2011

Employee benefit plans industry developments - 2011; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)

ISBN 978-0-87051-949-9
9 780870 519499

0224111

AICPA American Institute of CPAs

aicpa.org | cpa2biz.com

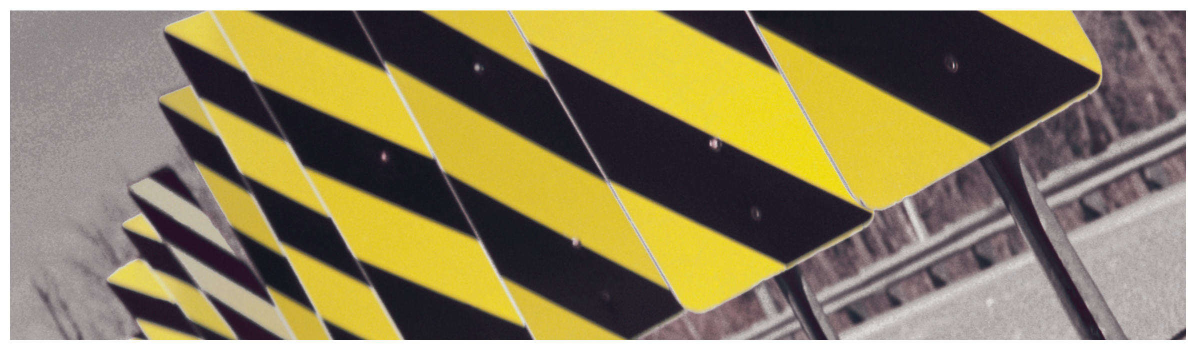
Audit Risk Alert: Employee Benefit Plans Industry Developments 2011

AICPA

2011

Employee Benefit Plans Industry Developments

AUDIT RISK ALERT



STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

AICPA

2011

Employee Benefit Plans Industry Developments

AUDIT RISK ALERT

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

AICPA®

1 2 3 4 5 6 7 8 9 0 AAP 0 9 8 7 6 5 4 3 2 1

ISBN 978-0-87051-949-9

Notice to Readers

This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2010*.

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by plan management and plan sponsors to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been 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, CPA
Senior Technical Manager
Audit and Attest Standards

Diana G. Krupica, CPA
Technical Manager
Accounting and Auditing Publications

Recognition

The AICPA gratefully acknowledges the Employee Benefit Plans Guide Task Force, the Office of the Chief Accountant, and the Employee Benefits Security Administration for their essential contributions in creating this publication.

Feedback

The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit or 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 also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

TABLE OF CONTENTS

P1: PjU
ACPA184-ARA-EBP ACPA184.cls March 29, 2011 14:59

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your employee benefit plan audits and also can be used by plan management and plan sponsors to address audit and accounting concerns. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

.03 When planning and performing an audit of an employee benefit plan, an auditor should understand the economic conditions facing the industry in which the plan sponsor operates as well as the effects of these conditions on the employee benefit plan. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's business and, therefore, its financial statements. As always, continue to remain alert to changes in economic, legislative, and regulatory developments as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

The Current Economy

.04 Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, by March 2010 all 3 national exchanges had increased in value by at least 59 percent from the previous year's lows. By December 2010 the Dow Jones

Industrials, the S&P 500, and the NASDAQ Composite closed up at least 11 percent over the prior year and in January 2011 the Dow closed at over 12,000. Although substantial improvement has occurred in the markets, uncertainty continues to exist due to the varying economic indicators, the regulatory financial reform changes, and the European and Middle East economies. Accordingly there is no clear idea of what the new "normal" will be. Although the overall economy may be moving in the right direction, how long a full recovery will take, and how bumpy that recovery will be, remain to be seen.

Help Desk: For a more robust discussion of the overall economic environment see the AICPA Audit Risk Alert *General Accounting and Auditing Developments—2010/11*.

.05 Individual investors have become increasingly important over the past several decades as company-funded pensions have given way to individually managed 401(k) accounts for retirement. Aon Hewitt (formerly, Hewitt Associates), a human resources consulting firm, asserts that until 2 years ago, 70 percent of the money in 401(k) accounts that it tracks was invested in stock funds. In 2010 that amount had fallen to approximately 57 percent, as investors pushed their portfolios toward bonds. Another important factor to consider is the aging of the baby-boomer generation. These investors are looking for guaranteed income during their later years and will likely move large amounts of investments away from riskier stock funds to more conservative bonds and bond funds. The growing demand for cash among those unable to find a job or obtain a home-equity loan may result in higher investment withdrawals. Further, as reported by Fidelity Investments, during 2010 a record number of workers made hardship withdrawals from their retirement accounts as the number of workers borrowing from their accounts reached a 10-year high.

Help Desk: For more information regarding the investment economic environment see the AICPA Audit Risk Alert *Investment Companies Industry Developments—2010/11* (product number 0223610 at www.cpa2biz.com)

Employee Benefit Plan Considerations

.06 Some challenges that may affect the plan or the plan sponsor, or both, in light of the current economic conditions are as follows:

- Uncertainty over pension and health care reform.
- Defined benefit plans still facing sizable funding obligations despite partial recoveries in 2010.
- Employer commitment to retirement plans—are employers able or willing to continue to offer the current level of benefits or have they already cut such benefits due to the economy?
- Plan design changes and amendments such as lifetime income options (annuities) for 401(k) plans and Roth conversion options.

- Retirees delaying retirement causing unemployment for younger members of society as well as a labor force consisting of part-time employees with no benefits.
- The continued credit crisis, which results in significant measurement uncertainty, including accounting estimates and fair value measurements.
- Operations that are exposed to volatile markets, such as currency and real estate markets.
- Going concern and liquidity issues particularly for defined benefit plans of single and multiemployer plans due to the deficit between plan assets and the plan's accumulated plan benefit obligations and funding requirements.
- Fraudulent internal and external transactions.

.07 Although many of these challenges are not new for plan audits, consideration of the ways an employee benefit plan is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include expanding the extent of procedures applied or modifying the nature of procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider reviewing audit procedures to ensure that risks are still adequately addressed.

Fraud Considerations

.08 When a sustained downturn in the economy occurs, the incentive or pressure to commit illegal acts increases. Greater opportunity exists due to deteriorating internal controls or lack of segregation of duties as well as increased rationalization to commit fraud. 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.

.09 Areas of fraudulent transactions could result due to the economic crisis related to the operation of the plan. Improper valuation of alternative investments, defalcations, inappropriate vesting of participants, ineligible participants included in the plan, and inappropriate assumptions for defined benefit and health and welfare plan obligations are possible areas to consider.

.10 For a defined benefit pension plan, a significant number of layoffs at plan sponsors may add to the liquidity issues that the plan faces. For both defined benefit pension plans and defined contribution plans, a provision of the Internal Revenue Code (IRC) requires that all affected participants be fully vested in the event of a *partial termination*. This is a technical term that does not have a clear definition but has generally been interpreted to apply when 20 percent or more of the workers have lost their jobs due to an event such as a plant closing or economic downturn. Legal counsel may be needed in determining whether a partial termination has occurred. Because many defined contribution plans use forfeitures to reduce employer contributions or to pay expenses, it is important for the client to properly identify when such a partial termination has occurred. See paragraph 12.25 of the Audit and Accounting Guide *Employee Benefit Plans* for further guidance.

.11 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 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.

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.12 In March 2010, the president signed into law a sweeping overhaul of the health care system that will affect individuals, insurance companies, health care providers, and employers. The 3 primary goals of the reform are to (1) expand coverage to those without health insurance, (2) reform the delivery system of benefits to improve quality, and (3) decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes. Health care reform presents challenges for employers given its many new requirements. Most of the current requirements that apply to all plans go into effect starting with plan years that begin on or after September 23, 2010. Employers who do not comply with health care reform's requirements may potentially be fined $100 per day, per employee (with limits on the penalty in the case of unintentional failures and for small employers). For further information, refer to the "Health and Welfare Plans" section in this alert.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.13 On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act, or the Act), considered to be the greatest change to financial regulation since the Great Depression, was signed into law. Although few provisions of the Act are effective immediately, Congress has designed the Act to become effective in stages with most provisions becoming effective 12 to 18 months after enactment.

.14 The Dodd-Frank Act will, among many other changes, create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisors. This legislation, although not directly affecting benefit plans, can affect certain investment advisors to benefit plans. Further information concerning the Act can be found at www.sec.gov/spotlight/dodd-frank.shtgml.

> **Help Desk—Resources for Economic Information**: The Internet covers a vast amount of information that you may find valuable. See appendix B for some of the sites not previously mentioned in this section and links to relevant documents regarding economic information.

Hot Topics

Participant Loans

.15 Financial Accounting Standards Board (FASB) Accounting Standard Update (ASU) No. 2010-25, *Reporting Loans to Participants by Defined Contribution Pension Plans*, was issued in September 2010 to amend generally accepted accounting principles (GAAP) related to how loans to participants should be classified and measured by defined contribution pension benefit plans. Previous guidance required loans to participants to be classified as plan investments, which are generally measured at fair value as required by FASB *Accounting Standards Codification* (ASC) 962-325-35-1. ASU No. 2010-25 requires that loans to participants be classified as notes receivable from participants and measured at their unpaid principal balance plus any accrued but unpaid interest.

.16 ASU No. 2010-25 amends FASB ASC 310-10, FASB ASC 962-310, and FASB ASC 962-325. ASU No. 2010-25 should be applied retrospectively to all prior periods presented, and is effective for fiscal years ending after December 15, 2010. This may require loans to participants to be reclassified in the prior periods presented. Consideration should be given to disclosing the adoption of ASU No. 2010-25 to explain this reclassification.

.17 Because loans to participants are no longer measured at fair value, FASB ASC 820, *Fair Value Measurements and Disclosures*, requirements are not applicable. Accordingly, loans to participants do not need to be presented in the fair value measurements note or in the hierarchy table as required by FASB ASC 820-10-50. Loans to participants can be removed from prior period disclosures, if applicable, because ASU No. 2010-25 is applied retrospectively.

.18 The fair value disclosures prescribed in paragraphs 10–16 of FASB ASC 825-10-50 are not required for loans to participants. In addition, ASU No. 2010-25 amends FASB ASC 310-10-50 such that certain disclosures are not required for loans to participants.

.19 The Department of Labor (DOL) still considers participant loans to be classified as an investment for purposes of the Form 5500. This results in the following considerations:

a. The DOL requires a note reconciling the financial statements to the Form 5500. Generally net assets are reconciled in total; however, if the notes reconcile subtotals within net assets then participant loans may be a reconciling item.

b. Participant loans should continue to be reported on Schedule H, line 4i—Schedule of Assets (Held at End of Year) as indicated in the instructions to Schedule H of the Form 5500. These instructions did not change as a result of ASU No. 2010-25.

c. If the trustee or custodian certifies that participant loans are complete and accurate then participant loans may continue to be subject to the limited scope exemption.

403(b) Plan Considerations

Overview of 403(b) Plans

.20 A 403(b) tax-sheltered annuity (TSA) plan is a retirement plan offered by schools, hospitals, churches, charities, and certain other tax-exempt organizations. An individual 403(b) annuity can be obtained only under an employer's TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and may include nonelective employer contributions. Participants may include the following:

- Employees of public school systems, colleges, or universities (teachers, school administrators, school personnel, professors, researchers, librarians, and so on)
- Employees of tax-exempt entities under Section 501(c)(3) of the IRC (charitable, scientific, educational, and so on)
- Employees of cooperative hospital service organizations (for example, nurses and doctors)
- Church employees and ministers
- Employees of public school systems organized by American Indian tribal governments

.21 A 403(b) plan comprises individual investment accounts that include the following types:

- Fixed and variable annuity contracts with insurance companies (403(b)(1) annuities)
- Custodial accounts made up of mutual funds (403(b)(7) accounts)
- A retirement income account set up for church employees (403(b)(9) accounts)

IRS Regulation Highlights

.22 In July 2007, the IRS issued the first comprehensive regulations for 403(b) plans, bringing 403(b) plans closer to the standards set for 401(k) plans. The new IRS regulations clarified several points on employer responsibility and required organizations to have a written plan in place. Additionally, in an effort to ease the administrative burden, the new IRS rules have the effect of encouraging employers to limit the number of investment vendors offered to employees while introducing due diligence expectations that affect the daily plan management. The new rules were effective on or after January 1, 2009, with some notable exceptions.

Filing and Audit Requirements for 403(b) Plans Covered Under the Employee Retirement Income Security Act

.23 In addition to the IRS regulations, the DOL issued amended regulations to subject Employee Retirement Income Security Act of 1974 (ERISA) covered 403(b) plans to the same Form 5500 reporting and audit requirements as 401(k) plans effective with their 2009 Form 5500 filings.

.24 A 403(b) plan generally will be covered under ERISA if there are employer contributions or if employer involvement in the plan exceeds the limitations permitted under the DOL's safe harbor regulations (see also DOL Field Assistance Bulletin [FAB] 2010-01, *Annual Reporting and ERISA Coverage* *for 403(b) Plans*, for specific questions and answers addressing the DOL's safe harbor regulations). *Governmental plans* (plans established or maintained by the U.S. or any state government or any political subdivision, agency, or instrumentality thereof for the benefit of its employees) and *church plans* (plans established by a church, convention, or association of churches for the benefit of its employees or their beneficiaries) are generally exempt from ERISA. In addition, other 403(b) plans that meet all of the following conditions are exempt:

- There are no employer contributions.
- The plan includes only employee voluntary contributions.
- The employer has limited involvement in the plan.
- No compensation is paid to the employer in connection with the plan.
- Rights under the plan are enforceable solely by the participants and their beneficiaries against the provider and not against the employer.

DOL FABs Related to 403(b) Plans

.25 On July 20, 2009, the DOL issued FAB No. 2009-02, *Annual Reporting Requirements for 403(b) Plans*. DOL FAB No. 2009-02 allows a plan administrator of a 403(b) plan to exclude certain contracts and accounts from plan assets for purposes of ERISA's annual reporting requirements under certain specified conditions.

.26 Section 103(a)(3)(A) of ERISA requires the plan administrator of an employee benefit plan to engage an independent qualified public accountant (IQPA) to audit the financial statements using generally accepted auditing standards (GAAS) and to prepare an opinion regarding whether the financial statements (and any supplemental schedules required to be included in the annual report) are presented fairly in conformity with U.S. GAAP.

.27 If the plan administrator elects to exclude some or all of those contracts or accounts meeting the conditions of DOL FAB No. 2009-02 from the plan's financial statements or instructs the auditor not to perform procedures on certain or all pre-2009 contracts, or both, the auditor will need to consider the effect of the exclusions on the completeness of the financial statement presentation and restrictions on the scope of the audit. The auditor may be faced with both a U.S. GAAP departure and a scope limitation on the audit. In many cases, this could result in the auditor issuing a qualified, adverse, or disclaimer of opinion. When some or all of the pre-2009 contracts are not specifically scoped out of the audit by the plan administrator, the auditor could still have difficulty in obtaining sufficient appropriate audit evidence for prior periods to evaluate completeness, as well as the valuation of opening balances and whether assets have been properly included or excluded, which could also result in the auditor modifying his or her opinion or disclaiming an opinion. See the "Forming an Opinion and Reporting on 403(b) Plans" section of this alert for additional information regarding the auditor's report.

.28 In February 2010, the DOL issued FAB 2010-01, which supplements DOL FAB 2009-02 and addresses questions the DOL received concerning the scope of FAB 2009-02 and the safe harbor regulations at Title 29 U.S. *Code of Federal Regulations* (CFR) Part 2510.3-2(f). DOL FAB 2010-01 addresses, among other things, the plan administrator's responsibility to determine whether the conditions of DOL FAB 2009-02 have been satisfied with respect to excluded contracts from the plan's annual report.

.29 The full text of DOL FAB No. 2009-02 and DOL FAB No. 2010-01 are available at www.dol.gov/ebsa/regs/fab2009-2.html and www.dol.gov/ebsa/regs/fab2010-1.html, respectively.

Significant Differences Between 401(k) Plans and 403(b) Plans

.30 This section highlights certain areas where 403(b) plans vary from 401(k) plans. This summary is not intended to be all inclusive.

Attribute	*401(k)*	*403(b)*
Eligible employees	Employer may apply a 1 year wait, age 21 entry age, or restrict eligibility to a group that satisfies the various tax code requirements for participation, coverage and nondiscrimination.	Employees are subject to universal availability;* the 401(k) rules may apply for employer contributions. *universal availability: Once a 403(b) permits employee salary deferrals, the opportunity must be extended to nearly all employees of the organization subject to certain exceptions.
Trust Requirement	All plan assets must be held in trust or by an insurance company.	No trust requirement, trust is permitted.
Funding requirement	Any investments considered prudent by the fiduciary.	Insurance annuity contracts (traditional annuities or pooled separate accounts) or custodial accounts which invest *solely* in shares of registered investment companies.
Long service employee additional catch up contribution (beyond age 50 catch up)	None	Employees with 15 or more years of service have an additional deferral limit.
Allowable employer contributions for terminated employees in years following termination	None	Allowed for 5 years following severance.
Average Deferral Percentage Test	Applies	None

Attribute	*401(k)*	*403(b)*
Other discrimination tests—limitation on allowable salary, Actual Contribution Percentage test, top heavy, coverage	Applies	Applies to any employer contributions. Top heavy rules do not apply.
Annual addition limits—IRC Section 415	Applies	Applies, with some unique attributes.
Distribution options	Outlined in plan document. Generally one set of salary deferrals and, possibly, another set for employer contributions.	Outlined in plan document. Distribution terms may vary by age on contract and type of investment—custodial account or annuity contract.
Required minimum distribution	Entire balance subject to these rules.	Only post-1986 balance is subject to these rules. Pre-1987 balances may be distributed over a longer period of time, if plan permits.
Prototype plan documents	Available	May be available in 2011.
IRS Determination Letter	Available	Program has not been established yet.
Nonexempt Transactions	Applies; excise tax paid under Tax Code provisions using Form 5330.	Applies; excise tax payable under Title I—DOL provision of ERISA; payment process not defined.

Engagement Letter Considerations

.31 An engagement letter represents the form of communication with the client concerning the scope of services for an audit of a 403(b) plan (see AICPA Audit and Accounting Guide *Employee Benefit Plans*, exhibit 5-5). Generally, this understanding would be obtained during the planning phase of an engagement and is part of the required communications to those charged with governance under paragraph .08 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), and AU section 380, *The Auditor's Communication With those Charged With Governance* (AICPA, *Professional Standards*). The standard engagement letter included in the AICPA Audit and Accounting Guide *Employee Benefit Plans* may need to be modified for an audit of a 403(b) plan, as follows:

- If the plan administrator has restricted the scope of the audit for any reason, the opening paragraph of the engagement letter may need to be revised, similar to when the limited scope audit exemption is used.[1]
- Because many audits of 403(b) plans may be initial audits and the fact that the statement of net assets available for benefits is required to be comparative, the engagement letter needs to include appropriate language regarding the auditor's responsibility for the prior year's statement of net assets available for benefits.

Initial Audit Considerations Unique to 403(b) Plans

.32 The initial audit of a 403(b) plan will likely require significant audit effort as the auditor will need to perform procedures to test the completeness and accuracy of plan and participant-level information going back numerous years. The assets attributable to a participant's vested interest may be held in a custodial account or in an annuity contract that is issued in the participant's name, rather than the plan's name. This industry practice raises plan reporting issues and associated audit issues related to beginning balances.

.33 As part of the auditor's risk assessment procedures, determining the nature, timing, and extent of auditing procedures for an initial audit of a 403(b) plan may be more challenging than general auditing procedures for an initial audit. Many plans may face significant challenges in establishing plan accounting records and proper controls, such as identifying all participant accounts to be included as plan assets, determining beginning account balances (that is, comparative balances are required as of December 31, 2009, for calendar year plans), and obtaining other financial information to be included in the plan's financial statements. For example, plans may have multiple third-party administrator (TPA) vendors (nonexclusive administration), orphan contracts (old accounts and contracts that were not transferred to the current TPA), missing participants, or participants with multiple annuity contracts. Also, historical plan records may not be readily available or may be nonexistent for previous years.

> ***Note:*** It may be challenging to obtain a complete population of contracts and transactions for 403(b) plans because IRS Revenue Ruling 90-24 previously allowed 403(b) participants to initiate a transfer of their 403(b) assets and accounts from a vendor offered by their employer to outside-of-plan vendors without any approval of the plan sponsor.

.34 Planning the nature, timing, and extent of further audit procedures depends on the outcome of the auditors risk assessment procedures. The following is a list of factors that the auditor may want to consider when performing their risk assessment procedures for an initial audit of a 403(b) plan. This list is not intended to be all inclusive.

---

[1] See footnote 7 to exhibit 5-5 in AICPA Audit and Accounting Guide *Employee Benefit Plans*, for illustrative wording when a limited scope audit is to be performed. ***Note***: The limited scope audit exemption allowed by the Department of Labor (DOL) under Title 29 U.S. *Code of Federal Regulations* (CFR) Part 2520.103-8 may not be appropriate.

- Size of plan and number of years in existence
- Adequacy and organization of critical plan documents
- Incomplete or missing records (participant data, payroll, and so on)
- Disaggregation and completeness of recordkeeping information
- Identifying all current and former participant accounts to be included as plan assets
- Multiple service provider concerns
- Adequacy of internal controls
- Regulatory compliance matters
- Investment valuation and reporting
- Fraud risks

.35 The auditor should also make inquiries of the plan administrator and outside service providers, as applicable, regarding the plan's operations during those earlier years. The auditor may also obtain relevant information (for example, trust statements, recordkeeping reports, reconciliations, minutes of meetings, and Statement on Auditing Standards [SAS]No. 70 reports[2]) for earlier years, as applicable, to determine whether any errors were noted 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. (See Technical Questions and Answers [TIS] section 6933.01, "Initial Audit of a Plan" [AICPA, *Technical Practice Aids*], for additional discussion of initial audits.)

.36 The inability of the auditor to obtain sufficient appropriate audit evidence supporting the accuracy and completeness of beginning balances of reported contracts and accounts is considered a restriction on the scope of the audit and may require the auditor to modify his or her opinion.

Year Two Audit Considerations Unique to 403(b) Plans

.37 In conducting an audit of a 403(b) plan in which the financial statements for the prior period included a modification to the auditor's opinion (for example, the auditor was unable to complete certain audit procedures relating to the completeness and accuracy of the beginning balances of participant accounts because the plan administrator lacked historical plan records) the auditor may consider determining whether changes have occurred during the current year that may affect the relevance of such information in the current period's financial statements. If the matter giving rise to the modification remains relevant and material to the current period's financial statements, the auditor may determine it is necessary to modify the opinion on the current period's financial statements.

---

[2] For information regarding updates to Statement on Auditing Standards (SAS) No. 70 reports see the "Service Organizations" section in this alert.

.38 If the prior period's financial statements were audited by a predecessor auditor, the auditor needs to obtain sufficient appropriate audit evidence regarding whether opening balances contain misstatements that materially affect the current period's financial statements. In addition, the auditor needs to identify if appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or, if not, changes are appropriately accounted for and adequately presented and disclosed. In this case, the auditor may be able to obtain sufficient appropriate audit evidence regarding the completeness and accuracy of opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence regarding the completeness and accuracy of beginning balances of participant accounts is a matter of judgment and is influenced by consideration of the professional competence, reputation and independence of the predecessor auditor. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor may need to express a qualified opinion or disclaim an opinion on the financial statements. In this case, considerations may also need to be given to the use of information obtained from reviewing the predecessor auditor's working papers. See AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*), for additional considerations regarding communications between predecessor and successor auditors.

Format for 403(b) Financial Statements and Disclosures

.39 403(b) plans are considered a type of defined contribution plan. Therefore, the financial statements and disclosures would be similar to those described in chapter 3 (and appendix E) of the AICPA Audit and Accounting Guide *Employee Benefit Plans*. However, consideration should be given concerning which disclosures may need to be modified or added. For example, the general description of the plan, eligibility requirements, funding, and tax status should reflect the requirements of the 403(b) plan document. Additional or modified disclosures of the accounting policies surrounding the accounting treatment of certain contracts may be necessary. It will be important to obtain an understanding of the operations of the plan in order to determine whether the presentation and disclosures are adequate and in accordance with U.S. GAAP. See paragraph .30 of this alert, which provides a summary of differences between 403(b) and 401(k) plans.

Forming an Opinion and Reporting on 403(b) Plans

.40 Many plan administrators of 403(b) plans were faced with considerable challenges last year relating to the first audits of their 403(b) plans. For certain 403(b) plans, historical financial records were either maintained by the plan sponsor, provided by vendors or were able to be recreated by the plan sponsors.

.41 In many instances, however, sufficient plan records were not maintained to permit the preparation of complete financial statements or proper governance controls established over the recording and maintenance of plan data. Also, vendors used by the plan may not have been able to, or refused to, provide such data prior to 2008.

.42 The type of auditor's report ultimately depends on the auditor's professional judgment of whether the auditor believes sufficient appropriate audit evidence has been obtained to form an opinion on the financial statements. AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional*

Standards), distinguishes the types of reports, describes the circumstances that may require the auditor to depart from the standard report, and provides reporting guidance in such circumstances.

.43 When there is a lack of sufficient appropriate audit evidence or there are restrictions on the scope of the audit that have led the auditor to conclude that the auditor cannot express an unqualified opinion, the auditor should express a qualified opinion or disclaim an opinion. A disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable the auditor to form an opinion on the financial statements. If the auditor disclaims an opinion, the auditor's report should give all the substantive reasons for the disclaimer.[3]

.44 According to paragraph .62 of AU section 508, when disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer, and that the scope of the audit was not sufficient to warrant the expression of an opinion. In addition, the auditor should also disclose any other reservations the auditor has regarding fair presentation in conformity with GAAP. Following are two of the reasons that a disclaimer of opinion was expressed on 403(b) plans in the initial year of the regulations (one or both may have been included in the auditor's report, as applicable).[4]

1. The plan did not maintain sufficient accounting records and supporting documents relating to certain annuity and custodial accounts issued to current and former employees prior to January 1, 2009.[5]
2. The plan excluded from investments certain annuity and custodial accounts issued to current and former employees prior to January 1, 2009, as permitted by DOL FAB No. 2009-02 and the amounts of these excluded annuity and custodial accounts and the related income and distributions are not determinable.

> ***Note*:** AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*), states that when an adverse opinion or disclaimer of opinion is issued on the basic financial statements, the auditor should not express the opinion described in paragraph .06 of AU section 551A on any accompanying information.

Representation Letter Considerations for 403(b) Plans

.45 Exhibit 12-1 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* includes an illustrative management representation letter for a full

---

[3] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles.

[4] Resources that contain actual plan financial statements and the auditor's report include ERISA Filing Acceptance System II (EFAST2) at www.dol.gov and Electronic Data Gathering Analysis & Retrieval at www.sec.gov.

[5] If the plan administrator also instructed the auditor not to perform any auditing procedures with respect to information which was certified by the trustee or custodian of the plan, as permitted by 29 CFR 2520.103-8 of the DOL's Rules and Regulations under the Employee Retirement Income Security Act of 1974 (ERISA), this may also have been included in the auditor's report.

scope defined benefit plan audit. Because specific considerations are associated with a 403(b) plan engagement, the auditor may want to consider the following when drafting the representation letter for a 403(b) plan audit.

a. Whether the auditor issued a modified opinion on the 403(b) plan financial statements due to a departure from GAAP when the plan sponsor elected to exclude certain pre-2009 contracts as permitted by FAB 2009-02.

b. The availability of records and data relating to certain excluded contracts as permitted by FAB 2009-02 and whether the excluded contracts were considered in relation to uncorrected financial statements misstatements.

c. Whether the specific tax circumstances relating to 403(b) plans are appropriately described in the representation letter. Currently no determination letter program exists for 403(b) plans. Frequently there is no trust and the tax status is an exclusion for plan participants, rather than an exemption at the plan level.

Communicating Internal Control Related Matters Identified in an Audit

.46 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA *Professional Standards*), establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct material misstatements on a timely basis.

.47 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

.48 A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

.49 Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses should be communicated, in writing, to management and those charged with governance as part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. See AU section 325 for complete guidance when communicating internal control matters.

Employee Benefit Plan Considerations

.50 AU section 325 requires significant consideration and judgment by the auditor to evaluate whether or not internal control over financial reporting deficiencies identified during a financial statement audit represent a significant deficiency or material weakness, and should be based upon the specific facts and circumstances related to the plan. The severity of a deficiency depends on the magnitude of the potential misstatement resulting from the deficiency or deficiencies, and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure. AU section 325 requires the auditor to consider certain internal control deficiencies, whether in design or in operation, as indicators of a material weakness.

.51 Two indicators of material weaknesses in internal control include identification by the auditor of a material misstatement of the financial statements in circumstances that indicate that the misstatement would not have been detected by the plan's controls; and ineffective oversight of the plan's financial reporting and internal control by those charged with governance. Therefore, when plan records have not been properly maintained, this may be a strong indicator of a material weakness in internal control over financial reporting. The auditor's assessment of whether AU section 325 communications are necessary will depend on the facts and circumstances surrounding each plan and its internal control.

Help Desk: Paragraph .15 of AU section 325 identifies indicators of material weaknesses in internal control. Exhibit B of AU section 325 provides examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

The AICPA Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) is intended to assist in understanding the requirements of SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 325), and provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; you can obtain this alert by calling the AICPA at (888) 777–7077 or visiting www.cpa2biz.com. See also the AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) *SAS No. 115 Toolkit* for additional information concerning the implementation of SAS No. 115.

Fair Value Measurements and Disclosures

.52 FASB ASC 820 defines fair value, sets a framework for measuring fair value, and requires certain disclosures about fair value measurements. For plan assets and liabilities that are traded in active markets, fair value is determined based on quoted market prices. If quoted market prices for identical assets and liabilities are not available, the plan uses valuation techniques that should maximize the use of observable inputs (assumptions based on market data) and minimize the use of unobservable inputs. In measuring fair value, the plan should make adjustments for risks and uncertainties if a market participant would include such an adjustment in its pricing. FASB ASC 820 requires entities to make certain disclosures for each major class of assets and liabilities that are measured at fair value, including the level within the fair value hierarchy in which the fair value measurements fall as discussed in FASB ASC 820-10-35. For disclosure requirements, refer to FASB ASC 820-10-50.

.53 "Pending Content" in FASB ASC 820-10-50-2A states that for equity and debt securities, class should be determined on the basis of the nature and risks of the investments in a manner consistent with the guidance in FASB ASC 320, *Investments—Debt and Equity Securities* (FASB ASC 320-10-50-1B), even if the equity securities or debt securities are not within the scope of FASB ASC 320.

.54 According to FASB ASC 320-10-50-1B, major security types should be based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, all of the following should be considered: the activity or business sector, vintage, geographic concentration, credit quality, and economic characteristic.

.55 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.56 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.57 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.58 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

.59 This guidance is located in FASB ASC 820-10-50 and 820-10-55 and is labelled as "Pending Content" due to the transition and open effective date information contained in FASB ASC 820-10-65-7.

.60 Readers are encouraged to consult the aforementioned "Pending Content" for illustrative disclosure examples that may provide useful information regarding the level of disaggregation for current year financial statement disclosures.

Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

.61 Paragraphs 51A–51H of FASB ASC 820-10-35 clarifies the application of FASB ASC 820 in determining fair value when the volume and level of activity for the assets or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, select paragraphs in 59A–59I of FASB ASC 820-10-55 provide illustrations on the application of this guidance.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.62 Paragraphs 59–62 of FASB ASC 820-10-35 provide additional guidance on the fair value measurements of investments in certain entities that calculate net asset value (NAV) per share (or its equivalent). This guidance permits, as a practical expedient, a reporting entity to estimate the fair value of an investment, that is within the scope of the guidance, using the NAV per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the reporting entity's measurement date.[6]

.63 "Pending Content" in FASB ASC 820-10-50-6A requires disclosures for each class of investment about the attributes of investments within the scope of paragraphs 4–5 of FASB ASC 820-10-15, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. These disclosures are required for all investments within the scope of paragraphs 4–5 of FASB ASC 820-10-15 regardless of whether the practical expedient in FASB ASC 820-10-35-59 has been applied.

> **Help Desk**: The AICPA has published TIS sections for auditors and financial statement preparers to help them gain a clearer understanding of the accounting rules for determining the fair value of investments in certain entities that calculate NAV. These entities, often called alternative investments, include hedge, private equity, and real estate funds. TIS sections 2220.18–.27 (AICPA, *Technical Practice Aids*) offer nonauthoritative implementation guidance to ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculated Net Asset Value per Share (or Its Equivalent)*.

[6] The AICPA issued a series of Technical Questions and Answers (TIS) to provide nonauthoritative guidance to assist reporting entities with the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures* (specifically, Accounting Standards Update No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculated Net Asset Value per Share (or Its Equivalent)*) to estimate the fair value of investments in certain entities that calculate net asset value. TIS sections 2220.18–.27 (AICPA, *Technical Practice Aids*) apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15.

These TIS sections cover a series of issues related to ASU No. 2009-12, including

- determining whether NAV calculation is consistent with FASB ASC 946.
- determining whether an adjustment to NAV is necessary.
- certain disclosure considerations.

You can find these TIS sections at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Effect on Employee Benefit Plans and Plan Sponsors

.64 Meeting the requirements of FASB ASC 820 requires coordination among plan management, custodians, investment fiduciaries, and auditors. U.S. GAAP requires plan management to take responsibility for the valuation of investments. Form 5500 requires assets to be reported at current value. Plan management has a fiduciary responsibility to ensure the accuracy of the information reported on the Form 5500. The nonauthoritative practice aid *Alternative Investments—Audit Considerations* states that management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements and this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management. Therefore, plan management can delegate but not abdicate its valuation responsibility. Although plan management is responsible for establishing an accounting and financial reporting process for determining fair value measurements, plan management will typically rely on the trustee or custodian for the pricing of its investments. The trustee or custodian may use an outside service provider or pricing service for valuation of the investments. Because many plans outsource investment management activities to third-party service providers, information regarding the pricing and valuation of the plan's investments may not be fully transparent to those responsible for financial reporting.

.65 Plan management is ultimately responsible for the fair values reported in the financial statements and is obligated to carefully consider how third-party input is used in estimating fair value. Accordingly, plan management needs to understand and document the pricing inputs used by plan custodians and others used to value each plan investment in order to properly classify each investment into the appropriate level within the FASB ASC 820 hierarchy. Plan management will need to obtain pricing service documentation describing the valuation methods they or their custodians use to support their fair value hierarchy. Pricing services, typically used by plan trustees or custodians to provide investment prices, usually prepare this information.

.66 Accordingly, for full scope audits, auditors need to consider the procedures and controls put in place by plan management and service providers to identify hard to value investments and validate the reliability of fair value procedures. Auditors may also consider the need to enhance audit procedures to ascertain that prices obtained from pricing services are reasonable, including the use of multiple pricing sources or valuation experts to review any pricing models or fair value methodologies put in place, or both. It has been noted in practice that the level of disclosures included in plan financial statements for the implementation of FASB ASC 820 and subsequent amendments vary by benefit plan. Certain plan sponsors have included more detailed disclosures than others to meet the requirements. A greater understanding of the requirements by plan sponsors could contribute to more robust financial statement disclosures. For example, according to FASB ASC 320-10-50-1B, major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, all of the following should be considered: the activity or business sector, vintage, geographic concentration, credit quality, and economic characteristic. Plan management should be considering the nature and risks of investments in determining major security types for FASB ASC 820 disclosures.

Help Desk: The following guidance would be applicable for audits of issuers, such as Form 11-K audits (annual reports of employee stock purchase, savings, and similar plans pursuant to Section 15[d]):

a. PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.02)

b. PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04), and

c. *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*.

You can find the PCAOB report at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

Fair Value Considerations in Limited Scope Audits

.67 For limited scope audits, if the auditor becomes aware that the certified information relating to investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. See the "Limited-Scope Audits Under DOL Regulations" section of this alert for further guidance.

.68 The auditor's responsibilities for investments covered by the limited scope audit exemption permitted by 29 CFR 2520.103-8 are discussed in paragraphs 7.73–.77 in the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

.69 Plan management's decision to rely on a certification for purposes of limiting the scope of the audit as permitted by 29 CFR 2520.103-8 has become increasingly more challenging, especially in light of recent economic events as well as the guidance in FASB ASC 820. Because plans increasingly invest in alternative investments, including hedge funds, real estate, limited partnerships, private equity funds, and other hard-to-value investments, care should be taken by plan management when determining if certified information can be relied upon in preparing the plan's Form 5500 and related financial statements.

.70 Plan management will need to have sufficient understanding of the nature of the plan's investments and the valuation methodologies, key assumptions, and inputs used to determine fair value. Plan management cannot outsource or assign its responsibility for properly reporting fair value of the plan's investments, even in situations when the plan's trustee or custodian certifies the completeness and accuracy of the plan's investments for a limited scope audit. Therefore, prior to being engaged to perform a limited scope audit as permitted by 29 CFR 2520.103-8, it is recommended that plan management and the auditor discuss the nature of the investments held by the plan, including how those investments are valued and where they fall in the fair value hierarchy, to help ensure that plan management engages their auditor to perform the appropriate type of audit.

Help Desk: FASB ASC 820 does not change the auditor's responsibility in a limited scope audit permitted by 29 CFR 2520.103-8. Third parties may provide pricing methodology information that assists plan management in determining the fair value hierarchy levels, or may provide preliminary suggestions of the fair value hierarchy levels. It is ultimately the responsibility of the plan's management to understand the basis for the designations to determine whether the plan's investments have been valued and disclosed in accordance with U.S. GAAP or whether revisions are necessary.

.71 If the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that may result in additional testing or modification to the auditor's report. For example, when a plan has significant interests in alternative investments that are hard to value or fall within level 3 of the fair value hierarchy, this may prompt the auditor to inquire whether these investments are covered by the certification, the method used to value these investments, and whether they are reflected in the certification at fair value in accordance with U.S. GAAP. Upon further inquiry, if the auditor becomes aware that adequate year-end valuation procedures have not been performed and therefore the financial statements may not be prepared in conformity with U.S. GAAP, the auditor would communicate those findings to the plan management. It is the plan management's responsibility to prepare the financial statements and note disclosures in conformity with U.S. GAAP and in compliance with DOL rules and regulations. Accordingly, plan management may request the trustee or custodian to recertify or amend the certification for such investments at their appropriate year-end values or to exclude such investments from the certification. If the trustee or custodian amends the certification to exclude such investments from the certification, or if the trustee or custodian does not recertify those investments, plan management is responsible for valuing such investments as of the plan year-end and engaging the auditor to perform full scope audit procedures on the investments excluded from the certification. Paragraph 7.77 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* contains an illustrative auditor's report when plan investments have been certified and plan management was unable to determine whether the investment information is valued in conformity with U.S. GAAP.

.72 If the trustee or custodian only certifies a portion of the investments or excludes certain investments from the certification, this ordinarily would not affect the limited scope (DOL disclaimer as permitted by 29 CFR 2520.103-8) language in the auditor's report. Accordingly, the note pertaining to certified information should reflect only the investment information that was included or derived from the certified information.

Auditing Fair Value Measurements

.73 As previously stated, it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).

.74 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 of AU section 328 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.

.75 According to FASB ASC 820, this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or

observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)

.76 It is also important for the auditor to evaluate the reasonableness of the determination within the fair value hierarchy of inputs. FASB ASC 820 defines level 1 inputs as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date; level 2 inputs are defined as inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly; and level 3 inputs are defined as unobservable inputs for the asset or liability. Further, in some cases the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety. This classification by management has long-reaching effects in the financial statements through the various classification-based required disclosures. Auditors should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. As stated in paragraph .07 of AU section 312, misstatements can result from error or fraud and may consist of a financial statement disclosure that is not presented in conformity with GAAP.

.77 In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for privately held employee stock ownership plans (ESOPs) or plans that hold alternative investments and subprime mortgage-backed securities. AU section 332 states that for some derivatives and securities, U.S. GAAP may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit a plan that includes hard to value investments. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance on the use of a specialist during an engagement. Also refer to the "Using the Work of a Specialist" subsection of this alert.

Valuation Testing

.78 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective.

.79 When an entity performs its own valuation, procedures to test fair value include the following:

- Assessing the reasonableness of key factors and assumptions
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.80 When extensive judgment is needed, consider using a specialist and refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.81 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

Help Desk: Refer to the following websites for helpful information on investment pricing services and valuation:

- www.bloomberg.com/
- www.idc.com/
- www.reuters.com/
- www.standardandpoors.com/home/en/us

Auditing Accounting Estimates

.82 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include fair value estimates, the actuarial present value of accumulated plan benefits for defined benefit plans or benefit obligations for health and welfare plans.

.83 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias;

however, it is important to consider whether historical patterns are still applicable.

.84 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet performance expectations, the determination of the reasonableness of management's accounting estimates would be made with an extra degree of professional skepticism. As noted by AU section 316, when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.85 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.

Using the Work of a Specialist

.86 It may be necessary to use a specialist (such as a securities valuation expert or actuary) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311 is applicable rather than AU section 336.

.87 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are the responsibility of the specialist, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Stable Value Funds

.88 Many employer-sponsored defined contribution plans offer an investment alternative often referred to as a stable value fund. Plans can invest directly in stable value contracts or through a stable value fund vehicle such as a collective investment trust. FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, allows stable value contracts to be presented at contract value for purposes of determining the net assets available for benefits for a defined contribution plan if the contract meets the definition of benefit responsiveness in accordance with FASB ASC 960-325.

.89 As a result of recent credit market events, some of the issuers of these contracts may have experienced a decline in credit worthiness. In addition, as a result of depreciation in the mortgage-backed securities and related markets, an increase in the difference between fair value and contract value for synthetic guaranteed investment contracts has resulted in greater risks relating to these contracts. For example, certain issuers are requesting to terminate or renegotiate contracts, limiting future contributions or redemptions, or increasing wrap fees.

> **Help Desk**: As a result of recent economic events, a decrease in the number of wrap providers has occurred. Consequently, many plan sponsors have entered into new contracts with existing wrap providers which may have different terms.

.90 In addition, certain issuers are deciding to no longer offer stable value products or are exiting the business altogether, thereby limiting the number of stable value alternatives for plan sponsors. Any new or renegotiated contracts must meet the benefit responsive requirements of FASB ASC 960-325 in order to be recorded at contract value on the plan's financial statements. Reading stable value contracts would enable auditors to gain an understanding of the terms for (*a*) 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 fund, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), and (*b*) events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the fund and settle at an amount different from contract value (for example, breaches of investment guidelines, investments in default, and so on).

.91 For appropriate financial statement accounting and reporting, it is important for the auditor to give careful consideration to the ability of the issuer to comply with the terms of the contract, the benefit-responsive provisions, the credit worthiness of the wrap provider and other risks relating to investing in these products. As a result of these industry issues, the plan sponsor may experience difficulties in obtaining certain inputs to determine a fair value for these products (for example, inability to obtain rebid quotes).

.92 Often the plan sponsor will look to an outside service provider to assist in the mechanics of the valuation. However, in practice, the outside service provider may not be able to assist in the mechanics of the valuation and the plan sponsor may have difficulties in determining fair value for the stable value investment. In these circumstances, the plan sponsor may consider the feasibility of alternative valuation methodologies or consultation with a valuation specialist, or both.

Observations Related to Audit Risk Areas Affected by the Economic Crisis

.93 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending from 2006–2008. One of the heightened risk factors identified by the PCAOB that is of particular importance to employee benefit plans is in the audit area of fair value measurements. The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.94 Although the PCAOB report focused on observations relating to issuers (for example, Form 11-Ks[7]), the key message in the report relating to testing fair value measurements are based on GAAS and could apply for all full scope employee benefit plan audits.

.95 The following is a summary of the PCAOB observations that plans may find pertinent. As part of the audit, firms sometimes planned to test issuers' estimates of fair value of financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Deficiencies observed by inspectors included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods. In some cases when the issuer used an external valuation, the firms failed to obtain a sufficient understanding of the valuation methods used by these third parties.
- test, or adequately test, controls over issuers' valuation processes. In some cases, by failing to test, or test sufficiently, the operating effectiveness of internal controls over various aspects of issuers' valuation processes, the firms did not have adequate support for the degree of reliance placed on these controls.
- evaluate or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist when appropriate.
- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.96 Alternatively, some firms evaluated issuers' estimates of fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

---

[7] As noted in paragraph 1.04 of Audit and Accounting Guide *Employee Benefit Plans*, plans that are required to file Form 11-K would be considered issuers.

.97 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). Firms also failed to perform sufficient procedures in light of the volatile market conditions, to provide a reasonable basis for extending to year end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

.98 The report also discusses deficiencies observed in other audit areas affected by the economic crisis. The observations from this report will serve to inform future PCAOB actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given regarding whether additional guidance is needed relating to existing standards. You can access the report at www.pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf

Lessons Learned from 1st EFAST Filings

.99 ERISA Filing Acceptance System II (EFAST2) is the all-electronic system designed by the DOL, IRS, and Pension Benefit Guaranty Corporation (PBGC) for the submission, receipt, processing, and accessing of the Form 5500 and Form 5500-SF. These forms must be electronically filed each year by employee benefit plans to satisfy annual reporting requirements under ERISA and the IRC.

.100 Under EFAST2, filers choose between using EFAST2-approved vendor software or the government's IFILE website to prepare and submit the Form 5500 or Form 5500-SF. EFAST2-approved software generally provides more value-added features than the government web application. Completed forms are submitted electronically via the Internet to EFAST2 for processing.

.101 The EFAST2 website, www.efast.dol.gov, provides filers with a variety of tools and guidance, including the 2010 Form 5500 and Form 5500-SF schedules and instructions, FAQs, user guide, and a tutorial. Filers and preparers can register for an account, complete the required forms and schedules online in multiple sessions, print a copy for their records, and submit it at no cost.

Common Problem Areas

.102 In its inaugural filing year, the EFAST2 system has received approximately one million 2009 Form 5500 and 5500-SF filings. The most common problem areas identified are as follows:

- Missing or invalid signature of the plan administrator or plan sponsor;
- Failure to attach an accountant's opinion;
- Inclusion of an attachment that was not able to be processed;
- Failure of a final plan filing to satisfy the termination criteria; and
- Indication that a plan's filing was beyond the due date.

Filing Tips

.103 For the 2011 filing season (of the 2010 Form 5500 and Form 5500-SF), plan administrators should

- register for credentials with EFAST2 in order to electronically sign the Form 5500 even if using third party software (unless they are using the e-signature option);
- know that if they cannot remember the answer to the EFAST2 website security question, they will not be able to log into their EFAST2 website account. As a result, they could lose access to filings being created or information regarding filings previously submitted;
- remember that any filings registered to a revoked account, that have not been submitted for processing, cannot be retrieved;
- ensure that if they are not attaching an accountant's opinion with their Form 5500, they do not fill out Schedule H, Part III, Lines 3a, 3b or 3d. Doing so will result in a filing status of "Filing Error";
- ensure that their Accountant's Report is in PDF format and not encrypted or password protected. EFAST2 cannot process these attachments if they are encrypted or password protected; and
- remember that the 2010 Form 5500 and 5500-SF cannot be filed on a 2009 form, even if their software provider has not released their 2010 version of the software. Check the EFAST2 website to verify that the software has been certified for 2010.

Filing Amended Returns

.104 Delinquent and amended Form 5500 and Form 5500-SF filings must be submitted electronically through EFAST2. To submit a delinquent or amended Form 5500 or Form 5500-SF for prior plan years, filers must submit the filing using current filing year Form 5500 schedules and instructions except as provided subsequently. The electronic filing of the delinquent or amended Form 5500 or Form 5500-SF must indicate, in the appropriate space at the beginning of the electronic Form 5500, the plan year for which the annual return/report is being filed.

.105 Filers using EFAST2 must use the following correct-year schedules (that is, the plan year for which the annual return/report relates) completed in accordance with the related correct-year instructions:

- Schedule B, SB, or MB (Actuarial Information);
- Schedule E (ESOP Annual Information);
- Schedule P (Annual Return of Fiduciary of Employee Benefit Trust);
- Schedule R (Retirement Plan Information); and
- Schedule T (Qualified Pension Plan Coverage Information).

Help Desk: To obtain correct-year schedules and related instructions, filers should go to the EFAST2 website, www.efast.dol.gov, and print the schedules and instructions of the form year that corresponds to the plan year for which the filing relates.

It is important to note that filers do not attach any Schedule SSA to any filing with EFAST2. Rather, this information should be submitted on the most current year Form 8955-SSA[8] to the IRS (along with all required attachments). Additional information is available at www.irs.gov/ep.

Other Accounting Issues and Developments

Disclosures About Derivative Instruments and Hedging Activities

.106 Guidance was effective for the first time last year which expanded the disclosure requirements in FASB ASC 815, *Derivatives and Hedging*, about an entity's derivative instruments and hedging activities. FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, which was codified in FASB ASC 815, is effective for financial statements issued for fiscal years beginning after November 15, 2008. The disclosure provisions of this statement apply to employee benefit plan financial statements. The guidance required more robust qualitative disclosures and expanded quantitative disclosures. A summary of the main requirements follows.

.107 For employee benefit plan financial statements, it is not necessary to designate certain derivatives as hedging instruments under FASB ASC 815. FASB ASC 815 requires entities to distinguish between instruments used for risk management (defined as derivatives designated as hedging instruments under FASB ASC 815 and those that serve as economic hedges) and instruments used for other purposes, and to make disclosures separately for the two types of instruments. Because employee benefit plan financial statements account for derivative instruments at fair value and record all associated fair value changes in the statement of changes in net assets available for benefits (and not to comprehensive income), such distinction is not applicable to employee benefit plan financial statements and is not described in this summary.

Effect on Employee Benefit Plans and Plan Sponsors

.108 Derivative financial instruments are commonly used in employee benefit plan investment portfolios, especially in defined benefit pension plans. In the past, some plans may not have had disclosures for derivative instruments because the year-end net fair value was not considered material. However, disclosure of the gross amounts of derivative instruments is now required. Consequently, consideration of materiality may focus instead on the gross notional value, volume of derivatives used during the year, gain or loss from derivatives during the year and overall risk relative to the entire investment portfolio instead of the net fair value. As a result, it is expected that these new disclosure requirements are applicable to employee benefit plan financial statements for those plans that use derivative financial instruments.

---

[8] See paragraph .280 in this alert for additional information on Form 8955-SSA.

.109 Some challenges during the first year of implementation included gathering the detailed information and gaining an understanding of the derivatives that were used and how they were reported. Although the plan sponsor is responsible for establishing an accounting and financial reporting process, plan sponsors typically rely on the trustee or custodian and investment manager for the information needed for the disclosures. Much of the information was with the investment managers and required coordination among plan management, custodians, investment managers, and auditors.

Summary of the Amended Disclosures

Qualitative Disclosures

.110 An entity with derivatives should describe the following:

- How and why it uses derivative instruments
- How derivative instruments and related hedged items are accounted for under FASB ASC 815
- How derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows

.111 The existing requirements of FASB ASC 815 to disclose an entity's objectives for holding or issuing derivative instruments, the context needed to understand those objectives and its strategies for achieving those objectives, have been retained. However, it also requires that such information be disaggregated by the primary underlying risk exposure (for example, interest rate, credit, foreign exchange rate, or overall price).

.112 Entities are also required to describe the volume of their derivative activity; however, no specific format is prescribed and entities must tailor such disclosure to their specific situations.

Quantitative Disclosures

.113 The quantitative disclosure requirements added by FASB Statement No. 161 are fairly detailed and illustrative disclosures are included in the text of the statement.

Tabular Disclosures

.114 One of the more significant disclosure requirements is for entities to provide tabular disclosures of the location, by line item, of fair value amounts in the statement of financial position (net assets available for benefits) and the location, by line item, of amounts of gains and losses reported in the statement of financial performance (statement of changes in net assets available for benefits).

.115 FASB Statement No. 161 also amends FASB ASC 825, *Financial Instruments*, to clarify that derivative instruments are subject to the concentration of credit risk disclosures required by FASB ASC 825. Although FASB intended the provisions in FASB ASC 825 to apply to all financial instruments, including derivatives, it believes the clarification was necessary to address diversity that has developed regarding whether entities' disclosures about concentration of credit risk should include derivative instruments.

Securities and Exchange Commission Letter Regarding Disclosure of Derivatives

.116 In a July 30, 2010, letter to the Investment Companies Institute, the Securities and Exchange Commission (SEC) staff made a number of comments regarding derivative related disclosures by investment companies in prospectuses and shareholder reports (http://sec.gov/divisions/investment/guidance/ici073010.pdf). Such comments may be informative to employee benefit plan financial statement preparers and their auditors given the similarity between fund and employee benefit plan accounting and reporting of derivative activities. Comments included how and why derivatives were used during the reporting period rather than how they "may" be used, volume disclosures, and identification between purchased and written derivatives.

Help Desk: The following are additional resources for derivatives accounting and reporting:

- FASB ASC 815 (example disclosures)
- AICPA Audit and Accounting Guide *Investment Companies*
- AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities*
- AICPA Audit Risk Alert *Investment Companies Industry Developments—2010/11*

Securities Lending

.117 Many large pension plans and master trusts (for example, those with $1 billion or more in investments) and some smaller pension plans or master trusts, participate in securities lending. Securities lending generally requires certain reporting on the face of the statement of net assets and in the notes. Securities lending activity is often not apparent from the trustee or custodian investment statements and consequently the reporting is missed. Often, plan sponsors are unaware of securities lending activities in their plans. A best practice is to inquire of the client as to the existence of securities lending by the plan or master trust, and include a representation in the management representation letter. For example, the representation could state that securities lending, including securities on loan, collateral held under securities lending agreements, and the liability to return collateral held under securities lending agreements has been appropriately identified, properly recorded, and properly disclosed in the financial statements. In addition, the existence of securities lending may be added as an item in the investment confirmation or, in limited scope audits, where a confirmation is not obtained, inquiring directly of the trustee or custodian as to the existence of securities lending.

.118 As a result of the recent market issues with securities lending programs, many employee benefit plans revised existing securities lending agreements. Identification of such revisions can be achieved through discussion with those responsible at the plan sponsor for investment decisions; discussion with the investment service providers or through the review of all related agreements; or both.

.119 It is important to consider such revisions in securities lending agreements in determining the proper accounting, auditing, and reporting in accordance with FASB ASC 860, *Transfers and Servicing*.

.120 For guidance on the accounting and reporting for transfers of financial assets, including securities lending, consult FASB ASC 860. Also refer to paragraphs 2.28–.32, 3.36–.40, and 4.53–.57 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further information.

Insurance Company Products Offered to Employee Benefit Plans

.121 Insurance companies offer a number of different investment alternatives for employee benefit plans. An employee benefit plan's investment arrangement with an insurance company is typically established pursuant to a contract. That contract could be either an insurance contract or an investment contract. An insurance contract subjects the insurer to significant insurance risks such as the mortality or morbidity of the contract holder. An investment contract does not subject the insurer to such risks and, therefore, is comparable to financial or investment products offered by other types of financial institutions. A plan may invest assets in an insurance company's general account or a separate account at the insurance company.

.122 Understanding the contract provisions is critical in determining the appropriate financial statement and Form 5500 accounting and reporting for these contracts, as well as the design of appropriate audit procedures. See the "Stable Value Funds" section following paragraph .88 of this alert for more information regarding these contracts.

Allocated and Unallocated Funding Arrangements

.123 In determining the proper accounting and reporting, paragraph 7.37 of AICPA Audit and Accounting Guide *Employee Benefit Plans* indicates that the fundamental basis of distinction in classifying contracts for accounting purposes is (*a*) whether the contributions are currently used to purchase insurance or annuities for the individual participants, or (*b*) whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right. Contractual arrangements under which funds are currently allocated to purchase insurance or annuities for individual participants are referred to as *allocated* funding arrangements, whereas other arrangements are called *unallocated* funding arrangements.

.124 Allocated funding arrangements include annuity contracts. An *allocated contract* is a contract with an insurance entity under which contributions paid to the insurance company are used to purchase deferred or immediate annuities for individual participants. As defined in the FASB ASC glossary, an *annuity contract* is a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. This arrangement is irrevocable and involves the transfer of significant risk from the plan to the insurance company. Generally, allocated contracts are excluded from the plan's financial statements.

.125 An *unallocated contract*, as defined in the FASB ASC glossary, is a contract with an insurance company under which related payments to the insurance company are accumulated in an unallocated fund to be used to meet benefit payments when employees retire, either directly or through the purchase of annuities. Funds in an unallocated contract may also be withdrawn and otherwise invested. Unallocated funding ordinarily is associated with a group deposit administration contract and an immediate participation guarantee contract. For investment purposes, unallocated funds may be comingled in a general or pooled separate account or held in an individual separate account. These contracts generally should be included in the plan's financial statements

.126 On March 4, 2010, the DOL issued Advisory Opinion 2010-01A on whether a specific annuity contract, as described in the Advisory Opinion, is a fully allocated contract for annual reporting purposes within the meaning of 29 CFR 2520.104-44(b)(2) and the Form 5500 annual return/report instructions. The DOL Advisory Opinion concluded that, based on the facts and circumstances set forth in the Advisory Opinion, the specified annuity contract is not a fully allocated contract within the meaning of 29 CFR 2520.104-44(b)(2). The Advisory Opinion can be viewed at www.dol.gov/ebsa/regs/aos/ao2010-01a.html

Accounting for Uncertainty in Income Taxes

.127 For many calendar-year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This ASU affects all nongovernmental entities, and the disclosure amendments apply only to nonpublic entities. Following are the four main provisions:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

.128 FASB ASC 740-10 clarifies the accounting and provides implementation guidance for uncertainty in income taxes recognized in an entity's financial statements. In certain situations, there may be uncertain tax positions associated with the determination of unrelated business taxable income (UBTI). Refer to the full text of ASU No. 2009-06 at www.fasb.org.

Considerations for Employee Benefit Plans

.129 A plan's status as tax-exempt is a tax position that may be subject to uncertainty. If the plan has entered into a correction program, such as the Employee Plans Compliance Resolution System, such a program may aid the plan administrator in assessing whether there is uncertainty with respect to the plan's tax exempt status. Such programs do not apply to tax exempt welfare benefit plans.

.130 Although qualified benefit plans are not generally subject to taxation, certain activities of a qualified plan may be taxable. In general, UBTI of a tax-exempt entity is subject to taxation. UBTI is

- gross income derived from an unrelated trade or business that is regularly carried on, less
- allowable deductions directly connected with the trade or business.

.131 With respect to qualified retirement plans, *unrelated trade or business* is defined as any trade or business regularly carried on by the trust or by a partnership or S corporation of which the trust is a member. This means that a qualified plan can have UBTI due to its investments. For tax-exempt welfare plans, UBTI includes the preceding definition. In addition, such plans may be subject to UBTI on their investment income, if their assets exceed certain allowable reserves.

.132 Nonleveraged investments, such as government securities, stocks and debt instruments of noncontrolled corporations, mutual funds and insurance company annuity contracts, do not typically generate UBTI. However, other nonleveraged investments, such as investments in partnerships, real estate investment trusts, loans or mortgages, and options to buy or sell securities such as short sales or repurchase agreements, may generate UBTI. Due to the nature of their investments, the most common plans that generate UBTI are health and welfare plans and defined benefit pension plans. With the increase, however, of such investments held by defined contribution plans, such plans may begin to be subject to UBTI also.

.133 In addition, UBTI may be generated when a plan uses debt to purchase an investment or if the plan purchases a partnership that uses debt to purchase an investment. Passive investments, such as these, may generate UBTI.

.134 Chapter 12 of AICPA Audit and Accounting Guide *Employee Benefit Plans* provides guidance for auditing plans that have UBTI.

Related Disclosures

.135 FASB ASC 740-10-50-15 states that all entities should disclose all of the following at the end of each annual reporting period presented:

- The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position

- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
  - — The nature of the uncertainty
  - — The nature of the event that could occur in the next 12 months that would cause the change
  - — An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
- A description of tax years that remain subject to examination by major tax jurisdictions[9]

.136 The following is an illustrative disclosure of a defined contribution plan's tax status and uncertain tax position:

> The Internal Revenue Service has determined and informed the company in a letter dated August 30, 20XX, that the plan and related trust are designed in accordance with applicable sections of the IRC. Although the plan has been amended since receiving the determination letter, the plan administrator and the plan's tax counsel believe that the plan is designed and is currently being operated in compliance with the applicable requirements of the IRC and therefore believe that the plan is qualified and the related trust is tax-exempt.
>
> Accounting principles generally accepted in the United States of America require plan management to evaluate tax positions taken by the plan and recognize a tax liability if the plan has taken an uncertain position that more likely than not would not be sustained upon examination by the [*Identify applicable taxing authorities*]. The plan administrator has analyzed the tax positions taken by the plan, and has concluded that as of December 31, 20X1, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the financial statements. The plan is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The plan administrator believes it is no longer subject to income tax examinations for years prior to 20XX.

Other Auditing Issues and Developments

Client Acceptance and Continuance

.137 Paragraph .27 of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), provides that policies and procedures should be established for the acceptance

---

[9] AICPA TIS section 5250.15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids)*, clarifies that the disclosures required by paragraph 15*c–e* of FASB ASC 740-10-50 remain in effect (if applicable), regardless of whether the entity has any uncertain tax positions. Typically, plan tax years will remain open for three years however this may differ depending upon the tax situations of each individual plan. Plan sponsors may consider consulting with their tax specialist to determine the applicable open tax years for their plan.

and continuance of client relationships and specific engagements. Such policies and procedures should provide the audit firm with reasonable assurance that it will undertake or continue relationships and engagements only when the firm

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so; and
- can comply with legal and ethical requirements.

.138 The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

.139 The following is a list of risk factors that engagement teams might consider during their client acceptance and continuance discussions related to an employee benefit plan engagement:

- Ineffective monitoring by management (for example, lack of oversight by plan management of outside providers [such as lack of review of reconciliations of trust assets to participant accounts or no independent records maintained by the sponsor to periodically check information provided by the custodian] or an ineffective plan oversight committee)
- Complex or unstable organizational structure (for example, turnover of plan management, oversight committee members, or outside service providers or difficulty in determining what individuals or committees have oversight or fiduciary responsibility for the plan)
- Weak financial reporting skills, failure by the plan administrator or plan management to take appropriate responsibility for the financial statements, or the plan has a material weakness or significant deficiency in its financial reporting process
- Significant related-party transactions or transactions with parties in interest, or history of engaging in prohibited transactions (for example, involvement in nonexempt transactions or events or activities [violations of laws, regulations, or plan provisions] that could cause loss of tax-exempt status)
- Plan invests in securities that do not have a readily determinable market value (such as limited partnerships and nonpublicly traded employer securities), specialized, or unique investments, or engages in securities lending (regardless of the scope of the audit) and management lacks the proper oversight and understanding of such investments, including valuation
- The use of service providers that do not provide a type 2 Statement on Standards for Attestation Engagements (SSAE) No. 16 report (formerly SAS No. 70 report, also known as a Service Organization Control [SOC] 1 report)

- The plan is inherently more complex (such as, health and welfare plans and leveraged ESOPs) and the engagement team lacks the technical skills that are necessary to audit such a plan
- Other inherent risk factors, such as electronic payroll or human resources systems, complex decentralized control environment, or in-house processing of complex transactions (such as benefit calculations and claims)
- The plan has significant issues with regulatory agencies, pending enforcement matters, or other investigations

Refer to the "403(b) Plan Considerations" section of this alert for unique considerations related to 403(b) plans.

Service Organizations

.140 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attestation standard and an auditing standard to better reflect the nature of the work being performed. SSAE No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), contains the requirements for performance of the examination and reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. Once effective, auditors that are engaged to report on a service organization's controls will no longer follow the guidance in AU section 324 but rather will follow the attestation standards when performing these engagements (hereinafter, referred to as SSAE No. 16 reports).

.141 A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012.

.142 An auditor that audits the financial statements of an entity that uses a service organization is known as a user auditor. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324.

Changes to SAS No. 70 Reports and the Effect on Employee Benefit Plans

.143 A service auditor may be engaged to provide the following two types of SSAE No. 16 reports:

- *Type 1 report*. A report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.

- *Type 2 report*. A report that is the same as a type 1 report but also includes (1) the service auditor's opinion on the operating effectiveness of the controls and (2) a description of the service auditor's tests of the operating effectiveness of the controls and the results of those tests.

.144 The AICPA has developed a new alert, *Service Organizations: New Reporting Options*, which provides user auditors with an overview of the changes to SAS No. 70 and introduces a series of three different SOC reports (SOC 1, SOC 2, and SOC 3). This series encompasses the new SSAE No. 16, which retains the original purpose of SAS No. 70, and adds two new reporting options. The SOC 1 report is another way to refer to the SSAE No. 16 report. You can find the new alert at www.cpa2biz.com with the code 0224811.

Considerations for Employee Benefit Plans

.145 Internal control of a benefit plan consists of the controls at the sponsor as well as the controls at applicable service and subservice organizations that perform significant plan functions including but not limited to processing of participant-level transactions such as contributions and distributions, investment custody and valuation, and execution of investment transactions. SSAE No. 16 reports may be useful in providing user auditors with a sufficient understanding of controls at the service organization to assess the risks of material misstatement in accordance with AU section 314.

.146 It is not uncommon for the service organization's SSAE No. 16 report to cover only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or not to cover activities performed by subservice organizations (for example, the report might not cover services performed by an investment pricing service). The subservice organization may be a separate entity from the service organization or may be related to the service organization. For example, 401(k) record keepers often exclude the related data processing center from their SSAE No. 16 reports. The independent auditor's report included in the SSAE No. 16 report will typically include language that the report does not cover certain significant service or subservice organizations or systems. For less significant service or subservice organizations or systems, this language will not be included in the auditor's report, but will be described elsewhere in the report. In these situations, auditors would gain an understanding of the controls related to the services not covered by the service or subservice organization that are part of the plan's information system. If the user auditor does not have sufficient information to assess control risk as low or moderate, the plan auditor may decide to perform additional tests of the service or subservice organization's controls or perform additional audit procedures on the plan's financial statements. The auditor may obtain a copy of the subservice organization's SSAE No. 16 report if one was issued.

.147 The AICPA is in the process of updating the Practice Aid *SAS No. 70 Reports and Employee Benefit Plans*. This Practice Aid provides guidance to user auditors about the use of SSAE No. 16 reports in the audit of employee benefit plans. Be alert for the issuance of this practice aid.

> **Help Desk**: See chapter 6 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further guidance regarding the use of service organizations.

Supplementary and Other Information Related to Financial Statements

.148 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.149 ERISA requires a plan's financial statements to include a note explaining differences, if any, between amounts reported in the financial statements and the amounts reported in the Form 5500, Schedule H. If, upon review of the Form 5500 subsequent to the issuance of the plan's financial statements, the auditor identifies any such differences, he or she may consider reissuing the auditor's report, dual-dated with respect to the note explaining the differences. If the differences represent a material inconsistency or misstatement of fact in the preparation of the Form 5500, then the guidance in AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), is appropriate.

.150 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information.[10] *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

SAS No. 118 Considerations Specific for Employee Benefit Plans

.151 Information in the Form 5500 may be relevant to an independent audit or to the continuing propriety of the auditor's report. In accordance with AU section 550, the auditor should read the other information in the Form 5500 in order to identify material inconsistencies, if any, with the audited financial

---

[10] *Required supplementary information* is defined in paragraph .04 of AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*). Also see the section of this alert beginning at paragraph .163.

statements when such financial statements are accompanied by the other information. The auditor should make appropriate arrangements with management to obtain the other information prior to the report release date. If it is not possible to obtain all of the other information prior to the report release date, the auditor should read such other information as soon as practicable. AU section 550 also addresses the auditor's responsibilities when the auditor (*a*) identifies material inconsistencies (*b*) identifies material inconsistencies prior to the report release date, (*c*) obtains other information subsequent to the report release date, or (*d*) becomes aware of material misstatements of fact.

Reports Issued Prior to Form 5500 Filing

.152 The auditor may encounter situations in which the financial statements and auditor's report are issued prior to the auditor's review of the Form 5500. If such a situation occurs, the plan administrator should not attach the financial statements and auditor's report to the filing without the auditor's review of the filing on Form 5500. When the engagement letter is prepared, it may include a statement that if the financial statements and auditor's report are issued prior to the filing of Form 5500, those statements and report should not be attached to the filing without it being reviewed by the auditor. The auditor may also wish to consider including a statement in the transmittal letter to the client indicating that the financial statements and auditor's report, as presented, are not to be attached to the Form 5500 filing without the auditor's review of that filing.

Supplementary Information in Relation to the Financial Statements as a Whole

.153 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

Supplemental Schedules Relating to ERISA and DOL Regulations

.154 ERISA and DOL regulations require additional information to be included as schedules to the financial statements. Some of this information is required to be covered by the auditor's report. Paragraphs .05–.08 of AU section 551 establishes procedures to determine whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. Such procedures include specific written representations that the auditor should obtain from management. In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should determine that all of the following conditions are met:

a. The supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

b. The supplementary information relates to the same period as the financial statements.

c. The financial statements were audited, and the auditor served as the principal auditor in that engagement.

d. Neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements. (When reporting under the limited scope audit exemption, see the section "Limited-Scope Audits Under DOL Regulations" that follows.)

e. The supplementary information will accompany the entity's audited financial statements, or such audited financial statements will be made readily available by the entity.

.155 Paragraph .07 of AU section 551 states that in addition to the procedures performed during the audit of the financial statements, in order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements:

a. Inquire of management about the purpose of the supplementary information and the criteria used by management to prepare the supplementary information, such as an applicable financial reporting framework, criteria established by a regulator, a contractual agreement, or other requirements

b. Determine whether the form and content of the supplementary information complies with the applicable criteria

c. Obtain an understanding about the methods of preparing the supplementary information and determine whether the methods of preparing the supplementary information have changed from those used in the prior period and, if the methods have changed, the reasons for such changes

d. Compare and reconcile the supplementary information to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves

e. Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information

f. Evaluate the appropriateness and completeness of the supplementary information, considering the results of the procedures performed and other knowledge obtained during the audit of the financial statements

g. Obtain written representations from management

i. that it acknowledges its responsibility for the presentation of the supplementary information in accordance with the applicable criteria

ii. that it believes the supplementary information, including its form and content, is fairly presented in accordance with the applicable criteria

iii. that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes

iv. about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information

v. that when the supplementary information is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the supplementary information no later than the date of issuance by the entity of the supplementary information and the auditor's report thereon

.156 Paragraph .09 of AU section 551 requires the auditor to report on the supplementary information in either (1) an explanatory paragraph following the opinion paragraph in the auditor's report on the financial statements or (2) in a separate report on the supplementary information.[11] The explanatory paragraph or separate report should include the following elements:

a. A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole

b. A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements

c. A statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements

d. A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America

e. If the auditor issues an unqualified opinion on the financial statements, and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole

f. If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor's report explaining the qualification), such information is

[11] Paragraph .10 of AU section 551, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), addresses how to report when the audited financial statements are not presented with the supplementary information. That is, in addition to the elements to be included in an explanatory paragraph (see AU section 551 paragraph .09), the report should include a reference to the report on the financial statements, the date of that report, the nature of the opinion expressed on the financial statements, and any report modifications.

fairly stated, in all material respects, in relation to the financial statements as a whole

.157 When the auditor's report on the audited financial statements contains an adverse opinion or disclaims an opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information. When reporting under the limited scope audit exemption, see the following section of this alert "Limited-Scope Audits Under DOL Regulations."

.158 The date of the auditor's report on the supplementary information in relation to the financial statements as a whole should not be earlier than the date on which the auditor completed the procedures required in paragraph .07 of AU section 551.

> **Help Desk**: Plans that are required to file Form 11-K are considered issuers and should submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. Accordingly, when reporting on supplemental schedules in a Form 11-K audit, AU section 551, *Reporting on Information in Auditor-Submitted Documents* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), should be followed.

.159 When additional information is presented on which the auditor does not express an opinion, the information should be marked as unaudited or should refer to the auditor's disclaimer of opinion. The exhibit of AU section 551 provides illustrative reports that the auditor may use when the auditor has expressed a qualified or adverse opinion or disclaims an opinion on the financial statements.

.160 If the auditor concludes, on the basis of the procedures performed, that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the supplementary information. If management does not revise the supplementary information, the auditor should either (*a*) modify the auditor's opinion on the supplementary information and describe the misstatement in the auditor's report or (*b*) if a separate report is being issued on the supplementary information, withhold the auditor's report on the supplementary information.

Limited-Scope Audits Under DOL Regulations

.161 When a plan administrator elects to limit the scope of the audit performed as permitted by 29 CFR 2520.103-8 of the DOL Rules and Regulations for Reporting and Disclosure under ERISA, the auditor is instructed by the plan administrator to limit the scope of testing of investment information prepared and certified by a qualified trustee, custodian or insurance company as complete and accurate.

.162 In situations in which a disclaimer arises from the exemption noted previously, the auditor is precluded from expressing an opinion that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, in accordance with paragraph .11 of AU section 551.

> **Help Desk**: If the auditor is unable to obtain sufficient appropriate audit evidence regarding other noninvestment related information or investment information not covered by the certification then the standard form of limited scope report may not be appropriate. Also, it likely will not be appropriate for the auditor to opine on the form and content of the supplemental schedules as presented in compliance with the DOL's Rules and Regulations for Reporting and Disclosure under ERISA.

Required Supplementary Information

.163 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to required supplementary information. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Employee benefit plan financial statements do not contain required supplementary information and therefore this SAS would not be applicable to plans.

Use of Electronic Confirmations

.164 Confirmations are undertaken to obtain sufficient appropriate audit evidence from third parties about financial statement assertions made by management. In a highly automated environment, auditors may face challenges in the confirmation process and therefore need to carefully manage the confirmation process and refrain from accessing information available to clients. It is important to note that an auditor's online inquiry of a third party's database does not meet the auditor's confirmation responsibility under AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*). Instead, such online inquiry constitutes an alternative procedure. Refer to the full text of AU section 330 and 9330, *The Confirmation Process—Auditing Interpretations of Section 330* (AICPA, *Professional Standards*), for guidance when using electronic confirmations. As discussed in paragraph 7.16 of the Audit and Accounting Guide *Employee Benefit Plans*, a certification does not constitute confirmation.

.165 In addition to challenges with confirmation inquiries, when confirming investment existence and ownership with third party custodians or trustees in a full scope audit, auditors are often faced with challenges regarding the method of response. The challenges relate to electronic responses and those that generally do not address all requests contained in an auditor's inquiry. AU section 330, requires an active response from a third party. Guidance related to this is available in AU section 9330. AU section 9330 states that electronic responses are not precluded and highlights considerations to assist auditors with their determination of the reliability of the information obtained through the confirmation process, including consideration of the risk that

- the information obtained may not be from an authentic source;
- a respondent may not be knowledgeable about the information to be confirmed; or
- the integrity of the information may have been compromised.

Form 11-K Audits

.166 Plans that are required to file Form 11-K are deemed to be issuers under SOX and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. Employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Security Act of 1933 are required by the SEC to file Form 11-K pursuant to Section 15(d) of the Security Exchange Act of 1934. Form 11-K must be filed with the SEC within 90 days after the end of the plan's fiscal year-end, when it is filed separately and not as an exhibit to Form 10-K. However, if a plan is subject to ERISA, and files plan financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA, the Form 11-K filing deadline is increased to 180 days after the plan's fiscal year-end. In addition, two separate audit reports, one referencing PCAOB standards for the Form 11-K filing with the SEC and a separate report referencing GAAS for the DOL filing, are required.

Help Desk: Instructions for completing Form 11-K can be found under topic 15 of the SEC manual located on the SEC website at www.sec.gov.

.167 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB website at www.pcaob.org for information about its activities.

Recent PCAOB Pronouncements and Related Guidance	
Public Company Accounting Oversight Board (PCAOB) Release No. 2010-06, *Report On Observations of PCAOB Inspectors Related to Audit Risk Areas Affected By the Economic Crisis*[12] Issue Date: September 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This release summarizes inspection observations of audits of financial institutions and other companies during the economic crisis. This release was issued to inform the public about the audit risks and challenges that the PCAOB has identified through its inspection program as a result of the disruption in credit and financial markets and the broader economic downturn.

(continued)

[12] See paragraph .93 in this alert for additional information on the *Report on Observation of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*.

Recent PCAOB Pronouncements and Related Guidance	
PCAOB *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, Auditing Standard Nos. 8–15 Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB Standards)	The new standards can be found in appendixes 1–8 of PCAOB Release No. 2010-004 at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf
Amendments to PCAOB Standards Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard Nos. 8–15, the PCAOB also adopted a number of related amendments to PCAOB standards. The amendments can be found in appendix 9 of PCAOB Release No. 2010-004 at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf
PCAOB Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.07) Issue Date: December 2010 (Applicable to audits conducted in accordance with PCAOB standards)	The PCAOB staff has taken this action in light of reports alleging that companies may have misrepresented the quality of many loans sold for securitization and that those companies could be required to repurchase the affected mortgages, creating an exposure for the banking industry of up to $52 billion. Additionally, allegations have surfaced that irregularities in the foreclosure process could result in further losses. The practice alert advises auditors that these mortgage- and foreclosure-related activities or exposures could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures.

Defined Benefit Plans

Actuarial Reports for Defined Benefit Plans

.168 Several economic and demographic assumptions are used in actuarial valuations for defined benefit plans to determine funding requirements and the actuarial present value of accumulated plan benefits in accordance with the guidance in FASB ASC 960. One of the most significant economic assumptions is the discount rate. Two approaches exist that can be used to select the discount rate. The most commonly used approach is to reflect the long-term expected rate of return on assets. This amount is generally stable from one year to the next. This assumption would reflect anticipated growth of the actual underlying investments in the pension trust. Many employers are changing the mix of investments that have been historically used. For employers that are changing their mix of assets, the actual history of returns is not as relevant as new expectations for the new mix of assets.

.169 Historically, when an approach of looking at the long term expected return was used, the rate selected had generally been the same as that used for funding purposes. However, the Pension Protection Act of 2006 (PPA) has changed the funding rate. The funding rate is no longer an appropriate rate for use in the plan's financial statements. Plans using expected return on plan assets as the basis for choosing the discount rate will need to have a benchmark other than the PPA funding rate. One of the most common approaches has been to use the expected return on plan assets that the employer uses when following the guidance in FASB ASC 715, *Compensation—Retirement Benefits*. It is important to note that this is not the discount rate used for purposes of applying FASB ASC 715. The discount rate and the expected return are separate and distinct rates. Therefore, auditors will need to take care when determining if the proper rate is disclosed in the benefit plan's financial statements.

.170 The second approach that may be used to select the discount rate used to determine the present value of accumulated plan benefits is to select a rate that reflects an insurance company's purchase rates as of the benefit information date. Because this is a settlement type of rate, it may be similar to (but not necessarily the same as) the discount rate used for the financial statements of the plan sponsor. A discount rate selected on this basis can be expected to change from year to year to reflect changes in the long term interest rate markets.

.171 It should be noted that if a plan has used one basis to select its discount rate and then changes to a different basis, a change in accounting principle may occur. For example, if a plan had used the funding rate prior to PPA (a long-term return basis) and then changes to a settlement type rate (such as the discount rate described in FASB ASC 715), it might be considered a change in accounting principle rather than a change in estimate. Consider the guidance in FASB ASC 250, *Accounting Changes and Error Corrections*, when making this determination.

.172 The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, retirement age, form of payment, or type of benefit elections and cash balance crediting rates, if applicable. With the increase in life expectancies, the mortality assumption should include improvements to longevity that were not included in earlier tables.

.173 Certain mortality tables used by actuaries include the 1983 Group Annuity Mortality (GAM), 1994 GAM, Uninsured Pensioner Mortality (UP) 1994, and Retired Pensioner Mortality (RP) 2000 tables. Auditors may consider challenging the use of such tables for purposes of determining the plan's benefit obligation beginning in 2007. For 2007 calendar year plans and beyond, a new mortality table is required as part of the minimum required contribution calculation. This table, which is based on the RP 2000 mortality table, has replaced the 1983 GAM table. Many actuarial reports will refer to this table as the RP 2000 Combined Mortality Table with projections as specified by IRS Regulation 1.412(1)(7)-1. It has been common practice to use the same mortality table for the financial statements of the plan as is required for minimum funding purposes. It can therefore be expected that the RP 2000 table with or without the IRS required projections will be used frequently for 2009 valuations. It is possible that the use of the 1983 GAM table, in limited circumstances, may continue to be acceptable depending on the plan's experience; however, most plans will be changing to use the 1994 GAM, UP 1994, or the recent RP 2000 tables for their mortality assumptions. It is expected that plan sponsors will consider the demographics of their participant population prior to utilizing a mortality table in determining the actuarial present value of accumulated plan benefits.

.174 The medical trend assumption is unique to postretirement health and welfare plans. This assumption is intended to project the current cost of health care benefits to future periods when those benefits will be paid. Health care costs have traditionally increased at a faster rate than general inflation. In addition to general inflation, health care costs are affected by increased utilization of plan benefits, rising cost of medical technology, and the leveraging effect of plan provisions such as co-pays and deductibles. Taken together, these factors contribute to cost increases well above the rate of general inflation. Most actuaries assume that these excess cost increases will continue in the near term but will ultimately merge with general inflation rates. Therefore, a common approach is to assume a higher trend rate for the current year and grade down to the general inflation rate after several years. An example is a trend rate of 9 percent for 2009 grading down by 0.50 percent each year until the ultimate rate of 5 percent is reached for 2017 and beyond. Auditors should question trend assumptions that reflect only general inflation for all years or that grade down to general inflation too quickly. For example, if the trend assumption is 8 percent for 2009 and grades to 5 percent in 2011, the auditor will want to obtain support for the rapid decline.

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

- *Trends and nature of benefit distributions* (for example, lump sum versus annuity). A plan that predominantly pays lump sum benefits may have a higher obligation than an equivalent plan that pays annuities. To properly value the plan's liabilities, assumptions must be used to reflect the cost of the lump sum benefits. If only assumptions that reflect annuities exist, the lump sum benefits may be undervalued.
- *Whether a shift in the plan population has occurred 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 recent plan mergers or acquisitions have occurred*. In the case of a plan merger, all assumptions would be reviewed for their

continued reasonableness because the assumptions used for one plan may not be appropriate for the plan being merged.

- *Whether changes to any plan benefit formula or a freezing of the plan has occurred*. Changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions would be reviewed if the plan is amended to change benefits.
- *Whether consistent gains and losses are generated each year*. If yes, this may indicate that one or more of the assumptions are not reasonable based on actual experience.

.176 When reviewing an actuarial report, consideration may be given to the following:

- Consistency of benefits accumulated each year (auditors would expect changes if a plan merger, acquisition, a significant plan provision change, or changes to the underlying assumptions have occurred).
- Benefit payments in the roll forward of accumulated plan benefits, which 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, which should match the asset value shown in the actuarial report.
- Inclusion of the effect of a change in plan provisions and the effect of merger, spin-off, or acquisition.

.177 It is also important to note that the assumption of salary increases may not be relevant because the disclosure of the actuarial present value of accumulated plan benefits does not take into account future salary increases. It may have some relevance if the actuary does not have or maintain salary histories for the plan participants and the salary increase assumption is used to estimate prior salary histories.

Help Desk: In light of funding pressures in the current economic environment, the risk that the plan's benefit obligation is understated due to inappropriate selection of an actuarial assumption or inaccurate or incomplete census data provided to the actuary may be a significant risk.

The calculation of the plan's benefit obligation can be very sensitive to actuarial assumptions and census data. Accordingly, it is important (*a*) to gain comfort regarding the reasonableness of the actuarial assumptions used, and (*b*) to properly test the census data in order to gain comfort that the calculation of the benefit obligation is based on correct census data and reasonable assumptions.

The Use of Beginning of Year Benefit Information Date

.178 The presentation of the financial statement information and the notes are affected by the benefit information date selected for disclosure. The preferred approach is to use an end-of-year benefit information date. If end-of-year is presented, the present value of accumulated plan benefits will be as of the same date as the net assets. In this case, at a minimum, two statements of net assets available for benefits and one statement of changes in net assets are presented. In addition, two corresponding statements (or disclosure in the notes) of the present value of accumulated plan benefits and one statement of changes also are presented. Examples of this are shown in exhibits D-1–D-4 of Audit and Accounting Guide *Employee Benefit Plans*.

.179 However, if beginning-of-year benefit information is used, the date of the benefit information in the actuarial report may not match the date that net assets are presented. For example, for financial statements presented as of December 31, 2008, and December 31, 2007, the actuarial valuation will be as of January 1, 2008. For the benefit information to match the statement of net assets, the present value of accumulated plan benefits should be presented as of December 31, 2007 (one day earlier). Typically, this will not cause a material misstatement unless a plan amendment was adopted on or after January 1, 2008, with a January 1, 2008, effective date. In that case, the effect of the amendment must be removed. As shown in Audit and Accounting Guide *Employee Benefit Plans*, when beginning-of-year benefit information is used, comparative statements of net assets and comparative statements of changes would be presented. Only a single year presentation of accumulated plan benefits is required with a roll forward of the change from the prior year. Examples of this are shown in exhibits D-1 and D-7–D-8 of Audit and Accounting Guide *Employee Benefit Plans*.

Effect of the PPA on Defined Benefit Plans

.180 The PPA has affected many aspects of plan design, administration, and funding. For defined benefit plans, the PPA focuses on the funded percentage as the trigger point to activate additional funding requirements and benefit limitations. These rules are very complex and this discussion will not address many of those complexities but rather will provide an overview of the key features.

.181 New minimum funding standards were fully operational for 2008 plan years. Minimum funding standards are established based on a plan's funded status. The funding target is the present value of accrued benefits. PPA defines the ratio of plan assets to the funding target as the adjusted funding target attainment percentage (AFTAP). If the assets equal the present value of accrued benefits, the plan's AFTAP will be 100 percent. The minimum required contribution for plans with an AFTAP of 100 percent or greater will be the plan's normal cost. This is the actuarially determined amount necessary to fund the benefits that have accrued in the current year. This minimum contribution could be reduced to zero if the excess of the assets over the funding target exceeds the plan's normal cost for the year. For plans with an AFTAP of less than 100 percent, the minimum required contribution will be the plan's normal cost plus an additional payment that will amortize the shortfall over 7 years plus, if applicable, the amortization of any funding waivers over a 5-year period.

.182 Funding waivers may be requested in cases of business hardship. Application for a funding waiver must be made within two-and-a-half months of the plan year-end. The plan may not be amended to increase benefits while a funding waiver is in effect. The IRS cannot grant extension of the funding waiver amortization period. If granted, waivers generally permit a plan sponsor to pay the ERISA minimum contribution over a five-year period. The auditor may need to ascertain whether the plan is a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited).

.183 As in prior years, the minimum required contribution will be part of the actuarial report. For financial statement purposes, the aforementioned minimum required contributions are accrued and any excess amounts received after year-end would be considered a Type 2 subsequent event unless evidence exists of a formal commitment as of the balance sheet date. The contributions receivable for the financial statements should include the amounts paid in the subsequent period and may be adjusted by the effective interest rate used. For plans when the plan sponsor has not made the final required contribution as of the date of the plan's filing, the receivable amount should include the amount required to be paid, based on the best estimate of when the payment will be made, as of the plan's year-end.

.184 Each year the actuary is required to certify to the plan's funded percentage. Plans with a funding percentage below 80 percent will be required to implement certain benefit limitations. Further limitations will be required when the AFTAP falls below 60 percent. Plans with an AFTAP above 60 percent but less than 80 percent may not be amended to provide additional or increased benefits. They must also place a limit on accelerated benefits such as lump sums and annuity purchases. This limit is 50 percent of the full amount allowed by the plan. If the AFTAP falls below 60 percent, the plan must freeze the accrual of all future benefits until such time as the percentage increases to over 60 percent. The plan will also not be allowed to make any accelerated payments. The auditor will need to determine if the plan is being operated in accordance with any limitations that apply based on the aforementioned rules and consider the need for disclosure of such limitations in the notes to the financial statements of the plan.

.185 The PPA imposed new disclosure requirements on plan sponsors of defined benefit plans, including sponsors of cash balance plans. If the plan sponsor maintains an intranet website, they are required to post the plan's Form 5500 actuarial information on the sponsor's intranet website. The PPA amendment also requires the DOL to post the plan's actuarial information on its website. The statutory requirements that apply to plan sponsors and the DOL are the same except the DOL is required to post the plan's Form 5500 actuarial information on its website within 90 days after the date the plan's Form 5500 is filed with the DOL.

.186 The statute does not contain a deadline for a plan sponsor to post this information on its intranet; however, if plan sponsors have not yet posted the plan's actuarial information for the 2008 year, they may want take action quickly to meet this requirement.

> **Help Desk:** The DOL has established a website that allows the public to search for a plan sponsor's Form 5500 actuarial information: www.dol.gov/ebsa/actuarialsearch.html.

Health and Welfare Plans

Tax-Advantaged Accounts for Health Care Expenses

.187 The IRC provides for the following types of tax-advantaged accounts that can be used to pay for unreimbursed medical expenses in defined-contribution arrangements: health care Flexible Spending Accounts (FSAs), Health Reimbursement Accounts (HRAs), Health Savings Accounts (HSAs), and Medical Savings Accounts (MSAs). Unreimbursed medical expenses typically include deductibles, copayments, and goods or services not covered by insurance. Although these accounts have some common features, they also differ in several important respects.

.188 Congressional Research Service issued a report in June 2010 that provides a brief summary of the four accounts and compares them with respect to eligibility, contribution limits, use of funds, and other characteristics: http://assets.opencrs.com/rpts/RS21573_20100618.pdf.

Health Care Reform

.189 In March 2010, Congress passed two pieces of legislation designed to reform the U.S. health care system. The Patient Protection and Affordable Care Act (PL 111-148) was quickly followed by the Health Care and Education Reconciliation Act of 2010 (PL 111-152). PL 111-152 amended several portions of the first act and added new provisions of its own. These two acts are collectively referred to as the Affordable Care Act. These two pieces of legislation were designed to reform the U.S. health care delivery system. Although the legislation generally deals with the health care system, it does contain many revisions to the IRC which may affect plan design or operation. The Affordable Care Act contains provisions that affect both individuals and employers.

> **Help Desk**: This alert describes many of the items in the Affordable Care Act applicable to individuals and employers; however, it is not an all-inclusive summary. Health reform is far-reaching and there is much uncertainty as to how health reform measures will affect the way health care entities will deliver services to their patients in the future and how they will be compensated for those services. In addition, ongoing litigation is challenging the Affordable Care Act.
>
> Much has been written on the topic of health care reform. For example, the following websites provide information that may be helpful to readers:
>
> - AICPA website www.aicpa.org/Research/HCR/Pages/HealthCareReform.aspx
> - HealthCare website www.healthcare.gov/law/about/order/byyear.html
> - Kaiser Family Foundation website www.kff.org/healthreform/upload/8061.pdf

.190 Under both prior law and the Affordable Care Act, employers who provide retiree prescription drug coverage that is at least as valuable as Medicare Part D are entitled to a subsidy from the federal government to help offset the cost of the coverage. This subsidy is not treated as income to the employer, and the employer is currently able to deduct the full cost of the retiree prescription drug coverage for income tax purposes (including the portion that is offset by the subsidy). Under the Affordable Care Act, for tax years beginning after December 31, 2012, companies will no longer be able to deduct the portion of the retiree prescription drug coverage cost that is subsidized by the federal government. Although companies will still be allowed to exclude the entire amount of the subsidy from their taxable income, companies will only be allowed to deduct the portion of the coverage that they pay with employer funds.

.191 In addition, the Affordable Care Act imposes an excise tax on high-value health plans (often referred to as "Cadillac" plans). Although this tax burden lies primarily on health insurance issuers, the tax is expected to affect many employers through increases in premiums or fees or both charged by insurance companies.

> **Help Desk:** These law changes are expected to result in an increase in the total cost of retiree medical coverage. Consequently, many companies are already evaluating the potential effect of these law changes on the level of benefits offered by the Plan and the associated effect on contribution rates. For a discussion of how these changes are already affecting benefit plans, see www.shrm.org/Publications/HRNews/Pages/TaxingRetireeDrugs.aspx.

Health Care Reform Requirements

.192 Health care reform presents challenges for employers given its many new requirements. Most of the current requirements that apply to all plans go into effect starting with plan years that begin on or after September 23, 2010. Employers who do not comply with health care reform's requirements may potentially be fined $100 per day, per employee (with limits on the penalty in the case of unintentional failures and for small employers).

.193 Following are some of the major new requirements for health-care benefit plans (as of December 2010), along with their respective effective dates. Numerous additional rules (not listed) apply to "nongrandfathered plans" (for example, new plans that go into effect after March 2010, as well as to existing plans that are modified in certain respects after March 2010).

Rules in effect for plan years beginning on or after September 23, 2010:

- Extend eligibility for dependent coverage (if offered) to employees' unmarried children who are not yet 26 years old, even if not otherwise a dependent for tax purposes
- No preexisting condition exclusions for children under age 19
- No lifetime maximum benefit on essential benefits
- Restricted annual limits on essential benefits
- Rescission of an individual's coverage prohibited

Rule in effect on January 1, 2011:

- No reimbursement in a health-care FSA, HRA, HSA, or MSA for over-the-counter drugs purchased without a prescription, except insulin

Rule in effect on January 1, 2012:

- W-2 reporting of the cost of health-care benefits (optional for 2011)

Rule in effect on January 1, 2013

- Employee contributions to health-care FSAs limited to $2,500 per year

Rules in effect on January 1, 2014:

- No exclusion from coverage due to preexisting conditions, regardless of the individual's age
- No annual dollar limits on benefits
- Large employers pay penalties for providing no coverage or inadequate coverage (employers with 50 or more full-time employees)

Rule in effect on January 1, 2018:

- Forty percent excise tax on high-cost plans (plans with a cost in excess of $10,200 for single coverage and $27,500 for family coverage)

.194 For welfare benefit plans subject to audit, these law changes present unique financial reporting issues that could affect a plan's reported obligations. Plan management should consider the effect of plan design and regulatory changes when developing their obligation estimates, including the effect of plan amendments and regulatory changes that go into effect after the measurement date. For example, the effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods (see FASB ASC 965-30-35-7 for such requirement). Auditors will want to determine if obligations have been properly calculated, reported, and disclosed in the financial statements.

.195 Prior to 2011, some sponsors split their retired participants into a separate health and welfare plan. Standalone retiree-only health and welfare plans could be affected to a lesser extent by healthcare reform than a plan with active participants. Regardless, plan management will want to consult with their actuary as to the ultimate effect.

Terminating Trusts

.196 In practice, terminating trusts are more commonly encountered than terminating health and welfare plans. Factors affecting the decision to terminate a trust may include moving a funded plan to an unfunded plan status or to a fully insured plan, both of which (upon termination of the existing trust) may eliminate the ongoing requirement for a plan audit. It is typically recommended that the trust be legally dissolved to accomplish the desired results, because even though the trust may not be utilized, if not legally dissolved, the plan may still be considered funded and, if all other audit requirements are met, may need an audit.

.197 Consideration should be given to the timing of the trust termination and the time period covered by the financial statements. If the trust was in existence at any time during the year, and all other audit requirements are fulfilled (see paragraph A.26 and exhibit 5-3), then the plan's financial statements would need to cover the entire year, not just the time period the trust was in operation.

Deficiencies Found in Employee Benefit Plan Audits

.198 The AICPA, working with Employee Benefits Security Administration (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 the individual's state license to practice public accounting. EBSA statistics indicate a higher number of deficiencies when practitioners audit less than 25 plans. In addition, more deficiencies were noted in defined benefit plans, health and welfare plans, and multiemployer plans.

.199 Most commonly found deficiencies by the DOL relate primarily to auditing procedures associated with inadequate planning of the engagement and inadequate test work for participant data, contributions, investments, benefit payments, plan obligations, and party-in-interest transactions. Deficiencies are also commonly found in the auditor's report. In addition, errors and omissions are commonly found in required note disclosures and supplemental schedules.

Help Desk: For a more comprehensive list of common deficiencies, see the practice tool "Common EBP Audit Deficiencies" issued by the AICPA EBPAQC at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/ToolsandAids/DownloadableDocuments/EBPAQC_Common_Audit_Deficiences.pdf.

Recent Pronouncements

Recent Auditing and Attestation Pronouncements and Related Guidance

.200 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
	control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Interpretation No.1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.
Interpretation No. 8, "Including a Description of Tests of Controls or Other Procedures and the Results Thereof, in an Examination Report," of AT section 101, *Attest Engagements*, (AICPA, Professional Standards, AT section 9101 par. .70–.72) Issue Date: July 2010 (Interpretive publication)	This interpretation addresses whether a practitioner performing an examination engagement under AT section 101 may include a description of tests of controls or other procedures, and the results thereof, in a separate section of the examination report, and includes relevant considerations in determining whether to do so.

Recent ASUs

.201 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC)	
Accounting Standards Update (ASU) No. 2011-01 (January 2011)	*Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*
ASU No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-28 (December 2010)	*Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-27 (December 2010)	*Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)*
Broad Transactions Area of FASB ASC	
ASU No. 2010-29 (December 2010)	*Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)*

(continued)

Recent Accounting Standards Updates	
Broad Transactions Area of FASB ASC—(continued)	
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-26 (October 2010)	*Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-25 (September 2010)	*Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)*

Recently Issued Technical Questions and Answers

.202 The following table presents a list of nonauthoritative accounting, audit, and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
Accounting	
Technical Questions and Answers (TIS) section 6910.18 (Revised October 2010)	"Disclosure of an Investment in an Issuer When One or More Securities or One or More Derivative Contracts Are Held—Nonregistered Investment Partnerships"
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"

(continued)

Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
Accounting—(continued)	
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
Audit and Attest	
TIS section 9110.17 (July 2010)	"Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), to Other Comprehensive Basis of Accounting (OCBOA) Financial Statements—Recognition and Measurement Provisions"
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"

Regulatory Developments

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

.203 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 assets, but in no event later than (1) for pension plans, the 15th business day of the month following the month in which the participant 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

.204 Failure to remit or untimely remittance of participant contributions 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.

.205 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.

.206 The following apply to 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 Voluntary Fiduciary Correction Program [VFCP] and for which the conditions of Prohibited Transaction Exemption [PTE] 2002-51 have been satisfied, as described subsequently) may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the 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. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, AU sec. 551A),[13] as amended, provides guidance

[13] In February 2010, the AICPA issued SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole,* (AICPA, *Professional Standards*, AU sec. 551), which, along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. SAS No. 119 addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted. See the "Supplementary and Other Information Related to Financial Statements" section of this alert for further information.

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 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further discussion of prohibited transactions.

Reporting of Delinquent Loan Repayments

.207 Generally speaking, participant loan repayments are not subject to the DOL's participant contribution regulation (29 CFR 2510.3-102). Accordingly, its 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.

.208 In Advisory Opinion 2002-2A, the DOL concluded that, although 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.

.209 Accordingly, the DOL will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan 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.

.210 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.

.211 For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or visit www.dol.gov/ebsa.

2010 Form M-1 for Multiple Employer Welfare Arrangements

.212 On January 6, 2011, the DOL published in the Federal Register the 2009 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.

.213 MEWAs generally are arrangements that offer medical benefits to the employees of two or more employers or to their beneficiaries. The filing deadline for the 2010 Form M-1 is March 1, 2011. Administrators can request, however, an automatic 60-day extension until May 2, 2011. The 2010 form is basically identical to the previous year's form.

.214 The online filing system is available at www.askebsa.dol.gov/mewa. It allows filers the flexibility to complete the form in multiple sessions, print a copy for his or her records and submit it at no cost. The website includes a user manual, frequently asked questions and a link to submit questions electronically.

Help Desk: Filers can use the following information to receive assistance:

- For the online filing system, call (202) 693-8600
- For Form M-1, visit www.askebsa.dol.gov/mewa or call (202) 693-8360

DOL Proposed Rule to Enhance Target Date Retirement Fund Disclosures

.215 On November 30, 2010, the DOL published in the Federal Register a proposed rule that would amend the "qualified default investment alternative regulation" and the "participant-level disclosure regulation" to enhance and provide more specificity regarding the information that must be disclosed to participants and beneficiaries concerning investments in qualified default investment alternatives, including target date or similar investments.

.216 The proposal also contains an amendment to the participant-level disclosure regulation that would require the disclosure of the same information concerning target date or similar investments to all participants and beneficiaries in participant-directed individual account plans.

.217 The proposed amendments require new disclosures about the design and operation of target date or similar investments, including an explanation of

- the investment's asset allocation;
- how that allocation will change over time, with a graphic illustration;
- the significance of the investment's "target" date; and
- a statement that a participant investing in a target date fund (TDF) risks losing money in that investment, even close to retirement.

You can view the proposed regulation and a related fact sheet www.dol.gov/ebsa.

.218 In addition, on May 6, 2010, the DOL and the SEC announced guidance to help investors and plan participants better understand the operations and risks of TDF investments. The guidance is designed to assist investors and participants in assessing the benefits and risks associated with TDFs and the appropriateness of including such an investment as part of their retirement portfolios.

.219 The guidance describes some basics features of TDFs, including the investment mix of such funds, the risks associated with the investments, how

TDFs operate, and ways to evaluate a target date retirement fund that will help increase awareness of both the value and risks associated with these types of investments.

> **Help Desk:** "Investor Bulletin: Target Date Retirement Plans" is available at www.dol.gov/ebsa or at www.sec.gov.

DOL Proposed Rule to Implement Annual Funding Notice Requirement for Defined Benefit Pension Plans

.220 On November 18, 2010, the DOL, pursuant to a requirement imposed by the PPA, published in the Federal Register a proposed rule to implement the annual funding notice requirement under section 101(f) of ERISA.

.221 The proposed regulation requires administrators of all defined benefit plans that are subject to Title IV of ERISA to provide an annual funding notice to the PBGC, to each plan participant and beneficiary, to each labor organization representing such participants or beneficiaries and, in the case of a multiemployer plan, to each employer that has an obligation to contribute to the plan. Prior to implementation of the PPA, only multiemployer plans were required to disclose any funding information.

.222 An estimated 29,500 plans covering approximately 44 million participants and beneficiaries are subject to these disclosure requirements. Among other information, a funding notice must include the plan's funding target attainment percentage or funded percentage, as applicable, over a period of time. You can view the proposed regulation, including model notices, at www.dol.gov/ebsa.

DOL Proposed Rule Defining Fiduciaries of Employee Benefit Plans

.223 On October 22, 2010, the DOL published in the Federal Register a proposed rule to update the definition of *fiduciary* to more broadly define the term as a person who provides investment advice to plans for a fee or other compensation.

.224 The proposed rule would amend a 1975 regulation that defines when a person providing investment advice becomes a fiduciary under ERISA. The proposed amendment would update that definition to take into account changes in the expectations of plan officials and participants who receive advice, as well as the practices of investment advice providers. You can view the proposed regulation at www.dol.gov/ebsa.

DOL Final Rule on Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans

.225 On October 20, 2010, the DOL published in the Federal Register a final rule that requires the disclosure of certain plan and investment-related information, including fee and expense information, to participants and beneficiaries in participant-directed individual account plans (for example, 401(k) plans).

.226 This rule will ensure that all workers who direct their plan investments have access to the information they need to make informed decisions regarding the investment of their retirement savings, including fee and expense information. Under the rule, workers will receive this information in a format that enables them to meaningfully compare the investment options under their plans.

.227 The final regulation requires plan fiduciaries to

- give workers quarterly statements of plan fees and expenses deducted from their accounts;
- give workers core information about investments available under their plan including the cost of these investments;
- use standard methodologies when calculating and disclosing expense and return information to achieve uniformity across the spectrum of investments that exist in plans;
- present the information in a format that makes it easier for workers to comparison shop among the plan's investment options; and
- give workers access to supplemental investment information in addition to the basic information required under the final rule.

Help Desk: You can view the final rule, including a fact sheet and sample investment chart, at www.dol.gov/ebsa.

DOL Proposed Rule to Amend the Procedures for Filing and Processing Prohibited Transaction Exemptions

.228 On August 30, 2010, the DOL published in the Federal Register a proposed rule that would amend the procedures for filing and processing prohibited transaction exemptions under ERISA.

.229 The proposal, if adopted, would consolidate the existing policies and guidance on the exemption process. The amended procedures would also clarify the types of information and documentation required to submit a complete filing, expand the methods for transmitting filings to include electronic submissions, and make the exemptions more understandable for participants and other interested parties.

.230 The proposed exemption procedure retains the section-by-section topical structure of the existing regulation. Among the proposed changes are

- a requirement that applicants provide interested persons with a brief objective summary of complex transactions;
- the consolidation of exemption policies and guidance within a single document;
- an updated description of the DOL's authority to propose and issue administrative exemptions on its own motion;
- a description of the current standards for obtaining retroactive exemption relief; and
- clarification of the content of specialized statements, as needed, from qualified independent appraisers and other relevant experts.

You can view the proposed rule at www.dol.gov/ebsa.

DOL Interim Final Rule on Disclosure of Fees and Conflicts of Interest Affecting 401(k) and Other Retirement Plans

.231 On July 16, 2010, the DOL issued in the Federal Register an interim final rule to enhance disclosure to fiduciaries of 401(k) and other retirement plans and assist fiduciaries in determining both the reasonableness of compensation paid to plan service providers and any conflicts of interest that may affect a service provider's performance under a service contract or arrangement.

.232 The rule requires that covered service providers satisfy certain disclosure requirements in order to qualify for the statutory exemption for services under ERISA section 408(b)(2). These requirements include the disclosure of the direct and indirect compensation certain service providers receive in connection with the services they provide. The rule applies to plan service providers that expect to receive $1,000 or more in compensation and that provide certain fiduciary or registered investment advisory services; make available plan investment options in connection with brokerage or recordkeeping services; or otherwise receive indirect compensation for providing certain services to the plan. The new disclosure rules are effective January 1, 2012, and the rules and the related fact sheet can be viewed at www.dol.gov/ebsa.

DOL Proposed Amendment to Class Exemption on Transactions Determined by In-House Asset Managers

.233 On June 14, 2010, the DOL published in the Federal Register a proposal to amend PTE 96-23. This proposed amendment would create a class exemption that would allow in-house managers of large employee benefit plans to engage in a wide range of transactions with related parties.

.234 The proposed amendment, if granted, would

- remove numerous administrative burdens that have been cited by practitioners, and would expand relief under the class exemption to include certain transactions not currently permitted;
- address practitioner uncertainty that exists regarding certain provisions contained in the class exemption; and
- clarify the DOL's views and expectations regarding the class exemption's annual audit and written report requirements. The application of these requirements will further enhance the participant protections embodied in the class exemption.

DOL Correspondence

No Processing-Related Correspondence Under EFAST2

.235 Under EFAST2, the DOL's all-electronic processing system for the Form 5500 and the new Form 5500-SF annual return/reports, filers will not receive written "edit test" correspondence regarding deficiencies identified during processing. Forms 5500 and 5500-SF are required to be prepared and submitted using DOL's IFILE application or EFAST2-approved third party software. Filers will be able to identify many of their own errors by using the "validate" feature in IFILE and helpful automatic error identifiers in EFAST2-approved third party software.

.236 In addition, those filings containing errors or omissions will continue to be subject to further review and possible civil penalties by the DOL, IRS, and PBGC. Plan auditors may consider communicating this processing change to their benefit plan clients and encourage them to take extra care when completing their Form 5500 filings.

Correspondence from the Office of the Chief Accountant

.237 The DOL's Office of the Chief Accountant (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 standards and regulatory requirements. 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 have gone uncorrected and those with improperly prepared auditor's reports. The OCA staff reviews the Form 5500 filings and also request copies of the independent auditor's working papers that support audit engagements. If the OCA staff identifies problems related to the Form 5500 or the audit working papers, a formal enforcement process commences with the issuance of a Notice of Rejection (NOR) against the plan administrator.

.238 Upon receipt of an 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.

.239 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.

.240 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.

Help Desk: Any questions regarding the DOL penalty process should be directed to the OCA at (202) 693-8360.

EBSA's Inspection Programs to Assess Plan Audit Quality

.241 The DOL's EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, 64 public accounting firms audit more than 100 plans that cover approximately 25,000 audits. The remaining 51,000 plan audits are performed by nearly 10,000 different CPA firms, 8,000 of whom perform five or fewer audits. The EBSA utilizes both top-down and bottom-up strategies in selecting and evaluating ERISA audits.

.242 First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices—those with greater than 200 benefit plan clients. The 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" and "bottom-up" approach provides the EBSA a more efficient means of evaluating the quality of audit work performed by these large firms and ensuring that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed 22 such reviews.

.243 Next, for firms that audit between 100 and 200 employee benefit plans, the EBSA carries out what it refers to as a "mini-inspection" program. This program is similar to the inspection program for larger firms, except that the work is performed in the EBSA's Washington, D.C. office. The top-level communications with firm management and personnel are conducted using a firm questionnaire (also used in the larger inspection program) and telephone interviews. A number of benefit plan engagements is also sampled, and firms are asked to make the audit working papers available for review in the EBSA's office.

.244 The "top-down" and "bottom-up" approach utilized in both the inspection and mini-inspection programs provides the EBSA an efficient means of evaluating the quality of audit work performed by these large firms and ensures that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed inspections of 14 firms and mini-inspections of 15 firms.

.245 Finally, for firms with employee benefit plan audit practices of 50 or less plans, the EBSA focuses its in-house work on reviewing copies of audit working papers. To date, the EBSA has conducted over 2,200 of these desk reviews.

.246 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.

.247 The EBSA has also expanded its enforcement efforts dealing with fiduciary breaches to include determining whether plan auditors may be considered as "knowing participants." An auditor is considered a knowing participant if at least one of the three following elements is present:

- The plan auditor took affirmative action to further the violation.
- The plan auditor helped in concealing the violation.
- The plan auditor failed to act when required to do so by applicable professional standards.

Final Rule—Safe Harbor for Employee Contributions to Small Pension and Welfare Plans

.248 On January 14, 2010, the DOL published a final rule to protect employee contributions deposited to pension and welfare benefit plans with fewer than 100 participants by proposing a safe harbor period of seven business days following receipt or withholding by employers.

.249 The final rule amends the participant contribution rules to create a safe harbor period under which participant contributions to a small plan will be deemed to comply with the law if those amounts are deposited with the plan within seven business days of receipt or withholding. Three examples are included in the final rule that illustrate its requirements.

.250 The DOL did not expand the safe harbor to cover plans with 100 or more participants due to a lack of information and data sufficient to evaluate current practices of such employers and assess the costs, benefits and risks to participants associated with extending the safe harbor to large plans. The final rule may be viewed at www.dol.gov/ebsa.

Revised Large Plan Example for Regulation on Timeliness of Deposits

.251 As noted in the previous section, the DOL issued the seven day safe harbor rule on the timeliness of the deposit of salary deferrals and loan payments for small plans. This safe harbor final rule includes illustrative examples which encompass the new requirements. These illustrations included a modification to the example for a large plan which received less attention. The conclusion in the large plan example was changed from

> "Therefore, the assets of X's 401(k) plan would include the participant contributions no later than 10 business days after the end of the month."

to now read

> "The assets of B's 401(k) plan would include the participant contributions no later than 3 business days after the issuance of paychecks." [Amended January 14, 2010 by 75 FR 2068].

.252 The new regulation became effective January 14, 2010. Plan sponsors and their service providers who previously relied on the example need to consider the changes made by this amendment. See the Electronic Code of Federal Regulations website at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6c06682d754e8fb62a2bd2e731a233e2&rgn=div8&view=text&node=29:9.1.3.2.2.0.10.9&idno=29.

.253 Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL's VFCP. Plans that fully comply with the program, including satisfaction of the conditions of 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 excise tax provisions of the IRC;
- 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); and

- not be required to report such transactions as supplemental information if the plan is required to be audited because the transactions are not considered to be prohibited transactions.

.254 See the EBSA's website at www.dol.gov/ebsa, which contains useful information about the VFCP, including a fact sheet, a frequently asked questions (FAQs) section, and a sample "no-action" letter.

Delinquent Filer Voluntary Compliance Program

.255 The Delinquent Filer Voluntary Compliance Program (DFVCP) is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The program gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount. To increase incentives for delinquent plan administrators to voluntarily comply, the department has reduced penalties and simplified the rules governing participation in the program.

Address to be used for the DFVCP

.256 Please note: This is a new address and there is no longer an overnight delivery address.

<u>Standard Mail</u>
DFVC Program—DOL
P.O. Box 71361
Philadelphia, PA 19176-1361

DFVCP Penalty Calculator and Online Payment Option

.257 The DOL provides two Web-based options that make participating in the DFVCP easy, quick, and error-free. An online DFVCP penalty calculator is available to help plan administrators accurately calculate the payment needed to participate in the program. In addition, plan administrators who use the online calculator have the option of paying the penalty electronically over the Internet.

> **Help Desk:** Additional details on the online calculator and online payment option may be found in the DFVCP FAQs: www.dol.gov/ebsa/calculator/dfvcpmain.html.

Program Eligibility

.258 Eligibility in the DFVCP 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 DFVCP because such plans are not subject to Title I.

Using the DFVCP in an Electronic Era

.259 Participation in the DFVCP continues to be a two-part process. First, plan administrators must file with the EBSA a complete Form 5500 Series annual return/report, including all schedules and attachments, for each year relief is requested.

> ***Note:*** All filings, regardless of the year must be submitted electronically through EFAST2 in an approved electronic format. For detailed information concerning which schedules should be filed with prior year filings, please visit the EFAST 2 FAQs website: www.dol.gov/ebsa/faqs/faq-EFAST2.html.

.260 Second, plan administrators must submit to the DFVCP the required documentation and applicable penalty amount. Plan administrators may choose to submit their DFVC filing and payment electronically using the Online Calculator (www.askebsa.dol.gov/dfvcepay/calculator) or file through the mail by submitting a paper copy the 5500 and a paper check.

.261 The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVCP are not to be paid from the assets of an employee benefit plan.

.262 Special simplified rules apply to "top hat" plans and apprenticeship and training plans.

Penalty Structure

.263 The penalty structure under the DVFCP is as follows:

- *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 DFVCP 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.

IRS and PBGC Participation

.264 Although the DFVCP 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 DFVCP have been satisfied.

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

Voluntary Fiduciary Correction Program

.265 The 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.

.266 In April 2006, the EBSA expanded and simplified the VFCP to help employers and their professional advisors voluntarily correct violations of the law for employee benefit plans. This update to the VFCP reflects public comments and includes

- expansion and simplification of eligible transactions;
- streamlined documentation and clarified eligibility requirements;
- a model application form;
- clarification of what constitutes "under investigation" allowing more entities to qualify for the program, and
- relief from civil penalties for transactions involving health and welfare plans.

.267 Under the VFCP, employers may 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.

.268 The DOL also provides applicants conditional relief from payment of excise taxes for certain VFCP transactions under a class exemption related to the VFCP. The amended class exemption was also published in the Federal Register in April 2006.

> **Help Desk**: More information about the VFCP is available by contacting a local EBSA regional office through its toll-free number, (866) 444-EBSA (3272), or by visiting the website at www.dol.gov/ebsa under "Correction Programs."

DOL Outreach and Customer Service Efforts

.269 The DOL's 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.

.270 In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to focus on plan audit quality, the current Form 5500 and Form 5500-SF, the EFAST2 Processing System, and other agency-related developments. Questions regarding these outreach efforts should be directed to the OCA at (202) 693-8360.

> **Help Desk:** Practitioners and other members of the public may also want to contact the EBSA at www.dol.gov/ebsa. The website also provides information on EBSA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Field Assistance Bulletins

.271 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. FABs 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 EBSA's views on technical applications of ERISA.

.272 Currently, 24 FABs are outstanding. They cover many topics of current interest such as refinancing ESOP loans (FAB 2002-1), ERISA rules on participant loans where securities law might otherwise limit such loans (FAB 2003-1), duties to lost participants in a terminated plan (FAB 2004-2), interaction between IRS rules and DOL provisions for 403(b) plans (FAB 2007-2), the responsibilities for ERISA fiduciaries to collect delinquent contributions (FAB 2008-1), and Form 5500 filing by 403(b) plans (FAB 2009-02).

> **Help Desk**: The FABs are available at www.dol.gov/ebsa under "Field Assistance Bulletins."

IRS and Treasury Department Developments

.273 The following section summarizes some of the more important developments within the IRS and Treasury Departments.

Plan Amendments

.274 The following list includes plan amendments that may have been required for the 2010 plan year. For a complete listing, see the IRS 2010 cumulative list (IRC Notice 2010-90) at www.irs.gov/pub/irs-drop/n-10-90.pdf.

- Amendments to comply with certain provisions of the PPA relating to stock diversification requirements, benefit restrictions, and hybrid plans require adoption by the last day of the first plan year beginning on or after January 1, 2010

- Amendments relating to the Heroes Earnings and Assistance Relief Tax Act of 2008 require adoption by the end of 2010 for calendar-year plans
- Certain provisions relating to automatic contribution arrangements require adoption by the *later of* the last day of the 2010 plan year or the due date of the employer's tax return that includes the first day of the 2010 plan year
- The plan amendments for a defined benefit plan which formalize the requirement that certain distribution forms must be modified based upon the plans funded status are due by the last day of the first plan year beginning on or after January 1, 2010 (See IRS Notice 2009-97)

.275 In addition to the preceding items, it is important to remember that any elective changes (for example, benefit terms, eligibility, or allocation rates) must be adopted no later than the last day of the plan year.

Defined Benefit Plan Funding Relief

.276 The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (PRA 2010) provided funding relief by allowing a plan sponsor to elect to extend the shortfall amortization period. IRS Notice 2011-3 provides guidance on how a sponsor elects one of the two alternative funding schedules allowed by PRA 2010 for one or two of the eligible plan years (2009, 2010, and 2011). A sponsor of a calendar year plan must have made the election by January 31, 2011, for plan years 2009 or 2010. For the 2011 plan year, the sponsor has until December 31, 2011, to elect. IRS Notice 2010-83 describes the procedures for multiemployer plans.

In-Plan Roth Rollovers

.277 IRS Notice 2010-84 describes the procedures and reporting for a plan which permits an in-plan Roth rollover. This is the conversion of a pretax account into an after-tax or Roth account. This conversion does involve the reporting of a distribution. Therefore, the auditor needs to recognize that the reported distributions may not correlate to amounts that were actually distributed from the plan. This privilege to convert is effective September 27, 2010. The plan does not have to be amended to incorporate these terms until the *later of* the last day of the plan year in which the privilege to convert became effective or December 31, 2011.

COBRA Subsidy

.278 The COBRA (Consolidated Omnibus Reconciliation Act) subsidy was extended on April 15, 2010, for those individuals who were involuntarily terminated, through May 31, 2010. Those individuals will be eligible for the full 15 months of coverage at the subsidized rate. The prior subsidy expired on March 31, 2010. Those individuals who lost employment between April 1, 2010, and April 14, 2010, were granted the subsidy.

Section 403(b) Plan Terminations

.279 In February 2011, the IRS published Revenue Ruling 2011-7 (Rev. Rul. 2011-7), which provides guidance on the plan termination rules under Reg.

Sec. 1.403(b)-10(a). According to Rev. Rul. 2011-7, in order for a 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. Rev. Rul. 2011-7 provides several examples that satisfy the distribution requirements. In addition, the tax treatment of distributions to plan participants or their beneficiaries is discussed. See www.irs.gov/pub/irs-drop/rr-11-07.pdf for additional information regarding 403(b) plan terminations.

Replacement of Schedule SSA with Form 8955-SSA

.280 In accordance with IRS Announcement 2011-21, the IRS coordinated with the Social Security Administration, and developed Form 8955-SSA, *Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits,* a stand-alone form to be filed with the IRS. Form 8955-SSA replaced the Schedule SSA (Form 5500). For plan years beginning on or after January 1, 2009, the Form 8955-SSA should be used to comply with the reporting requirements of IRC section 6057(a). Form 8955-SSA for the 2009 plan year is expected to be available for plan administrators early in 2011, with the 2010 form available for filing later in the year. See www.irs.gov/pub/irs-drop/a-11-21.pdf for additional information regarding Form 8955-SSA.

Foreign Bank Account Filings

.281 Over the last two years, the IRS has been working to clarify if and when benefit plan fiduciaries may be required to file a Report of Foreign Bank and Financial Accounts, IRS Form TD F 90-22.1 (FBAR). See IRS Notice 2010-23 for the current status of the relief granted in this area. It is important to recognize that this notice does not specifically address benefit plans; it merely describes relief in the context of the nature of the plan's interest in a foreign financial account.

.282 The basic filing duties with respect to employee benefit plans are as follows:

- Plan filers invested in a foreign account, such as a foreign mutual fund, must file an FBAR. The 2009 filing was due by June 30, 2010. The 2010 filing will be due by June 30, 2011. Note that the plan is not required to file for a domestic mutual fund with foreign investments, only a foreign mutual fund.
- Plan filers with only signature authority over a foreign financial account (that is, no financial interest in such account) have received a one-year extension of their filing deadline through June 30, 2011.
- Plan filers with either a financial interest in, or signature or other authority over, a foreign comingled account other than a foreign mutual fund are not required to file an FBAR for 2009 and prior years but may be required for the 2010 year. This is one of the many unresolved issues in this area.

.283 Significant penalties can be imposed on a filer, thus benefit plans holding foreign accounts should follow these developments. See the FAQs related to an FBAR at www.irs.gov/businesses/small/article/0,,id=148845,00.html.

EBP Guide Overhaul Status

.284 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Employee Benefit Plans*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1991. A working draft of the accounting related guidance is expected to be posted to the AICPA website in the second quarter of 2011. The purpose of the working draft is to solicit comments from preparers, auditors, and users of employee benefit plan financial statements and other interested parties. Be alert for the posting of this working draft.

Recent AICPA Independence and Ethics Developments

.285 Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

On the Horizon

.286 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance for employee benefit plans or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.287 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.288 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the second half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections

341, *The Auditor's Consideration of the Entity's Ability to Continue as a Going Concern,* and 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

.289 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.290 The year 2010 was a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the International Accounting Standards Board (IASB) have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects.

.291 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of International Financial Reporting Standards (IFRSs) as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Financial Instruments Exposure Draft

.292 In January 2011, the IASB and FASB published a proposal for accounting for impairment of financial assets managed in an open portfolio. For U.S. GAAP, this proposal applies to open portfolios of loans and debt instruments that are not measured at fair value with changes in value recognized in net income. This proposal is a supplement to the exposure draft published by the

IASB in November 2009 and the FASB exposure draft published in May 2010. The new proposal is the product of an aligned approach between the boards regarding how to account for credit impairment and takes into consideration feedback received on the aforementioned exposure drafts and recommendations by the Expert Advisory Panel.

.293 FASB expects to issue final guidance that includes credit impairment during 2011.

.294 FASB has issued FAQs for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. You can access this document at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447 (note this FAQ has not been updated for the January 2011 impairment supplementary document). You can find the exposure draft in its entirety, the impairment supplementary document, and project updates at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123.

Fair Value Exposure Draft

.295 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.296 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011. You can find updates on this project at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156576143.

P1: PjU
ACPA184-ARA-EBP ACPA184.cls March 29, 2011 14:59

FASB Accounting Pipeline

Other Accounting Projects

.297 Additionally, FASB has the following projects underway:

- Disclosure of certain loss contingencies
- Risks and uncertainties
- Insurance contracts
- Investment properties
- Disclosure framework

Employee Benefit Plan Resources

.298 The following are various resources that practitioners engaged in the employee benefit plan industry may find beneficial.

AICPA Employee Benefit Plan Audit Quality Center

.299 The AICPA EBPAQC is a firm-based, voluntary membership center of over 2,080 firms with the goal of promoting quality employee benefit plan audits. EBPAQC member firms receive valuable ERISA audit and firm best practice tools and resources that are not available from any other source.

.300 The EBPAQC provides timely e-alerts with information about recent developments affecting employee benefit plan audits, as well as other resources and tools including

- Audit and Accounting Resource Centers, including limited scope audits, 403(b) plans, SAS No. 115 communications for benefit plans, plan investments, EBP fraud, auditor independence and more.
- Exclusive member-only live forum webinars on current topics and preparing your firm for the EBP audit season. These webinars are free to members and continuing professional education (CPE) is available for paid registration.
- Center tools including a SAS No. 70 checklist[14], internal self-inspection tool, illustrative FASB ASC 820 disclosures; a summary of DOL criminal enforcement cases; SAS No. 115, tools and examples of internal control communications for employee benefit plans.
- A Member-to-Member Online Discussion Forum with over 3,000 participants and 1,900 topics.
- "Topix" primer on topics such as plan investments in bank collective investment funds, limited scope audits, and 403(b) plans.
- Plan Advisories to share with plan clients that help plan sponsors and administrators understand auditor communications and responsibilities of internal controls, monitoring outsourced services and plan investment valuation.

---

[14] For information regarding updates to SAS No. 70 reports see the "Service Organizations" section in this alert.

Help Desk: Visit the center website at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/EBPAQhomepage.aspx to see a list of EBPAQC member firms and to preview EBPAQC benefits. For more information, contact the EBPAQC at ebpaqc@aicpa.org.

Publications

.301 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Employee Benefit Plans* (2011) (product no. 0125911 [paperback], WEBXX12 [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- *Checklists and Illustrative Financial Statements for Defined Benefit Pension Plans* (2010) (product no. 0089910 [paperback] or WDB-CL [online])
- *Checklists and Illustrative Financial Statements for Defined Contribution Pension Plans* (2010) (product no. 0090010 [paperback] or WDC-CL [online])
- *Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans* (2010) (product no. 0090110 [paperback] or WHW-CL [online])
- *Accounting Trends & Techniques, 64th Edition* (product no. 0099010 [paperback] or WAT-XX [online])
- *Employee Benefit Plans Accounting Trends & Techniques, 3rd edition* (product no. 0066510 [paperback] or WET-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Audit and Accounting Practice Aid *SAS No. 70 Reports and Employee Benefit Plans* (product no. 061061 [paperback])
- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.302 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com/library.

Continuing Professional Education

.303 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following are specifically related to employee benefit plans:

- Audits of 403(b) Plans: A Challenging New Audit Area
- Audits of 401(k) Plans
- Employee Benefit Plans: Audit and Accounting Essentials

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.304 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.305 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

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

Hotlines

Accounting and Auditing Technical Hotline

.307 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a technical inquiry form found on the same website.

Ethics Hotline

.308 In addition to the Technical Hotline, the AICPA also offers an 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. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.309 The AICPA offers an annual Employee Benefit Plans Accounting, Auditing, and Regulatory Update Conference in late fall. This conference is a two-day high-level forum that lets you interact with expert auditors and members of the DOL. The 2011 conference will be held December 12–13, 2011, in Washington, D.C.

.310 The AICPA offers an annual National Conference on Employee Benefit Plans each spring. The conference is a three-day conference designed to update attendees on recent developments related to employee benefit plans. The 2012 conference will be held in May 2012. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Industry Expert Panel—Employee Benefit Plans

.311 For information about the activities of the Employee Benefit Plans Industry Expert Panel, visit the panel's Web page at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/EMPLOYEEBENEFITPLAN/Pages/EmployeeBenefitPlan.aspx.

.312

Appendix A—Definitions of Certain Investments

The following list includes certain investments as defined by the instructions to the Form 5500, Annual Return/Report of Employee Benefit Plan.

103-12 Entity. An entity that is not a master trust, common or collective trust, or pooled separate account whose underlying assets include plan assets within the meaning of Title 29 U.S. *Code of Federal Regulations* Part 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans.

common or collective trust (CCT). 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 or a controlled group of corporations.

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.

pooled separate account (PSA). 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 or a controlled group of corporations.

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).

.313

Appendix B—Resources for Economic Information

The Internet covers a vast amount of information that may be valuable to auditors of employee benefit plans, including current industry trends and developments. Some of the more relevant sites not previously mentioned in this alert include those shown in the following table:

Organization	***Website***
Chartered Accountants of Canada Canadian Performance Reporting Alert MD&A Disclosures in Volatile and Uncertain Times	www.cica.ca/download.cfm?ci_id=47101&la_id=1&re_id=0
Emergency Economic Stabilization Act	www.treas.gov/initiatives/financial-stability/
Interagency Statement on the Regulatory Capital Impact of Losses on Fannie Mae and Freddie Mac Preferred Stock	http://files.ots.treas.gov/481135.pdf
Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.03)	www.pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf
PCAOB Standing Advisory Group Meeting Emerging Issue-Audit Considerations in the Current Economic Environment	www.pcaobus.org/News/Events/Documents/10222008_SAGMeeting/BP_Audit_Considerations.pdf

.314

Appendix C—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org

(continued)

Website Name	*Content*	*Website*
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov