Employee benefit plans industry developments - 1997; Audit risk alerts

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Employee Benefit Plans Industry Developments—1997

Complement to AICPA Audit and Accounting Guide Audits of Employee Benefit Plans
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 and the AICPA Employee Benefit Plans Committee. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA. The AICPA staff wishes to thank the Office of the Chief Accountant of the U.S. Department of Labor Pension and Welfare Benefits Administration for contributing to this Audit Risk Alert.

Linda Delahanty
Technical Manager
Accounting and Auditing Publications
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Employee Benefit Plans Industry Developments—1997

Industry and Economic Developments

Plan sponsors increasingly continue to offer 401(k) and other defined contribution plan options in lieu of traditional defined benefit plans and to offer more investment options for participants. The following list is based on a survey conducted by Buck Consultants, 401(k) Plans—Employer Practices & Policies, September 1996 Survey Results, eighth edition:

- 95 percent of all 401(k) plans offer four or more investment options.
- Voice response systems are used in 76 percent of all respondents' plans, as opposed to 35 percent in 1993 and 58 percent in 1995.
- 86 percent of all 401(k) plans offer a participant loan feature, whereas in 1984 only 39 percent did.
- 53 percent of plans surveyed allowed for daily changes in investment elections, whereas in 1989 only 4 percent did.
- 49 percent of plans surveyed allow participants to change investment of new monies every pay period, whereas in 1989 only 4 percent did.

Regulatory and Legislative Developments

Regulatory Developments

Department of Labor Nonenforcement of GAAP Disclosures of Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans. On March 13, 1997, the Department of Labor (DOL) published in the Federal Register a notice and request for comment on an annual enforcement policy pursuant to which the DOL would not reject the Form 5500 annual report, filed for the 1996 and 1997 plan years, of a multiemployer welfare benefit plan solely because the accountant's opinion accompanying such report is qualified or adverse due to a failure to account and report for postretirement benefit obligations in accordance with the financial statement disclosure requirements of AICPA Statement of Position (SOP) 92-6, Accounting and Reporting by Health and Welfare Benefit Plans. The AICPA is on record opposing the DOL's nonenforcement position. The DOL's action does not affect generally
accepted accounting principles (GAAP) for multiemployer health and welfare benefit plans. However, if a plan decides not to fully comply with the requirements of SOP 92-6, then the auditor must consider the effect of a GAAP departure on his or her audit report. See related discussion under Audit Issues and Developments section of this alert.

**Final Regulation Relating to Definition of Plan Assets: Participant Contributions.** On August 7, 1996, the DOL published in the Federal Register final rules that lower the maximum period that employers may hold contributions to contributory employee benefit pension plans (both defined benefit and defined contribution plans). These new regulations amend an existing regulation, adopted in 1988, as to when participant contributions become plan assets.

Previous rules required employers to remit money withheld from employees to their plans as soon as reasonably possible, but in no event longer than ninety days. However, some employers misinterpreted the prior rule to mean that contributions could be held for ninety days even though these contributions could have been remitted to the plan in a shorter period.

The new regulation, effective February 3, 1997, includes the following changes:

- For pension plans (both defined benefit and defined contribution plans), the maximum period for remittance of employee contributions to the plan has been reduced to fifteen business days after the month in which the participant contribution was withheld or received by the employer.

- To accommodate the special situation of employers who, on occasion and for good cause, cannot remit participant contributions to pension plans within the fifteen business day limit, the DOL has established a procedure by which an employer may obtain an extension of the limit for an additional ten business days.

- For welfare plans, the maximum period for remittance of employee contributions to the plan was not changed, remaining ninety days after the day the contribution was withheld or received by the employer.

Failure to remit, or untimely remittance of, participant contributions may constitute a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of credit) and, in certain circumstances, may constitute embezzlement of plan assets. Additionally, such information should be properly presented on the required Form 5500 supplemental schedule of nonexempt transactions.
with parties in interest. When plan administrators have failed to disclose this information, plan auditors should consider the effect on the independent auditors' opinion on the required supplemental schedule accompanying the plan's financial statements. When auditing contributions for defined contribution plans, auditors should consider inquiring about the timing of employee contribution remittances to the plan. Consideration should also be given to expanding the client representation letter to include specific prohibited transactions, such as the untimely remittance of employee contributions. (See paragraph A.14 for further discussion of the remittance rules, and paragraph 11.09 for a discussion of prohibited transactions, in the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans (the Guide), with conforming changes as of May 1, 1997.)

For collectively bargained plans, there is a special effective date of the later of February 3, 1997, or the first day of the plan year that begins after the end of any collectively bargained agreement in effect on February 3, 1997. To accommodate the special situation of employers who, for good cause, need additional time to complete their benefit system changes, the DOL has established a procedure by which an employer may obtain an extension of the effective date of up to ninety days. (For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 219-7461.)

PWBA Review of Plan Audits and Related Peer Review Developments. The PWBA has established an ongoing quality review program to ensure the quality of audit work performed by independent auditors in audits of plan financial statements that are 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, 1996, 69 referrals had been made to state licensing boards and 286 referrals had been made to the AICPA Professional Ethics Division; of the 286, the Professional Ethics Division has resolved 223 cases. Of those resolved cases, 71 were referred to the AICPA's Trial Board or were settled without a Trial Board hearing, 110 resulted in letters of recommended corrective action, 1 11 were found to contain no deficiencies, and 31 were closed

1 Disciplinary actions available to the Professional Ethics Executive Committee include termination or suspension of membership in the AICPA (and possibly in the state society), publicizing such actions in the CPA Letter, completion of specified continuing professional education, review of additional work product, imposition of mandatory independent preissuance review of some or all financial statements and accountant's reports, and accelerated quality review. The action taken is determined by the severity of the violations of the Code of Professional Conduct.
for other reasons. Common deficiencies noted in the referrals included the following:

- Inadequate or no audit program or planning\(^2\)
- Inadequate or no documentation of the auditor’s understanding of the internal control structure
- Inadequate or no documentation supporting the audit work performed\(^3\)
- Deficiencies in the auditor’s report\(^4\)
- Deficiencies in the note disclosures\(^5\)

Because ERISA holds plan administrators responsible for assuring that plans’ financial statements are audited in accordance with generally accepted auditing standards (GAAS), deficient audit work can also expose plan administrators to significant penalties under ERISA section 502(c)(2). The PWBA will continue to conduct periodic working

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\(^2\) Such deficiencies included lack of a specific audit program tailored to the audit of employee benefit plans; failure to obtain or review relevant documents such as plan agreements, summary plan descriptions, annual reports, and investment advisor agreements; and failure to determine the operations of the plan or current developments affecting the plan.

\(^3\) Such deficiencies included failure to perform sufficient audit work related to participant data, benefit payments, plan obligations, or all three. Also, in certain instances the auditor did not test the fair market valuations, investment transactions, or authorizations for investment transactions. In limited-scope engagements, the auditor did not obtain the proper certification from the bank or insurance company or the certification did not cover all of the plan assets. The audit program used by the auditor did not address the area of prohibited transactions. In the audit of multi/multiple-employer plans, the auditor performed inadequate work relating to the contributions received from contributing employers. In participant-directed plans, the auditor did not test the allocation of employee contributions to selected investment options.

\(^4\) Such deficiencies included failure to reflect a departure from GAAP and failure to report on all the years presented.

\(^5\) Such deficiencies included failure to disclose—
- The investments that represent 5 percent or more of the plan’s net assets available for benefits.
- Information as to whether or not the plan has received a favorable tax determination ruling from the IRS.
- The priorities upon termination of the plan.
- The basis for determining contributions of the plan.
- The funding policy of the plan.
- Information regarding the method and significant assumptions used to determine the actuarial present value of the plan’s accumulated plan benefits as required by Financial Accounting Standards Board (FASB) Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans.
paper review, and, in time, will conduct another assessment of the
level and quality of audit work performed by independent auditors.

The AICPA, working with the PWBA, has made a concerted effort to
improve the guidance and training available to auditors of employee
benefit plans. Such efforts include issuing annual Audit Risk Alerts,
conducting annual national conferences on employee benefit plans, de­
veloping continuing professional education courses and technical
checklists, and issuing accounting and auditing pronouncements
aimed at improving plan financial reporting and providing guidance
for plan auditors. Also, the AICPA has consulted with the PWBA on
additional actions the AICPA and PWBA can take to strengthen the
quality of ERISA audits. These actions include communicating to
AICPA members the findings noted in the PWBA’s report and the im­
portance of ERISA audits; developing additional audit programs,
manuals, checklists, or other technical practice aids; strengthening ad­
ttional technical support for auditors through the AICPA technical
hotline; offering additional training programs on employee benefit
plan audits; identifying ways the AICPA can work with state CPA
societies to enhance training opportunities in employee benefit plan
audits; and improving the AICPA’s peer review process in ERISA
audits.

Also, the AICPA self-regulatory teams continue to be concerned
about deficiencies noted on audits of employee benefit plans. The com­
mon GAAS and GAAP deficiencies noted by the AICPA are the same
as those already listed in this section. In the spirit of protecting the
public interest and in response to the high rate of noncompliance, both
the SEC Practice Section (SECPS) and AICPA Peer Review Programs
have special criteria for selecting audits of employee benefit plans for
review during a peer review. The SECPS Peer Review Program re­
quires that such audits be reviewed if the firm plans to continue per­
forming these engagements. Effective for peer review years beginning
on or after January 1, 1997, the AICPA Peer Review Program will re­
quire reviewers to assess employee benefit plan audits at a higher level
of peer review risk. If the firm performs such audits, and at least one is
not selected for review, the reviewer will be required to document his
or her justification for such omission in the summary review memora­
dum. Under both programs, peer review teams performing a review of
employee benefit plan audits, must have experience in audits of em­
ployee benefit plans, as well as knowledge about current rules and
regulations of ERISA.

This is a serious effort by the PWBA and AICPA. Practitioners need
to understand that severe consequences, including loss of membership
in the AICPA and loss of license, can result from inadequate plan
audits.
PWBA Reporting Compliance Program. The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting and disclosure requirements. In 1996 the PWBA rejected over fifty-one hundred filings, many for audit reporting deficiencies, and imposed over $64 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.

In addition, the PWBA continues to actively identify and target both late filers and nonfilers. More than 980 late filers and nonfilers have been identified and assessed over $56 million in late filing and nonfiling penalties. The following penalties may be assessed by the DOL against late filers or nonfilers:

- **Late filers**—Plan administrators who voluntarily file annual reports for 1988 and subsequent reporting years after the due date and are subsequently identified by the PWBA will be considered late filers. They may be assessed $50 per day, per plan filing, for the period for which they failed to file timely.

- **Nonfilers**—Plan administrators who fail to file required reports for 1988 and subsequent reporting years and are subsequently identified by the PWBA will be considered nonfilers. They may be assessed a penalty of $300 per day, per plan filing, with the penalty continuing to accrue up to $30,000 per year for each plan year until a filing is submitted.

The Internal Revenue Service (IRS) may also impose penalties, including a late filing penalty of $25 a day, up to $15,000 for not filing returns for certain plans of deferred compensation, certain trusts and annuities, and bond purchase plans.

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

In addition to handling technical telephone inquiries, PWBA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. Questions regarding these outreach efforts should be directed to the Office of the Chief Accountant at (202) 219-8818. Practitioners and other members of the public may also wish to contact PWBA at their website — Internet: http://www.dol.gov/dol/pwba.
The website provides information on PWBA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

**Delinquent Filer Voluntary Compliance Program.** In April 1995, the PWBA initiated an ongoing Delinquent Filer Voluntary Compliance (DFVC) program designed to encourage filer compliance by allowing plan administrators who failed to file or who filed their Form 5500 Series annual reports late to apply for relief from full delinquency penalties. Auditors should be aware of this program if their clients' plan reports have not been filed or have been filed late and they qualify for this program.

This program was designed to be less burdensome for small plans and to balance the PWBA's limited resources between enforcement and compliance objectives. Participation in the DFVC program constitutes a waiver by plan administrators to receive notice of assessment of civil penalties under ERISA section 502(c)(2) and to contest the DOL's assessment of the penalty amount. Participation in the DFVC program does not preclude assessment of nonfiling or late-filing penalties by the IRS. The IRS has recommended that plan administrators participating in the DFVC program attach a reasonable-cause statement to their original Form 5500 Series filing with the IRS. In the case of Form 5500 filings which are filed on or before twelve months after the due date (without regard to any extensions), plan administrators who qualify for the DFVC program will be assessed a penalty of $50 per day, up to a maximum of $2,500 per Form 5500 filing. The maximum penalty for Form 5500-C filings who file under these circumstances is $1,000. In the case of Form 5500 filings which are filed more than twelve months after the due date (without regard to any extensions), plan administrators who qualify for the DFVC program will be assessed a penalty of $5,000 per filing. Form 5500-C filers will be assessed a penalty of $2,000 per filing.

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 making annual report filings. Participation by these filers in the DFVC program will be assessed $2,500 per statement.

To date, participation in the DFVC program by plan administrators has been successful. As of December 31, 1996, the DOL has received 5,607 annual report filings and 288 statements by top hat plans and apprenticeship and training plans, totaling $17.3 million in reduced penalties.

Questions concerning the DFVC program should be directed to the PWBA's Division of Reporting Compliance at (202) 219-8770.
Revision of the Form 5500 Series and Related Regulations Under the Employee Retirement Income Security Act of 1974. The Form 5500 Series of reports are filed annually by pension and health and welfare benefit plans to provide information about plan operations to plan participants and the regulatory agencies. Since 1976, the forms have been processed by the IRS which provides the data to the respective agencies.

As part of the President’s Pension Simplification proposal, the regulatory agencies are undertaking a comprehensive review of the annual return report forms in an effort to streamline the information required to be reported and the methods by which such information is filed and processed. The proposed revision to the Form 5500 Series is being coordinated among the DOL, the IRS, and the Pension Benefit Guaranty Corporation.

Legislative Developments

Pension Audit Legislation. Several bills aimed at repealing the limited-scope audit exemption that currently exists under Section 103(a)(3)(C) of the ERISA are expected to be introduced in the 105th Congress. The DOL and the U.S. General Accounting Office have recommended that Congress repeal the limited-scope audit exemption that, according to the DOL, is utilized in about half of the approximately 70,000 audits of employee benefit plans subject to ERISA. The AICPA supports repeal of the limited-scope audit exemption. Further, the proposed legislation would require auditors to report certain significant events to the DOL and to establish additional educational and quality control review requirements for plan auditors. As of the date of this Alert, two bills (S.14, Retirement Security Act of 1997, and H.R.83, Comprehensive Pension and Retirement Security Act of 1997) have been introduced. Senator Jim Jeffords (R-VT), chair of the Senate Labor and Human Resources Committee, and other Senate and House members are expected to introduce pension audit legislation. The DOL is also expected to have its recommendations introduced in proposed legislation. Pension audit legislation, if enacted, would be effective for plan years beginning after the date of enactment of the legislation.

Other Legislation Affecting Plans. Employee benefit plan issues continue to receive emphasis by Washington policy makers and regulators. 1996 was a busy year for legislation affecting employee benefit plans. Following is some of the legislation passed in 1996:

- The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was signed into law on August 21, 1996. HIPAA includes important new protections for an estimated 26 million Americans who move from one job to another, who are self-employed, or who
have preexisting medical conditions, and places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations (HMOs).

- The Newborns' and Mothers' Health Protection Act of 1996 (NMHPA) was signed into law on September 26, 1996. NMHPA includes important new protection for mothers and their newborn children regarding the length of the hospital stays following the birth of a child. The requirements under NMHPA apply to group health plans, insurance companies, and HMOs for plan years beginning on or after January 1, 1998.

- The Mental Health Parity Act of 1996 (MHPA) was signed into law on September 26, 1996. MHPA provides for parity in the application of limits to certain mental health benefits. Under MHPA, group health plans, insurance companies, and HMOs will no longer be allowed to set annual or lifetime limits on mental health benefits that are lower than any such limits for medical and surgical benefits. Generally, these requirements apply to group health plans for plan years beginning on or after January 1, 1998, that meet certain requirements.

Further information regarding the above legislation can be obtained from the Pension and Welfare Benefits Administration (PWBA), U.S. Department of Labor, 200 Constitution Avenue, N.W., Room N-5625, Washington, D.C. 20210, 202/219-8776 (Internet: http://www.dol.gov/dol/pwba).

Audit and Accounting Developments

Audit Issues and Developments

Multiemployer Health and Welfare Benefit Plan Accounting for Postretirement Benefit Obligations. Employee health and welfare benefit plans that prepare financial statements in accordance with GAAP must follow the accounting and reporting requirements set forth in Chapter 4 of the AICPA Audit and Accounting Guide, Audits of Employee Benefit Plans, which incorporates the guidance of AICPA SOP 92-6. SOP 92-6 is effective for all single-employer plans, and became effective for multiemployer plans for plan years beginning after December 15, 1995.

Among other requirements, SOP 92-6 required plans that provide postretirement benefits to include in their financial statements the amount of the accumulated postretirement benefit obligation representing the actuarial present value of all future benefits attributed to plan participants' services rendered to date. Because accumulated benefit obligations are not reported on Form 5500 submitted to the
DOL, plans adopting SOP 92-6 should include a note to their financial statements reconciling the amounts reported in the financial statements to amounts reported on Form 5500.

As noted in the Regulatory Developments section of this alert, the DOL will not enforce the postretirement benefit obligation disclosure requirements in SOP 92-6 for multiemployer health and welfare benefit plans for plan years 1996 and 1997. If a plan does not adopt all of the provisions of SOP 92-6, including presenting the postretirement benefit obligation amount in the statement of plan's benefit obligations and statement of changes in plan's benefit obligations, which is required to fairly present the plan's financial statements in conformity with GAAP, the auditor should consider the effect of this departure from GAAP on his or her report. SAS No. 58, Reports on Audited Financial Statements (AICPA, Professional Standards, Vol. 1, AU sec. 508), describes the circumstances that may require a qualified or adverse opinion when the financial statements contain departure from GAAP (sections AU 508.35 through 508.60). A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which material, and he or she has concluded not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

Trend Toward Outsourcing and the Use of Statement on Auditing Standards (SAS) No. 70 Reports. With the trend toward daily valuation of 401(k) plans, more benefit plans are using service providers to execute transactions and maintain accountability on behalf of the plan administrator. For example, outside service organizations such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators may keep records and process benefit payments. Often the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option. In these situations, the auditor may not be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70, Reports on the Processing of Transactions by Service Organizations (AICPA, Professional Standards, vol. 1, AU sec. 324), for the service or-
ganization that addresses the controls at the service organization that are relevant to the audit of the plan.

If the independent auditor determines that the service organization had effective controls in place for processing plan transactions during the reporting period, the auditor generally would conclude that it is not necessary to visit or perform additional procedures at the service organization. However, in some situations, the auditor may conclude that additional audit work should be performed at the service organization. Following are some examples of such situations. (See chapter 6 of the Guide for audit guidance on the situations listed below.)

- The service organization issued a SAS No. 70 report describing the controls placed in operation ("Type I" report) and the auditor wishes to determine whether to reduce the assessed level of control risk at the service organization.
- The service organization's SAS No. 70 report covers a reporting period different from the plan's fiscal year.
- The service organization's SAS No. 70 report covers only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or the report does not cover activities performed by subservice organizations.
- The service organization's SAS No. 70 report identifies instances of noncompliance with the service organization's controls.

If the SAS No. 70 report is unavailable, the auditor should consider other appropriate procedures to obtain sufficient evidence to achieve the audit objectives. For example, if participant enrollment forms are unavailable from the plan sponsor, the auditor may wish to confirm the information directly with the participants. Alternatively, the auditor could consider requesting the enrollment forms from the service provider or visiting the service provider to perform the necessary testing.

Auditing in a Mutual Fund Environment. Many employee benefit plans, particularly 401(k) plans and profit sharing plans, hold investments in mutual funds (also known as registered investment companies). Typically, a plan holds units of the mutual funds which are valued at quoted market prices that may fluctuate daily, representing the net asset value of the units held by the plan.

When auditing mutual fund investments, difficulties are often encountered with daily valuations, participant-directed automated transactions (for example, voice-activated telephone systems), and other "paperless transactions". In such circumstances, the plan is often unable to maintain independent records of such transactions, necessitat-
ing that the auditor obtain an understanding of internal control of the service organization in order to plan the audit in accordance with SAS No. 55, Consideration of Internal Control in a Financial Statement Audit, as amended by SAS No. 78 (AICPA, Professional Standards, vol. 1, AU sec. 319). This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70 on the relevant controls of the service organization (typically the record keeper, which in certain circumstances may be a service division of the mutual fund organization). (See paragraphs 6.07 through 6.14 in the Guide for a further discussion of SAS No. 70.) The auditor should consider the areas and findings addressed in the SAS No. 70 report, and whether the SAS No. 70 report is a Type I or Type II report, to determine the extent of substantive procedures to perform.

Many of the audit procedures discussed in chapter 7 of the Guide are applicable for mutual funds. Such procedures may include the following:

1. Confirming transactions (contributions, transfers, and withdrawals) account balances, or both, with individual participants
2. Tracing contributions and withdrawals from the plan record keeper’s records to the mutual fund’s activity statements for the applicable time period
3. Confirming directly with the mutual fund the number of units of participation held by the plan
4. Testing the fair value of the investments in mutual funds by agreeing per-unit values as of year end to market quotations
5. Obtaining a copy of the mutual fund’s recent financial statements (or alternative source of yield information, such as business journals) and analytically comparing for reasonableness the information in the mutual fund’s financial statements to the information recorded by the plan for its units of participation, including market values and the net change in fair value of investments (that is, realized and unrealized gains and losses) for the period under audit. The mutual fund’s financial statements need not cover the exact period covered by the plan’s financial statements; they should, however, be sufficiently recent to satisfy the plan auditor’s objectives (The financial statements of mutual funds are typically readily available.)

Synthetic GICs. Many plans hold guaranteed investment contracts (GICs) in their investment portfolio. Normally issued through the general account, in its simplest form a GIC is a contract between an insurance company and a plan that provides for a guaranteed return on
principal invested over a specified time period. For defined contribution plans, one variation of a GIC is commonly referred to as a synthetic GIC. A synthetic GIC is an investment contract that simulates the performance of a traditional GIC through the use of financial instruments. A key difference between a synthetic GIC and a traditional GIC is that the plan owns the assets underlying the synthetic GIC. (With a traditional GIC, the plan owns only the investment contract that provides the plan, with a call on the contract issuer's assets in the event of default.) Those assets may be held in a trust owned by the plan, and typically consist of government securities, private and public mortgage-backed and other asset-backed securities, and investment-grade corporate obligations. To enable the plan to realize a specific known value for the assets if it needs to liquidate them to make benefit payments, synthetic GICs utilize a benefit-responsive "wrapper" contract issued by a third party that provides market and cash flow risk protection to the plan. (The third-party issuer of the wrapper is an entity other than the plan sponsor, administrator, or trustee, and could be the entity that issues the investment contract.) Synthetic GICs are unallocated and are to be included as plan assets at their contract or fair values, as appropriate. (See paragraphs 3.17 and 4.24 of the Guide for a further discussion of measuring and valuing investment contracts.) Because the assets underlying a synthetic GIC are owned by the plan, those assets and the wrapper should be separately valued and disclosed in the Form 5500 Schedule of Assets Held for Investment Purposes. The value of the benefit responsive wrapper would be the difference between the fair value of the underlying trust assets and the contract value attributable by the wrapper to those assets. (See Example 5 in the Appendix to SOP 94-4, Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans, found in appendix I, paragraphs I.12 and I.13, in the Guide, for a discussion of synthetic GICs.)

For defined contribution plans for which the "wrapper" is benefit responsive, the auditing procedures to be applied to synthetic GICs should include tests of the individual securities or other investments that constitute the assets underlying a synthetic GIC and tests of the related wrapper contract to ascertain the fairness of the values of each to be disclosed by the plan in the Form 5500 Schedule of Assets Held for Investment Purposes.

**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. However, this limited-scope audit exemption does not apply to infor-
mation 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 also be aware that the limited-scope audit exemption does not apply to assets held by a broker-dealer or an investment company unless the company owns a subsidiary bank that can certify the investment information. The exemption also does not apply to investment information other than that certified by a qualified trustee or custodian or to other noninvestment information. Plan investments not held by a qualified trustee or custodian, and all noninvestment related information (for example, contributions receivable, benefits paid, other expenses), should be subjected to full-scope audit procedures. The auditor's responsibilities in limited-scope engagements are discussed in detail in paragraphs 7.51 and 7.52 of the Guide.

**Limited-Scope Audits (When Only a Portion of the Investments Are Certified).** Plan investments not held by a qualified trustee or custodian that meets the limited-scope exemption criteria set forth in the DOL regulations (see paragraphs A.57 and A.58 of the Guide, for a discussion of such criteria) should be subjected to appropriate audit procedures. Plans may hold investment assets of which only a portion are covered by certification by a qualified trustee or custodian. In that case, the balance of the investments are not eligible for the limited-scope exemption and should be subjected to auditing procedures by the plan auditor. In these circumstances, the limited-scope audit report would be required if the plan's assets that are not audited (that is, those assets covered by the trustee or custodian's certification) are material to the plan's financial statements taken as a whole. See paragraph 13.26 of the Guide for limited-scope reporting guidance.)

**Auditing Funded Welfare Plans.** A trust may be established to hold the assets of an employee welfare benefit plan; it may or may not be tax-exempt. A common form of tax-exempt trust is a an Internal Revenue Code (IRC) Section 501(c)(9) trust, referred to as a voluntary employee beneficiary association (VEBA). The audit requirement for a health and welfare plan that utilizes a VEBA trust applies to the plan, not to the VEBA trust. VEBA trusts generally have no language covering the plan's operations. The governing instrument is limited to the investment and management of plan assets. Disbursements are made as authorized by the plan administrator. Operational attributes of the related plan must still be audited in accordance with chapter 4 of the Guide. However, the tax status is unique to the VEBA and, for the trust to be tax-exempt, the tax requirements of the IRC must be satisfied.
Paragraph 4.09 of the Guide explains that a VEBA is one of several arrangements available to hold plan assets of an employee welfare plan. Key considerations in auditing VEBAs arise from the distinct tax regulations associated with VEBAs, and often assets of several welfare plans are commingled into a single VEBA.

The audit and reporting issues for a VEBA that holds the assets of a single plan of a single sponsor are discussed fully in chapter 4 of the Guide. When the VEBA holds the assets of several plans of a single employer, additional audit issues are present. If the VEBA qualifies as a master trust, the master trust rules discussed in paragraph 4.09 of the Guide will apply. In cases in which the underlying welfare plans have no assets other than those held by the VEBA, Form 5500 schedules are generally attached to the master trust filing and need not be included with the separate filing of each participating plan. (See the instructions to Form 5500 for guidance on master trust filing information.) If the VEBA does not qualify as a master trust, Form 5500 schedules should be prepared for each plan. (See appendix A of the Guide for a discussion of Form 5500 schedules.)

Claims Incurred but not Reported. Paragraph 39 of SOP 92-6 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 (paragraph 4.43 of the Guide). However, financial statement preparers and auditors often are unclear about what the estimated ultimate cost should include. In some cases, plans may only 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 the issuance of the financial statements) to estimate the ultimate cost of IBNR claims and without considering any future obligations of the plan relating to conditions that existed as of the end of the period but that 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 plan provisions or regulatory requirements. (See paragraph 4.43 in the Guide.) For example, a participant 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 fully covers 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 in the IBNR calculation.

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 discuss with the plan administrator the need for the plan to engage an actuary and should consider the guidance in SAS No. 73, Using the Work of a Specialist (AICPA, Professional Standards, vol. 1, AU sec. 336).

**New Pronouncements**

There are no new auditing standards affecting 1996 plan audits; however early adoption of the following pronouncements is permitted.

**SAS No. 78.** In December 1995 the Auditing Standards Board (ASB) issued SAS No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards (SAS) No. 55, which revises the definition and description of internal control contained in the SASs to recognize the definition and description contained in Internal Control-Integrated Framework (the COSO report), published by the Committee of Sponsoring Organizations of the Treadway Commission. SAS No. 78 is effective for audits of financial statements for periods beginning on or after January 1, 1997, with earlier application permitted. In March 1997 the ASB issued conforming changes to SAS No. 70 to reflect the issuance of SAS No. 78 and to conform the SAS No. 70 reports to COSO terminology.

**SAS No. 82.** In February 1997 the ASB issued SAS No. 82, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1, AU sec. 316), which describes the auditor’s responsibilities relating to fraud in a financial statement audit and provides guidance on what should be done to meet those responsibilities. SAS No. 82 supersedes SAS No. 53, The Auditor’s Responsibility to Detect and Report

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6 Practitioners should also be aware that SAS No. 80, Amendment to Statement on Auditing Standards No. 31, Evidential Matter, was issued in December 1996 and is effective for engagements beginning on or after January 1, 1997; and SAS No. 81, Auditing Investments, was issued in December 1996 and is effective for audits of financial statements for periods ending on or after December 15, 1997.

Errors and Irregularities (AICPA, Professional Standards, vol. 1, AU sec. 316), and is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application if permitted. (See appendix A, “Fraud Risk Factors for Employee Benefit Plans,” in this Alert for further guidance on SAS No. 82.)

Accounting Issues and Developments

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 plan 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.

The AICPA Employee Benefit Plans Committee currently has an SOP project under way to provide guidance on the accounting for and disclosure of 401(h) features of both defined benefit pension plans and health and welfare benefit plans. The committee expects to issue an exposure draft by the end of 1997. This exposure draft will be a three-part SOP that will also include a proposed SOP on accounting for and reporting on certain health and welfare benefit plan transactions, and a proposed SOP on accounting for and reporting of certain employee benefit plan investments (including amending paragraph 3.28k of the Guide). This project would not affect plan accounting and reporting for 1996 plan year-end reporting; however, auditors should be alert for further developments on this project.

Health and Welfare Benefit Plans. In August 1992 the AICPA Employee Benefit Plans Committee issued SOP 92-6, which clarified several accounting and reporting requirements set forth in chapter 4 of the Guide and updated this chapter to incorporate Statements issued by the FASB.

SOP 92-6 is now effective for all employee benefit plans. It was 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 SOP 92-6, the plan must adopt it in its entirety.
Accounting changes adopted to conform to the provisions of the SOP should 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 auditors should refer to the change in an explanatory paragraph of their 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 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 12.21 and A.51 of the Guide.

If a plan does not adopt the provisions of SOP 92-6, including presenting a statement of plan benefit obligations and a statement of changes in plan benefit obligations, which are required to present fairly the plan’s financial statements in conformity with GAAP, the auditor should consider the effect of this departure from GAAP on his or her report. SAS No. 58 describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP (specifically AU sections 508.35 through 508.60). A qualified opinion is expressed when the auditor believes, on the basis of his or her audit, that the financial statements contain a departure from GAAP, the effect of which is material and he or she has concluded not to express an adverse opinion. An auditor should express an adverse opinion when, in the auditor’s judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP.

Some plan administrators prepare plan financial statements on a modified cash basis or an other comprehensive basis of accounting (OCBOA) rather than in conformity with GAAP. Paragraph 5 of SOP 92-6 (see also paragraph 4.05 of the Guide), states that the presentation of a plan’s benefit obligation information in GAAP-basis financial statements, as required by paragraph 20 of SOP 92-6, (see also paragraph 4.20 of the Guide), is consistent with the disclosures required in OCBOA financial statements (as defined by the requirements of financial reporting to the DOL). 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. (See paragraphs 9 and 10 of SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 623], for guidance on evaluating the adequacy of disclosures prepared in conformity with an other com-
Valuation of Insurance and Investment Contracts. In September 1994 the AICPA Employee Benefit Plans Committee issued SOP 94-4, which provides guidance on how those plans should report investment contracts issued by insurance companies, banks, thrift institutions, and others. In addition, SOP 94-4 provides guidance for determining the fair value of investment contracts held by all types of plans. SOP 94-4 was 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, was delayed to plan years beginning after December 15, 1995.

As discussed in paragraph 4 of SOP 94-4, certain fully benefit responsive 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) and SOP 94-6, Disclosure of Certain Significant Risks and Uncertainties.

New Pronouncements

FASB Statement No. 126. In December 1996 FASB issued FASB Statement No. 126, Exemption from Certain Required Disclosures About Financial Instruments for Certain Nonpublic Entities. FASB Statement No. 126 amends FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for (1) entities that are nonpublic entities, (2) entities whose total assets are less than $100 million on the date of the financial statements, and (3) entities that have not held or issued any derivative financial instruments, as defined in FASB Statement No. 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, other than loan commitments, during the reporting period. FASB Statement No. 126 is effective for fiscal years ending after December 15, 1996, with earlier application permitted for financial statements not previously issued. Plans filing a Form 11-K under the Securities Exchange Act of 1934 (the 1934 Act) with the Securities Exchange Commission would not meet...
this disclosure exemption even when plans elect to file ERISA financial statements in lieu of financial statements filed in accordance with the 1934 Act filing requirements.

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This Audit Risk Alert supersedes Employee Benefit Plans Industry Developments—1996.

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Auditors should also be aware of the economic, regulatory, and professional developments described in Audit Risk Alert—1996/97, which can be obtained by calling the AICPA Order Department at the number below and requesting publication number 022194.

Copies of the AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) 862-4272. 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.

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Fraud Risk Factors for Employee Benefit Plans

The following section is based on material from the AICPA publication Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82.

Instructions: Statement on Auditing Standards (SAS) No. 82 describes the auditor’s responsibilities relating to fraud in a financial statement audit and provides guidance on what should be done to meet those responsibilities. There are two types of misstatements relevant to the auditor’s consideration of fraud in a financial statement audit: material misstatements arising from fraudulent financial reporting, and material misstatements arising from misappropriation of assets. Misstatements of fraudulent financial reporting refer to intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Misstatements arising from misappropriation of assets involves the theft of an entity’s assets, in which the effect of the theft is that the financial statements are not presented in conformity with generally accepted accounting principles. Although fraud usually is concealed, the presence of risk factors or other conditions may alert the auditor to a possibility that fraud exists. SAS No. 82 describes fraud and its characteristics in more detail and requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors that should be considered in the auditor’s assessment. The SAS also provides guidance on how the auditor should respond to the results of the assessment and on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud. In addition, the SAS describes related documentation requirements and provides guidance regarding the auditor’s communication about fraud to management, the audit committee, and others.

Fraud risk factors may be identified throughout the entire engagement process (for example, during client acceptance or continuance procedures, planning, fieldwork, or review). Other conditions, which may support or alter an auditor’s judgment about the risk of material misstatement due to fraud, may be identified during audit fieldwork. The following fraud risk factors and other conditions are intended to help auditors of employee benefit plans tailor the five broad risk factor categories defined in SAS No. 82. This list is intended to supplement the risk factors, other conditions, and related guidance found in the SAS. (It is a companion to but not a substitute for the guidance in the SAS.)
Also, the presence of these example risk factors and other conditions identified during the engagement do not necessarily indicate the existence of fraud.

When fraud risk factors or other conditions are found to be present during the engagement, professional judgment should be exercised when assessing their significance and relevance. As the auditor assesses the risk of material misstatement, it is important to keep in mind that the presence of a risk factor or condition should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances.

The Auditor Responses sections include some suggested alternative procedures to consider when fraud risk factors and other conditions are present. Like the fraud risk factors and conditions, these suggestions supplement the responses already described in SAS No. 82.

The following list should be used in conjunction with SAS No. 82 because not every example risk factor in paragraphs 17 and 19 of the SAS have been tailored, interpreted, or reprinted here and some of the example risk factors not reprinted may be applicable to the engagement.

Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

A. Risk Factors and Other Conditions Relating to Management Characteristics and Influence Over the Control Environment

- A motivation for management to engage in fraudulent financial reporting.
  - Senior management of the plan sponsor appoints itself trustee of the plan and uses that position to benefit the plan sponsor—for example, uses the plan’s money to do speculative investing or to support the company through buying employer assets or supporting a supplier.

- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
— Failure by management to have adequate valuations performed, including actuarial valuations.

— The plan administrator lacks an understanding of the major regulations that govern the plans (ERISA, IRS Code, and so forth.)

- **Management displaying a significant disregard for regulatory authorities.**
  — Management displaying a significant disregard toward compliance with ERISA, IRS Code, and Department of Labor regulations.
  — The plan administrator or trustees have been investigated by the Department of Labor or IRS for fiduciary violations in operating the plan.

- Lack of management candor in dealing with plan participants, claimants, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements.

The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL (Such participation could be an indication of ineffective management of the plan or controls over the plan.)

**B. Risk Factors and Other Conditions Relating to Industry Conditions**

- **Declining industry, with increasing business failures and significant declines in customer demand.**
  — The plan sponsor is in an industry that is declining in stability. This could lead to difficulties in meeting financial commitments to the plan, including contributions.

- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable.

- The plan has limited investment options or the plan has invested significantly in employer securities or other employer assets (for example, owning franchise stores).

**C. Risk Factors and Other Conditions Related to Operating Characteristics and Financial Stability**

- **Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.**
  — Indications of significant or unusual parties-in-interest transactions not in the ordinary course of operations.
— Excessive or unusual transactions with the plan sponsor/administrator.

D. Auditor Responses

In addition to the sample responses presented in SAS No. 82, an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- **Investment Results.** Obtain the requisite investment information directly from the plan trustee, and obtain the same information from the party named as having discretion to make investment decisions, such as the plan administrator, the plan’s investment committee, or the plan’s investment advisor (the directing party) and review and reconcile the directing party’s reports (investment position and activity) with those of the trustee.

- **Claim Reserves.** Confirm, with third parties, the historical and statistical information that is being used to prepare the reserves. Review the qualifications of the individuals preparing the reserves.

- Apply the following procedures to fully understand a party-in-interest transaction:1
  - Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
  - Inspect evidence in possession of the other party or parties to the transaction.
  - Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
  - Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
  - With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing

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1 See chapter 11 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for further audit guidance.
authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

- For single-employer plans, obtain the most recent financial statements of the plan sponsor and review for indicators of financial difficulties. For multiple-employer plans, obtain an understanding of the industry.

**Misappropriation of Assets**

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions will be present in entities where the specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

**A. Risk Factors and Other Conditions Related to Controls**

- **Lack of appropriate management oversight.**
  - Lack of review of investment transactions by trustees, sponsor, or investment committee.

- **Lack of appropriate segregation of duties or independent checks.**
  - Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan.
  - Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans.
  - No independent records of the plan are maintained to enable the plan administrator to periodically check the information to the custodian.

- **Lack of appropriate system of authorization and approval of transactions.**
  - Insufficient approval over transactions with parties-in-interest that could lead to prohibited transactions.

- **Lack of timely and appropriate documentation for transactions.**
  - Trustee does not prepare required supplemental information (for example, historical cost records not maintained.)
- Lack of controls surrounding benefit payments, including the termination of payments in accordance with plan provisions.
- Lack of appropriate segregation of plan assets from the sponsors assets or inappropriate access to plan assets by plan sponsor.
- SAS No. 70 report indicating a lack of adequate controls at an outside service provider.
- Use of a service provider that does not provide a SAS No. 70 report.
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recordkeeping amounts for a defined contribution plan (unallocated assets or liabilities).

B. Auditor Responses

In addition to the sample responses presented in SAS No. 82, an auditor in an employee benefit plan audit engagement may want to consider the following responses.

- Review reconciliations of the assets held by the trust with participant records throughout the year. Review any reconciling adjustments for propriety.
- Review the account activity for participants who have access to plan assets or assist in administering the plan.
- The auditor may have concluded that a risk of material misstatement exists with regard to a lack of a qualified outside service provider acting as trustee, custodian, or both for plan assets. In these instances, the auditor should physically inspect assets and examine other evidence relating to ownership. In addition, the fair value of investments should be tested by reference to market quotations or other evidence of fair value in accordance with SAS No. 57, Auditing Accounting Estimates.
- The auditor may have concluded that a risk of material misstatement exists with regard to unreconciled differences between net assets available for benefits per the trustee/custodian records and the recordkeeping amounts for a defined contribution plan. If the trustee/custodian records are higher than the recordkeeping totals (excluding accrual adjustments), an unallocated asset exists that should be allocated to participant accounts. If the trustee/custodian records are lower than the recordkeeping totals (excluding accrual adjustments), plan assets may have been misappropriated, requiring further investigation by the auditor (for example, reconciliation of monthly trustee/custodian activity to the record keeper).
• The auditor may have concluded that a risk of material misstatement exists with regard to remittance of employee contributions for a defined contribution plan with a sponsor experiencing cash flow problems. In this instance, the auditor may perform a reconciliation of total employee contributions per the payroll register to the recordkeeping report for the year. In addition, the auditor may select certain months to test for the timely remittance of employee contributions in accordance with regulations.

• The auditor may have concluded that a risk of material misstatement exists with regard to expenses being paid by an overfunded defined benefit plan on behalf of an underfunded plan. In this instance, the auditor might select expense amounts paid by the overfunded plan and trace them to specific invoices, noting that the expense pertained to the proper plan. Alternatively, the auditor could ask to review expense invoices pertaining to the underfunded plan paid by the company to make sure the overfunded plan did not pay them.

• Review the timeliness of contributions from the plan sponsor throughout the year.

• Compare canceled checks to disbursement records. Where benefits are paid by check disbursements, compare the signature on the canceled check to participant signatures on other employee documents.

• Confirm benefit payments with participants or beneficiaries.

• Confirm medical bills directly with service providers.

Fraud Examples

Listed below are actual instances of fraudulent activity on employee benefit plan engagements. They are presented to help auditors become better acquainted with fraudulent activities. Although none of these particular examples resulted in a material misstatement of the financial statements, similar fraudulent activity at other benefit plans may cause a material misstatement of the financial statements, depending upon the circumstances.

• A pension plan notifies participants who have reached the age of seventy and one half that they must, under law, take their distributions from the plan. An employee of the company is responsible for notifying the participants and providing distribution forms. Once the forms are completed, they are provided to a supervisor for approval and submitted to the insurance company (custodian) for payment. For all participants reaching the age of seventy and
one half, the employee decides to forge the distribution forms and not notify the participants of the distributions. The forged forms are provided to the supervisor, who approves them, and the insurance company is directed to make lump sum distributions via wire transfers into an account set up with the employee’s name as a relative for the beneficiary. The fraud continues for several months until a participant notifies the supervisor that he would like to receive his distribution, and the supervisor notices that a lump sum was already distributed.

- A long-time employee at a company is responsible for reporting loan repayments (for loans not paid off by automatic payroll deduction) to the record keeper by providing copies of the face of the repayment checks to the record keeper. The employee is also a participant in the plan and currently has a $20,000 loan from her account. The employee decides to take a second loan but, under plan provisions, cannot do it until her first loan is paid off. The employee makes out a check to pay off the $20,000 loan from her personal account and provides a copy of the check to the record keeper. A second loan for $25,000 is taken out for the employee. However, the first loan is never paid off because the employee never deposits the $20,000 check into the plan. Cash reconciliations continually show immaterial unreconciled items that are not followed up in a timely manner and the fraud is not discovered for months.

- A company has two defined benefit plans; one is overfunded and one is underfunded. In past years, administrative expenses were paid from each plan’s assets. However, this year the company decides it will pay the expenses for the underfunded plan. The overfunded plan continues to pay its own expenses. Because of an administrative error, the overfunded plan ends up paying the expenses for both plans. When management discovers this fact, a decision is made not to reimburse the plan that paid the expenses because it is fully funded.