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Employee Benefit Plans Industry Developments—1995

Complement to AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert 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. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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The staff of the AICPA is grateful to the members of the AICPA Employee Benefit Plans Committee for their contribution to this document.

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Industry and Economic Developments

Plan Funding

The adequacy of plan funding has been a source of concern among plan participants, the Department of Labor (DOL), the Pension Benefit Guaranty Corporation (PBGC), and the United States Congress for some time now. In recent years, economic trends seem to have exacerbated the underfunded status of many defined benefit plans, and have eroded the overfunded status of some traditionally well-funded plans. In particular, recessionary pressures made it difficult for some plans to adequately fund their plans. In addition, unusually low interest rates caused many plans to decrease the assumed discount rates used in actuarial calculations, resulting in increases in the actuarial present value of accumulated plan benefits. Although recently passed funding legislation and rising interest rates may gradually improve plan funding levels, those rising interest rates also could create unexpected asset valuation issues.

The Effect of Interest-Rate Fluctuations on High-Risk Investments

As interest rates fell to historically low levels over the past two years, a number of pension plan administrators and investment managers adopted aggressive investment strategies—directing an increasingly larger proportion of plan investments into higher yielding and frequently higher risk investment vehicles. Derivative products such as futures, options, and swap contracts have become popular investment vehicles for plans attempting to increase their investment yields. As interest rates have begun to climb, the quality and value of many of the derivative products and other high-risk plan investments may be called into question. In light of the volatility of financial markets, auditors should continue to be particularly sensitive to concerns about the valuation of plan investments—especially derivative products—and the adequacy of related disclosures.

Trends in Pension Plans

Plan Types. Significant changes have occurred over time in the types of retirement plans offered by employers. Traditionally, medium-sized and

large firms established defined benefit plans as primary plans, while small firms preferred defined contribution plans. For more than a decade, employers increasingly have chosen to sponsor defined contribution plans rather than defined benefit plans. For many years, the shift from goods-producing industries to service industries and from large to small firms caused rapid growth in defined contribution plans. Recently, however, many large firms have established defined contribution plans as supplemental plans to give employees the opportunity for participation in more than one plan, or as replacements for their defined benefit plans. Companies have found that defined contribution plans are less complex, more popular with plan participants, and are administratively less costly to maintain than defined benefit plans. In addition, they relieve the plan sponsor of the financial risks inherent in a promise to pay specified benefits.

As the dynamics of the workplace continue to change, some companies are finding that one plan often cannot satisfy all of their needs. As a result, many new plans, such as hybrid defined benefit/defined contribution plans, target benefit plans[1] and 401(h) plans[2] have emerged. Those new types of plans may require the use of judgment in determining the appropriate accounting, reporting, and disclosure requirements. For example, although target benefit plans ordinarily are considered defined contribution plans, in some cases the substance of the plan may be to provide a defined benefit. For such plans, accounting and reporting as defined benefit plans may be more appropriate.

Plan Administration. Changes in the way plans are administered may affect the way audits are performed. Increasingly, companies are outsourcing the administration of their plans to third-party administrators. In some cases, the plans maintain no participant records; even personnel files are maintained by the third-party administrator. In addition, many third-party administrators now use voice response systems that allow participants to initiate transactions by phone and eliminate the "paper trail" provided by written transaction requests. Auditors should consider obtaining a service

[1] A target benefit plan is a form of defined contribution plan under which the employer's annual contribution on behalf of each participant is the actuarially determined amount required to fund a target benefit established by a plan formula. The target benefit is usually based on compensation and length of service.

[2] Some defined benefit pension plans have been amended to provide for the payment of certain health benefits for retirees, their spouses, and dependents in addition to the normal retirement benefits. Under the Internal Revenue Code (IRC), defined benefit pension plan sponsors may fund all or a portion of their postretirement medical obligations through a 401(h) account in their defined benefit pension plans, subject to certain restrictions and limitations. Contributions to the 401(h) account can only be used to pay health benefits.

auditor's report prepared in accordance with AICPA Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), when plans use third-party administrators. In such cases, auditors also may wish to consider confirming information directly with plan participants. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance about the confirmation process.

Regulatory and Legislative Developments

Regulatory Developments

DOL Interpretive Bulletin on In-Kind Contributions. On December 21, 1994, the DOL Pension and Welfare Benefits Administration (PWBA) issued Labor Department Interpretive Bulletin 94-3, *In-Kind Contributions to Employee Benefit Plans* (*Federal Register* [December 28, 1994]). Interpretive Bulletin 94-3, which was issued in response to the 1993 Supreme Court decision *Commissioner v. Keystone Consolidated Industries Inc.*, places limits on in-kind contributions by employee benefit plan sponsors to defined contribution and health and welfare plans. It indicates that in-kind contributions of property, other than cash, that reduce the sponsor's obligation to fund the plan in cash generally constitute party in interest transactions that are prohibited under section 4975(c)(1)(A) of the Internal Revenue Code (IRC) and section 406(a)(1)(A) of the Employee Retirement Income Security Act of 1974 (ERISA). It also indicates that the decision to accept an in-kind contribution is a fiduciary decision subject to the fiduciary standards contained in section 404 of ERISA.

Paragraph 11.09 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, states that in accordance with the provisions of SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor should be alert to party in interest transactions that may be prohibited by ERISA. Paragraphs 11.09 through 11.16 of *Audits of Employee Benefit Plans* provide guidance on the auditor's responsibility for detecting prohibited transactions and evaluating the adequacy of the related disclosures in the plan's financial statements. Those paragraphs also address the implications of prohibited transactions in relation to other aspects of the audit, the potential effect of prohibited transactions on the auditor's report, and the auditor's responsibility for communicating information about prohibited transactions to the plan administrator.

PWBA Review of Plan Audits. The PWBA has established an ongoing quality review program to assess the quality of audit work performed by independent auditors in audits of plan financial statements that are required by ERISA. Practitioners deemed by the PWBA to have per-

formed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. As of December 31, 1994, 46 referrals had been made to state licensing boards and 225 referrals had been made to the AICPA Professional Ethics Division; of those, the Professional Ethics Division has resolved 180 cases. Of those resolved cases, 61 were referred to the AICPA's Trial Board or were settled without a Trial Board hearing, 90 resulted in letters of recommended corrective action, 9 were found to contain no deficiencies, and 20 were closed for other reasons. Common deficiencies noted in the referrals included the following:

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

Because ERISA makes plan administrators responsible for assuring that plans' financial statements are audited, deficient audit work can also expose plan administrators to significant penalties under ERISA section 502(c)(2).

In response to a request by the U.S. General Accounting Office (GAO), during 1994, the PWBA began a comprehensive, nationwide project to assess the quality of employee benefit plan audits. PWBA representatives are performing on-site workpaper reviews on a statistically selected random sample of 276 plan audits to determine the extent of compliance with professional accounting and auditing standards and ERISA's reporting and disclosure requirements. As of December 31, 1994, approximately 150 on-site workpaper reviews had been performed, although no interim results have been made public. PWBA expects to contact the remaining 126 plan sponsors and complete their on-site reviews of audit workpapers by May 1995.

PWBA Reporting Compliance Program. In addition to its quality review programs for ERISA audits, the PWBA has an aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting requirements. Through 1994, the PWBA has rejected over 3,500 filings and imposed over $64 million in civil penalties under ERISA section 502(c)(2), which provides for penalties of up to one thousand dollars per day against plan administrators who fail to file acceptable annual reports on a timely basis.

The PWBA continues to actively identify and target both late filers and nonfilers. Over 450 late filers and nonfilers have been identified and assessed over $38 million in late filing and nonfiling penalties.

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 per day, per plan, for the period for which they failed to timely 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.

Delinquent Filer Voluntary Compliance Program. The PWBA plans to initiate a Delinquent Filer Voluntary Compliance (DFVC) program designed to allow plan administrators who failed to file or filed their Form 5500 Series Annual Reports late to apply for relief from full delinquency penalties. The program will be ongoing and is expected to begin in early 1995.

Plan administrators who qualify for the DFVC program will be assessed the following amounts:

- $50 per day per filing up to a maximum of $2,500 for annual reports filed less than one year late
- $5,000 for annual reports one year or more late

In addition, plan administrators of certain employee benefit plans for highly compensated individuals, known as *top hat* plans, and apprenticeship and training plans who missed their filing deadlines, may submit statements and elect an alternative method of compliance in lieu of annual report filings. Those filers will be assessed $2,500 per statement. Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 219–8770.

Form 5500 Reporting Requirements. The DOL previously had indicated that use of the Schedule G, "Financial Schedules," by plans answering "yes" to Items 27a through 27f on the 1993 Form 5500, would be mandatory for the 1993 plan year and thereafter. However, mandatory use of Schedule G was deferred. The PWBA has now indicated that it will not reject Form 5500 Annual Return/Report filings for the 1994 plan year solely because of a failure to file required financial schedules in accordance with the format prescribed by Schedule G. However, plan auditors and administrators should be aware that, although the use of the Schedule

G *form* is optional, the *information* required by that schedule still must be included in the filings.

PWBA Outreach and Customer Service Efforts. The PWBA encourages auditors and plan filers to call its Division of Accounting Services at (202) 219–8794 with ERISA-related accounting and auditing questions and questions regarding the preparation of the Form 5500. Questions concerning filing requirements should be directed to the Division of Reporting Compliance at (202) 219–8770.

In addition to handling technical telephone inquiries, the PWBA is involved in numerous outreach efforts (for example, making presentations at AICPA and state CPA society functions) designed to provide information practitioners need in complying with ERISA's reporting and disclosure requirements. Questions on PWBA's outreach efforts should be directed to the Office of the Chief Accountant at (202) 219–8818.

Legislative Developments

Pension Reform. Recently, attention has been focused on underfunded retirement plans and how the PBGC's growing accumulated deficit will affect its ability to meet its obligation to guarantee employees' benefits under most private sector defined benefit pension plans. In December 1994, The Retirement Protection Act of 1994 (the Act) was enacted as part of the General Agreement on Tariffs and Trade (GATT) legislation. The Act is intended to increase the security of the pension system and improve the PBGC's ability to meet its obligations to plan participants. It modifies existing rules to encourage employers to more fully fund their defined benefit pension plans by imposing new minimum funding rules for plans with more than one hundred participants and by raising the full-funding limit. The Act amends various qualification requirements, including limiting the ability of sponsors of underfunded plans to select interest and mortality assumptions for purposes of calculating their minimum contributions, and modifies the interest and mortality assumptions used for calculating lump-sum distributions from defined benefit plans. Other key provisions of the Act include elimination of the cap on variable rate PBGC premiums, which could increase premiums for underfunded plans; addition of new participant notice and PBGC reporting requirements; establishment of a new PBGC program for missing participants in standard terminations; elimination of quarterly contributions for well-funded plans, elimination of the excise tax for some nondeductible contributions; extension until the year 2000 of a company's ability to transfer excess pension assets to a 401(h) account to pay current retiree health benefits; and limiting future contributions to 401(k) plans. The provisions of the Act generally are effective for 1995 plan years.

Such changes could, among other things, affect a plan's tax qualification status. Auditors should be aware of the possibility that violations of tax laws and regulations may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred (see SAS No. 54, paragraph 7). The auditor also is expected to inquire of, and obtain representations from, management concerning compliance with the laws and regulations and the prevention of violations that may cause disqualification. The auditing procedures ordinarily applied in an audit of a plan's tax status are discussed in paragraph 12.03 of *Audits of Employee Benefit Plans.*

ERISA Audit Improvement Act. The ERISA Audit Improvement Act (the Bill) was introduced late in the 103rd Congress, with the objective of improving audits of the financial statements of employee benefit plans. It is expected that the Bill, or certain audit-related provisions of the Bill, will be reintroduced in the 104th Congress in 1995.

Among other things, the Bill proposed repealing the limited scope audit exemption and mandating external quality control reviews every three years for public accountants who conduct ERISA audits. The Bill also proposed requiring qualified public accountants to report directly to the Secretary of Labor certain events that come to their attention during the audit of plan financial statements.

Auditors should be aware that such a bill, if enacted, could substantially change the way benefit plan audits are conducted and could affect their audit practices. Auditors should be alert for new developments in this area.

Audit and Accounting Developments

Audit Issues

Investments in Derivatives. Interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past year. As a result, a number of entities using these instruments have incurred significant losses. Employee benefit plans sometimes use such instruments as risk management tools (hedges) or as speculative investment vehicles. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to those about other transactions, an auditor's approach to achieving related audit objectives may differ because certain derivatives—futures contracts, forward contracts, swaps, options, and other contracts

with similar characteristics—are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994* (Product No. 022141). The AICPA publication *Derivatives—Current Accounting and Auditing Literature* (Product No. 014888) summarizes current authoritative accounting and auditing guidance and provides background information on basic derivatives contracts, risks, and other general considerations.

SAS No. 70 Reports. Many employee benefit plans use service organizations, such as banks or electronic data processing (EDP) service bureaus, to process plan transactions. In such cases, the plan auditor may obtain a report prepared in accordance with SAS No. 70 to gain an understanding of the control structure policies and procedures at the service organization sufficient to plan the audit in accordance with SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319), and possibly reduce the assessed level of control risk.

Plan auditors should be aware that although a service auditor's report on policies and procedures placed in operation at the service organization may be helpful in providing a sufficient understanding to plan the audit, the auditor should not rely on such a report to justify a reduction of the assessed level of control risk below the maximum. If the auditor plans to use a service auditor's report to reduce the assessed level of control risk, he or she should obtain a service auditor's report on policies and procedures placed in operation that includes tests of operating effectiveness.

The AICPA is also preparing an Auditing Procedure Study (APS) that provides assistance to user auditors as well as service auditors in the implementation of SAS No. 70. The APS is expected to be issued in the third quarter of 1995.

Rejection of Form 5500 Filings. There are many situations in which, in accordance with SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), plan auditors should issue other than an unqualified opinion on plan financial statements. For example, paragraph 13.32 of *Audits of Employee Benefit Plans* states that when the auditor determines that a plan's valuation procedures for nonreadily marketable investments are inadequate or unreasonable, the auditor should qualify his or her opinion because of the departure from generally accepted accounting principles (GAAP).

Historically, the DOL has rejected Form 5500 filings that contain either qualified opinions, adverse opinions, or disclaimers of opinion other than those issued in connection with a limited scope audit pursuant to ERISA

section 103(a)(3)(C). Failure of plans to prepare financial statements in conformity with GAAP or an other comprehensive basis of accounting (OCBOA) will likely result in the rejection of their Form 5500 filings.

OCBOA Financial Statement Disclosures. Some plan administrators prepare plan financial statements on a modified cash basis or an OCBOA rather than in conformity with GAAP. Often, such financial statements do not include information about accumulated plan benefits. Auditors should be aware that paragraphs 9 and 10 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards,* vol. 1, AU sec. 623), require that the auditor apply essentially the same criteria to OCBOA financial statements as he or she does to financial statements prepared in conformity with GAAP. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in paragraph 4 of SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 411). Thus, as noted in paragraph 13.22 of *Audits of Employee Benefit Plans,* plan financial statements prepared on an OCBOA should disclose information regarding accumulated plan benefits or accumulated benefit obligations, as applicable. Certain other disclosures also may be appropriate. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or an adverse opinion on the financial statements.

Limited Scope Audit Exemption. ERISA section 103(a)(3)(C) allows auditors to limit the scope of their testing of *investment information* prepared and certified by a qualified trustee or custodian such as a bank, trust company, or similar institution or an insurance company. Some plan auditors assume that this limited scope audit exemption also applies to information prepared and certified by broker/dealers and investment companies, or to noninvestment information, such as benefit payments, employer/employee contributions, loans, and receivables.

Auditors should be aware that the limited scope audit exemption does *not* apply to assets held by a broker/dealer or an investment company, unless the investment company owns a subsidiary bank that can certify the investment information. The exclusion also does not apply to investment information other than that certified by a qualified trustee or custodian or to other noninvestment information. The scope limitation and the corresponding limitation of the auditor's work extends *only* to investments and related investment activity certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, and *all* noninvestment related information should be sub-

jected to the same audit procedures as for a full scope audit. The auditor's responsibilities in limited scope engagements are discussed in detail in paragraphs 7.45 and 7.46 of *Audits of Employee Benefit Plans.*

Financial Statements Issued Before Completion of Form 5500. Plans that meet certain criteria are required to file audited financial statements along with Form 5500. Paragraphs 12.12 through 12.14 of *Audits of Employee Benefit Plans* remind auditors that, when audited financial statements are filed along with a plan's Form 5500, the auditor should read the Form 5500 and consider whether it is materially inconsistent with the financial statements that are to be included in the filing.

Auditors may encounter situations in which the financial statements and auditor's report are issued for purposes other than ERISA filings prior to the completion of the Form 5500. In such situations, the auditor should inform the plan administrator that the financial statements and auditor's report are not to be attached to the Form 5500 filing without the auditor's reading of the filing on Form 5500. Paragraphs 12.15 and 12.16 of *Audits of Employee Benefit Plans* provide further guidance that may be useful when audit reports are issued prior to the Form 5500 filing.

Reporting on Fund Information. Requirements for presenting information related to separate investment fund options of defined contribution plans are described in paragraph 3.23(k) of *Audits of Employee Benefit Plans.* Whether the required information on separate investment options is presented on the face of the financial statements or in the related notes, the auditor's measure of materiality remains that with respect to the financial statements taken as a whole, rather than each investment fund option. When presented on the face of the financial statements, the auditor's report should state that the fund information included in the financial statements is presented for purposes of additional analysis rather than to present the net assets and changes in net assets for each fund. In addition, the auditor should be satisfied that the separate investment fund information is suitably identified. Paragraph 13.36 of *Audits of Employee Benefit Plans* illustrates an auditor's report on a full scope audit of the financial statements of a defined contribution plan containing separate investment fund option information, filed with Form 5500. When a limited scope audit is performed, no special mention of the investment fund option information is necessary because the auditor disclaims an opinion on the financial statements, including the fund information, and the supplemental schedules as they relate to those financial statements.

Claims Incurred But Not Reported. Paragraph 39 of AICPA Statement of Position (SOP) No. 92-6, *Accounting and Reporting by Health and Welfare*

Benefit Plans, requires that self-funded health and welfare benefit plans measure the cost of claims incurred but not reported (IBNR) at the present value, as applicable, of the estimated ultimate cost to the plan of settling the claims. However, financial statement preparers and auditors often are unclear about what the estimated ultimate cost should include. In some cases, plans may inappropriately be using a "lag" approach (recording known amounts that relate to the period covered by the financial statements that are reported subsequent to year-end but prior to issuance of the financial statements) to estimate the ultimate cost of IBNR claims, and do not consider any future obligations of the plan relating to conditions that existed as of the end of the period but had not been reported prior to the issuance of the financial statements.

SOP 92-6 states that the estimated ultimate cost of IBNR claims should reflect the plan's obligation to pay claims to or for participants regardless of status of employment, beyond the financial statement date pursuant to the provisions of the plan or regulatory requirements. For example, an individual contracts a terminal disease or has a catastrophic accident in December. The claim is reported to the plan subsequent to the plan's calendar year-end. Treatment is ongoing and is expected to continue throughout the next year. The plan does not require any return to work and will fully cover all services. The actuarial present value of the obligation for all future payments to be made as of the plan year-end (December) should be included as a benefit obligation in IBNR.

Auditors should be aware that the calculation of IBNR amounts is often quite complex, and may require the use of actuarial estimates. In such cases, the auditor should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336).

Audit Development

SAS on Using the Work of a Specialist[3]. In July 1994, the AICPA Auditing Standards Board issued SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336). SAS No. 73 supersedes SAS No. 11 and is effective for audits of financial statements for periods ending on or after December 15, 1994.

Plan auditors frequently rely on the work of actuaries and appraisers to corroborate assertions in the financial statements (for example, the actuarial present value of benefit obligation amounts and asset values). SAS No. 73 provides guidance for auditors who use the work of such specialists in audits performed in accordance with generally accepted

[3] For further discussion of this topic, refer to "When Auditors Use Specialists," T.E. Durbin and J.M. Summo, *Journal of Accountancy,* August 1994.

auditing standards (GAAS). SAS No. 73 clarifies the applicability of the guidance. It also provides updated examples of situations that might require using the work of specialists and types of specialists being used today and guidance on using the work of a specialist related to the client.

SAS No. 73 does not apply if a specialist employed by the auditor's firm participates in the audit. For example, if the auditor's firm employs an appraiser and decides to use that appraiser as part of the audit team to evaluate the carrying values of properties, SAS No. 73 would not apply. In such cases, the auditor should refer to SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311). SAS No. 73 is broader in scope than SAS No. 11 in that it also applies to engagements performed under SAS No. 62 including those to report on special presentations and financial statements using a comprehensive basis of accounting other than GAAP, such as the modified cash basis used by many plans.

One of the new requirements added by this standard is for the auditor to consider the specialist's experience in the kind of work under consideration. For example, if the auditor is using an actuary in connection with the audit of an employee benefit plan, he or she will need to consider not only the actuary's professional qualifications but also his or her experience in working with plan-related actuarial issues.

SAS No. 73 does not preclude the auditor from using the work of a specialist who has a relationship with the client, including situations in which the client has the ability to directly or indirectly control or significantly influence the specialist. The standard does, however, require the auditor to evaluate the relationship and consider whether it might impair the specialist's objectivity. If the auditor concludes that the specialist's objectivity might be impaired, additional procedures should be performed, possibly including using the work of another specialist.

Accounting Issue

401(h) Plans. A number of employers have amended defined benefit pension plans that they sponsor to provide for the payment of certain health benefits for retirees, their spouses, and dependents in addition to the normal retirement benefits. The IRC permits defined benefit pension plan sponsors to fund (subject to certain restrictions and limitations) all or a portion of their postretirement medical obligations through a 401(h) account in their defined benefit pension plans. Contributions to a 401(h) account may be used only to pay health benefits. Auditors should be aware that the assets set aside in a 401(h) account are *not* assets available to pay pension benefits, and should not be characterized as such in the plan's financial statements.

Accounting Developments

Valuation of Insurance and Investment Contracts. In September 1994, the AICPA's Employee Benefit Plans Committee issued SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined Contribution Pension Plans,* that provides guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, the SOP provides guidance for determining the fair value of investment contracts held by all types of plans. The SOP is effective for financial statements for plan years beginning after December 15, 1994, except that the application of the SOP to investment contracts entered into before December 31, 1993, is delayed to plan years beginning after December 15, 1995.

Certain investment contracts that are held by health and welfare plans and defined contribution pension plans may be reported at contract value. In the current economic environment, some of those contracts may have been issued by what are now troubled insurers. In those cases, the auditor should be aware that continuing to carry the assets at contract value may not be appropriate, because the plan may not recover the entire contractual amount. When addressing contracts issued by troubled insurers, auditors should consider the guidance in FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text,* vol. 1, sec. C59).

Defined Contribution Pension Plan Disclosures. In September 1994, the AICPA's Employee Benefit Plans Committee issued Practice Bulletin 12, *Reporting Separate Investment Fund Option Information of Defined Contribution Pension Plans,* which clarifies the related reporting requirements established by paragraph 3.23k of *Audits of Employee Benefit Plans.* Practice Bulletin 12 is effective for plan years beginning after December 15, 1993.

See the "Audit Issues" section of this Audit Risk Alert for a discussion of the auditor's reporting considerations related to such fund option information.

Derivatives Disclosures. In October 1994, the FASB issued FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25). FASB Statement No. 119 requires disclosures about derivative financial instruments—futures, forward, swap, and option contracts, and other financial instruments with similar characteristics.

More specifically, the Statement requires disclosures about amounts, nature, and terms of derivative financial instruments that are not subject to FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text,* vol. 1, sec. F25), because

they do not result in off-balance-sheet risk of accounting loss. It requires that a distinction be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. Employee benefit plans that engage in such activities are required to provide those disclosures in their financial statements.

FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement is effective for financial instruments issued for fiscal years ending after December 15, 1995.

In December 1994, the FASB issued a Special Report, *Illustrations of Financial Instrument Disclosures,* which illustrates the disclosure requirements set out in FASB Statement Nos. 119, 105, and 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25). It was prepared to assist financial statement preparers, auditors, and others in understanding and implementing FASB Statement No. 119 in the context of those other disclosure Statements.

Fair Value Disclosures. FASB Statement No. 107, as amended by FASB Statement No. 119, requires all entities to disclose, within the body of the financial statements or in the accompanying notes, the fair value of financial instruments, both assets and liabilities recognized and not recognized in the statement of financial position, for which it is practicable to estimate fair value. The disclosures should distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading. An entity also should disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. Auditors should be aware that, generally, financial instruments of an employee benefit plan other than insurance contracts as defined in FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts* (FASB, *Current Text,* vol. 2, sec. Pe5), are included in the scope of FASB Statement No. 107 and are subject to the disclosure requirements of paragraphs 10–14 of that Statement.

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 *Audits of Employee Benefit*

Plans and updates chapter 4 to incorporate new statements issued by the FASB.

SOP 92-6 is now effective for most employee benefit plans. It is effective for single-employer plans with more than five hundred participants for plan years beginning after December 15, 1992; for single-employer plans with no more than five hundred participants for plan years beginning after December 15, 1994; and for multiemployer plans for plan years beginning after December 15, 1995. When a plan adopts the SOP, the plan must adopt it in its entirety.

Accounting changes adopted to conform to the provisions of the SOP shall be made retroactively. When there has been a change in accounting principles that has a material effect on the comparability of the plan's financial statements, SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), states that the auditor should refer to the change in an explanatory paragraph of his or her report. Because ERISA requires comparative statements of net assets available for plan benefits, it will be necessary to restate the prior year's statement of net assets in the year of adoption in an ERISA audit to comply with the provisions of the SOP. In addition, because accumulated benefit obligations are not reported on Form 5500, plans adopting SOP 92-6 for the 1994 plan year should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500, as described in paragraphs A.41 and A.42(c) of *Audits of Employee Benefit Plans.*

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This Audit Risk Alert supersedes *Employee Benefit Plans Industry Developments—1994.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994*, which may be obtained by calling the AICPA Order Department at the number below and requesting publication number 022141.

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO–AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847–0700, ext.10.