contributions under the plan is also an eligible employee under a 401(k) feature that satisfies the ADP safe harbor, and no other matching contributions are provided under the plan.

b. The plan satisfies either of the matching contribution requirements discussed in item b. of the "ADP Safe Harbor" paragraph. However, matching contributions for the ACP safe harbor must not exceed 6% of the employee's compensation.

However, if these safe harbor requirements are not met, a plan can still satisfy the matching contribution requirement if the following conditions are met (referred to as "the alternate matching requirements"):

a. The matching contribution rate does not increase as the rate of an employee's contributions or elective deferrals increases.

b. Matching contributions, in the aggregate, do not exceed 4% of the employee's compensation.

c. The matching contribution rate for any HCE does not exceed that for NHCEs having the same rate of employee after-tax or elective contributions.

Failure to meet the ACP test can be corrected after the plan year end by a timely distribution of excess contributions to the appropriate highly compensated participants and by forfeiture of excess unvested matching contributions. These corrections must be made no later than 12 months after the plan's fiscal year end. However, if the excess contributions are distributed later than 2½ months after the end of the plan year, the plan sponsor must pay a 10% excise tax (IRC Sec. 4979).

Qualified Automatic Contribution Arrangements. According to IRC Sec. 401(k)(13), certain plans with qualified automatic contribution arrangements are deemed to meet the nondiscrimination requirements under the ADP and ACP tests. Though outside the scope of this course, qualified automatic contribution arrangements are discussed in further detail in *PPC's 5500 Deskbook*.

Other Nondiscrimination Regulations. The IRS regulations [Reg. 1.401(a)(4)] contain separate tests for nondiscrimination in defined contribution plans and defined benefit plans. The tests for contributions of defined contribution plans and benefits of defined benefit plans are discussed in separate paragraphs below. However, the regulations include provisions and requirements for "cross-testing," in which a defined contribution plan's contributions may be converted to an equivalent benefit rate and tested, or a defined benefit plan's benefits may be converted to an equivalent contribution rate and tested. Regulations also allow a plan to be "restructured," that is, split up into components, for purposes of nondiscrimination testing. The complex requirements for adopting such testing options are beyond the scope of this course. The regulations have safe harbor and plan design tests that, if met, satisfy the IRC Sec. 401(a)(4) nondiscrimination requirements. That is, if a plan contains certain safe harbor provisions, it will be considered to be nondiscriminatory by design, and the plan sponsor will not have to make calculations based on employee data to determine that the plan is nondiscriminatory. Plans that do not meet any of the safe harbors must meet a general test requiring calculations that can be very time consuming and costly. (Actions taken by the IRS to simplify the calculations and reduce the related data collection burden are discussed later in this lesson.)

If a plan is not qualified because it fails the nondiscrimination tests described in the following paragraphs, highly compensated participants are taxed on the value of their vested accrued benefit, but nonhighly compensated participants are not taxed. Reg. 1.401(a)(4)-11 includes a provision that allows employers to make certain retroactive adjustments to ensure compliance with the nondiscrimination requirements. These adjustments may be made up to the fifteenth day of the tenth month after the plan year end, for example, up to October 15 for a plan with a calendar year end.

Nondiscrimination Safe Harbors for Defined Contribution Plans. The first of two safe harbors in Reg. 1.401(a)(4) is met if a defined contribution plan allocates employer contributions and forfeitures [excluding elective 401(k) contributions and matching contributions] to participants based on a formula that allocates the same dollar amount or percentage of compensation.

The second safe harbor may be used by plans that allocate contributions and forfeitures [excluding elective 401(k) contributions and matching contributions] based on an age or service formula if the formula would allocate the same dollar amount or percentage of compensation to every participant if every participant were the same age or had the same years of service. The safe harbor is met if the average rate of allocations for HCEs does not exceed the average for NHCEs.

General Nondiscrimination Test for Defined Contribution Plans. If the safe harbors for defined contribution plans described above are not met, calculations must be made to determine that a defined contribution plan meets the general test of not resulting in any HCE having an allocation rate greater than that of any NHCE. The allocation rate is the total of allocations to the participant's account divided by the participant's compensation. Allocations generally include all employer contributions and forfeitures allocated to the account and exclude income, expenses, gains, and losses allocated to the account balance. Allocation rates for elective deferrals under 401(k) arrangements and matching contributions under 401(m) arrangements are separately tested in the ADP test and the ACP tests were previously discussed.

Nondiscrimination Safe Harbors for Defined Benefit Plans. A defined benefit plan may demonstrate that it is nondiscriminatory by meeting either of the following:

a. The uniformity requirement and satisfying one of six safe harbors, or

b. The general test.

To meet the uniformity requirement, the plan must generally have a benefit formula that provides all participants, having the same number of years of service at normal retirement, with the same percentage of average annual compensation or with the same dollar amount. Also, the benefit must be payable in the same form commencing at the same normal retirement age. Normal retirement age generally means a stated age (no older than 65) or, if later, a stated anniversary of the participation commencement date (no later than the fifth such anniversary).

Actuarial assistance is usually necessary to determine whether a plan satisfies one of the six safe harbors. The following are the available safe harbors and the applicable Reg. reference:

a. Unit credit safe harbor [Reg. 1.401(a)(4)-3(b)(3)].

b. Unit credit fractional accrual safe harbor [Reg. 1.401(a)(4)-3(b)(4)(i)(C)(1)].

c. Fractional rule flat benefit safe harbor [Reg. 1.401(a)(4)-3(b)(4)(i)(C)(2)].

d. Insurance contract plan safe harbor [Reg. 1.401(a)(4)-3(b)(5)].

e. Cash balance plan safe harbor [Reg. 1.401(a)(4)-8(c)(3)].

f. Nondesigned based safe harbor [Reg. 1.401(a)(4)-3(b)(4)(i)(C)(3)].

General Nondiscrimination Test for Defined Benefit Plans. Reg. 1.401(a)(4) provides a general test for defined benefit plans that do not meet any of the safe harbors discussed in the preceding paragraph. The test requires detailed calculations based on employee data to determine that no highly compensated employee has a benefit accrual rate greater than the rate for any nonhighly compensated employee. The regulation provides three methods for determining the accrual rate, and certain "disparities" are allowed for plans that integrate social security benefits. Disparity for social security integration is discussed in the following paragraphs.

Disparity for Social Security Integration

Many defined benefit and defined contribution plans take into account the fact that employer contributions to social security provide a retirement benefit. Social security taxes are a flat rate of salaries and wages up to a certain salary or wage level and are not imposed on salaries or wages above that level. Thus, if a plan accrued benefits at the same rate on all salary and wage levels, the total benefit would be a higher proportion of salary and wages for lower paid employees than for higher paid employees when social security benefits were added to plan benefits. A plan may close this disparity by accruing benefits at a higher rate on compensation above the social security base. This is called social security integration.

The IRC does not consider an integrated plan as not qualified just because it provides greater contributions or benefits to highly compensated participants. However, it does set limits on such disparity. The IRC allows the portion of each participant's social security benefits that is considered to be paid by the employer to be counted in determining whether a defined benefit plan discriminates in favor of highly paid employees. It allows the employer social security contribution to be counted in determining whether a defined contribution plan is discriminatory.

Limits are set on how much the "excess benefit percentage" for defined benefit plans and the "excess contribution percentage" for defined contribution plans may exceed the "base benefit percentage" and the "base contribution percentage." (Though outside the scope of this course, *PPC's 5500 Deskbook* provides details of these excess percentages.) There are detailed definitions of these terms and special provisions for various situations such as multiple integrated plans. Also, permitted disparity is not available to ESOPs and 401(k) or 401(m) arrangements.

Limit on Maximum Contributions and Benefits

The IRC imposes limits on the amount of contributions or benefits a qualified plan may provide individual plan participants. The following paragraphs discuss those limits.

Limit on Annual Contributions to Defined Contribution Plans. The annual contribution from all sources to a participant's account in a defined contribution retirement plan [profit sharing, money purchase, 401(k), or stock purchase plan] may not exceed the lesser of $61,000 for 2022 ($58,000 for 2021) or 100% of the participant's compensation.

For purposes of determining the limit described in the preceding paragraph, contribution sources include the employer's contributions and matches, all employee contributions, elective deferrals, and forfeitures allocated to the participant's account. Earnings on plan investments are not counted as additions to the participant's account for purposes of determining the contribution limitation. Employee contributions do not include tax free rollovers into the account or repayments of a participant loan. A plan may define compensation under one of the following methods:

a. As taxable wages required to be reported under IRC Secs. 6041, 6051, and 6052, which generally conforms to box 1 of the Form W-2,

b. As wages subject to federal income tax withholding, or

c. As defined by IRS Reg. 1.415(c)-2(a), which includes salary, bonus, commissions, other fees received for rendering services to the employer, and elective deferrals to 401(k) plans, 403(b) plans, cafeteria plans, and Section 457 nonqualified deferred compensation plans of state and local governments and tax-exempt employers, to the extent that such amounts are includable in gross income.

The maximum annual amount that can be contributed to a 401(k) arrangement as an elective deferral, that is, as a pretax contribution or as a Roth contribution, is $20,500 for 2022 and $19,500 for 2021 The maximum compensation amount that may be taken into account in computing maximum contributions for a defined contribution plan is $305,000 for 2022 and $290,000 for 2021. Individuals age 50 or over by the end of the plan year are allowed to make additional contributions to a 401(k) plan, in excess of the standard limits. Such additional contributions are limited to the lesser of a specified dollar amount ($6,500 in2022 and 2021) or the participant's compensation for the year reduced by the participant's other elective deferrals. However, individuals are subject to a single additional contribution limit for each taxable year, regardless of the number of plans in which the individual participates.

Limit on Annual Benefits of Defined Benefit Plans. The highest annual benefit that a defined benefit retirement plan may pay is the lesser of $245,000 for 2022 and $230,000 for 2021 or 100% of the participant's average compensation for the three consecutive years during which the participant had the greatest aggregate compensation. (The dollar limit will be reduced for benefits beginning before age 62 and increased for benefits beginning after age 65. In addition, multiemployer plans are exempt from the percentage-of-compensation limit and may not be aggregated with single employer plans for purposes of satisfying the 100% of compensation limit. The dollar limits still apply.) For example, if a participant's average compensation for the highest three years was $85,000, he could receive a benefit of that amount for 2022 if he were entitled to that amount under the plan's benefit accrual formula. If, however, his highest average compensation was $250,000, his benefit would be limited to $245,000 in 2022 even if he would be entitled to more under the plan's benefit accrual formula.

There is a *de minimis* exception to the benefit limit. Up to $10,000, derived from employer contributions, may be paid annually, even if the formula described in the preceding paragraphs would result in a lower limit.

The limit described in the preceding paragraphs is adjusted for an annual benefit payable in a form other than a straight life annuity or qualified joint and survivor annuity, or if there were employee contributions or rollovers. Also, the limit is reduced for situations such as early retirement or fewer than 10 years of plan participation.

Limit on Annual Employer Contribution to Defined Benefit Plans. The employer's contribution to a defined benefit plan is limited to the amount necessary to fund the maximum annual benefits determined as described in the preceding paragraphs.

Minimum Distribution Requirements

The minimum required distribution (MRD) rules prevent participants from deferring the receipt of benefits beyond their life expectancies. To accomplish this, the IRS set out a specific date when distributions must begin and provided a minimum time period over which benefits may be distributed. The MRD rules apply to participants who have reached their required beginning date (RBD) and to beneficiaries of those who have died. The plan administrator is responsible for calculating and timely paying the MRD amount.

The IRC Sec. 401(a)(9) provision on minimum distributions relates to plan qualification for tax purposes only and does not have an ERISA counterpart. To be a qualified plan, a plan must require participants to receive, or begin receiving, plan benefits not later than their RBD. Further, the MRD rules dictate the minimum amount and latest date that benefits may be distributed. Depending on the terms of the plan (and on applicable participant elections), distributions may be made earlier and in larger amounts than required under these rules. Distributions made before the participant's RBD (other than on account of the participant's death) need not satisfy the MRD rules.

Required Beginning Date. The required beginning date for a participant (other than a 5% owner) in a qualified plan is April 1 of the year following the *later* of the calendar year in which the participant (a) turns age 70½ or (b) retires. Qualified plan participants who are 5% or more owners must begin receiving distributions by April 1 following the year in which they turn 70½, even if not retired.

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) changed the start date for MRDs from age 70 ½ to age 72. The change applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70 ½ after December 31, 2019.

Distribution Calendar Year. A year for which a MRD must be made is called a "distribution calendar year." The first distribution calendar year is the year the participant reaches age 70½ (or retires, which ever applies). Even though the RBD is not until April 1 of the calendar year following the year in which the individual attains age 70½ (or retires), the MRD required on that date is for the prior year (that is, the year during which age 70½ is attained or the participant retires). Thus, the MRD that must be made by the required beginning date is for the prior year; a second MRD for the current year must be made on or before December 31 of the year in which the RBD falls. Thereafter, the MRD must be made on or before December 31 of each year.

Time over Which Benefits Must Be Paid. Distributions during the participant's life must begin no later than the participant's RBD and must be distributed over a period no longer than:

a. The period determined under the "Uniform Lifetime Table," regardless of who is named as beneficiary; or

b. The participant's and spouse's joint life expectancies, if the participant's spouse is more than 10 years younger than the participant.

Additional rules apply to distributions after the death of a participant. Though outside the scope of this course, more detail on those rules is available in *PPC's 5500 Deskbook*.

Exceptions to the Minimum Distribution Rules. Participants who made a valid election before 1984 are not subject to the minimum distribution rules discussed in the previous paragraphs. If made in accordance with the plan and the pre-1984 law, distributions may be made over a longer payout period and at a later date than otherwise

required by the minimum distribution rules. However, if the method of distribution is changed or the benefits are transferred to another plan by the participant's voluntary action, this election will no longer apply.

Top-heavy Plans

A top-heavy retirement plan is one in which the aggregate account balances (for defined contribution plans) or the present value of accumulated accrued benefits (for defined benefit plans) of participants who are key employees exceed 60% of the aggregate account balances or the present value of accumulated accrued benefits of all participants under the plan. (Plans consisting only of a cash-or-deferred arrangement meeting the Section 401(k)(13) safe harbor as a qualified automatic contribution arrangement will be excluded from the top-heavy rules.) Top-heavy plans often involve closely held businesses. If an employer sponsors two or more plans, they are combined to determine whether the plans as a group are top-heavy.

What Is a *Key Employee*? A key employee is any participant, including a deceased participant, who at any time during the prior plan year, is—

a. an officer who earned more than $200,000 for 2022 and $185,000 for 2021 in compensation from the employer. (This amount is adjusted for inflation in $5,000 increments periodically.) The maximum number of officers that must be included as key employees is limited to the greater of three employees or 10% of the employees (but no more than 50 officers).

b. an owner of more than 5%, or

c. an owner of more than 1% with more than $150,000 in annual compensation.

In applying the 1% and 5% ownership criteria listed in item b., an employee is considered to own any stock that is owned directly or indirectly by the employee's spouse, children, grandchildren, or parents.

The special rules for top-heavy plans are in addition to all the other ERISA and plan qualification rules. Congress felt that in top-heavy plans, highly compensated employees receive a disproportionate share of plan benefits, in spite of the other nondiscrimination rules. The additional rules are intended to provide a minimum level of benefits, contributions, and vesting to the non-key employees participating in top-heavy plans. The following paragraphs discuss those minimums.

Minimum Contribution for Nonkey Employees Participating in Top-heavy Defined Contribution Plans. In any year in which a defined contribution retirement plan is top-heavy, the employer contribution (including allocated forfeitures) for each participant who is not a key employee must generally be at least 3% of the participant's compensation. If no key employee's contribution rate equals 3% in that year, then the rate for non-key employees is reduced to the highest key-employee rate. For purposes of this test, compensation may be defined in the same way as in the discussion about the limit on annual contributions to defined contribution plans earlier in this lesson.

Minimum Benefit for Nonkey Employees Participating in Top-heavy Defined Benefit Plans. In any plan year in which a defined benefit retirement plan is top-heavy, each participant who is not a key employee must accrue a benefit that is at least 2% of the average annual compensation of the employee's five consecutive years of highest compensation multiplied by the number of years of service. However, the benefit need not exceed 20% of average compensation. The normal qualification rules for years of service described at the beginning of this lesson apply. Also, for purposes of this test, compensation may be defined in the same way as in the discussion about the limit on annual contributions to defined contribution plans earlier in this lesson.

Vesting Rules for Top-heavy Plans. For any plan year in which a plan is top-heavy, benefits for that year must vest according to the minimum vesting rules described earlier in this lesson.

Other Requirements

ESOP Securities Appraisal. IRC Sec. 401(a)(28)(C) requires that employer securities acquired by an ESOP after 1986 that are not readily tradable on an established securities market be valued by an independent appraiser.

ESOP Account Diversification. A qualification requirement for ESOPs is that they give "qualified participants" the right to diversify up to 25% of their account balances during the 90-day period following each of the first five years of the six plan years (eligibility period) after they become "qualified participants." Up to 50% of the account balance may be diversified in the sixth year. "Qualified participants" are those who have participated in the ESOP for at least 10 years and are at least 55 years of age.

This requirement gives older ESOP participants the opportunity to diversify into investments appropriate for their anticipated retirement. The securities that may be diversified are stock of the plan sponsor acquired by, or contributed to, the ESOP. The diversification requirement may be met by distributing the portion of the account balance to the participant or by transferring the portion of the account balance to another defined contribution plan of the plan sponsor that offers at least three distinct investment options.

Participant Loans. Plans with individual participant accounts may allow for participants to borrow against their account balances. However, the loans must be authorized in the plan document and must be available on a basis that does not discriminate in favor of highly compensated employees. The loans must also bear a reasonable rate of interest and be adequately secured. Generally, participant loans are treated as taxable distributions. However, the general rule may be overcome if the loan meets all of the following conditions:

a. It does not exceed the maximum loan amount. The total amount of all outstanding loans that a participant has from a plan cannot exceed the *lesser* of—

   (1) $50,000, minus the highest outstanding loan balance during the one-year period ending on the day the loan was made, or

   (2) the greater of 50% of the present value of the participant's vested accrued benefit in the plan, or $10,000.

   A loan in excess of 50% of a participant's vested accrued benefit will require additional security.

b. The loan terms require repayment within five years. However, loans to purchase a principal residence may require repayment over a period longer than five years without being treated as a taxable distribution if the plan's loan program allows this alternative.

c. Amortization of the loan (with principal and interest payments no less frequent than quarterly) is required to be substantially level over the term of the loan. Limited exceptions are made to this requirement for valid leaves of absence or leaves for military service.

d. For loans made after 2001, the loan must be evidenced by a legally enforceable agreement (which may include more than one document). The agreement must be in writing in a reasonably accessible electronic medium, or in such other form as the Commissioner of the IRS approves. The agreement must specify the loan amount, term, and repayment schedule. However, it does not have to be signed as long as it is enforceable under applicable law.

The CARES Act allowed plan sponsors to amend their defined contribution plans to allow for coronavirus-related loans to qualified individuals (as defined below). For those plans that were amended to allow for these loans, the maximum loan amount available to qualified individuals for loans made from March 27, 2020, to September 22, 2020, was increased to the *lesser* of—

a. $100,000, minus outstanding plan loans to the participant, or

b. 100% of the individual's vested benefit under the plan.

If a loan was outstanding on or after March 27, 2020, and any repayment on the loan was due from March 27, 2020, to December 31, 2020, that due date may have been delayed under the plan for up to one year. Any payments made after the suspension period should be adjusted to reflect the delay and any interest accrued during the delay.

Qualified individuals under the CARES Act include plan participants, their spouse, or their dependent, who experienced at least one of the following:

- A diagnosis of SARS-Cov-2 or COVID-19 by a CDC-approved test;
- Financial difficulties after being quarantined, furloughed, laid off, or given reduced work hours due to the disease;
- An inability to work due to lack of child-care due to the disease; or
- An inability to work due to the closing or reduced hours of a business owned or operated by the individual due to the disease.

The CARES Act allowed plan administrators to rely on a participant's self-certification that the participant satisfies the conditions for the distribution to be qualified as a coronavirus-related loan.

Hardship Withdrawals. The tax rules impose limitations on withdrawal of elective contributions to a 401(k) arrangement prior to retirement, severance from employment, or other specified circumstances. However, participants may make hardship withdrawals if they have an immediate and heavy financial need and other resources are not available to meet the need. Using the "deemed hardship" rules of Reg. 1.401(k)-1(d)(3)(iii)(B), such needs include medical expenses, costs related to the purchase of a principal residence (excluding mortgage payments), payments needed to prevent eviction from the principal residence or mortgage foreclosure, payment of college tuition, payment for burial or funeral expenses, and expenses for the repair of the participant's residence. [Hardship withdrawals may also be made based on the need of a primary beneficiary. A primary beneficiary under a 401(k) plan is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance under the plan upon the death of the participant.]

As of January 1, 2019, plans can allow, but are not required to allow, hardship distributions of elective contributions, QNECs, QMACs, and safe harbor contributions, as well as earnings on these amounts regardless of when contributed or earned [Reg 1.401(k)-1(d)(3)(ii)]. Catch-up contributions and Roth contributions are included as elective contributions. Any other amounts under the plan (e.g., regular matching contributions, discretionary profit-sharing contributions) may also be eligible for a hardship distribution if provided for in the plan document. Hardship distributions from a 401(k) plan were previously limited to the amount of the employee's elective deferrals and generally did not include any income earned on the deferred amounts. Prior to 2018, QNECs and QMACs generally could not be distributed for hardship. However, plans were able to provide for hardship distributions of QNECs and QMACs and earnings on elective contributions if the plan provided for certain amounts credited before 1989 to be included.

According to the IRS, *the plan sponsor* is responsible for the proper administration of its retirement plan, including maintaining adequate and proper documentation of certain transactions. The IRS emphasizes this on their website at **www.irs.gov/retirement-plans/its-up-to-plan-sponsors-to-track-loans-hardship-distributions**. These transactions include hardship distributions even if the plan uses a third party administrator (TPA) to process participant transactions. The plan sponsor must obtain and keep hardship distribution records, including:

- Documentation of the hardship request, the review, and the approval;
- Financial information and documents to substantiate the participant's immediate and heavy financial need;
- Documentation that the hardship distribution was made according to the provisions of the plan and the IRC; and
- Proof of the actual distribution payment and the related Forms 1099-R.

The records must be accessible in the case of an IRS audit of the plan. Failure by the plan sponsor to have these records available for examination is a *qualification failure* that should be corrected using the Employee Plans Compliance Resolution System (EPCRS).

The CARES Act allowed plan sponsors to amend their defined contribution plans to allow for coronavirus-related distributions to qualified individuals of up to $100,000 through December 31, 2020. To qualify to receive a coronavirus-related distribution, participants, their spouse, or their dependent must meet the qualifications listed earlier in this discussion. The CARES Act allows plan administrators to rely on a participant's self-certification that the participant satisfies the conditions for the distribution to be qualified as a coronavirus-related distribution and does not require plan administrators to maintain documentation of such qualifying conditions.

Income Tax Withholding. Federal income tax withholding rules apply to certain distributions made from qualified plans. The withholding rate is 10% for a nonperiodic distribution that is not eligible for rollover distribution unless the recipient elects not to have tax withheld. A nonperiodic distribution is any distribution that is not an annuity payment. A lump sum distribution is an example of a nonperiodic distribution, as is an in-service distribution (for example, a hardship withdrawal) of a portion of a participant's account. The withholding rate is 20% for any distribution greater than $200 that is eligible for rollover treatment but that is not transferred directly to an eligible transferee plan.

Simplified Procedures for Nondiscrimination Testing

IRS Revenue Procedure 93-42 simplifies the process of substantiating that a retirement plan satisfies various nondiscrimination requirements found in IRC Secs. 401(a)(4), 410 (b), and related IRS Reg. 1.414(s)-1(d)(3). The procedures are simplified as follows:

a. Employers that do not have precise data available at reasonable cost may substantiate compliance with the nondiscrimination requirements using reliable substitute data.

b. Employers may substantiate compliance using "snapshot" testing on a single representative day.

c. Employers will not be required to test a plan more than once every three years provided there is no significant change.

d. Plan administrators for multiemployer plans may rely on appropriate, employer provided information.

However, Rev. Proc. 93-42 does not pertain to the ADP test for 401(k) plans nor to the ACP test for 401(m) arrangements.

Health and Welfare and Fringe Benefit Plans

The term *welfare benefit plan* is a DOL term, while the term *fringe benefit plan* is an IRS term. A fringe benefit plan is known by the IRC Section that describes it. A fringe benefit plan may also be a welfare benefit plan. The benefit accrual, vesting, and funding requirements discussed in preceding paragraphs do not apply to welfare benefit plans or fringe benefit plans. However, the fiduciary responsibilities and reporting requirements discussed in Lesson 2 do apply to welfare benefit plans.

Nondiscrimination Requirements. The IRC has separate nondiscrimination rules for each type of fringe benefit plan that must be met for all or a portion of the value of the fringe benefit to be excluded from employees' income. These nondiscrimination rules are not consistent. For example, some of them define nondiscrimination in terms of *key employees* and others define it in terms of *highly compensated employees*. Also, the definition of highly compensated employees is not always the same. If a welfare or fringe benefit plan is funded by an IRC Sec. 501(c)(9) voluntary employees' beneficiary association (VEBA), the VEBA must meet certain nondiscrimination requirements to have tax-exempt status. The following paragraphs briefly discuss nondiscrimination requirements for some of the more common fringe benefit plans.

IRC Sec. 79 Group-Term life Insurance Plan. Employees may exclude the value of up to $50,000 of group-term life insurance from income only if the plan is nondiscriminatory. If the plan is discriminatory, key employees must include the value of such insurance in income. Nondiscrimination requirements for a group-term life insurance plan relate to

eligibility to participate and benefits provided. To be nondiscriminatory in eligibility, a plan must meet one of the following tests—

a. the plan must benefit at least 70% of all employees,

b. at least 85% of those participating in the plan must not be key employees, as defined,

c. the plan must benefit a classification of employees that does not discriminate in favor of key employees, or

d. the plan must satisfy the eligibility requirements for a cafeteria plan, if it is part of a cafeteria plan.

A key employee is one who meets the criteria in the "What Is a *Key Employee*?" paragraph earlier in this lesson.

To be nondiscriminatory in benefits, a group-term life insurance plan must provide to all plan participants the same benefit that is available to key employees participating in the plan.

IRC Secs. 105 and 106 Group Health and Accident Plan. All group health plans (except for certain plans grandfathered under the Affordable Care Act) must meet specific nondiscrimination requirements. To be nondiscriminatory, a plan must not discriminate in favor of highly compensated employees as to eligibility to participate or benefits provided. To be nondiscriminatory as to eligibility, the plan must cover—

a. 70% or more of all employees, or 80% or more of eligible employees if 70% or more of all employees are eligible, or

b. a classification of employees found to be nondiscriminatory by the IRS.

A highly compensated employee is—

a. one of the five highest paid officers,

b. a shareholder owning more than 10% of the stock, or

c. one of the 25% highest paid employees.

To be nondiscriminatory in benefits, a health and accident plan must provide the same benefits for all participants as are provided for highly compensated participants. If the plan is discriminatory, the highly compensated employees must include the value of the benefit in income.

IRC Sec. 129 Dependent Care Plan. The maximum annual amount related to a dependent care plan that may be excluded from an employee's income is the lesser of $5,000 ($2,500 for a married employee filing separately) or earned income of the employee or his lower earning spouse. If the plan is discriminatory, highly compensated employees (but not nonhighly compensated ones) must include the value of the benefit in income.

To be nondiscriminatory, a dependent care plan must benefit a classification of employees that does not favor highly compensated employees or their dependents. Unionized employees may be excluded from the classification if the benefit was the subject of good-faith bargaining. Also, employer-provided dependent care services are not discriminatory if they are offered on an impartial basis, such as on a first-come, first-served basis. Other nondiscrimination requirements include the following:

- No more than 25% of the benefits may be provided to owners of more than 5% of the stock or capital of the employer.
- Nonhighly compensated employees must receive average benefits of at least 55% of the average benefits provided to highly compensated employees.

A highly compensated employee is one who—

a. during the current or preceding year owned directly or indirectly more than 5% of the employer, or

b. for the previous year received compensation of more than $135,000 for 2022 and $130,000 for 2021 (as adjusted for inflation periodically) from the employer. The employer can elect to have this rule apply only if

the employee's compensation in the prior year ranks in the top 20% of all employees' compensation for that year. When determining highly compensated employees, compensation is the same definition as used for the annual addition limitation for defined contribution plans.

IRC Sec. 125 Cafeteria Plan. An IRC Sec. 125 cafeteria plan provides participants a choice between two or more benefits, one of which is a taxable benefit (cash), and the other(s) of which are certain nontaxable qualified benefits. That is, the participant may choose between receiving an amount as current, taxable, compensation and receiving one or more qualified benefits, the value of which is not included in taxable income. If a plan offers only nontaxable qualified benefits, it is not a cafeteria plan. Benefits that a cafeteria plan may offer include accident and health benefits, dependent care benefits, or group-term life insurance (including the group-term life insurance that is includable in income because it exceeds $50,000 and the opportunity to purchase additional insurance coverage with after-tax employee contributions). However, a cafeteria plan may not offer certain benefits, including educational assistance. A cafeteria plan may include a flexible spending arrangement, which is explained below.

To be nondiscriminatory, a cafeteria plan's benefits must each meet the separate nondiscrimination requirements applicable to the benefit. In addition, the cafeteria plan must not discriminate in favor of highly compensated employees in terms of participation, contributions, and benefits. Highly compensated employees include officers, shareholders owning more than 5% of voting stock, employees in the highest paid group of employees, and spouses and dependents of these employees. If the cafeteria plan is discriminatory, the value of the benefits offered is included in income of the highly compensated employees (but not of the nonhighly compensated ones).

To be nondiscriminatory in terms of participation, each employee must be subject to the same service requirement, which may not exceed three years. The plan may exclude certain groups of employees if it still meets the separate participation requirements of the benefits included in the plan. To be nondiscriminatory, the plan may not provide more than 25% of the benefits to key employees. The definition of a key employee is the same as the one in the "What Is a *Key Employee*?" paragraph earlier in this lesson.

A cafeteria plan that offers health benefits is nondiscriminatory if—

a. contributions on behalf of each participant equal either 100% of the cost of health coverage of the majority of comparable (in terms of family size, etc.) highly compensated participants or at least 75% of the cost of the most expensive coverage for any comparable participant, and

b. contributions exceeding those described in the preceding item bear a uniform relationship to compensation.

Flexible Spending Arrangement. In a flexible spending arrangement, participants may elect to have a portion of their compensation (salary reduction amounts) contributed (that is, withheld from their wages) to an individual account for the reimbursement of qualifying medical and/or dependent care expenses instead of receiving the amount as compensation. As the qualifying expenses are incurred, they are reimbursed from the account. Neither the amount contributed nor the value of the benefit is included in the participant's income, but only if the plan provides that any amount remaining in the account at the end of the year will be forfeited by the participant (that is, the participant will not receive the remaining amount as compensation). Flexible spending arrangements can be used for health care (including the cost of deductibles or copayments incurred under the employer's health insurance plan and the cost of health services not covered by the employer's plan) or dependent care. If a cafeteria plan includes a flexible spending arrangement, a separate account is established for each type of benefit chosen.

A health care flexible spending account cannot be used to pay premiums for an individual health insurance policy. The maximum amount that may be funded through a dependent care flexible spending account is the lesser of $5,000 or the participant's (or spouse's) earned income for 2022 and 2021. The limit for a health care flexible spending account is $2,850 for 2022 and $2,750 for 2021.

IRC Sec. 501(c)(9) VEBA Trust. Welfare and fringe benefit plans are not required to be funded, but if they are, the plan assets must be held in trust. Unlike a qualified retirement plan trust, a welfare or fringe benefit plan trust is not automatically tax-exempt. To be tax-exempt, the trust must qualify as an IRC Sec. 501(c)(9) VEBA trust. VEBAs can be used to fund current or post-employment medical care, disability coverage, life coverage, supplemental unemployment benefits, vacation pay, child-care, severance pay in certain instances, and other benefits. To be a

VEBA an organization must (a) be an association of employees and membership must be voluntary, (b) provide health and welfare type benefits and substantially all of its activities must be associated with providing such benefits, and (c) no income of the organization may benefit any private shareholder or individual other than through payment of permitted benefits.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Title I of the Employee Retirement Income Security Act of 1974 (ERISA) covers what type of employee benefit plans?

   a. Governmental plans.

   b. Plans maintained to comply with workers' compensation, unemployment compensation, or disability insurance laws.

   c. Plans established by employers engaged in interstate commerce or industries and activities affecting commerce.

   d. Deemed individual retirement accounts (IRAs) under a pension plan for years after December 31, 2002.

2. Why does the Internal Revenue Service (IRS) issue determination letters?

   a. To provide a complete list of the requirements an employee retirement plan must meet to be considered qualified under the Internal Revenue Code (IRC).

   b. To state the IRS's opinion on whether an employee retirement plan's design satisfies the qualification requirements listed in the IRC as of a certain date.

   c. To establish minimum standards for plan participation as both a matter of law and as a requirement for plan qualification.

   d. To determine whether an employee retirement plan is a defined contribution plan or a defined benefit plan.

3. Assuming a defined benefit plan does not use graded vesting and is not considered top-heavy, employees should be fully vested in their accrued benefit derived from employer contributions after how many years of service?

   a. Three years.

   b. Five years.

   c. Six years.

   d. Seven years.

4. Which of the following employees would be excluded when applying the ratio percentage or average benefit test on a retirement plan?

   a. Sam is a nonresident alien who received taxable income from the U.S. branch of the company.

   b. Eileen has been working for the company for two years.

   c. Joanna is a full-time leased employee performing services under the employer's direction for two years.

   d. Charlie is a collectively bargained employee.

5. When using the actual deferral percentage (ADP) test for 401(k) plans and arrangements, the average ADP of the plan's highly compensated employees (HCEs) may not exceed which of the following, if the average ADP of the nonhighly compensated employees (NHCEs) is 2% or less?

    a. 200% of the average ADP of the NHCEs.

    b. The average ADP for the NHCEs plus two percentage points.

    c. 125% of the average ADP of the NHCEs.

    d. 3% of the average ADP of the NHCEs.

6. What change did the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) change about the required beginning date (RBD) for minimum required distributions (MRDs)?

    a. It changed RBDs from April 1 to January 1.

    b. It made the RBD for 5% or more owners the same as the RBD for other participants.

    c. It delayed the start date for MRDs to age 72.

    d. It changes the "distribution calendar year" so only one distribution is needed in the year of the RBD.

7. Which of the following is an IRS-approved method for simplifying nondiscrimination testing?

    a. Only specific, precise data can be used to substantiate compliance.

    b. Compliance can be substantiated using "snapshot" testing.

    c. Employers only need to test the plan once per year.

    d. Administrators of multiemployer plans must substantiate provided information.

8. An IRC Sec. 79 group-term life insurance plan is considered nondiscriminatory under which of the following circumstances?

    a. It benefits more than 50% of the company's employees.

    b. The majority of plan participants are considered key employees.

    c. It benefits a classification of employees that does not favor key employees.

    d. The plan is not part of a cafeteria plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Title I of the Employee Retirement Income Security Act of 1974 (ERISA) covers what type of employee benefit plans? **(Page 301)**

   a. Governmental plans. [This answer is incorrect. Governmental plans are specifically *not* covered by Title I of ERISA.]

   b. Plans maintained to comply with workers' compensation, unemployment compensation, or disability insurance laws. [This answer is incorrect. Plans maintained *solely* to comply with these types of laws are *not* covered by ERISA, Title I.]

   c. **Plans established by employers engaged in interstate commerce or industries and activities affecting commerce. [This answer is correct. As outlined in that guidance, ERISA, Title I, covers employee benefit plans established or maintained by an employer (or employee organization) engaged in interstate commerce or in any industry or activity affecting commerce.]**

   d. Deemed individual retirement accounts (IRAs) under a pension plan for years after December 31, 2002. [This answer is incorrect. Such IRAs are *not* covered by ERISA, Title 1. A qualified employer plan may set up separate accounts or annuities as deemed IRAs, which will be treated as IRAs rather than as part of a qualified retirement plan.]

2. Why does the Internal Revenue Service (IRS) issue determination letters? **(Page 302)**

   a. To provide a complete list of the requirements an employee retirement plan must meet to be considered qualified under the Internal Revenue Code (IRC). [This answer is incorrect. A qualified employee retirement plan is a stock bonus, pension, or profit-sharing plan that meets the requirements that are outlined in IRC Sec. 401(a). Those requirements are not outlined in determination letters.]

   b. **To state the IRS's opinion on whether an employee retirement plan's design satisfies the qualification requirements listed in the IRC as of a certain date. [This answer is correct. Determination letters may provide evidence that the design of an employer-sponsored retirement plan satisfies the IRC qualification requirements as of the date of issuance of the letter. The IRS issues determination letters regarding the qualified status of retirement plans under Section 104(a) of the IRC and the status of related trusts under Section 501(a). However, as mentioned in the AICPA Audit and Accounting Guide, *Employee Benefit Plans*, (AEBP), the existence of a favorable determination letter does not, by itself, provide evidence that a plan is qualified.]**

   c. To establish minimum standards for plan participation as both a matter of law and as a requirement for plan qualification. [This answer is incorrect. ERISA, Title I, Section 303, and IRC Sec. 410(a) establish minimum standards for plan participation as a matter of law and as a requirement for plan qualification.]

   d. To determine whether an employee retirement plan is a defined contribution plan or a defined benefit plan. [This answer is incorrect. A plan's benefit accrual is affected by whether it was established as a defined contribution plan or a defined benefit plan. However, determination letters are not issued specifically for making the distinction between these plan types.]

3. Assuming a defined benefit plan does not use graded vesting and is not considered top-heavy, employees should be fully vested in their accrued benefit derived from employer contributions after how many years of service? **(Page 303)**

   a. Three years. [This answer is incorrect. Three-year cliff vesting is used by top-heavy defined benefit plans. It does not apply to plans that do not fall into that top-heavy status.]

   b. **Five years. [This answer is correct. According to IRC Sec. 411(a)(2), unless a plan is deemed to be top-heavy, an employee's accrued benefit derived from employer contributions in defined benefit plans must vest according to one of two schedules. If the plan does not use graded vesting, then the other option is five-year cliff vesting. Use of this vesting schedule means that employees contributing to this type of plan will be 100% vested after five years of service. They will be 0% invested until the fifth year.]**

   c. Six years. [This answer is incorrect. Six-year graded vesting is used by top-heavy defined benefit plans. Plans that are not considered top-heavy would not use this vesting schedule.]

   d. Seven years. [This answer is incorrect. Per IRC Sec. 411(a)(2), defined benefit plans that are not deemed top heavy can use seven-year graded vesting. This means that the employees will be 100% vested after seven years of service on a graded schedule of 20% after three years followed by an additional 20% after each of years four through seven (that is, 40% vested after four years, 60% vested after five years, 80% vested after six years, and 100% vested after seven years). However, when graded vesting is not used, employees must be fully vested in the plan in fewer years of service.]

4. Which of the following employees would be excluded when applying the ratio percentage or average benefit test on a retirement plan? **(Page 306)**

   a. Sam is a nonresident alien who received taxable income from the U.S. branch of the company. [This answer is incorrect. According to Reg. 1.410(b)-6(c), nonresident aliens who receive *no* earned income from U.S. sources are excludable employees. Also, nonresident aliens receiving income from U.S. sources are excludable if the income is exempt from U.S. income tax under a tax treaty. Since Sam earned taxable income from a U.S source, he cannot be excluded from these tests.]

   b. Eileen has been working for the company for two years. [This answer is incorrect. Assuming the company has a minimum service requirement of one year, as allowed by ERISA, Title I, Section 202, and IRC Sec. 410(a), Eileen cannot be excluded from the above-mentioned tests for the current plan year based on her length of service.]

   c. Joanna is a full-time leased employee performing services under the employer's direction for two years. [This answer is incorrect. Certain leased employees must generally be considered for minimum coverage purposes if they have performed services for the employer (recipient) under the "primary direction or control" of the employer and have performed those services for the employer on a substantially full-time basis for at least one year, per IRC Sec. 414(n)(1), (2), and (3). Therefore, Joanna would not be excluded from these tests based on this information alone.]

   d. **Charlie is a collectively bargained employee. [This answer is correct. According to Reg. 1.410(b)-6(d), collectively bargained employees are excludable when testing a plan or a portion thereof that does not benefit members of the unit. Therefore, based on the information provided, Charlie can be excluded from some portions of the testing.]**

5. When using the actual deferral percentage (ADP) test for 401(k) plans and arrangements, the average ADP of the plan's highly compensated employees (HCEs) may not exceed which of the following, if the average ADP of the nonhighly compensated employees (NHCEs) is 2% or less? **(Page 311)**

   a. **200% of the average ADP of the NHCEs. [This answer is correct. One of the rules of the ADP test is that the average ADP of the group of HCEs may not exceed 200% of the average ADP for the group of NCHEs, if the average ADP of the NHCEs is 2% or less. If the average ADP of the NHCEs is more than 2%, another amount applies.]**

b. The average ADP for the NHCEs plus two percentage points. [This answer is incorrect. This amount is correct if the average ADP of the NHCEs is between 2% and 8%. If the average ADP of the NHCEs is 2% or less, a different amount applies.]

c. 125% of the average ADP of the NHCEs. [This answer is incorrect. This amount is correct if the average ADP of the NHCEs is 8% or more. A different amount applies if the average ADP of the NHCEs is 2% or less.]

d. 3% of the average ADP of the NHCEs. [This answer is incorrect. For the first year testing of a new plan, the ADP for the NHCEs (not the HCEs) will be assumed to be 3%, unless the employer chooses to use the actual ADP for the first plan year.]

6. What change did the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) change about the required beginning date (RBD) for minimum required distributions (MRDs)? **(Page 317)**

a. It changed RBDs from April 1 to January 1. [This answer is incorrect. The RBD for a participant in a qualified plan is April 1 of the calendar year following the later of two specific events. This April 1 date was not affected by the SECURE Act.]

b. It made the RBD for 5% or more owners the same as the RBD for other participants. [This answer is incorrect. Qualified plan participants who are 5% or more owners must begin receiving distributions by April 1 following the year in which they turn 70½, even if they are not retired. This is different from other participants who can delay their RBD if they are not yet retired, and the SECURE Act did not eliminate this difference.]

c. **It delayed the start date for MRDs to age 72. [This answer is correct. The SECURE Act changed the start date for MRDs from age 70½ to age 72. The change applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70½ after December 31, 2019.]**

d. It changes the "distribution calendar year" so only one distribution is needed in the year of the RBD. [This answer is incorrect. A year for which an MRD must be made is called a "distribution calendar year." The first distribution calendar year is the year the participant reaches age 70½ (or retires, whichever applies). The distribution made as of the RBD is for the prior year (that is, the year during which age 70½ is attained or the participant retires). A second MRD for the current year must be made on or before December 31 of the year in which the RBD falls. The SECURE Act does not affect distribution calendar years or the fact that two distributions are needed in the first year.]

7. Which of the following is an IRS-approved method for simplifying nondiscrimination testing? **(Page 321)**

a. Only specific, precise data can be used to substantiate compliance. [This answer is incorrect. As discussed in IRS Revenue Procedure 93-42, employers that do not have precise data available at reasonable cost may substantiate compliance with the nondiscrimination requirements using reliable substitute data.]

b. **Compliance can be substantiated using "snapshot" testing. [This answer is correct. IRS Revenue Procedure 93-42 simplifies the process of substantiating that a retirement plan satisfies various nondiscrimination requirements found in IRC Secs. 401(a)(4), 410(b), and related IRS Reg. 1.414(s)-1(d)(3). For example, this procedure allows employers to substantiate compliance using "snapshot" testing on a single representative day.]**

c. Employers only need to test the plan once per year. [This answer is incorrect. According to IRS Revenue Procedure 93-42, employers will not be required to test a plan more than once every *three* years provided there is no significant change.]

d. Administrators of multiemployer plans must substantiate provided information. [This answer is incorrect. Plan administrators for multiemployer plans may rely on appropriate, employer provided information, per IRS Revenue Procedures 93-42.]

8. An IRC Sec. 79 group-term life insurance plan is considered nondiscriminatory under which of the following circumstances? **(Page 321)**

   a. It benefits more than 50% of the company's employees. [This answer is incorrect. The plan must benefit at least 70% of all employees to be considered nondiscriminatory.]

   b. The majority of plan participants are considered key employees. [This answer is incorrect. Such a plan is considered nondiscriminatory if at least 85% of the participating employees are *not* key employees.]

   c. **It benefits a classification of employees that does not favor key employees. [This answer is correct. Nondiscrimination requirements for a group-term life insurance plan relate to eligibility to participate and benefits provided. To be nondiscriminatory in eligibility, a plan must meet one of four tests. One of those tests is that the plan must benefit a classification of employees that does not discriminate in favor of key employees.]**

   d. The plan is not part of a cafeteria plan. [This answer is incorrect. If an IRC Sec. 79 group-term life insurance plan is part of a cafeteria plan, it must satisfy the eligibility requirements for the cafeteria plan to be considered nondiscriminatory. Such plans can be nondiscriminatory and also be part of a cafeteria plan.]

Lesson 2: Fiduciary Responsibilities, Reporting, and Other ERISA and Tax Requirements

INTRODUCTION

Lesson 2 covers additional ERISA and tax requirements that affect employee benefit plans. It begins with a discussion of fiduciary responsibilities. Next, this lesson takes a look at the disclosures plans must make to their participants, followed by a discussion of what plans must report to the DOL, IRS, and PBGC. Finally, Lesson 2 concludes with a discussion of requirements related to a selection of topics including plan termination, reportable events, reversion, unrelated business income, and correcting violations.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine who is the fiduciary of an employee benefit plan and what responsibilities that role entails.
- Identify required disclosures that must be made to plan participants and what information must be reported to the DOL, IRS, and PBGC.
- Recognize other requirements that affect employee benefit plans, including those related to plan termination and correcting violations.

FIDUCIARIES AND THEIR RESPONSIBILITIES

To protect the interests of employee benefit plans, ERISA defines a fiduciary, establishes prudent man and exclusive benefit rules governing fiduciaries' behavior, and prohibits fiduciaries and plans from engaging in certain transactions. This section defines a fiduciary, describes fiduciary responsibilities and liabilities for breach of those responsibilities, and summarizes rules on prohibited transactions.

Definition of a Fiduciary

ERISA, Title I, Section 3(21), defines a fiduciary as a person who—

a. exercises discretionary authority or control over the management of an employee benefit plan or the disposition of its assets,

b. gives investment advice about plan funds or property for a fee or compensation or has the authority to do so,

c. has discretionary authority or responsibility in plan administration, or

d. is designated by a named fiduciary to carry out fiduciary responsibility. (ERISA requires the naming of one or more fiduciaries to be responsible for managing the plan's administration. This is the plan administrator or administrative committee. The plan administrator may engage others to perform some administrative duties.)

Who Is a Fiduciary?

Performers of Managerial versus Administrative Duties. There have been court cases over the issue of whether a person acting in a certain capacity in a certain situation was a fiduciary. Based on case law, generally, lawyers and consultants who in effect manage a plan are fiduciaries. However, a person or company that performs purely administrative duties within the framework, rules, and procedures established by others, such as collecting contributions, maintaining participants' service and employment records, calculating benefits, processing claims, preparing government reports and employee communications, etc., is not a fiduciary.

Plan Auditor and Others Performing "Ministerial Duties." The plan auditor ordinarily is not a fiduciary. Courts have held that Congressional intent was that accountants, lawyers, actuaries, and other outside consultants not be treated as fiduciaries unless they go beyond their normal role and assume management or administrative responsibility. Thus, courts have held that CPAs performing "ministerial duties" for the plan, such as accounting and auditing, are not fiduciaries. However, as discussed later in this section, even if a CPA is not a fiduciary, he may still incur a civil penalty if he is held to have had "knowing participation" in a fiduciary's breach of responsibility. Also, maintaining financial records for the plan may impair auditor independence under AICPA or DOL independence rules even if such a service does not make the accountant a fiduciary.

Participant-directed Accounts. ERISA, Title I, Section 404(c), states that a participant in an employee benefit plan who exercises control over the assets in his individual participant account (for example, by choosing among available investment alternatives) is not a fiduciary. Section 404(c) also relieves those who are fiduciaries of liability for the results of the participant's exercise of control. DOL Regs. 2550.404c-1(b)(2)(i) and 2550.404a-5 describe the kinds of plans that are Section 404(c) plans and when a participant is deemed to have exercised independent control over the assets. A plan fiduciary is not liable, under the ERISA fiduciary rules, for any loss resulting from a participant's exercise of control provided certain conditions are met.

The Section 404(c) relief from liability does not apply in connection with a blackout period during which a participant's ability to direct the assets in his account is suspended by the plan sponsor or fiduciary. However, a plan fiduciary will not be liable under the ERISA fiduciary rules for any loss occurring during the blackout period if the fiduciary meets the requirements of ERISA in connection with the authorization and implementation of the blackout period.

According to ERISA Section 404(c)(5), a participant in an individual account plan will be treated as exercising control over the assets in his account if contributions and earnings are invested by the plan in a default investment arrangement that complies with DOL regulations until the participant makes an election regarding those amounts. The participant must be provided timely notice of his rights and obligations under the default arrangement. For example, the notice must explain the participant's right to determine how contributions and earnings will be invested and how such amounts will be invested without an election by the participant.

Noncompliance with the regulations does not result in an ERISA violation, but results in the plan fiduciary not being provided relief under the liability rules. For example, in one particular situation, a participant-directed retirement plan's investment manager invested money market funds in derivatives, and the derivatives subsequently declined in value. The plan and many individual participants incurred significant losses. To avoid potential breach of fiduciary responsibility lawsuits, the plan sponsor proposed reimbursing the plan for the losses incurred. In 1995, the IRS ruled in a letter ruling that the replacement payments would not cause the plan to be disqualified, and would not be considered current taxable income for the participants in the plan. The payments would not, however, be deductible as contributions by the plan sponsor.

Insurance Companies. An insurance company may or may not be a fiduciary, depending on the extent of its discretionary control over plan assets.

Investment Advisor. The definition of a fiduciary includes one who renders investment advice. Under 1975 DOL regulations, to determine if a person meets the definition of fiduciary by providing investment advice for a fee, there is a five-part test. Under the five-part test, a person is considered a fiduciary if the following conditions are met: the recommendations are provided for compensation on a regular basis, pursuant to a mutual understanding that the advice will serve as a primary basis for investment decisions and that the advisor will provide individualized advice based on the particular needs of the investor. The DOL issued final regulations, referred to as the "DOL Fiduciary Rule," that described the circumstances in which a person providing investment advice acts as a fiduciary. On June 21, 2018, as the effective date of the transition period to the new rules was about to end, the Fifth Circuit Court of Appeals vacated the Fiduciary Rule and its related exemptions. The effect of the court's decision puts back into effect the 1975 five-part test for determining fiduciary status. However, many companies had already transitioned to the new rules and are likely to continue using their new procedures until new regulations or guidance is issued. Because it is expected that many advisors will still operate under the guidance of the DOL's Fiduciary Rule, even though it is not current law, a brief summary follows. While some actions are considered a fiduciary action under the DOL Fiduciary Rule, they are not considered as such under the five part test. However, many commentators believe the five-part test will be more narrowly applied due to the effect of the later ruling. Though outside the scope of this

course, the definition of fiduciaries and these regulations are discussed in more detail in *PPC's 5500 Deskbook*. Future editions of this course will address any relevant changes to the regulations concerning fiduciaries. The DOL Fiduciary Rule consisted of Impartial Conducts Standards which required the following of advisors:

a. Give advice in the retirement investor's "best interest." This consists of (a) prudence—the advice must meet the professional standard of care set forth in the exemption and be consistent with the standard of care in ERISA Sec. 404, and (b) loyalty—the advice must be based on "the interests of the customer, rather than the competing financial interest of the advisor or firm."

b. Charge no more than reasonable compensation.

c. Make no misleading statements about investment transactions, compensation, and conflicts of interest. This includes both material omissions as well as material misstatements.

A person may provide investment education to employees without being considered a fiduciary. To distinguish between rendering investment advice as a fiduciary and providing nonfiduciary investment education, the DOL issued Interpretive Bulletin 96-1, "Participant Investment Education." These regulations divide nonfiduciary investment education services into four types:

a. providing plan information to employees;

b. providing general financial information to employees, such as describing the different investment options;

c. describing possible investment allocation models to employees; and

d. providing employees with interactive investment materials, such as worksheets to assist an employee in determining what annual growth rates are needed to meet his or her financial goals.

Information or services provided by an individual under one of these four categories would not be considered "rendering investment advice." In addition, see the exception to the prohibited transaction rules regarding investment advice discussed later in this section.

Third-party Administrators. A third-party administrator who exercises discretion in resolving benefit claims or who exercises other discretionary authority is a fiduciary.

Fiduciary Responsibilities

Prudent Man/Exclusive Benefit Rule. ERISA, Title I, Section 404, requires that fiduciaries discharge their duties solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits for them and defraying reasonable plan administrative expenses. Specifically, fiduciaries must perform their duties as follows:

- With the care, skill, prudence, and diligence of a prudent man under the circumstances.
- In accordance with plan documents and instruments, insofar as they are consistent with the provisions of ERISA.
- By diversifying plan investments so as to minimize risk of loss under the circumstances, unless it is clearly prudent not to do so.

The IRS has rules for the investing of plan assets. The cost of the assets purchased must not exceed their fair market value at the time of purchase, and the assets should provide a return comparable to the prevailing market rate. Also, plan assets should be sufficiently liquid to permit distributions from the plan.

Investment Diversification. The diversification requirement mentioned above does not apply to plans that, by their nature, must concentrate their investments, such as an ESOP, which owns stock of the plan sponsor.

ERISA does not specify a degree of concentration that would violate the diversification requirement. DOL Reg. 2550.404a-1(b)(2)(ii) merely states that in making investment decisions, the fiduciary should consider the following factors:

a. the portfolio's composition with respect to diversification,

b. the portfolio's liquidity and current return relative to the plan's anticipated cash flow requirements, and

c. the projected return of the portfolio relative to the plan's funding objectives.

The regulations also state that the fiduciary should consider the risk of loss associated with investments. For example, court cases have held that consideration of risk of loss requires the fiduciary to investigate the financial soundness of an insurance company before purchasing certificates of deposit from it and to conduct his own credit check on borrowers in real estate transactions rather than relying on real estate appraisals conducted by the borrowers.

With the increased popularity over the past several years of self-directed investments in retirement plans and the advent of automatic enrollment 401(k) plans, plan fiduciaries have been seeking guidance on the default investment choices in plans. DOL Reg. 2550.404c-5 provides a safe harbor for default investments. If certain conditions are met, plan fiduciaries are relieved from liability for losses resulting from a participant's account being invested in the qualified default investment arrangement (QDIA). The sponsor remains liable for the selection and monitoring of the QDIA. Though outside the scope of this course, qualified default investment arrangements are discussed in detail in *PPC's 5500 Deskbook*.

Fiduciary Liability

A fiduciary is personally liable to the plan for losses resulting from a breach of his or her fiduciary responsibility. Also, the fiduciary must restore to the plan any profits realized on misuse of plan assets. The limitations of fiduciary liability with respect to participant-directed investments was discussed earlier in this section.

Not only is a fiduciary liable for his own breaches, but he is liable if he has knowledge of another fiduciary's breach and either conceals it or does not make reasonable efforts to remedy it. ERISA, Title I, Section 409, "Liability for Breach of Fiduciary Duty," and ERISA, Title I, Section 405, "Liability for Breach by Co-Fiduciary," discuss fiduciary liability.

A civil penalty is imposed on a fiduciary who breaches his responsibility or on a "knowing non-fiduciary" who participates in a fiduciary's breach of trust. The penalty is 20% of any amount the plan recovers from the fiduciary or other person in a settlement or judicial proceeding related to the breach.

Prohibited Transactions

ERISA, Title I, Section 406, prohibits a plan fiduciary from allowing a plan to engage in the following transactions:

- Sale, exchange, or leasing of property with a party in interest.
- Lending of money or extension of credit between the plan and a party in interest, which includes failing to remit employee contributions to the plan on a timely basis.
- Furnishing of goods, services, or facilities between the plan and a party in interest.
- Transfer of plan assets to, or for the use or benefit of, a party in interest.
- Acquisition of qualifying employer securities or qualifying employer real property exceeding, at the time of the acquisition, 10% of the fair value of plan assets. In general, qualifying employer securities are stock or marketable obligations (bonds, debentures, etc.) of the plan sponsor, if not more than 25% of the total issue is held by the plan and if at least 50% of the issue is held by persons independent of the issuer. There are requirements for stock or obligations that are not traded on the market to be qualifying. Qualifying employer real property is real property leased to the employer or an affiliate that is geographically dispersed and suitable (or adaptable) for more than one use.

Party in Interest. A party in interest is defined in IRC Sec. 4975(e)(2) as follows—

a. A fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of the plan.

b. A person providing services to the plan.

c. An employer, any of whose employees are covered by the plan.

d. An employee organization, any of whose members are covered by the plan. [ERISA, Title I, Section 3(4), defines an employee organization as including a labor union or employee representation committee that deals with employers concerning an employee benefit plan or concerning other matters incidental to employee relationships, or an employees' beneficiary association organized for the purpose of establishing an employee benefit plan.]

e. An owner, direct or indirect, of 50% or more of—

   •• the combined voting power or the total value of all shares of a corporation that is an employer or employee organization whose employees/members are covered by the plan,

   •• the capital or profits interest of a partnership that is an employer or employee organization whose employees/members are covered by the plan, or

   •• the beneficial interest of a trust or unincorporated enterprise that is an employer or employee organization whose employees/members are covered by the plan.

f. A relative of any individual listed in items a., b., c., or e. of this paragraph. For this purpose, a relative is a spouse, ancestor, lineal descendant, or spouse of a lineal descendant.

g. A corporation, partnership, trust, or estate of which (or in which) 50% or more of any of the following is owned directly or indirectly, or held by any person described in items a. through e. of this paragraph:

   •• The combined voting power or the total value of all shares of such corporation.

   •• The capital or profits interest of such partnership.

   •• The beneficial interest of such trust or estate.

h. An employee, officer, director (or an individual having powers similar to those of officers or directors), or a 10%-or-more shareholder, directly or indirectly, of a person described in items b. through e., or g., of this paragraph, or of the employee benefit plan. This definition includes all employees, even those who are not highly compensated. It also includes service provider employees.

   Under the Internal Revenue Code, only highly compensated employees (i.e., employees earning 10% or more of the employer's yearly wages) are included in this category [IRC Sec. 4975(e)(2)(H)]. Also, employees of service providers (item b.) are not included. Thus, nonhighly compensated employees are not disqualified persons subject to the IRC Sec. 4975 prohibited transaction penalty under this category, nor are employees of service providers. They are, however, subject to the ERISA requirements and penalties relating to parties-in-interest.

i. A 10%-or-more partner or joint venturer (directly or indirectly in capital or profits) of a person described in items b. through e., or g. This definition includes service provider employees.

   Under the Internal Revenue Code, service provider employees (item b.) are not included in this category and, thus, are not disqualified persons subject to the IRC Sec. 4975 prohibited transaction penalty under this category [IRC Sec. 4975(e)(2)(I)]. They are, however, subject to the ERISA requirements and penalties relating to parties-in-interest.

The IRC uses the term *disqualified person* with substantially the same meaning as "party in interest." Also, the terms *prohibited transaction*, *nonexempt transaction*, *nonexempt party-in-interest transaction*, and *prohibited party-in-interest transaction* are used interchangeably.

Other Prohibited Fiduciary Actions. In addition to the prohibited transactions from ERISA, Title I, Section 405, listed previously that a fiduciary must not allow a plan to engage in, the fiduciary is prohibited from doing the following:

- Dealing with plan assets for his own account or for his own interest, which includes failing to remit employee contributions to the plan within the defined time period.
- Transacting with the plan on behalf of any party whose interests are adverse to the interests of the plan or its participants or beneficiaries.
- Receiving any personal consideration from anyone in a transaction involving plan income or assets.

Exceptions to the Prohibited Transaction Rules. Some exceptions to the prohibited transaction rules listed in preceding paragraphs are discussed below:

- Nothing prohibits a fiduciary from being an officer, employee, agent, or other representative of a party in interest. Thus, for example, a fiduciary may be an employee of the plan sponsor (employer).
- A fiduciary may receive any benefit to which he is entitled as a plan participant as long as it is computed and paid in a manner consistent with that applied to all other plan participants and beneficiaries.
- A plan may make reasonable compensation payments to parties in interest that provide operating services to the plan. For example, the plan may reimburse an employer for plan administrative expenses the employer incurs on the plan's behalf, such as for rent, legal, and accounting services. A fiduciary may also receive reasonable compensation or expense reimbursement for services provided to the plan.
- The 10% limit on the acquisition of qualifying employer securities or qualifying employer real property does not apply to ESOPs, thrift or savings plans, stock bonus plans, profit-sharing plans, and many money purchase plans in existence on September 2, 1974.
- Plans may make loans available to participants on a nondiscriminatory basis if the plan document provides for such loans (that is, there must be a written loan program), and if the loans are adequately secured, bear a reasonable interest rate, and do not exceed certain limits.
- ESOPs may borrow from a party in interest if the loan is to benefit plan participants and beneficiaries, the interest rate is reasonable, and the only collateral is employer securities.
- Plans covering employees of a bank or similar institution that is supervised by a federal or state agency may have deposits in the bank or similar financial institution that is a fiduciary if the plan document or a fiduciary other than the bank authorizes the deposit, and the deposit bears a reasonable interest rate.
- Plans may enter into transactions with a common/collective trust fund or pooled investment fund by a party in interest which is a bank, trust company, or insurance company supervised by a state or federal agency if (a) the transaction is a sale or purchase of an interest in the fund, (b) the compensation for the transaction is no more than reasonable, and (c) the transaction is expressly permitted by the plan document or by a fiduciary (other than the bank, trust company, or insurance company) who has authority to manage and control the assets of the plan.
- Eligible investment advice arrangements that provide investment advice to participants or beneficiaries of a defined contribution plan who direct the investment of their accounts are exempt. Also exempt is the selling, buying or holding of a security or other property and the direct or indirect receipt of fees or other compensation for providing advice or from transactions based on the advice. The arrangement must be authorized by a plan fiduciary other than (a) the person offering the investment advice program, (b) any person providing investment options under the plan, or (c) affiliates of either. In addition, one of the following must be met: (a) any fees or other compensation received by the fiduciary adviser must not vary depending on the investment option chosen by the participant or (b) a computer model is used under an investment advice program that meets certain requirements. Additional notice and annual audit requirements apply.

ERISA, Title I, Section 408 provides numerous other exceptions covering matters such as insurance contracts with an insurance company that is the plan sponsor, etc. The DOL and IRS have published numerous "class exemptions" relating to various types of transactions with banks, broker/dealers, insurance companies, investment companies, etc. Class exemptions apply to all plans and parties engaging in transactions of the type covered by the exemption. In addition to statutory and class exemptions, the DOL may be requested to grant an administrative exemption related to a specific transaction involving a specific plan. A specific exemption is granted if it is in the interest of the plan and its participants and beneficiaries to allow the transaction.

Liability for Prohibited Transactions. A plan that engages in a prohibited transaction does not lose its plan qualification; instead, the persons engaging in the transaction are subject to an IRC excise tax of 15%. The tax is imposed even if the transaction was inadvertent or benefits the plan. Additional taxes are imposed if the transaction is not corrected in a specified period. An exemption from the prohibited transaction penalty is provided for securities transactions if those transactions are generally corrected within 14 days of the discovery date.

ERISA Bonding Requirements

Generally, every fiduciary of a plan and every person who handles funds or other property of the plan must be bonded. An in-depth discussion of bonding is beyond the scope of this course, but *PPC's Guide to Audits of Employee Benefit Plans* includes a practice aid that can be used to assist the auditor in determining if the bonding requirements have been met.

Operating Expenses

Administrators are often troubled over what plan expenses can be reasonably paid from plan assets. The general rule is that fiduciaries must administer a plan for the exclusive benefit of the participants. This rule would allow payments from plan assets for any necessary services provided at a reasonable cost, as long as the costs are not prohibited by the plan document. The expense of a qualified domestic relations order (QDRO) review may be charged to individual participants as long as the summary plan description includes the provisions (DOL Field Assistance Bulletin 2003-3). When the plan document is silent on the allocation of expenses, the fiduciary has considerable discretion. However, the fiduciary must act solely in the interest of the participants and be careful not to make allocation decisions that may result in a breach of fiduciary duty or a prohibited transaction. Rev. Rul. 2004-10 goes even further allowing administration expenses to be allocated to accounts of former employees while not charging the accounts of current employees.

The Employee Benefits Security Administration (EBSA) has paid particular attention to the expenses incurred by defined contribution plans with 401(k) features. To help 401(k) plans and plan sponsors understand and evaluate the fees that may be charged to their plans, the DOL has prepared several products including the "401(k) Plan Fees Disclosure Form" and "Understanding Retirement Plan Fees and Expenses" that are available at the DOL's website at **www.dol.gov/agencies/ebsa**.

Monitoring Service Provider Fees. As discussed earlier in this section in relation to prohibited transactions, a service provider to the plan would be considered a party-in-interest. The provision of services to the plan and the plan's payment for those services would be considered a prohibited transaction were it not for the statutory exemption allowing a "reasonable contract." The DOL issued final regulations under ERISA Sec. 408(b)(2) to define what would be considered a reasonable contract or arrangement, and thus, allow the plan fiduciary and the service provider to enter into an arrangement for necessary services for the plan's operation without committing a prohibited transaction.

The regulations apply to "covered plans," which include qualified plans and 403(b) plans subject to ERISA. They do not apply to welfare plans, governmental plans, nonelecting church plans, unfunded excess benefit plans, IRAs, SIMPLE IRAs, or SEPs.

A service provider is subject to the regulations if it—

a. enters into a written or verbal contract or arrangement with the plan,

b. reasonably expects to receive at least $1,000 either directly or indirectly for services rendered,

c. provides services as a fiduciary, registered investment advisor, recordkeeper, or broker to the plan with an investment platform, or

d. is reasonably expected that the service provider will receive indirect compensation. (This category could include accountants, auditors, consultants, TPAs, or investment advisors.)

While there is no prescribed or model format required, a service provider must disclose in writing the following information to a responsible plan fiduciary (RPF):

a. A description of the services to be provided.

b. A description of the direct or indirect compensation that the provider reasonably expects to receive in connection with the services.

c. A description of the compensation paid if set on a transaction basis or if charged against the investment and reflected in net asset value (NAV).

d. A description of compensation reasonably expected in connection with the termination of the contract.

e. A description of all direct and indirect compensation related to recordkeeping services.

f. A description of how the compensation will be received.

The service provider must make the disclosures reasonably in advance of the date the arrangement is entered into, extended, or renewed. There is no requirement for an annual disclosure. Therefore, the initial disclosure is adequate until the contract is changed, extended, or renewed. The covered service provider must provide to the plan administrator the investment information that the administrator must provide to the participants.

If the disclosures are not made according to the regulation, a prohibited transaction (subject to a 15% excise tax on the fee paid) has occurred between the RPF and the covered service provider (CSP). The regulation provides some relief for the RPF for inadvertent violations. The same relief is not provided for the CSP, although the regulation does provide a method to cure an incorrect or incomplete disclosure. The CSP must disclose the information as soon as possible, but no later than 30 days after it discovers the error.

The regulation provides a class exemption from the prohibited transaction rules. The exemption requires that fiduciaries notify the DOL of any disclosure failures.

All of this activity should prompt plan fiduciaries to clearly monitor the fees within a plan and clearly document the decisions made when comparing fees in investment choices made. The authors do not believe that the auditor is responsible for evaluating the reasonableness of fees charged to the plan; however, the engagement team does need to be familiar with the plan's covered service providers and obtain an understanding of management's processes for complying with the regulations as noncompliance is a prohibited transaction that requires disclosure in the plan's financial statements and on Schedule G of Form 5500.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. What is one requirement made by ERISA's prudent man/exclusive benefit rule for how fiduciaries perform their duties?

   a. They must perform their duties with the care, skill, prudence, and diligence of a prudent man in those circumstances.

   b. They must perform their duties in accordance with plan documents and instruments when they differ from ERISA requirements.

   c. They must ensure that the plan invests its funds in the same investments for consistency.

   d. They must ensure that the cost of assets purchased exceed their fair market value at the time of the purchase.

10. Fiduciaries are prohibited from doing which of the following in relation to an employee benefit plan?

    a. Receiving compensation payments for services provided to the plan.

    b. Participating in the plan and receiving benefits.

    c. Serving as officers, employees, or agents of the plan sponsor.

    d. Dealing with plan assets for their own interest.

11. A service provider is subject to the regulations for covered plans if it does which of the following?

    a. Expects to receive a minimum of $10,000 for services rendered.

    b. Begins negotiations to perform work for the plan.

    c. Provides services to the plan as a fiduciary.

    d. Elects to be considered a party-in-interest in relation to the plan.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

9. What is one requirement made by ERISA's prudent man/exclusive benefit rule for how fiduciaries perform their duties? **(Page 333)**

   a. **They must perform their duties with the care, skill, prudence, and diligence of a prudent man in those circumstances. [This answer is correct. ERISA, Section 107, requires that fiduciaries discharge their duties solely in the interest of plan participants and beneficiaries and of the exclusive purpose of providing benefits for them and defraying reasonable plan administrative expenses. Specifically, it says, among other things, fiduciaries must perform their duties with the care, skill, prudence, and diligence of a prudent man under the circumstances.]**

   b. They must perform their duties in accordance with plan documents and instruments when they differ from ERISA requirements. [This answer is incorrect. Under this rule, fiduciaries must perform their duties in accordance with plan documents and instruments, insofar as they are *consistent* with the provisions of ERISA.]

   c. They must ensure that the plan invests its funds in the same investments for consistency. [This answer is incorrect. To follow this rule, fiduciaries must perform their duties by *diversifying* plan investments so as to minimize risk of loss under the circumstances, unless it is clearly prudent not to do so.]

   d. They must ensure that the cost of assets purchased exceed their fair market value at the time of the purchase. [This answer is incorrect. The IRS has rules for the investing of plan assets. The cost of the assets purchased must *not* exceed their fair market value at the time of purchase, and the assets should provide a return comparable to the prevailing market rate. However, this is IRS guidance, not ERISA guidance provided in this rule.]

10. Fiduciaries are prohibited from doing which of the following in relation to an employee benefit plan? **(Page 336)**

    a. Receiving compensation payments for services provided to the plan. [This answer is incorrect. There are some exceptions to the prohibited transaction rules in relation to fiduciaries and employee benefit plans. One such exception is that a plan may make reasonable compensation payments to parties in interest that provide operating services to the plan. For example, the plan may reimburse an employer for plan administrative expenses the employer incurs on the plan's behalf, such as for rent, legal, and accounting services. Fiduciaries may also receive reasonable compensation or expense reimbursement for services provided to the plan.]

    b. Participating in the plan and receiving benefits. [This answer is incorrect. Fiduciaries may receive any benefits to which they are entitled as plan participants as long as those benefits are computed and paid in a manner consistent with that applied to all other plan participants and beneficiaries.]

    c. Serving as officers, employees, or agents of the plan sponsor. [This answer is incorrect. Nothing prohibits a fiduciary from being an officer, employee, agent, or other representative of a party in interest. Thus, for example, a fiduciary may be an employee of the plan sponsor (employer).]

    d. **Dealing with plan assets for their own interest. [This answer is correct. Among other things, fiduciaries are prohibited from (1) dealing with plan assets for their own account or for their own interest (which includes failing to remit employee contributions to the plan within the defined time period), (2) transacting with the plan on behalf of any party whose interests are adverse to the interests of the plan or its participants or beneficiaries, and (3) receiving any personal consideration from anyone in a transaction involving plan income or assets.]**

11. A service provider is subject to the regulations for covered plans if it does which of the following? **(Page 337)**

    a. Expects to receive a minimum of $10,000 for services rendered. [This answer is incorrect. If the service provider reasonably expects to receive at least $1,000 either directly or indirectly for services rendered, it is subject to the regulations. So, while a plan that receives $10,000 would be subject to those rules, this is not the minimum amount triggering those rules to apply.]

    b. Begins negotiations to perform work for the plan. [This answer is incorrect. If the services provider enters into a written or verbal contract or arrangement to the plan, it will be subject to the regulations. It is not subject to them just by beginning negotiations related to possible work in the future.]

    c. **Provides services to the plan as a fiduciary. [This answer is correct. The Department of Labor (DOL) issued final regulations under ERISA Sec. 408(b)(2) to define what would be considered a reasonable contract or arrangement, and thus, allow the plan fiduciary and the service provider to enter into an arrangement for necessary services for the plan's operation without committing a prohibited transaction. The regulations apply to "covered plans," which include qualified plans and 403(b) plans subject to ERISA. A service provider is subject to the regulations under certain circumstances, including when it provides services as a fiduciary, registered investment advisor, recordkeeper, or broker to the plan with an investment platform.]**

    d. Elects to be considered a party-in-interest in relation to the plan. [This answer is incorrect. On prohibited transactions, a service provider to the plan would be considered a party-in-interest. This is not an election the service provider chooses to make in relation to the DOL regulations.]

MAKING REQUIRED DISCLOSURES TO PLAN PARTICIPANTS

ERISA, Title I, Section 101, requires employee benefit plans to make certain disclosures to plan participants. This section discusses the various disclosure responsibilities.

Summary Plan Description (SPD) and Summary of Material Modifications (SMM)

ERISA requires most plans, whether qualified or not, to provide plan participants with a summary plan description (SPD) within 90 days from when they become participants or a beneficiary begins receiving benefits. New plans must provide the SPD within 120 days after the plan is established.

Plan administrators are not required to automatically file summary plan descriptions and summary of material modifications with the DOL. However, these documents must be submitted to the DOL, if requested, and must still be provided to plan participants.

The SPD must explain in easily understandable language matters such as the type of plan, the requirements for participation and benefits, benefit accrual and vesting provisions, how to file claims, etc. It must also describe participants' rights under ERISA, for example, the right to examine plan documents and obtain copies of annual reports, etc. If the plan is materially amended, a summary of material modifications (SMM) must be provided within 210 days of the end of the plan year in which the amendment is adopted, unless an updated SPD is provided. A new SPD must be furnished once every five years after the initial filing date if the plan is amended; otherwise, it must be furnished every 10 years.

Summary Annual Report (SAR)

An employee benefit plan must annually provide participants and beneficiaries with a summary of the annual report that the DOL requires. The SAR must generally be provided within nine months after the plan year end. If an extension of time is obtained for filing Form 5500, the SAR must be filed within two months after the close of the extended period.

The SAR need not contain financial statements, but it must include certain information such as total plan income and expenses, benefits paid, the value of plan assets at the beginning and end of the plan year, any funding deficiencies, etc. The information ties into various lines of the Form 5500 schedules. DOL regulations 2520.104b-10(d) include several formats for different types of plans that must be used. (The formats are also included in *PPC's 5500 Deskbook*.) The SAR is completed by inserting information from the current Form 5500 into the required format and by omitting any part of the prescribed format that is not applicable to the plan. If necessary, explanatory information may be added in a section headed "Additional Explanation."

The plan must make the complete annual report (Form 5500) available to any participant who requests it in writing.

Participant Fee Disclosure

Participant direction of investments has become a dominant feature in 401(k) and 403(b) plans. The DOL wants to ensure that participants with self-directed account plans have the information they need regarding their rights and responsibilities in managing their accounts, and that they are provided sufficient information about the plan, the designated investment alternatives, and fees to make informed decisions about the management of their accounts. To that end, the DOL published final regulations under ERISA Sec. 404(a), known as the *Participant Fee Disclosure Regulations*.

The regulations apply to all participant-directed defined contribution plans that are subject to ERISA. If a plan has both participant-directed and trustee-directed investments, the plan must comply with the plan-related and investment-related disclosures. However, the investment-related information for the trustee-directed investments need not be supplied and is limited to the plan's designated investment alternatives (DIAs) (EBSA Field Assistance Bulletin 2012-02, Q&A-1).

The fiduciary duty to follow these regulations has been placed on the plan administrator. Failure to follow these regulations is a breach of fiduciary duty and a prohibited transaction. While there is currently no DOL penalty

imposed for failure to follow these regulations, the consequences of failure could be legal action brought by the DOL or a participant.

Initial and Annual Notices. Under DOL Reg. 2550.404a-5, an initial notice must have been provided to each participant or beneficiary on or before the first date the person could first direct his or her investments. These disclosures must be provided annually thereafter.

The disclosures required by the regulation include the following:

a. General disclosures—

(1) How the participants and beneficiaries may give investment instructions.

(2) Any limitations of such instructions, including any restrictions on transfer to or from a DIA.

(3) Any plan provisions relating to the exercise of voting, tender, and similar rights.

(4) The DIAs offered under the plan.

(5) Any designated investment managers.

(6) Any brokerage windows, self-directed brokerage accounts, or similar arrangements that enable the selection of investments beyond those designated by the plan.

b. Administrative expenses—

(1) An explanation of any expenses or fees for general administrative services (e.g., accounting, legal, recordkeeping) that may be charged to or deducted from all individual accounts and are not reflected in the total operating expenses of any DIA.

(2) A description of the basis on which these fees will be allocated.

c. Individual expenses—

(1) An explanation of any fees that will be charged to an individual account rather than on a plan-wide basis (e.g., loan fees, self-directed brokerage fees, redemption fees, and commissions).

d. Investment-related disclosures—

(1) The information must be provided for each investment alternative under the plan.

(2) The name and category of each investment.

(3) The performance data on each investment (must be disclosed for one, five, and 10-year periods or since inception, if shorter).

(4) Benchmark returns for each investment option based on the appropriate broad market index based on one-, five-, and 10-year periods.

(5) The amount and description of each shareholder type fee against a participant's investment.

(6) The total operating expense for each investment expressed as a percentage (i.e., expense ratio).

(7) A statement indicating that the cumulative effect of fees can substantially reduce the growth of the account.

(8) A statement that fees are only one of several factors to consider in making investment decisions.

(9) An internet website that is sufficiently specific to provide participants information about the investment alternatives.

(10) A glossary of general terms.

(11) Fixed investment and annuity disclosures.

(12) Upon request, a paper copy of the website information is available.

Quarterly Disclosures. Additional disclosures must be provided on a quarterly basis and must be furnished no later than the 45th day of the third quarter in which the initial disclosure was required. The additional disclosures include the following:

a. The dollar amount of any plan administrative fees actually charged during the preceding quarter.

b. The dollar amount of any individual fees and expenses charged to the participant's account during the preceding quarter.

c. A description of the services to which the fees relate.

d. The amount and nature of any administrative expenses paid from total operating expenses of any of the plan's investment options.

Format of Disclosures. The regulations suggest a model chart as the format in providing this information. Plan administrators have the discretion to provide both plan-related and investment-related information as either stand-alone documents or in conjunction with other documents. For example, some of the information may be provided in the SPD, some in new enrollment packets, or some in benefit statements. Regardless of the means, the required information must always be provided by the timing requirements in the regulations.

Plan administrators may furnish multiple comparative charts or documents that are supplied by the plan's various service providers or investment issuers, provided all of the charts or documents are designed to facilitate a comparison among DIAs available under the plan and are furnished at the same time in a single mailing or transmission to participants and beneficiaries. However, permitting individual investment issuers, or others, to separately distribute comparative documents reflecting their particular investment alternatives does not provide an adequate comparison (EBSA Field Assistance Bulletin 2012-02, Q&A-21).

Other Required Disclosures to Retirement Plan Participants

Other disclosure responsibilities to plan participants that are imposed on employee benefit plans include the following:

- Upon written request, the plan must provide a participant or beneficiary with a statement of his total accrued benefit and earliest vesting date. The plan is not required to provide such a statement more than once a year.
- Plans that must provide benefits in the form of a qualified joint and survivor annuity, or that provide a preretirement annuity, must inform participants of the terms and conditions of such an annuity, their right to waive such a form of benefit, and their spouse's rights.
- Employees who have terminated employment must be notified of their accrued benefits and the percentage that is nonforfeitable.
- A plan that fails to make an installment to meet a minimum funding requirement must notify participants of that fact if it has not received a funding waiver.
- If a plan intends to terminate, it must give participants and beneficiaries a "Notice of Intent to Terminate" at least 60 days and not more than 90 days before the proposed termination date. A plan must also issue a "Notice of Plan Benefits" to participants and beneficiaries no later than the time the plan administrator files the "Standard Termination Notice" (PBGC Form 500) with the PBGC, which is no later than 180 days after the proposed termination date. PBGC regulations require that the notice of an intended standard termination explain that in such a termination, all benefit liabilities will be provided to participants and beneficiaries, and that the PBGC's guarantee of benefits ends once plan assets have been distributed to provide those benefits either through purchase of an annuity or by an alternative form of payment. The PBGC has also issued a requirement to identify insurers from whom annuity contracts will or may be purchased.

- If a plan adopts an amendment that will significantly reduce future benefit accruals, the plan administrator must notify participants of the amendment within a reasonable period of time before the amendment takes effect. The notice must be written and must provide sufficient information to allow participants to understand the effect of the amendment. Failure to comply with these regulations will subject the employer to an excise tax. (Plans may not reduce the benefits participants have earned, but may adopt changes that reduce future benefits.)

- Defined contribution plans are required to provide 30 days advance notice of a blackout period. A blackout period is a period of more than three business days during which plan participants or beneficiaries have temporary suspension, limitation, or restriction on the ability to direct or diversify assets in their accounts, obtain a loan, or take a distribution. This requirement only applies to plans where participants have individual accounts. The blackout notice must include certain disclosures, including the reason for the blackout, investment options or rights affected, expected beginning and ending date, and the name and address of a contact person to answer questions regarding the blackout. If investments are affected, the disclosure should notify participants and beneficiaries about evaluating their current investment decisions and the possible affects of their inability to diversify during the blackout period. The DOL may assess a civil penalty for noncompliance with these requirements.

- The administrator of a defined contribution plan is required to provide a benefit statement (a) to a participant or beneficiary who has the right to direct the investment of the assets in his or her account, at least quarterly, (b) to any other participant or beneficiary who has his own account under the plan, the statement must be provided at least annually, and (c) to other beneficiaries, upon written request, but limited to one request during any 12-month period. The administrator of a defined benefit plan is required either: (a) to furnish a benefit statement at least once every three years to each participant who has a vested accrued benefit under the plan and who is employed by the employer at the time the benefit statements are furnished to participants; or (b) to furnish at least annually to each participant a notice of the availability of a benefit statement and how the statement can be obtained. Those requirements do not apply to one-participant plans. In addition, defined benefit plans are required to provide participants an annual funding notice.

In addition to the disclosure responsibilities to plan participants discussed in the preceding paragraphs, employee benefit plans have a reporting responsibility to government agencies, as discussed in the following section.

WHAT A PLAN IS REQUIRED TO REPORT TO THE DOL, IRS, AND PBGC

ERISA, Title I, Section 103, "Annual Reports," requires employee benefit plans to file an annual report with the DOL, IRS, and (for defined benefit pension plans) the Pension Benefit Guaranty Corporation (PBGC). The "alternative method" of reporting, which consists of Form 5500 and appropriate related schedules and financial statements, if applicable, satisfies the reporting requirements of the three agencies. The auditor needs to be familiar with Form 5500. Some of the items in Form 5500 directly relate to the auditor's responsibility; for example, one item specifies disclosures that accompanying audited financial statements must include. Also, even if the auditor is not engaged to prepare the Form 5500, he has a responsibility to read the Form 5500 and consider whether other information in it is materially inconsistent with information in the audited financial statements, and he has certain responsibilities if he becomes aware of information in the form that he believes is a material misstatement of fact. The following are discussed in this section:

- Plans required to file Form 5500.
- Which Form 5500 to file?
- Plans exempt from filing Form 5500.
- Welfare and fringe benefit plan filing summary.
- "Large" plan vs. "small" plan.
- Determining the number of participants.

- DOL audit requirements.
- Forms 5500, 5500-SF, and 5500-EZ.
- Schedules and PBGC Form 1.
- Filing due date.
- Record retention requirements.

PPC's 5500 Deskbook discusses and illustrates a completed Form 5500 and related schedules for retirement and welfare benefit plans. It also gives more details about matters summarized in this section.

Plans Required to File Form 5500

All references to Form 5500 in this course are to the 2021 edition of the form, schedules, and instructions. Copies of the Form 5500, schedules, and instructions are available on the EBSA's website at **www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500**.

Each defined benefit or defined contribution retirement plan or welfare benefit plan covered under Title I of ERISA must file an annual report. The instructions to Form 5500 state that the following plans must file an annual return/report:

a. Defined benefit pension plans, including:
   (1) Tax sheltered annuity plans under IRC Sec. 403(b)(1).
   (2) Custodial accounts for regulated investment company stock under IRC Sec. 403(b)(7).
   (3) Individual retirement accounts maintained by employers for employees under IRC Sec. 408(c).
   (4) Pension benefit plans maintained outside the U.S. for nonresident aliens by domestic employers or foreign employers with U.S. source income.
   (5) Church plans electing coverage under IRC Sec. 410(d).
   (6) Plans covering residents of Puerto Rico and certain other U.S. territories.
b. Defined contribution plans, including:
   (1) Profit-sharing plans.
   (2) Stock bonus plans.
   (3) Money purchase plans.
   (4) 401(k) plans.
   (5) Plans that adopt the "SIMPLE" provisions of IRC Sec. 401(k)(11) to satisfy the ADP requirements of IRC Sec. 401(k)(3)(A)(ii).
c. Welfare benefit plans covered by ERISA, Title I.

Which Form 5500 to File?

There are three 5500 forms:

- Form 5500—Annual Return/Report of Employee Benefit Plan.
- Form 5500-SF—Short Form Annual Return/Report of Small Employee Benefit Plan.
- Form 5500-EZ—Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan.

Form 5500-EZ

Certain one-participant defined contribution plans and defined benefit pension plans may elect to file Form 5500-EZ. One-participant plans may not file using Form 5500. Welfare benefit plans and fringe benefit plans do not file Form 5500-EZ. One-participant plans are those that cover—

a. only the participant (or the participant and the participant's spouse) and the participant (or the participant and the participant's spouse) owns the entire business (incorporated or unincorporated), or

b. only one or more partners [or partner(s) and spouse(s)] in a partnership.

PPC's 5500 Deskbook provides a more complete discussion of the filing requirements relating to Form 5500-EZ. A detailed discussion of Form 5500-EZ is outside the scope of this course because plans filing a Form 5500-EZ have no audit requirement.

Form 5500-SF

The Form 5500-SF is a simplified annual reporting form that small employee benefit plans may elect to file if certain eligibility requirements are met. It may be used by defined benefit plans, defined contribution plans, and welfare benefit plans. However, employee stock ownership plans (ESOPs) and direct filing entities (DFEs) may not file the Form 5500-SF. To be eligible to use Form 5500-SF, a plan must meet the following requirements:

a. The plan is considered a small plan. Thus, it either covered less than 100 participants at the beginning of the 2021 plan year or under the 80–120 Participant Rule [DOL Reg. 2520.103-1(c)], filed as a small plan for the 2020 plan year and covered 120 or fewer participants at the beginning of the 2021 plan year.

b. The plan held no employer securities at any time during the plan year.

c. The plan was 100% invested at all times during the plan year in certain secure, easy-to-value assets that are considered eligible plan assets. The instructions to Form 5500-SF define eligible plan assets. Such assets have a readily determinable fair market value and include mutual fund shares, investment contracts with insurance companies and banks that are valued at least once a year, publicly traded securities held by a registered broker dealer, cash and cash equivalents, and participant loans.

d. The plan is eligible for the audit waiver provided by the Small Pension Plan Audit Waiver Regulation (DOL Reg. 2520.104-46), but not by reason of enhanced bonding.

e. The plan is not a multiemployer plan.

f. The plan will not be required to file a Form M-1 [Report for Multiple Employer Welfare Arrangements (MEWAs) and Certain Entities Claiming Exception (ECEs)] during the plan year.

A detailed discussion of Form 5500-SF is outside the scope of this course because if a plan is eligible to file and chooses to file using Form 5500-SF, an audit would not be required. Plans that are required to file an annual return/report that do not meet the requirements for filing Form 5500-SF must file either a Form 5500 or a Form 5500-EZ.

Plans Exempt from Filing Form 5500

The instructions to Form 5500 state that the following plans are exempt from the requirement to file an annual report:

- Welfare benefit plans with fewer than 100 participants as of the beginning of the year that are fully insured, unfunded, or a combination of insured and unfunded, and which is not subject to the Form M-1 requirements under DOL Reg. 2520.101-2.
  - The definitions of an insured welfare plan and an unfunded welfare plan are provided below.
  - Guidance on determining the number of participants is provided later in this section.
  - An example of a combination insured and unfunded plan is one that is unfunded with respect to its medical benefits and insured with respect to its life insurance benefits.

- Certain unfunded pension benefit plans or unfunded or insured welfare benefit plans that benefit only a select group of management or highly compensated employees, that is, "top-hat" plans.
- Plans maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws.
- An unfunded excess benefit plan.
- A welfare benefit plan maintained outside the U.S. primarily for nonresident aliens.
- Certain qualified foreign pension plans maintained outside the U.S.
- Certain annuity or custodial account arrangements.
- Certain simplified employee pension (SEP) plans.
- Certain savings incentive match plans for employees of small employers (SIMPLE plans).
- Church plans not electing coverage under IRC Sec. 410(d) or a governmental plan.
- A welfare plan participating in a group insurance arrangement that files a Form 5500 on behalf of the plan.
- Certain apprenticeship or training plans.
- Certain unfunded dues financed pension or welfare benefit plans.
- Welfare benefit plans solely for an individual or an individual and spouse who wholly own a trade or business, or partners or partners and spouses in a partnership.
- Certain individual retirement accounts or annuities not considered a pension plan.
- A church plan under ERISA Sec. 3(33).
- A governmental plan.

There is an important exception to the list above. DOL Reg. 2520.104-20(b)(4) stipulates that plans subject to the Form M-1 [Report for Multiple Employer Welfare Arrangements (MEWAs) and Certain Other Entities Claiming Exception (ECEs)] requirements under DOL Reg. 2520.101-2 are not exempt from filing. Such plans must file a Form 5500 regardless, even when the plan has less than 100 participants or would otherwise meet exemption criteria.

Some plans that are not exempt from the requirement to file a Form 5500 are exempt from the requirement to include audited financial statements with the form.

Definition of Insured Welfare Plan for Exemption Purposes. With respect to the first item in the list above, the instructions to Form 5500 indicate that to be fully insured, a welfare benefit plan:

- must have its benefits provided exclusively through insurance contracts or policies issued by an insurance company or similar organization (such as Blue Cross, Blue Shield, or a health maintenance organization) that can legally do business in any state, and
- the premiums of which must be paid—
  - directly by the employer or employee organizations from its general assets or
  - partly from its general assets and partly from contributions by its employees or members (salary reduction amounts in an IRC Sec. 125 cafeteria plan are considered employee contributions for this purpose). The employer or employee organization must forward the employee contributions within three months of receipt.

This filing exemption for unfunded, fully insured, and combination unfunded/insured welfare plans with fewer than 100 participants is also stated in DOL Reg. 2520.104-20, "Limited Exemption for Certain Small Welfare Plans". According to DOL Reg. 2520.104-20(b)(3), another condition of the exemption for an insured plan is that any refunds

to which contributing participants are entitled must be returned to them within three months of receipt by the employer or employee organization. Additionally, DOL Reg. 2520.104-20(b)(4) stipulates that plans subject to the Form M-1 requirements under DOL Reg. 2520.101-2 are not exempt from filing.

Definition of Unfunded Welfare Plan for Exemption Purposes. With respect to the first item listed in the "Definition of Insured Welfare Plan for Exemption Purposes" paragraph above, unfunded welfare benefit plans, the instructions to Form 5500 state that:

> An *unfunded welfare benefit plan* has its benefits paid as needed directly from the general assets of the employer or employee organization that sponsors the plan. **Note:** Plans that are NOT unfunded include those plans that received employee (or former employee) contributions during the plan year and/or used 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 during the year. A welfare benefit plan with employee contributions that is associated with a cafeteria plan under Code Section 125 may be treated for annual reporting purposes as an unfunded welfare plan if it meets the requirements of DOL Technical Release 92-01 . . ."

An employee organization, as used in this definition, is not to be confused with an IRC Sec. 501(c)(9) voluntary employees' beneficiary association (VEBA).The definition of an unfunded welfare benefit plan is also stated in DOL Reg. 2520.104-20 ("Limited Exemption for Certain Small Welfare Plans") and in DOL Reg. 2520.104-44 ("Limited Exemption and Alternative Method of Compliance for Annual Reporting by Unfunded Plans and by Certain Insured Plans"). (When making the initial evaluation of whether the plan is funded, the auditor ought to consider encouraging the plan to obtain an opinion from its legal counsel.) Considerations in applying this definition of an unfunded welfare benefit plan include the following:

a. According to Paragraph A.15 of Appendix A to AEBP, the IRC does not require a separate trust for welfare or fringe benefit plans, whereas ERISA generally requires that any assets of welfare benefit plans be held in trust. (Welfare and fringe benefit plans are not required to be funded, thus, they may have no assets that need to be held in trust.) As the above indicates, existence of a trust causes a plan to be considered a funded plan. Item b discusses DOL relief from the requirement to establish a trust for certain welfare plans.

b. DOL Reg. 2510.3-102, "Definition of 'Plan Assets'—Participant Contributions," states that employee contributions (including amounts withheld and elective contributions) become plans assets "as of the earliest date on which such contributions . . . can reasonably be segregated from the employer's general assets," not to exceed 90 days for welfare benefit plans from the date on which such amounts are received by the employer or withheld from wages.

   The IRC and DOL regulations differ about whether salary reduction amounts (for example, amounts withheld in flexible spending arrangements under an IRC Sec. 125 cafeteria plan) are employer contributions or are employee contributions and plan assets requiring segregation. The IRC considers salary reduction amounts to be employer contributions, whereas the DOL considers such amounts to be employee contributions. However, as Paragraph A.15 of Appendix A to AEBP indicates, the DOL has announced that it will not presently enforce the trust requirement for IRC Sec. 125 cafeteria plans to which employees make contributions. If a plan were required to establish a trust, it could not be considered to be unfunded for the purposes of the filing exemption discussed in the "Plans Exempt from Filing Form 5500" paragraph or the audit exemption covered in the "DOL Audit Requirements" discussion.

   Also, DOL Technical Release 92-01 states that, with respect to IRC Sec. 125 cafeteria plans that involve employee contributions paid by the participant or withheld by the employer (including elective contributions and flexible spending arrangements that meet the requirements of IRC Sec. 125), the DOL will not assert a violation solely because of failure to hold participant contributions in a trust. Release 92-01 remains in effect until adoption of final regulations on this matter.

c. Normally, a welfare plan that uses employee contributions directly to pay benefits would not meet the requirements for an unfunded plan. The reason is that, as the quote from the instructions to Form 5500 provided earlier states, to be unfunded, a plan must pay benefits ". . . directly from the general assets of the employer." DOL Technical Release 92-01 states that an IRC Sec. 125 cafeteria plan that does not

establish a trust will not fail to meet the filing exemption in DOL Reg. 2520.104-20 for unfunded welfare benefit plans with fewer than 100 participants or the audit exemption in DOL Reg. 2520.104-44 for unfunded welfare benefit plans with 100 or more participants solely because the plan uses employee contributions to pay benefits.

Welfare and Fringe Benefit Plan Filing Summary

A summary of the Form 5500 filing requirements for welfare and fringe benefit plans is provided in Exhibit 2-1.

Exhibit 2-1

Welfare and Fringe Benefit Plan Filing Summary

Plan	Description	Filing Requirements
1. Cafeteria plan (IRC Sec. 125 plan).	Participants choose between cash and nontaxable benefits. The plan typically has flexible spending accounts and/or a full menu of benefits choices (medical, dental, etc.). Participants may use pre-tax dollars to pay for some benefits (e.g., medical and dental premiums). Plans that provide benefits under ERISA (e.g., medical benefits) are welfare benefit plans. All cafeteria plans are fringe benefit plans.	IRS Notice 2002-24 suspended the filing requirements for all fringe benefit plans under IRC Sec. 6039D. However, if the plan provides ERISA benefits, it is a welfare benefit plan and must file Form 5500 unless it meets one of the exceptions listed earlier in this section.
2. Premium-only plan (POP) or premium conversion plan.	Benefits (group-term life insurance, dental, disability income, vision care, accidental death and dismemberment, and/or health care) are provided from employer and/or pre-tax employee contributions. Employees choose between pretax premium payments or taxable salary. This employee option makes this plan a cafeteria plan under IRC Sec. 125. See item 1.	See item 1.
3. Plan providing medical, surgical, hospital care, accident, disability, or death benefits.	These plans are welfare benefit plans and fringe benefit plans. If part or all of the insurance premiums are paid for by participants with pre-tax dollars, then the plan is a cafeteria plan and is discussed in item 1.	Must file Form 5500 unless the plan meets one of the exceptions listed earlier in this section.
4. Educational assistance program (EAP).	Assists employees in furthering their education. Educational assistance includes tuition, fees, books, supplies, and equipment. It does not include meals, lodging, or transportation.	Is not required to file Form 5500 since IRS Notice 2002-24 suspended the filing requirements for this type of plan.
5. Dependent care assistance plan (DCAP).	Provides care for employees' dependents. Benefits may be employer-maintained day care centers, cash reimbursement, or dependent care centers.	No Form 5500 filing required (DOL Reg. 2520.104-25; IRS Notice 2002-24).

Plan	Description	Filing Requirements
6. Sick pay.	Provides pay for employees who are absent from work due to illness. Unfunded plans are not welfare benefit plans [DOL Reg. 2510.3-1(b)(2)] or fringe benefit plans under IRC Sec. 6039D. Funded plans are welfare benefit plans.	No Form 5500 filing requirement for *unfunded* plans. However, *funded* plans must file Form 5500. (The small plan exception does not usually apply to a funded sick pay plan because the funding mechanism is not usually insurance.)
7. Vacation and holiday pay.	Provides pay for employees who are on vacation or absent from work because of a holiday. Unfunded plans are not welfare benefit plans [DOL Reg. 2510.3-1(b)(3)(i)] or fringe benefit plans under IRC Sec. 6039D. Funded plans are welfare benefit plans (*Mackey v. Lanier Collection Agency and Service, Inc.*).	No Form 5500 filing requirement for *unfunded* plans. However, *funded* plans must file Form 5500. (The small plan exception does not usually apply to a funded vacation plan because the funding mechanism is not usually insurance.)
8. Severance pay plan.	Provides payments to terminated employees. May provide payments for voluntary or involuntary separations. These plans are not fringe benefit plans. They are, however, welfare benefit plans, whether or not funded.	*Funded* and *unfunded* plans must file Form 5500 unless the plan meets one of the DOL exceptions listed earlier in this section.
9. Employee assistance plan (EAP).	Employer provides benefits which may include referrals, counseling, or treatment for various items such as drug abuse, alcohol abuse, marital problems, depression, etc.	Plans that provide counseling and treatment of health and medical problems such as drug and alcohol abuse, anxiety, and depression, are welfare benefit plans and must file Form 5500 unless the plan meets one of the DOL exceptions listed earlier in this section. Plans that simply make referrals from a published list of community resources are not welfare benefit plans and are not required to file Form 5500 (DOL Opinion Letter 91-26A).
10. Adoption assistance programs (AAP).	Provides payment for qualified adoption expenses for the adoption of a child by the employee. Such plans are fringe benefit plans. They are not welfare benefit plans.	IRS Notice 2002-24 suspended the filing requirements for all fringe benefit plans under IRC Sec. 6039D; therefore, this type of plan is not required to file Form 5500.

[SOURCE: *PPC's 5500 Deskbook* (Thomson Reuters, 2021).]

"Large" Plan vs. "Small" Plan

The instructions to Form 5500 use the following categories for employee benefit plans to determine which schedules and attachments must be filed with the Form 5500 or Form 5500-EZ:

- Large pension plans.
- Small pension plans.
- Large welfare plans.
- Small welfare plans.
- Direct Filing Entities (DFE).

General Rule. The general rule is that plans with 100 or more participants at the beginning of the plan year are considered "large plans," and plans with fewer than 100 participants are considered "small plans." This category affects the schedules that must be filed with the Form 5500, as described later in this section. The number of participants entered on line 5 of the Form 5500 should be used to determine whether a plan is large or small.

80–120 Participant Rule. If the general rule were applied without exception, plans that frequently fluctuate between slightly more or less than 100 participants would have to switch between being categorized as a "small" plan and a "large" plan, which could be inconvenient and disruptive. Thus, an exception to the general rule is provided by DOL Reg. 2520.103-1(c) and (d).The regulation provides relief from having to switch to the reporting requirements that the general rule would otherwise require. It provides that plans with between 80 and 120 participants (inclusive) at the beginning of the current plan year may elect to complete the current year return using the same category (that is, "large" plan or "small" plan) that was used in the previous year.

- Thus, for example, if a plan that had 115 participants at the beginning of the 20X1 plan year was considered a "small" plan for the previous year, the plan may complete the Form 5500 using the "small" plan category again in 20X1 (rather than having to use the "large" plan category) and each subsequent year until the number of participants exceeds 120.
- Similarly, if a plan that had 95 participants at the beginning of the 20X1 plan year was considered a "large" plan for the previous year, it may elect to file Form 5500 again in 20X1 as a "large" plan, rather than follow the general rule and switch to the "small" plan category. Such a plan might elect not to switch but to file the Form 5500 again as a "large" plan if the decline to 95 participants was considered to be temporary and it was considered likely that next year the plan would exceed 120 participants and thus would again have to file Form 5500 as a "large" plan.

Note that the exception is designed to avoid having to switch filing categories; it does not necessarily permit switching categories just because a plan falls within the 80–120 participant range.

- Thus, if a plan with 115 participants at the beginning of the 20X1 plan year had filed Form 5500 as a "large" plan for the previous year, it could not switch to filing Form 5500 this year as a "small" plan just because it had between 80–120 participants, but would have to file Form 5500 again as a "large" plan.
- Likewise, if a plan that had 95 participants at the beginning of the 20X1 plan year had filed Form 5500 as a "small" plan for the previous year, it need not switch to filing Form 5500 as a "large" plan this year just because it had between 80–120 participants.

Exhibit 2-2 summarizes the filing possibilities under the "80–120 participant" rule.

Exhibit 2-2

Filing Provisions for Plans with 80–120 Participants

Number of Participants at Beginning of Current Year	**Requirements Followed for the Previous Year Form 5500**	**Requirements to Be Followed for the Current Year Form 5500**
Fewer than 80	"Small" plan	"Small" plan
Fewer than 80	"Large" plan	"Small" plan
80–99 (inclusive)	"Small" plan	"Small" plan
80–99 (inclusive)	"Large" plan	May elect to file Form 5500 again as a "large" plan or switch to a "small" plan
100–120 (inclusive)	"Small" plan	May elect to file Form 5500 as a "small" plan again or switch to a "large" plan
100–120 (inclusive)	"Large" plan	"Large" plan
More than 120	"Large" plan	"Large" plan
More than 120	"Small" plan	"Large" plan

Determining the Number of Participants

As discussed in the preceding paragraphs, the Form 5500 reporting requirements vary based on the number of plan participants. Thus, determining the number of participants is crucial to determining which schedules are required to be filed with the Form 5500. Plans are required to enter the total number of participants at the beginning of the plan year on line 5 of the Form 5500. The number of participants as of the end of the plan year is entered on line 6 of the Form 5500; however, plans are required to segregate the number of participants as of the end of the plan year using various categories of participants on lines 6a through 6h, such as active participants and retired or separated participants entitled to future benefits. The instructions to Form 5500 lines 5 and 6 provide guidance on counting the number of participants. Participants include the following:

- *Active Participants.* Active participants include current employees who are earning or retaining credited service under the plan including nonvested participants. This category does not include nonvested former employees who have incurred a break in service or former employees who have received a deemed distribution or a "cash-out" distribution of their entire nonforfeitable accrued benefit. The authors believe that employees who have rolled over amounts into the plan but are not yet eligible participants are not to be counted. The instructions to Form 5500 state that active participants include employees "who are eligible to elect to have the employer make payments under a Code Section 401(k) qualified cash or deferred arrangement." Thus, even if an employee does not make contributions and does not have an account in a 401(k) plan, if he is eligible to participate, he is considered an active participant.

- *Retired or Separated Participants Receiving Benefits.* Former employees who are covered by the plan and receiving benefits under the plan are considered participants. This includes former employees receiving group health continuation coverage and who are covered by the employee welfare benefit plan. Those for whom an insurance company has made an irrevocable commitment to pay all benefits are not included.

- *Retired or Separated Participants Entitled to Begin Receiving Benefits in the Future.* The authors believe that terminated employees who still have balances that will or must be withdrawn (rolled over), but have not been, must be counted. Former employees for whom an insurance company has made an irrevocable commitment to pay all benefits (that is, those covered by an allocated insurance contract) are not included as participants.

- *Deceased Participants with Beneficiaries.* Deceased participants with one or more beneficiaries who are currently receiving (or entitled to receive) benefits under the plan are included as participants. This does not include a person if an insurance company has made an irrevocable commitment to pay all of the benefits to which the beneficiaries of that person are entitled. The deceased participant is counted as a participant, but the number of beneficiaries receiving benefits attributed to that participant are not.
- Dependents are not counted as participants for purposes of a welfare benefit plan. For example, an employee's family members who are covered by the company health insurance plan would not be counted as a participant.
- A child who is an alternate recipient entitled to health benefits under a qualified medical child support order is not considered a participant.

DOL Audit Requirements

All plans filing a Form 5500-EZ, a Form 5500-SF, and health and welfare plans filing a Form 5500 as a "small" plan (as discussed earlier in this section) have no audit requirement. Plans exempt from filing the 5500 forms are also exempt from the audit requirements.

The DOL's *Small Pension Plan Audit Waiver Regulation* (2520.104-46) requires all *pension* plans, including "small" plans, to be audited annually unless certain requirements are met. Under this rule (which does not apply to health and welfare plans) a pension plan with less than 100 participants is exempt from the requirement to have an annual audit only if the following conditions are met:

a. At least 95% of the plan assets are "qualifying plan assets," or if more than 5% of the plan's assets are nonqualifying plan assets, any person who handles the nonqualifying plan assets must be covered by a fidelity bond. (The amount of the bond must be at least equal to the value of the related assets.) *Qualifying plan assets* include:

    (1) Any assets held by a bank (or similar financial institution), an insurance company qualified to do business under the laws of a state, a registered broker-dealer, and any other organization authorized to act as a trustee for IRAs under the IRC.

    (2) Qualifying employer securities.

    (3) Participant loans.

    (4) Shares issued by a registered investment company.

    (5) Investment and annuity contracts issued by an insurance company authorized to do business under the laws of a state.

    (6) For an individual account plan, any assets in the account of a participant or beneficiary over which the participant or beneficiary may exercise control. In addition, the participant must receive, at least annually, a statement from a regulated financial institution that describes the assets held or issued by the institution and the amount of the assets.

b. The plan's summary annual report contains the following additional disclosures:

    (1) The name of each regulated financial institution holding or issuing "qualifying plan assets" and the amount of the assets reported by the institution as of the end of the plan year. This requirement does not apply to qualifying employer securities, participant loans or assets in an individual account plan.

    (2) If more than 5% of the plan's assets are nonqualifying plan assets, the name of the surety company issuing the bond.

    (3) A notice that participants and beneficiaries may request, without charge, to examine, or receive copies of, evidence supporting the required bond and the statements regarding the "qualifying plan assets" received from the regulated financial institution.

(4) A notice that participants and beneficiaries should contact the EBSA if they are unable to obtain or examine copies of the regulated financial institution's statements concerning the "qualifying plan assets" or evidence of the required bond.

c. If requested by a participant or beneficiary, the plan administrator, without charge, makes available for examination, or upon request furnishes copies of, each regulated financial institution statement and evidence of any required bond.

Plans that are exempt from the requirement to have an annual audit under this rule are not exempt from the obligation to file a Form 5500, including any required schedules or statements.

Plans filing the Form 5500 as a "large" plan are generally required to have an annual audit. This is true even if the plan has, for example, 81 participants but has elected to file Form 5500 as a "large" plan under the 80–120 participant rule discussed previously. However, the instructions to Form 5500 list the following as being exempt from the audit requirement:

- Welfare benefit plans that are unfunded, fully insured, or a combination of unfunded and insured as described in DOL Reg. 2520.104-44(b)(1) for the entire plan year.
  - The definitions of "fully insured" and "unfunded" were discussed earlier in this section.
  - The Form 5500 instructions state that welfare benefit plans that use a VEBA generally are *not* exempt from the audit requirement. Appendix A, Paragraph A.16, of AEBP also states this position.
  - DOL officials have stated that neither COBRA nor retiree premium payments will by themselves cause an audit to be required.
- Pension plans whose sole assets are insurance contracts that fully guarantee benefit payments attributable to plan participants for the plan year, as specified in DOL Reg. 2520.104-44(b)(2), that is, defined benefit or defined contribution retirement plans whose sole assets are allocated contracts.

  Appendix A, Paragraph A.25, of AEBP lists the following conditions of DOL Reg. 2520.104-44(b)(2) for such allocated contracts:

  a. the insurance company . . . unconditionally guarantees, . . . , to provide a retirement benefit of a specified amount, . . . ;

  b. the contracts are funded solely by premiums paid directly from the general assets of the employer or employee organization maintaining the plan, or partly from such general assets and partly from contributions from employees;

  c. the participant contributions are forwarded to the insurance company within three months of receipt; and

  d. refunds are returned to contributing participants within three months of receipt by the employer or employee organization.
- Plans may elect to defer (but not eliminate) the audit requirement for the first of two consecutive plan years if one is a short year and the following conditions are met:
  - The short plan year is seven or fewer months.
  - The short plan year must occur when a plan is established or commences operations, is merged or consolidated with another plan or plans, is terminated, or changes the annual date when the plan year begins.
  - The annual report for the short plan year must include the financial statements and appropriate schedules, an explanation why the plan year is seven or fewer months in duration and a statement indicating the annual report for next plan year will include an auditor's report for both plan years. The box in Line 3d(2) of Schedule H should be checked.

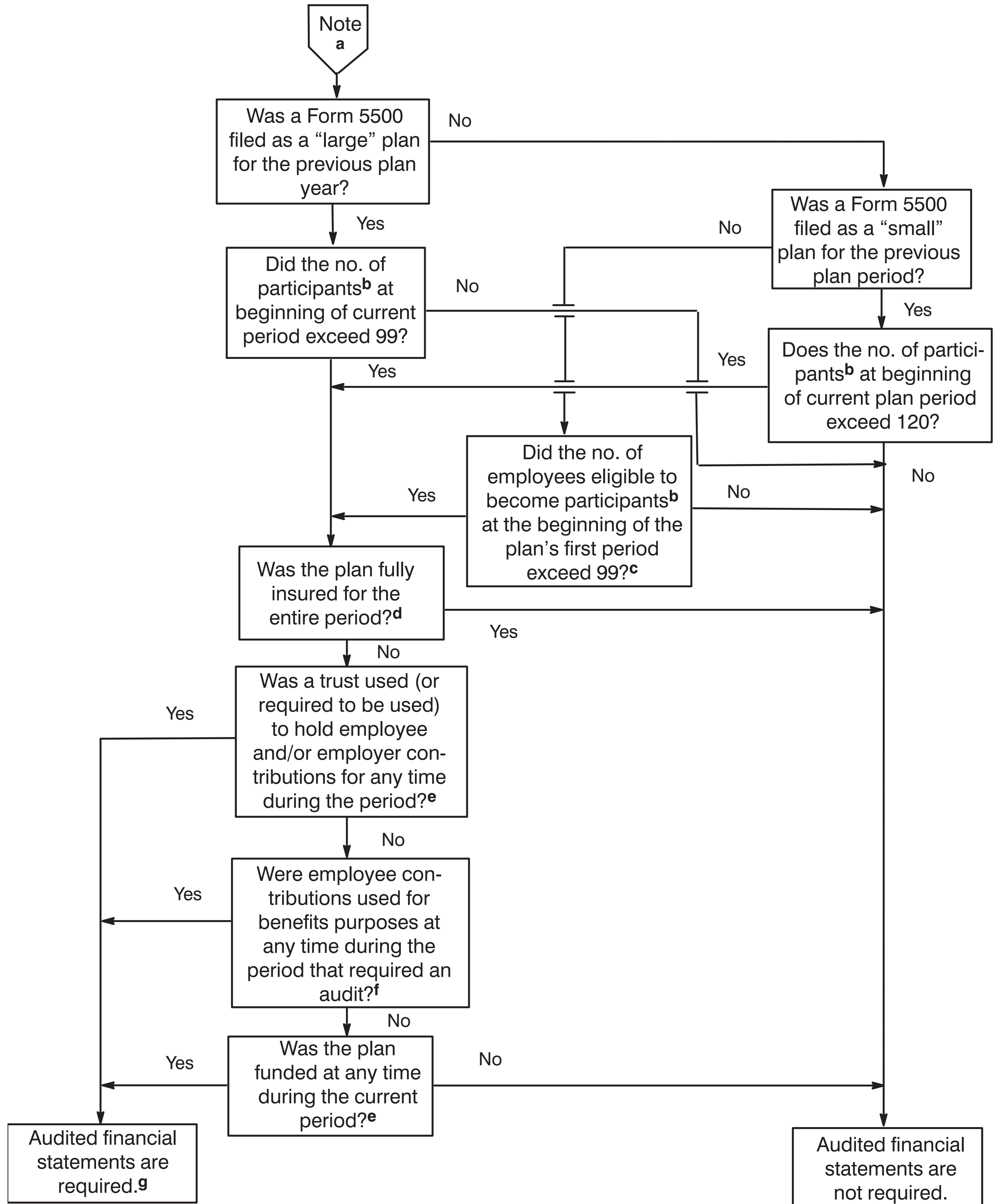
- •• The annual report for the second plan year must include financial statements and appropriate schedules for the first (short) plan year and the second plan year, an auditor's report for both periods, and a statement identifying any material differences between the unaudited financial information for the short period for the first plan year and the audited information for that period.

- Plans that meet the requirements of DOL Technical Release 92-01, that is, contributory welfare plans not meeting the trust requirements of DOL Reg. 2520.104–20 or the requirements of DOL Reg. 2520.104–44.

Exhibit 2-3 provides an audit decision tree for health and welfare plans.

Exhibit 2-3

Audit Decision Tree—Health and Welfare Plans



Notes:

[a] Certain plans (as previously discussed) are not required to file a Form 5500. These plans also have no audit requirement. Further, this decision tree assumes the plan is not eligible to file a Form 5500-SF. If a health and welfare plan is eligible to file a Form 5500-SF and chooses to use that form for filing, an audit would not be required.

[b] The number of participants was discussed earlier in this section.

[c] A plan that did not file a Form 5500 for the prior period is assumed for purposes of this decision tree to be a new plan. If the first plan year is a short period of seven months or less, and an audit is otherwise required.

[d] 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.

[e] A discussion of trust funds and unfunded plans was provided at earlier in this lesson.

[f] As previously discussed, a welfare plan that uses employee contributions directly to pay benefits normally would not meet the requirements for an unfunded plan (and thus, would not be exempt from the audit requirements). However, DOL Technical Release 92-01 provides an audit exemption for an IRC Sec. 125 cafeteria plan that uses employee contributions to pay benefits.

[g] Financial statements include a statement of net assets available for benefits as of the current and prior period ends, a statement of changes in net assets available for benefits for the current plan period, and, when applicable, certain supplemental schedules for the current plan period. An auditor's report must also be included.

Form 5500

Content of Form 5500. The Form 5500 contains general questions such as the name of the plan, plan sponsor, and plan administrator; the type of plan; the number of participants; and a code for the types of benefits provided under the plan. The instructions to Form 5500 include a table of the available plan characteristics codes.

Line 10 of the Form 5500 asks the preparer to check which schedules are applicable to the plan and, for some schedules, asks for the number of schedules attached. See the discussion of the schedules below.

Schedule A—Insurance Information

Schedule A, "Insurance Information," must be attached to Form 5500 if any benefits of a defined benefit, defined contribution, or welfare benefit plan are provided by an insurance company or similar organization.

Part I of Schedule A asks for summary information about all insurance contracts included in the Schedule. Part II relates to insured pension plans (defined benefit or defined contribution). It asks for information about premiums paid on insurance contracts and for activity (dividends and interest, benefits paid or annuities purchased, administrative charges, etc.) in unallocated contracts, for example DAs and IPGs, that are not maintained in separate accounts. It also asks for the current value of interests in general and separate accounts.

Part III of Schedule A relates to insured welfare benefit plans. It asks for information about premiums paid on nonexperience-rated contracts. It asks for activity in experience-rated contracts (premiums, claims paid and incurred, expenses and other charges to the contract, dividends, and reserves). Part IV of Schedule A allows plan administrators to report insurance companies that fail or refuse to provide any information necessary to complete Schedule A.

Schedule C—Service Provider Information

Schedule C, "Service Provider Information," is filed with Form 5500 by large pension and welfare plans. It lists persons who received $5,000 or more directly or indirectly from the plan to provide services to the plan; for example, accountants, actuaries, brokers, custodians, investment advisors, lawyers, etc. Part II of Schedule C reports plan fiduciaries or service providers who failed or refused to provide any necessary information to complete Part I of Schedule C.

Part III of Schedule C explains the reason for terminating an accountant or actuary. Any material disputes or disagreements concerning the termination must be explained, even if they were resolved before the termination. The terminated party must receive a copy of the schedule and a completed copy of the notice included in the instructions. The terminated party then has the right to submit comments about the termination to the DOL.

Schedule D—DFE/Participating Plan Information

Schedule D, "DFE/Participating Plan Information," must be filed with Form 5500 if any defined benefit, defined contribution, or welfare benefit plan participated in or invested in one or more common/collective trusts, pooled separate accounts, master trusts, or 103–12 investment entities at any time during the plan year. (This schedule must also be completed by any trusts, accounts, or other investment arrangements that file Form 5500 as a "direct filing entity" or DFE.)

Part I of Schedule D asks for the name and sponsor of the investment account, trust, etc. The Schedule also asks for the value of the interest at the end of the plan year. Part II of Schedule D should only be completed by DFEs.

Schedule G—Financial Transaction Schedules

Schedule G, "Financial Transaction Schedules," must be filed with Form 5500 by any large plan with loans or fixed income obligations in default or determined to be uncollectible as of the plan year end, leases in default or classified as uncollectible, or nonexempt (prohibited) transactions. The auditor must also report on this schedule if any of the previously mentioned items exist. The authors suggest that when applicable, Schedule G be attached to the Form 5500 and to the auditor's report.

Schedule H—Financial Information

Schedule H, "Financial Information," must be filed with Form 5500 by "large" pension plans or "large" welfare benefit plans, except for the following plans:

- Fully insured, unfunded, or unfunded/insured welfare benefit plans.
- Fully insured pension plans (pension plans that provide benefits exclusively through fully guaranteed, that is, allocated, insurance contracts that meet the conditions of DOL Reg. 2520.104-44.)
- Plans that filed a Form 5500 as a "small" plan in the prior year and qualify under the "80–120 participant" rule as a "small" plan.

More details about all of these were provided earlier in this lesson.

The instructions to Schedule H state that the cash, modified cash, or accrual basis of accounting may be used. However, assets and liabilities must be reported at current value, which the instructions define as fair market value when available, otherwise, fair value as determined in good faith by a trustee or fiduciary, "assuming an orderly liquidation at [the] time of the determination."

Asset and Liability Statement Included in Schedule H. Part I of Schedule H is a statement of the current value of plan assets and liabilities, that is, net assets, as of the beginning and end of the plan year. This means that a comparative statement of net assets is required even though GAAP does not require a comparative statement unless a defined benefit retirement plan has a beginning-of-year benefit information date.

Investments and Insurance Contracts. Lines 1c(9) to 1c(12) relate to investments in DFEs, that is, common/ collective trusts, pooled separate accounts, master trusts, and "103–12 investment entities" (a "103–12 IE" is an investment entity that holds assets of two or more plans that are not members of a related group of plans). The instructions to these items require plans with such investments to also report the plan's interest in each DFE on Schedule D. If the plan invests in a common/collective trust or a pooled separate account that has not filed a Form 5500, the plan may not report its interest on lines 1(c)(9) or 1(c)(10). The plan should determine its interest in the underlying assets of the DFE and report those interests in the appropriate categories in Part I.

Line 1c(14) relates to unallocated contracts in insurance company general accounts, for example, GICs. The instructions to line 1c(14) require the contract to be reported using the same basis as used in Schedule A.

Property Used in Plan Operations. Line 1e of Schedule H reports buildings and other property used in plan operations. The instructions to this item state that "the current (not book) value of the buildings and other property used in the operation of the plan" should be reported. However, GAAP requires such assets to be reported at cost less accumulated depreciation. DOL officials have publicly commented that the GAAP requirement conflicts with the ERISA requirement to present plan assets at current value, and that Form 5500 filings that report operating assets at cost will be rejected. Thus, the DOL would expect operating assets to be reported at current value in the Schedule H and at cost in audited GAAP financial statements, with a disclosure of the difference and a reconciliation between the two amounts being presented in the notes to the financial statements.

Income and Expense Statement. Part II of Schedule H is a statement of plan income, expenses, and changes in net assets for the current year.

Investment Gains and Losses. Line 2b(4) of Schedule H calls for the net realized gain or loss on assets disposed of during the year, and line 2b(5) calls for the unrealized appreciation or depreciation of assets held at year end. The instructions to these items state that these realized and unrealized gains and losses must be determined based on revalued cost, that is, on the current value of the assets at the beginning of the year carried forward from the prior year end or on the historical cost if the investment was acquired during the current year.

Thus, the realized gain or loss to be reported in line 2b(4) on an investment acquired in a prior year and sold in the current year should be calculated as the sales proceeds minus the current value at the beginning of the current year (that is, at the end of the prior year), not as the sales proceeds minus the original cost. Only if the investment had been both purchased and sold in the current year would the realized gain or loss be calculated for line 2b(4) as sales proceeds minus original cost. Likewise, the unrealized gain or loss on investments held at year end to be reported in line 2b(5) should be calculated as the current value at the end of the year minus the current value at the beginning of the year (that is, at the end of the prior year) or minus the original cost, if the investment was acquired during the year. Exhibit 2-4 illustrates the Schedule H requirements.

Exhibit 2-4

Calculation of Realized and Unrealized Investment Gains and Losses

Example 1 (Buy and Sell Security in Same Year)			
Year of purchase		20X1	
Purchase price		$20	
Year of sale		20X1	
Sales price		$60	
20X1 Realized Gain:			
Form 5500 Schedule H [line 2b(4)]		$40 ($60 – $20)	
GAAP		$40 ($60 – $20)	
Difference		$ 0	
Example 2 (Buy and Sell Security in Different Years)			
Year of purchase		20X1	
Purchase price		$20	
Current value at 12/31/X1		$45	
Year of sale		20X2	
Sales price		$77	
20X1 Unrealized Gain:			
Form 5500 Schedule H [line 2b(5)]		$25 ($45 – $20)	
GAAP		$25 ($45 – $20)	
Difference		$ 0	
20X2 Gain:	Realized	Unrealized	Net
Form 5500 Schedule H	$ 32 ($77 – $45)	—	$32
GAAP	$ 57 ($77 – $20)	$(25) (reversal of 20X1)[a]	$32
Difference	$(25)[b]	$ 25[b]	$ 0

Notes:

[a] Amount is included in change in unrealized appreciation in GAAP financial statements.

[b] Differences will not show up in GAAP financial statements if realized and unrealized gains and losses are combined, as GAAP allows.

Schedule H's required method of determining realized investment gains and losses described in the preceding paragraph differs from the way realized gains and losses traditionally are determined under GAAP. For GAAP financial statements, the current value is compared to historical cost, not to the prior year end current value. Exhibit 2-4 illustrates the GAAP methods of determining realized and unrealized gains and compares them to the method required in Schedule H.

GAAP also does not require the segregation of realized and unrealized gains and losses in the statement of changes in net assets, as Schedule H does. The difference between the GAAP and Schedule H determinations is just a swing

between realized and unrealized gains and losses amounts. The difference does not show up if realized and unrealized amounts are combined in the GAAP financial statements because under the traditional GAAP method, when the realized gain or loss is calculated on an investment that is sold, the previously recorded unrealized gains or losses are reversed, that is, recorded as a change in unrealized appreciation/depreciation. Example 2 in Exhibit 2-4 illustrates this reversal. If the audited financial statements combine realized and unrealized gains and losses, the net GAAP result will equal the realized gain or loss recognized in Schedule H. Otherwise, the notes should include a reconciliation between the Schedule H and the audited financial statements. Some accountants have stated that the method of computing realized gains and losses required by Schedule H does not conform to GAAP, and that the audited financial statements should not segregate realized and unrealized gains and losses if the Schedule H method is used in the audited statements. Other accountants believe that if the audited financial statements do segregate realized and unrealized gains and losses, the Schedule H method should be used so that the statements and Schedule will be consistent.

Accountant's Opinion. Part III of Schedule H contains questions about the accountant's opinion that is expressed on the audited financial statements. The instructions to Schedule H state that any separate financial statements prepared for the accountant to "form the opinion and notes" must be attached to the Form 5500. Such statements must include the information required to be disclosed in Parts I and II of Schedule H but may be aggregated differently.

Line 3a asks which type of accountant's opinion was issued on the plan's financial statements. (If the auditor issues a qualified opinion or disclaims an opinion on the plan's financial statements, the DOL will generally not accept the Form 5500 as meeting the ERISA requirements.) The opinion issued on the supplemental schedules should not affect the answer to this question. For example, if an unmodified opinion is issued on the financial statements and a qualified opinion is issued on the supplemental schedules, the answer to line 3a would be "unmodified."

Line 3b provides boxes to check to indicate whether (1) an ERISA section 103(a)(3)(C) audit was performed pursuant to DOL Reg. 2520.103-8, and (2) an audit was performed pursuant to DOL Reg. 2520.103-12(d). Check both boxes if both apply. Check box (3) if the audit is performed pursuant to neither. (Though outside the scope of this course, *PPC's Guide to Audits of Employee Benefit Plans* provides more in-depth information about how an ERISA Section 103(a)(3)(C) audit is performed.) Line 3c asks for the name and employer identification number (EIN) of the auditor or auditor's firm.

Lines 3d(1) and 3d(2) provide reasons for not attaching an auditor's report:

- The Form 5500 is filed for a DFE, that is, a common/collective trust, a pooled separate account, or a master trust investment account, or
- The period being reported is seven months or less and the audit requirement is being deferred until the next year, as permitted under DOL Reg. 2520.104-50.

Thus, as stated in the instructions to Schedule H, the accountant's "report *must* be attached to the Form 5500 when a Schedule H is attached unless line 3d(1) or 3d(2) . . . is checked."

Transactions during the Plan Year. Part IV of Schedule H asks whether certain types of transactions occurred during the year. Line 4a asks if the employer failed to remit any participant contributions to the plan within the time period described in DOL Reg. 2510.3-102. If line 4a is answered "yes," the total amount of all late contributions for the year must be entered in the "Amount" column and a schedule of delinquent participant contributions must be attached to the Form 5500. Employers are required to remit amounts paid by a participant or beneficiary to an employer and/or withheld by an employer for contribution to an employee benefit plan or repayment of a participant loan to the plan as soon as they can be reasonably segregated from the employer's general assets. The instructions to Schedule H say that "an employer holding these assets after that date commingled with its general assets will have engaged in a prohibited use of plan assets."

Lines 4b, 4c, and 4d ask whether the plan has any loans, fixed income obligations, or leases, that are in default or classified as uncollectible, or had any nonexempt transactions with parties in interest (prohibited transactions). For any questions answered "yes," the applicable part of Schedule G must be completed and attached to the Form 5500.

Delinquent participant contributions or delinquent participant loan repayments reported on line 4a should not be considered a nonexempt transaction with a party-in-interest for purposes of answering line 4d.

Lines 4e and 4f ask questions about the plan's use of fidelity bonds and whether any losses have occurred because of fraud or dishonesty. Lines 4g and 4h ask whether the plan holds any assets or received any noncash contributions that are not traded on an established market and were not valued by an independent appraiser.

Lines 4i and 4j ask whether the plan held assets as investments or had reportable transactions (certain transactions, or a series of transactions, exceeding 5% of the current value of plan assets). For any questions answered "yes," supplemental explanatory schedules must be attached to the Form 5500. The instructions to Schedule H specify the schedules' format and content. The schedules must be in the specified format or the filing will be rejected. The auditor needs to be aware of the following matters related to the schedules:

- Inclusion of the information in the notes to the financial statements will not substitute for its inclusion in the required supplemental schedules. Thus, a disclosure that would also be required in the financial statements would have to be reported both in the notes to the financial statements and in a supplemental schedule. For example, line 4i requires a schedule of assets held for investment even if such investments are disclosed in the notes to the financial statements.

- The supplemental schedules should be on the same basis of accounting as the audited financial statements. The auditor should note that a trustee may provide information on plan investments that is not on the GAAP basis (for example, it may be on the cash basis, use settlement date rather than trade date accounting, or report investment gains and losses on the "revalued method" required for Schedule H of the Form 5500). The auditor may have to make adjustments to the information to put it on the GAAP basis for inclusion in the GAAP financial statements and supplemental schedules.

Finally, supplemental schedules must be presented and reported on in an ERISA Section 103(a)(3)(C) audit as well as in a non-Section 103(a)(3)C) audit. Though outside the scope of this course, more information about these schedules, including their required form and content, is provided in *PPC's Guide to Audits of Employee Benefit Plans*.

As previously mentioned, the auditor must report on the supplemental schedules, including Schedule G. The IRS and DOL expect the financial statements, schedules, and auditor's report to be "attached to" the "return/report," separate and apart from the audited financial statements and clearly and fully labeled. However, the audited financial statements should also include these schedules (if applicable).

Schedule I—Financial Information—Small Plan

Schedule I, "Financial Information—Small Plan," must be filed with Form 5500 by "small" pension plans or "small" welfare benefit plans (see the discussion of "large" vs. "small" plans earlier in this lesson), including plans filing as a "small" plan under the "80–120 participant" rule. Only Schedule H or Schedule I, but not *both*, should be attached to the Form 5500.

Schedule I is a less detailed version of Schedule H. For example:

- Line 4 of Schedule I includes questions about loans and fixed income obligations in default or other reportable transactions similar to questions on Schedule H, but only amounts must be disclosed on Schedule I and not details that must be attached in supplemental schedules to Form 5500.

- "Small" pension plans may claim a waiver of an annual audit if the criteria provided earlier in this section are met. Therefore, a "small" pension plan that files a Schedule I may not be required to attach an auditor's report if it claims the waiver by answering "yes" to line 4k. "Large" pension plans that file a Schedule H must generally engage an independent qualified public accountant and attach an auditor's report to the Schedule H.

- The statement of net assets and the statement of income, expenses, and changes in net assets in Part I are less detailed than the same statements in Schedule H. However, the same rules about a comparative statement of net assets, basis of accounting, current value accounting, determination of unrealized gain or

loss on plan assets, and information related to investments in common/collective trusts, pooled separate accounts, master trusts, and "103–12 IE" entities apply as for Schedule H. Also, the instructions to Form 5500 and Schedule I state that fully insured pension plans meeting the conditions of the DOL Reg. 2520.104-44 need not complete the Schedule (a summary of these conditions was provided earlier in this section).

Schedule MB—Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information

Schedule MB, "Multiemployer Defined Benefit Plan and Certain Money Purchase Plan Actuarial Information," is required to be attached to Form 5500 if the plan is a multiemployer defined benefit plan subject to the minimum funding standards. Except as noted in the following paragraph, Schedule MB must be signed by an enrolled actuary. (Enrolled actuaries were discussed in Lesson 1.)

Schedule MB is also required to be attached to Form 5500 if the plan is a money purchase defined contribution plan (including a target benefit plan) that has received a waiver of the minimum funding standard, and the waiver is currently being amortized. For those money purchase plans, only certain lines of the Schedule must be completed and the Schedule does not require the signature of an enrolled actuary.

A new line 3(d) has been added to Schedule MB to require a multiemployer defined benefit plan to report the amount of withdrawal liability payments included in line 3(b) employer contributions. Line 6c, mortality table, has been revised to add new mortality tables released by the Society of Actuaries and to simplify reporting of older mortality tables. Line 7, New Amortization Bases Established, has been revised reflecting changes made by the American Rescue Plan Act of 2021 for Code 8 to be used for next investment losses and other losses related to the coronavirus incurred in either or both of the first two plan years ending after February 29, 2020.

Schedule R—Retirement Plan Information

Schedule R, "Retirement Plan Information," must be filed with Form 5500 by all defined benefit and certain defined contribution plans. This schedule reports information on plan distributions and funding. Defined benefit plans must also disclose whether any amendments were adopted that increased or decreased the value of benefits. The schedule also reports information on employee stock ownership plans (ESOPs) and multiemployer defined benefit plans.

Schedule SB—Single-employer Defined Benefit Plan Actuarial Information

Schedule SB, "Single-employer Defined Benefit Plan Actuarial Information," is required to be attached to Form 5500 by single-employer defined benefit plans (including multiple-employer defined benefit plans) that are subject to the minimum funding standards. Schedule SB must be signed by an enrolled actuary.

Line 6, target normal cost is broken down into new lines 6a, 6b and 6c. Line 6a requires the plan to report the present value of current plan year accruals decreased by any mandatory employee contributions. Line 6b requires the plan to report expected plan-related expenses included in target normal cost, and line 6c requires it to report the total target normal cost (i.e., the sum of lines 6a and 6b). The table in the Form 5500 instructions for line 27 contains an additional code (Code 9) for community newspaper as described in the SECURE Act.

Multiple-Employer Plan Information

Multiple employer pension plans are required to attach a schedule to the Form 5500 (or 5500-SF) listing the name and EIN of each employer that participated in the plan during the year. The schedule must also provide a "good faith estimate" of each employer's percentage of total contributions for the plan year. ERISA section 103(g) in the Setting Every Community Up for Retirement Enhancement Act of 2019 requires multiple-employer defined contribution pension plans to report aggregate account balance information by employer on the existing Form 5500/Form 5500-SF attachment for reporting participating employer information.

PBGC Premiums

Plans covered by PBGC insurance (defined benefit plans) pay an annual premium electronically with the PBGC. Other interactions with the PBGC are discussed later in this lesson in the section on plan terminations.

Filing Due Date

The Form 5500 and applicable related schedules, financial statements, and auditor's report must be filed by the last day of the seventh month after the plan year end, for example, by July 31 for a December 31 plan year end. One extension of up to two and one-half months (to October 15 for a December 31 plan year end) may be requested on Form 5558, "Application for Extension of Time To File Certain Employee Plan Returns."

Single-employer plans and plans of a controlled group of corporations that file a consolidated federal income tax return have an automatic extension until the due date of the federal income tax return if the plan and tax year coincide and an extension has been granted for filing the federal tax return. In such a case, a copy of the application for extension should be maintained with the plan's records.

An auditor has no direct responsibilities under GAAS if he becomes aware that a plan has not timely filed its Form 5500 return. The auditor may, however, consider notifying the plan administrator of the delinquent filing and advise the administrator of the late filing options, as discussed in the following paragraphs.

DOL Delinquent Filer Voluntary Compliance (DFVC) Program

The Delinquent Filer Voluntary Compliance (DFVC) Program was established by the DOL for plan administrators who failed to file one or more Form 5500 returns to encourage voluntary compliance with ERISA's reporting requirements. The DFVC program includes a basic penalty of $10 per day for delinquent filings subject to the following maximums based on whether the plan is considered "small" or "large."

- For single delinquent annual reports, the maximum penalty is $2,000 for a large plan and $750 for a small plan.
- For multiple delinquent annual reports related to a single plan, the maximum penalty is $4,000 for a large plan and $1,500 for a small plan. This cap applies regardless of the number of late annual reports as long as the delinquent reports are all filed at the same time and pertain to the same plan.

Because the DFVC penalties can be substantially less than those under the DOL Penalty Assessment Program, the DFVC program represents an opportunity for plan administrators to catch up on past due filings while facing a reduced (and quantifiable) exposure to DOL penalties. The IRS and the PBGC have agreed to provide penalty relief for plans that satisfy the requirements of the DFVC program. Additional information regarding the DFVC Program is available at **www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/correction-programs**. The DOL also has an online penalty calculator that can be used to compute the penalty amounts. For information about paying penalties electronically as well as an online penalty calculator, see **www.askebsa.dol.gov/dfvcepay/calculator**. *PPC's Guide to Small Employer Retirement Plans* contains a complete discussion of the late-filing options available to plan administrators and the procedures for each option.

Record Retention Requirements

General. ERISA and the IRS specify the time that plan records should be kept. Generally, records supporting information required to be reported under ERISA must be maintained for at least six years after the filing date. However, a longer period is required for records supporting benefit determinations. When benefits are deferred until a later date, such as age 65, records should be maintained to support those deferred benefits. Every employer with a benefit plan subject to ERISA is required to maintain sufficient records on each participating employee to determine the benefits due those employees. The IRS also requires information to be retained by any employer or plan administrator who must file information returns, such as Forms 1099.

ERISA Limitations. Generally, if claims are filed under ERISA, the statute of limitations is three years from the time the claim was known and six years from the actual act in question. If a plan participant sues the plan or plan sponsor to recover benefits, the statute of limitations may be determined based on the breach of contract statutes, which vary

from state to state, but may extend to 10 years or more. Thus, some ERISA attorneys suggest keeping records for a minimum of seven to 10 years.

Other. If a plan identifies plan qualification problems, such as operational defects, and decides to participate in the Employee Plans Compliance Resolution System, the plan is required to go back to the beginning of the problem to determine the correction required. Thus, if a problem that began in 2000 was not detected until 2021, the plan would have to go back to the 2000 records to determine what corrective actions would be necessary.

Penalties. ERISA or the IRS may assess penalties on employers or plan administrators who do not comply with these requirements. Penalties may range from $10 to $50 for each individual for whom the failure occurred, depending on the type of failure.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Employee benefit plans should disclose which of the following to participants on a quarterly basis?
    a. How participants and beneficiaries may give investment instructions.
    b. The names and categories of each plan investment.
    c. The dollar amount of any plan administrative fees actually charged.
    d. A description of the basis upon which administrative expenses will be allocated.
13. What type of plan can file a Form 5500-EZ?
    a. Defined benefit plans.
    b. Defined contribution plans.
    c. Small employee benefit plans.
    d. One-participant defined contribution plans and defined benefit pension plans.
14. Which of the following plans is exempt from the requirement to file an annual return?
    a. A welfare benefit plan with 500 participants.
    b. A top-hat plan.
    c. Annuities that are considered pension plans.
    d. Plans that are required for file Form M-1.
15. Which of the following plans correctly used the 80-120 participant rule to determine the best way to file its Form 5500?
    a. Plan 1 has 76 participants this year, but it continues to file Form 5500 as a large plan, as that is how it filed last year.
    b. Plan 2 has 98 participants this year, down from 103. It elects to continue to file its Form 5500 as a large plan, consistent with what it did last year.
    c. Plan 3 has 114 participants this year, down from 130 last year. It elects to file this year's Form 5500 as a small plan instead of as a large plan like last year.
    d. Plan 4 has 125 participants this year, but it continues to file Form 5500 as a small plan, as that is how it filed last year.
16. What type of information is provided in Schedule G of Form 5500?
    a. Service provider information.
    b. Insurance information.
    c. Retirement plan information.
    d. Financial transaction schedules.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

12. Employee benefit plans should disclose which of the following to participants on a quarterly basis? **(Page 344)**

    a. How participants and beneficiaries may give investment instructions. [This answer is incorrect. This general disclosure should be made to plan participants annually under DOL Reg. 2550.404a-5.]

    b. The names and categories of each plan investment. [This answer is incorrect. Investment-related disclosures, including this information, should be made annually under DOL Reg. 2550.404a-5.]

    c. **The dollar amount of any plan administrative fees actually charged. [This answer is correct. Additional disclosures to those required annually under DOL Reg. 2550.404a-5 must be provided on a quarterly basis, including the dollar amount of any plan administrative fees actually charged during the preceding quarter and the dollar amount of any individual fees and expenses charged to the participant's account during the preceding quarter.]**

    d. A description of the basis upon which administrative expenses will be allocated. [This answer is incorrect. Per DOL Reg. 2550.404a-5, this description must be provided annually. Other information about administrative fees, such as a description of the services to which the fees relate, must be provided quarterly.]

13. What type of plan can file a Form 5500-EZ? **(Page 347)**

    a. Defined benefit plans. [This answer is incorrect. Defined benefit plans are required by Title I of ERISA to file an annual report, which can be Form 5500, but all defined benefit plans are not allowed to file Form 5500-EZ.]

    b. Defined contribution plans. [This answer is incorrect. Certain requirements must be met to file Form 5500-EZ, but being a defined contribution plan is not one of those requirements. All defined contribution plans, however, are required by Title I of ERISA to file an annual report, which will often be Form 5500.]

    c. Small employee benefit plans. [This answer is incorrect. Form 5500-SF (not Form 5500-EZ) is a simplified annual reporting form that small employee benefit plans may elect to file if certain eligibility requirements are met.]

    d. **One-participant defined contribution plans and defined benefit pension plans. [This answer is correct. Certain one-participant defined contribution plans and defined benefit pension plans may elect to file Form 5500-EZ. One-participant plans may not file using Form 5500.]**

14. Which of the following plans is exempt from the requirement to file an annual return? **(Page 347)**

    a. A welfare benefit plan with 500 participants. [This answer is incorrect. According to the instructions of Form 5500, welfare benefit plans with fewer than 100 participants as of the beginning of the year that are fully insured, unfunded, or a combination of insured and unfunded, and which is not subject to the Form M-1 requirements under DOL 2520.101-2 are exempt from filing an annual report.]

    b. **A top-hat plan. [This answer is correct. As mentioned in the instructions of Form 5500, top-hat plans are exempt from the requirement to file an annual report. Top-hat plans are certain unfunded pension benefit plans or unfunded or insured welfare benefit plans that benefit only a select group of management or highly compensated employees.]**

    c. Annuities that are considered pension plans. [This answer is incorrect. According to the instructions of Form 5500, certain individual retirement accounts or annuities that are *not* considered pension plans are exempt from the requirement to file an annual report.]

d. Plans that are required for file Form M-1. [This answer is incorrect. Plans subject to the Form M-1 requirements under DOL Reg. 2520.101-2 are *not* exempt from filing an annual report. Such plans must file Form 5500 regardless, even when the plan has less than 100 participants or would otherwise meet exemption criteria.]

15. Which of the following plans correctly used the 80-120 participant rule to determine the best way to file its Form 5500? **(Page 352)**

a. Plan 1 has 76 participants this year, but it continues to file Form 5500 as a large plan, as that is how it filed last year. [This answer is incorrect. Because Plan 1 has dropped under 80 participants, it needs to change its status from last year and file its Form 5500 as a small plan.]

b. **Plan 2 has 98 participants this year, down from 103. It elects to continue to file its Form 5500 as a large plan, consistent with what it did last year. [This answer is correct. If the general rule for plan participants were applied without exceptions, plans that frequently fluctuate between slightly more or less than 100 participants would have to switch between being categorized as a "small" plan and a "large" plan, which could be inconvenient and disruptive. An exception is provided by DOL Reg. 2520.103-1(c) and (d) that plans with between 80 and 120 participants (inclusive) at the beginning of the current plan year may elect to complete the current year return using the same category that was used in the previous year. Based on this information, Plan 2 has correctly utilized the 80-120 participant rule to avoid complications with its filing by continuing to file as a large plan despite its drop in participants. If more participants are added next year to boost Plan 2 back over 100, it will now be better placed to continue its regular filing.]**

c. Plan 3 has 114 participants this year, down from 130 last year. It elects to file this year's Form 5500 as a small plan instead of as a large plan like last year. [This answer is incorrect. This is an incorrect use of the 80-120 participant rule. Just because Plan 3 has fallen under 120 participants, it should not file as a small plan. Since it filed as a large plan last year, it needs to continue to do so this year.]

d. Plan 4 has 125 participants this year, but it continues to file Form 5500 as a small plan, as that is how it filed last year. [This answer is incorrect. Because Plan 4 has gone over 120 participants, it needs to file its Form 5500 as a large plan this year, regardless of last year's status.]

16. What type of information is provided in Schedule G of Form 5500? **(Page 359)**

a. Service provider information. [This answer is incorrect. Service provider information is included on Schedule C of Form 5500, which is filed by large pension and welfare plans.]

b. Insurance information. [This answer is incorrect. Insurance information is provided on Schedule A of Form 5500 if any benefits of a defined benefit, defined contribution, or welfare benefit plan are provided by an insurance company or similar organization.]

c. Retirement plan information. [This answer is incorrect. Retirement plan information is filed on Schedule R of Form 5500. This schedule must be filed with Form 5500 by all defined benefit and certain defined contribution plans. It reports information on plan distributions and funding.]

d. **Financial transaction schedules. [This answer is correct. Schedule G, "Financial Transaction Schedules," must be filed with Form 5500 by any large plan with loans or fixed income obligations in default or determined to be uncollectible as of the plan year end, leases in default or classified as uncollectible, or nonexempt (prohibited) transactions. The auditor must also report on this schedule if any of the previously mentioned items exist.]**

CONSIDERATIONS FOR PLAN TERMINATION, REPORTABLE EVENTS, AND REVERSION

The PBGC

ERISA, Title IV, established the Pension Benefit Guaranty Corporation (PBGC) to provide limited insurance for defined benefit retirement plans that terminate without sufficient assets to pay vested pension benefits. Only a portion of a retiree's benefit (up to $6,205 a month or $74,460 per year for 2022 and $6,034 a month or $72,408 per year for 2021 for those who retire at age 65) may be covered by the insurance, not necessarily the entire benefit. Also, the PBGC insurance program relates only to defined benefit plans; it does not cover defined contribution plans. Finally, failures of insurance companies have caused the PBGC to reiterate that it does not guarantee pension benefits payable through annuity contracts issued by insurance companies, and to issue a rule requiring that participants be notified of that fact by plans intending a standard termination. Covered plans are charged annual premiums on a per-participant basis and based on the amount of unfunded vested benefits.

Standard Termination

A plan sponsor may terminate an employee benefit plan if the plan contains a provision allowing termination. A standard termination is when the plan has sufficient assets to meet all benefit liabilities. Required notices to plan participants of a plan's intent to terminate were described earlier in this lesson. In addition, a notice of the proposed standard termination (PBGC Form 500, "Standard Termination Notice/Single-Employer Plan Termination") must be filed with the PBGC giving information on the plan's assets and actuarial present value of benefit liabilities as of the proposed asset distribution date. This notice must include an actuary's certification that plan assets are sufficient.

Benefits of a terminating plan must become 100% vested. The benefit liabilities must be paid by purchasing insurance annuity contracts or by otherwise providing benefits in accordance with plan provisions. PBGC Form 501, "Post-Distribution Certification for Standard Termination," must be filed no later than 30 days after completing the final distribution of plan assets.

Distress Termination

A distress termination is a voluntary termination involving financial hardship. It is one in which the PBGC determines that the plan sponsor (including all members of a controlled group) meets one of the following distress tests:

- Chapter 7 or Chapter 11 bankruptcy proceeding.
- The PBGC concludes that the plan sponsor will be unable to meet its debts and continue in business without a termination, or that continued pension costs are unreasonably burdensome because of a decline in the workforce covered by the plan.

In a distress termination, the plan assets may or may not be sufficient to meet all plan benefit liabilities. As in a standard termination, benefits become 100% vested.

In addition to the required notices to participants, the plan must file PBGC Form 600, "Distress Termination Notice of Intent to Terminate," and Form 601, "Distress Termination Notice/Single-Employer Plan Termination," with the PBGC. Form 600 advises the PBGC of the proposed distress termination, and Form 601 provides information demonstrating satisfaction of the criteria for a distress termination. Form 601 includes an actuary's certification of the level of benefits that the plan assets can provide. The PBGC may become trustee of the plan, acquire the plan's assets, assume its liabilities, and use its insurance funds to the extent necessary to pay guaranteed benefits to plan participants. The plan sponsor, including members of a controlled group, becomes liable to the PBGC for payments the PBGC makes.

The PBGC may encourage a plan to avoid termination by alternatives such as "freezing" the plan. Also, the PBGC requires early warning of conditions that indicate a potential distress termination. Such "reportable events" are discussed in the following paragraph. They should not be confused with reportable *transactions* that are disclosed in a required supplemental schedule.

Reportable Events

A defined benefit plan covered by PBGC insurance is subject to special reporting requirements to notify the PBGC of events that could give rise to a potential insufficiency (reportable events) to meet benefit obligations. The reportable event requirements are set forth in ERISA Sec. 4043 and in final regulations issued by the PBGC. The reportable events requirements apply to all defined benefit plans that are subject to ERISA Title IV; however, the regulations waive the requirements for multiemployer plans.

Plan Reversion

If a plan includes provisions for asset reversion, the terminating plan may return to the employer any assets that remain after satisfying all plan liabilities to participants and beneficiaries. However, any excess assets attributable to employee contributions must be distributed to those who made contributions. Also, all benefits must become 100% vested in a reversion. In a typical reversion, a new plan is established covering the same participants as before.

A 50% excise tax is imposed on the employer receiving the reverted assets; unless a new plan is established, the employer transfers 25% of the reverted assets to it, and certain other conditions in IRC Sec. 4980(d)(1) are met. If such a transfer is made, the tax rate is only 20%.

Withdrawal from a Multiemployer Plan

If an employer partially or completely withdraws from a multiemployer plan, the employer must continue to fund a proportional share of the plan's unfunded vested benefits. A withdrawal liability is determined and must be paid over not more than 20 years.

Audit Requirement

The terminating of a plan does not eliminate the audit requirement. Thus, if a plan with 121 participants at the beginning of the plan year is terminated (and is not otherwise exempt from the audit requirement), a Form 5500 must be filed for the period from the end of the previous plan year to the termination date, and an audit report must be attached. A plan is considered "terminated" when all of the assets are distributed.

DEALING WITH UNRELATED BUSINESS INCOME

A principal advantage of a qualified employee benefit plan is that income on the plan's invested funds is not taxed currently. However, any income (less allowable deduction) the plan earns from a regularly carried-on trade or business that is not related to its tax-exempt function as an employee benefit plan is taxed as unrelated income.

A "trade or business" includes the production of income from the sale of goods or performance of services, but not the mere passive receipt of income. However, a plan's income from an interest in a partnership that engages in a trade or business would be unrelated business income.

The definition of unrelated income specifically excludes dividends, interest, royalties, rents from real property, and gains or losses from the sale, disposition, or exchange of property not held for sale in the ordinary course of business.

Unrelated business income includes income from property acquired with debt financing. Thus, plan income earned on securities bought on margin would be considered unrelated business income, as would income from a plan's partnership interest if the partnership acquires securities with borrowed funds.

However, a leveraged ESOP may purchase employer securities with borrowed funds, and the interest and dividends earned on such securities would not be considered unrelated business income. The reason for this exemption is that the borrowing is an inherent part of an ESOP's tax-exempt function.

AEBP reinforces the idea that an employee benefit plan's investments may be a source of unrelated business income, which AEBP refers to as *unrelated business taxable income*, or UBTI. AEBP, Paragraph 12.17, indicates that certain nonleveraged investments (for example, partnership investments; real estate investment trusts; and

options to buy or sell securities, including short sales or repurchase agreements) could generate unrelated business taxable income. AEBP further indicates health and welfare plans with VEBA trust are the most common plans that generate UBTI but other plans are increasingly holding investments that may generate UBTI.

Unrelated business gross income of more than $1,000 must be reported on Form 990-T (Exempt Organization Business Income Tax Return).

OPTIONS FOR CORRECTING A VIOLATION

IRS's Employee Plans Compliance Resolution System

The Employee Plans Compliance Resolution System (EPCRS) was developed by the IRS to provide a single, comprehensive system to allow plan sponsors to correct plan qualification problems and to maintain a plan's qualified status. The EPCRS program consists of the following three sections:

a. *Self-correction Program (SCP).* A plan sponsor that has established compliance practices and procedures may, at any time without paying any fee or sanction, correct insignificant operational failures under a qualified plan, 403(b) plan, and certain SEP or SIMPLE IRA plans. If the plan has a favorable determination letter or is a 403(b) plan, the sponsor may generally correct even significant operational failures within two plan years without paying any fee or sanction. Rev. Proc. 2016-51 changed the availability of SCP for significant failures to say that, for qualified individually designed plans, a determination letter does not have to be current to satisfy the favorable letter requirement.

b. *Voluntary Correction Program (VCP).* If a plan is not under examination, the sponsor may pay a limited fee and receive IRS approval for correction of a qualified plan, 403(b) plan, SEP, or SIMPLE IRA plan. Under VCP, there are special procedures for anonymous submissions and group submissions. VCP provides general procedures for correction of all plan qualification failures. (Rev. Proc. 2018-4 revised the fees for submissions for correction under the VCP. In many cases, the fees were significantly lowered.)

c. *Audit Closing Agreement Program (Audit CAP).* If a qualification failure (other than a failure corrected as described in Items a and b) is identified on audit and corrected, the sanction imposed will bear a reasonable relationship to the nature, extent, and severity of the failure, taking into account the extent to which correction occurred before audit.

EBSA's Voluntary Fiduciary Correction Program

The Voluntary Fiduciary Correction Program (VFCP) was developed by the EBSA to allow plan officials to avoid civil actions (but not criminal actions) and the 20% fiduciary breach penalty under ERISA Sec. 502(l) for certain fiduciary violations that are fully and accurately self-corrected. The cost of correction cannot be borne by the plan. The VFCP can only be used if the DOL has not already provided oral or written notification to representatives of the plan of an investigation by the DOL or other federal agencies.

To qualify for relief under VFCP, applicants do not need to consult or negotiate with the EBSA. Instead, they must follow specified procedures as outlined in the program. Basically, resolving violations using VFCP will entail the following:

a. Identifying the violation and determining if it can be corrected under VFCP.

b. Correcting the violation using the specified procedures.

c. Calculating and restoring any losses and profits with interest and distributing any supplemental benefits.

d. Filing an application with the EBSA that documents the correction.

There are currently 19 specific financial transactions covered by VFCP in the following categories:

a. Delinquent participant contributions and participant loan repayments to pension plans
b. Delinquent participant contributions to insured welfare plans
c. Delinquent participant contributions to welfare plan trusts
d. Fair market interest rate loans with parties in interest
e. Below market interest rate loans with parties in interest
f. Below market interest rate loans with non-parties in interest
g. Below market interest rate loans due to a delay in perfecting the security interest
h. Participant plans failing to comply with plan provisions for the loan amount, duration or level amortization
i. Defaulted participant loans
j. Purchase of assets by plans from parties in interest
k. Sale of assets by plans to parties in interest
l. Sale and leaseback of property to sponsoring employers
m. Purchase of assets from non-parties in interest at more than fair market value
n. Sale of assets to non-parties in interest at less than fair market value
o. Holding of an illiquid asset previously purchased by the plan
p. Benefit payments based on improper valuation of plan assets
q. Payment of duplicate, excessive, or unnecessary compensation
r. Improper payment of expenses by the plan
s. Payment of dual compensation to plan fiduciaries

The DOL has provided a model application form which can be found on its website (**www.dol.gov/ebsa**). The DOL has also simplified the method of calculating lost earnings or profits. To assist fiduciaries, the DOL website includes an online calculator with all of the appropriate factors built in (**www.askebsa.dol.gov/VFCPCalculator/WebCalculator.aspx**). The authors recommend retaining documentation of lost earnings calculations and contributions.

If the procedures are completely followed and accepted, the EBSA will issue a "No-Action Letter" to the applicant. The No-Action Letter indicates that the EBSA will neither conduct a civil investigation nor assess a penalty regarding the violation. Further, certain violations corrected through the VFCP are eligible for relief from the 15% excise tax generally imposed by the IRS on prohibited transactions. However, if the application is rejected, the EBSA may take enforcement action against the appropriate parties.

An auditor needs to consider discussing these programs with the plan administrator if the plan is not in compliance with the applicable regulations. *PPC's 5500 Deskbook* and *PPC's Guide to Small Employer Retirement Plans* provide guidance on the actions required to participate in these programs.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. Which of the following statements best describes an issue related to the Pension Benefit Guaranty Corporation (PBGC)?

    a. No special reporting requirements apply to plans covered by the PBGC.

    b. It offers only limited insurance and partial benefits, not a retiree's full benefit amount.

    c. It covers both defined benefit plans and defined contribution plans.

    d. In a distress termination, the PBGC makes recommendations to the plan sponsor for how to proceed.

18. Which of the following sections of the IRS's Employee Compliance Resolution System (EPCRS) allows the sponsors of qualified plans to correct errors without paying fees or sanctions?

    a. The Self-correction Program (SCP).

    b. The Voluntary Correction Program (VCP).

    c. The Audit Closing Agreement Program (Audit CAP).

    d. The Voluntary Fiduciary Correction Program (VFCP).

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

17. Which of the following statements best describes an issue related to the Pension Benefit Guaranty Corporation (PBGC)? **(Page 370)**

    a. No special reporting requirements apply to plans covered by the PBGC. [This answer is incorrect. A defined benefit plan covered by PBGC insurance is subject to special reporting requirements to notify the PBGC of events that could give rise to a potential insufficiency (reportable events) to meet benefit obligations. The reportable event requirements are set forth in ERISA Sec. 4043 and in final regulations issued by the PBGC.]

    b. **It offers only limited insurance and partial benefits, not a retiree's full benefit amount. [This answer is correct. ERISA, Title IV, established the PBGC to provide limited insurance for defined benefit plans that terminate without sufficient assets to pay vested pension benefits. Only a portion of a retiree's benefit (up to $6,205 a month or $74,460 per year for 2022 and $6,034 a month or $72,408 per year for 2021 for those who retire at age 65) may be covered by the insurance, not necessarily the entire benefit.]**

    c. It covers both defined benefit plans and defined contribution plans. [This answer is incorrect. The PBGC insurance program relates only to defined benefit plans; it does *not* cover defined contribution plans.]

    d. In a distress termination, the PBGC makes recommendations to the plan sponsor for how to proceed. [This answer is incorrect. In a distress termination, the PBGC may become trustee of the plan, acquire the plan's assets, assume its liabilities, and use its insurance funds to the extent necessary to pay guaranteed benefits to plan participants. The plan sponsor, including members of a controlled group, becomes liable to the PBGC for payments that the PBGC makes. Therefore, the PBGC does more than merely make recommendations.]

18. Which of the following sections of the IRS's Employee Compliance Resolution System (EPCRS) allows the sponsors of qualified plans to correct errors without paying fees or sanctions? **(Page 372)**

    a. **The Self-correction Program (SCP). [This answer is correct. The EPCRS's SCP allows a plan sponsor that has established compliance practices and procedures to, at any time without paying any fee or sanction, correct insignificant operational failures under a qualified plan, 403(b) plan, and certain SEP or SIMPLE IRA plans. If the plan has a favorable determination letter or is a 403(b) plan, the sponsor may generally correct even significant operational failures within two plan years without paying any fee or sanction.]**

    b. The Voluntary Correction Program (VCP). [This answer is incorrect. If a plan is not under examination, the EPCRS's VCP allows the sponsor to pay a limited fee and receive IRS approval for correction of a qualified plan, 403(b) plan, SEP, or SIMPLE IRA plan.]

    c. The Audit Closing Agreement Program (Audit CAP). [This answer is incorrect. Under the EPCRS's Audit CAP, if a qualification failure (other than a failure corrected under the SCP or VCP) is identified on audit and corrected, the sanction imposed will bear a reasonable relationship to the nature, extent, and severity of the failure, taking into account the extent to which correction occurred before audit.]

    d. The Voluntary Fiduciary Correction Program (VFCP). [This answer is incorrect. The VFCP was developed by Employee Benefits Security Administration (EBSA), not the IRS, to allow plan officials to avoid civil actions (but not criminal actions) and the 20% fiduciary breach penalty under ERISA Sec. 502(l) for certain fiduciary violations that are fully and accurately self-corrected.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 3—ERISA and Certain Tax Requirements (EBPTG223)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     EBPTG223 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **March 31, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 3—ERISA and Certain Tax Requirements (EBPTG223)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. Requirements for minimum plan participation, plan coverage, vesting, and funding are provided by which of the following?

   a. Laws and regulations provided by the Department of Labor (DOL).

   b. Regulation provided by the Pension Benefit Guaranty Corporation (PBGC).

   c. ERISA, Title I, and various sections of the Internal Revenue Code (IRC).

   d. The AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AEBP).

2. What is one tax advantage of a qualified employee benefit plan?

   a. Within limits, employer contributions can be deducted for federal income tax purposes.

   b. The employer's contributions are not considered compensation to the employees.

   c. Employee contributions to all types of plans are not currently taxed to the employees.

   d. The full benefit of a health and welfare plan is included in employees' income.

3. Jessica is 21 years old. She has been working at HunterCo full time since March 15, 2021. What is the maximum length of time that Jessica must wait before she can participate in HunterCo's qualified employee retirement plan based on the minimum age and service requirements in ERISA, Title I, Section 202, and IRC Sec. 410(a)?

   a. September 15, 2021.

   b. January 1, 2022.

   c. March 15, 2022.

   d. December 31, 2022.

4. Typically, all employer contributions to defined contribution plans must fully vest using which two methods?

   a. Three-year or five-year cliff vesting.

   b. Three-year cliff vesting or six-year graded vesting.

   c. Five-year cliff vesting or seven-year graded vesting.

   d. Six-year or seven-year graded vesting.

5. The minimum required contribution (MRC) for a plan year depends on what?

   a. Whether the plan has a funding shortfall.

   b. Whether it is a multiemployer plan.

   c. Whether the fund uses an enrolled actuary.

   d. Whether all the participants are 100% vested.

6. The ratio percentage test and the average benefit test are used to test if a plan meets which of the following?

   a. Minimum age and service requirements.

   b. Minimum funding requirements.

   c. Minimum plan coverage.

   d. Minimum vesting requirements.

7. According to the ratio percentage test, the percentage of active, nonhighly compensated employees (NHCEs) benefitting under the plan must equal at least what percentage of the active, highly compensated employees (HCEs) benefitting under the plan?

   a. 60%.

   b. 70%.

   c. 80%.

   d. 90%.

8. The 50-40 rule (i.e., the small plan minimum rule) applies to what type of qualified plans?

   a. Defined benefit retirement plans.

   b. Defined contribution retirement plans.

   c. Defined benefit and defined contribution retirement plans.

   d. Health and welfare and fringe benefit plans.

9. For 2022, the annual contribution from all sources to a participant's account in a defined contribution retirement plan cannot exceed the lesser of what amount (or 100% of the participant's compensation)?

   a. $57,000.

   b. $58,000.

   c. $60,000.

   d. $61,000.

10. If the aggregate account balances of participants that are key employees exceeds 60% of the aggregate account balances of all plan participants, a defined contribution plan is considered to be which of the following?

    a. Closely held.

    b. Limited.

    c. Nondiscriminatory.

    d. Top-heavy.

11. A plan participant can make hardship withdrawals from a 401(k) arrangement related to what kind of "deemed hardship" expenses described in Reg. 1.401(k)-1(d)(3)(iii)(B)?

    a. Automobile payments.

    b. Medical expenses.

    c. Vacation home remodeling.

    d. Private elementary school tuition.

12. What is one characteristic of a flexible spending arrangement?

    a. The funds cannot be used for health care deductibles.

    b. A certain percentage of the contributions are included in the participant's income.

    c. Any funds left at the end of the year are forfeited by the participant.

    d. The funds in such an account can be used to pay health insurance premiums.

13. According to ERISA, Title I, Section 3(21), a fiduciary is someone who does which of the following?

    a. Exercises discretionary authority or control over an employee benefit plan or the disposition of its assets.

    b. Provides investment education to employees, such as plan information and general financial information.

    c. Works with plan administration to make sure the person with discretionary authority uses it appropriately.

    d. Performs "ministerial duties" for a plan, including providing normal accounting and auditing services.

14. Fiduciaries are liable to the plan for losses under what circumstances?

    a. They are liable for any losses that occur under their purview.

    b. They are liable for losses resulting from a breach of their fiduciary responsibility.

    c. They are liable for losses resulting from a breach of other fiduciaries, whether or not they were known.

    d. They are liable for losses resulting from an unexpected dip in the market that affects plan assets.

15. Under ERISA, Title I, Section 114, a plan fiduciary is prohibited from allowing a plan to engage in which of the following transactions?

    a. Furnishing goods, services, or facilities to an independent individual.

    b. Making loans available to plan participants on a nondiscriminatory basis, if appropriate measures are taken.

    c. Entering into transactions with a common/collective trust fund by a party in interest that is a bank.

    d. Selling, exchanging, or leasing property with a party in interest.

16. According to IRC Sec. 4975(e)(2), all of the following individuals would be considered parties in interest in relation to an employee benefit plan **except:**

    a. A fiduciary, counsel, or employee of the plan.

    b. A person who provides services to the plan.

    c. An employer with employees who are covered by the plan.

    d. An acquaintance of a fiduciary.

17. What happens when a plan engages in a prohibited transaction?

    a. The plan loses its qualified status.

    b. The excise tax is waived if the prohibited transaction benefitted the plan.

    c. The persons engaging in the transaction will be subject to a 15% excise tax.

    d. Nothing, as long as the problem is corrected by the end of the plan year in which the prohibited transaction occurred.

18. Who needs to be bonded when working with an employee benefit plan?

    a. One representative fiduciary.

    b. Only the plan's fiduciaries.

    c. All of the fiduciaries and everyone who handles plan funds or property.

    d. All the fiduciaries, everyone who handles plan funds or property, and plan participants actively receiving distributions.

19. How long do previously existing employee benefit plans, qualified or not, have to provide new plan participants or beneficiaries with a summary plan description (SPD)?

    a. 10 days.

    b. 30 days.

    c. 90 days.

    d. 210 days.

20. When must employee benefit plans provide plan participants and beneficiaries with a summary annual report (SAR), assuming no extension is filed for the plan's Form 5500?

    a. By the last day of the plan year.

    b. By two months after the plan's year end.

    c. By nine months after the plan's year end.

    d. Twice per year—once at an interim period and once after Form 5500 is submitted.

21. Are employee benefit plans required to disclose statements of total accrued benefits and their earliest vesting date to plan participants?

    a. No, such information is not required to be disclosed.

    b. Yes, such information must be disclosed annually.

    c. Yes, such information must be disclosed monthly.

    d. Such information need only be disclosed upon written request.

22. How much notice must a defined contribution plan provide its participants of a blackout period?
    a. One day.
    b. Thirty days.
    c. Sixty days.
    d. Ninety days.
23. Assuming all other conditions are met, which of the following plans is eligible to file Form 5500-SF?
    a. Plan A is considered a large plan.
    b. Plan B holds a significant amount of employer securities.
    c. Plan C is 100% invested in secure, easy-to-value assets.
    d. Plan D is a multiemployer plan.
24. Generally, a large employee benefit plan will have a minimum of how many participants at the beginning of its plan year?
    a. 100.
    b. 250.
    c. 500.
    d. 1,000.
25. Which of the following statements best describes the financial information included on Schedule H of Form 5500?
    a. Generally, this schedule is only filed by small pension plans or small welfare benefit plans.
    b. Though the cash, modified cash, or accrual basis of accounting may be used by the plan, assets and liabilities must be reported at current value.
    c. Property used in plan operations should be reported at cost less accumulated depreciation, as required by GAAP.
    d. It is not necessary to provide the accountant's opinion on Schedule H, as that opinion is already noted in the plan's financial statements.
26. If a plan's year end is on December 31, 2022, and no extensions are filed, the plan must file its Form 5500 and related schedules, financial statements, and auditor's report by what date?
    a. March 31, 2023.
    b. July 31, 2023.
    c. October 31, 2023.
    d. December 31, 2023.

27. Generally, records of supporting information required to be reported under ERISA must be retained for a minimum of how many years after the filing date of Form 5500?

    a. Five.

    b. Six.

    c. Seven.

    d. Ten.

28. Which of the following may occur when an employee benefit plan undergoes a distress termination?

    a. Plan participants become 50% vested in the terminating plan's benefits.

    b. A certain amount of assets revert to the employer prior to paying plan liabilities.

    c. Payments for a withdrawal liability will be deducted immediately from plan assets.

    d. Plan assets may not be enough to meet all plan benefit liabilities.

29. An employee benefit plan might be taxed on which of the following?

    a. Income related to its tax-exempt function as an employee benefit plan.

    b. Income related to an unrelated trade or business.

    c. Passively receiving income from investments or royalties.

    d. Passively receiving income from renting or selling real property.

30. Which of the following statements best describes the Voluntary Fiduciary Correction Program (VFCP), which was developed by the Employee Benefits Security Administration (EBSA)?

    a. The VFCP allows plan officials to avoid criminal actions.

    b. The VFCP can only be used if required by the DOL.

    c. The plan will need to negotiate with the EBSA before using the VFCP.

    d. The VFCP requires four steps for resolving violations, including identification and correction.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 3—ERISA and Certain Tax Requirements (EBPTG223)

CTEC Course No. 3039-CE-2210

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	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	9.	○	○	○	○	17.	○	○	○	○	24.	○	○	○	○
2.	○	○	○	○	10.	○	○	○	○	18.	○	○	○	○	25.	○	○	○	○
3.	○	○	○	○	11.	○	○	○	○	19.	○	○	○	○	26.	○	○	○	○
4.	○	○	○	○	12.	○	○	○	○	20.	○	○	○	○	27.	○	○	○	○
5.	○	○	○	○	13.	○	○	○	○	21.	○	○	○	○	28.	○	○	○	○
6.	○	○	○	○	14.	○	○	○	○	22.	○	○	○	○	29.	○	○	○	○
7.	○	○	○	○	15.	○	○	○	○	23.	○	○	○	○	30.	○	○	○	○
8.	○	○	○	○	16.	○	○	○	○										

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Course Title: Companion to PPC's Guide to Audits of Employee Benefit Plans—Course 3—ERISA and Certain Tax Requirements (EBPTG223)

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GLOSSARY

80–120 participant rule: This rule is intended to provide relief from switching between *large plan* and *small plan* status under Form 5500. Plans that have between 80 and 120 participants (inclusive) at the beginning of the current plan year may elect to complete the current year return using the same category (large or small) that was used the previous year. This eliminates the inconvenience and disruption that would occur when plans frequently switch between slightly more or less than 100 participants.

Accumulated funding deficiency: The excess of the total amount that must be contributed under the plan formula over the total amount actually contributed. Such deficiencies are subject to excise tax.

Alternative method: This alternative reporting method, consisting of Form 5500 and appropriate related schedules and financial statements, if applicable, satisfies a plan's ERISA, Title I, Section 103, reporting requirements to the Department of Labor (DOL), Internal Revenue Service (IRS), and *Pension Benefit Guaranty Corporation (PBGC)*.

Benefit accrual: The rate at which plan participants earn benefits under a plan. The method used to determine benefit accrual depends on whether the plan is a defined contribution plan or a defined benefit plan.

Blackout period: This is a period of more than three business days during when the plan participants or beneficiaries of a defined contribution plan will have temporary suspension, limitation, or restriction on the ability to direct or diversify assets in their accounts, obtain a loan, or take a distribution.

Determination letters: These may provide evidence that the design of an employer-sponsored plan satisfies the Internal Revenue Code (IRC) qualification requirements as of the date of issuance of the letter. The IRS issues determination letters regarding the qualified status of retirement plans under Section 401(a) of the IRC and the status of related trusts under Section 501(a). Existence of a favorable determination letter, however, does not, by itself, provide evidence that a plan is qualified.

Distress termination: This is a voluntary termination involving financial hardship. Plan assets may or may not be sufficient to meet all plan benefit liabilities. To qualify for this type of termination, the *PBGC* must determine that the plan sponsor (including all members of a controlled group) meets one of three specific distress tests.

Enrolled actuary: An actuary who is enrolled in the Joint Board for the Enrollment of Actuaries, which was established to set standards and qualifications for plan actuaries.

Fiduciary: According to ERISA, Title I, Section 3(21), this is a person who (1) exercises discretionary authority or control over the management of an employee benefit plan or the disposition of its assets, (2) gives investment advice about plan funds or property for a fee or compensation or has the authority to do so, (3) has discretionary authority or responsibility in plan administration, or (4) is designated by a named fiduciary to carry out fiduciary responsibility.

Flexible spending arrangement: An arrangement in which participants may elect to have a portion of their compensation (salary reduction amounts) contributed (that is, withheld from their wages) to an individual account for the reimbursement of qualifying medical and/or dependent care expenses instead of receiving the amount as compensation. As qualifying expenses are incurred, they are reimbursed from the account. Neither the amount contributed nor the value of the benefit is included in the participant's income, but only if the plan provides that any amount remaining in the account at the end of the year will be forfeited by the participant.

Fringe benefit plan: This is an IRS term. Such plans are known by the IRC Section that describes them (e.g., an IRC Sec. 125 cafeteria plan). They may also be *welfare benefit plans*, as that term is defined by the DOL. The benefit accrual, vesting, and funding requirements for retirement plans do not apply to fringe benefit or welfare benefit plans. The fiduciary responsibilities and reporting requirements, however, do apply to these types of plans.

Funding shortfall: If the plan's *funding target* for the year exceeds the value of plan assets (on the valuation date), the plan has a funding shortfall for the year.

Funding target: The present value of all benefits accrued, earned, or otherwise allocated to years of service under the plan as of the beginning of the plan year. It is used to determine if the plan has a *funding shortfall*.

Highly compensated employee (HCE): An employee who (1) during the current or preceding year owned directly or indirectly more than 5% of the employer or (2) for the previous year received compensation of more than $135,000 for 2022 and $130,000 for 2021 (as adjusted for inflation) from the employer. The employer can elect to have this rule apply only if the employee's compensation ranks in the top 20% of all employees' compensation for that year.

Insured welfare plan: According to Form 5500, this type of plan must have its benefits provided exclusively through insurance contracts or policies issued by an insurance company or similar organization that can legally do business in any state and the plan's premiums must be paid (1) directly by the employer or employee organizations from its general assets or (2) partly from its general assets and partly from contributions by its employees or members.

Key employee: Any participant, including a deceased participant, who at any time during the plan year, is (1) an officer who earned more than $200,000 for 2022 and $185,000 for 2021 in compensation from the employer; (2) an owner of more than 5%; or (3) an owner of more than 1% with more than $150,000 in annual compensation. The maximum number of officers that can be included is limited to the greater of three employees or 10% of the employees (but no more than 50 officers).

Large plan: In relation to Form 5500, this is a plan with 100 or more participants at the beginning of the plan year.

Minimum funding standard: This is an actuarial calculation of an employer's annual contribution to ensure the amount contributed covers the annual cost of future benefits and administrative expenses.

Nonqualified employee retirement benefit plan: A stock bonus, pension, or profit-sharing plan that does *not* meet the requirements of IRC Sec. 401(a).

Pension Benefit Guaranty Corporation (PBGC): This was established by ERISA, Title IV, to provide limited insurance for defined benefit retirement plans that terminate without sufficient assets to pay vested pension benefits.

Qualified change in investment options: A reallocation of a participant's account among one or more new or remaining investment options in place of investment options offered prior to the date of the change when certain criteria are met.

Required beginning date (RBD): The date by which participants in a qualified plan must begin receiving distributions. For participants other than 5% owners, this is April 1 of the year following the later of the calendar year in which the participant (1) turns age 70½ or (2) retires. For those who are 5% or more owners, the RBD is April 1 following the year in which they turn 70½, even if not retired. For individuals who turn 70½ after December 31, 2019, the RBD has been delayed to age 72.

Shortfall amortization installment: This is the amount necessary to amortize the shortfall amortization base for any plan year over a 7-plan-year period using specified interest rate rules.

Small plan: In relation to Form 5500, this is a plan with fewer than 100 participants at the beginning of the plan year.

Standard termination: This occurs when a plan terminates with sufficient assets to meet all benefit liabilities.

Summary annual report (SAR): An employee benefit plan must annually provide participants and beneficiaries with a summary of the annual report required by the DOL. The SAR must generally be provided within nine months after the plan year end. Though it need not contain financial statements, the SAR must include certain information such as total plan income and expenses, benefits paid, the value of plan assets at the beginning and end of the plan year, any funding deficiencies, etc. The information ties into various lines of the Form 5500 schedules.

Summary of material modifications (SMM): If a plan is materially amended, an SMM must be provided within 210 days of the end of the plan year in which the amendment is adopted, unless an updated *SPD* is provided.

Summary plan description (SPD): ERISA requires most plans to provide plan participants with a summary plan description within 90 days from when they become participants or a beneficiary begins receiving benefits. The SPD must explain in easily understandable language matters such as the type of plan, the requirements for participation and benefits, benefit accrual and vesting provisions, how to file claims, etc. It must also describe participants' rights under ERISA.

Target normal cost: The present value (determined as of the valuation date) of all benefits that accrue or are earned during or are otherwise allocated to service for the current plan year.

Top-heavy plans: A plan in which the aggregate account balances (for defined contribution plans) or the present value of accumulated accrued benefits (for defined benefit plans) of participants who are key employees exceed 60% of the aggregate account balances or the present value of accumulated accrued benefits of all participants under the plan. They often involve closely held businesses.

Qualified employee retirement benefit plan: A stock bonus, pension, or profit-sharing plan that meets the requirements of IRC Sec. 401(a). These qualification requirements do not apply to health and welfare benefit plans. Qualified retirement plans must be funded, and plan assets must be kept in trust.

Unfunded welfare benefit plan: According to Form 5500, this type of plan has its benefits paid as needed directly from the general assets of the employer or employee organization that sponsors the plan.

Unrelated business income: Any income earned by a qualified plan from a regularly carried-on trade or business that is not related to its tax-exempt function as an employee benefit plan.

Vesting: This relates to the rate at which an employee's accrued benefit becomes nonforfeitable if the employee terminates employment. Minimum vesting schedules are set by ERISA, Title I, Section 304, and IRC Sec. 411(a).

Waiver amortization base: For a plan year, this is the amount of waived funding deficiency.

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