2006

Employee benefit plans industry developments - 2006; Audit risk alerts

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Employee Benefit Plans Industry Developments — 2006

Strengthening Audit Integrity
Safeguarding Financial Reporting
Employee Benefit Plans Industry Developments—2006

Strengthening Audit Integrity
Safeguarding Financial Reporting
Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in AU section 150, Generally Accepted Auditing Standards (AICPA, Professional Standards, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Linda C. Delahanty
Technical Manager
Accounting and Auditing Publications

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Acknowledgments

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**Employee Benefit Plans Industry Developments—2006**

**How This Alert Helps You**

This Audit Risk Alert provides information on current auditing, accounting, and regulatory developments effecting employee benefit plans. It delivers information about current industry developments and emerging practice issues. It is intended to help you plan and perform your employee benefit plan audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business, economic, and regulatory environment that your clients operate in.

**References to Professional Standards.** When referring to the professional standards, this Alert cites the applicable sections as codified in the AICPA Professional Standards and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317 of the AICPA Professional Standards. See Appendix G of this Risk Alert for a transition schedule cross-referencing the SASs to their applicable AU sections in the AICPA Professional Standards, vol. 1.

**Help Desk**—See the AICPA publication *Audit Risk Alert—2005/06* (product no. 022336kk) for general guidance.

**Help Desk**—See the AICPA Audit Risk Alert *Independence and Ethics Alert—2005/06* (product no. 022476kk) for a thorough discussion of recent developments and key issues in the area of independence and ethics. It is important to point out that, for Employee Retirement Income Security Act of 1974 (ERISA) engagements, the Department of Labor (DOL) has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.88 in Appendix A of the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2006 (EBP Guide), for a listing of the DOL’s independence standards.
Help Desk—See the AICPA Audit Risk Alert *SEC and PCAOB Developments—2005/06* (product no. 022496kk) for a thorough discussion of recent Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) developments.

**Industry and Economic Developments**

In planning their audits, auditors need to understand the economic conditions facing their client’s industry. 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.

An auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include:

- Industry conditions;
- The regulatory environment encompassing, among other matters, relevant accounting pronouncements;
- The legal and political environment; and
- Other external factors, such as general economic conditions.

Presented in this Alert are current business, economic, regulatory, accounting, and auditing matters that may affect your clients. Reading about these matters and properly addressing them as necessary will help you gain a better understanding of your client’s environment, will help you better assess risks of material misstatement of the financial statements, and will ultimately strengthen the integrity of your audits.

**The AICPA Employee Benefit Plan Audit Quality Center**

The AICPA Employee Benefit Plan Audit Quality Center celebrated its two-year anniversary in March 2006. Created with the goal of promoting quality employee benefit plan audits, this firm-based, voluntary membership Center now has over 1,080 member firms from around the country. Center member firms
demonstrate their commitment to ERISA audit quality by joining the Center and agreeing to adhere to its membership requirements.

The Center helps CPAs meet the challenges of performing quality audits in the area of employee benefit plans (EBP) by providing member firms with valuable tools and resources, which are sent to members as developed and archived on the Center's Web site, including:

- Over 56 Center E-Alerts keeping members abreast of important EBP issues and developments.
- Useful tools such as audit preparedness and planning checklists and schedules, auditor guidelines for preparing proposals, “Topix” primers on various subjects of interest to employee benefit plan auditors, and a SAS 70 Review Checklist.
- An online Member Forum that provides members with the opportunity to share ideas, best practices, and questions with other members.
- A marketing toolkit to promote the firm’s commitment to ERISA audit quality.

The Center also sponsors member-only conference calls and other important events; provides information about the Center's activities and members to plan sponsors, trustees, and other employee benefit plan stakeholders; and serves as a single voice for Center members to the DOL.

Visit the Center Web site at www.aicpa.org/ebpaqc to see a complete list of Center members under Membership and to preview Center benefits.

The EBPAQC can be contacted at www.aicpa.org/ebpaqc or ebpaqc@aicpa.org.

**AICPA Employee Benefit Plans Guide Project**

In 2005 an AICPA task force began work on a project to revise the AICPA Audit and Accounting Guide *Employee Benefit Plans.*
This project is at the beginning stages and the AICPA Accounting Standards Executive Committee (AcSEC) and AICPA Auditing Standards Board (ASB) will be participating in the update of the guide. The financial reporting issues to be addressed in the project are identified in a project prospectus and will be discussed at various AcSEC meetings. Some of the issues currently being discussed include accounting for contributions receivable, presentation and disclosure of master trusts, presentation and disclosure of excess contributions, and accounting for limited partnerships. To monitor this project, see the AcSEC minutes posted on the AICPA Web site at www.aicpa.org.

**New Automatic Rollover Provisions**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) added automatic rollover provisions to the Internal Revenue Code (IRC), requiring that retirement plans that cash out participant account balances of $5,000 or less without participant consent (involuntary distributions) establish IRAs on behalf of participants who don’t provide affirmative payment or rollover elections. The DOL issued final regulations on September 28, 2004, and they apply to any rollover of involuntary distributions on or after March 28, 2005.

In IRS Notice 2005-5 and in an IRS Employee Plans News Flash dated February 16, 2005, the IRS clarified that the deadline for amending retirement plans to reduce or eliminate the $5,000 limit for involuntary distributions was the end of the first plan year ending on or after March 28, 2005 (that is, December 31, 2005, for calendar year plans). The IRS provided a sample plan amendment in Notice 2005-5 for plan sponsors who want to keep the $5,000 cash-out limit and provide for automatic rollovers of involuntary distributions between $1,000 and $5,000. Later, in Notice 2005-95, IRS extended the deadline for amendments to the latest of (1) December 31, 2005; (2) the last day of the plan year that contains March 28, 2005; or (3) the tax filing deadline for the plan sponsor’s tax year containing March 28, 2005. This effectively means that calendar year plans sponsored by calendar year taxpayers don’t need to be amended for the
new rules until the extended due date of their calendar 2005 tax year (which could be fairly late in 2006).

Overview

Under prior rules, when a participant terminated employment, a plan could immediately distribute the participant’s benefit in a lump sum without the participant’s consent if the present value of the benefit was $5,000 or less. Before making the distribution, the plan administrator was required to provide the participant with a written explanation of these payment options and the related tax consequences. This written explanation is sometimes referred to as the “Section 402(f) Notice.”

The new automatic rollover provisions added by EGTRRA keep these rules intact but also require that involuntary distributions of more than $1,000 be rolled over into a designated IRA, absent an affirmative election by the participant to have the distribution paid in cash or as a direct rollover. Plan administrators must provide advance written notice, as part of the Section 402(f) notice or as a separate notice, that unless the participant elects otherwise, his or her distribution will be transferred into an IRA. The written notice must identify the trustee or issuer of the IRA.

The automatic rollover requirements apply to any involuntary distribution of more than $1,000 made before a participant reaches normal retirement age under the plan. Amounts attributable to rollover contributions into the plan are taken into account when determining if a participant’s benefit exceeds $1,000 (even though these amounts need not be taken into account when determining if the value of the participant’s benefit is $5,000 or less and, thus, payable without the participant’s consent). Distributions to surviving spouses and alternate payees (under qualified domestic relations orders (QDROs)) are not subject to the automatic rollover requirements.

DOL Safe Harbor for Plan Fiduciaries

DOL regulations issued on September 28, 2004, provide a “safe harbor” for satisfying the fiduciary responsibilities associated with (1) selecting an institution to receive automatic rollovers and (2)
making an initial investment election for the rollover funds. Generally, the safe harbor requires that the plan fiduciary enter into a contract with the IRA provider on behalf of the participant. The IRA must be invested in a product that is designed to preserve principal and provide a reasonable rate of return, and the fees and expenses associated with the IRA may not exceed those the provider charges for comparable IRAs. The plan administrator must also provide participants with an updated summary plan description (SPD) or a summary of material modifications (SMM) that describes the automatic rollover requirements; the investment product; fees (and whether any will be borne by the plan or the plan sponsor); and, if not otherwise provided in the updated SPD or in the applicable SMM, the name, address, and phone number of a plan contact for more information about the plan’s automatic rollover provisions, the IRA provider, and the fees and expenses associated with the IRA.

Audit Implications
Plan auditors, in conjunction with tax specialists, should confirm that plans were amended timely to reflect the new automatic rollover requirements. In some cases, plan sponsors may have either amended their plans to lower the cash-out threshold to $1,000, or less likely, to eliminate involuntary distributions altogether. Careful review of the plan document is essential to determine exactly what the plan’s provisions are currently and were previously. It is important for auditors to consider plan amendments when performing distribution testing.

Roth 401(k) Considerations
While most of the qualified retirement plan changes brought about by EGTRRA have long since gone into effect, a notable exception is the ability to add a “designated Roth contribution” provision to a 401(k) plan, which became possible as of January 1, 2006. Adding a Roth contribution feature to an existing plan presents a host of administrative, tax, and financial planning issues, so it’s not yet certain how popular this new feature will ultimately prove to be.
Overview

Designated Roth contributions are a new type of contribution that can be accepted by new or existing 401(k) or 403(b) plans. If a plan adopts this feature, plan participants can designate some or all of their elective deferrals as designated Roth contributions, which are included in gross income, rather than traditional, pretax elective contributions. EGTRRA permits designated Roth contributions to be made under 401(k) or 403(b) plans after December 31, 2005. However, per IRS Revenue Procedure 2005-66 and Notice 2005-95, plans must be properly amended to add a designated Roth feature by the end of the plan year in which the Roth contributions are first effective (that is, by December 31, 2006, for a calendar year plan that adds Roth contributions in 2006).

Since Roth 401(k) contributions are after-tax deferrals, they are subject to both income and FICA tax at the time they are made (traditional, pretax deferrals are subject to FICA only). If certain requirements are met, future distributions of the money held in a participant’s designated Roth account, including earnings, will be tax-free.

Participants must irrevocably elect to treat some or all of their deferrals as designated Roth contributions at the time of deferral. Contributions that were initially treated as pretax cannot later be “converted” to Roth contributions, and vice versa.

Key Points

The following is some of the key issues concerning designated Roth contributions:

- **Eligibility requirements**—Roth 401(k) contributions are available to all plan participants regardless of income level, unlike Roth IRA contributions, which are restricted to taxpayers with adjusted gross incomes (AGIs) of no more than $160,000.

- **Contribution limits**—Up to the regular elective deferral limit for the calendar year (that is, $15,000 for 2006). Traditional 401(k) and Roth 401(k) contributions are combined to determine whether a participant has reached this statutory
limit. There’s no requirement that a certain amount or percentage of contributions be designated as either traditional 401(k) or Roth 401(k). The designated Roth limit is much higher than the contribution limit for Roth IRAs ($4,000 for 2006).

- **Distribution rules**—(1) Roth 401(k) account balances can be distributed tax-free if the requirements for qualified distributions are satisfied. (a) Distribution occurs at least 5 years after the participant’s first designated Roth contribution and (b) distribution is attributable to the participant’s attainment of age 59½, disability or death. (2) Five-year waiting period begins on the first day of the year in which designated Roth contributions are initially made (that is, if the first contribution is made on December 1, 2006, the five-year period begins on January 1, 2006, and is considered satisfied as of January 1, 2011). Designated Roth contributions in subsequent tax years do not trigger the need for a new five-year waiting period. (3) Earnings on non-qualified distributions are taxable and may be subject to 10 percent premature distribution penalty; this may require each dollar of distribution to be prorated between a nontaxable return of after-tax contributions (that is, investment in the contract) and taxable investment earnings (income on the contract). (4) Roth 401(k) accounts can be rolled over to another Roth 401(k) account or to a Roth IRA, but Roth IRA money cannot be rolled into a Roth 401(k).

- **Other Rules:**
  - A 401(k) or 403(b) plan cannot feature just designated Roth contributions, but must offer participants the option to make both traditional, pretax deferrals and Roth contributions.
  - Plan sponsors can match designated Roth contributions, but any such matching contributions must be allocated to a separate, pretax account, just as regular matching contributions would be (because the matching contributions will be taxed when distributed).
– Designated Roth contributions are treated as ordinary deferrals for purposes of discrimination testing, and so are included in a plan's actual deferral percentage (ADP) test. Corrective distributions to highly compensated employees (HCEs), which are needed to pass testing, can be made either from the participant's traditional 401(k) account or Roth account, depending on the plan's provisions.

– If a plan provides for automatic enrollment, its document must specify whether contributions for automatically enrolled participants will be Roth or traditional, pretax contributions.

– Catch-up contributions can be made as designated Roth contributions.

– Designated Roth contributions won't be allowed after 2010, when EGTRRA sunsets (unless Congress acts to extend EGTRRA).

**Frozen Plans**

Over the past few years more than 20 percent of corporations have frozen their defined benefit plans, and that trend is expected to continue. Defined benefit plans have been frozen either through elimination of future benefit accruals or through the disallowance of new participation in the plan. Some plans eliminate future service accruals but allow future salary increases to be taken into account in calculating the benefits. Many plan sponsors freeze the plan in anticipation of terminating the plan at some future date depending on the attractiveness of interest rates for settling the plan (for example, purchasing annuities). A number of plan sponsors have frozen their defined benefit plans and offered a defined contribution plan in its place or increased contributions in existing defined contribution plans.

The decision to freeze a plan may have certain auditing implications. For a continuing auditor of a plan, the freezing of the plan will typically change the nature of the auditing procedures for participant data. For example, if the plan freezes participation,
the census data information should not change from year to year, and the testing of the census data for completeness and accuracy can be limited to comparing the current year listing to prior year listing (and vice versa). The auditor should obtain copies of all plan amendments and discuss with the client, actuary, and legal counsel the effect of the freezing on participant accruals in order to determine the nature of the testing. For the year that the freeze is effective, it is important to maintain a full copy of the census data in the working papers so data can be used going forward for participant data testing. For certain situations when a successor auditor is performing an audit of a frozen plan for the first time, consider results of the review of the predecessor audit working papers in determining the scope of census data testing. Also, refer to “Missing Participant Data” section of this Audit Risk Alert for situations when participant data records for frozen plans are not available.

The decision to freeze a plan may also have reporting implications. Paragraph 2.49 of the EBP Guide requires that when the decision to freeze a plan has been made, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. The decision to freeze a plan typically does not have an effect on the present value of accumulated plan benefits. However, once the plan has been frozen, you would not expect to see an increase in accumulated plan benefits as a result of benefits accumulated in future years.

Economic Environment

A number of serious threats to the economy and business environment exist. They include:

- Rising interest rates. Remember that approximately half of all U.S. corporate debt outstanding has floating interest rates. Moreover, trillions of dollars worth of derivatives exist, many of which are based on interest rates.

- Soaring gasoline prices, which threaten a key pillar of the U.S. economy—consumer spending.
• Dangerously high and rising consumer debt levels.
• A softening housing boom in some markets.

Although the economy has been performing nicely, these threats could derail economic growth, possibly affecting your client’s business and therefore possibly affecting the risks on your audit.

You should be alert to economic and business conditions and events that, when considered in the aggregate, indicate that there could be a substantial negative effect on your client’s financial condition, including consideration of substantial doubt about your client’s ability to continue as a going concern.

The U.S. gross domestic product (GDP), which is the broadest measure of economic activity, slowed to an annual rate increase of 1.7 percent in the fourth quarter of 2005, down from a 4.1 percent increase in the third quarter of 2005. While this is the slowest rate since 2002, the U.S. economy remains strong.

The unemployment rate has decreased from 5.4 percent in February of 2005 to 4.8 percent in February 2006. This is little changed from the 4.9 percent in December 2005, supporting a tight labor market.

The Federal Reserve has continued to raise interest rates, although rates are still historically low. In March 2006, the federal funds rate, the rate at which banks pay for overnight loans, increased to 4.75 percent. Since June 2004, this has been the 15th time the Federal Reserve has raised rates.

**Hurricane Relief**

In response to the devastation from hurricane damage that affected so many people in the Gulf Coast area, the federal government has acted to provide relief from certain rules applicable to retirement plans, including facilitation of access to participant account balances in qualified retirement plans.

The level of relief often depends on the level of damage in the applicable area (county or parish) and the other assistance that was
made available in that area from the Federal Emergency Management Agency (FEMA).

Some of the more notable areas of relief include:

- Extension of various administrative deadlines:
  - Form 5500 filing deadlines (see the section “Extended Filing Deadline for Annual Report Filers in Gulf Coast Region” in this Alert for more details)
  - Deadline for minimum funding contribution or for applying for a waiver
  - Deadline for making Pension Benefit Guaranty Corporation (PBGC) premium filings
  - The amendment period for adding the appropriate amendments covering hurricane provisions

- Hardship withdrawals—Qualified plans have the ability and flexibility to make hardship distributions for a need arising from a hurricane.

- Distributions—Plans can make qualified distributions to participants who have sustained an economic loss, and such distributions are not subject to the 10 percent excise tax on early distributions or the 20 percent withholding requirement. Such distributions will not be subject to federal income tax if they are repaid within a specified three-year period. The amount available for distribution is not limited to the loss amount.

- Loans—Plans can make loans to affected participants with special repayment terms. In addition, already outstanding participant loans may defer repayment on that loan for a period not to exceed 12 months.

Service Provider Arrangements

As a way to reduce costs and increase efficiencies, employee benefit plan sponsors often use third-party service providers in some capacity to assist in administering their plans. Such functions include recordkeeping and/or benefit payments or claims processed.
by outside service organizations, such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators.¹

During the planning process the auditor should obtain and document an understanding of the nature and extent of activities performed by each service organization by (1) reviewing the contract between the client and the service provider, (2) reviewing other documentation maintained by the client and/or service provider (for example, brochures, user manuals, system overviews, and technical manuals), and (3) inquiring of client and/or service provider personnel regarding the service organization’s processing of transactions. SAS No. 103, *Audit Documentation*, requires that copies of significant and specific contracts and agreements be included as part of the audit documentation.² The terms of the contract should also be reviewed to determine reasonableness of financial statement disclosures (for example, which costs are being paid by the plan and any related party fee disclosures).

SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, provides, among other things, guidance on the factors an independent auditor should consider when auditing the financial statements of a plan that uses a service organization to process certain transactions.

**Help Desk**—For guidance on using a SAS No. 70 report when auditing employee benefit plans or for when no SAS No. 70 report is available, see Chapter 6 of the EBP Guide and the AICPA Practice Aid *SAS No. 70 Reports and Employee Benefit*

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¹ Many plan sponsors and their employees may not be familiar with their fiduciary responsibilities regarding employee benefit plans. Auditors should refer plan sponsors to their plan legal counsel for interpretations of specific actions and how these may or may not be in accordance with their fiduciary responsibilities.

Plan (product no. 061061kk). For further guidance on subservice organizations, see paragraph 6.18 of the EBP Guide and Chapter 5 in the AICPA Audit Guide Service Organizations: Applying SAS No. 70, as Amended (product no. 012772kk).

The following sections touch on certain topics of particular concern when using SAS No. 70 reports.

**Complementary User Organization Controls**

The plan auditor should read the description of controls to determine whether complementary user organization controls are required (for example, at the plan sponsor level) and whether they are relevant to the service provided to the plan. If they are relevant to the plan, the plan auditor should consider such information in planning the audit. The plan auditor should consider the need to document and test such user organization controls.

**Fiduciary Oversight**

While the plan sponsor may have outsourced administrative functions to a third party, the plan sponsor still has a fiduciary duty to monitor the activities of the third party. Examples of such monitoring controls, which should be considered in planning and performing the audit, may include:

- Review of third-party service provider’s SAS No. 70 report
- Fluctuation analysis or reasonableness review of periodic third-party service provider reports with reconciliations with and comparisons to client data
- Predetermined communication, escalation, and “follow up” procedures in the event of an issue or problem
- Periodic review of financial and control measures included in the third-party service provider contract
- On-site visits to the third-party service provider
- Annual reassessment of effectiveness of the third-party service provider relationship
Mutual Fund Industry Abuses and Related Settlements

In April 2004, the SEC issued final rules to prevent late trading and to curb market timing abuses. The rules to prevent market timing abuses include, among others, rules that require explicit disclosure in fund-offering documents of market timing policies and procedures. The final rules are available on the SEC Web site at www.sec.gov/rules/final/33-8408.htm.

Late trading and market timing may affect benefit plans in two ways. First, plan sponsors have a fiduciary duty to select prudent investments and investment options for participants. It could be considered a fiduciary breach if it was determined the plan sponsor was not prudent in selecting a mutual fund as a plan investment that had losses due to market timing or late trading.

Second, some benefit plan sponsors have determined that certain plan participants in participant-directed defined contribution plans have been engaging in market timing, potentially raising expenses for all participants. Many benefit plans and their third-party administrators have implemented policies and procedures to restrict and deter market timing. These policies include larger redemption fees for certain investment funds as well as third-party administrators providing reports to the plan sponsor listing participants engaging in excessive trading. Some of the consequences of abuses to the system include (1) restrictions of purchases/sales of the mutual fund in question for all participants of the plan for a period, (2) closing the mutual fund to new monies for all participants in the plan, (3) removal of the mutual fund(s) as an investment option for the plan, and (4) restricting the initiation of transactions to paper forms. Plan sponsors have a fiduciary duty to be on the watch for such transactions and could be liable for potential losses incurred by participants.

Many mutual funds have settled with the SEC regarding market timing issues. Such settlements could raise reporting and auditing implications for benefit plans. Plan investors in funds where late trading or improper trading by market timers occurred may receive compensation for losses resulting from the dilution of fund gains. Also, as a result of these investigations, there may be greater
scrutiny of investment policies and trading procedures by the plan sponsor. Plan sponsors may respond to information about a fund’s illegal or improper trading by redeeming shares in these funds, or opt for other investments or investment options for participants.

**Help Desk**—It is important for the plan auditor to inquire of the plan sponsor whether there are any settlement amounts due the plan. Plan sponsors should consult with legal counsel regarding the treatment of settlement amounts. If settlement amounts are received directly by the plan sponsor that are due the plan and are not remitted to the plan, it may be considered a prohibited transaction under ERISA section 406, regardless of materiality.

The auditor of an employee benefit plan should be aware of the possibility that violations of laws and regulations may have occurred. If specific information that provides evidence concerning the existence of possible violations affecting the financial statements comes to the auditor’s attention, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred [see AU sec. 317.07, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1)].

According to paragraph 7.15 of the EBP Guide, one of the objectives of auditing procedures applied to benefit plan investments is to provide the auditor with a reasonable basis for concluding whether investment transactions are initiated in accordance with the established investment policies of the plan. As part of a full-scope audit, auditors should review relevant plan documents, such as the latest plan agreement, investment adviser agreements, and investment policy statement. Auditing procedures for investments (EBP Guide, paragraph 7.16) also include inquiring of the plan administrator or other appropriate parties if they are aware of any situation where the plan’s investments or other transactions violate applicable laws or regulations. The auditor should consider whether management has identified any noncompliance with the stated investment restrictions and test the compliance

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with the restrictions to the extent considered necessary. A benefit plan sponsor's failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the plan.

**Independence Issues**

For various reasons, including mergers and acquisitions, companies change auditors as well as their auditors for related employee benefit plan audits. As a result, it is important to recognize that there are independence issues that should be addressed.

For ERISA engagements, the DOL has separate independence standards that are more restrictive than those of the AICPA or SEC. For example, DOL guidelines require the auditor to be independent for the period of engagement and during the period covered by the financial statements. See paragraph A.88 of the EBP Guide for a listing of the DOL’s independence standards.

According to the Employee Benefit Security Administration (EBSA) Unified Agenda Entries from fall 2005, the EBSA is conducting a review of the guidelines applicable to determining when a qualified public accountant is independent for purposes of auditing and rendering an opinion on the financial information required to be included in the annual report of an employee benefit plan. Given the changes that have taken place with respect to employee benefit plans and auditing practices and standards, as well as changes in the industry, since the issuance of those guidelines, EBSA is preparing a request for information (RFI) that will invite interested persons to submit written comments and suggestions concerning whether and to what extent the current guidelines should be modified. It is expected that this RFI will be issued in May 2006.

**Regulatory Developments**

**2005 Form 5500 Series**

The DOL, IRS, and PBGC have released the 2005 Form 5500 return/reports, schedules, and instructions to be used by employee
benefit plans for plan year 2005 filings. The IRS has also released the Form 5500-EZ return and instructions to be used by certain one-participant retirement plans for plan year 2005 filings.

The modifications to the Form 5500 for plan year 2005 are described under “Changes to Note” in the 2005 instructions.

**Modifications to the Form 5500 Annual Report for 2005**

- **Form 5500**—The instructions for lines 6 and 7 have been improved to provide additional information on how to determine the number of participants in a welfare plan and how to determine whether a plan sponsor has established one or more welfare plans.

- **Schedule A**—The instructions on required fee and commission reporting and disclosures reflect DOL Advisory Opinion 2005-02A.

- **Schedule B**—Instructions to line 6 have been modified to describe more precisely the level of detail that needs to be included in the attachments for (a) the statement of actuarial assumptions and methods and (b) the summary of eligibility and benefit provisions used in the plan valuation.

- **Schedule B**—Line 6j has been added to obtain information on the estimated annual investment return on the current value of assets. It parallels the line 6i information already required to be provided for investment returns on the actuarial value of assets.

- **Schedule D**—The instructions have been improved to emphasize the proper use of Direct Filing Entity (DFE) EIN/PNs versus plan EIN/PNs in Part I and to emphasize that only DFEs need to complete Part II.

- **Schedule H**—The instructions for line 4a have been clarified to make clear that the total amount of any delinquent contributions should be carried over and reported again on line 4a of the Schedule H or I for each year in which the contributions are delinquent and for each subsequent year until the year after the violation has been fully corrected.
which correction includes payment of the late contributions and reimbursement of the plan for lost earnings or profits.

- **Schedule R**—Line 8 has been modified to identify plan amendments that decrease, as well as increase, the value of benefits.

- **Schedule R**—Part IV has been added to include a plan coverage question previously included in Schedule T. The instructions for Schedule R now reflect the requirements of plan coverage (ration percentage or average benefit test) and include the exceptions for not meeting the coverage requirements. Part IV must be completed annually, unless the plan meets any of the five exceptions mentioned in the instructions.

- **Schedule T**—The IRS no longer requires the filing of Schedule T, Qualified Pension Plan Coverage Information. However, unless the plan meets one of the exceptions (see the instructions for Schedule R), the plan will still need to indicate whether the plan meets the ration percentage or average benefit test.

- **Compliance Checklist**—The plan administrator compliance checklist has been revised to alert filers to their duties under the Sarbanes-Oxley Act by asking whether the plan gave proper notice to participants for any “blackout periods.”

**Modifications to the Form 5500-EZ Annual Report for 2005**

Effective for calendar year 2005, filers of Form 5500-EZ are no longer required to file any schedules or attachments (including the Schedule B (Form 5500)). Filers, however, are still required to collect and retain completed and signed Schedules B and P, if applicable.

This change does not eliminate the requirement to both perform an annual valuation and maintain the funding standard account required for all plans subject to the minimum funding requirements of IRS section 412.
The official government printed forms are available by calling (800) TAX-FORM ((800) 829-3676). Information copies of the forms, schedules, and instructions are available on EBSA’s Web site at www.efast.dol.gov. Filers should monitor the EFAST Web site for information on approved software vendors when completing 2005 Forms 5500 by computer and for electronic filing options. Filers may contact the EFAST Help Line for general assistance by calling (866) 463-3278.

**Extended Filing Deadline for Annual Report Filers in Gulf Coast Region**

In a February 27, 2006, press release, the DOL’s EBSA announced an extension of the deadline for filing the Form 5500 series annual returns/reports to August 28, 2006. This additional reporting relief is being granted to filers in 31 parishes in Louisiana, 46 counties in Mississippi, and 11 counties in Alabama.

The new extension for reporting applies to plan administrators, employers, and other entities affected by Hurricane Katrina and located in one or more parishes or counties listed in the IRS’s Notice IR-2006-30, dated February 17, 2006. The extension also applies to firms located outside the affected areas who are unable to obtain the necessary information from service providers, banks, or insurance companies whose operations were located in the areas listed in IR-2006-30 and affected by Hurricane Katrina.

Form 5500 filers using this extension should check Form 5500, Part I, Box D, and attach a statement labeled “Form 5500, Box D—Hurricane Katrina Disaster Relief Extension.” Similarly, Form 5500 EZ filers should check Form 5500 EZ, Part I, Box B, and attach a statement labeled “Form 5500 EZ, Box B—Hurricane Katrina Disaster Relief Extension.”

For more information about disaster relief, contact FEMA at (800) 621-3362 or (202) 621-FEMA, or the Internal Revenue Service at www.irs.gov under “Disaster Area Tax Relief.” Filers who have additional questions may contact EBSA’s EFAST help line at (866) 463-3278.
2005 Form M-1 for Multiple Employer Welfare Arrangements

On December 9, 2005, the DOL published the 2005 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). Plan administrators may use EBSA’s online filing system to expedite processing of the form.

MEWAs are arrangements that offer medical benefits to the employees of two or more employers or to their beneficiaries. The annual filing date for the 2005 Form M-1 is March 1, 2006. In addition, administrators can request an automatic 60-day extension to May 1, 2006. The 2005 form has few changes from the previous year.

The online filing system is available on the DOL’s Web site. It allows filers to complete the form and submit it at no cost. The online form can be completed in multiple sessions and can be printed for the filer’s records. The Web site includes a user manual, frequently asked questions, and a link to submit questions electronically.

To use the online filing process, go to www.askebsa.dol.gov/mewa/. Technical assistance for the online filing system is also available by calling (202) 693-8600. Information about the Form M-1 and how to fill it out is available on the Web site or by calling (202) 693-8360. Paper copies of the form may be obtained by calling EBSA’s toll free number at (866) 444-EBSA (3272) or visiting the Web site at www.dol.gov/ebsa and clicking on Forms/Doc Requests.

Small Pension Plan Security Regulation

On October 19, 2000, the DOL published a final rule designed to safeguard small pension plan assets by adding new conditions to the audit waiver requirement that focus on persons who hold plan assets, enhanced disclosure to participants and beneficiaries, and improved bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation. See Appendix I of this Audit Risk Alert for frequently asked questions on the small pension plan audit waiver regulation.
Correspondence From EFAST or the DOL Office of the Chief Accountant

Plan administrators often receive correspondence from the DOL regarding the Form 5500 filed for their pension and welfare benefit plans. These letters are generated by both the EFAST processing center in Lawrence, Kansas, and the DOL’s Office of the Chief Accountant (OCA) in Washington, D.C. Auditors are often asked by their clients to assist in the resolution of issues contained in these government letters.

EFAST-Generated Correspondence

Each year, plan administrators complete and submit to the DOL a Form 5500 for each of their qualified employee benefit plans. Large plans (and certain small pension plans) also require an annual audit, and the independent auditor’s report and audited financial statements become an integral part of the Form 5500 filing.

Once completed, the Form 5500 is filed with the DOL’s EFAST processing center in Lawrence, Kansas. EFAST uses sophisticated electronic technologies to review each filing before acceptance. The DOL, IRS, and the PBGC have created a variety of edit tests designed to check for things such as completeness, accuracy, timeliness, internal consistency, missing schedules or attachments, and failure to answer mandatory questions. If deficiencies or discrepancies are identified after subjecting Form 5500 filings to these multiagency edit tests, the EFAST system generates a letter addressed to the plan administrator that identifies the problem(s) and provides 30 days within which to make any necessary corrections. After 30 days, if the filing remains deficient, EFAST will generate a second letter in a final attempt to perfect the filing. At the end of a second 30-day period, the Form 5500 filings are said to “post” final to the ERISA database. Those filings still containing errors or omissions are flagged for further review by the DOL’s OCA, the IRS, and the PBGC.

Correspondence From the Office of the Chief Accountant

The DOL’s OCA has the responsibility for enforcing ERISA reporting and disclosure requirements. This includes ensuring that
the Form 5500 filings are filed timely and correctly, and determining whether plan audits are performed in accordance with professional auditing and regulatory standards. The OCA routinely queries the ERISA database and targets for review Form 5500 filings that satisfy certain criteria, including those filings in which processing errors went uncorrected and those with improperly prepared auditor's reports. The OCA staff review the Form 5500 filings and also request copies of working papers that support audit engagements. If the OCA staff identifies problems, a formal enforcement process commences with the issuance of a Notice of Rejection (NOR) against the plan administrator.

Upon receipt of a NOR, the plan administrator has 45 days to make any necessary corrections to the Form 5500 filing. This may involve the auditors having to correct their audit reports or even perform additional fieldwork in audit areas where work was previously not performed or deemed by the DOL to be insufficient. At the end of the 45-day period, if the Form 5500 filing remains deficient, the DOL issues a Notice of Intent to Assess a Penalty (NOI), potentially subjecting the plan administrator to civil penalties of up to $1,100 per day (imposed from the day after the original due date of the filing). As a policy matter, however, most deficiencies are penalized at $150 per day with penalties capped at $50,000.

When plan administrators receive an NOI, they have 35 days to submit to the DOL a Statement of Reasonable Cause, submitted under penalty of perjury, in which they set forth any reasons why the penalty should be abated in part or in full. (It is important to note that traditionally the DOL will not consider abatement of any penalties in cases where deficiencies still exist.) If the plan administrator fails to comply with the requirements of the NOI, the penalty becomes a final agency action, and the plan administrator forfeits all appeal rights.

After the DOL reviews the statement of reasonable cause, the agency issues a Notice of Determination that contains the final penalty amount assessed against the plan administrator. The plan administrators may choose to pay the penalty amount or, within
35 days as provided for in the letter, file an answer with the administrative law judge, appealing the penalty.

**Important Reminders**

Plan administrators should make all efforts to respond timely and thoroughly to all correspondence they receive from the EFAST processing center. Failure to do so may result in future enforcement correspondence from the DOL’s OCA. The DOL’s penalty process contains rigid timeframes, and DOL officials do not have latitude to extend the deadlines contained in any correspondence. Plan administrators should also be aware that they may receive future enforcement correspondence from the IRS, PBGC, or both, regarding any unresolved filing issues.

Plan auditors often assist their clients in responding to the various DOL penalty notices. To respond on behalf of their clients, plan auditors must be authorized to do so pursuant to a duly executed, notarized power of attorney. Any questions regarding the DOL penalty process should be directed to the OCA at (202) 693-8360.

**EBSA-Enhanced Programs to Assess Plan Audit Quality**

The EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, 37 public accounting firms audit more than 100 plans that cover approximately 80 percent of plan assets subject to audit. In addition, 8,200 firms perform five or fewer audits. Accordingly, the EBSA has modified its approach for selecting and evaluating ERISA audits, using both top-down and bottom-up strategies.

First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices. EBSA staff meet with firm management, review firm policies and procedures that relate to employee benefit plan audits, and conduct on-site reviews of a sample of ERISA audit engagements. This “top-down” approach will provide the EBSA a more efficient means of evaluating the quality of audit work performed by these large firms and ensure that findings and recommendations are communicated to those
in a position to effect any necessary changes. To date, the EBSA has completed three such reviews.

Audit quality also remains a primary focus of EBSA’s desk reviews. The agency focuses its in-house work on reviewing copies of selected audit working papers prepared by firms with small to medium-size audit practices. To date, the EBSA has conducted approximately 700 of these desk reviews.

In instances in which deficient audit work is identified, the related Form 5500 filings are subject to rejection, and auditors potentially face referral to the AICPA’s Professional Ethics Division or State Board of Public Accountancy.

**DOL Fiduciary Education Initiatives**

The DOL is committed to providing employers and service providers with clear and easy-to-access information on how to comply with federal employment laws. Such information and guidance are often referred to as “compliance assistance,” which is a cornerstone of the DOL’s mission.

The DOL’s fiduciary education initiatives include nationwide educational seminars to help plan sponsors understand rules and meet their responsibilities to workers and retirees, thereby improving their financial security. Also included are the following DOL-issued publications:

- **Meeting Your Fiduciary Responsibilities.** To meet their responsibilities as plan sponsors, employers need to understand some basic rules, specifically the Employee Retirement Income Security Act (ERISA). ERISA sets standards of conduct for those who manage an employee benefit plan and its assets (called fiduciaries). This publication provides an overview of the basic fiduciary responsibilities applicable to retirement plans under the law.

- **Understanding Retirement Plan Fees and Expenses.** This booklet will help retirement plan sponsors better understand and evaluate their plan’s fees and expenses. While the focus is on fees and expenses involved with 401(k) plans,
many of the principles discussed in the booklet also will have application to all types of retirement plans.

- **401(k) Plan Fee Disclosure Tool.** This is a form that 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. Now available in MS Word format.

- **Selecting an Auditor for Your Employee Benefit Plan.** Federal law requires employee benefit plans with 100 or more participants to have an audit as part of their obligation to file the Form 5500. This booklet will assist plan administrators in selecting an auditor and reviewing the audit work and report.

- **Reporting and Disclosure Guide for Employee Benefit Plans.** This guide is intended to be used as a quick reference tool for certain basic reporting and disclosure requirements under ERISA.

Further information regarding DOL publications and the dates and locations of upcoming educational programs may be found on the EBSA’s Web site, at www.dol.gov/ebsa.

**DOL Issues Rules on Multiemployer Pension Plan Funding Notices**

On January 11, 2006, the DOL published final rules requiring administrators of multiemployer pension plans to furnish annually a notice on the funding status of the plans under provisions of the Pension Funding Equity Act of 2004.

The regulation provides that a notice be sent annually to multiemployer plan participants, beneficiaries, labor organizations, contributing employers, and the PBGC. The notice must include basic financial information about the multiemployer plan, such as a statement as to whether the plan is 100 percent funded. The notice also must include a comparison of the plan’s assets to benefit payments, a description of the law governing insolvent multiemployer plans and the benefits guaranteed under the PBGC’s multiemployer program. The regulation contains a model notice to reduce compliance burdens on plans and their administrators.
The DOL proposed the regulations February 4, 2005, and received comments from plan administrators, employers, service providers, and others who would be affected. In response to these comments, the DOL made minor changes to clarify the rules and the accompanying model notice.

The text of the DOL final rule is available on the EBSA Web site at www.dol.gov/ebsa.

Delinquent Filer Voluntary Compliance Program

The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage plan administrators to file overdue annual reports by paying reduced penalties. Established in 1995 and revised in March 2002, the program offers incentives for delinquent plan administrators to voluntarily comply with ERISA’s annual reporting requirements.

Change in Mailing Address

The DOL has announced a new address to be used for the DFVC Program, for all submissions and correspondence starting on April 11, 2006. The new address is:

<table>
<thead>
<tr>
<th><strong>Standard Mail</strong></th>
<th><strong>Private Delivery Service</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>DFVC Program—DOL</td>
<td>DFVC Program—DOL</td>
</tr>
<tr>
<td>P.O. Box 70933</td>
<td>QLP Wholesale Lockbox—NC 0810</td>
</tr>
<tr>
<td>Charlotte, NC</td>
<td>1525 West WT Harris Blvd.</td>
</tr>
<tr>
<td>28272-0933</td>
<td>Charlotte, NC 28262</td>
</tr>
</tbody>
</table>

Mail submitted to the former address will be forwarded to the new address for a short time. After this period, mail will be returned, unopened, to the sender.

Program Eligibility

Eligibility in the DFVC Program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29
CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVC Program because such plans are not subject to Title I.

Program Criteria
Participation in the DFVC Program is a two-part process. First, file with EBSA a complete Form 5500 Series Annual Return/Report, including all schedules and attachments, for each year relief is requested. Special simplified rules apply to “top hat” plans and apprenticeship and training plans. Second, submit to the DFVC Program the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount and, therefore, amounts paid under the DFVC Program shall not be paid from the assets of an employee benefit plan.

Penalty Structure

- **Per day penalty.** The basic penalty under the program is $10 per day for delinquent filings.

- **Per filing cap.** The maximum penalty for a single late annual report is $750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and $2,000 for a large plan.

- **Per plan cap.** This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The per plan cap limits the penalty to $1,500 for a small plan and $4,000 for a large plan, regardless of the number of late annual reports filed for the plan at the same time. There is no “per administrator” or “per sponsor” cap. If the same party is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

- **Small plans sponsored by certain tax-exempt organizations.** A special “per plan” cap of $750 applies to a small plan sponsored by an organization that is tax-exempt under IRC section 501(c)(3). The $750 limitation applies regardless of the number of late annual reports filed for the plan at the
same time. It is not available, however, if as of the date the plan files under the DFVC Program there is a delinquent annual report for a plan year during which the plan was a large plan.

- “Top hat” plans and apprenticeship and training plans. The penalty amount for “top hat” plans and apprenticeship and training plans is $750.

**Internal Revenue Service and Pension Benefit Guaranty Corporation Participation**

Although the DFVC Program does not cover late filing penalties under the IRC or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVC Program have been satisfied.

Questions about the DFVC Program should be directed to the EBSA by calling (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov, or call the EBSA Help Desk toll-free at (866) 463-3278.

**Voluntary Fiduciary Correction Program**

The Voluntary Fiduciary Correction Program (VFCP) encourages voluntary compliance by self-correcting violations of the law. The program also helps plan officials understand the law and gives immediate relief from payment of excise taxes under a class exemption.

A revised VFCP, which simplifies and expands the original VFCP, was published in the Federal Register in April 2005. The revised VFCP allows applicants to rely on the revised provisions in seeking VFCP relief. Alternatively, applicants may choose to rely on the provisions of the original VFCP until the revised VFCP is published in final form.

An amended class exemption was published in the Federal Register but may not be relied upon until published in final form. The
companion class exemption to the original VFCP remains effective and available to applicants until the revised class exemption is finalized.

Proposed amendments to the VFCP include:

- Three new eligible transactions dealing with delinquent participant loan repayments, illiquid plan assets sold to interested parties, and participant loans that violate certain plan restrictions on such loans
- Simpler methods and an online calculator for figuring out the amount to be restored to plans
- Streamlined documentation and clarified eligibility requirements, and a model application form

The VFCP allows employers to voluntarily correct specific ERISA violations. Applicants must fully correct any violations, restore to the plan any losses or profits with interest, and distribute any supplemental benefits owed to eligible participants and beneficiaries. A “No-Action Letter” is given to plan officials who properly correct violations.

An amendment to add the sale of illiquid assets to the existing VFCP class exemption is simultaneously proposed and will not be effective until finalized.

For more information about the VFCP Program, contact a local EBSA regional office through its toll-free number, (866) 444-EBSA (3272), or visit the DOL online at www.dol.gov/ebsa.

**EBSA Outreach and Customer Service Efforts**

The EBSA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 693-8360 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the EBSA’s EFAST Help Desk at its toll-free number, (866) 463-3278.

In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide in-
formation to practitioners to help their clients comply with
ERISA's reporting and disclosure requirements. The agency's out-
reach efforts continue to focus on plan audit quality, the current
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)
693-8360. Practitioners and other members of the public may
also wish to contact the EBSA at its Web site at www.dol.gov/
ebsa. The Web site also provides information on EBSA's organiza-
tional structure, current regulatory activities, and customer ser-
vice and public outreach efforts.

**Timeliness of Remittance of Participant Contributions Remains an
Enforcement Initiative for the EBSA**

The EBSA continues to focus on the timeliness of remittance of
participant contributions in contributory employee benefit plans.
Participant contributions are plan assets on the earliest date that
they can reasonably be segregated from the employer's general as-
sets, but in no event later than (1) for pension plans, the 15th
business day of the month following the month in which the par-
ticipant contributions are withheld or received by the employer,
and (2) for welfare plans, 90 days from the date on which such
amounts are withheld or received by the employer.

**Reporting of Late Remittances**

Failure to remit or untimely remittance of participant contribu-
tions constitutes a prohibited transaction under ERISA section
406, regardless of materiality. Such transactions constitute either
a use of plan assets for the benefit of the employer or a prohibited
extension of credit. In certain circumstances, such transactions
may even be considered an embezzlement of plan assets.

Information on all delinquent participant contributions should
be reported on line 4a of either Schedule H or Schedule I of the
Form 5500, regardless of the manner in which they have been
corrected. In addition, plan administrators should correct the
prohibited transaction with the IRS by filing a Form 5330 and
paying any applicable excise taxes.
Beginning with the 2003 Form 5500, information on delinquent participant contributions is no longer required to also be reported on line 4d of Schedule G. For large plans that are subject to the audit requirement:

- Delinquent participant contributions reported on line 4a that constitute prohibited transactions (excluding those that have been corrected under the VFCP and for which the conditions of PTE 2002-51 have been satisfied, as described below) may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the independent qualified public accountant (IQPA).

- ERISA and DOL regulations require additional information to be disclosed in supplemental schedules. Some of this information is required to be covered by the auditor’s report. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), as amended, provides guidance on the form and content of reporting when the auditor submits a document containing information accompanying 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 EBP Guide for further discussion of prohibited transactions.

Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL’s Voluntary Fiduciary Correction Program (VFCP). Plans that fully comply with the program, including satisfaction of the conditions of Prohibited Transaction Exemption (PTE) 2002-51:
• Will receive a “No-Action Letter” issued by the DOL that provides for no imposition of section 502(l) penalties

• Receive relief from the IRC’s excise tax provisions

• Continue to report the occurrence and amount of the corrected delinquent remittances on line 4a of either Schedule H or Schedule I (but not on line 4d or Schedule G)

• Are not required to report such transactions as supplemental information if the plan is required to be audited since the transactions are not considered to be prohibited transactions

The EBSA’s Web site, www.dol.gov/ebsa, contains useful information about the VFCP, including a Fact Sheet, a FAQ section, and a sample No-Action Letter.

**Reporting of Delinquent Loan Repayments**

Generally speaking, participant loan repayments are not subject to the DOL’s participant contribution regulation (29 C.F.R. sec. 2510.3-102). Accordingly, their delinquent remittance is not reported on line 4a of either Schedule H or Schedule I. However, delinquent remittance of participant loan repayments is a prohibited transaction.

In Advisory Opinion 2002-2A, the DOL concluded that, while not subject to the participant contribution regulation, participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer’s general assets.

Accordingly, the DOL will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan
DOL Proposed Rule on Electronic Filing of the Form 5500

As part of its continuing effort to update and streamline the annual reporting process, the EBSA has published a proposed regulation that would require plans to file the Form 5500 Series report electronically beginning with plan filings due in 2008.

Adopting an electronic filing system is consistent with recommendations made by the Government Accountability Office and the ERISA Advisory Council.

The proposed regulation would apply to all employee benefit plans required to file Form 5500 reports with the DOL. In conjunction with this regulatory initiative, EBSA also will update EFAST to ensure that plans and service providers have secure Internet-based methods for transmitting filings. The text of the proposed regulation is available on the EBSA Web site at www.dol.gov/ebsa.

In addition, the DOL, along with the IRS and PBGC, will propose revisions to the 2007 plan year forms to streamline and improve the information filed by plans.

DOL Abandoned Individual Account Plan Proposed Regulations and Class Exemption

The DOL has proposed rules to facilitate a voluntary, safe, and efficient process for winding up the affairs of abandoned individual

repayments is included on Line 4a of the Schedule H or Schedule I. Filers that choose to include such participant loan repayments on Line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

Delinquent forwarding of participant loan repayments is eligible for correction under the VFCP and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions.

For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or at the EBSA’s Web site at www.dol.gov/ebsa.

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As part of its continuing effort to update and streamline the annual reporting process, the EBSA has published a proposed regulation that would require plans to file the Form 5500 Series report electronically beginning with plan filings due in 2008.

Adopting an electronic filing system is consistent with recommendations made by the Government Accountability Office and the ERISA Advisory Council.

The proposed regulation would apply to all employee benefit plans required to file Form 5500 reports with the DOL. In conjunction with this regulatory initiative, EBSA also will update EFAST to ensure that plans and service providers have secure Internet-based methods for transmitting filings. The text of the proposed regulation is available on the EBSA Web site at www.dol.gov/ebsa.

In addition, the DOL, along with the IRS and PBGC, will propose revisions to the 2007 plan year forms to streamline and improve the information filed by plans.

DOL Abandoned Individual Account Plan Proposed Regulations and Class Exemption

The DOL has proposed rules to facilitate a voluntary, safe, and efficient process for winding up the affairs of abandoned individual

repayments is included on Line 4a of the Schedule H or Schedule I. Filers that choose to include such participant loan repayments on Line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

Delinquent forwarding of participant loan repayments is eligible for correction under the VFCP and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions.

For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or at the EBSA’s Web site at www.dol.gov/ebsa.
account plans, so benefit distributions are made to participants and beneficiaries. Significant business events, such as bankruptcies, mergers, acquisitions, and other similar transactions affecting the status of an employer, too often result in employers, particularly small employers, abandoning their individual account pension plans (for example, 401(k) plans). When this happens, custodians such as banks, insurers, and mutual fund companies are left holding the assets of these abandoned plans but do not have the authority to terminate such plans and make benefit distributions. Participants and beneficiaries are left with no ability to access the benefits they have earned.

Overview of Proposed Regulations
The proposed regulations establish standards for determining when a plan is abandoned, simplified procedures for winding up the affairs of the plan and distributing benefits to participants and beneficiaries, and guidance on who may initiate and carry out the winding-up process.

Plan Abandonment
A plan generally will be considered abandoned under the proposal if no contributions to or distributions from the plan have been made for a period of at least 12 consecutive months and, following reasonable efforts to locate the plan sponsor, it is determined that the sponsor no longer exists, cannot be located, or is unable to maintain the plan.

Determinations of Abandonment
Only a qualified termination administrator (QTA) may determine whether a plan is abandoned under the proposal. To be a QTA, an entity must hold the plan’s assets and be eligible as a trustee or issuer of an individual retirement plan under the IRC (for example, bank, trust company, mutual fund family, or insurance company).

Termination and Winding-Up Process
The regulations establish specific procedures that QTAs must follow, including:
Notifying EBSA prior to, and after, terminating and winding up a plan
Locating and updating plan records
Calculating benefits payable to participants and beneficiaries
Notifying participants and beneficiaries of the termination and their rights and options
Distributing benefits to participants and beneficiaries
Filing a summary terminal report

A QTA is not required to amend a plan to accommodate the termination, and the rules include model notices that the QTA may use.

Rollover Safe Harbor for Missing Participants
The regulations establish a fiduciary safe harbor for the investment of rollover distributions from terminated plans to IRAs for missing participants.

Fiduciary Liability and Annual Reporting Relief
QTAs that follow the regulation will be considered to have satisfied the prudence requirements of ERISA with respect to winding-up activities.

The regulation provides annual reporting relief, under which QTAs are not responsible for filing a Form 5500 Annual Report on behalf of an abandoned plan, either in the terminating year or any previous plan years, but the QTA must complete and file a summary terminal report at the end of the winding-up process.

Proposed Class Exemption
Accompanying the proposed regulations is a proposed class exemption that would provide conditional relief from ERISA’s prohibited transaction restrictions.

The proposal would cover transactions where the QTA selects and pays itself to provide services in connection with terminating an abandoned plan, and for selecting and paying itself in connection with rollovers from abandoned plans to IRAs maintained by the
QTA, including payment of investment fees as a result of the investment of the IRA’s assets in a proprietary investment product.

Any questions about the proposed regulation should be directed to the EBSA’s Office of Regulations and Interpretations at (202) 693-8500. Questions about the proposed exemption should be directed to EBSA’s Office of Exemption Determinations at (202) 693-8540.

**Legislative Developments**

On December 15, 2005, the House passed the Pension Protection Act (H.R. 2830) and on November 16, 2005, the Senate passed its own reform bill, The Pension Security and Transparency Act of 2005 (S. 1783). Members of a House-Senate conference are in the process of merging the two bills into a single measure that must be approved by both the House and Senate before being sent to the President for his signature.

The legislation is aimed at improving workers’ retirement security through strengthening the funding requirements for single-employer defined benefit pension plans, creating new rules for multiemployer plans, and improving disclosures to current plan participants. Legislation would also expand retirement savings options and provide enhanced disclosures to participants in defined contribution plans.

Further information about the House and Senate bills may be found at the House Education & the Workforce Committee Website at http://edworkforce.house.gov/issues/109th/workforce/pension/pension.htm.

**Audit Issues**

**Investments**

Pension funds, especially master trust arrangements and those with large investment portfolios, continue to invest in hard-to-value and alternative investments, including hedge funds, limited partnerships, real estate, and derivatives. Many plans also use
securities lending arrangements as a way to enhance investment performance.

Plan investments represent the majority of assets held by a benefit plan. Benefit plans invest in a wide variety of investments and investment vehicles, some of which are not easily identified by review of the investment trust statements. It is important for auditors to gain an understanding of the types of investments the plan holds to determine the proper auditing procedures and accounting and reporting implications. This understanding can be obtained through (1) discussions with plan management, investment advisers, custodians, or trustees and (2) reviews of investment agreements, minutes of investment committee meetings, and other documentation. Chapter 7 of the EBP Guide provides a description of various investments and related audit procedures. Also see Appendix B of this Alert for definitions of certain investments.

Investment Confirmation for Full-Scope Audits

Investment confirmations are used to obtain evidence regarding the existence and ownership of investments held by a benefit plan. The following is an example investment confirmation that can be used to help confirm existence and ownership of investments for full-scope audits. For further guidance on the use of confirmations, refer to Interpretation No. 1, “Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value,” of AU section 328, Auditing Fair Value Measurements and Disclosures (AICPA, Professional Standards, vol. 1). Engagement teams should modify the confirmation as considered necessary to the specific circumstances of each engagement.

In addition to the confirmation below, engagement teams may also want to inquire of the plan sponsor and/or trustee/custodian the following:

- The identification of any nonreadily marketable securities
- Any accounting policy changes implemented by the trustee/custodian during the year ended December 31, 200X, that affected the plan’s records.
• The basis of accounting of the records of the trust. If the records are maintained on a basis of accounting other than the accrual basis, the amount and nature of any unrecorded accrued income and expenses as of [statement of net asset date].

• The basis of how gains and losses on investments are calculated (that is, historical cost or current value cost basis).

• How gains and losses on investment are calculated (that is, moving average, specific identification or other basis).

If the portfolio includes common collective trust funds and/or pooled separate accounts, engagement teams should consider requesting a copy of the most recent annual report (with audited financial statements) for each of the common collective trust funds or pooled separate funds held by the plan.

Help Desk—It is becoming more common for trustees/custodians to provide audit firms with electronic access to trust statements using a protected password. This may be an acceptable method to obtain a listing of assets of the plan but does not preclude the audit firm from confirming the existence of the investments with the respective trustee/custodian.

The following is an illustrative full-scope investment confirmation:

[Date]
[Contact’s Name]
[Name of Custodian or Trustee]
[Address]
[City, State, Zip Code]

Dear [Name of Custodian or Trustee],

In connection with the audit(s) of the financial statements of [name of plan(s)] (the Plan), as of [statement of net asset date], please provide the following directly to our independent auditors [name of audit firm]:

1. A complete listing of all securities held by you as of [statement of net asset date]. Such listing should include the
name of the issuer, description of the investment including the number of shares of stock, par value of bonds, units of participation, principal amount of mortgages, maturity date, interest rate, cost and fair market value at the end of the period.

2. [Include this paragraph if securities lending transaction exist.] The dollar amount by type of investment of securities on loan and the nature and amount of collateral held as of [statement of net asset date]. In addition provide the amount of income earned for securities lending activities for the year ended [December 31, 200X].

In addition, please confirm that:

1. There are no pledges, liens or other security interests against the securities owned by the Plan as of [statement of net asset date], other than those disclosed in item 2 above and that we are aware of or that we exercised. If there are any pledges, liens, or other security interest, please provide the details of these items.

2. No loans were made by the plan that we are aware of during the year ended December 31, 200X, other than individual participant loans, if applicable.

3. There were no obligations in default for the year ended December 31, 200X.

4. The records of the trust are recorded on the trade date basis. If transactions are recorded on a basis other than the trade date, please provide a listing of unsettled transactions as of [statement of net asset date].

5. The listing of securities held by you as of [statement of net assets date], provided by you and sent directly to our independent auditors, is a complete and accurate listing of all securities held by you, as trustee/custodian for the plan.

To assure an independent confirmation, please send your reply directly to [name of firm] at [address of firm], in the enclosed self-addressed envelope by [date].

Sincerely,

[Name of Plan Administrator]
CONFIRMATION

To [Name of Audit Firm]

We have attached the requested information and confirm that the information above is correct except as noted below:

________________________________________________
________________________________________________
________________________________________________
________________________________________________
________________________________________________

Signature Date

[Title]

Separately Managed Accounts

Some plans have accounts at a trust company or similar institution consisting of individual plan assets that are managed by an investment manager specifically for the plan. Often these separately managed accounts are mistaken for pooled investment vehicles. A review of the underlying investment agreement with the investment manager will typically reveal whether the investment is a pooled or separately managed vehicle. Individual assets of a separately managed account are held in the name of the plan. The auditing objectives and procedures described in paragraphs 7.15 and 7.16 of the EBP Guide also apply to individual assets and activity for a separately managed account. (Such individual investments are also subject to the reporting requirements in paragraph 2.14, 3.25, or 4.42 of the EBP Guide. In addition, these investments would be considered individual investments for purposes of reporting on Form 5500, Schedule H, line 4i-Schedule of Assets (Held at End of Year) and line 4j-Schedule of Reportable Transactions.)
Limited Partnerships, Hedge Funds, Private Equity, or Venture Capital Funds

Limited partnerships, hedge funds, private equity, or venture capital funds are pooled investment funds that are lightly regulated and not readily marketable, unlike registered investment funds, commonly known as mutual funds. Plan sponsors typically invest in such vehicles to enhance investment returns. However, such vehicles may result in increased audit risk as there is typically not a SAS No. 70 report available covering the internal controls at the investment manager for the funds. Auditors should take special care in identifying when a plan invests in such funds because it is not uncommon for such investments to be classified incorrectly (for example, as a registered investment company or other type of fund) on the schedule of investments provided by the custodian or trustee.

Paragraph 7.60 of the EBP Guide addresses auditing procedures for alternative investments, such as limited partnerships, hedge funds, and private equity, or venture capital funds when performing full-scope audits.


Auditors should take special care in performing limited scope audit procedures on limited partnership investments and similar vehicles, as often the certifying entity does not have timely or accurate information regarding the amount and valuation of the plan’s investment in the limited partnership or similar vehicles. If such investments have not had adequate year-end valuation procedures performed, the plan administrator should consider (1) requesting the trustee/custodian to exclude such investments from the limited scope certification and (2) instructing the auditor to perform full scope procedures on such investments. Although the auditor is not required to audit certain investment information when the limited scope audit exemption is applicable, further investigation and testing are required whenever the auditor becomes
aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of reporting on the financial statements (see paragraph 7.65 of the EBP Guide). Plan sponsors often use the information certified by the trustee/custodian to prepare the plan’s financial statements. However, information certified by the trustee/custodian is not always in a proper financial statement format. Auditors should keep in mind that while they may not be auditing investments when performing a limited scope audit, they are still responsible for ensuring that the required financial statement disclosures are adequate.

In addition, often the financial statements or appraisal prepared for limited partnerships and similar vehicles do not have the same year end as the plan. The financial statements or appraisal need not cover the exact period covered by the plan’s financial statements; they should, however, be sufficiently recent to satisfy the plan auditor. Auditors may wish to consider additional auditing procedures to address the gap in reporting, such as (1) requesting monthly financial activity of the partnership or similar vehicle since the financial statement or valuation date and performing substantive analytics, (2) inquiring of the investment adviser regarding monthly valuation procedures and any unusual investment activity changes that would result in significant changes in market value, and (3) evaluating the need for additional evidence to determine the fair value of the investments.

**Securities Lending Transactions**

Under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, plans that engage in securities lending should present the assets received in return for the securities, as well as the exchanged securities, on the statement of net assets available for benefits. The exchanged securities, as well as the assets received for them (if an investment) should be reported on the ERISA-required supplemental schedule of assets (held at end of year) with the appropriate disclosures.

For securities lending arrangements within a master trust, footnote disclosure of the master trust investments should include the
collateral pledged as well as an offsetting liability for the return of the collateral. Since plan investments in a master trust are recorded as a single line item on the plan’s statements of net assets, securities lending in the master trust would not be reflected on the face of the plan’s financial statements. Often auditors are unaware that the plan has entered into these transactions because the trustee/custodian nets the collateral assets against the collateral liabilities and the only indication is the existence of “other income” on the statements. Auditors should ask the plan sponsor and service providers about the existence of a securities lending arrangement as well as reviewing plan documents to determine the proper auditing procedures. It is important to note that the terms of security lending agreements vary; therefore, it is recommended that auditors obtain a copy and review the security lending agreements to help gain an understanding of the security lending arrangements entered into by the plan sponsor.

Securities loaned under a securities lending program at the end of the year should be reported on the Form 5500 Schedule of Assets (Held at End of Year). If applicable, a notation should be made in column (c) showing there is a restriction on transferability of the loaned securities.

103-12 Entities

How a plan reports investments on Schedule H to the Form 5500 depends on the nature of the underlying assets of the investments and whether the plan sponsor elects to file directly with the DOL.

DOL regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity, other than a master trust investment account (MTIA), common/collective trust (CCT), or pooled separate account (PSA), whose underlying assets include “plan assets” (within the meaning of DOL regulation 29 CFR 2510.2-101) of two or more plans that are not members of a related group of employee benefit plans. Making this determination can be complicated and may necessitate legal or other specialized industry consultation. Generally a 103-12 entity will operate based on its legal structure (according to its operating agreements) in the form of a financial services product.
such as a trust or a limited partnership. Typically, audited financial statements are required by the entity’s operating agreement and are prepared in accordance with generally accepted accounting principles (GAAP) in a format following industry standards consistent with the entity’s operations. For example, a 103-12 entity that operates as a limited partnership would prepare financial statements in accordance with GAAP for limited partnerships. See paragraph A.56 of the EBP Guide for guidance on the filing requirements for 103-12 entities.

Often the format of the financial statement schedules (for example, the Schedule of Assets) for the 103-12 entity prepared in accordance with industry standards is not consistent with the format of the schedules as required by Form 5500 instructions. Form 5500 requirements should be considered when reporting on additional information schedules to be attached to the 103-12 entity’s financial statements filed with the Form 5500.

**Self-Directed Investments**

Plan sponsors of participant-directed defined contribution plans continue to allow participants to expand their control over investment decisions, 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. Self-directed investments are 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 fund vehicles, such as registered investment companies (that is, 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. Paragraphs 7.61 through 7.63 of the EBP Guide provide additional guidance on self-directed features.

**Help Desk**—Auditors should note that when a SAS No. 70 report is available, often it does not cover the self-directed investments.
Common Audit Concerns

The following table lists specific areas, often overlooked, that auditors should pay particular attention to when auditing employee benefit plans. Discussion of these hot topics can be found in the “Audit Issues” section or the “Industry and Economic Developments” section of this Audit Risk Alert (see the Table of Contents for applicable page references).

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Auditing Health and Welfare Plans

Health and welfare plans present unique audit challenges. They continue to be more complex and more expensive to audit than other types of plans. The administration of health claims payments has always been complicated, and the requirements for more timely claims processing, appeal decisions, and the privacy requirements under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) have added to these complexities. When auditors are using standard audit programs for employee benefit plans, those programs should be tailored to the unique nature of health and welfare plans.

Before performing a health and welfare plan audit, it is critical for the auditor to obtain a clear understanding of the plan. It is important to note that the audit requirement is of the plan and not of the trust. Therefore, the auditor needs to understand the benefits offered by the plan and should consider the following:

- Which benefits are fully insured versus self-insured
- Who the providers are and the elements of the contractual arrangement with the plan
For self-insured claims, how the various claims are administered and adjudicated, and how fees are charged

What information systems are used to support the plan operations, and which of those are in-house systems or outsourced

When answering these questions, the auditor should consider the responses with regard to all covered participants (that is, active participants, Consolidated Omnibus Budget Reconciliation Act (COBRA), and retirees). Understanding the various benefits offered, the service providers, and the control environment are key to developing the audit approach and the sampling methodology.

This section is intended to describe certain areas unique to health and welfare benefit plans, including suggested audit procedures such as:

A. HIPAA Privacy Concerns
B. Health and Welfare Claims and Potential Problems
C. Contracts with Benefit Service Providers
D. Rebates Receivable
E. Accumulated Eligibility Credits
F. Actuarial Data and Census Information
G. Stop-Loss Coverage
H. Premium Stabilization Reserves
I. COBRA
J. Health Savings Accounts and Health Reimbursement Arrangements

A. HIPAA Privacy Concerns

HIPAA established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protec-

4. Some of the audit procedures noted may be more than what is required by generally accepted auditing standards (GAAS).
tion 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.

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 information. The rules were effective for most health plans on April 21, 2005 (small health plans, as defined, have until April 21, 2006, to comply).

**Business Associates Agreements.** HIPAA requires that plan sponsors enter into a business associates agreement with any of their service providers that have access to any protected health information (PHI). If asked to sign such confidentiality, indemnification, or business associates agreements, 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 until 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. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor's legal counsel. Auditors need to keep in mind that the testing of claims by 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. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, or a third-party administrator’s
refusal to provide access under any circumstances, a scope limitation could result.

**Audit Documentation.** As previously noted, HIPAA requires that plan sponsors enter into a business associates agreement with any of their service providers that have access to any PHI. Accordingly, an auditor is considered a business associate and, after entering into a business associates agreement, should be permitted access to the necessary information required by professional standards to opine on a plan’s financial statements. HIPAA regulations allow for the auditors’ working papers to contain PHI; however, PHI in working papers obligates the auditing firm to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of the PHI, which includes:

- Restricting access to the working papers
- Providing an accounting of disclosures of PHI
- Reporting to the sponsor any misuse of PHI by the accounting firm

Auditors should follow the documentation requirements of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), and their documentation should include:

- Summary of evidence obtained, reviewed, and tested.
- Identification of actual selection made for testing, such as claim number, dollar amount, and check number. Due care should be taken to employ an alternative system of participant identification to avoid identification of the participant in the working papers.

• Names of individuals at the sponsor or third-party administrator with whom discussions were held to determine propriety of payment or other operational procedures.
• Methodology employed to determine sample size and selection criteria.

B. Health and Welfare Claims and Potential Problems
The auditor should have a basic understanding of the terms of the plan and have the skill and knowledge to test that claims are being properly adjudicated. It is not expected that the auditor would have the knowledge of a skilled billing claims specialist or a skilled medical specialist when claims are processed by a third-party administrator. The auditor should be aware, however, of the typical problems that a health and welfare plan might experience when processing claims. The auditor should be aware of any processing problems with claims that the plan is experiencing, and should discuss with the plan administrator what the plan is doing to correct these issues. See Appendix E of this Audit Risk Alert for claims testing information. These potential problems may include:

• Unbundling (charging for performance of multiple procedures when only one procedure was performed) or upcoding (charging for a higher level of service than the procedure actually performed)
• Fictitious services or unnecessary services performed by providers
• Duplicate claims or duplicate coverage
• Kickbacks
• Nontransmittal of rebates and discounts to the plan

When testing health and welfare claims, some errors typically found include:

1. Eligibility. Testing for eligibility is different from those procedures for a pension or 401(k) plan. In many cases the person receiving the benefit is different from the actual participant. Audit procedures may include verifying the
coverage elected by the participant at the date of service. Many plans allow coverage for a spouse, dependents, or other family members. Most problems with eligibility relate to a participant who terminates and whose eligibility ceased before the date of service for which the claim was filed.

2. Wrong individual. The claim was paid for the wrong person. This occurs when two or more participants have the same or similar names. Claims are also paid for the wrong family member.

3. Other errors. These may occur in the diagnosis code, the CPT/HCPCS code, or in the information in the claims form.

C. Contracts With Benefit Service Providers

For any contracts the plan has with a benefit service provider, the reconciliation of the amounts due to or from the benefit service provider should be examined to determine if the amounts are appropriate. Any amounts due from the benefit provider should be classified as a receivable in the statement of net assets, and amounts due to the provider would normally be shown in the financial statements with the other benefit obligations of the plan.

D. Rebates Receivable

If there are rebates receivable from a service provider, those rebates should be examined to determine if the correct amount for the appropriate periods of time has been reflected in the proper period. In addition, the auditor should gain an understanding of the service contracts and apply procedures to determine if all rebates have been received by the plan. These include rebates from prescription drug programs or excess premiums paid over claims incurred under certain contractual arrangements with insurance companies. Finally, the auditor should consider the propriety of

6. Physicians’ Current Procedural Terminology (CPT) is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The Health Care Financing Administration (HCFA) developed level II and level III codes in its Healthcare Common Procedure Coding System (HCPCS codes) to bill for supplies and services not covered by a CPT code (level I).
the rebate. For example, if the payment vehicle for the claims receiving the rebate was the Voluntary Employees’ Beneficiary Association (VEBA) trust account, receipt of the rebate by the plan sponsor and deposit of such rebate into a nontrust account may not be appropriate.

E. Accumulated Eligibility Credits
Many plans cover participants when they are terminated or otherwise unemployed. Single employer plans often cover up to 30 days after employment ends. Multiemployer plans can cover up to 60 days or longer after employment ends. In the construction industry, where work is seasonal, hour banks are often used to provide insurance coverage for the months when the participant does not work. If the plan permits accumulated eligibility credits, there should be an obligation recorded for those credits. The auditor should determine whether the plan provides for accumulated eligibility credits and should determine if the obligation has been properly calculated, reported, and disclosed in the financial statements in accordance with paragraph 23 of Statement of Position (SOP) 01-2, Accounting and Reporting by Health and Welfare Benefit Plans.

F. Actuarial Data and Census Information
The actuarial data and census information furnished by the health and welfare plan sponsor to the actuary, especially when the plan covers retirees, is as important as the data used in a defined benefit pension plan. The auditor should gain assurance through confirmation or other audit procedures to ensure that the actuarial data and census information furnished to the actuary is complete and accurate.

G. Stop-Loss Coverage
One way for a plan to protect itself against excessive losses is to purchase stop-loss insurance. Stop-loss insurance can be either specific or aggregate. Specific stop-loss insurance protects the plan against claims that exceed a predetermined maximum per person or per family. All claims above the specific stop-loss amount (for example, $25,000) are normally reimbursed at 100
percent up to a limit contained in the plan. Aggregate stop-loss coverage reimburses the plan when total eligible claims exceed a predetermined aggregate, such as 125 percent of expected claims.

The auditor should gain an understanding of the stop-loss coverage that a plan has and should test that claims have been properly filed against the policy within the period specified by the policy.

**Help Desk**—Employers sponsoring welfare plans may purchase a stop-loss insurance policy with the employer as the insured to help the employer manage its risk associated with its liabilities under the plan. These employer contracts with premiums paid exclusively out of the employer’s general assets without any employee contributions generally are not plan assets and are not reportable on Schedule A or the plan’s financial statements.

**H. Premium Stabilization Reserves**

In some fully insured or minimum premium arrangements, an insurance company may require a contract holder to maintain a premium stabilization reserve. Such reserves are usually adjusted by the insurance company at the end of the policy year. The annual adjustment is often the computed difference, or some factor thereof, between actual claims experience of the insurer and premiums paid by the contract holder. Generally, premium stabilization reserves are held in the general assets of the insurance company and are used to pay future premiums of the contract holder. If the premium stabilization reserve is certain to provide future benefits to the plan, the reserve is reported as an asset of the plan. In some cases, the contract holder may liquidate the premium stabilization reserve via cash payment from the insurance company. In other cases, the premium stabilization reserve is forfeited by the contract holder in the event of termination of coverage. Criteria for realization of the reserve should be considered when evaluating the existence of the asset.

**I. COBRA**

Many health and welfare plans are required to provide continuation of benefits upon termination of employment through
COBRA. This continuation of benefits may be considered a postemployment or postretirement obligation, depending upon the terms of participation. In accordance with SOP 01-2, the benefit obligation associated with COBRA would be equal to the actuarial present value of the cost of such benefits, less the present value of expected participant contributions for such benefits. Many plans require that participants pay the estimated full cost of health benefits provided under COBRA. In such situations, the net cost to the plan sponsor for such benefits is zero, and thus the plan would not recognize an obligation. If the plan sponsor subsidizes the cost of health benefits under COBRA, an obligation should be recognized by the plan to the extent that all criteria required by FASB Statement No. 112, Employers’ Accounting for Postemployment Benefits, FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions, or both, are satisfied.

In many cases, the collection of COBRA contributions and payment of COBRA benefits are performed by third-party administrators. The administration of these benefits should be understood so accounting for all COBRA activity is included in the financial statements of the plan. In the event that benefits provided by COBRA are self-insured, the obligation for claims incurred but not reported should include COBRA participants.

Notices for COBRA Continuation Health Care Coverage. The DOL has published final rules clarifying the requirements for notices under COBRA for employees, employers, and plan administrators. The rules provide guidance and model notices for workers and family members to continue their group health care coverage. Under COBRA, most group health plans must give employees and their families the opportunity to elect a temporary continuation of their group health coverage when coverage would otherwise be lost for reasons such as termination of employment, divorce, or death. COBRA requires that certain notices be given before individuals can elect COBRA coverage. The plan administrator must give employees and spouses a general notice explaining COBRA when the employees and spouses first become covered under the plan. When
an event occurs that would trigger a right to elect COBRA coverage, either the employer or the employee and his or her family members must notify the plan of the event. Finally, when the plan receives this notice, the plan must notify individuals of their COBRA rights and allow them to elect continuation coverage. Model notices contained in the regulation are available for download from the EBSA’s Web site at www.dol.gov/ebsa.

J. Health Savings Accounts and Health Reimbursement Arrangements

Individuals enrolled in certain high-deductible health plans (HDHPs) can establish Health Savings Accounts (HSAs) to receive tax-favored contributions (from either the employee or employer). The contribution made to the HSA is distributed on a tax-free basis to pay or reimburse qualifying health expenses, may be used for future expenses, or may be used (on a taxable basis) for non-health purposes. Funds held in the HSA can be used to pay premiums for long-term care insurance, and can be used to pay for health insurance premiums while receiving unemployment benefits or continuation benefits under COBRA. The HSAs funds are required to be held by an insurance company or trustee (bank).

A Health Reimbursement Arrangement (HRA) is similar to an HSA; however, HRAs are funded solely through employer contributions and may not be funded by the employee through a voluntary salary reduction agreement. There is no requirement for the arrangement to be part of an HDHP, and the funds can be held by the employer or a VEBA trust. Employees are reimbursed tax free for qualified medical expenses up to a maximum dollar amount for a coverage period.

When HSAs or HRAs are standalone, they have no audit requirement. However, HSAs and HRAs that are a component of a health and welfare plan are subject to audit, as are the other components of that health and welfare plan. See paragraph 4.06 in the EBP guide for further information about HSAs and HRAs.

7. This refers to qualified health expenses as defined under IRC section 213(d).
Eligible Compensation and Payroll Data

Eligible Compensation

Plan documents specify the various aspects of compensation (for example, base wages, overtime, and bonuses) that are considered in the calculation of plan contributions for defined contribution plans and in the determination of benefits in a defined benefit plan. Testing of payroll data should address the determination of eligible compensation for individual employees and comparison of the definition of eligible compensation used in the calculation to the plan document. Since this process is generally not included in the payroll testing of the plan sponsor or in type 2 SAS No. 70 reports, a comparison of eligible compensation per the plan document to eligible compensation used in plan operations is necessary.

The auditor should examine the definition of compensation used to determine whether the method used is allowable within the IRC. An employer may use any definition of compensation that satisfies IRC section 414(s), which does not allow a method of determining compensation if that method discriminates in favor of highly compensated employees. Salary deferrals do not have to be included in the definition of compensation if the plan specifically provides for this limitation.

Payroll Data

If one audit firm performs both the plan audit and corporate audit, there may be some efficiencies to be achieved surrounding the testing of payroll. While testing of the payroll area may have been performed in conjunction with the corporate audit, all of the assertions surrounding payroll relevant to the plan audit may or may not have been tested. The plan auditor needs to understand which assertions surrounding payroll were tested during the corporate audit in order to determine the scope of payroll testing required for the plan audit.

For example, payroll testing performed for a corporate audit may include only high-level analytics with limited documentation of control environment or performance of substantive procedures,
and may be insufficient to satisfy the payroll testing requirements for a plan audit. Often payroll processing is outsourced to an outside service provider that may have a SAS No. 70 type 1 report, which provides a description of procedures and controls, but does not have a SAS No. 70 type 2 report, which also includes testing of the procedures and controls and can be used to reduce the scope of substantive testing. There are some payroll service providers that have a SAS No. 70 type 2 report. However, the SAS No. 70 type 2 reports often have extensive user controls that must be present at the plan sponsor and tested by the plan auditor in order to rely on the SAS No. 70 type 2 report. Paragraph 10.05 of the EBP Guide describes procedures the auditor should consider to test payroll in conjunction with the plan audit. Also see Appendix F of this Audit Risk Alert for guidance on payroll auditing.

In certain circumstances the plan sponsor may issue an integrated Rule 404 report under PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, that includes tests of controls surrounding the payroll area. The report should be reviewed carefully by the plan auditor to determine its usefulness in reducing the scope of testing for the plan audit. Plan auditors should be aware that while they may be able to rely on key controls tested by the corporate auditor to reduce the scope of payroll testing for the plan audit, key controls tested by management may not be used to reduce the scope of the payroll testing for the plan audit.

If the plan sponsor has an internal audit department that has performed work on payroll data that is relevant to the audit, and it is efficient to incorporate their work into the audit, AU sec. 322, *The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance on what the auditor needs to consider when making use of the internal auditors’ work in the plan audit.

**Consideration of Fraud in Employee Benefit Plan Engagements**

AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), establishes standards
and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. AU section 316 was effective for audits of financial statements for periods beginning on or after December 15, 2002.

Practical Guidance
The AICPA Practice Aid *Fraud Detection in a GAAS Audit, Revised Edition* (product no. 006615kk) provides a wealth of information and can help in complying with the provisions of AU section 316. Moreover, this Practice Aid will assist auditors in understanding the requirements of AU section 316 and whether current audit practices effectively incorporate these requirements. This Practice Aid is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply AU sections.

Some of AU section 316 requirements include:

1. A required brainstorming session among the audit team members to discuss the potential for material misstatement due to fraud.

2. An increased emphasis on inquiry as an audit procedure that increases the likelihood of fraud detection. Inquiries should be made of management and others to understand their opinions on fraud risk. Individuals the auditor should consider making inquiries of may include plan administrators, service providers, chief financial officer or vice president of finance (especially if not auditor of the plan sponsor), vice president of human resources, internal audit director or manager, and the audit committee or plan oversight committee members. In addition, auditors should consider expanding their inquiries to others when appropriate (for example, operating personnel; lower-level employees; and
employees involved in structuring, recording, or processing complex or unusual transactions).

3. Expanded use of analytical procedures to gather information used to identify risks of material misstatement due to fraud. Analytics should be considered at planning and throughout the audit.

4. The consideration of other information, such as client acceptance and continuance procedures, during the information-gathering phase.

5. Expanded guidance on evaluating information obtained and identifying the risks that may result in a material misstatement due to fraud. The auditor needs to perform an effective synthesis of the identified risks in an effort to determine where the entity is most vulnerable to material misstatement due to fraud, the types of frauds most likely to occur, and how those material misstatements are likely to be concealed.

6. The presumption that improper revenue recognition is a fraud risk in all entities. For employee benefit plans, this risk is primarily related to investment income resulting from inappropriate investment valuation. For multiemployer plans, the auditor should consider whether employers are motivated to understate the employer contributions due.

7. Mandate of certain audit responses on every audit engagement. These responses are designed to specifically address the risk of management override over internal controls. The risk of management override of controls should be considered a fraud risk in every audit and the auditor should perform tests in response to it [for example, journal entries, accounting estimates, unusual transactions (business rationale)].

8. Requirements for the auditor to take into account an evaluation of the entity’s programs and controls that address
the identified fraud risks. Examples of programs and controls for employee benefit plans include those listed in Appendix B of the EBP Guide. The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud.

The use of service providers to perform administrative functions does not eliminate the requirements of AU section 316. The plan sponsor still has user controls and responsibilities for data submitted to service providers. The auditor should consider:

1. Asking the plan sponsor about its procedures to detect, monitor, and control fraud at service organizations.
2. Obtaining and reviewing the SAS No. 70 reports from service organizations.
3. Making inquiries directly of the service provider, especially if no SAS No. 70 report is available.

The Auditors’ Response

The auditor may respond to the risks of material misstatement due to fraud in three ways:

1. A response that has an overall effect on how the audit is conducted. For example:
   a. Assignment of personnel and supervision—The greater the risk of material misstatement, the more experienced the personnel should be and the greater the amount of supervision required.
   b. Accounting principles—Consider the choice of accounting principles selected and potential biases.
   c. Predictability of auditing procedures—Incorporate an element of unpredictability into auditing procedures performed. This is important because these tests are not performed based on risk or materiality.

2. A response to identify risks involving the nature, timing, and extent of audit procedures. In particular, the auditor should evaluate the procedures performed to address specific
accounts or classes of transactions (for example, revenue recognition and accounting estimates).

3. A response to address management override of controls, including examining journal entries and other adjustments. The auditor should test the appropriateness of journal entries and other adjustments (for example, review the detailed trust statements for nonstandard or unusual journal entries). They might consider making inquiries of various individuals as to their awareness of inappropriate entries.

See Appendix H of the EBP Guide for specific procedures that may be performed.

The Importance of Exercising Professional Skepticism

Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Actuarial Reports

Several economic and demographic assumptions are used in actuarial valuations for defined benefit plans to determine the actuarial present value of accumulated plan benefits and funding requirements in accordance with FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans. One of the most significant economic assumptions is the discount rate (that is, rate on return of assets). The discount rate should reflect the long-term expected rate for asset returns. This amount is generally stable from one year to the next. Based on recent economic
trends, the range of discount rates used is 7 percent to 8.5 percent for 2005 calendar year-end plans.

The discount rate used for defined benefit plans for the actuarial present value of accumulated plan benefits is typically the equivalent rate of the assumed rate of return on investments used for ERISA funding purposes. Plan auditors should not assume that the FASB Statement No. 35 discount rate is the same as the FASB Statement No. 87, *Employers’ Accounting for Pensions*, expected long-term rate of return on assets, and care should be taken to determine if the proper amount is disclosed in the benefit plan’s financial statements.

The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, turnover, retirement, marriage statistics, and form of payment or type of benefit elections. With the increase in life expectancies, the mortality assumption should be improving. Certain mortality tables used by actuaries include the 1971 GAM table, the 1983 GAM table, and 1994 GAR and RP-2000 tables. Older mortality tables such as 1971 GAM and 1983 GAM are becoming outdated and auditors should consider challenging the use of such tables for purposes of determining the FASB Statement No. 35 liability. It is possible that the use of the 1983 GAM table may be acceptable depending on the plan’s experience; however, most plans are changing to use the 1994 GAR or the recent RP-2000 tables for their mortality assumption.

Regardless of the assumption used, each assumption must be individually reasonable. Plan administrators should review actual plan experience to assumptions used periodically to determine if any changes should be made. The following should also be considered as plan auditors review actuarial valuations:

- Trends and nature of benefit distributions (for example, lump sum versus annuity). This is important to understand, so plans don’t use a single retirement age assumption if benefit payments are predominantly paid out in lump-sum amounts and the actuary incorporates the form of payment assumed at retirement equal to a lump sum.
• Whether there has been a shift in the plan population over time. This could warrant a different assumption for turnover or retirement, for example, if participants are retiring much earlier or later than assumed.

• Whether there have been recent plan mergers or acquisitions. In the case of a plan merger, all assumptions should be reviewed for their continued reasonableness, as the assumptions used for one plan may not be appropriate for the plan being merged.

• Whether there have been any plan benefit formula changes or a freezing of the plan. Changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions should be reviewed if the plan is amended to change benefits.

• Whether consistent gains/losses are generated each year. If yes, this may indicate that assumptions are not reasonable based on actual experience.

Other items that plan auditors should review when looking at an actuarial report include:

• Consistency of benefits accumulated each year. Auditors should expect changes if there has been a plan merger, acquisition, or significant plan provision change.

• Benefit payments in the roll forward of accumulated plan benefits should match the amount per the statement of changes in net assets. To properly match these amounts, it is necessary to understand if the beginning of the year or end of the year information is used for the actuarial valuation.

• The asset value on the financial statements should match the asset value shown in the actuarial report.

• Inclusion of impact of a change in plan provisions and impact of merger, spin-off, or acquisition.

It is also important to note that the assumption of salary increases is not relevant for FASB Statement No. 35 since FASB Statement
No. 35 is based on the disclosure of the actuarial present value of accumulated plan benefits, which does not take into account future salary increases.

Observations noted during this review of the actuarial report should be discussed with plan management and the actuary and changes made appropriately.

**Allocation Testing for Defined Contribution Plans**

One of the objectives of auditing procedures applied to individual participant accounts of a defined contribution plan is to provide the auditor with a reasonable basis for concluding whether net assets and transactions have been properly allocated to participant accounts in accordance with the plan documents. Each type of participant account activity during the year (for example, contributions, income allocations, expense allocations, and forfeiture allocations) should be taken into consideration in the determination of auditing procedures. In a limited scope audit, the allocation of investment income to individual accounts is not certified by the trustee or custodian and must be tested by the auditor, taking into consideration reliance on a SAS No. 70 type 2 report, if available. See Chapter 10 of the EBP Guide for further discussion of auditing participant data.

**Missing Participant Data**

With recent trends in plan mergers as a result of corporate actions, a number of plan sponsors have been experiencing difficulties in maintaining all pertinent participant data relating to census data and benefit payments. Lapses in maintaining data can also be caused by a change in service providers (for example, actuaries or other third-party administrator). ERISA requires plans to maintain records detailed enough to determine benefits due or that may become due.

When auditors are unable to obtain the necessary information to test participant data or benefit payments, this could be considered a restriction on the scope of the audit. According to AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional...* 64
Standards, vol.1), restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In these situations, the auditor will need to determine how significant the restriction on the scope of the audit is to the overall engagement to determine the effect on the auditor's report.

Auditors should recommend that a plan sponsor consult with legal counsel and consider contacting the DOL before attaching a qualified or disclaimer of opinion relating to a Form 5500 filing for a benefit plan.

Analytical Procedures as Substantive Tests

For all audits of financial statements in accordance with generally accepted auditing standards (GAAS), analytical procedures should be applied to some extent for the purposes of assisting the auditor in planning the nature, timing, and extent of other auditing procedures, and as an overall review of the financial information in the final review stage of the audit. In some cases, however, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. Analytical procedures may be used as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

AU section 329, Analytical Procedures (AICPA, Professional Standards, vol. 1), as amended, provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

Because the planning for employee benefit plan audits is often done after year end, preliminary analytics are performed using year-end numbers with minimum subsequent adjustment. In such instances, final analytics can be documented on the same schedule; however, because each type of analytic is done for a different purpose, different purposes, expectations, and conclusions need to be documented. There may be certain areas where the
Auditor knows during planning that substantive analytics will be performed. For these areas it may be efficient to document preliminary, substantive, and final analytics on the same schedule, making sure the purpose of each test, expectation, and conclusion is documented appropriately. If there are any audit adjustments, a separate final analytic would need to be performed.

**Analytical Procedures in Planning the Audit**

For planning purposes, these procedures should focus on (1) enhancing the auditor’s understanding of the plan and the transactions and events that have occurred since the last audit date and (2) identifying areas that may represent specific risk relevant to the audit. These procedures can help identify such things as the existence of unusual transactions and events. They can also help identify amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications.

The following are examples of analytical procedures that the auditor may find useful in planning an audit of an employee benefit plan:

- Comparison of investment balances and rates of return with prior-period amounts.
- Analysis of changes in contributions and benefit payments during the current period based on statistical data (for example, number of participants eligible to receive benefits in the current period, or the number of terminations).

**Analytical Procedures Used as Substantive Tests**

The auditor’s reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedures to use to achieve a particular audit objective is based on the auditor’s judgment on the expected effectiveness and efficiency of the available procedures.

The auditor considers the level of assurance, if any, he or she wants from substantive testing for a particular audit objective and
decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For example, the auditor may be able to obtain a moderate to high level of assurance over the accuracy of insurance premiums by performing an analytic regarding monthly premium amounts using the rates in the insurance agreement to set the expectation. For other assertions, however, analytical procedures may not be as effective or as efficient as tests of details in providing the desired level of assurance. For example, for a plan with multiple payroll locations, it may be difficult to obtain disaggregated information regarding participant contributions and therefore substantive analytics may not be effective or efficient.

The expected effectiveness and efficiency of an analytical procedure in identifying potential misstatements depends on, among other things, (1) the nature of the assertion, (2) the plausibility and predictability of the relationship, (3) the availability and reliability of the data used to develop the expectation, and (4) the precision of the expectation.

**Documentation of Substantive Analytical Procedures**

When an analytical procedure is used as the principal substantive test of a significant financial statement assertion, the auditor should document all of the following:

1. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
2. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts
3. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

See AU section 329 for further guidance.
Examples of Analytical Procedures

Auditors should be aware that the examples contained in this section typically would not eliminate the need for detailed testing but may be used to supplement such testing.

- **Investments.** Investment balances may fluctuate during the year based on changes in (1) investment strategy resulting from management decisions (or resulting from participant decisions, in the case of a defined contribution participant directed plan), (2) market trends, or (3) other plan changes (for example, merger or termination). Once the auditor understands what types of changes have occurred, an expectation can be developed. Review market trends for similar types of investments and determine expectations based on plan activity (level of contributions or distributions), taking into account plan changes. Often the recordkeeper or investment manager prepares quarterly investment return reports that can be used to assist in developing an expectation. In addition, benchmarks for yields and total return can be obtained for asset classes or specific investments (for example, mutual funds).

- **Participant contributions.** Review the prior year Form 5500 to determine the participant headcount in the plan. Obtain the total contribution balance for the prior year, and divide this amount by the participant headcount to determine an average participant contribution amount for the prior year. Determine (1) the growth or decline of participants for the current year, (2) changes in contribution rates (for example plan amendments and so on), and (3) pay increases. Calculate current year contribution amount using last year’s average contribution amount and this year’s headcount taking into account any changes in contribution rates or pay increases.

  **Participant Contributions Example:**

  Prior-year headcount per the Form 5500 = 130 people
  Prior-year participant contributions balance = $401,828
Prior-year “average” participant contribution = $401,828/130 = $3,091

Per discussion with management, during the current year, due to significant layoffs in the Company, only 50 people remain actively contributing in the plan. No pay increases took effect during the year. Therefore, total participant contributions are expected to be:

$3,091 × 50 people = $154,550 expected contribution

Oftentimes the recordkeeper prepares quarterly reports that include headcount and contribution rate information that can be used to assist in developing an expectation.

- **Claims.** Determine number of claimants receiving claims in the prior year and the average claim per participant. Determine the number of claims during the year. Apply the average claim per participant to the expected number of claimants, taking into account plan amendments, individual large claims, stop loss insurance coverage, or the health care cost trend rate increase. Often the third-party administrator prepares quarterly reports that include headcount and claim information that can be used to assist in developing an expectation.

- **Payroll.** For single employer plans, develop an expectation for current-year gross wages using prior-year gross wages and taking into account change in number of employees, average percentage pay increases, and addition and termination of highly compensated employees.

**Audit Documentation**


SAS No. 103 establishes standards and provides guidance on audit documentation. The auditor must prepare audit documen-
tation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation:

1. Provides the principal support for the representation in the auditor’s report that the auditor performed the audit in accordance with generally accepted auditing standards.

2. Provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.\(^8\)

Audit documentation includes, for example, audit programs,\(^9\) analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity’s records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced audi-

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8. There may be legal, regulatory, or other reasons to retain the original paper document.

9. See paragraph 5 of AU section 311, Planning and Supervision, as amended, for guidance regarding preparation of audit programs.
tor to understand the work performed and conclusions reached.

The audit documentation for a specific engagement is assembled in an audit file.\(^{10}\)

The auditor need not retain in audit documentation superseded drafts of working papers or financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

In addition to the objectives set out in paragraph 3 of SAS No. 103, audit documentation serves a number of other purposes, including:

- Assisting the audit team to plan and perform the audit;
- Assisting auditors who are new to an engagement and review the prior year’s documentation to understand the work performed as an aid in planning and performing the current engagement;
- Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to review the quality of work performed;
- Demonstrating the accountability of the audit team for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached;
- Retaining a record of matters of continuing significance to future audits of the same entity;
- Assisting quality control reviewers (for example, internal inspectors) who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions;

\(^{10}\) The audit documentation contained within the audit file may consist of cross-references to documentation for audit engagements with related entities. For example, the documentation for an audit of the financial statements of an employee benefit plan may consist partly of cross-references to the documentation of dual-purpose payroll-related tests performed in connection with the audit of the financial statements of the plan’s sponsor.
• Enabling an experienced auditor to conduct inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements; and

• Assisting a successor auditor who reviews a predecessor auditor’s audit documentation.

For the purposes of SAS No. 103, *experienced auditor* means an individual (whether internal or external to the firm) who possesses the competencies and skills that would have enabled him or her to perform the audit. These competencies and skills include an understanding of (1) audit processes, (2) the SASs and applicable legal and regulatory requirements, (3) the business environment in which the entity operates, and (4) auditing and financial reporting issues relevant to the entity’s industry.

SAS No. 103 provides guidance on the form, content, and extent of audit documentation. It also discusses how to document significant findings or issues. This SAS requires the identification of the preparer and reviewer of the audit work. In addition, it provides guidance on audit documentation of specific items tested, documentation when there is a departure from a SAS, revisions to audit documentation made after the date of the auditor’s report, and the ownership and confidentiality of audit documentation. See SAS No. 103 for specific guidance.

**Retention of Working Papers**

SAS No. 103 says that the auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention. Such retention period, however, should not be shorter than five years from the report release date. Statutes, regulations, or the audit firm’s quality control policies may specify a longer retention period.

**Help Desk**—It is important to note that ERISA section 107 requires “persons” who have to file any report or certify any information required under ERISA to maintain records (for example, vouchers, worksheets, receipts, and applicable resolu-
tions) on matters of which disclosures are required and keep such records available for examination for a period of not less than six years. The DOL interprets this section of ERISA to include all working papers supporting audits of employee benefit plans. The ERISA retention policies are more stringent than those required by SAS No. 103. Be aware, however that certain states may be even more restrictive.

**AICPA Peer Review Developments—Recurring Deficiencies Found in Employee Benefit Plan Audits**

The AICPA, working with the EBSA, 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 found in employee benefit plan audits include:

- 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 the 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 the DOL

The EBP Guide provides guidance concerning areas of noted deficiencies.

### Recent Auditing and Attestation Pronouncements and Related Guidance (Audits of Nonissuers Only)

Presented below is a list of auditing and attestation pronouncements and related guidance issued since the publication of last year’s Alert. For information on auditing and attestation standards and related guidance issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. For audits of issuers, such as Form 11-K audits, see the section “For Audits of ‘Issuers’—Form 11-K Audits” of this Audit Risk Alert.


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<tr>
<th>SAS No.</th>
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<td><em>Defining Professional Requirements in Statements on Auditing Standards</em> [Effective upon issuance]</td>
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<tr>
<td>103</td>
<td><em>Audit Documentation</em> [Effective for audits of financial statements for periods ending on or after December 15, 2006]</td>
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<td>104</td>
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As necessary, auditors should obtain and understand the complete text of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

Risk Assessment Standards

This discussion is applicable to audits of privately held entities or other “nonissuers.”

11. The term issuer means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes-Oxley Act of 2002, such as Form 11-K filers.
In March 2006, the ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs, and their effect on existing standards:

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<td>Amends SAS No. 1, Due Professional Care in the Performance of Work</td>
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<tr>
<td>SAS No. 108, Planning and Supervision</td>
<td>Supersedes SAS No. 1, Appointment of the Independent Auditor; and supersedes SAS No. 22, Planning and Supervision</td>
</tr>
<tr>
<td>SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</td>
<td>Supersedes SAS No. 55, Consideration of Internal Control in a Financial Statement Audit</td>
</tr>
<tr>
<td>SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</td>
<td>Supersedes SAS No. 45, Substantive Tests Prior to the Balance-Sheet Date; and together with Statement on Auditing Standards No. 109, supersedes SAS No. 55, Consideration of Internal Control in a Financial Statement Audit</td>
</tr>
<tr>
<td>SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling</td>
<td>SAS No. 39, Audit Sampling</td>
</tr>
</tbody>
</table>
Key Provisions of the SASs

The SASs emphasize the linkage between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls; these procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity’s risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. To ease the implementation process, firms should consider adopting at least some of the provisions of the SASs in advance of the required implementation date. Readers can obtain the SASs at www.cpa2biz.com.
Auditing Standards Available on AICPA and PCAOB Web Sites

The standards and interpretations promulgated by the AICPA ASB as of June 1, 2005, are now available free of charge by visiting the AICPA’s Audit and Attest Standards Team’s page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can view and read the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Also, the Public Company Accounting Oversight Board (PCAOB) has published its standards for audits of public companies on their Web site (www.pcaobus.org) free of charge.

For Audits of “Issuers”—Form 11-K Audits

Preapproval of Employee Benefit Plan Audits

In December 2005, page 59 in the SEC Accounting and Disclosures Issues provided guidance regarding the preapproval of audits of employee benefit plans. This section states:

An employee benefit plan may be an affiliate of a registrant as its plan sponsor. The Commission's independence rules related to pre-approval surround services provided to the issuer and the issuer’s subsidiaries, but not services provided to other affiliates of the issuer that are not subsidiaries. Therefore, the independence rules do not require the audit committee of the plan sponsor to pre-approve audits of the employee benefit plans, although the audit committee is encouraged to do so. When employee benefit plans are required to file Form 11-K, those plans are separate issuers under the Exchange Act; as a result, those issuers are subject to the pre-approval requirements. This pre-approval can be provided by either the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the trustee, plan administrator or responsible party. The Commission’s rules
require that all fees, including fees related to audits of employee benefit plans, paid to the principal auditor be included in the company’s fee disclosures, regardless of whether or not the audit committee of the company pre-approved those fees. As part of the exercise to gather the information for the required fee disclosures, the audit committee should be made aware of all fees paid to the principal auditor, including those related to audits of the employee benefit plans. The company may elect to separately indicate in their disclosures those fees paid to the principal auditor that were not subject to the preapproval requirements. Registrants and their auditors are reminded that the financial statements included in a Form 11-K must be audited by an independent auditor that is registered with the PCAOB and the audit report must refer to the standards of the PCAOB rather than GAAS.

To view the entire document, see the Web site www.sec.gov/divisions/corpfin/acctdis120105.pdf.

Audit Reports—Following Two Sets of Standards

SEC Requirements
The SEC requires employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. Reports on Form 11-K must be filed with the SEC within 90 days after the end of the fiscal year of the plan, provided that plans subject to ERISA file the plan financial statements within 180 days after the plan’s fiscal year end.

Applicable Audit Standards
Plans that are required to file Form 11-Ks are deemed to be “issuers” under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. These plans may also be subject to ERISA and must submit to the DOL an audit in accordance with GAAS promulgated by the AICPA’s ASB. It is our understanding that the SEC will not accept an audit report
that references GAAS, and the DOL will not accept an audit report that does not reference GAAS.

Performance and Reporting Requirements

Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of 11-K filers, firms will need to conduct their audits of these 11-K plans in accordance with two sets of standards and prepare two separate audit reports: an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing GAAS for DOL filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, References in Auditors’ Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules), does not allow a reference to GAAS, hence a “dual” standard report is not appropriate and will not be accepted by the SEC.

Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, Office of the Chief Accountant at (202) 942-2960.

See the EBP Guide, paragraph 13.19 for an example of an opinion for an 11-K audit.

PCAOB Standards and Conforming Amendments

As a result of the Sarbanes-Oxley Act of 2002, both U.S. and non-U.S. public accounting firms wishing to prepare or issue reports on U.S. public companies, or to play a substantial role in the preparation or issuance of such reports, must be registered with the PCAOB and comply with the standards and rules of the PCAOB. The PCAOB’s standards and rules apply to registered public accounting firms and their associated persons in connection with their audits of the financial statements of issuers, as defined in Section 2(a)(7) of the Sarbanes-Oxley Act, and those firms’ auditing and related attestation practices. Plans that are required to file Form 11-Ks are deemed to be “issuers” under the
Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. The PCAOB does not intend to suggest that registered public accounting firms and their associated persons must comply with the PCAOB’s standards and rules in auditing nonissuers. Auditors who fall within the PCAOB’s scope should understand and follow the standards, rules, and other requirements of the PCAOB. All PCAOB standards and rules must be approved by the SEC before taking effect.

**PCAOB Auditing Standard No. 4**

Since the publication of last year’s Alert the PCAOB has issued PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. This standard applies if auditors report on the elimination of a material weakness in a company’s internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.

For information on auditing standards and related guidance issued subsequent to the writing of this Alert, please refer to the PCAOB Web site at www.pcaobus.org (audits of issuers only).

**Auditing Pipeline—Public Companies**

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. For a complete picture of all auditing projects in progress, you should check the PCAOB Web site at www.pcaobus.org.

**Accounting Developments**

**FASB Staff Position AAG INV-1 and SOP 94-4-1**

This FSP amends the guidance in AICPA SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined- Contribution Pension Plans*, with respect to the definition of fully benefit-responsive and the presentation and disclosure of fully benefit-responsive investment contracts. Amendments to SOP 94-4 will be reflected in the AICPA Audit and Accounting Guide, *Employee Benefit Plans*. This FSP also amends SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*. It also amends paragraph 10(h) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to effectively remove the scope exception provided for fully benefit-responsive investment contracts reported at contract value in accordance with SOP 94-4. (Appendix B of the FSP shows the amendments to SOPs 94-4 and 92-6 and FASB Statement No. 133.)

**Effective Date**

The financial statement presentation and disclosure guidance in paragraphs 8 through 11 of FSP AAG INV-1 and SOP 94-4-1 is effective for financial statements for plan years ending after December 15, 2006. The revised definition of *fully benefit-responsive* in paragraph 7 of the FSP shall be effective for all investment contracts as of the last day of the annual period ending after December 15, 2006. Earlier application is permitted for fiscal years in which annual financial statements have not been issued. If comparative financial statements are presented, the guidance in that FSP shall be applied retroactively to all prior periods presented. If an investment contract is considered fully benefit-responsive under the revised definition as of the last day of the annual period ending after December 15, 2006, that contract shall be considered fully benefit-responsive for all periods presented, provided that contract would have been considered fully benefit-responsive in accordance with the then existing provisions of this SOP.

**Definition of Fully Benefit-Responsive**

Defined-benefit health and welfare benefit plans should report investment contracts at fair value. Defined-contribution plans,
including both health and welfare and pension plans, should report all investments (including derivative contracts) at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined-contribution plan attributable to fully benefit-responsive investment contracts. An investment contract is considered fully benefit-responsive for purposes of this SOP, if all of the following criteria are met for that contract, analyzed on an individual basis:

1. The investment contract is effected directly between the plan and the issuer and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.

2. Either (1) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer, whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract shall no longer be considered fully benefit-responsive.

3. The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the plan, such as withdrawals for benefits, loans, or transfers to other funds within the plan.

4. An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings,
layoffs, plan termination, bankruptcy, mergers, and early retirement incentives) and that also limits the ability of the plan to transact at contract value with the participants in the plan must be probable of not occurring.

5. The plan itself must allow participants reasonable access to their funds.

Financial Statement Presentation and Disclosure Requirements

The statement of net assets available for benefits of the plan shall present amounts for (1) total assets, (2) total liabilities, (3) net assets reflecting all investments at fair value, and (4) net assets available for benefits. The amount representing the difference between (3) and (4) shall be presented on the face of the statement of net assets available for benefits as a single amount, calculated as the sum of the amounts necessary to adjust the portion of net assets attributable to each fully benefit-responsive investment contract from fair value to contract value. The statement of changes in net assets available for benefits shall be prepared on a basis that reflects income credited to participants in the plan and net appreciation or depreciation in the fair value of only those investment contracts that are not deemed to be fully benefit responsive.

Defined-contribution plans, including both health and welfare, and pension plans, shall disclose the following in connection with fully benefit-responsive investment contracts, in the aggregate:

1. A description of the nature of those investment contracts, how they operate, and the methodology for calculating the interest crediting rate, including the key factors that could influence future average interest crediting rates, the basis for and frequency of determining interest crediting rate resets, and any minimum interest crediting rate under the terms of the contracts. This disclosure should explain the relationship between future interest crediting rates and the amount reported on the statement of net assets available for benefits representing the adjustment for the portion of net assets attributable to fully benefit-responsive investment contracts from fair value to contract value.
2. The average yield earned by the plan for all fully benefit-responsive investment contracts (which may differ from the interest rate credited to participants in the plan) for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings of all fully benefit-responsive investment contracts in the plan (irrespective of the interest rate credited to participants in the plan) by the fair value of all fully benefit-responsive investment contracts in the plan.

3. The average yield earned by the plan for all fully benefit-responsive investment contracts with an adjustment to reflect the actual interest rate credited to participants in the plan for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings credited to participants in the plan for all fully benefit-responsive investment contracts in the plan (irrespective of the actual earnings of those investments) by the fair value of all fully benefit-responsive investment contracts in the plan.

4. A description of the events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), including a statement as to whether the occurrence of those events that would limit the plan’s ability to transact at contract value with participants in the plan is probable or not probable. (The term *probable* is used in this Statement consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*.)

5. A description of the events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the plan and settle at an amount different from contract value.

Help Desk—The complete FSP can be viewed on the FASB Web site at www.fasb.org.
Technical Practice Aids on the Effects of the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on Plans

In May 2004 the FASB issued FSP FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003*. The FASB FSP addressed when and how an employer that provides postretirement prescription drug coverage should recognize the effects of the Act but did not address the accounting for the subsidy by the health and welfare plan itself. The AICPA staff, helped by industry experts, released two Technical Practice Aids (TPAs), on accounting and disclosures for single employer and multiemployer employee benefit plans related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Medicare Act).

- TPA section 6930.10—“Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003”

These TPAs provide accounting and disclosure guidance for both single employer and multiemployer plans relating to the effects of the Medicare Act. These TPAs can also be found in the AICPA publication *AICPA Technical Practice Aids*.


*Inquiry.* On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) for employers that sponsor postretirement health care plans that provide prescription drug benefits. The Act introduces a prescription drug benefit under Medicare (Medicare Part D)
as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.1. In May 2004, the FASB issued FSP FAS 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. That FSP addresses the issue of whether an employer that provides postretirement prescription drug coverage should recognize the effects of the Act on its accumulated postretirement benefit obligation (APBO) and net postretirement benefit costs and, if so, when and how to account for those effects. FSP FAS 106-2 says that the APBO and net periodic postretirement benefit costs should reflect the effects of the Act. The FSP does not address accounting for the subsidy by health and welfare benefit plans.

For a single-employer health and welfare benefit plan, should the effects of the plan sponsor’s (employer’s) Medicare prescription drug subsidy (Medicare subsidy) be taken into consideration when calculating the health and welfare plan’s postretirement benefit obligation?

Reply. No, the effects of the employer’s Medicare subsidy should not be reflected in the plan’s obligations. The primary objective of the financial statements of a health and welfare benefit plan is to provide financial information that is useful in assessing the plan’s present and future ability to pay its benefit obligations when due. The Medicare subsidy amount is paid to the plan sponsor and does not flow into the plan. The plan sponsor is not required to use the subsidy amount to fund the postretirement benefits and may use the subsidy for any valid business purpose. As a result, the Medicare subsidy does not reduce the amount of benefits that need to be covered by plan assets and future employer contributions. Therefore, the APBO, without reduction for the Medicare subsidy, is a more meaningful measure of the benefits. Further, the information necessary to calculate the gross measure should be readily available for sponsors who are subject to income taxes, because those plan sponsors should maintain gross and net measures of the APBO in order to properly account for income taxes under FASB Statement No. 109, Accounting for Income Taxes.
Disclosures. The plan should disclose the following:

1. The existence of the Act

2. The fact that the APBO and the changes in the benefit obligation do not reflect any amount associated with the Medicare subsidy because the plan is not directly entitled to the Medicare subsidy

Until the plan sponsor (employer) is able to determine whether benefits provided by its plan are actuarially equivalent to Medicare Part D.1, that employer is not able to determine whether the benefits provided by its plan are actuarially equivalent to Medicare Part D.1. If the plan sponsor (employer) has included the effects of the Medicare subsidy in measuring its APBO and changes in benefit obligation, the plan should disclose the fact that the amount of the APBO differs from that disclosed by the plan sponsor (employer) because the plan sponsor’s amounts are net of the Medicare subsidy.


Inquiry. On December 8, 2003, the President signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) for employers that sponsor postretirement health care plans that provide prescription drug benefits. The Act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D.1. In May 2004, the FASB issued FSP FAS 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003. That FSP addresses the issue of whether an employer that provides postretirement prescription drug coverage should recognize the effects of the Act on its APBO and net postretirement benefit costs and, if so, when and how to account for those effects. FSP FAS 106-2 says that the APBO and net periodic
postretirement benefit costs should reflect the effects of the Act. The FSP does not address accounting for the subsidy by multi-employer health and welfare benefit plans or by the sponsors or participating employers of those plans.

For multiemployer health and welfare benefit plans, should the effects of the Medicare prescription drug subsidy (Medicare subsidy) be taken into consideration when calculating the health and welfare plan’s postretirement benefit obligation?

Reply. Yes, the multiemployer plan’s benefit obligations should be reduced by the effects of the Medicare subsidy because the multi-employer plan trust receives the subsidy amount directly and not the individual employers. Because the primary objective of the financial statements of a health and welfare benefit plan is to provide financial information that is useful in assessing the plan’s present and future ability to pay its benefit obligations when due, and because the Medicare subsidy amount flows into the multi-employer plan trust, the APBO net of the Medicare subsidy is a more meaningful measure of those benefits.

Disclosures. Until the multiemployer plan is able to determine whether benefits provided by its plan are at least actuarially equivalent to Medicare Part D, the plan should disclose the following in the notes to its financial statements:

1. The existence of the Act
2. The fact that measures of the APBO and changes in the benefit obligation do not reflect any amount associated with the subsidy because the plan is unable to conclude whether the benefits provided by the plan are actuarially equivalent to Medicare Part D under the Act.

If the multiemployer plan has included the effects of the Medicare subsidy in measuring its APBO and changes in the benefit obligation, the plan should disclose the following:

1. The existence of the Act
2. The reduction in the APBO for the subsidy related to benefits attributed to past service
3. The effect of the subsidy on the changes in the benefit obligation for the current period

4. An explanation of any significant change in the benefit obligation or plan assets not otherwise apparent in the other disclosures

5. The gross benefit payments (paid and expected, respectively) including prescription drug benefits, and separately the gross amount of the subsidy receipts (received and expected, respectively)

Illustrative Disclosure for the Medicare Prescription Drug Act

The following is an illustrative disclosure for employee benefit plans where the plan sponsor has included the effects of the Medicare subsidy in measuring its APBO and changes in benefit obligation:

Note X: Medicare Subsidy

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) for employers sponsoring postretirement health care plans that provide prescription drug benefits was signed into law. The Act introduces a prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care benefit plans providing a benefit that is at least actuarially equivalent to Medicare Part D.\textsuperscript{12} Under the Act, the Medicare subsidy amount is received directly by the plan sponsor and not the related plan. Further, the plan sponsor is not required to use the subsidy amount to fund postretirement benefits and may use

\textsuperscript{12} For multiemployer plans where the plan has included the effects of the subsidy in measuring its APBO and changes in benefit obligation, the remainder of the paragraph would be replaced with the following:

Under the Act, for multiemployer plans, any Medicare subsidy is received directly by the Plan trust and not the individual employers participating in the Plan. The Plan's accumulated postretirement benefit obligation has been reported net of $XXX and $YYY as of December 31, 20X5 and 20X4, respectively, for the Medicare subsidy related to benefits attributed to past service. The Medicare subsidy reduced the increase in the Plan's benefit obligation by $XX and $YY for the years ended December 31, 20X5 and 20X4, respectively.

(To the extent that similar information is not provided on the face of the financial statements, the following disclosures should also be provided.)
the subsidy for any valid business purpose. The accumulated postretirement benefit obligation as of December 31, 2004 and 2003 and the changes in the accumulated benefit obligation for the years then ended do not reflect any amount associated with the Medicare subsidy as the Plan is not directly entitled to the Medicare subsidy. The Plan’s accumulated postretirement benefit obligation as of December 31, 2004, differs from that disclosed by the Company by $315 million, as the Company’s accumulated postretirement benefit obligation as of December 31, 2004 has been presented net of the Medicare subsidy.

Recent Accounting Pronouncements and Related Guidance

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year’s Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

The Plan made benefit payments, including prescription drug benefits, of $ZZ million and $QQ million and received a Medicare subsidy of $Z million and $Q million for the years ended December 31, 20X5 and 20X4, respectively. The amount of expected benefit payments was $WW million and $VV million, and the amount of expected Medicare subsidy was $W million and $V million for the years ended December 31, 20X5 and 20X4, respectively.

For multiemployer plans where the plan is unable to determine whether benefits provided by the plan are at least actuarially equivalent to Medicare Part D.1, the remainder of the paragraph should note that under the Act, for multiemployer plans, any Medicare subsidy is received directly by the Plan trust and not the individual employers participating in the plan. The Plan has not determined whether the benefits provided by the Plan are actuarially equivalent to Medicare Part D.1 under the Act. Multiemployer plans would also note that the plan’s accumulated postretirement benefit obligation and the changes in the benefit obligation do not reflect any amount associated with the Medicare subsidy.

13. If the plan sponsor has not determined whether the benefits provided under the plan are actuarially equivalent to Medicare part D.1., then the remainder of the paragraph would note that currently, [the plan sponsor] has not determined whether the benefits provided by the Plan are actuarially equivalent to Medicare Part D.1.
FASB Statement of Financial Accounting Standards No. 152  
(December 2004)  
Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67  
This Statement amends FASB Statement No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA SOP 04-2, Accounting for Real Estate Time-Sharing Transactions. This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (1) incidental operations and (2) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.

FASB Statement No. 153  
(December 2004)  
Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29  
This Statement amends Accounting Principles Board (APB) Opinion No. 29, Accounting for Nonmonetary Transactions, to eliminate the exception for nonmonetary exchanges of similar productive assets, and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.

FASB Statement No. 123(R)  
(December 2004)  
Share-Based Payment  
This Statement is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation; it supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity’s equity instruments or that may be settled by the issuance of those equity instruments.

FASB Statement No. 154  
(May 2005)  
Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3  
This Statement replaces APB Opinion No. 20,
Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements—an amendment of APB Opinion No. 3, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.

FASB Statement No. 155 (February 2006) Accounting for Certain Hybrid Financial Instruments—and amendment of FASB Statements No. 133 and 140

FASB Statement No. 156 (March 2006) Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140
This Statement amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities.

FASB Interpretation No. 47 (March 2005) Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143
This Interpretation clarifies that conditional asset retirement obligations describes a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may not be under the entity’s control.

FASB EITF Issues (Various dates) Go to www.fasb.org/eitf/ for a complete list of EITF Issues.

(continued)
FASB Staff Positions

Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others, as well as to FASB Interpretation No. 46(R).

AICPA Statement of Position 05-1

Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

Recent FASB EITF Issues and FSPs

The FASB is very active in issuing Emerging Issues Task Force (EITF) Issues and FSPs. Auditors should visit the FASB Web site to stay abreast of these many issues and understand those accounting requirements that may pertain to their client’s financial statements.

Recent AICPA Independence and Ethics Pronouncements

The AICPA Independence and Ethics Alert—2005/06 (product no. 022476kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice.

Recent SEC and PCAOB Developments

The AICPA SEC and PCAOB Alert—2005/06 (product no. 022496kk) contains a complete update on new SEC and PCAOB pronouncements and other issuances. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of SEC and PCAOB matters that may affect their engagements.

Audit and Accounting Guide Revisions as of March 1, 2006

The EBP Guide has been updated to reflect FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1, and SAS No. 103, Audit Documentation. The EBP Guide also includes new guidance on health savings accounts, health reimbursement arrangements, and separately managed accounts.
Help Desk—To order the Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2006, call the Service Center Operations at (888) 777-7077 or go to www.cpa2biz.com and order product no. 012596kk.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. Presented below is brief information about certain projects that are expected to result in final standards in the near future. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP, GAAS, or PCAOB standards.

The following table lists the various standard-setting bodies’ Web sites, where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

<table>
<thead>
<tr>
<th>Standard-Setting Body</th>
<th>Web Site</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA Auditing Standards Board (ASB)</td>
<td><a href="http://www.aicpa.org/members/div/auditstd/drafts.htm">www.aicpa.org/members/div/auditstd/drafts.htm</a></td>
</tr>
<tr>
<td>(Note that for audits of public companies, the Public Company Accounting Oversight Board sets auditing standards.)</td>
<td></td>
</tr>
<tr>
<td>Public Company Accounting Oversight Board (PCAOB)</td>
<td><a href="http://www.pcaobus.org">www.pcaobus.org</a></td>
</tr>
<tr>
<td>AICPA Accounting Standards Executive Committee (AcSEC)</td>
<td><a href="http://www.aicpa.org/members/div/acctstd/edo/index.htm">www.aicpa.org/members/div/acctstd/edo/index.htm</a></td>
</tr>
<tr>
<td>Financial Accounting Standards Board (FASB)</td>
<td><a href="http://www.fasb.org">www.fasb.org</a></td>
</tr>
<tr>
<td>Governmental Accounting Standards Board (GASB)</td>
<td><a href="http://www.gasb.org">www.gasb.org</a></td>
</tr>
<tr>
<td>Professional Ethics Executive Committee (PEEC)</td>
<td><a href="http://www.aicpa.org/members/div/ethics/index.htm">www.aicpa.org/members/div/ethics/index.htm</a></td>
</tr>
</tbody>
</table>
Auditing Pipeline—Nonissuers

The proposed standards discussed in this section would not apply to the audits of issuers, such as Form 11-K audits, or other audits conducted under the standards of the PCAOB. See the “Auditing Pipeline—Public Companies” section of this Alert for Issuers.

Readers should keep abreast of the status of the following projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA’s Web site at www.aicpa.org.

Proposed SAS, Communication of Internal Control Related Matters Noted in an Audit

This proposed SAS will supersede AU section 325, Communication of Internal Control Related Matters Noted in an Audit (AICPA, Professional Standards, vol. 1), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in 2006.

Proposed SAS, The Auditor’s Communication With Those Charged With Governance

This proposed SAS will replace SAS No. 61, Communication With Audit Committees, as amended, and establishes standards and provides guidance to an auditor on matters to be communicated with those charged with governance. The proposed SAS uses the term those charged with governance to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity’s financial reporting process and internal control over financial reporting. It uses the term management to refer to those who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for preparation of the entity’s financial statements. The proposed SAS also identifies specific matters to be communicated and amends SAS No. 59, The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern, as
amended. Readers should be alert for the issuance of a final standard.

Accounting Pipeline

Proposed FASB Statement, *Fair Value Measurements*
In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements*, which seeks to establish a framework for measuring fair value that would apply broadly to financial and nonfinancial assets and liabilities, improving the consistency, comparability, and reliability of the measurements. The fair value framework would clarify the fair value measurement objective and its application under authoritative pronouncements that require fair value measurements. The exposure draft would replace any current guidance for measuring fair value in those pronouncements and would expand current disclosures. Readers should be alert for the issuance of a final Statement. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of FASB Statements No. 87, 88, 106, and 132(R)
At the end of March 2006, the FASB published an exposure draft of a proposed Statement, *Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans*, which would improve existing reporting for defined benefit postretirement plans by requiring an employer that is a business entity to recognize the overfunded or underfunded positions of defined benefit postretirement plans, including pension plans (plans), in their balance sheets. The proposed statement would also require that employers measure plan assets and obligations as of the date of their financial statements. The proposed statement is the result of the initial phase of a comprehensive project to reconsider guidance in FASB Statement No. 87, *Employers’ Accounting for Pensions*, and FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*. A second, broader phase will comprehensively address remaining issues. The comment period ends on May 31, 2006. The FASB also plans to hold public roundtable
meetings on June 27, 2006, in Norwalk, Connecticut, to listen to the views of, and obtain information from, a wide variety of interested constituents about the exposure draft. Readers should be alert for the issuance of a final Statement. Refer to the FASB Web site at www.fasb.org for complete information.

**Proposed FASB EITF Issues**
Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

**Proposed FASB Staff Positions**
A number of proposed FASB Staff Positions are in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

**International Accounting Standards**
The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard-setter based in London. In April 2001, IASB assumed accounting standard-setting responsibilities from its predecessor body, the International Accounting Standards Committee (IASC). The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition, the IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world. The IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). It has also adopted the body of Standards issued by the IASC. Those pronouncements continue to be designated “International Accounting Standards” (IAS).

**Employee Benefit Plan-Related Standards**
The following are employee benefit plan-related standards:
• IAS No. 19, *Employee Benefits*, addresses postemployment benefits, including pensions.

• IAS 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.iasb.org.

**Resource Central**

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*Employee benefit plan-related educational courses, Web sites, publications, and other resources available to CPAs*

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**Related Publications**

The following are some of the AICPA publications that deliver valuable guidance and practical assistance as potent tools to be used on your employee benefit plan engagements.

• AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2006 (product no. 012596kk).

• *Accounting Trends & Techniques—Employee Benefit Plans, second edition* (product no. 006624kk). Offering the same kind of powerful help that the AICPA’s *Accounting Trends and Techniques* does, this comprehensive book illustrates a wide range of employee benefit plan financial statement disclosures and auditors’ reports for both full-scope and limited-scope audits. The publication also includes a chapter dedicated to illustrative management letters and management letter comments.

• *SAS No. 70 Reports and Employee Benefit Plan* (product no. 061061kk). In practice, auditors of employee benefit plans have continued to raise questions about how SAS No. 70 reports should be considered in their audits and the auditing
procedures that should be applied to these reports to increase their reliability as audit evidence. This publication provides you with guidance on the use of SAS No. 70 reports in your employee benefit plan audits.

- Checklists and Illustrative Financial Statements for:
  - *Defined Benefit Pension Plans* (008995kk). The 2006 checklist will be available this summer (product no. 008996kk).
  - *Defined Contribution Pension Plans* (009005kk). The 2006 checklist will be available this summer (product no. 009006kk).
  - *Health and Welfare Benefit Plans* (009015kk). The 2006 checklist will be available this summer (product no. 0090156kk).

- *A Wake-Up Call*, an employee benefit plan audit video (013801kk).

**Web Casts**

June 30, 2006—*Strategic Industry Briefing—Employee Benefit Plans*. This AICPA strategic briefing will address current industry developments and emerging practice issues relating to employee benefit plans. Participants will learn about current accounting, auditing, and regulatory developments, including the impact of recently issued pronouncements on both preparers and auditors of employee benefit plans. Speakers include Marcus J. Aron, CPA; Marilee Lau, CPA; and Deborah Smith, CPA. [Level: Intermediate. Recommended CPE credit (based on a 50-minute hour): 2]

**Conferences**

**National Conference on Employee Benefit Plans**

Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and plan sponsors on various topics, including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments.
The 2007 National Conference on Employee Benefit Plans will be held May 21 through 23, 2007, in New Orleans, Louisiana. For a conference brochure, please call (888) 777-7077, and request brochure G50038; for more information, visit the Web site at www.cpa2biz.com/conferences.

**Education Courses**

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working on employee benefit plan engagements. Those courses include:

- **Audits of 401(k) Plans**
- **Employee Benefit Plans: Audit and Accounting Essentials**
- **Form 5500: Prepare It Fast—File It Right…The 1st Time**
- **SAS No. 70 Auditing Guidance**
- **Online CPE: AICPA InfoBytes**

**Service Center Operations**

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Center Operations at (888) 777-7077.

**Hotlines**

**Accounting and Auditing Technical Hotline**

The AICPA Technical Hotline answers members’ inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

**Ethics Hotline**

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. Call (888) 777-7077.
Web Sites

AICPA Online and CPA2Biz

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including Audit Risk Alerts, Audit and Accounting Guides, Professional Standards, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

This Audit Risk Alert replaces Employee Benefit Plans Industry Developments—2005.

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
### APPENDIX A

**IRS Limits on Benefits and Compensation**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>2004</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>$175,000</td>
<td>$170,000</td>
<td>$165,000</td>
</tr>
<tr>
<td><strong>Defined contribution</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum annual addition</td>
<td>44,000</td>
<td>42,000</td>
<td>41,000</td>
</tr>
<tr>
<td><strong>401(k) plan</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum elective deferral</td>
<td>15,000</td>
<td>14,000</td>
<td>13,000</td>
</tr>
<tr>
<td><strong>403(b) plan</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum elective deferral</td>
<td>15,000</td>
<td>14,000</td>
<td>13,000</td>
</tr>
<tr>
<td><strong>457 plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum elective deferral</td>
<td>15,000</td>
<td>14,000</td>
<td>13,000</td>
</tr>
<tr>
<td><strong>SIMPLE plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum elective deferral</td>
<td>10,000</td>
<td>10,000</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Qualified plans</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum compensation limits</td>
<td>220,000</td>
<td>210,000</td>
<td>205,000</td>
</tr>
<tr>
<td>Highly compensated limits</td>
<td>100,000</td>
<td>95,000</td>
<td>90,000</td>
</tr>
<tr>
<td>Officer limits (key employee)</td>
<td>140,000</td>
<td>135,000</td>
<td>130,000</td>
</tr>
<tr>
<td>FICA taxable wage base</td>
<td>94,200</td>
<td>90,000</td>
<td>87,900</td>
</tr>
<tr>
<td>Employer and employee Social Security tax</td>
<td>6.20 percent</td>
<td>6.20 percent</td>
<td>6.20 percent</td>
</tr>
</tbody>
</table>

1. Catch-up contributions for individuals over age 50 increased to $3,000 in 2004, to $4,000 in 2005, and to $5,000 in 2006.
APPENDIX B

Definitions of Certain Investments

The following list includes certain investments as defined by the instructions to the Form 5500.

- **Master trust.** A trust for which a regulated financial institution (bank, trust company, or similar financial institution that is regulated, supervised, and subject to periodic examination by a state or federal agency) serves as trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.

- **Common/collective trust.** A trust maintained by a bank, trust company, or similar institution, that is regulated, supervised, and subject to periodic examination by a state or federal agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of controlled group of corporations.

- **Pooled separate account.** An account maintained by an insurance carrier, which is regulated, supervised, and subject to periodic examination by a state agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of controlled group of corporations.

- **103-12 Entity.** An entity that is not a master trust, common/collective trust, or pooled separate account whose underlying assets include “plan assets” within the meaning of 29 CFR 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans.

- **Registered investment company.** An investment firm that is registered with the Securities and Exchange Commission.
and complies with certain stated legal requirements for the collective investment and reinvestment of assets contributed thereto from investors (employee benefit plans and nonemployee benefit plans).
APPENDIX C

EBSA Field Assistance Bulletins

In the course of audits and investigations by EBSA field enforcement staff, difficult legal issues often arise. In an effort to provide the regional office staff with prompt guidance, EBSA has developed a vehicle for communicating technical guidance from the national office. Field Assistance Bulletins (FAB) ensure that the law is applied consistently across the various regions. They also provide the regulated community with an important source of information about the agency’s views on technical applications of ERISA. All FABs are posted on EBSA’s Web site and available to the public.

FABs are available at www.dol.gov/ebsa under Compliance Assistance. The following is a listing and brief description of the FABs:

| Field Assistance Bulletin 2002-1 | Addresses the fiduciary considerations involved with the refinancing of an ESOP loan under section 408(b)(3) of ERISA |
| Field Assistance Bulletin 2002-2 | Addresses whether the trustees of two related multiemployer plans were subject to ERISA’s fiduciary standards when they amended the plan’s trust agreements |
| Field Assistance Bulletin 2002-3 | Addresses the fiduciary considerations regarding the use of agreements in which the service provider retains the “float” on plan assets |
| Field Assistance Bulletin 2003-1 | Addresses the issue of whether corporate directors and officers may be denied participant loans that might violate securities laws when ERISA requires that such loans be made available to all participants on a reasonably equivalent basis |
| Field Assistance Bulletin 2003-2 | Considers the application of EBSA’s participant contribution requirements to multiemployer defined contribution pension plans |
| Field Assistance Bulletin 2003-3 | Addresses the rules that apply to how expenses are allocated among plan participants in a defined contribution pension plan |
Field Assistance Bulletin 2004-01: Addresses whether health savings accounts established in connection with employment-based group health plans constitute “employee welfare benefit plans” for purposes of Title I of ERISA.

Field Assistance Bulletin 2004-02: Addresses a fiduciary’s duties with respect to missing participants in a terminated defined contribution plan.

Field Assistance Bulletin 2004-03: Addresses the fiduciary responsibilities of a directed trustee in the context of publicly traded securities.
APPENDIX D

**Commonly Asked Questions and Answers**

The following questions and answers have been developed by the members of the Employee Benefit Plans Audit Guide Revision Task Force and the Employee Benefit Plans Expert Panel. They include technical questions and answers included in volume 1 of AICPA *Technical Practice Aids* and frequently asked questions encountered by the task force members on accounting, auditing, and regulatory matters.

**EBP-Related Technical Practice Aids**

**Auditing**

1. In an initial audit of a plan that has been in existence for several years, to what extent does the auditor need to audit information from previous years?

   A. In an initial audit of a plan which has been in existence in previous years, ERISA requires that the audited financial reports contain a comparative Statement of Net Assets Available for Benefits and, as such, there should be some consideration of the accumulation of data from prior years, and the effect on current year balances. The auditor can choose to compile, review, or audit the opening Statement of Net Assets Available for Benefits. It is important to note, however, that regardless of which level of service he or she chooses to render, the auditor must satisfy himself or herself as to the reasonableness of the amounts reported in the opening Statement of Net Assets Available for Benefits, because material misstatements in that information may materially impact the Statement of Changes in Net Assets Available for Benefits under audit.

   The auditor should apply appropriate audit tests and procedures to the opening balances in the Statement of Net Assets
Available for Benefits to determine that those balances are not materially misstated. The auditor should make inquiries of the plan’s management and outside service providers, as applicable, regarding the plan’s operations during those earlier years. The auditor also may wish to obtain relevant information (for example, trust statements, recordkeeping reports, reconciliations, minutes of meetings, and SAS No. 70 reports) for earlier years, as applicable, to gather evidence that there do not appear to be errors during those years that could have a material effect on current year balances. Further, the auditor should gain an understanding of the accounting practices that were followed in prior years to determine that they have been consistently applied in the current year. Based on the results of the auditor’s inquiries, review of relevant information, and evidence gathered during the current year audit, the auditor would determine the necessity of performing additional substantive procedures (including detailed testing or substantive analytics) on earlier years’ balances.

(Source: AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2005, paragraphs 5.21 through 5.22 and 13.43 through 13.46.)

2. How should the auditor test for proper investment allocation in situations where changes may be made by participants electronically, via phone or Internet, on a daily basis?

A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), the auditor should consider confirming the contribution percentage, source, and investment election directly with the participant, or compare that information to detail of the transaction (for example, a copy of the transaction confirmation) if maintained by the plan sponsor or service provider. Alternatively, if a service provider has a type 2 SAS No. 70 report that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce (not eliminate) substantive testing.
3. Can a limited scope certification cover participant loans?

A. Yes. Participant loans should be classified as an investment asset for financial statement reporting purposes. As such, if the participant loans are investment assets held, administered, and processed by a bank, trust company, or similar institution, or by a regulated insurance company, the related investment information held by the bank (or insurance company) is not required to be audited provided the institution certifies that information. A limited scope certification of participant loans includes the investment in plan loans as well as the interest earned on those loans. If the certifying institution does not include participant loans as part of the certified investment statement, then participant loans are subject to audit. If the trustee or custodian does not process and administer the loans (for example, the administration is performed by an outside TPA), that institution is not eligible to certify the loan information.

(Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005, paragraphs 7.54 and 7.55. Paragraphs 7.64 and 13.27 of the March 2005 Guide provide limited scope auditing and reporting guidance, respectively.)

4. What procedures need to be performed in audits where the plan doesn’t receive a SAS No. 70 report from the service provider?

A. Service providers are not required to furnish SAS No. 70 reports. However, this does not relieve the auditor of his or her responsibility to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed by considering those components of internal control maintained by the service organization. In situations where an appropriate SAS
No. 70 report is not available, other sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports on the service organization's controls issued by internal auditors or regulatory authorities, may provide sufficient information about the nature of the services provided by the service organization that are part of the user organization's information system and the service organization's controls over those services. If both the services provided and the service organization's controls over those services are highly standardized, information obtained through the plan auditor's prior experience with the service organization may be helpful in planning the audit. The plan auditor may wish to consider the specific control objectives and selected controls outlined in Exhibit B-1 of Appendix B of the AICPA Accounting and Audit Guide Employee Benefit Plans, in obtaining his or her understanding. If the user auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to plan the audit, consideration should be given to contacting the service organization through the user organization to obtain adequate internal control information, or request that a service auditor be engaged to perform procedures at the service organization.

The level of substantive testing that should be performed depends on the amount of reliance the auditor can place on controls. Thus, if a SAS No. 70 report is not available, the auditor would need to increase substantive testing or consider testing controls at the service provider.

Auditing procedures applied to data maintained by the service provider may include tests of participant data, payroll data, or benefits data to determine that they agree with the information obtained and maintained by the employer. If the data is not available at the employer, consideration should be given to confirming the information directly with participants or to reviewing hard copy information obtained from the service provider, if available.
Individual participant accounts in 401(k) plans or other defined contribution pension plans should be tested for proper allocation of plan assets, contributions, income, and expenses. As such, the auditor should consider confirming contribution percentages and investment elections directly with the participants in situations where transactions are performed electronically or by phone. In addition, recordkeepers may maintain back up documentation of participant transactions, which may be requested as audit evidence to test participant data.

Procedures that should be considered in the audit of benefit payments, particularly those initiated by telephone or electronic methods, include confirming disbursements directly with participants, or comparing the disbursement to a transaction report if one is maintained, and testing the documentation underlying the benefit payment transactions.

(Source: AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2005, Chapters 7, 9, and 10).

5. In plan audits where a type 2 SAS No. 70 report is used, how extensively should the allocation of investment earnings at the participant level be tested? What are commonly used methods for testing this information?

A. In audits where a type 2 SAS No. 70 report is relied upon, the extent of testing of the allocation of investment earnings at the participant level will be determined based on the assessed level of the plan’s control risk in this area. The SAS No. 70 report can provide information about the controls in place within the service organization to help the auditor assess this risk. However, the auditor should not use the SAS No. 70 report to completely eliminate substantive testing.

A commonly used method of testing this information is comparing the yield in the participants’ accounts (selecting a sample of funds) for a certain period of time to the yield that the plan reported as a whole (as compared to published sources) for those funds for the same period of time.
6. In a full scope audit, why is it necessary to test investment values when those investments are covered by a SAS No. 70 report?

A. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, requires an auditor to obtain a sufficient understanding of an entity’s internal control to plan the audit. Per paragraph 1.09 of the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, this understanding would include controls placed in operation by the entity and by service organizations whose services are part of the entity’s information system. The SAS No. 70 report is a tool that can be used to obtain the understanding of internal control within the service organization. It does not eliminate the need to perform substantive tests, but may be relied upon to reduce the level of testing.

In performing a full scope audit, an auditor may use the SAS No. 70 report to obtain information about the controls at the service organization to assess control risk and design methods of testing the investment information. AU section 328, *Auditing Fair Value Measurements and Disclosures* (*AICPA Professional Standards*, vol.1), provides guidance on auditing fair value measurements contained in financial statements. Frequently, a SAS No. 70 report will address the controls over calculating the value of marketable securities, but will not address the market value of nonmarketable investments, such as real estate and limited partnerships. If the SAS No. 70 report covers controls over the pricing of investments for specific assets that the plan holds, an auditor may be able to rely on it to reduce, but not eliminate, the extent of substantive testing in that area.

7. How much reliance can be placed on the SAS No. 70 report? The AICPA EBP Guide says that the SAS No. 70 report may only be used to reduce testing, not eliminate it. However, I heard at a conference that with an appropriate SAS No. 70 report, substantive testing may be eliminated. What is the correct answer?
A. Testing may be reduced if the SAS No. 70 report addresses a specific audit area and the controls around it appear satisfactory, but testing may not be eliminated entirely.

SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, requires an auditor to obtain a sufficient understanding of an entity’s internal control to plan the audit. Per paragraph 1.09 of the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, states that this understanding would include controls placed in operation by the entity and by service organizations whose services are part of the entity’s information system. The SAS No. 70 report is a tool that can be used to obtain the understanding of internal control within the service organization. As such, it can be used in planning the audit, but not in place of performing audit procedures.

(Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2005, paragraph 10.19.)

8. What is the auditor’s responsibility for testing a plan’s compliance with top heavy rules, the Average Deferral Percentage Test, and other qualification issues?

A. An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, a plan must be designed to comply with all provisions, and must meet certain operating tests in order to maintain its qualified status. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible violations of provisions that may affect the financial statements, he or she should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor also is expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations, and the controls in place to prevent violations of those laws and regulations that may cause the plan to lose its qualified status.
9. In recent audits of health and welfare plans, our firm has been denied access to personnel files because of Health Insurance Portability and Accountability Act of 1996 (HIPAA) rules. In such cases, it has prohibited us from performing certain procedures necessary to render our opinion on the financial statements, such as testing of birth date, hire date, elections, and other such information. How can we overcome this obstacle?

A. The items mentioned (birth date, hire date, elections) are not “protected health information” (PHI) under the HIPAA rules.

PHI is individually identifiable health information that is created or received from a health care provider, health plan, employer, or health care clearinghouse; that either identifies or can be used to identify an individual; and relates to the individual’s past, present, or future physical or mental health, to the provision of health care to an individual, or to the payment for the provision of health care to the individual. In other words, there are two components to PHI: (1) the identification of an individual and (2) health information. Identification of an individual without the corresponding health information is not PHI, nor is health information without identifying the corresponding individual to whom it relates.

The first step is to understand what information is needed for the audit and whether it constitutes PHI. If access to PHI is necessary for the audit, HIPAA regulations allow for that access.

HIPAA privacy regulations indicate that a plan sponsor may not use or disclose protected health information except as permitted or required by the regulations. The regulations permit use of the “minimum necessary” information for use in health care operations, including conducting audits. If the auditor has signed a business associate agreement with
the plan sponsor, then that auditor is considered a business associate under the regulations, and access to such minimum necessary information required for the audit should not be restricted by HIPPA.

Discussion with the plan sponsor may be necessary to demonstrate that the requested information is the minimum necessary for the audit and, if such information is not obtained, would result in a disclaimer of opinion.

For more information, call the Department of Labor Office of Health Plan Standards and Compliance Assistance at (202) 693-8335, or call the EBSA’s toll free inquiry line at (866) 444-EBSA (3272). Health and Human Services (HHS) also has a toll-free number dealing with HIPAA privacy related issues. That number is (866) 627-7748. You also may wish to visit the HHS Web site, http://www.hhs.gov/ocr/hipaa/.

10. Are Frozen and terminated plans that are still paying out benefits required to have an audit?

A. An audit is required if the plan has more than 100 participants at the beginning of the plan year. Exhibit 5-2 of the AICPA Audit and Accounting Guide Employee Benefit Plans provides guidance with regard to the definition of participants. When a plan has been terminated or frozen, complete and prominent disclosure of the relevant circumstances is essential in all subsequent financial statements issued by the plan. If the number of participants falls below 100, auditors should consider whether the plan meets the criteria for the Small Pension Plan Audit Waiver.

(Source: AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2005, Paragraph 2.49 and Exhibits 5-1 and 5-4.)

11. For the year ended December 31, 2002, an audit was performed for AB Plan with more than 100 participants that covered two related companies (Company A and Company B). In July 2003, Company A was sold, and the plan assets related
to those participants were transferred to a new plan (Plan C). What are the audit requirements for the remaining portion of the AB Plan which, as of July 2003, cover only employees at Company B and had fewer than 100 participants?

A. An audit for the AB Plan is required for the year ended December 31, 2003, because the plan had over 100 participants at the beginning of the plan year. For the year ended December 31, 2004, an audit of plan AB may not be required if the number of participants at January 1, 2004, is under 100 and the plan meets the criteria for the Small Pension Plan Audit Waiver.

12. Assume a partially insured H&W plan where the employer pays claims to a certain level and then reinsurance assumes the liability. There are over 100 participants, and the employer and employees each pay a portion of the premiums. The employee share is paid on a pretax basis through a section 125 plan. There is no trust established, but at year end there may be a minimal payable to the third-party administrator for regular monthly charges and a small reinsurance receivable, depending on timing. Does this plan require an audit?

A. No, the plan does not require an audit. According to the fact pattern described, no separate trust exists to hold the assets of this plan, and therefore it is not a funded plan for ERISA purposes. ERISA exempts unfunded plans from the requirement to perform an annual audit. Participant contributions made through a section 125 cafeteria plan are not required to be held in trust per DOL Technical Release 92-1, and as long as no trust is being utilized, no audit requirement exists.

(Source: AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2005, Appendix A, paragraphs A.25 and A.28.)

13. If a defined contribution plan has an effective merger date, per the merger agreement, of December 31, 2003, but a significant portion of the plan’s assets have not been transferred
as of December 31, 2003, should the audit be done as of the
December date, or when the majority of the assets were
transferred? Would the answer be any different for a defined
benefit plan? Would a liability representing the assets due to
the acquiring plan be reflected on the statement of net assets
if the audit date is December 31, 2003?

A. For defined contribution plans, if there is a significant dif-
ference between the effective merger date per the merger
agreement and the actual date of transfer of assets, consider-
ation should be given to performing an audit through the
date of the actual transfer. However, all facts and circum-
stances should be considered, including management’s in-
tent, before determining the proper merger date.

For defined benefit plans, the merger typically is recorded on
the effective merger date per the merger agreement because
legal title to the assets, liabilities, and benefit obligations has
transferred. In certain circumstances, it may be appropriate
to record a liability representing the assets due the acquiring
plan at year end (for example, if the physical transfer from
one plan to another has been requested and is pending).

Auditor’s Reports

14. In situations where the plan has no audit committee, but the
plan sponsor has an audit committee, are the plan auditors
required to communicate pursuant to SAS No. 61? What is
the requirement if the plan has an administrative committee?
Would the answer be different for public and nonpublic
entities?

A. AU section 380, Communication With Audit Committees
(AICPA, Professional Standards, vol. 1), as amended, requires
the auditor to determine that certain matters related to the
conduct of an audit are communicated to those who have re-
sponsibility for oversight of the financial reporting process.
The communications are to be made to an audit committee
or to a group equivalent to an audit committee which has
formal designated oversight responsibility of the financial
reporting process, such as a finance committee or budget committee. For employee benefit plans, formal oversight may be delegated to a pension or administrative committee.

Required communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

The communications are not required to occur before the issuance of the auditor’s report on the entity’s financial statements (see rules for public entities later in this section) so long as the communications occur on a timely basis.

Nonpublic entities. Plans that do not file a Form 11-K with the SEC are considered nonpublic entities. If a plan that does not file a Form 11-K with the SEC has no designated group or body equivalent to an audit committee with formal responsibility for the financial reporting process, the auditor is not required to make the communications required by AU section 380, as amended.1

Public entities. Plans that file a Form 11-K with the SEC are considered public entities. For such plans, the communications required by AU section 380 must be made in every situation. When issuing an audit report on financial statements that are filed with the SEC, auditors are required to follow Rule 2-07 of Regulation S-X in addition to the matters required to be communicated to the audit committee by AU section 380, as amended.

Rule 2-07 of Regulation S-X requires that auditors communicate certain matters to audit committees prior to the filing of the audit report with the SEC. As such, any auditor’s report that is included (or incorporated by reference) in a client’s periodic report should only be included in such periodic report after the auditors have communicated the matters

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1. Proposed SAS The Auditor’s Communication With Those Charged With Governance will replace SAS No. 61, Communication With Audit Committees, as amended, and establishes standards and provides guidance to an auditor on matters to be communicated with those charged with governance. Be alert for the issuance of a final standard.
required by Rule 2-07 of Regulation S-X to the audit com-
mittee.

Currently there is no guidance from the SEC in determining
the appropriate group (other than the audit committee)
with whom to have the required communications as they re-
late to Form 11-K filers.

(Source: AU section 380, Communication With Audit Com-
mittees (AICPA, Professional Standards, vol. 1), the related
Interpretation at AU section 9380, and Rule 2-07 of SEC
Regulation S-X, Communication with Audit Committees.)

15. We have completed the audit of a plan except for reviewing
the 401(k) and 401(m) discrimination testing, which has
not yet been done and quite possibly may not ever be done.
If such testing is not performed, what type of audit opinion
should be issued?

A. Independent auditors should inquire if the plan has com-
plied with the annual limitation tests to determine if the plan
has met the requirements in order to maintain its tax exempt
status. Since the nondiscrimination requirements under
401(k) and 401(m) are required to be met annually, the inde-
pendent auditor should understand the results of similar tests
performed in the past and the reasons why the associated
testing has not been performed in the current year. The audi-
tor should be aware that any corrections, corrective distribu-
tions, or qualified nonelective contributions (QNECs) that
would result from failure of these compliance tests must be
made before the end of the following plan year to preserve
the plan’s qualified status. If correction is to be made through
refunds, then a correction made within 2 ½ months after the
plan’s year end will avoid potential excise tax and preserve the
plan’s qualified tax status. In contrast, a refund after 2 ½
months triggers an excise tax payable by the plan sponsor. In
the event that testing has not been completed for the year
under audit, the auditor should consider the results of testing
performed in the past, any corrections that were made, and
whether significant changes in the plan’s demographics have
occurred. The client should determine whether or not it is expected that a correction will be necessary, and should make an estimate for accrual purposes of the amount required for correction. Consideration should be given to modifying the tax note in the financial statements to indicate that the plan sponsor will take the necessary steps, if any, to bring the plan’s operations into compliance with the Code. Similar wording also should be included in the management representation letter. If the results of the testing, when completed, are expected to be material based on similar issues in the past or discussions with the client and a correction amount cannot be reasonably estimated, the auditor should consider withholding his or her report until the testing is completed and the appropriate accruals recorded. If, however, the financial statements are issued and the client doesn’t remedy or complete the tests by the next audit, the auditor should consider the effect on the financial statements as well as other implications as described in AU section 317, Illegal Acts by Clients (AICPA, Professional Standards, vol. 1), since the plan’s tax qualified status may be in jeopardy.

(Source: AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2005, paragraph 12.03b.)

Sale of Real Estate Investments Held by Employee Benefit Plans

16. Many employee benefit plans invest directly in real estate (for example, a building) that generates rental income and operating expenses for the plan. Generally, these plans are defined benefit plans but certain defined contribution plans may also hold these investments.

Paragraph 41 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, provides that a “component of an entity” comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be a re-
portable segment or an operating segment, a reporting unit, a subsidiary, or an asset group.

Paragraph 42 of FASB Statement No. 144 provides that the results of operations of a component of an entity that either has been disposed of or is classified as held for sale shall be reported in discontinued operations in accordance with paragraph 43 of FASB Statement No. 144 if both of the following are met:

- The operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction.
- The entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

Paragraph 43 of FASB Statement No. 144 states that in a period in which a component of an entity either has been disposed of or is classified as held for sale, the income statement of a business enterprise (or statement of activities of a not-for-profit organization) for current and prior periods shall report the results of operations of the component, including any gain or loss recognized in accordance with paragraph 37 of FASB Statement No. 144, in discontinued operations.

Because employee benefit plans are not specifically scoped out of FASB Statement No. 144, if an employee benefit plan invests in real estate that generates rental income and operating expenses for the plan and then sells that property, is the sale of the real estate investment considered a discontinued operation of the plan?

A. No. For many entities, after evaluating the conditions in paragraph 42 of FASB Statement No. 144, an investment in real estate (such as a building) that generates rental income and operating expenses would be considered to meet the definition of a “component of an entity” (as defined in FASB Statement No. 144) and, therefore, any gains or losses relating to the disposal of that “component” would be reported in discontinued operations. However, employee benefit plan
financial statements show financial status or net assets available for benefits and changes in financial status or net assets available for benefits. Because they do not show a statement of operations or activities, there is no reason to distinguish between continuing and discontinued operations. Rather, real estate in an employee benefit plan should be treated as an investment carried at fair value and the related income/expenses and net appreciation/depreciation should be included in the statement of changes in financial status or statement of changes in net assets available for benefits. No distinction should be made between continuing and discontinued operations.

(Source: TPA Section 6930.05, “Sale of Real Estate Investments Held by Employee Benefit Plans and Discontinued Operations”.)

Other Commonly Asked Questions

Employee Benefit Security Administration Guidance on Insurance Company Demutualizations

1. During the past few years there have been a number of insurance companies that have demutualized, resulting in the insurance contract policyholder receiving demutualization proceeds. What alternatives are available with respect to receipt by policyholders of demutualization proceeds?

A. On February 15, 2001, Employee Benefit Security Administration (EBSA) 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
demutualization 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. Auditors should take care to identify those plans with contracts with insurance companies that have demutualized and ensure that the proceeds are properly recorded as plan assets. Plan sponsors may not be familiar with EBSA’s letter regarding alternatives available with respect to receipt by policyholders of demutualization proceeds. In addition, it has been noted that demutualization proceeds are often deposited into a separate account or trust and may be overlooked in financial reporting for the plan.

**Reporting of Participant Loans on Defined Contribution Plan Master Trust Form 5500 Filings**

2. How should participant loans be reported on defined contribution plan master trust Form 5500 filings?

A. The face of Schedule H Form 5500 instructs master trust investment accounts not to complete line 1c(8) participant loans. In practice, many master trusts for defined contribution plans include participant loans as part of their master trust agreement. However, even though these loans may be included as part of the master trust agreement, the Form 5500 instructs the preparer not to include them as part of the master trust assets. Thus, the plan’s financial statements would require a supplemental schedule, Schedule of Assets (Held at End of Year), to report participant loans as a non-master trust investment. The plan’s Form 5500 filing would require the participant loans to be broken out separately from the investment in the master trust on the Schedule H.

**Other Questions**

3. Can the plan sponsor accept a certification from the plan’s recordkeeper if the recordkeeper certifies the investment
information to be complete and accurate on behalf of the plan's trustee/custodian as “agent for”?

A. According to the DOL, such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee's behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited scope report to include reference to such an arrangement. Sample language might include the following: “any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan, . . . We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate.” The third paragraph of the report should also be modified.

4. Is it permissible to perform a limited scope audit on a portion of the plan's investments but not all (some investments did not meet the DOL 29 CFR 2520.103-8 criteria for a limited scope audit)? If yes, what form does the auditors' report take?

A. Yes, it is permissible to perform a limited scope audit on only a portion of a plan's investments and audit the remaining investments. The auditors' report is the same as that used for a limited scope audit. However, the note that is referenced in the auditor report should clearly identify the investments that were not audited.

5. 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. Often 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 before the transfer to new investment options. Such transactions would not be required to be included on the Schedule of Reportable Transactions.

6. 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 *Employee Benefit Plans*, with conforming changes as of March 1, 2005 (the EBP Guide) provides guidance on determining who is considered a participant. In addition, 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.

7. 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 trans-
ferred 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 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 12.13 through 12.16 of the EBP Guide.)

8. 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.

9. 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.

10. 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.

11. 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, the DOL requires separate individual plan certifications from the trustee or the custodian regarding the allocation of the assets and the related income activity to the specific plan.

12. 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 noninterest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.

13. 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.

14. What is the auditor’s responsibility for detecting nonexempt 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 (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, 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 about the existence of any party-in-interest
or nonexempt 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.

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

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

16. 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 12.24 of the EBP Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.

17. 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.

18. 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 ERISA does not eliminate the requirement to include this disclosure in the financial statements.

19. 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.

20. 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 issue should be resolved with the actuary to determine whether payments recorded by the plan or used by the actuary require adjustment.

21. 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.

22. 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 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 that 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.

23. 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 have elected coverage under the plan.

24. 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 that has an Internal Revenue Code (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.

25. 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 reporting entity and thus the audit requirement is of the entire plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.
26. If a VEBA trust is used 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.

27. If multiple plans use 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.

28. 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.

29. What responsibility does the auditor have in testing plan qualification tests (for example, ACP and ADP) prepared by a client’s third-party administrator?

A. An audit in accordance with generally accepted auditing standards (GAAS) is not designed to ensure compliance with all legislative and regulatory provisions. However, plans must be designed and comply with certain operating tests to maintain their qualified status. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor is also expected to inquire of, and ob-
tain representation from, management concerning compliance with laws and regulations and the prevention of violations that may cause disqualification.

30. If the plan fails its 20X0 discrimination test and has to return employee contributions in 20X1, should “excess contribution payable” liability be shown on the 20X0 financial statement?

A. Yes, the financial statements should reflect a liability for excess contributions payable on the financial statements if the amount is material to the financial statements.

31. What alternate audit procedures should be done to test participants’ investment allocation of deferral contributions where no documentation exists (participants can change deferrals and allocation of such online or via phone)?

A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), consider confirming contribution percentage, source, and investment election directly with the participant or compare to a transaction report, if one is maintained. Alternatively, if the service provider has a type 2 SAS No. 70 report2 that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce (not eliminate) substantive testing.

32. For a DOL limited-scope audit, is it necessary to test the allocation of investment earnings at the participant account level?

A. The testing of allocation of investment earnings at the participant level is part of the participant data testing and is recommended for a limited scope audit.

33. Brokerage accounts can be listed on one line item on the Form 5500. Can they be listed on one line item on the supplemental schedules to the financial statements, or do the individual underlying investments have to be listed?

2. AU section 324, Service Organizations (AICPA, Professional Standards, vol. 1), as amended.
A. As described in the Form 5500 instructions, individually directed brokerage accounts may be listed as one line item on the statement of net assets available for benefits and on the supplemental schedule of assets, provided the investments are not loans, partnerships or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction. However, the notes to the financial statements must disclose any individual investment that is over 5 percent of net assets available for benefits at the end of the year. In addition, the investment income for individually directed brokerage accounts may be shown as one line item in the Form 5500; however, the financial statements must separate interest and dividends from net appreciation (depreciation) in fair value on the statement of changes in net assets available for benefits and disclose net appreciation (depreciation) by type of investment in the notes to the financial statements.

34. When a defined benefit plan has a 401(h) account and the assets of the 401(h) account are commingled in a master trust, are the required master trust disclosures included in the defined benefit plan or the health and welfare plan?

A. Since the 401(h) assets legally belong to the defined benefit plan, the master trust disclosures should be included in the defined benefit plan’s financial statements.

35. If a limited-scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, should separate individual plan certifications from the trustee or the custodian be obtained for the allocation of the assets and the related income activity to the specific plan?

A. Yes, 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.
APPENDIX E

Claims Testing

There are three sources that the auditor may need to consult when testing claims. They are the sources that contain Current Procedural Terminology (CPT) codes, Healthcare Common Procedure Coding System (HCPCS) codes, and International Classification of Diseases, Ninth Edition (ICD-9) codes.

Physicians’ CPT is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The purpose of CPT is to provide a uniform language that accurately describes medical, surgical, and diagnostic services and thereby serves as an effective means for reliable nationwide communications among physicians, patients, and third parties. In addition, for use in federal programs (Medicare and Medicaid), CPT is used extensively throughout the United States as the preferred system of coding and describing health care services.

CPT does not contain all the codes needed to report medical services and supplies. The Health Care Financing Administration (HCFA) developed level II and level III codes, which are published as HCPCS codes for supplies and services not covered by a CPT code (level I). These codes cover such items as durable medical equipment, ambulance services, and various drugs.

The ICD-9-CM is published by the United States government and is the classification employed for cause-of-death coding. The ICD-9 coding system is recommended for use in all clinical settings and is required for reporting diagnoses and diseases to the U.S. Public Health Service.

If medical claims are not submitted electronically, they are submitted on one of two types of forms. All hospital bills, both outpatient and inpatient, are submitted on a form UB92. All other bills are submitted on a form HCFA 1500.
APPENDIX F

Payroll Auditing

AU section 316, Consideration of Fraud in a Financial Statement Audit (AICPA, Professional Standards, vol. 1), states that the auditor should assume that revenue recognition is an area where fraud could occur in any entity. For employee benefit plans, the primary sources of revenue are income from investments and employer contributions. The AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2006 (EBP Guide), contains chapters detailing audit procedures for investments and employer contributions.

In single-employer employee benefit plans, the auditor can test payroll audits directly. Often the auditor performs the audit for both the employer and the employee benefit plan, and this enables the auditor to do the testing of the employer’s payroll without a great deal of difficulty.

For multiemployer benefit plans, employers contribute to an employee benefit plan based on the provisions of a collective bargaining agreement (CBA) negotiated between a union representing employees in a specified trade or industry and their employers. A multiemployer plan may be local, regional, or national in scope and may bind a few employers or several thousand employers.

What Is a Payroll Audit?

A payroll or compliance audit is an audit of a contributing employer to determine whether the employer has contributed the amount specified by the CBA to a multiemployer plan. Although they are called payroll audits, these examinations are actually agreed-upon procedure engagements. When a plan uses a CPA to perform payroll audits, the plan trustees will agree with the auditor about the records to examine and the steps to perform. The CPA will perform the agreed-upon procedures specified and will
write a report addressed to the trustees of the multiemployer plan detailing the findings of the engagement. The agreed-upon procedures report issued will typically be in accordance with AT sections 101 through 701 (AICPA, Professional Standards, vol. 1), as amended.

**Purpose of a Payroll Audit**

There are two primary purposes of a payroll audit. First is to determine that the employer is complying with the CBA. Only those employees covered by the CBA should be reported. The payroll audit helps ensure that all wages and hours for all covered employees are reported.

The second purpose of a payroll audit is to determine the accuracy of employer contributions. Only by having a payroll audit program of contributing employers can an independent auditor gain assurance that the completeness objective has been fulfilled for employer contributions to the multiemployer plan.

**Who Should Perform the Payroll Audits?**

Payroll audits can be performed internally by the staff of the multiemployer plan or externally by the auditors performing the audit of the plan, another CPA firm, or another entity specializing in payroll auditing. It does not matter who performs the payroll audits if the CPA firm conducting the audit of the plan has the opportunity to review the working papers of the payroll audits performed to the extent necessary to gain assurance regarding the completeness of employer contributions.

Payroll auditing done in-house can be less expensive if the plan can use its own employees to do the audits. In-house auditors can also be used effectively to educate contributing employers regarding their reporting responsibilities in complying with the CBA.

Other plans prefer to hire outsiders to perform payroll audits. These plans prefer to have someone else handle the employment and training issues of payroll auditors.
Are Payroll Audits Required?

Paragraph 10.09 of the EBP Guide states that in a multiemployer environment “plan sponsors or trustees may engage the employer’s auditor, other outsider auditors, in-house compliance personnel, or others to perform agreed upon procedures to test the completeness of employer contributions.” The Department of Labor has suggested that it is difficult to ensure the completeness objective over employer contributions without performing payroll audits and that without an effective payroll audit program, the plan auditor should consider issuing a qualified opinion on the plan’s financial statements.

There may be some limited circumstances where payroll audits are not necessary. For example, some plans cover only a few contributing employers and the control system for those employers is effective and can give the external auditor confidence that all employer contributions are being collected.

How Often Should Payroll Audits Be Performed?

Paragraph 10.09 of the EBP Guide states that “a representative group of contributing employers should be tested each year.” Does this mean that every contributing employer will be audited within a three- or four-year cycle? While a three- or four-year cycle might be acceptable in a small plan, a national plan with thousands of contributing employers may never audit all contributing employers.

The plan should monitor from year to year the effectiveness of its payroll auditing program. The payroll audit program should help ensure the completeness objective in measuring employer contributions. The plan itself should also be able to conclude that the payroll audit program is operating on a cost-effective basis. If revenue from employer contributions generated as a result of the payroll audit program increases from year to year as a percentage of the costs of the program, then consider increasing the number of audits performed. If revenue is declining as a percentage of costs, then consider reducing the number of payroll audits being performed.
### APPENDIX G

**Statement on Auditing Standards Cross-Referenced to Professional Standards AU Sections Transition Schedule**

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APPENDIX H

Form 5500 Filing Tips for Pension Plans, Welfare Plans, and Direct Filing Entities

The U.S. Department of Labor (DOL), Pension Benefit Guaranty Corporation (PBGC), and the Internal Revenue Service (IRS) have compiled the following practical, common sense tips for some of the most frequently occurring Form 5500 filing problems. The tips are intended to reduce the number of basic filing errors encountered when processing the Form 5500 and Form 5500-EZ returns, and also help filers avoid getting EFAST correspondence regarding these basic mistakes. Filers may obtain more information in the DOL’s Trouble Shooter’s Guide to Filing the ERISA Annual Report (Form 5500), which is available on the DOL Internet site at www.dol.gov/ebsa. Also, filers with questions can call the EFAST Help Line at (866) 463-3278.

1. Important Reminder for Fringe Benefit Plans

The IRS reminds employers that they no longer have to file an annual Form 5500 and Schedule F for so-called “pure fringe benefit plans.”

Employers who in the past filed Form 5500 and the Schedule F (Fringe Benefit Plan Annual Information Return), solely to meet the reporting requirements of Internal Revenue Code (IRC) section 6039D (fringe benefit plans), should file neither Form 5500 nor Schedule F. In fact, the Schedule F has been eliminated and the Form 5500 has been modified so fringe benefit plan information cannot be reported.

Fringe benefit plans are often associated with ERISA group health plans and other welfare benefit plans. The IRS announcement regarding fringe benefit plans does not cover these associated welfare plans. But, in many cases, a Form 5500 was not
required for the welfare plan because it was exempt from filing a Form 5500 report under Department of Labor regulations. For example, fully insured or unfunded welfare plans covering fewer than 100 participants at the beginning of the plan year are eligible for a filing exemption. Unless exempt, however, ERISA welfare plans must still file in accordance with the Form 5500 instructions on welfare plan filing requirements.


2. The Form 5500 Must Be Properly Signed and Dated

Failure to sign the form is the number one reason filers receive correspondence from the government regarding their Form 5500 or Form 5500-EZ. Filers should make sure they have the proper signatures and dates on the Form 5500, Form 5500-EZ, and any attached schedules that require a signature (Schedules B, P and SSA).

The type of plan or DFE filing the Form 5500 determines who is required to sign the form. Filers should consult Section 4 of the Instructions for Form 5500, under the heading “How to File,” for information on who is required to sign the return/report.

It is important to remember that, for those filings submitted electronically, the plan must keep in its records an original copy of the Form 5500 filing with all required signatures.

3. The Form 5550 Must Have the Proper EIN and Plan Number (PN)

It is critical that the Employer Identification Number (EIN) used to identify the “plan sponsor” be the same year to year when completing line 2b of the Form 5500 or Form 5500-EZ. Switching EINs without reporting the change on line 4 of the Form 5500 or Form 5500-EZ will disrupt proper processing of the form and cause the generation of correspondence with the filer. Also, the same EIN must go on line D of all the attached schedules (except
Schedule P, which reports the EIN of the plan’s employee benefit trust(s) or custodial account(s).

A multiple-employer plan or plan of a controlled group of corporations should select one of the participating employers to list as the plan sponsor and use that employer’s EIN on line 2b. If the plan sponsor is a group of individuals (for example, a board of trustees of a collectively bargained plan) a single EIN should be obtained and used for the group. In the case of a Form 5500 filed for a Direct Filing Entity (DFE), use the EIN assigned to the CCT, PSA, MTIA, 103-12 IE or GIA.

The three-digit plan number (PN), in conjunction with the EIN, is used as a unique 12-digit number to identify the plan or DFE. Although EINs are obtained from the IRS, the plan sponsor/employer or plan administrator assigns the PN. Also, once a three-digit plan number and EIN combination is used for one plan or DFE, it cannot be used for any other plan or DFE, even after the plan or DFE terminates.

Plan administrators, plan sponsor/employers, and DFE sponsors should assign PNs as follows. Plans providing pension benefits (such as profit-sharing or money purchase plans) should be assigned plan numbers starting with 001, and consecutive numbers should be assigned to other pension plans (for example, 002, 003, 004, and so on). The sponsor of an MTIA, CCT, PSA or 103-12 IE filing as a DFE should also start with number 001, and consecutive numbers should be assigned to other DFEs of the sponsor. Welfare plans and group insurance arrangements (GIAs) filing as DFEs should be assigned plan numbers starting with 501, and consecutive numbers should be assigned to other welfare plans and GIAs (for example, 501, 502, 503, and so on). 888 or 999 should not be used as PNs.

Filers should consult the Form 5500 filing instructions for line 1b and 2b in Section 6, “Line-by-Line Instructions”, for additional information on EINs and PNs. The instructions for line 2b include information on how to obtain EINs from the IRS.
4. The Form 5500 Filing May Not Be for a Period Greater Than 12 Months

The time period entered in Part I of the Form 5500 may not be greater than 12 months. If the plan year is a calendar year (January 1 through December 31), the spaces provided for dates in Part I may be left blank. If the plan or DFE is not reporting on a calendar year basis, but instead is using a fiscal year, then the 12-month (or shorter) fiscal year period should be inputted in the spaces provided. Example: fiscal year beginning 07/01/2003 and ending 06/30/2004.

Filers should make certain there is no gap between the ending date of their previous year’s Form 5500 and the beginning date of the current year’s form. Special care should be taken if filing a Form 5500 for a short plan year (a plan or DFE year of less than 12 months). For instance, if a plan or DFE changes from a calendar year to a noncalendar fiscal year, the beginning date entered on the “short plan year” Form 5500 should be one day after the ending date of the previous year’s Form 5500, and the ending date should be one day before the beginning date entered on the next year’s Form 5500. In addition, line B(4) should be checked on the short plan year Form 5500. The Form 5500 filing instructions, Section 4 (“How to File” and “Change in Plan Year”) contains additional information.

Finally, the plan year beginning and ending date on all attached Schedules (except Schedule P) must match the plan year beginning and ending dates on Part I of the Form 5500.

5. Use a Proper Business Code When Completing Line 2d of the Form 5500

On Form 5500, line 2d, filers should enter a valid business code that best describes the nature of the plan sponsor’s business.

The only business codes that are valid for use in answering line 2d are listed in the Form 5500 filing instructions section marked “Codes for Principal Business Activity.” If more than one em-
ployer and/or employee organization is involved, the business code for the main business activity of the employers and/or employee organizations should be entered.

Business codes may change from year to year. Therefore, the business code used for a previous year's filing may not be a valid business code for the current year filing. Filers should select the appropriate business code from the Form 5500 filing instructions section marked “Codes for Principal Business Activity” (for example, if filing a 2002 Form 5500, the business code you select should be one of the business codes from the 2002 instructions).

6. Use the Correct Plan Characteristics Codes on Line 8 of the Form 5500

On Form 5500, line 8, filers must check box A and/or B to indicate if the plan is providing pension benefits and/or welfare benefits.

After indicating which benefits are being provided by checking box A and/or B, filers must enter the plan characteristics codes in the space provided beneath boxes A and/or B. These codes describe the type of pension and/or welfare benefits provided and other features of the plan. A list and description of the plan characteristics codes is in Section 6 of the Instructions for Form 5500.

An individual account pension plan like a money purchase plan or profit-sharing plan (including a 401(k) arrangement) should enter on Form 5500 line 8 the appropriate “Defined Contribution Pension Features” and “Other Pension Benefit Features” codes that are listed in the Form 5500 instructions. Individual account plans would not normally enter codes for “Defined Benefit Pension Features,” such as 1A, 1B, or 1C.

7. Properly Identify the Funding and Benefit Arrangements on Line 9 of the Form 5500

Filers should indicate all the proper funding and benefit arrangements on Form 5500, lines 9a and 9b. The “Funding Arrangement” is the method used for the receipt, holding, investment,
and transmittal of plan assets prior to the time the plan actually provides benefits. The “Benefit Arrangement” is the method by which the plan provides benefits to participants.

Filers should remember to indicate all the applicable funding and benefit arrangements. The responses on lines 9a and 9b are cross-referenced against information on Schedules H, I, and/or A, as appropriate. Be careful to attach the appropriate financial or insurance schedule (H, I, A) that corresponds to the benefit and funding arrangements you indicate. For instance, if “Trust” is indicated as an arrangement, then a Schedule H or I (as appropriate) should be submitted with the Form 5500. Likewise if “insurance” is indicated as a funding and/or benefit arrangement, a Schedule A should be filed with Form 5500 for any insurance contract with a contract or policy year that ended with or within the plan year.

Filers should refer to the Form 5500 filing instructions, Section 6, “Line-by-Line Instructions,” for a description of the funding and benefit arrangements.

8. File All the Required Schedules and Attachments With Your Form 5500

Filers should make sure they file all the required schedules and attachments with their Form 5500. The Form 5500 instructions in Section 5, under the heading “What to File,” break down filing requirements based on type of filer (large plan, small plan, pension plan, welfare plan, or DFE), and include a Quick Reference Chart that lists each of the Form 5500 schedules and identifies who has to file them.


The information entered in the checklist on line 10 of the Form 5500 must match schedules that are submitted with the Form 5500. If a box is checked indicating that a schedule is attached, the schedule must be submitted with the Form 5500.
When filing Schedules A, P, or T, special care should be taken to enter the total number of each schedule filed in the spaces provided on line 10.

10. File the Appropriate Financial Information Schedule (H or I) With Your Form 5500

Filers should make sure to file the proper Financial Information Schedule with their Form 5500. The Schedule H is for “large plan” filers (generally plans with 100 or more participants at the beginning of the plan year) and all DFEs. The Schedule I is for “small plan” filers (generally plans with fewer than 100 participants at the beginning of the plan year).

If a Form 5500 is filed as a “small plan” last year and the number of plan participants is fewer than 121 at the beginning of this plan year, the plan administrator may continue to file Schedule I as a “small plan” under the “80-120 Participant Rule.” This rule allows plans with between 80 and 120 participants at the beginning of the plan year to file the Form 5500 in the same category (large plan or small plan) as the prior year filing. Please consult Section 5 of the Instructions for Form 5500 under the “What to File” heading for more information on the “80-120 Participant Rule.”

Certain Code section 403(b) retirement arrangements, IRA pension plans, fully insured pension plans, and insured, unfunded, or combination insured/unfunded welfare plans do not have to file Schedule H or I. Please consult Section 5, under the heading “Limited Pension Plan Reporting” and “Welfare Benefit Plan Filing Requirements” in the Instructions for Form 5500 for additional information and eligibility requirements.

When filing Schedule H or I, filers should make certain that all required information provided is accurate and complete. Make sure the spaces on the asset/liability and income/expense statements (lines 1 and 2) on the Schedule H and I that require a total from the lines above are completed accurately.
Schedule H
If Schedule H is filed, Part III of the schedule, regarding the independent qualified public accountant’s (IQPA) report and opinion, must be completed. The report of the IQPA identified on line 3 must be attached to the Form 5500 unless line 3d(1) or 3d(2), (3b(1) or 3b(2) on 2002 and prior year forms) is checked. Plans filing Schedule H must answer all items in Part IV, lines 4a through 4k and line 5a. Check either “yes” or “no” as appropriate, and, where applicable, enter the dollar amounts or other information that is required. Not responding or indicating “n/a” to an item may cause the filing to be rejected.

MTIAs, 103-12 IEs, and GIAs should leave Schedule H, lines 4a, 4e, 4f, 4g, 4h, 4k, and 5 blank; 103-12 IEs also do not complete 4j.

Schedule I
When filing Schedule I, filers should ensure that the amounts entered on Part I, lines 3a through 3g (Specific Assets of the Plan) are the year-end values for the assets. The purchase price for an asset that was purchased during the plan year is not necessarily the year-end value. Also, if the plan sold an asset reportable on lines 3a through 3g during the plan year, a “0” should be entered on the appropriate line in the amount column if there were no other asset values to report on that line.

The amounts entered on Schedule I, Line 3f, “Loans (other than to participants),” should be the value of the loans that are an asset of the plan. Loans are assets to be reported on line 3f if the plan loaned the amounts (other than participant loans) or purchased loans originated by a third party. Do not include amounts the plan borrowed; amounts the plan owes should be reported as a liability on Schedule I, line 1b.

Plans completing Schedule I must answer all items in Part II, lines 4a through 4k and line 5a. Check either “yes” or “no” as appropriate, and, where applicable, enter the dollar amounts or other information that is required. Not responding or indicating “n/a” to an item may cause the filing to be rejected.
11. Do Not Submit Loose Schedules or Attachments

The Form 5500 must be submitted in its entirety with all required schedules and attachments (including the report of the IQPA, if applicable).

Loose schedules and attachments filed without a completed Form 5500 or amended Form 5500 will not be considered filed or processed. However, government, church, or other plans that elect voluntarily to file the Schedule SSA are not required to attach the schedule to a Form 5500 but must check box 1b on the Schedule SSA. See the Schedule SSA instructions for more information.

Hand print and machine print forms generated by EFAST approved software will not be processed if they are printed out blank, or with limited information, and then completed by pen or typewriter. Only official hand print paper forms printed by the IRS are allowed to be completed by pen or typewriter.

12. Follow the Proper Procedures When Filing an Amended Form 5500

If the amended return/report is filed electronically, filers should submit a completed and dated Form 5500 with electronic signature (check box B(2) in Part I to indicate it is an amended return/report), and refile all schedules and attachments, including those that are not being amended.

If the amended return/report is submitted in paper form, submit a new completed, signed, and dated Form 5500 (check box B(2) in Part I) and attach only the schedules or attachments that are being changed from the prior filing. Do not attach schedules and attachments that are not being changed. Do not attach schedules where only attachments are being amended. Identify only the schedules that are being amended on line 10 of Form 5500. If only attachments are being amended, do not identify any schedules on line 10 of Form 5500.

When submitting a corrected Form 5500 in response to correspondence from EBSA regarding processing of a return/report, filers should not check box B(2) on the Form 5500.
APPENDIX I

Frequently Asked Questions on the Small Pension Plan Audit Waiver Regulation

1. What Is the Small Pension Plan Audit Waiver Regulation?

The Department of Labor’s (DOL’s) regulation at 29 CFR 2520.104-46 establishes conditions for small employee benefit plans (generally those with fewer than 100 participants) to be exempt from the general requirement under Title I of the Employee Retirement Income Security Act (ERISA) that plans be audited each year by an independent qualified public accountant (IQPA) as part of the plan's annual report (Form 5500).

The DOL amended the regulation in October 2000 to impose additional conditions for small pension plans to be exempt from the annual audit requirement. The purpose of the new conditions is to increase the security of assets in small pension plans by improving disclosure of information to participants and beneficiaries and, in certain instances, requiring enhanced fidelity bonds for persons who handle plan funds. The amendments went into effect beginning in 2001.

The Employee Benefits Security Administration (EBSA) has received a variety of questions on how to determine whether a small plan has met the conditions for the audit waiver. The purpose of this document is to answer frequently asked questions about the audit waiver requirements under the amended regulation. Questions concerning this guidance may be directed to the EFAST Help Line at (866) 463-3278. The EFAST Help Line is available Monday through Friday from 8:00 a.m. to 8:00 p.m., Eastern Time.
2. Eligible Pension Plans

2a. What pension plans are eligible for an audit waiver under the Small Pension Plan Security Amendments?

Pension plans with fewer than 100 participants at the beginning of the plan year are eligible if they meet the conditions for an audit waiver under 29 CFR 2520.104-46.

2b. Can a plan that uses the “80-120 Participant Rule” to file as a small plan claim the audit waiver?

Yes. All Schedule I filers that meet the conditions of the audit waiver are eligible. If the plan meets the conditions of the “80-120 Participant Rule,” it may file as a small plan and attach Schedule I instead of Schedule H to its Form 5500. Under the 80-120 Participant Rule, if the number of participants covered under the plan as of the beginning of the plan year is between 80 and 120, and a small plan annual report was filed for the prior year, the plan administrator may elect to continue to file as a small plan.

2c. Does the plan have to tell participants, beneficiaries, and the DOL if it is claiming the audit waiver? If so, how?

Yes. The plan administrator must disclose that it is claiming the waiver by checking “yes” on line 4k of Schedule I of the Form 5500 filed for the plan.

2d. Does a small pension plan that does not meet the audit waiver conditions need to file Schedule H instead of Schedule I?

No. Small pension plans that cannot claim the audit waiver may still file Schedule I but must attach the report of an IQPA to their Form 5500. They also do not need to include schedules of assets held for investment, a schedule of reportable transactions, the Schedule C, or Schedule G.
2e. If a small plan elects to file as a large plan pursuant to the 80-120 Participant Rule, can it still claim the small pension plan audit waiver?

No. Only plans filing as small plans can rely on the small pension plan audit waiver.

2f. If the plan previously did not have to include an audit with its annual report filing because it met another ERISA exception to the audit requirement, does it now have to meet the conditions under 29 CFR 2520.104-46?

No. If a plan meets another exception to the IQPA audit requirement, for example, if it is a small pension that is not required to complete Schedule I (such as a plan using an Internal Revenue Code [IRC] section 403(b) annuity arrangement that is exempt from the audit requirement under 29 CFR 2520.104-44) it does not have to meet the audit waiver requirements in 29 CFR 2520.104-46.

3. General Conditions for Audit Waiver

3a. What are the requirements for the audit waiver?

In addition to being a small pension plan filing the Schedule I, there are three basic requirements for a small pension plan to be eligible for the audit waiver:

First, as of the last day of the preceding plan year at least 95 percent of a small pension plan’s assets must be “qualifying plan assets” or, if less than 95 percent are qualifying plan assets, then any person who handles assets of a plan that do not constitute “qualifying plan assets” must be bonded in an amount at least equal to the value of the “non qualifying plan assets” he or she handles.

Second, the plan must include certain information (described below) in the summary annual report (SAR) furnished to participants and beneficiaries in addition to the information ordinarily required.
Third, in response to a request from any participant or beneficiary, the plan administrator must furnish without charge copies of statements the plan receives from the regulated financial institutions holding or issuing the plan’s “qualifying plan assets” and evidence of any required fidelity bond.

3b. What are qualifying plan assets?

“Qualifying plan assets” are:

- Any asset held by certain regulated financial institutions (see the next question);
- Shares issued by an investment company registered under the Investment Company Act of 1940 (for example mutual fund shares);
- 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 plan assets held or issued by the institution and the amount of such assets;
- Qualifying employer securities, as defined in ERISA section 407(d)(5); and
- Participant loans meeting the requirements of ERISA section 408(b)(1), whether or not they have been deemed distributed.

3c. Which financial institutions are “regulated financial institutions” for purposes of the audit waiver conditions?

Only the following institutions are “regulated financial institutions” for purposes of the audit waiver conditions:
Banks or similar financial institutions, including trust companies, savings and loan associations, domestic building and loan associations, and credit unions;

Insurance companies qualified to do business under the laws of a state;

Organizations registered as broker-dealers under the Securities Exchange Act of 1934;

Investment companies registered under the Investment Company Act of 1940; or

Any other organization authorized to act as a trustee for individual retirement accounts under IRC section 408.

3d. If more than 5 percent of the plan’s assets are nonqualifying, does that mean that the plan must be audited?

Not necessarily. If the plan obtains bonding in accordance with the provisions of the regulation and otherwise meets the waiver requirements, it can still claim the audit waiver.

3e. What are the basic decisions that must be made to determine whether a small pension plan may claim the audit waiver?

Administrators can use the decision tree found in Exhibit 5-4 of the AICPA Audit and Accounting Guide Employee Benefit Plans, with conforming changes as of March 1, 2006 (EBP Guide) for guidance.

4. Qualifying Plan Assets

4a. How do I calculate the percentage of “qualifying plan assets” for my plan?

All plan assets that must be reported on the Form 5500 Schedule I, line 1a, column (b) for the end of the prior plan year must be included in the calculation of “qualifying” and “nonqualifying” plan assets. The calculation must be made as soon as the information regarding the plan’s assets at the close of the preceding plan year is available.
year practically can be ascertained. This generally will be much sooner than the due date for filing the Form 5500 for that preceding plan year.

4b. How is the percentage of “qualifying plan assets” determined for initial plan years?

In the initial plan year, the plan administrator may rely on estimates. The administrator should follow a similar method to the one described in 29 CFR 2580.412-15 for estimating the amount required for the ERISA section 412 fidelity bond for an initial plan year. For example, if a plan will be investing exclusively in assets that meet the definition of “qualifying plan assets,” for example, insurance contracts and mutual fund shares, bonding in addition to that required under section 412 would not be necessary to meet the first condition for claiming the audit waiver.

4c. When a new plan is initially funded through the transfer of assets from a predecessor plan, how is the percentage of “qualifying plan assets” determined for the initial plan year?

You should make the determination by treating the new plan as not having a preceding reporting year and use the assets actually transferred from the predecessor plan to determine whether the new plan meets the 95 percent percentage condition for “qualifying plan assets.”

4d. Does the type of account the plan has with a “regulated financial institution” matter in determining whether assets are “qualifying plan assets”?

Generally, the account must be a trust or custodial account. For example, plan assets held in bank custodial, common or collective trust, or separate trust accounts are qualifying plan assets. In addition, securities held by a broker-dealer for the plan in an omnibus account are qualifying plan assets. Checking and savings accounts that create a debtor-creditor relationship between the plan and the bank are also “qualifying plan assets” for purposes of the audit waiver conditions.
4e. If I put plan assets in a bank safe deposit box, can I treat those assets as “qualifying plan assets”?

No. Plan assets put in a safe deposit box with a bank are not qualifying plan assets.

4f. Can assets in individual participant accounts be treated as qualifying plan assets if the individual account statements from the regulated financial institutions are mailed by affiliates of the regulated financial institutions, other unaffiliated service providers, or the plan administrator?

Yes. The account statements must be statements of the regulated financial institution, but the institution's regular distribution systems may be used to transmit the statements to participants and beneficiaries. For example, a statement prepared by the regulated financial institution, on the institution's letterhead including contact information that a participant could use to confirm the accuracy of the information in the statement with the regulated financial institution could be given to the plan administrator for distribution to the plan participants and beneficiaries. However, a statement prepared by the plan administrator, even if based on data from the regulated financial institution, would not meet the audit waiver condition.

5. Fidelity Bonding for Nonqualifying Assets

5a. What type of fidelity bond is needed to meet the audit waiver conditions if more than 5 percent of its assets are nonqualifying assets?

Persons that handle nonqualifying assets must be covered by a fidelity bond or bonds that meet the requirements of section 412 of ERISA, except that the bond amount must be at least equal to 100 percent of the value the nonqualifying plan assets the person handles. Persons handling nonqualifying plan assets can rely on normal rules and exemptions under section 412 in complying with the audit waiver's enhanced bonding requirement. For example, if the only nonqualifying assets that a person handles are not required to be covered under a standard ERISA section 412
bond (for example, employer and employee contribution receiv-
ables described in 29 CFR 2580.412-5) that person would not
need to be covered under an enhanced bond for a plan to be eli-
gible for the audit waiver.

5b. If the plan has more than 5 percent of its assets in
nonqualifying plan assets, does the enhanced bond have to
cover all the nonqualifying assets or only those in excess of the
5 percent threshold?

All the nonqualifying assets, not just a selection that represent the
excess over 5 percent, are subject to the enhanced bond requirement.

5c. Can the plan satisfy the audit waiver bonding requirement
by having persons who handle the nonqualifying plan assets get
their own bond?

Yes. The person handling the nonqualifying plan assets can ob-
tain his or her own bond. Also, a company providing services to
the plan can obtain a bond covering itself and its employees that
handle nonqualifying plan assets. The bond has to meet the re-
quirements under section 412, such as the requirements that the
plan be named as an insured, that the bond not include a de-
ductible or similar feature, and that the bonding company be on
the U.S. Department of the Treasury’s Circular 570 list of ap-
proved surety companies. [www.fms.treas.gov/c570/c570.html]

5d. Can the plan’s section 412 fidelity bond be used to satisfy the
bonding requirements for an audit waiver?

Section 412 of ERISA provides that persons that handle plan
funds or other property generally must be covered by a fidelity
bond in an amount no less than 10 percent of the amount of
funds the person handles, and that in no case shall such bond be
less than $1,000 nor is it required to be more than $500,000. In
some cases, 100 percent of the value of nonqualifying plan assets
may be less than 10 percent of the value of all of the plan funds a
person handles. Under those circumstances, the section 412
bond covering the person will satisfy the audit waiver condition
because the amount of the bond will be at least equal to 100 percent of the nonqualifying plan assets handled by that individual.

For example, a person may handle a total of $1 million in plan funds, but only $50,000 are nonqualifying plan assets. In that case, the ERISA section 412 bond covering the person should be equal to or greater than $100,000, which would be more than the value of the nonqualifying assets the person handles. For that person, the ERISA section 412 bond would also satisfy the audit waiver enhanced bonding requirement.

Even where the amount of an existing section 412 bond is insufficient to meet the audit waiver requirement, plan administrators may want to consider increasing the coverage under the section 412 bond rather than getting a new fidelity bond.

6. Summary Annual Report (SAR) Disclosures

6a. What information must be included in the SAR for the plan to be eligible for the audit waiver?

The plan administrator must include the following additional information in the SAR furnished to participants and beneficiaries to be eligible for the small pension plan audit waiver:

- Except as noted in the following question below, 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;

- The name(s) of the surety company issuing enhanced fidelity bonding, 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 from the plan copies of evidence of the required bond and copies of statements from the regulated financial institutions describing the “qualifying plan assets”; and
• A disclosure stating that participants and beneficiaries should contact the DOL’s Employee Benefits Security Administration (EBSA) regional office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond.

6b. Do the enhanced SAR disclosure requirements apply to all “qualifying plan assets”?

No. The enhanced SAR disclosure is not required for the following qualifying plan assets:

Qualifying employer securities as defined in section 407(d)(5) of ERISA and the regulations issued thereunder;

Participant loans meeting ERISA section 408(b)(1) and the regulations issued thereunder; and,

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 provided the participant or beneficiary is furnished, at least annually, a statement from an eligible regulated financial institution describing the assets held or issued by the institution and the amount of such assets.

6c. Do the enhanced SAR disclosure requirements apply even if 95 percent of the plan’s assets are “qualifying plan assets”?

Yes. Even if 95 percent of the plan’s assets are qualifying plan assets, to be eligible for the audit waiver, the SAR must include the required information on the regulated financial institutions holding or issuing the plan’s qualifying plan assets.

6d. Is there model language for the enhanced SAR requirements?

The regulations do not require that model language be used for the required enhanced SAR disclosures. Rather, as long as the SAR includes the required information, it will satisfy the audit waiver condition. The DOL did not issue model SAR disclosure text as part of the regulation because there are various ways that
plans can satisfy the audit waiver conditions. Nonetheless, the following example may assist administrators in composing SAR disclosures for their plans that would satisfy the regulation. Plan administrators will need to modify the example to omit bonding or other information that is not applicable to their plan.

The following is model language for a notice:

The U.S. Department of Labor’s regulations require that an IQPA audit the plan’s financial statements unless certain conditions are met for the audit requirement to be waived. This plan met the audit waiver conditions for [insert year] and therefore has not had an audit performed. Instead, the following information is provided to assist you in verifying that the assets reported in the Form 5500 were actually held by the plan.

At the end of the [insert year] plan year, the plan had [include separate entries for each regulated financial institution holding or issuing qualifying plan assets]:

- [set forth amounts and names of institutions as applicable]
- [insert $ amount] in assets held by [insert name of bank],
- [insert $ amount] in securities held by [insert name of registered broker-dealer],
- [insert $ amount] in shares issued by [insert name of registered investment company],
- [insert $ amount] in investment or annuity contract issued by [insert name of insurance company]

The plan receives year-end statements from these regulated financial institutions that confirm the above information. [Insert as applicable:] The remainder of the plan’s assets were (1) qualifying employer securities, (2) loans to participants, (3) held in individual participant accounts with investments directed by participants and beneficiaries and with account statements from regulated financial institutions furnished to the participant or beneficiary at least annually, or (4) other assets covered by a fidelity bond at least equal to the value of the assets and issued by an approved surety company.
Plan participants and beneficiaries have a right, on request and free of charge, to get copies of the financial institution year-end statements and evidence of the fidelity bond. If you want to examine or get copies of the financial institution year-end statements or evidence of the fidelity bond, please contact [insert mailing address and any other available way to request copies such as e-mail and phone number].

If you are unable to obtain or examine copies of the regulated financial institution statements or evidence of the fidelity bond, you may contact the regional office of the U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) for assistance by calling toll-free (866) 444-EBSA (3272). A listing of EBSA regional offices can be found at www.dol.gov/ebsa. General information regarding the audit waiver conditions applicable to the plan can be found on the DOL Web site at www.dol.gov/ebsa under the heading “Frequently Asked Questions.”
### INFORMATION SOURCES

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<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">www.aicpa.org</a></td>
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<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">www.fasb.org</a></td>
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<td>Public Company Accounting Oversight Board</td>
<td>1666 K Street, NW Washington, DC 20006-2803 (202) 207-9100</td>
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<td><a href="http://www.pcaob.org">www.pcaob.org</a> or <a href="http://www.pcaob.com">www.pcaob.com</a></td>
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<td>Department of Labor Employee Benefits Security Administration:</td>
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<td>Office of the Chief Accountant</td>
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<td>(202) 693-8360</td>
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<td>Division of Accounting Services</td>
<td>ERISA related accounting and auditing questions (202) 693-8360</td>
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<td>Division of Reporting Compliance</td>
<td>Form 5500 preparation and filing requirements (202) 693-8360</td>
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<td>Office of Regulations and Interpretations</td>
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<td>(202) 693-8500</td>
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