2001

Employee benefit plans industry developments - 2001; Audit risk alerts

American Institute of Certified Public Accountants

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
American Institute of Certified Public Accountants, "Employee benefit plans industry developments - 2001; Audit risk alerts" (2001).
Industry Developments and Alerts. 72.
https://egrove.olemiss.edu/aicpa_indev/72

This Article is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
Employee Benefit Plans Industry Developments—2001

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

This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The AICPA staff wishes to thank the members of the Employee Benefit Plans Expert Panel; the 2001 Employee Benefit Plans Audit Guide Revision Task Force; Wendalyn Frederick, technical manager, AICPA Professional Standards and Services; and The Office of Chief Accountant, Pension and Welfare Benefits Administration of the U.S. Department of Labor for their contributions to this Audit Risk Alert.

2001 Employee Benefit Plans Audit Guide Revision Task Force:

Lawrence Beebe
Paula Conroy
Marilee P. Lau
Alexander Miller

Beth Ann Thompson
Michele Weldon
Alice Wunderlich

Linda C. Delahanty
Technical Manager
Accounting and Auditing Publications

Copyright © 2001 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please call the AICPA Copyright Permissions Hotline at (201) 938-3245. A Permissions Request Form for e-mailing requests is available at www.aicpa.org by clicking on the copyright notice on any page. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1234567890 AAG 0987654321
In This Year's Alert...

Introduction

• What is the purpose of this Audit Risk Alert? Page 7

Industry and Economic Developments

• How are employee benefit plans affected by the current conditions in the U.S. economy? Page 7
• What are negative elections? Page 8
• What is HIPAA and what new rules have been enacted? Page 9

Regulatory Developments

• What's new for plan year 2000? Page 12
• How do you file the Form 5500? Page 14
• What should the auditor's report look like when a qualified or adverse opinion was issued on prior-year financial statements that are being restated in the current period to conform to GAAP? Page 15
• Whom should you call if you have ERISA or Form 5500 preparation questions? Page 25
• What is the DFVC program? Page 25
• What other PWBA matters should you be aware of? Page 26

Audit Issues

• What are self-directed investments and how should they be reported? Page 33
• What audit adjustments are likely to be included on a summary of uncorrected misstatements? Page 34
• What are some derivative financial instruments commonly found in employee benefit plans? Page 36
• How should you audit benefit claims that are processed electronically? Page 39
• What are some recurring deficiencies found in employee benefit plan audits? Page 42
New Auditing and Attestation Pronouncements

- What new auditing and attestation pronouncements have been issued recently? Page 44

New GAAP Pronouncements

- What new accounting pronouncements have been issued recently? Page 52

Audit and Accounting Guide Revisions as of May 1, 2001

- What revisions have been made to the Guide? Page 55

Resource Central

- What other AICPA publications related to employee benefit plans may be of value to your practice? How can you order AICPA products? Page 58
# Table of Contents

**Employee Benefit Plans Industry Developments—2001**

- Introduction ........................................................................................................... 7
- Industry and Economic Developments ................................................................. 7
  - Economic Environment .................................................................................... 7
  - Negative Elections ............................................................................................ 8
  - The Health Insurance Portability and Accountability Act .................................... 9
  - PWBA Issues Final Rules to Strengthen Workers’ Health Benefit Rights ........... 10
- Regulatory Developments .................................................................................... 12
  - 2000 Form 5500 Series .................................................................................... 12
  - EFAST Computerized Filing System .................................................................. 14
  - DOL Non-Enforcement of GAAP Disclosures of Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans .................................................. 15
  - Small Pension Plan Security Regulation .......................................................... 18
  - PWBA Review of Plan Audits .......................................................................... 20
  - Section 401(k) Plan Fees .................................................................................. 21
  - Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the PWBA ................................................................. 23
  - PWBA Outreach and Customer Service Efforts ................................................. 25
  - Delinquent Filer Voluntary Compliance Program ............................................. 25
  - Other Current Matters ...................................................................................... 26
- Audit Issues ........................................................................................................... 33
  - Self-Directed Investments .................................................................................. 33
  - Common Audit Adjustments .............................................................................. 34
  - Investment in Derivatives ................................................................................... 36
  - Insurance Contracts With Participation ............................................................ 39
  - Health and Welfare Benefit Plan Issues ............................................................ 39
  - Plan Mergers ...................................................................................................... 41
  - AICPA Peer Review Developments ................................................................... 42
New Auditing and Attestation Pronouncements .................44
   Auditing Standards ..........................................................44
   Auditing Interpretations ....................................................47
   New Attestation Standard .................................................49

Accounting Developments ................................................51
   New AICPA Statement of Position for Health and Welfare Benefit Plans ...........................................51

New GAAP Pronouncements .............................................52
   FASB Pronouncements ....................................................52
   EITF Consensus Positions .................................................54

Audit and Accounting Guide Revisions as of May 1, 2001 .....55

AICPA Professional Ethics Division Interpretations
   and Rulings .........................................................................55

On the Horizon ..................................................................56

International Accounting Standards .................................57
   Employee Benefit Plan Related Standards .........................57

Resource Central ............................................................58
   On the Bookshelf ................................................................58
   National Conference ........................................................59
   Continuing Professional Education .................................59
   AICPA—At Your Service ..................................................60

APPENDIX A—IRS LIMITS ON BENEFITS AND COMPENSATION......63

APPENDIX B—COMMONLY ASKED QUESTIONS AND ANSWERS........64

APPENDIX C—WHO’S WHO IN EMPLOYEE BENEFIT PLANS .............71

APPENDIX D—GOVERNMENT EMPLOYEE BENEFIT PLANS ...........73
Introduction

What is the purpose of this Audit Risk Alert?

This Audit Risk Alert is intended to help you plan and perform your employee benefit plan audits. The Alert addresses current industry developments and emerging practice issues and provides information on current auditing, accounting, and regulatory developments. Armed with a sound understanding of these areas allows you, among other things, to perform your audits in a more efficient and effective manner, and to deliver greater value to your clients through audit and related services.

Industry and Economic Developments

The need for individuals to provide for their own retirement continues. The use of the Internet to educate and manage retirement accounts has become more prevalent as plan sponsors continue to increase the number of investment options offered in defined contribution pension plans.

Economic Environment

How are employee benefit plans affected by the current conditions in the U.S. economy?

Statement on Auditing Standards (SAS) No. 22, Planning and Supervision (AICPA, Professional Standards, vol. 1, AU sec. 311), among other matters, points out some of the important considerations that should be addressed in the planning phase of the audit. One of those considerations is the need for auditors to understand the economic conditions affecting the industry in which the client operates. Economic activities relating to such factors as interest
rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market, are likely to have an impact on the entity being audited.

In April 2001 the federal funds rate (the interest rate at which banks lend to each other overnight) was reduced another half-point to 4.5 percent—this is down from 6.5 percent in the third quarter of 2000. This has been the fastest series of interest rate cuts seen in the past fourteen years with rates being lowered for the fourth time this year alone. Historically, as interest rates start to fall many plan administrators and investment managers adopt more aggressive investment strategies, such as directing a larger proportion of plan investments into higher yielding and higher risk investment vehicles including derivatives.

In addition, 2001 has seen much volatility in the stock market. With the economy continuing to slow, March 2001 saw the Dow Jones Industrial Average (DJIA) fall below the 10,000 mark for the first time since October 2000 and the National Association of Securities Dealers Automated Quotation (NASDAQ) lost almost 18 percent. Many defined benefit plans are finding that the decline in the stock market is "eating away" at their funding. If the market continues to decline, many defined benefit plan sponsors may need to make contributions to their plans.

Be alert to plan administrators moving away from the stock market and investing in harder-to-value securities such as real estate, limited partnerships, and derivatives. See the "Investment in Derivatives" section of this Alert for a discussion of certain derivative financial instruments.

Negative Elections

What are negative elections?

Defined contribution pension plans are making use of recent revenue rulings allowing for negative elections. A negative election is a plan provision where the plan sponsor enrolls a new employee or a current nonparticipating employee into the plan at a proscribed contribution deferral amount and into a proscribed investment option. Employees are provided notification informing them of the
right to opt out of the plan. If employees elect to remain in the plan, they are informed that they can modify the original investment election, the deferral percentage, or both. This is a popular mechanism for plans to encourage participation. However, plans should provide communications to employees. In addition, plans should be prepared for the additional fiduciary risk associated with those employees who do not opt out or do not direct how their contributions should be invested. For such participants, many plans specify a default investment. Before your client changes to negative elections, you may want to recommend they consult with their legal counsel regarding the increased fiduciary risk involved.

The Health Insurance Portability and Accountability Act

What is HIPAA and what new rules have been enacted?

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protection for those 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.

In August 2000 the administrative simplification provisions of HIPAA were enacted to improve the efficiency and effectiveness of the health care system by standardizing electronic data interchange while protecting the security and privacy of health care information, and reducing the costs and administrative burdens of health care.

In December 2000 the final rules on standards for privacy of individually identifiable health information were published in the Federal Register. The rules include standards to protect the privacy of individually identifiable health information. The rules (applicable to health plans, health care clearinghouses, and certain health care providers) present standards with respect to the rights of individuals who are the subjects of this information, procedures for the exercise of those rights, and the authorized and required uses and disclosures of this information. These are the first-ever national
standards to protect medical records and other personal health in-
formation. The new standards—

• Limit the nonconsensual use and release of private health
  information.

• Give patients new access to their records and let them know
  who else has accessed them.

• Restrict most disclosure of information to the minimum
  needed for the stated purpose.

• Establish criminal and civil sanctions.

• Establish requirements for access by researchers and others.

Providers will be required to obtain advance written consent from
their patients to disclose information and to provide those patients
with written information on their privacy rights.

The regulations were to take effect February 26; however, President
George W. Bush's Health and Human Services secretary agreed to
push the effective date back to April 14, 2001, to give lawmakers
more time to review the regulations and to decide whether they
should be changed. Health care providers will not be forced to fully
comply with the changes until April 14, 2003.

In response to this regulation, claim processors may be updating
and instituting a variety of confidentiality or indemnification
agreements to protect their organizations when third parties request
claim information. See the section "Confidentiality or Indemnifica-
tion Letters" in the "Health and Welfare Benefit Plan Issues" section
of this Alert for further information.

**PWBA Issues Final Rules to Strengthen Workers' Health
Benefit Rights**

On November 21, 2000, the Pension and Welfare Benefits Admin-
istration (PWBA) published two new rules aimed at ensuring that
workers receive quick processing of health insurance claims and
timely decisions on appeals when claims are denied.
First, the agency published a final rule, the first of its type in twenty years, to ensure plan participants a timely, fair internal review when they have a grievance against their health plan and an expedited review for urgent claims. The new rule covering the Employee Retirement Income Security Act (ERISA)-governed health plans—

- Requires timely coverage and appeal decisions.
- Provides meaningful information to patients about their rights under the appeals process.
- Creates a more fair process to review decisions to deny benefits.

The final rule provides for—

- Faster decisions on initial claims and appealed claims, with time frames based on whether the claims are pre-service or post-service.
- Special rules requiring expeditious consideration of claims involving “urgent care.”
- More time for patients to appeal denied health claims.
- Different decision maker to handle appeals.
- Consultation with relevant health care professionals in making decisions about appeals that involve medical judgment.
- Enforcement of claimants’ rights through the court.
- Timely action on “concurrent care reviews” for patients receiving a course of treatment who face early termination of benefits or have a need to extend treatment.
- Enhanced disclosure, including a full decision of the plan’s claim procedures.
- More information about the reasons for a denied claim and the criteria and rules applied by the plan.

In addition, the PWBA issued final amendments to its regulation governing the contents of summary plan descriptions to update and clarify specifically what information must be disclosed to workers
and their families about their health plans. The final rule covers plan
descriptions that affect both pension and welfare benefit plans. It fur­
ther adopts in final form regulations that were effective on an interim
basis implementing certain amendments to ERISA’s disclosure rules
that were enacted as part of the HIPAA and the Newborns’ and
Mothers’ Health Protection Act.

Executive Summary—Industry and Economic Developments

• Be alert to the economic environment, such as the decline in interest
  rates and the volatility of the stock market, and how such economic
  activity may affect employee benefit plans.

• Negative elections are becoming more prevalent. Be aware that they
do carry some fiduciary risk.

• The final rules on privacy standards have been issued.

• The PWBA published new rules on the processing of health insur­
  ance claims and timely decisions on appeals when claims are denied.

Regulatory Developments

2000 Form 5500 Series

What’s new for plan year 2000?

The Department of Labor (DOL), Internal Revenue Service (IRS),
and the Pension Benefit Guaranty Corporation (PBGC) have re­
leased the 2000 Form 5500 return/reports, schedules, and instruc­
tions to be used by employee benefit plans for plan year 2000
filings. The IRS has also released the Form 5500-EZ return and in­
structions to be used by certain one-participant retirement plans
for plan year 2000 filings.

The Form 5500 and Form 5500-EZ for plan year 2000 remain
essentially unchanged from 1999, except for certain changes
made to reflect changes in the law, improve forms processing, and
clarify the instructions. These include, among other things—

• Replacement of the “green drop out ink” used in the 1999
  Form 5500 and Form 5500-EZ “hand print” forms with eas­
er to read “gray drop out ink” versions.
• Inclusion in the instructions of an expanded list of tips to help filers reduce the likelihood of filing errors under the ERISA Filing Acceptance System (EFAST).

• The ability to complete the 2000 hand print form using EFAST approved software.

• Clarification for master trusts that hold assets attributable to participant or beneficiary directed transactions under individual account plans that these assets may be treated as a single master trust investment account if certain conditions are met.

• Clarification that administrators of large plans and direct filing entities (DFEs) that participate in common/collective trusts (CCTs) and pooled separate accounts (PSAs) are entitled to reporting relief on Schedule H of their Form 5500 filings only if the CCT or PSA file a Form 5500.

In March 2001, the IRS mailed the annual Form 5500 and Form 5500-EZ package to filers.

Help Desk—Information copies of the forms, schedules and instructions are available on PWBA's Web site at www.efast.dol.gov. Filers may also order forms and IRS publications twenty-four hours a day, seven days a week, by calling 800-TAX-FORM (800-829-3676). The list of approved software vendors on the EFAST Web site will be updated as software is approved for plan year 2000 filings. For assistance, filers may also contact PWBA's Help Desk toll-free at (866) 463-3278.

When plan annual reports are filed electronically, the DOL encourages attachments to the electronic form (for example, certain applicable supplemental schedules) to be submitted in a single Adobe Portable Document format (PDF); however, data can be submitted in a single file or multiple files in any of the following formats:

• ASCII/EBCIDIC Character (text) format
• Microsoft Word Document format
• Corel Wordperfect Document format
• Adobe PDF
• Hypertext-Markup Language (HTML) format
• Microsoft Excel format
• Lotus 1-2-3 format

Here are some final helpful hints:

• Remember to have the appropriate individuals sign the Form 5500.

• Do not bind or attach the audit report and financial statements.

• Make sure you, as auditor, review and retain a printout of the electronic version being filed.

**EFAST Computerized Filing System**

*How do you file the Form 5500?*

On July 1, 2000, the DOL took over the processing responsibilities for the Form 5500 and Form 5500-EZ from the IRS. The DOL has developed a new computerized system that will simplify and expedite the receipt and processing of the Form 5500 by relying on computer scannable forms and electronic filing technologies. This system, called the ERISA Filing Acceptance System (EFAST), will reduce government and filer costs associated with filing, receiving, and processing annual reports.

EFAST processes the Form 5500 in two computer scannable formats: *machine print* and *hand print* (the questions are the same, only the appearance is different). Except for those who file electronically, use of computer scannable forms continues to be mandatory for 2000 plan year reports. Filers can choose a machine print format that utilizes computer software to complete the Form 5500. The machine print forms can be filed electronically, or they may be printed out on computer printers and mailed to the DOL's processing center in Lawrence, Kansas. The printed form will include a computer scannable 2D bar code on the bottom of each page for expedited processing. Plans interested in using the machine print version of the Form 5500 will need to use EFAST approved software.
Help Desk—Check the DOL's EFAST Web site at www.efast.dol.gov for more information regarding the machine print forms and electronic filing.

Filers may also choose a hand print format to complete their Form 5500 by hand or typewriter. However, the hand print format can be filed only by mail (including certain private delivery services) to the DOL's processing center in Lawrence, Kansas. The 2000 hand print version of the Form 5500 is printed in “gray ink,” and may be completed using EFAST approved software.

Help Desk—The gray ink hand print forms will be available in the Form 5500 package mailed by the IRS and will also be available 24 hours a day, 7 days a week, by calling 800-TAX-FORM (800-829-3676).

DOL Non-Enforcement of GAAP Disclosures of Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans

What should the auditor's report look like when a qualified or adverse opinion was issued on prior-year financial statements that are being restated in the current period to conform to GAAP?

Annual reports of multiemployer welfare benefit plans filed for plan years commencing on or after January 1, 2000, are now subject to rejection by the PWBA if there is any material qualification in the accountant's opinion accompanying the annual report due to a failure to comply with the requirements of SOP 92-6, Accounting and Reporting by Health and Welfare Benefit Plans. The proposed non-enforcement policy affecting Form 5500s filed by multiemployer welfare benefit plans was not adopted by the PWBA.

To ensure that multiemployer welfare plans had an adequate opportunity to prepare their financial record keeping and other related systems to comply with SOP 92-6, the PWBA stated that these plans could continue to rely on its previously announced interim non-enforcement relief for their 1999 Form 5500 reports. Auditors should note, however, that SOP 92-6 requires restate­ment of prior-period financial statements only if they are presented together with the current year's financial statements. Therefore, be-
cause ERISA requires comparative statements of net assets available for benefits, when adopting SOP 92-6 for plan year 2000 it will be necessary to restate the 1999 statement of net assets to comply with provisions of SOP 92-6.1

Help Desk—In April 2001 the AICPA issued SOP 01-2, Accounting and Reporting by Health and Welfare Benefit Plans, which amends SOP 92-6. For a further discussion of this SOP see the “New AICPA Statement of Position for Health and Welfare Benefit Plans” section in this Alert.

Employee health and welfare benefit plans that prepare financial statements in accordance with generally accepted accounting principles (GAAP) must follow the accounting and reporting requirements set forth in chapter 4, “Accounting and Reporting by Health and Welfare Benefit Plans,” of the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, which incorporates the guidance of SOP 92-6.

Among other requirements, SOP 92-6 requires 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. Accounting changes adopted to conform to the provisions of the SOP should be made retroactively.

SAS No. 58, Reports on Audited Financial Statements (AICPA, Professional Standards, vol. 1, AU sec. 508.68-.69), provides guidance on when an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of prior periods because of a departure from GAAP and the prior-period financial statements are restated in the current period to conform with GAAP. SAS No. 58 requires the auditor’s updated report on the financial statements of the prior period to indicate that the statements have been restated and to express an opinion with respect to

---

1. If accounting changes were necessary to conform to the provisions of Statement of Position (SOP) 92-6, Accounting and Reporting by Health and Welfare Benefit Plans, that fact should be disclosed when financial statements for the year in which the SOP is first applied are presented either alone or with financial statements of prior years.
the restated financial statements. Further, when the updated report has an opinion different from the opinion previously expressed on the prior-period financial statements, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) preceding the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose—

1. The date of the auditor's previous report.
2. The type of opinion previously expressed.
3. The circumstances or events that caused the auditor to express a different opinion.
4. That the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements.

If a plan does not adopt all 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.2 SAS No. 58 describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from generally accepted accounting principle (AICPA, Professional Standards, vol. 1, AU sec. 508.35-.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.

2. In April 2001 the AICPA Accounting Standards Executive Committee issued SOP 01-2, Accounting and Reporting by Health and Welfare Benefit Plans. This SOP allows the information about benefit obligations to be presented in a note to the financial statements. See the section "New AICPA Statement of Position for Health and Welfare Benefit Plans" of this Audit Risk Alert for a further discussion of this SOP.
Small Pension Plan Security Regulation

On October 19, 2000, the PWBA published a final rule to improve the security of the more than $300 billion in assets held in private-sector pension plans maintained by small businesses. In recent years, considerable public attention has focused on the potential vulnerability of small plans to fraud and abuse. Although such circumstances are rare, the DOL decided it was appropriate to strengthen the security of pension assets and the accountability of persons handling those assets.

Historically, pension plans with fewer than 100 participants have been exempt from the requirement to have an independent audit of the plan's financial statements. This new regulation, designed to safeguard small pension plan assets by adding new conditions to the audit waiver requirement which focus on persons who hold plan assets, enhances disclosure to participants and beneficiaries, and improves bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation.

Under the new regulation, the administrator of an employee pension benefit plan with fewer than 100 participants as of the beginning of a plan year is not required to engage an independent auditor provided—

1. At least 95 percent of the assets of the plan constitute "qualifying plan assets" or any person who "handles" assets of the plan that do not constitute qualifying plan assets is bonded in accordance with section 412 of ERISA and DOL regulation 29 CFR 2580.412-6.

2. Certain required disclosures are made in the plan's summary annual report.

According to the PWBA, the vast majority of the assets of small plans are "qualifying plan assets." The PWBA believes that the plans that do not meet the 95 percent threshold will opt for the less expensive bonding alternative to avoid an independent audit of the plan's financial statements.
Definition of Qualifying Plan Assets

For purposes of this new regulation, the term “qualifying plan assets” means:

- Qualifying employer securities, as defined in section 407(d)(5) ERISA and the regulations issued thereunder
- Any loan meeting the requirements of section 408(b)(1) of ERISA and the regulations issued thereunder
- Any assets held by any of the following institutions:
  - A bank or similar financial institution as defined in section 2550.408b-4(c)
  - An insurance company qualified to do business under the laws of a state
  - An organization registered as a broker-dealer under the Securities Exchange Act of 1934
  - Any other organization authorized to act as a trustee for individual retirement accounts under section 408 of the Internal Revenue Code
- Shares issued by an investment company registered under the Investment Company Act of 1940
- Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state
- In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished, at least annually, a statement from a regulated financial institution describing the assets held (or issued) by such institution and the amount of such assets

Disclosure Requirements

The exemption from the audit requirement for small pension plans is further conditioned on the disclosure of certain information to participants and beneficiaries. Specifically, the summary annual re-
port (SAR) of a plan electing the waiver must include, in addition to any other required information—

- The name of each regulated financial institution holding (or issuing) qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year (except for qualifying plan assets, as previously described).

- The name of the surety company issuing the bond, if the plan has more than 5 percent of its assets in nonqualifying plan assets.

- A notice indicating that participants and beneficiaries may, upon request and without charge, examine, or receive copies of, evidence of the required bond and statements received from the regulated financial institutions describing the qualifying plan assets.

- A notice stating that participants and beneficiaries should contact the regional office of the PWBA if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond, as applicable.

In response to a request from any participant or beneficiary, the administrator, without charge to the participant or beneficiary, must make available for examination, or upon request furnish copies of, each regulated financial institution statement and evidence of any bond required.

Effective Date

The amendments made by this final rule are applicable as of the first plan year beginning after April 27, 2001. This date was chosen to give the employee benefit plan community more time to comply with the new requirements. Accordingly, this change applies to the 2001 year filings for fiscal year filers whose plan years begin after April 27, 2001, and the 2002 filings for calendar year filers.

PWBA Review of Plan Audits

The PWBA has established an ongoing quality review program to assess the quality of audit work performed by independent audi-
tors in audits of plan financial statements that are required by 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. Because ERISA holds plan administrators responsible for assuring that plan 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 continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA’s reporting and disclosure requirements. The DOL has established a major performance goal that no more than 12 percent of employee benefit plan audits contain deficiencies with professional and regulatory standards and no more than 3 percent of Form 5500 filings contain reporting and disclosure deficiencies. The PWBA plans to conduct a nationwide study to once again assess the quality of employee benefit plan audits and evaluate compliance with its goal.

Section 401(k) Plan Fees

On July 15, 1999, the DOL joined representatives of the American Bankers Association (ABA), the American Council of Life Insurance (ACLI), and the Investment Company Institute (ICI) to release new 401(k) fee disclosure tools. These new tools will help employers, especially small employers, understand the investment fees and expenses which are charged to 401(k) retirement plans. The “401(k) Plan Fee Disclosure Form” features a flexible format which employers can use in whole or in part, depending on the type of plan investments and services. In addition, the form provides employers with a handy way to make cost-effective decisions and compare the investment fees and administrative costs of competing providers of plan services. The 401(k) fee form contains basic information employers may use in calculating and accounting for the total costs of operating a plan. It contains—

- An overview of the purpose of the form and general description on calculating 401(k) fees.
• A schedule which summarizes the total plan fees and expenses.
• Additional schedules providing information on investment product fees and estimates, plan administration expenses, one-time start-up and conversion expenses and service provider termination expenses.

Also, a DOL pamphlet, "A Look at 401(k) Fees For Employers," highlights the overall obligations employers must fulfill in operating a plan. The pamphlet, which employers may use in conjunction with the form, describes the various fiduciary standards they must comply with under federal pension law. The pamphlet lists ten basic questions employers should answer in considering fees and expenses paid for services. This includes employers' obligation to assure that fees paid by 401(k) plans are reasonable.

Help Desk—Both the form and publication are available through the department's Web site at www.dol.gov/dol/pwba or at the Web sites of any of the following organizations: www.aba.com, www.acli.com, www.ici.org. The public may also obtain this material from the American Bankers Association at (800) 338-0626.

Investment expenses in defined contribution plans, particularly 401(k) plans, normally include administrative fees (such as record-keeping, voice response systems, daily valuations, legal, trustee, and accounting services); investment fees (such as management fees which are normally a percentage of the assets invested, and sales charges or loads which are transaction charges); and additional fees (such as loan initiation charges). Some of these expenses are netted against investment earnings (for example, investment management fees), while others are charged as administrative expenses that are then allocated proportionately to participant accounts or charged as a flat fee per participant. These fees may be "bundled" when all such services are provided by one service provider, or "unbundled" when more than one service provider is utilized. Additionally, the nature of the investment vehicle may modify the types of expenses encountered (certain expenses may be charged at the investment vehicle level and not by the plan itself). For example—
• Mutual funds will often have sales charges (such as front-end load—paid when you invest in a fund, or back-end load, which is more like an early redemption fee, based on the actual time the fund was held). Mutual funds may also charge rule 12b-1 fees, which are fees paid from plan assets for commissions to brokers, advertising, or other promotional costs, and service provider fees. A “no load” fund will indicate that there are no sales charges; however, there could still be 12b-1 fees.

• Collective investment funds offered by banks and trust companies do not have sales charges; however, they do have investment management and administrative fees.

• Pooled guaranteed investment contracts offered primarily by insurance companies have investment management and administrative expenses.

• Variable annuity contracts offered by insurance companies normally “wrap” an annuity contract around investment options, such as mutual funds. Participants invest in these investment options. In addition, there are insurance elements present in these arrangements such as interest return guarantees, death benefits, and annuity features. Expenses include investment management and administrative expenses, and may also include surrender or transfer charges upon withdrawal before the contract expires and insurance related charges which could include sales charges, costs of issuing contracts, and mortality risk charges.

Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the PWBA

The PWBA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are required to be remitted as soon as they can reasonably be segregated from an employer’s general assets. DOL regulations require employers who sponsor pension
plans (both defined benefit and defined contribution) to remit employee contributions as soon as practicable, but in no event more than 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 regulation establishes a procedure by which an employer may obtain an extension of the fifteen-business-day limit for an additional ten business days. This regulation does not change the maximum period for remittance of employee contributions to welfare plans; as soon as practicable, but in no event more than 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. GAAS requires that the auditor’s report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules when they are presented along with the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements, or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See chapter 11, “Party in Interest Transactions,” of the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans for further discussion of prohibited transactions.

Help Desk—For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 219-7461.
PWBA Outreach and Customer Service Efforts

Whom should you call if you have ERISA or Form 5500 preparation questions?

The 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 PWBA's EFAST Help Desk at their new toll-free number, (866) 463-3278.

In addition to handling technical telephone inquiries, the 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. This year, the DOL's outreach efforts will feature the 2000 Form 5500, the EFAST Processing System, and other agency-related developments. 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 the PWBA at its Web site at www.dol.gov/dol/pwba. The Web site also provides information on PWBA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Delinquent Filer Voluntary Compliance Program

What is the DFVC 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 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.

The DFVC Program has two components. Under the first component eligible administrators are required to file the delinquent annual report. For administrators of apprenticeship and training plans and "top hat" plans, this requirement is satisfied by, respectively, fil-
ing the notice described in 29 CFR 2520.104-22 and the statement described in 29 CFR 2520.104-23.

Under the second component of the DFVC Program, filers must send the applicable penalty amount along with the first page of the Form 5500 Series to: DFVC Program, PWBA, P.O. Box 277025, Atlanta, GA 30384-7025. Because of the recent revisions to the Form 5500 Series, the information needed to process the DFVC filing is no longer confined to the first page of the revised Form 5500. Accordingly, filers who are using the 1999 or a subsequent version of the form should include a copy of all the pages of the Form 5500 (dated with original signature(s) but without any schedules and attachments). Administrators of apprenticeship and training plans and “top hat” plans filing under section 4 of the DFVC Program who are using a 1999 or a subsequent version of the form should sign and date the Form 5500 and complete lines 1a-1c, 2a-2c, 3a-3c, and 8a or 8b as applicable.

Help Desk—Questions concerning the DFVC Program should be directed to the PWBA’s Division of Reporting Compliance at (202) 219-8818. Practitioners and other members of the public may also wish to contact the PWBA at its Web site at www.dol.gov/dol/pwba.

Other Current Matters

What other PWBA matters should you be aware of?

PWBA Guidance on Insurance Company Demutualization

On February 15, 2001, the PWBA issued a letter regarding alternatives available under the trust requirement of Title I of ERISA with respect to receipt by policyholders of demutualization proceeds belonging to an ERISA-covered plan in connection with the proposed plan of demutualization of an insurance company (the Company).

In its letter, the DOL noted that the application of ERISA’s trust requirements would depend on whether demutualization proceeds received by a policyholder constitute plan assets. The DOL stated that, in the case of an unfunded or insured welfare plan in which participants pay a portion of the premiums, the portion of the de-
mutualization proceeds attributable to participant contributions must be treated as plan assets. In the case of a pension plan, or where any type of plan or trust is the policyholder or where the policy is paid for out of trust assets, the DOL stated that all of the proceeds received by the policyholder in connection with the demutualization would constitute plan assets. (Also see the Financial Accounting Standards Board [FASB] Emerging Issues Task Force [EITF] Issue No. 99-4, Accounting For Stock Received from the Demutualization of a Mutual Insurance Company.)

The DOL, in describing the alternatives available to policyholders of the Company, stated that:

Consistent with the provisions of section 403, policyholders receiving demutualization proceeds constituting plan assets could place those assets in trust until appropriately expended in accordance with the terms of the plan. Alternatively, the DOL believes that, prior to or simultaneous with the distribution of demutualization proceeds constituting plan assets, such assets could be applied to enhancing plan benefits under existing, supplemental or new insurance policies or contracts; applied toward future participant premium payments; or otherwise held by the insurance company on behalf of the plan without violating the requirements of section 403.

Further, in recognition of the unique circumstances giving rise to the distribution of plan assets to policyholders in conjunction with the Company’s demutualization, the DOL has determined that, pending the issuance of further guidance, it will not assert a violation in any enforcement action solely because of a failure to hold plan assets in trust, provided that: such assets consist solely of proceeds received by the policyholder in connection with the demutualization; such assets, and any earnings thereon, are placed in the name of the plan in an interest-bearing account, in the case of cash, or custodial account, in the case of stock, as soon as reasonably possible following receipt and such proceeds are applied for the payment of participant premiums or applied to plan benefit enhancements or distributed to plan participants as soon as reasonably possible but no later than twelve (12) months following receipt; such assets are subject to the control of a designated plan fiduciary; the plan is not otherwise re-
quired to maintain a trust under section 403 of ERISA; and the
designated fiduciary maintains such documents and records as
are necessary under ERISA with respect to the foregoing.

The letter also stated that, with respect to plans satisfying the fore­
going, the DOL would not assert a violation in any enforcement
proceeding or assess a civil penalty with respect to such plans be­
cause of a failure to meet the reporting requirements by reason of
not coming within the limited exemptions set forth in 29 CFR sec­
tions 2520.104-.120 and 2520.104-.144 solely as a result of receiv­
ing the Company’s demutualization proceeds which may be, in
whole or in part, plan assets.

Help Desk—Copies of the Department’s information letter
are available on the PWBA’s Web site at www.dol.gov/dol/

2000 Form M-1 for Multiple Employer Welfare Arrangements

On December 13, 2000, the PWBA published in the Federal Register
the year 2000 Form M-1 annual report for multiple employer wel­
fare arrangements (MEWAs). This form is the same as the 1999
form, but several clarifications were added to the instructions in re­
sponse to comments.

Generally MEWAs are arrangements that offer medical benefits to
the employees of two or more employers, or to their beneficiaries.
These arrangements may not include plans that are established or
maintained under collective bargaining agreements, by a rural elec­
tric cooperative, or by a rural telephone cooperative association.

The DOL has authority under the HIPAA to require reporting of
information about MEWAs. Administrators generally must file the
one-page Form M-1 once a year. The year 2000 form is generally
due March 1, 2001, but administrators can request an automatic
sixty-day extension to May 1, 2001.

Help Desk—The year 2000 Form M-1 is available by calling
PWBA’s toll-free publications hotline at (800) 998-7542 and is
available on the Internet at www.dol.gov/dol/pwba. Administra­
tors may contact the PWBA Help Desk for assistance in com­
pleting this form by calling (202) 219-8818.
DOL Voluntary Fiduciary Correction Program

On March 15, 2000, the DOL adopted the Voluntary Fiduciary Correction (VFC) Program, which will help plan officials quickly and completely correct certain employee benefit plan violations.

The PWBA has authority to bring civil enforcement actions and assess monetary penalties for violations of ERISA. The VFC Program lays out procedures, the types of transactions covered by the program, and acceptable corrective actions that do not require consultation or negotiation with the department.

Any plan official, sponsoring employer, or parties to affected transactions may apply to voluntarily correct violations covered by the program. In order to qualify for the program, applicants must fully undo any prohibited transactions, calculate any losses and restore any losses with interest or profits, and distribute any supplemental benefits owed to eligible participants and beneficiaries.

A notice must be given to participants advising them of corrected violations.

Transactions eligible for the program include the following:

- Repayment of delinquent employee contributions
- Certain prohibited loans
- Loans with inadequate collateral or security
- Certain improper sales or purchases, including prohibited transactions
- Improper valuation of assets which affects benefits
- Payment of excessive or duplicate plan expenses

Applicants who fully comply with all of the terms and procedures of the VFCP will receive a “No-Action Letter” from the PWBA. The agency does, however, reserve the right to conduct investigations to determine truthfulness, completeness, and full correction. Full correction under the department’s program will not give applicants relief from actions by other governmental agencies.
The PWBA may conduct investigations to determine compliance with the program and verify that corrective action has been taken. However, applicants who fail to fully correct fiduciary violations will be rejected and become subject to enforcement action and civil penalties. In addition, persons involved in pending investigations or criminal violations cannot take advantage of the program.

Help Desk—Information regarding the VFC Program is available on the PWBA's Web site at www.dol.gov/dol/pwba. Persons should telephone the PWBA regional in their area with any questions about the application process. These telephone numbers may be found on the PWBA's Web site at www.dol.gov/dol/pwba/public/contacts/folist.htm.

PWBA Orphan Plan Initiative

The PWBA has initiated a program in which it intends to play a proactive role in locating orphan plans and, if necessary, appoint fiduciaries to manage and distribute employee benefit plan assets to participants. This initiative provides a new tool to take action when designated fiduciaries are no longer present or otherwise unable to perform or are recalcitrant in executing their fiduciary responsibilities.

Orphan plans are ERISA-covered pension and welfare plans with plan assets that have been abandoned by their employer-sponsors or fiduciaries. Indications of an abandoned plan may include the absence of fiduciaries to handle plan affairs, the lack of any fiduciary activity for an extended period of time, the nonfiling of annual reports, the incarceration of plan fiduciaries, the plan sponsor’s filing for bankruptcy, the death of fiduciaries, the plan’s nonpayment of third-party administrator (TPA) or service provider fees, the inability of plan participants to exercise their rights guaranteed under ERISA and the plan document, and the negligence of plan fiduciaries to perform their duties.

The objectives of the project are to—

• Locate orphan plans which have been abandoned by fiduciaries as a result of death, neglect, bankruptcy, or incarceration.
• Determine if the fiduciary is available to make fiduciary decisions such as the termination of the plan and the distribution of the plan assets.

• Require fiduciaries to perform their fiduciary duties, file appropriate compliance forms, and ensure that proper action is undertaken to protect and deliver promised benefits.

• Have the PWBA take an active role in the appointment of an independent fiduciary in the event that no other fiduciary is available.

PWBA's Rapid ERISA Action Team Project

In carrying out its responsibility to protect participants and beneficiaries' benefits, the PWBA has targeted populations of plan participants who are potentially exposed to the greatest risk of loss. One such group of individuals is participants and beneficiaries of plans whose sponsor has filed for bankruptcy.

The PWBA has pursued bankruptcy cases for a number of years; however, the PWBA typically does not become aware of a bankruptcy filing until it receives a participant complaint regarding the payment of benefits. This notice often comes too late for the PWBA to take any affirmative action.

The new Rapid ERISA Action Team (REACT) initiative will enable the PWBA to respond in an expedited manner to protect the rights and benefits of plan participants when a plan sponsor faces severe financial hardship or bankruptcy and the assets of the employee benefit plan are in jeopardy. In such situations, it is common to find employers holding assets that belong to or are owed to plans, occasionally intermingling those assets with the employers' own assets. When a plan sponsor faces severe financial hardship, the assets of any plans and the benefits of participants are placed at great risk. Due to the tight time frames and the intricacies of the bankruptcy laws, plan assets and employee benefits are often lost because of the plan fiduciaries' failure to timely identify pension plan contributions that have not been paid to the plan's trust. REACT will provide the PWBA with a dedicated staff to respond
to employer bankruptcies by ensuring that all available legal actions have been taken to preserve pension plan assets. Under REACT, when a company has declared bankruptcy the PWBA will take immediate action to ascertain whether there are plan contributions which have not been paid to the plan's trust, to advise all affected plans of the bankruptcy filing, and to provide assistance in filing proofs of claim to protect the plans, the participants, and the beneficiaries. The PWBA will also attempt to identify the assets of the responsible fiduciaries and evaluate whether a lawsuit should be filed against those fiduciaries to ensure that the plans are made whole and the benefits secured.

Executive Summary—Regulatory Developments

- The 2000 Form 5500 return/reports are available and remain essentially unchanged from last year.
- The DOL is using EFAST for processing the Form 5500. Make sure you are using the correct forms.
- The 2000 plan year annual reports of multiemployer welfare benefit plans are now subject to rejection by the PWBA if there is any material qualification in the accountant's opinion accompanying the report due to a failure to comply with the requirements of SOP 92-6.
- The final rule to improve the security of small pension plans was published in October 2000.
- The PWBA plans to conduct a nationwide study to once again assess the quality of employee benefit plan audits.
- 401(k) fee disclosure tools are available to help employers understand the investment fees and expenses charged to 401(k) retirement plans.
- The PWBA issued a letter regarding the receipt of demutualization proceeds belonging to an ERISA covered plan.
- The 2000 Form M-1 for MEWAs remains essentially unchanged from last year with several clarifications added to the instructions.
- On March 15, 2000, the DOL adopted the Voluntary Fiduciary Correction (VFC) program to help plan officials quickly and completely correct certain employee benefit plan violations.
- The PWBA has a new program to become proactive in locating orphan plans.
• The PWBA has a new initiative called the Rapid ERISA Action Team (REACT) to respond to protect the rights and benefits of plan participants when a plan sponsor faces severe financial hardship or bankruptcy.

Audit Issues

Self-Directed Investments

What are self-directed investments and how should they be reported?

The trend toward participant-directed defined contribution plans is taking a more aggressive turn as more plan sponsors allow participants to expand their control over investment decisions. Frequently, this is accomplished through self-directed investments sometimes referred to as self-directed brokerage accounts. These features allow participants to select any investment they choose without oversight from the plan administrator or investment committee. The only limitation is the availability of the desired investment through the plan's service provider, which generally is a securities broker-dealer or is a broker-dealer that has an alliance with the plan's service provider. (This is different from participant-directed investment fund options. Participant-directed investment fund options allow the participant to select from among various available alternatives and to periodically change that selection. The alternatives are usually pooled fund vehicles, such as registered investment companies [meaning, mutual funds]; commingled funds of banks; or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds.) The self-directed feature is often in addition to a more traditional array of risk diverse mutual funds and other investment option choices. Often plan sponsors may charge participants fees to provide this investment feature and may also require a minimum balance to be invested. Once offered to plan participants, the self-directed feature creates special considerations for the plan.

From a risk perspective, the plan's fiduciary risk accompanying investments is not mitigated automatically by simply allowing participants complete control over their investment choices. ERISA
section 404(c) offers plan administrators protection from fiduciary responsibilities arising from investments; however, compliance requires a thorough knowledge of the provisions of 404(c). Section 404(c) is not onerous to invoke but it does contain several compliance issues that are frequently overlooked, leaving many plans and named fiduciaries at risk.

Financial reporting for the self-directed feature is not difficult but often is not done properly as trustees and custodians often consolidate self-directed investments as a single fund option and the activity is sometimes reported as a one-line item (for example, transfer from self-directed investments). If this is the case, you should obtain the details to determine what investments are included in the self-directed investments and obtain the proper breakout of activity (for example, interest, and dividends). In fact, the investments are individual security transactions and must be aggregated by class of investment for purposes of reporting unrealized and realized gains and losses in the footnotes. In addition, individual investments must be detailed out on the Schedule H, line 4i—Schedule of Assets (Held At End of Year). This latter requirement can be tedious for plans that have many participants choosing to self-manage their investments.

The issues and risks associated with self-directed features are broader than explained here and include the investment education and savvy of participants. However, section 404(c) and proper financial reporting significantly reduce the plan’s risk and financial liability associated with the investments.

**Common Audit Adjustments**

*What audit adjustments are likely to be included on a summary of uncorrected misstatements?*

SAS No. 89, *Audit Adjustments*, was issued in December 1999 and is effective for audits of financial statements for periods beginning on or after December 15, 1999. SAS No. 89 amends three SASs to establish audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor. It also clarifies management’s responsibility for the disposition of financial statement misstatements brought to its attention.
Among other things, SAS No. 89 says that the management representation letter should include a representation related to management’s belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such uncorrected misstatements, if any, should be included in or attached to the management representation letter. Often plan sponsors do not keep general ledger records for their employee benefit plans. The financial statements for employee benefit plans are typically prepared using trial balances prepared by a trustee or custodian which are on a modified cash basis. As a result, there are often accrual type adjustments that need to be considered (depending on de-minimus levels) for inclusion on a summary of uncorrected misstatements.

The following are examples of common uncorrected misstatements (mainly relating to accruals) for employee benefit plans that should either be included in the financial statements at year end or included on the summary of uncorrected misstatements:

- For plans that pay their own administrative expenses, amounts paid after year end that pertain to the current year
- For defined benefit plans, employer contributions paid after year end that pertain to the current year (often amounts contributed above the minimum required are not considered in the accrual calculation when they should be)
- For defined contribution plans, company matching or profit sharing contributions that are paid after year end that pertain to the current year (often contributions paid once a year or quarterly are material and are usually recorded in the financial statements while contributions paid more frequently are more likely to not be accrued for in the financial statements)

3. If management believes that certain of the identified items are not misstatements, management’s belief may be acknowledged by adding to the representation. See Professional Standards, vol. 1, AU sec. 333.06, footnote 5, for illustrative wording.
• For defined contribution plans, employee contributions paid after year end that pertain to the current year (often these amounts are paid frequently [monthly or biweekly] and therefore are not accrued for in the financial statements)

• For defined contribution plans that use forfeitures to reduce contributions or expenses, forfeitures used after year end that pertain to the current year (for most plans, the use of forfeitures is not material and amounts may not be accrued for in the financial statements unless there were significant distributions of nonvested participant accounts in a given year)

• For defined contribution plans that fail discrimination testing, amounts paid into the plan by the employer or amounts paid back by the plan to participants in the following year to correct nondiscrimination testing failures for the current year (corrections made through paybacks to participants are typically lower [de-minimus] than corrections made through employer contributions and may not even be large enough to appear on the summary of uncorrected misstatements)

• For health and welfare benefit plans, the difference between the amount of claims incurred but not reported (IBNR) calculated by the actuary and the amount calculated by management

• For health and welfare benefit plans, any tax liability for unrelated business income for investments

• For health and welfare benefit plans, claims payable not properly accrued for

• For health and welfare benefit plans, activity that may occur through the plan only and not the trust (often only trust information is picked up, for example dental or vision activity)

Investment in Derivatives

What are some derivative financial instruments commonly found in employee benefit plans?

Employee benefit plans sometimes use derivatives as risk management tools to manage the risk stemming from fluctuations in foreign
currencies, interest rates, and other market risks, or as speculative investment vehicles to enhance earnings. As noted earlier, the recent decline in the stock market may prompt plan administrators to invest in higher yielding investments such as derivatives. The use of derivatives often increases audit risk. Chapter 3 of the AICPA Audit and Accounting Guide Audits of Investment Companies (new edition as of December 1, 2000) includes brief descriptions of certain financial instruments that may be helpful when such investments are used by employee benefit plans. The following is a description of some derivative financial instruments commonly found in employee benefit plans:

- **Call option**—A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price (strike price) at any time until the stated expiration date of the contract. The option, which is transferable, is bought in the expectation of a price rise above the strike price. If the price rises, the buyer exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There is a listed and also an over-the-counter market in options. During the existence of an option, the exercise price and underlying number of shares are adjusted on the exercise date for cash dividends, rights, and stock dividends or splits.

- **Forward foreign exchange contract**—An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.

- **Futures contract**—A transferable agreement to deliver or receive during a specific future month a standardized amount of a commodity of standardized minimum grade or a financial instrument of standardized specification under terms and conditions established by the designated contract market.

- **Guaranteed investment contract (GIC)**—Nontradeable contract that guarantees return of principal and a specific minimum rate of return on invested capital over the life of the
contract. Many contracts also provide for withdrawals of principal at par at specified dates and/or upon specified conditions before maturity. Most frequently used by pension and retirement plans where withdrawals are permitted to fund retirement benefits, payments to employees leaving the company, or transfers of benefits among investment options.

- **Put option**—A contract entitling the holder to sell (put), at his or her option, a specified number of shares or units of a particular security at a specified price (strike price) at any time until the contract's stated expiration date. The option, which is for a round lot and is transferable, is bought on the expectation that the price will decline below the strike price. If the price declines below the strike price, the buyer exercises or sells the option. If the price does not decline below the strike price, the buyer lets the option expire and loses only the cost of the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an over-the-counter option are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

- **Synthetic GICs**—An investment contract that simulates the performance of a traditional GIC through the use of financial instruments. (For more information regarding current accounting and financial reporting for GICs and synthetic GICs see paragraphs 7.40 and 7.41 of the Audit and Accounting Guide *Audits of Employee Benefit Plans*.)

In September 2000 the AICPA Auditing Standard Board (ASB) issued SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332). SAS No. 92 will help auditors plan and perform auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities. See the “Auditing Standards” section of this Alert for a further discussion of SAS No. 92.
Insurance Contracts With Participation

Many defined benefit plans have entered into transactions with insurance companies whereby group annuity contracts are purchased by the plan that may or may not meet the definition of a fully allocated contract. Determining whether contract assets and related obligations should be reported in the plan’s financial statements requires a careful review of the contract. Typical deposit administration contracts and immediate participation guarantee contracts are unallocated funding arrangements, and the value of these contracts generally should be included in a plan’s financial statements. Assets held in separate accounts are similarly reflected in the plan’s financial statements, because they are unallocated amounts held by the insurance company.

In some instances the contracts purchased are fully allocated (situations in which the obligation to pay defined benefits under the plan is assumed by the insurance company) but include a participating right in the assets held in the separate account of the insurance company. Accounting for these participation rights could differ depending on the circumstances surrounding the ability of the plan to actually withdraw the assets from the insurance company. The auditors should be aware that management may not have accounted for the purchase of the group annuity contracts appropriately and that assets belonging to the plan may not be appropriately recorded or adequately disclosed in the plan financial statements.

Health and Welfare Benefit Plan Issues

How should you audit benefit claims that are processed electronically?

Electronic Processing of Benefit Claims

Providers and claim administrators have been processing and sending health and prescription drug claims electronically for years. When claims are submitted electronically they are compared with the system parameters which have been programmed by the claim administrator based upon the plan’s specifications. If these system
parameters have not been programmed correctly, the claim may not be accurately processed.

Auditors should gain an understanding of the internal control surrounding the processing and payment of claims. Generally, the claims administrator is authorized by the plan to initiate, execute, and account for the processing of electronic claims without specific authorization of the transactions, there is a lower degree of interaction and it may not be practicable for the plan to implement effective controls over these transactions. The auditor may not be able to obtain an understanding of the components of internal control, relevant to such transactions, sufficient to plan the audit and to determine the nature, timing, and extent of tests to be performed without considering those components of internal control maintained by the claims administrator. This understanding can be efficiently achieved by obtaining and reading a report prepared in accordance with SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, for the claims administrator. 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, the engagement team should consider information available at the sponsor level about the controls at the claims administrator, including user manuals, system overviews, technical manuals, and reports from claims administrator's internal auditors. The audit may determine that it is necessary to conduct tests of the claims administrator's systems and procedures.

In addition to the above, the auditor should consider testing the eligibility data supplied to the claims administrator and review the accuracy of the system parameters (that is, the deductible or copay level, coinsurance, internal maximums, and so on, are in accordance with the plan specifications). The system parameters should also verify that referral or authorization, and negotiated fee arrangements with providers are followed. In order to determine the propriety of a claim in an electronic environment, the auditor should consider confirming the claims directly with the participants.
Confidentiality or Indemnification Agreements

As noted earlier, in response to the new HIPAA regulations (see the section "The Health Insurance Portability and Accountability Act") claim processors may be updating and instituting a variety of confidentiality or indemnification agreements to protect the organization when third parties request claim information. Many third-party administrators that process health and welfare claims for plan administrators do not have a report on their internal control prepared in accordance with SAS No. 70 as amended. It may be necessary for the auditor to request access to the third-party administrator’s records to test claim transactions in order to obtain sufficient evidence to achieve the audit objectives. In many instances, a third-party administrator will request that the auditor enter into a confidentiality or indemnification agreement signed by the auditor, third-party administrator, and plan sponsor relating to the claims testing. Auditors need to take special care in reviewing these agreements. Often the auditor may not agree with certain language in the agreement, resulting in delays in the audit while mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. Auditors need to keep in mind the testing of claims at a third-party administrator could be delayed as a result of the request to sign such an agreement and should plan the timing of the audit accordingly. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor’s legal counsel. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, a scope limitation could result.

Plan Mergers

As a result of the recent flurry in corporate actions, there has been a significant increase in defined contribution plan merger trans-
actions. Paragraphs 12.11 to 12.14 in the Audit and Accounting Guide *Audits of Employee Benefit Plans* detail suggested auditing procedures when testing plan mergers. Careful consideration should be given to reconciling net assets from the former plan to the current plan. For example, participant loans are often excluded in error from the reconciliation of net assets transferred. In addition, record-keepers and custodians may record certain merger transactions using dates that are conducive to system limitations versus using the actual trade date of the transaction.

Many times a portion of a plan is transferred to another plan instead of a complete plan merger. The auditor should make sure the composition of the balances transferred in or out follows management’s intention. For example, if a whole division is to be transferred, the auditor can perform full and false inclusion testing from the listing of participants to be transferred to the divisional payroll register.

Significant merger activity is also occurring in the multiemployer plan area. Local unions are merging into district councils or other regional affiliations. As a result, mergers are taking place for the affiliated pension plans, health and welfare plans, and other jointly trustees plans. The auditor should insure that all assets are transferred to the surviving plan and that proper action is taken to close out the old plan or plans. Coordination of effort between the administrators, actuaries, attorneys, and auditors of the plans is necessary.

**AICPA Peer Review Developments**

*What are some recurring deficiencies found in employee benefit plan audits?*

The AICPA, working with the PWBA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans, and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of license.
Some common recurring deficiencies noted by the AICPA Peer Review Board\(^4\) in its review of employee benefit plans follow:

- Inadequate testing of participant data
- Inadequate testing of investments, particularly when held by outside parties
- Inadequate disclosures related to participant-directed investment programs
- Failure to understand testing requirements on a limited-scope engagement
- Inadequate consideration of prohibited transactions
- Incomplete description of the plan and its provisions
- Inadequate or missing disclosures related to investments
- Failure to properly report on a DOL limited-scope audit
- Improper use of limited scope exemption because financial institution did not qualify for such an exemption
- Inadequate or missing disclosures related to participant data
- Failure to properly report on and/or include the required supplemental schedules relating to ERISA and DOL

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* provides guidance concerning areas where the Peer Review Board noted deficiencies.

**Executive Summary—Audit Issues**

- More plan sponsors are allowing self-directed accounts which creates special considerations for the plan.
- SAS No. 89, *Audit Adjustments*, is now effective. A summary of uncorrected misstatements, if any, is required to be included in or attached to the management representation letter.

\(^4\) Taken from the 1999/2000 AICPA Peer Review Board Oversight Task Force Report and Comments.
• The recent decline in the stock market may prompt plan administra-
tors to invest in higher yielding investments such as derivatives.
• Health and prescription drug claims are typically processed electron­
ically which makes auditing these claims more difficult.
• Increasingly, third-party administrators are requesting auditors to
enter into confidentiality or indemnification agreements.

New Auditing and Attestation Pronouncements

What new auditing and attestation pronouncements have been
issued recently?

Auditing Standards

In this section we present brief summaries of auditing pro-
nouncements issued since the publication of last year’s Alert ap-
plicable to employee benefit plans. The executive summary at the
end of this section includes a listing of all auditing pronounce-
ments issued since the publication of last year’s Alert. The sum-
maries are for informational purposes only and should not be
relied on as a substitute for a complete reading of the applicable
standard. For information on auditing pronouncements issued
subsequent to the writing of this Alert, please refer to the AICPA
You may also look for announcements of newly issued standards
in the CPA Letter and Journal of Accountancy.

SAS No. 92, Auditing Derivative Instruments, Hedging
Activities, and Investments in Securities

In September 2000 the AICPA Auditing Standards Board (ASB)
issued SAS No. 92, Auditing Derivative Instruments, Hedging Ac-
tivities, and Investments in Securities. SAS No. 92 helps auditors
plan and perform auditing procedures for financial statement as-
sertions about derivative instruments, hedging activities, and in-
vestments in securities. SAS No. 92 supersedes SAS No. 81,
Auditing Investments (AICPA, Professional Standards, vol. 1, AU
sec. 332). The guidance in the SAS applies to—
• Derivative instruments, as that term is defined in FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities.

• Hedging activities in which the entity designates a derivative or a nonderivative financial instrument as a hedge of exposure for which FASB Statement No. 133 permits hedge accounting.

• Debt and equity securities, as those terms are defined in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.

For a more detailed summary of SAS No. 92 see Audit Risk Alert—2000/01 (Product No. 022260) or the AICPA Web site at www.aicpa.org. SAS No. 92 is effective for audits of financial statements for fiscal years ending on or after June 30, 2001. Early application of the SAS is permitted. The ASB also has developed a companion Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities (new edition as of March 15, 2001) (Product No. 012520) to help practitioners implement the new SAS.

SAS No. 93, Omnibus Statement on Auditing Standards—2000

Issued by the ASB in October 2000, SAS No. 93, Omnibus Statement on Auditing Standards—2000 (AICPA, Professional Standards, vol. 1, AU secs. 315, 508, and 622)—

1. Withdraws SAS No. 75, Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement (AICPA, Professional Standards, vol. 1, AU sec. 622). The guidance in SAS No. 75 was incorporated in AT section 201, “Agreed-Upon Procedures Engagements,” in Statement on Standards for Attestation Engagements (SSAE) No. 10, Attestation Standards: Revision and Recodification (AICPA, Professional Standards, vol. 1, AU secs. 101-701), to consolidate the guidance on agreed-upon procedures engagements in professional standards. The withdrawal of SAS No. 75 is concurrent with the effective date of SSAE No. 10, which is effective for
agreed-upon procedures engagements for which the sub-
ject matter or assertion is as of or for a period ending on or
after June 1, 2001, with earlier application permitted.

2. Amends SAS No. 58, *Reports on Audited Financial State-
ments*, to include an identification in the auditor's report of
the country of origin of the accounting principles used to
prepare the financial statements and the auditing standards
that the auditor followed in performing the audit. This
amendment withdraws Auditing Interpretation No. 13,
"Reference to Country of Origin in the Auditor's Standard
vol. 1, AU sec. 9508.53-.55). This amendment is effective
for reports issued or reissued on or after June 30, 2001, with
earlier application permitted.

3. Amends SAS No. 84, *Communications Between Predecessor
and Successor Auditors* (AICPA, *Professional Standards*,
vol. 1, AU sec. 315), to clarify the definition of a predecessor au-
ditor. This amendment is effective for audits of financial
statements for periods ending on or after June 30, 2001,
with earlier application permitted.

**SAS No. 94, The Effect of Information Technology on the
Auditor’s Consideration of Internal Control in a Financial
Statement Audit**

Issued by the ASB in May 2001, SAS No. 94, *The Effect of Infor-
mation Technology on the Auditor’s Consideration of Internal Control
1, AU sec. 319), amends SAS No. 55, *Consideration of Internal
Control in a Financial Statement Audit* (AICPA, *Professional Stan-
dards*, vol. 1, AU sec. 319), to—

1. Incorporate and expand on the concept from SAS No. 80,
*Amendment to Statement on Auditing Standards No. 31, Evi-
326.14), that in circumstances where a significant amount of
information supporting one or more financial statement as-
assertions is electronically initiated, recorded, processed, and reported, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to reduce the assessed level of control risk.

2. Describe how information technology (IT) may affect internal control, evidential matter, and the auditor's understanding of internal control and assessment of control risk.

3. Describe both benefits and risks of IT to internal control, and how IT affects the components of internal control, particularly the control activities and information and communication components.

4. Provide guidance to help auditors determine whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the controls, or to design and perform audit procedures.

5. Clarify that in obtaining an understanding of the financial reporting process, the auditor should understand how both standard, recurring entries and nonstandard, nonrecurring entries are initiated and recorded, and the auditor should also understand the controls that have been placed in operation to ensure that such entries are authorized, complete, and correctly recorded.

6. Update terminology and references to IT systems and controls.

The SAS was issued in May 2001. The amendment is effective for audits of financial statements for periods beginning on or after June 1, 2001, with earlier application permitted.

Auditing Interpretations

Auditing Interpretations are issued by the Audit Issues Task Force of the ASB to provide timely guidance on the application of au-
diting pronouncements. Interpretations are reviewed by the ASB. An Interpretation is not as authoritative as a pronouncement of the ASB, but members should be aware that they may have to justify a departure from an Interpretation if the quality of their work is questioned. The following Auditing Interpretations have been issued since our last Alert:

1. Interpretation No. 3, “Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization’s Description of Controls,” of SAS No. 70 (AICPA, Professional Standards, vol. 1, AU sec. 9324.19-.31)


4. Interpretation “The Meaning of the Term Misstatement” of SAS No. 47, Audit Risk and Materiality in Conducting an Audit (AICPA, Professional Standards, vol. 1, AU sec. 9312.01-.04)

5. Interpretation “Evaluating Differences in Estimates” of SAS No. 47 (AICPA, Professional Standards, vol. 1, AU sec. 9312.05-.09)


5. Withdrawn by SAS No. 93. See the “New Auditing and Attestation Pronouncements” section of this Alert for further information.
7. Interpretation "Considering the Qualitative Characteristics of Misstatements" of SAS No. 47 (AICPA, *Professional Standards*, vol. 1, AU sec. 9312.15-.17)

Help Desk—The full text of these Interpretations can be obtained at the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

**New Attestation Standard**

SSAE No. 10, *Attestation Standards: Revision and Recodification*

The ASB issued SSAE No. 10, *Attestation Standards: Revision and Recodification*, in January 2001. SSAE No. 10 does the following:

- Changes the title of AT section 101 to *Attest Engagements*

- Changes the definition of an attest engagement into a statement of applicability of the standard, as follows:

  This statement applies to engagements in which a certified public accountant in the practice of public accounting (hereinafter referred to as a *practitioner*) is engaged to issue or does issue an examination, a review or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

- Revises the third general standard to focus on the essential elements of criteria: the criteria must be suitable and must be available to users. The subject matter also must be capable of reasonably consistent evaluation against the criteria.

- Enables true direct reporting on subject matter by eliminating the requirement to make reference to the assertion in the practitioner's report.

- Provides expanded guidance on the circumstances in which the use of attest reports should be restricted to specified parties.

- Supersedes SSAE Nos. 1 through 9, and revises and renumbers the AT sections.

49
The new SSAE also eliminates the requirement in AT section 201, "Agreed-Upon Procedures Engagements," for the practitioner to obtain a written assertion in an agreed-upon procedures attest engagement. It also incorporates changes needed as a result of the withdrawal of SAS No. 75. That withdrawal is reflected in SAS No. 93.

SSAE No. 10 is effective when the subject matter or assertion is as of or for a period ending on or after June 1, 2001. Early application is permitted.

Help Desk—Look for a new AICPA Practice Aid on how to understand and apply the provisions of SSAE No. 10.

Executive Summary—New Auditing and Attestation Pronouncements

- SAS No. 91, Federal GAAP Hierarchy, was issued in April 2000 and was effective upon issuance.
- SAS No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities, was issued in September 2000 and is effective for audits of financial statements for fiscal years ending on or after June 30, 2001.
- SAS No. 93, Omnibus Statement on Auditing Standards—2000, was issued in September 2000.
- SAS No. 94, The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit, was issued in May 2001.
- SOP 00-1, Auditing Health Care Third-Party Revenues and Related Receivables, was issued in March 2000.
- New Auditing Interpretations and Statements on Quality Control Standards were issued since the last Alert.
- Statement on Standards for Accounting and Review Services (SSARS) No. 8, Amendment to SSARS No. 1, was issued in October 2000.
- SSAE No. 10, Attestation Standards: Revision and Recodification, was issued in January 2001.
- For a summary of most of the auditing and attestation pronouncements listed here see Audit Risk Alert—2000/01 (Product No. 022260) or the AICPA Web site at www.aicpa.org.
Accounting Developments

New AICPA Statement of Position for Health and Welfare Benefit Plans

SOP 01-2, *Accounting and Reporting by Health and Welfare Benefit Plans*

In April 2001 the AICPA Accounting Standards Executive Committee (AcSEC) issued SOP 01-2, *Accounting and Reporting by Health and Welfare Benefit Plans*. This SOP amends chapter 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, and SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. This SOP—

- Specifies the presentation requirements for benefit obligations information. (Specifically, it allows information about the benefit obligations to be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to the financial statements.)
- Requires disclosure of information about retirees' relative share of the plan's estimated cost of providing postretirement benefits.
- Clarifies the measurement date for benefit obligations.
- Establishes standards of financial accounting and reporting for postemployment benefits provided by health and welfare benefit plans.
- Requires disclosure of the discount rate used for measuring the plan's obligation for postemployment benefits.
- Requires the identification of investments representing 5 percent or more of the net assets available for benefits.

This SOP is effective for financial statements for plan years beginning after December 15, 2000, with earlier application encouraged. Financial statements presented for prior plan years are required to be restated to comply with the provisions of this SOP.
Help Desk—See “Resource Central” in this Alert for order information (request Product No. 014929kk).

New GAAP Pronouncements

What new accounting pronouncements have been issued recently?

In this section we present brief summaries of accounting pronouncements issued since the publication of last year’s Alert, applicable to employee benefit plans. The executive summary at the end of this section includes a listing of all accounting pronouncements issued since the publication of last year’s Alert. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please visit the FASB Web site at www.fasb.org or the AICPA Web site at www.aicpa.org. You may also look for announcements of newly issued standards in the CPA Letter and the Journal of Accountancy.

FASB Pronouncements

FASB Statement No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities

FASB Statement No. 138 addresses a limited number of issues causing implementation difficulties for numerous entities that apply FASB Statement No. 133. This Statement amends the accounting and reporting standards of FASB Statement No. 133 for certain derivative instruments and certain hedging activities as indicated in the following paragraphs.

1. The normal purchases and normal sales exception in paragraph 10(b) may be applied to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).

2. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest-rate risk, the risk
of changes in the benchmark interest rate (benchmark interest rate is defined in paragraph 4(jj) of FASB Statement No. 138) would be the hedged risk.

3. Recognized foreign-currency-denominated assets and liabilities for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 15 of FASB Statement No. 52, Foreign Currency Translation, may be the hedged item in fair value hedges or cash flow hedges.

4. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

FASB Statement No. 138 also amends FASB Statement No. 133 for decisions made by the FASB relating to the derivatives implementation group (DIG) process. Certain decisions arising from the DIG process that required specific amendments to FASB Statement No. 133 are incorporated into FASB Statement No. 138.

FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinugishments of Liabilities

Issued in September 2000, FASB Statement No. 140 replaces FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. It revises the standards for accounting for securitizations and other transfers of financial assets and collateral and requires certain disclosures, but it carries over most of FASB Statement No. 125's provisions without reconsideration.

The Statement provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. Statement
No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

FASB Statement No. 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. The Statement is effective for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral for fiscal years ending after December 15, 2000. Disclosures about securitization and collateral accepted need not be reported for periods ending on or before December 15, 2000, for which financial statements are presented for comparative purposes.

FASB Statement No. 140 is to be applied prospectively with certain exceptions. Other than those exceptions, earlier or retroactive application of its accounting provisions is not permitted.

**EITF Consensus Positions**

The Emerging Issues Task Force (EITF) was established by the FASB in July 1984 to assist in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature. The application of EITF consensuses (category “c” of the GAAP hierarchy) effective after March 15, 1992, is mandatory under SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor’s Report*. Any EITF consensus issued before March 16, 1992, becomes effective in the hierarchy for initial application of an accounting principle after March 15, 1993. The EITF meets approximately every eight weeks. All meetings are announced by the FASB in its *Action Alert*, together with a listing of the topics on the meeting agenda.

**Executive Summary—New GAAP Pronouncements**

• FASB Statement No. 139, Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121.

• FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement No. 125

• FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation—an interpretation of APB Opinion No. 25

• For a summary of all the FASB Statements listed here and for information regarding the EITF visit the FASB Web site at www.fasb.org

Audit and Accounting Guide Revisions as of May 1, 2001

What revisions have been made to the Guide?

The following list summarizes some of the revisions that will be included in the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans (the Guide), with conforming changes as of May 1, 2001.

The Guide has been updated to reflect the issuance of the following pronouncements:

• SOP 01-2, Accounting and Reporting by Health and Welfare Benefit Plans

• SAS No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities

• SAS No. 93, Omnibus Statement on Auditing Standards—2000

To order this Guide see the “Resource Central” section of this Alert (Product No. 012341kk).

AICPA Professional Ethics Division Interpretations and Rulings

Ethics Interpretations and rulings are promulgated by the executive committee of the Professional Ethics division of the AICPA to provide guidelines on the scope and application of ethics rules but are not intended to limit such scope or application. Publication of an
Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing.

**Help Desk**—It is important for you to monitor the activities of the Professional Ethics Executive Committee because it may issue Interpretations, ethics rulings, or both, that may be relevant to your engagements. See the *Audit Risk Alert—2000/01* (Product No. 022260kk) for a summary of the committee’s 2000 activities. For full information about the Interpretations and rulings, visit the Professional Ethics Team Web page at http://www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 2, followed by menu option 2. It is important to point out that, for ERISA engagements, the DOL has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.85 in appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of May 1, 2001, for a listing of the DOL’s independence standards.

**On the Horizon**

The purpose of exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties. They are nonauthoritative and cannot be used as a basis for changing GAAS or GAAP. The following lists where certain exposure drafts can be found.

- For information on exposure drafts issued by the FASB, see the FASB Web site at www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html.
- For information on exposure drafts issued by the ASB, see the ASB exposure drafts Web site at www.aicpa.org/members/div/auditstd/drafts.htm. Note that the AICPA’s standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site.
The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field and include your full name, mailing address, and, if known, your membership and subscriber number in the message.

- See the AcSEC exposure drafts Web site at www.aicpa.org/members/div/acctstd/edo/index.htm for information on exposure drafts issued by AcSEC.

- See the AICPA Professional Ethics section of the AICPA Web site at www.aicpa.org/members/div/ethics/index.htm for information on exposure drafts, along with other ethics-related matters.

**International Accounting Standards**

The International Accounting Standards Committee (IASC) was formed in 1973 and is an independent, private sector body. The objective of the IASC is to harmonize the accounting principles for financial reporting around the world. The IASC publishes the International Accounting Standards.

**Employee Benefit Plan Related Standards**

The following are employee benefit plan related standards—


- International Accounting Standard No. 26, *Accounting and Reporting by Retirement Benefit Plans*, addresses the accounting and reporting by retirement benefit plans. It establishes separate standards for reporting by defined benefit plans and by defined contribution plans.

**Help Desk**—For further information regarding the IASC and its standards visit its Web site at www.iasc.org.uk
Resource Central

What other AICPA publications related to employee benefit plans may be of value to your practice? How can you order AICPA products?

For a complete listing of AICPA services see Audit Risk Alert—2000/01 (Product No. 022260kk).

On the Bookshelf

Related AICPA Publications include the following:

- AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, with conforming changes as of May 1, 2001 (Product No. 012341kk)

- AICPA Practice Aid Series, including
  - Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans, second edition. Offering the same kind of powerful help AICPA's Accounting Trends & Techniques does, this comprehensive Practice Aid illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The Practice Aid includes SOP 99-2, Accounting for and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans, and SOP 99-3, Accounting for and Reporting of Certain Defined Contribution Plan Investments and Other Disclosure Matters, and the new Form 5500 schedules. (Product No. 006608kk)
  - Auditing Multiemployer Plans. This brand new publication provides guidance on unique issues regarding the accounting, auditing, and reporting on financial statements of various types of multiemployer employee benefit plans. This nonauthoritative Practice Aid is designed to complement the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans. There are chapters on SOP 92-6 application, investments, employer payroll audits, internal control testing, and more. Also included are illustrative fi-
financial statements for various types of multiemployer employee benefit plans. (Product No. 006603kk)

- Checklists and Illustrative Financial Statements for—
  - *Defined Benefit Pension Plans* (008758kk)
    (The 2001 checklist will be available this summer —Product No. 008776kk)
  - *Defined Contribution Pension Plans* (008759kk)
    (The 2001 checklist will be available this summer—Product No. 008777kk)
  - *Health and Welfare Benefit Plans* (008760kk)
    (The 2001 checklist will be available this summer —Product No. 008778kk)
- “A Wake-Up Call”—an employee benefit plan audit video (013801kk)

**National Conference**

Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and industry or plan sponsors on various topics including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2002 National Conference on Employee Benefit Plans will be held May 20-22, 2002, in San Diego, California. For a conference brochure, please call (888) 777-7077 and request brochure G50038, or for more information, visit the AICPA Web site at www.aicpa.org.

**Continuing Professional Education**

The AICPA offers the following self-study courses:

- *Audits of Employee Benefit Plans—I*
- *Audits of Employee Benefit Plans—I I*
- *Audits of 401(k) Plans*
AICPA—At Your Service

Order Information
Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

Accounting and Auditing Technical Hotline and Ethics Hotline
The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. To reach either hotline, call (888) 777-7077.

World Wide Web Site
The AICPA has a home page on the World Wide Web. "AICPA Online," the Web site (URL or uniform resource locator: http://www.aicpa.org), offers CPAs the unique opportunity to stay abreast of developments in accounting and auditing, including exposure drafts. The home page is updated daily. The Web site includes In Our Opinion, the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

New! Online CPE Offer!
The AICPA has launched a new online learning tool, AICPA InfoBytes. An annual fee ($95 for members and $295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today as our guest at infobytes.aicpaservices.org.

........

This Audit Risk Alert replaces Employee Benefit Plans Industry Developments—2000.
The AICPA CD-ROM product, titled reSource: AICPA's Accounting and Auditing Literature, enables subscription access to the following AICPA professional literature products in a Windows format: Professional Standards, Technical Practice Aids, and Audit and Accounting Guides (available for purchase as a set that includes all twenty-five Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products. To order any publications included on the CD-ROM, call (888) 777-7077.

Practitioners Publishing Company (PPC) and the AICPA are currently offering publications issued by PPC, the AICPA, and the FASB on one CD-ROM disk, titled The Practitioner's Library—Accounting and Auditing. The FASB publications include Original Pronouncements, Current Text, Emerging Issues Task Force Abstracts, and FASB Implementation Guides; the AICPA publications include Professional Standards, Technical Practice Aids, Audit and Accounting Guides, and Peer Review Program Manual. The disk also contains eighteen PPC engagement manuals. The disk may be customized so that purchasers pay for and receive only selected segments of the material. For more information about this product call (800) 323-8724.

The Audit Risk Alert Employee Benefit Plans Industry Developments is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to:

Linda C. Delahanty
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881
# IRS Limits on Benefits and Compensation

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>2001</th>
<th>2000</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Defined Benefit</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Annual Pension</td>
<td>$140,000</td>
<td>$135,000</td>
<td>$130,000</td>
</tr>
<tr>
<td><strong>Defined Contribution</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Annual Addition</td>
<td>$35,000</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>401(k) Plan</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Elective Deferral</td>
<td>$10,500</td>
<td>$10,500</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>403(b) Plan</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Elective Deferral</td>
<td>$10,500</td>
<td>$10,500</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>457 Plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Elective Deferral</td>
<td>$8,500</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td><strong>SIMPLE Plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Elective Deferral</td>
<td>$6,500</td>
<td>$6,000</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>Qualified Plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Compensation Limits</td>
<td>$170,000</td>
<td>$170,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Highly Compensated Limits</td>
<td>$85,000</td>
<td>$85,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Officer Limits (Key Employee)</td>
<td>$70,000</td>
<td>$67,500</td>
<td>$65,000</td>
</tr>
<tr>
<td>FICA Taxable Wage Base</td>
<td>$80,400</td>
<td>$76,200</td>
<td>$72,600</td>
</tr>
<tr>
<td>Employer and Employee Social Security Tax</td>
<td>6.20%</td>
<td>6.20%</td>
<td>6.20%</td>
</tr>
</tbody>
</table>
APPENDIX B

Commonly Asked Questions and Answers

The following questions and answers have been developed by the members of the 2001 Employee Benefit Plans Audit Guide Revision Task Force. They include frequently asked questions encountered by the task force members on accounting, auditing, and regulatory matters.

Q. Under Form 5500 (Schedule H, Part IV, line 4j), there is a special rule whereby transactions under an individual account plan that a participant directs should not be taken into account for purposes of preparing the Schedule of Reportable Transactions. What about situations where an individual account plan is participant-directed but has certain transactions that appear to be nonparticipant-directed (for example, “pass through” account for contributions)?

A. If the plan is an individual account plan and the overall structure of the plan is participant-directed, “pass through” account transactions would not be required to be included on the Schedule of Reportable Transactions. Another example would be a participant-directed individual account plan that liquidates its investment options as a result of a plan termination, merger, or change in service provider. Oftentimes such changes result in the plan sponsor directing the plan trustee to liquidate the current balance in the participant-directed investment options into a short-term fund prior to the transfer to new investment options. Such transactions would not be required to be included on the Schedule of Reportable Transactions.

Q. What are the general conditions requiring an audit of pension plan financial statements?

A. An audit generally is required if the plan is covered under Title I of ERISA and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in chapter 5 of the AICPA Audit and Accounting Guide Audits of Employee Benefit Plans 64
(the Guide) provides guidance on determining who is considered a participant. In addition, U.S. Department of Labor (DOL) regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category ("large plan" or "small plan") as was filed in the previous year.

Q. What audit procedures should be performed on material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?

A. If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance transferred from the prior plan financial statements reconciles to the balance that is reflected on the new plan’s financial statements. Also, the auditor will generally perform procedures to ensure that a sample of participant accounts were properly set up under the new plan. In addition to the participant level testing, if the prior plan was not audited, the auditor will generally perform audit procedures to determine that the equity that is transferred from the prior plan is reasonable based upon an analysis of historical activity. (Other audit procedures relating to plan mergers can be found in paragraphs 12.11 through 12.14 of the Guide.)

Q. When a plan operates in a decentralized environment, what additional audit procedures should be considered?

A. The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.

Q. When the majority of a plan’s assets are held in a master trust, but the plan has investments outside of the master trust, what are the requirements for the supplemental schedules?

A. The Form 5500 instructions exclude master trust assets from the supplemental schedule reporting requirements. However, any assets held outside the master trust must be reported on
the supplemental schedules. When calculating the 5 percent threshold for disclosing reportable transactions, the current value of master trust assets is subtracted from the beginning of the year net asset balance.

Q. Is the master trust required to be audited?
A. While the DOL does not require the master trust to be audited, the plan administrator normally engages an auditor to report only on the financial statements of the individual plans. If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to the plan's investments or qualify or disclaim his or her report.

Q. Is a certification at the master trust level acceptable under DOL regulation 2520.103-8?
A. If a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets, and the related income activity, to the specific plan.

Q. Should noninterest-bearing cash be included as an asset on the supplemental schedule of assets (held at end of year)?
A. Generally, only assets held for investment are included on the supplemental schedule of assets (held at end of year), thus non-interest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.

Q. Can immaterial investments be netted together as “other” on the supplemental schedule of assets (held at end of year)?
A. No, each investment must be separately listed on the supplemental schedule.

Q. What is the auditor’s responsibility for detecting non-exempt transactions resulting from participant contributions that are not remitted to the plan within the guidelines established by DOL regulations?
A. An audit performed in accordance with generally accepted auditing standards cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Never-
theless, during the audit the auditor should be aware of the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire as to the existence of any party-in-interest or non-exempt transactions. If any issues relating to late remittances are brought to the auditor's attention, the auditor may consider obtaining a schedule of employee contributions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.

Q. If a non-exempt transaction related to the above is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of non-exempt transactions?

A. There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.

Q. When is a plan subject to the requirements of the Securities Act of 1933, thus requiring a Form 11-K filing under the Securities Exchange Act of 1934?

A. Section 3(a)(2) of the Securities Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements provided they are both voluntary and contributory. (For further guidance see paragraph 12.21 of the Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.

Q. In a defined contribution plan, can investments be shown as a one-line item on the financial statements?

A. Participant-directed plan investments may be shown in the aggregate, as a one-line item in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available
for benefits or in the notes should be detailed by general type, such as registered investment companies, government securities, corporate bonds, common stocks, and so on.

Q. If investments are shown as a one-line item in a defined contribution plan, what disclosures are required?
A. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise. Investments that represent 5 percent or more of the net assets available for benefits should be separately identified. If any of those investments are nonparticipant-directed, they should be identified as such. Listing all investments in the schedule of assets (held at end of year) required by the Employee Retirement Income Security Act (ERISA) does not eliminate the requirement to include this disclosure in the financial statements.

Q. Are participant loans considered an investment on the face of the financial statements or as a loan receivable?
A. Loans are considered an investment for reporting purposes.

Q. Should the benefits paid per the statement of changes in net assets available for plan benefits agree to the benefits paid in the statement of changes in accumulated plan benefits for a defined benefit pension plan?
A. The benefits paid should be the same on both statements. If differences are noted, the auditor should resolve the issue with the actuary to determine if the actuarial number requires adjustment.

Q. Is the schedule of 5 percent reportable transactions required for defined benefit plans?
A. As defined benefit plans generally are not participant-directed, the reportable transactions schedule would be required.

Q. When does a health and welfare plan require an audit?
A. A health and welfare plan is required to have an audit when the plan has more than 100 participants at the beginning of the plan year (this can be expanded to 120 if the 80-to-120-participant rule applies) and the plan is funded. According to DOL Regulation 2520.104-44, the existence of a separate
fund or account for the plan by the employer or a third-party administrator (TPA) can cause the requirement that funds be paid directly from the general assets of the sponsor not to be met. For example, if a separate account is maintained which would be deemed to be a trust under state law, the related plan would be deemed to be funded under ERISA. It is not always easy to determine when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, or the DOL to determine if a plan meets the definition of funded.

Q. Are participants counted the same way for pension plans and health and welfare benefit plans?

A. Participants for health and welfare plans are employees who are eligible and are receiving coverage under the plan.

Q. If participants are contributing toward the health and welfare benefits, is an audit required?

A. According to DOL technical releases 88-1 and 92-1, participant contributions to a welfare plan which has an IRC section 125 cafeteria plan feature do not have to be held in trust. If contributions are not through a section 125 plan and they are not used for the payment of insurance or health maintenance organization (HMO) premiums, generally, they will be required to be held in trust. If the plan is funded voluntarily or as required by DOL regulation, then the plan would require an audit.

Q. If a plan offers several benefits under the plan document, and only medical is funded through the voluntary employees’ beneficiary association (VEBA) trust, what is the audit requirement?

A. The audit requirement is of the plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.

Q. If a VEBA trust is utilized as a pass-through for claims payment during the year, but there are no monies in the VEBA trust at year end, is an audit of the plan required?

A. If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.
Q. If multiple plans utilize a VEBA trust, can an audit be performed at the VEBA trust level?

A. The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.

Q. Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?

A. If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.
Who's Who In Employee Benefit Plans

This appendix describes the roles and responsibilities of some of the key parties associated with employee benefit plans. The following parties are typically associated with the plan:

- **Plan sponsor**—The plan sponsor establishes, funds, and maintains the plan. This may be an employer (for a pension plan established or maintained by a single employer); an employee organization (for a plan established or maintained by an employee organization); or an association, committee, joint board of trustees, or other group or representatives (for a plan established or maintained jointly by two or more employers or by one or more employers and one or more employee organizations).

- **Plan administrator**—The plan administrator manages the operation and administration of the plan. The plan administrator is the person or group of persons responsible for the content and issuance of a plan's financial statements.

The following parties are typically outside the plan:

- **Actuary**—The actuary determines the funding requirement and accumulated benefit obligations (defined benefit plans).

- **Benefit consultant**—A benefit consultant advises the plan sponsor regarding plan design, administration, and compliance issues.

- **Insurance company**—An insurance company can function as a trustee and assumes obligation for payment of benefits to the extent the plan is insured.

- **Investment advisor or manager**—The investment advisor or manager advises regarding overall investment policy and may authorize investment transactions.
• **Legal counsel**—Legal counsel prepares plan documents and amendments and provide legal advice and counsel.

• **Named fiduciary**—The named fiduciary is the individual responsible for the operation and administration of a plan including the identification of a plan administrator; usually an officer or other employee of the plan sponsor who reports to the plan sponsor's board of directors or management. The named fiduciary has the ultimate responsibility for the overall activities of the plan.

• **Third-party welfare plan claims administrator**—The third-party administrator is a party unrelated to the plan who contracts to be responsible for plan administration. The third-party administrator reviews and processes claims from participants, directs the trustee or custodian to pay valid claims, or pays claims directly and is reimbursed by the trustee or custodian.

• **Third-party defined contribution plan administrator (outside recordkeeper)**—The third-party administrator is a party unrelated to the plan who contracts to be responsible for plan administration. The third-party administrator maintains plan and participant records, detailed participant investment records, and processes certain plan transactions.

• **Trustee or asset custodian**—The trustee or asset custodian safeguards trusteed assets and pays benefits upon instruction from the plan administrator.
Government Employee Benefit Plans

This appendix has been added to address audit, accounting, and regulatory issues unique to government employee benefit plans. Auditors of government employee benefit plans should also see the AICPA Audit and Accounting Guide Audits of State and Local Governmental Units (Product No. 012062kk), the AICPA Audit Risk Alert State and Local Governmental Developments (Product No. 022269kk), and the GASB Q&A Implementation Guide on GASB 25, 26, and 27 for further guidance.

Help Desk—To order AICPA products, see the “Resource Central” section of this Alert. To order a copy of the GASB implementation guide, contact the GASB order department, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700, extension 555.

The accounting for certain governmental employee benefit plans is prescribed by Governmental Accounting Standards Board (GASB) Statements No. 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans, and No. 26, Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans. The AICPA Audit and Accounting Guide Audit of Employee Benefit Plans and related AICPA publications (see the “On the Bookshelf” section of this Alert for a listing) address issues related to plans sponsored by commercial and not-for-profit private sector entities.

1. GASB Statement No. 25 establishes financial reporting standards for defined benefit pension plans and for the notes to the financial statements of defined contribution plans of state and local governmental entities.

2. GASB Statement No. 26 establishes financial reporting standards for postemployment healthcare plans administered by state and local governmental defined benefit pension plans. It is an interim statement pending completion of the GASB’s project on accounting and financial reporting of other postemployment benefits by plans and employers.
and do not apply to government employee benefit plans. (How­ever, portions of these publications including this Alert may be use­ful to auditors of governmental employee benefit plans.)

Governmental plans encompass retirement systems offered by state, county, or local governments, also known as public employee retirement systems (PERSs), as well as single employer plans offered by special-purpose governmental entities, such as hospitals. These benefit plan arrangements are not subject to the Employee Retirement Income Security Act (ERISA) and do not require the typical Department of Labor (DOL) supplemental schedules. However, GASB requires supplementary information and these plans typically include other unique supplemental schedules. In addi­tion, plans offered by special-purpose governments may have re­porting requirements that vary by state.

There are over 2000 PERSs in the United States with more than $1.9 trillion dollars in cash and security holdings. Many of these PERSs voluntarily seek to receive an annual certification to denote quality in financial reporting for governmental entities, including PERSs. In addition to the guidance provided here, the AICPA Em­ployee Benefit Plans Expert Panel has established a task force to focus on issues relating to government employee benefit plans.

Current Trends

A recent survey\(^3\) of governmental plans was performed to gather key aspects of state and local retirement system’s administration, retirement benefits, actuarial methods and assumptions, actuarial liabilities and assets, contributions, investments, and rates of in­vestment return. The survey results found that PERSs generally are well funded. Other current trends are a shift of pension assets to equities from bonds, a reduction in employer contribution require­ments, a slight increase in base benefits, and an increase in number and size of cost of living adjustments (COLAs). The survey, in part, showed that, in the aggregate—

3. Survey was prepared for the members of the Public Pension Coordinating Council (PPCC) by the Government Finance Officers Association Research Center.
• The funding level improved from 82 percent to 95.2 percent.

• Five-year portfolio returns increased from 10.62 percent in 1992 to 13.36 percent in 1998 while investment assumptions rose from 7.83 percent in 1992 to 7.88 percent in 1998.

• The portion of assets held in domestic equities rose from 39.3 percent in 1992 to 47.9 percent in 1998. The portion of assets held in international equities rose from 3.7 percent in 1992 to 12.0 percent in 1998.

• The percentage of plans with COLAs increased from 57 percent in 1992 to 77 percent in 1998.

• The average employer contribution rate as a percentage of covered salary fell from 13.19 percent in 1992 to 11.62 percent in 1998.

Other trends include the following:

• Many pension plans are getting into new areas of investing in an attempt to obtain higher returns. Accordingly, many pension plans are investing in new types of investments.

• Many pension plans are now paying performance-based bonuses to investment managers.

• Pension plans are moving into higher risk investments (also called innovative, sophisticated risk strategies). These investment strategies include high-yield (junk) bonds, private equity, venture capital, and hedge funds, for example.

• Many pension plans are outsourcing more investment management functions, especially in newer areas that may include investments of higher risk. In many cases, the entire process of investing, processing transactions, and accounting for these investments is outsourced, and the manager is effectively a third-party administrator.

• Plans are making more use of soft dollars in order to obtain use of funds that may be outside of the budget and normal controls, or not on the general ledger.
• Plans are making increased use of securities' lending programs, primarily in response to the preferred practices of the plans' trustee-custodian institutions. The plan often receives additional income as a result of this practice.

• Plans are adding a deferred retirement option program (DROP). The person “retires,” but continues to work for a defined amount of time while the retirement payments are accumulated in a deferred payment account. The deferred payment money is generally distributed in a lump sum to the person at the time of “true retirement” at the end of the defined time.

• PERSs are becoming more autonomous from the sponsoring government to the extent that many are choosing to employ separate independent accountants.

Regulatory Issues

The IRS created the Tax Exempt and Government Entities (TE/GE) Division. The division has three segments to deal separately with exempt organizations, employee plans, and governmental entities. The Division addresses key customer needs by providing the following services:

• Education and communication efforts, which focus on helping customers understand their tax responsibilities with outreach programs and activities tailored to their specific needs

• Rulings and agreements efforts, which have a strong emphasis on up-front compliance programs such as the determination, voluntary compliance, and private letter ruling programs

• Examination initiatives, which identify and address non-compliance through customized activities within each customer segment

• Customer account services, which coordinates tax filings and responses to questions and requests for information

The IRS continues to develop a customer-friendly Web site at http://www.irs.gov. That site provides contact information for the
leadership of the TE/GE Division and currently has separate pages to serve the customers of the Exempt Organizations and Employee Plans segments of the TE/GE Division.

Employers With 403(b) and 457 Plans
The TE/GE Division's Employee Plans segment has a new initiative to examine employers that offer both Internal Revenue Code (IRC) section 403(b) tax-sheltered annuities (403(b) plans) and IRC section 457 deferred compensation plans. That initiative would affect, for example, school districts, public colleges and universities, and governmental hospitals. For further information see the Audit Risk Alert State and Local Governmental Developments—2001 (Product No. 022269kk).

Automatic Deferrals
IRS Revenue Rulings 2000-33 and 2000-35 (Internal Revenue Bulletin 2000-31, July 31, 2000) were issued to specify the criteria that have to be met to defer a certain percentage of an employee's compensation automatically into a section 457 deferred compensation plan or a 403(b) plan, respectively. These rulings address situations in which deferrals are made without an affirmative election by the employee to receive the amount in cash.

Administration of Section 457 Deferred Compensation Plans
The IRS has published information about the administration of section 457 deferred compensation plans. You may want to make sure that the governments you audit have considered that information. In Notice 2000-38 (Internal Revenue Bulletin 2000-33, August 14, 2000), the IRS describes the withholding and reporting requirements applicable to section 457(b) plans. In Notice 2000-66 (Internal Revenue Bulletin 2000-52, December 26, 2000), the IRS increased the limit on deferrals under section 457(b)(2) and (c)(1) from $8,000 to $8,500 effective January 1, 2001.

Employee Plans Compliance Resolution System
The IRS recently issued Revenue Procedure 2001-17 (Internal Revenue Bulletin 2001-7, February 12, 2001) to update and expand on its Employee Plans Compliance Resolution System (EPCRS). The
EPCRS is a comprehensive set of corrective programs that enable sponsors of qualified retirement plans that have experienced compliance violations to preserve the tax benefits of their plans. Those programs apply to various qualified plans, including 403(b) plans. Effective May 1, 2001, Revenue Procedure 2001-17 superseded Revenue Procedure 2000-16, which was the previous statement of the correction programs under EPCRS.

Educational Outreach

The TE/GE Division's Employee Plans segment has formalized its educational outreach program to increase understanding and compliance with the tax law applicable to 403(b) plans. It calls this program the Section 403(b) Tax-Sheltered Annuity Partnership for Compliance. Under the program, trained and experienced IRS employees are available to provide educational services relating to 403(b) plans, including delivering speeches, participating in panel discussions, conducting training sessions, and helping to prepare newsletter articles. If one of your auditees is concerned about the compliance of its 403(b) plan, you should consider referring it to the Partnership for Compliance.


Audit Issues

Independence

PERSs issue separate financial statements that often are included in a primary government's financial statements. If the PERS's auditors are different from those of the primary government (provided the PERS's financial statements are material to the primary government), the PERS's auditors need to be independent of the primary government in order for the primary government's auditors to rely on the work of the other auditors. Depending on the timing of the respective audits, postreport review procedures may be required by the PERS's auditors for inclusion of their financial statements in the sponsoring organization's financial statements. For additional
discussion of independence issues see the “Revision of State and Local Governmental Units Audit and Accounting Guide” section of the AICPA Audit Risk Alert State and Local Governmental Developments—2001 (Product No. 022269kk).

Benefit Payment Risk

The accuracy of benefit payment calculations is a primary risk area due to the unique and complex definitions of compensation and years of service for PERSs. In fact, currently, some PERSs are involved in litigation regarding retroactive adjustment of benefits due to a change in the components of compensation. The determination of a participant's years of service becomes complex due to carryover years of service from other government agencies as well as credit for time served in the armed forces and other organizations. The latter credit is often "earned" as participants make additional contributions.

Investment Risk

In July 2000 the Association of Public Pension Fund Auditors (APPFA) issued the publication Statements of Key Investment Risks and Common Practices to Address those Risks. This publication provides general guidance for pension plans and auditors of those plans in addressing investment risks. The document identifies key investment risks associated with public pension systems and common practices to address, manage, and, to the extent possible, control those risks.


Recent Exposure Drafts

Practitioners should note that the purpose of exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties, and that they are nonauthoritative. The following is a listing of some of the more significant exposure drafts outstanding at the time we went to press that may affect government employee benefit plans.
Help Desk—See the GASB Web site http://www.gasb.org for a complete listing of outstanding exposure drafts for GASB documents.

**Certain Financial Statement Note Disclosures**

An exposure draft for a proposed GASB statement, *Certain Financial Statement Note Disclosures*, was issued July 31, 2000. The proposed statement would modify, establish, or rescind certain note disclosures.

**Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus, an amendment of GASB Statements No. 21 and No. 34**

An exposure draft for a proposed GASB statement, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, an amendment of GASB Statements No. 21 and No. 34, was issued December 29, 2000. The proposed statement would clarify certain provisions of previously issued statements.

**Resources for Government Employee Benefit Plans**

The following lists certain resources that may be helpful when auditing government employee benefit plans. These items can be ordered from the GFOA Web site at www.gfoa.org (from the main page click on “products” and then “public employee retirement administration”) or by contacting the GFOA at 180 N. Michigan Ave., Suite 800, Chicago, IL 60601, (312) 977-9700.

- The *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*, also known as the “Blue Book,” has been revised by the Government Finance Officers Association (GFOA). The new GAAFR can be ordered from the GFOA Web site

- *Pension Accounting and Reporting* (by William R. Schwartz)

- *Pension CAFRS: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report*


- PENDAT database
<table>
<thead>
<tr>
<th>Organization</th>
<th>General Information</th>
<th>Fax Services</th>
<th>Web Site Address</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Institute of Certified Public Accountants</td>
<td>Order Department Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 (888) 777-7077</td>
<td>24 Hour Fax Hotline (201) 938-3787</td>
<td><a href="http://www.aicpa.org">http://www.aicpa.org</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board</td>
<td>Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10</td>
<td>24 Hour Fax-on-Demand (203) 847-0700, menu item 14</td>
<td><a href="http://www.fasb.org">http://www.fasb.org</a></td>
</tr>
<tr>
<td></td>
<td>Division of Reporting Compliance</td>
<td>Form 5500 preparation and filing requirements (202) 219-8770</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Office of Regulations and Interpretations</td>
<td>(202) 219-7461</td>
<td></td>
</tr>
</tbody>
</table>