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Employee benefit plans industry developments - 1993; Audit risk alerts

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Employee Benefit Plans
Industry Developments—1993

Update to AICPA Audit and Accounting Guide
Audits of Employee Benefit Plans

AICPA
American Institute of Certified Public Accountants
NOTICE TO READERS

This document is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Employee Benefit Plans
Industry Developments—1993

Industry and Economic Developments

Pension plans and the Pension Benefit Guaranty Corporation (PBGC), which insures most private-sector defined benefit pension plans, made headlines during the past year. Under a proposal by the Clinton administration, pension funds would be encouraged, but not required, to invest in a new infrastructure security paying a federally insured, competitive, market rate of return. Pension plan administrators have expressed concern that their plans might be forced to invest in these projects or risk losing their tax-exempt status. There is also concern that pressure from Congress will force them to invest in projects that may not provide suitable returns or may otherwise compromise fiduciary responsibilities and investment flexibility.

In addition, the funding problems at the PBGC are creating growing concern in both the public and private sectors. As of September 30, 1992, the PBGC had an accumulated deficit of $2.7 billion. More important, a relatively small number of underfunded plans in the airline, auto, steel, and tire industries present an estimated additional risk to the PBGC of $12 billion to $20 billion because the plans are sponsored by financially troubled companies. Many of these already underfunded plans have granted enhanced pension benefits in conjunction with work force or salary reduction programs, thereby causing them to fall even further behind in funding. There is speculation that a taxpayer bailout of the PBGC may be necessary unless Congress takes steps immediately to improve the situation. Proposals include increasing funding requirements, increasing the linkage of premiums to risks, limiting companies' ability to increase benefits or requiring them to fund any such increases more rapidly, limiting the PBGC's guarantees of certain benefits, and changing the status of the PBGC's claims in bankruptcy. Some industry experts fear that any of these changes might cause companies to terminate their pension plans in favor of less costly defined contribution plans.

Many plans' funding problems have been exacerbated by the continuing weak economy. With interest rates at their lowest levels in years, some plans are having difficulties earning projected returns. As a result, some investment managers are moving their assets out of the
bond market and various money market investment vehicles and acquiring specialized financial products and other assets with potentially higher yields such as repurchase or reverse-repurchase agreements, futures, options, securitized lending arrangements, global securities, real estate and specialized real estate investment securities, and certain derivative products. These and even more traditional investment vehicles may warrant heightened audit concern in the current economic environment. Auditors should consider whether the estimated rates of return used in calculating a plan's benefit obligations are reasonable.

Regulatory and Legislative Developments

PWBA Review of Plan Audits

During 1992, the Department of Labor's (DOL) Pension and Welfare Benefits Administration (PWBA) continued to implement its quality review program for audits required by the Employee Retirement Income Security Act of 1974 (ERISA). Practitioners deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. As of December 31, 1992, 37 referrals had been made to state licensing boards and 199 referrals had been made to the AICPA Professional Ethics Division; of these the Professional Ethics Division has resolved 101 cases. Of these resolved cases, 27 were referred to the AICPA's Trial Board, 54 resulted in letters of recommended corrective action, 9 were found to contain no deficiencies, and 11 were closed for other reasons. Common deficiencies noted in the referrals included—

- Inadequate or no audit program or planning.
- Inadequate or no understanding of internal control structure.
- Inadequate or no documentation supporting the audit work performed.
- Deficiencies in the auditor's report.
- Deficiencies in the note disclosures.

As part of its quality review program, the PWBA also performs on-site reviews of independent auditor's working papers. As of December 31, 1992, eighty-three such reviews had been performed. Professional work deemed significantly deficient by the PWBA as a result of its reviews is referred to the AICPA Professional Ethics Division or to appropriate state boards of accountancy. In addition, deficient audit
work can expose plan administrators to significant penalties under ERISA section 502(c)(2).

**PWBA Reporting Compliance Program**

In addition to its quality review program for ERISA audits, PWBA has a reporting compliance program to ensure that plan administrators comply with ERISA's reporting requirements. Through 1992, the DOL imposed over $34 million in civil penalties under ERISA section 502(c)(2), which provides for penalties of up to $1,000 per day against plan administrators who fail to file acceptable annual reports on a timely basis.

Plan administrators who fail to file an auditor's report, or whose audit report contains material deficiencies, may be subject to civil penalties of $150 per day, up to a maximum of $50,000 per plan filing. Annual report filings that contain financial reporting deficiencies (for example, missing supplemental schedules) may be subject to a $100-per-day penalty, not to exceed $36,500 per plan filing.

The PWBA encourages practitioners to urge their clients to file any delinquent annual report filings. The following penalties may be assessed against late filers or nonfilers:

- **Late Filers**—Plan administrators who voluntarily file annual reports for 1988 and subsequent reporting years after the due date will be considered late filers. They may be assessed $50 a day, per plan, for the period for which they failed to file.
- **Nonfilers**—Plan administrators who fail to file required reports and are subsequently identified by the PWBA will be considered nonfilers. They may be assessed a penalty of $300 per day, per plan, with the penalty continuing to accrue up to $30,000 per year for each plan year until a filing is submitted.

**Reporting Participant Loans**

The DOL requires that loans to participants of plans that offer such a feature (for example, 401(k) or annuity plans) be included as investments on Form 5500 and disclosed in the Schedule of Assets Held for Investment Purposes. Loans that meet the requirements of the DOL's regulations under ERISA section 408(b)(1) may be aggregated and may be presented with a general description of terms and interest rates. Representatives of the DOL have informed the AICPA staff that a number of plans are not including these loans on the schedule as required. Auditors should inform their clients that the DOL may reject filings that do not properly disclose participant loans on the Schedule of Assets Held for Investment Purposes.
Limited-Scope Audits

Legislation that would eliminate the limited-scope audit exemption for all plans that require audited financial statements to be filed with Form 5500 was recently introduced in the House of Representatives by Congressman William J. Hughes (D-N.J.) and in the Senate by Senator Jim M. Jeffords (R-Vt.). No action has yet been taken on the bills; however, auditors should be alert for any new developments in this area.

Audit and Accounting Developments

Audit Issues

Auditor Independence. ERISA section 103(a)(3)(A) requires that an accountant retained by an employee benefit plan be "independent" when auditing plan financial information and rendering an opinion on the financial statements and schedules of a plan required to be included with the Form 5500 filing.

Interpretive guidelines adopted by the DOL in 1975 for determining when an accountant is independent state that an accountant who maintains "financial records" for an employee benefit plan is not independent with respect to the plan. The term financial records is undefined in the DOL guidelines.

Auditors should be aware that in cases in which the auditor is not deemed independent, the DOL may reject the plan's annual filing and impose a civil penalty against the plan administrator.

The AICPA Code of Professional Conduct permits auditors to perform certain routine services for an employee benefit plan. Some of these services may conflict with the DOL's rules. The AICPA is currently working with the DOL to clarify the DOL's rules, especially with regard to the performance of participant account allocation services.

Attorney's Letters. An audit inquiry letter to the plan's attorney is the auditor's primary means of corroborating the information provided by the plan's management concerning litigation, claims, and assessments. Paragraph 12.06 of the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans (the Guide) states that auditors should request the plan's management to send an audit inquiry letter to those lawyers who have been consulted regarding litigation, claims, and assessments and regarding qualification matters relating to the plan. In addition, a number of specific matters that should be considered for inclusion in the letter are listed in paragraph 12.06. Audit inquiries to plan attorneys should be made in the context of the American Bar
Association's (ABA) "Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information" (the ABA-AICPA understanding), which is set forth in exhibit II of AICPA Statement on Auditing Standards (SAS) No. 12, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments.

An article in a recent issue of Business Law Today reported that many plan audit inquiry letters include open-ended inquiries regarding many of the matters listed in paragraph 12.06 of the Guide in the "Other Matters" section of the letter, which is not in the context of the ABA-AICPA understanding. Auditors should be aware that inquiries regarding matters listed in paragraph 12.06 of the Guide should be included in the "Pending and Threatened Litigation" section or the "Unasserted Claims and Assessments" section, and the letter should refer to specific matters or should expressly state that there are no such matters.

Cafeteria Plans. Many employers have established welfare benefit and fringe benefit plans that allow employees to choose from among a number of benefit options. Options frequently include medical, surgical, hospital, sickness, accident, disability, child care, severance, vacation, legal service, apprenticeship, and training benefits. Such plans are commonly referred to as "cafeteria plans." Most cafeteria plans do not require that the assets from which plan benefits are paid be set aside in a separate trust. Since such plans frequently require employee contributions, they may be subject to the financial reporting and audit requirements of ERISA. However, cafeteria plans may not require audits if the participant contributions used to pay benefits have not been held in trust. In addition, audits may not be required for other contributory welfare plans in which participant contributions are applied to the payment of premiums and these contributions have not been held in trust.

Current guidance concerning plans that are subject to ERISA's requirements can be found in the summary of ERISA and related regulations in appendix A of the Guide. Further guidance can be found in the PWBA's Technical Release 92-1, which was issued in June 1992. Technical Release 92-1 discusses the DOL's enforcement policy with respect to welfare benefit plans with employee contributions.

Audit Development

New SAS on Service Organizations. In April 1992 the AICPA Auditing Standards Board issued SAS No. 70, Reports on the Processing of Transactions by Service Organizations, which is effective for service auditor's reports dated after March 31, 1993. SAS No. 70 provides guidance to
auditors of financial statements of entities that use service organizations, such as bank trust departments, that provide investment or administrative services to employee benefit plans. SAS No. 70 provides that if a user organization is affected by internal control structure policies and procedures at a service organization, the user organization’s auditor may find a service auditor’s report helpful in gaining an understanding of an entity’s internal control structure and in assessing control risk. SAS No. 70 supersedes SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations.* The AICPA is preparing an auditing procedures study (APS) that will provide assistance to service auditors as well as user auditors in the implementation of SAS No. 70. The APS is expected to be issued in late 1993.

Auditors should be aware that many bank trustees are on a calendar year and, consequently, will obtain special-purpose reports in accordance with SAS No. 44 prior to March 31, 1993, for use by auditors in audits of 1992 plan financial statements.

**Accounting Issues**

*Defined Contribution Plan Disclosure Requirements.* Paragraph 3.23k of the Guide requires participant-directed plans to disclose in their financial statements for each investment program (for example, equity, debt, employer securities, and participant loans) asset amounts and changes in those amounts in columnar form either (1) on the statement of net assets available for benefits and the statement of changes in net assets available for benefits, (2) in the notes to the financial statements, or (3) in separate financial statements for each fund. Many plans are disclosing the asset information or the changes in asset amounts, but not both. Auditors should consider this requirement as they evaluate whether appropriate presentation and disclosures in this area have been made.

Paragraph 3.23m of the Guide requires that the plan disclose the amounts of assets that have been allocated to participants who have withdrawn from the plan as of year end, but for which disbursement of those funds from the plan has not yet been made. The amount should be disclosed in the notes to the financial statements. It should not be classified as a liability in the statement of net assets available for benefits. When evaluating the adequacy of disclosures in this area, auditors should be aware that for plans filing under the alternative method, the DOL requires that these amounts be reported as liabilities on Form 5500, which will require a reconciling footnote in the plan’s financial statements as described in paragraphs A.41 and A.42c of the Guide.
Accounting Developments

Valuation of Insurance and Investment Contracts. The Financial Accounting Standards Board (FASB) has issued FASB Statement of Financial Accounting Standards No. 110, Reporting by Defined Benefit Pension Plans of Investment Contracts, which is an amendment to FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans. FASB Statement No. 110 requires fair-value reporting for all investment contracts held by defined benefit pension plans. However, it permits the continued use of contract value for insurance contracts as defined in FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, as well as deposit administration and immediate participation guarantee contracts entered into before March 20, 1992. FASB Statement No. 110 is effective for fiscal years beginning after December 15, 1992.

In March 1992 the AICPA's Employee Benefit Plans Committee added to its agenda a project on how health and welfare benefit plans and defined contribution pension plans report investment contracts issued by insurance companies, banks, savings and loans, thrift institutions, and others. The project's aim is to evaluate the appropriateness of the current reporting standards for such contracts. In addition, the committee is considering how the fair value of investment contracts held by all types of plans should be determined, including what circumstances, if any, might indicate that contract value approximates fair value. The committee expects to issue a proposed statement of position (SOP) for public comment in mid-1993.

Reporting Investment Contracts Issued by Troubled Insurance Companies. The Guide permits the reporting of investment contracts issued by insurance companies that are held by health and welfare plans and defined contribution pension plans at the value determined on Schedule A, “Insurance Information,” of Form 5500 (that is, contract value).

In the current economic environment, certain of these contracts may have been issued by what are now troubled insurance companies. When this is the case, the auditor should be aware that continuing to carry these assets at contract value may not be appropriate, because the plan may not recover the entire contractual amount. When addressing problem contracts, auditors should consider the guidance in FASB Statement No. 5, Accounting for Contingencies.

Health and Welfare Benefit Plans. In August 1992 the AICPA Employee Benefit Plans Committee issued SOP 92-6, Accounting and Reporting by Health and Welfare Benefit Plans. The SOP clarifies several accounting
and reporting requirements set forth in chapter 4 of the Guide and updates the Guide to incorporate new statements issued by the FASB. Significant changes include clarification of—

- The objective of financial reporting by defined benefit health and welfare plans.
- How defined benefit health and welfare plans, both single-employer and multi-employer, should account for and report benefit obligations, including postretirement obligations.
- The requirement to recognize claims incurred but not reported.
- The stipulation that benefit obligations should not include death benefits actuarially expected to be paid during participants’ period of active service.
- The distinction between defined contribution health and welfare plans and defined benefit health and welfare plans.
- The requirement that the current insurance premium rates used in determining the obligation for accumulated eligibility credits should generally consider mortality rates and the probability of employee turnover.

SOP 92-6 is effective for audits of single-employer plans with more than 500 participants for plan years beginning after December 15, 1992; for audits of single-employer plans with no more than 500 participants for plan years beginning after December 15, 1994; and for audits of multi-employer plans for plan years beginning after December 15, 1995. When a plan adopts the SOP, the plan must adopt it in its entirety.

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This audit risk alert supersedes Employee Benefit Plans Industry Developments—1992.

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform as described in Audit Risk Alert—1992, which was printed in the November 1992 issue of the CPA Letter.

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